Working Capital Management
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Lecture-47
Cash Flow Presentation

Welcome students, so we are discussing the cash management and in the previous class we learnt about the difference between the cash and profit. There we could make out that profit is nominal and the cash is real. So, how much profit is in cash and how much profit is not in cash which is nominal part of the profit we should be very clear about that right. So, profit by simply satisfying our self with the profit is not sufficient.

We will have to understand that is for that the cash has to be there and if the cash is there how to manage the cash, how to keep cash how much cash to be kept as cash and how much to be converted into marketable securities short term investments. So, that the cost of these current assets goes down and they also start earning also.

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So, it means cash and profit they are the 2 different things, so we have to look at the cash ability of the profit and if there is a high amount of the cash then we also must be careful about how to manage the investment of that cash. Second important point here is the cash flow and the cash stock, once we have say known the amount of the cash flow in the firm and availability of the cash at the firm then how much what part of that cash is flowing.

And what part of that cash is kept as say static amount or stocked amount, you know it well that cash will earn the income if it is flowing. Because we are using the cash, we are moving the cash if the cash is kept as cash only that we are stocking the cash maybe as in the form of cash or maybe in the form of the bank balance. So, even you keep the bank balance in the bank as a stock of the cash.

The bank balance or the say balance in the bank account of the companies is in the current account and that does not earn even 4% or 3% of interest which is there on the savings account. So, we will have to make sure that whatever the amount of the cash is there with us it should be flowing, it should be moving. And it should not be kept as stock either it should be utilize within the firm.

So, it means we should use it in the operations for buying the raw material or for buying other kind of inputs. Then paying the salaries of the workers and we will be using it for paying the bills of the utilities like power, water and other kind of things. So, how much cash we are keeping and part of the profit which is in the cash that is being retained by the firm that must be flowing in the firm from the 1 department to the other department from the 1 unit to the other unit for the 1 purpose to the other purpose.

If the cash is flowing it is in use it is in the working condition, if the cash is kept as cash only in the stock just you say either we are not aware about that how to use this cash stock. How to converted into marketable securities at what intern to converted into marketable securities or we do not know how much cash is required to make the payment, short term payments or sudden payments or urgent payments.

So, because we are not aware or we have not prepared the cash budgets, so if we are not forecasting the cash inflow and the outflow. If we are not preparing any kind of the cash budgets. In that case the cash stock will be kept as a very high amount and if we are not utilizing it for making the payments if it is not required within the firm. In that case that is lying as unused, so for that we were talking about and we were discussing that the cash budgeting is most important.

And the budget horizon can be different depending upon the resources of the firm depending upon the capabilities of the firm to budget like minimum budget horizon should be 1 month but sorry normally I would say it is maximum budget horizon which is useful that can be 1 month period of 1 month it can be for 15 days and minimum it has to 1 week. So, the form which are preparing budgets for the 1 week.

They are keeping lesser amount of the stock they are saving sufficiently hugely on the financial cost of this current asset managing thus current asset because they are not keeping large amount of the cash as cash and they know it that in the coming 1 week this much cash is flowing in, this much cash is flowing out. So, what is the net difference if there is a possibility of shortage of the cash then we can keep some cash or we can aware about that we have to arrange this much of the cash from the different sources.

But if we are knowing it in advance that we are going to have surplus balance at the end of the week. So, it means we should thinking in advance where there surplus has to be invested. So, it means cash flow or the cash stock 2 important things, so to earn sufficient income from the cash whatever the cash we have that must be flowing in the firm there should not be retained or kept as stock otherwise cost will increase.

There will be no returns the financial cost is going up returns are not matching with the cost and finally we are ending up with loss making situation. Third important thing is the cash flow presentation as I told you sometime back in the previous class that now apart from the 2 say statutory financial statements.

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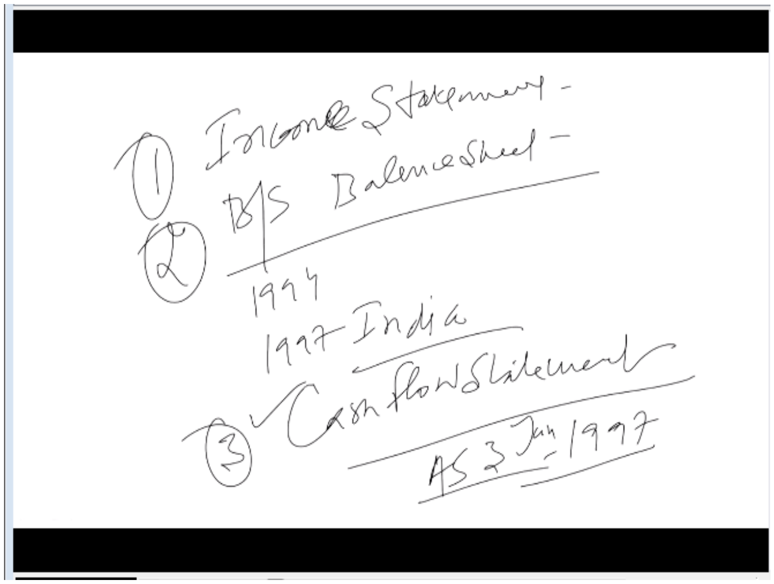

One is the income statement and second is the balance sheet, so apart from these 2 these are the 2 other 2 statutory financial statements for a bill company they are certainly required to be prepared every end of the year or normally at the end of the accounting period which can be the period of 12 months.

But after 1994 at the international label and after 1997 at the Indian label or at the level of India we introduce one more statement and that statement is called as the cash flow statement that has also becomes. So, this is the first statutory statement this is the second statutory statement and this is the third statutory statement firms are public limited companies especially even the private limited also.

But in case of the public limited companies because public companies invested, so income statement is required to be prepared that is profit and loss account. Balance sheet is again statutory required to be prepared to know the financial position of the firm. And then third statement which has been made mandatory that is the cash flow statement. So, in 1994 then international accountings Tondon committee.

On 1st January 1994 decided that apart from the income statement and the balance sheet every firm must have the third statement also compulsorily the third statement also and that statement is called as the cash flow statement, so that did not only make made this statement as statutory statement rather they device the format also that how now the cash flow statement has to be prepared after 1st January 1994.

And is not like a simple cash flow statement which were preparing earlier but now will be preparing a different cash flow statement which will be reporting the cash position of the firm in a very different and that in a much better way. So, the IASC International Accounting Standard Committee they decided and in India this decision was implemented in 1997. In 1997 where we have introduced 1 important accounting standard which is called a AS3 new accounting standard AS3 was introduced.

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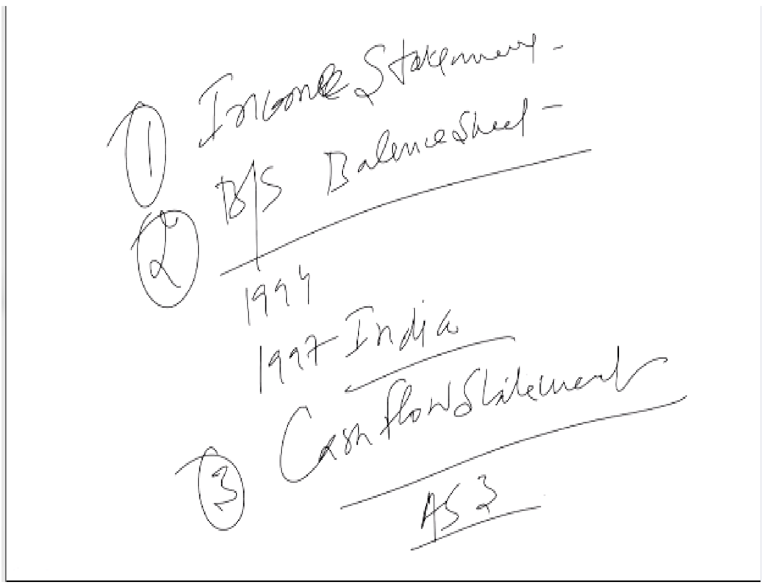

And under this AS3 from 1997 onwards January 1997 onwards this statement was made compulsory also in India in on the Indian organizations that every Indian public limited company has to prepare 3 statutory statements now, 1 is the income statement, second is the balance sheet which were already there and third one is the cash flow statement. So, now the cash flow statement also has become a statutory statement, compulsory statement, required statement under the statutes at Indian companies at 1956 or 2013 it is a important statement.

And this statement is required or was required or was made compulsory because of certain reasons and these reasons are very well founded and very valid reasons, for very valid reasons this statement was made compulsory for all the companies public limited companies. So, first of all the as I told you that ISA did not only made it compulsory but the rather this, so just at the format also that now the cash flow statement which is the third important statement apart from the income statement and balance sheet has to be prepared under the 3 broad categories.

First one is the Operating Activities, second one are the Investing Activities and then is the Financing Activities. So, clearly they have to divide the cash flow statement being prepared now into 3 important activities operating activities, investing activities and the financing activities why it is has been done we want to know by preparing the statement this way that if it is a manufacturing firm. Then the main source of the cash or the profit number 1 profit and then the cash should be from where that is from operations.

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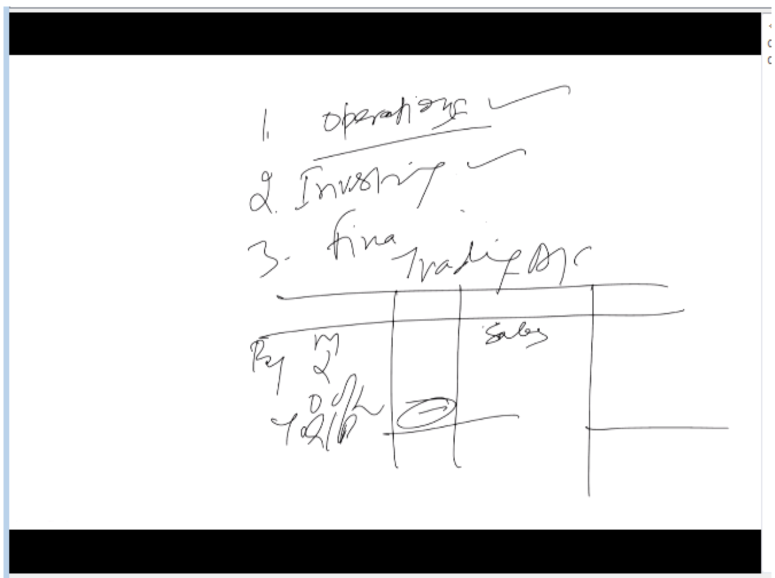

Main cash should be flowing in from the operations, after operations means source of profitability and the cash profitability 1 source first and the (()) (09:59) source is the operations. Second source can be the say investing activities and third source can be the financing activities. So, these are to be clearly define because if you know or more to know about the financial health of a company.

In that case you must be knowing that how much profit or funds or income there earning from their operations which is a major source of income how much is earning from the investing activities. And third one is how much they are earning from the third that is the financing activities, so in this case that is the investing activities and it is the financing activities it may be possible as I told you that when you talk about the operating activities.

The main source of the operations is that in the income statement when you prepare the income statement here in the upper part of this income statement, you divide this income statement into 2 parts, 1 part is here that trading account we call it as the first part is the upper part of this income statement is called as the trading account and second part is called as the profit and loss account.

So, this is the trading account and in the trading account you take this side the sales and you take here the buy all expenses that is the material, labor and the other overheads right and the difference of this and this side this will be called as say 2 gross profit. So, this is the gross profit and then the gross profit goes down.

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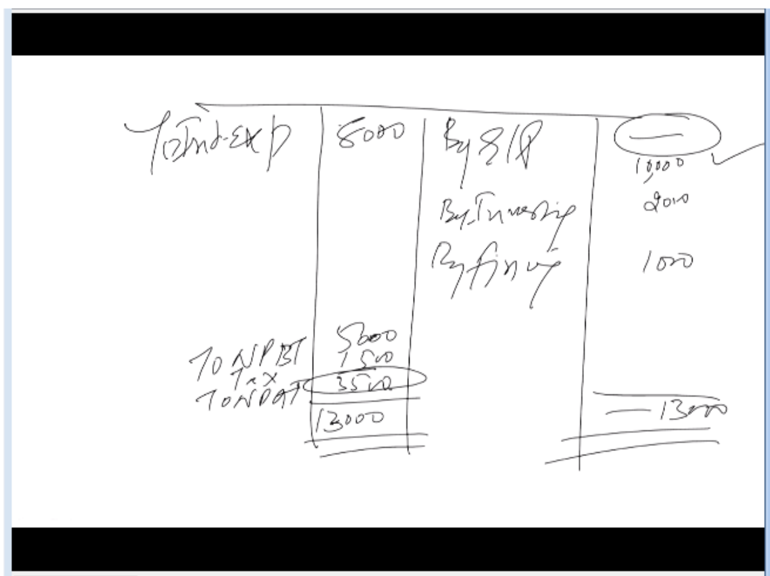

And when you prepare the profit and loss account you start the profit and loss account with this, you start here with the by gross profit which is coming from the trading account. Then you subtract the other indirect expenses and finally your IBAT here that is the profit which is called as the net profit before tax and then is the tax part and then is the to net profit after tax right.

So, this is and then is the total of the profit and loss account are the loss part of the income statement. Now we want to know about that here the net profit which has been earned from where the net profit has come to the company larger junk of the net profit must be coming from the gross profit. If there is a gross profit say for example the gross profit here is I would call it as say we assume that this amount is 10000.

Now apart from this main source of income firm earned something that is the buy investing income buy investing into the some important investments by making in the market. They earned some income nominal income of 2000 rupees and then by financing income they got an another 1000 rupees and –expensive. So, this became the total amount this became as the 13000 and here also 13000 right.

And indirect expenses for example in total indirect expenses 8000, so net profit here before tax is how much net profit before tax is say 5000 and P this is the 8000. So, 13-8 is the 5000 your paying tax as say for example 1500 rupees. So, finally your net profit after tax will be 3500 rupees. So, main source of this 3500 rupees is this one that is the gross profit. And gross profit is the output or finally the result of the efficient operations or the income generated firm or the profit generated firm operations.

So, if this kind of the situation is there, where able to find out that income largely because this is a manufacturing organization. So, major or the main source of the income of this company should be that is the gross profit that is from the operations and that is the in a ways called as the gross profit partly the firm can generate income from the investing activities also and financing activities also.

But that should be the amount lesser much lesser than the income from operations, if I reverse is happening for example you see here that say we have another situation likes say it is not 10000 here and it is not 2000, this is not 1000 here right. Here you can say that gross profit is we called it as how much 5000 and investing activities are generally helping us to have say 4000 and this is help us say financing activities helping to us have the again 4000 rupees.

So, though the income from the operation is more than the investing and financing for put together this+this income is 8000 rupees. It means either the companies involved into investing activities or the companies involved into financing activities their operations which should have been contributing the largest share of the total profit and cash that is contributing. But some total of the contribution of the profit and cash from the investing and financing activities is much higher.

It means it gives the indication the source of cash is not only operations of the firm but larger junk of the cash is flowing in under the investing of the financing activities. Because this firm is not a finance company, this firm is not a investment company, this firm is basically manufacturing company. So, major source of the income major source of the profit must be the operations and that to be in the form of gross profit.

But gross profit is only 5000 and here you earning this+this is 38000 it is much more than the gross profit we have here. So, means there is doubt something fishy about something doubtful about the operations of the firm. And we have to investing at this firm very clearly that what are the activities contributing to the profits of the firm and finally to the cash of the firm. And, if the investing activities and financing activities are contributing in total contributing more than the operations.

It means either the form has deviated from it is main operations or it is not able to generates sufficient returns from it is operations product has become less salable in the market, less acceptable in the market. So, that is why they are using their investments as well as the financing things or activities for generating the income. So, there you have found out here is that is 3500 is the total net profit after tax.

But in this 3500 major contribution is from the investing and financing activities total and lesser contribution is from the operations and this is not the acceptable state of affairs. If any companies is a manufacturing organization, so for that reason IASC the view and then that is the international IASC International Accounting Standard Committee beginning and later on ICI Institute of charted Accountants of India accepted this contention of the IASC that yes it should be clearly defined in the cash flow statement that what is the source of the cash, whether the operation of the firm is the cash source of the cash.

Or whether investing activities is the source of cash or whether financing activities are source of cash or whether total of investing and financing activities is generating more cash as compared to it is operations. So, it means it will be clearly giving indication that all is not well in this firm and there is some serious need to look into the problems this firm maybe facing or is facing right. So, here in this case the IASC has device the format also and they said that the cash flow statement must be prepared under 3 activities operating activities, investing activities and financing activities.

And now what are these activities what they have included and suggested to be included in the operating activities this is the just a list of the operating activities cash flow from operating activities or you can say it as cash flow from operations that is on the one side they have given the cash inflow from operations.

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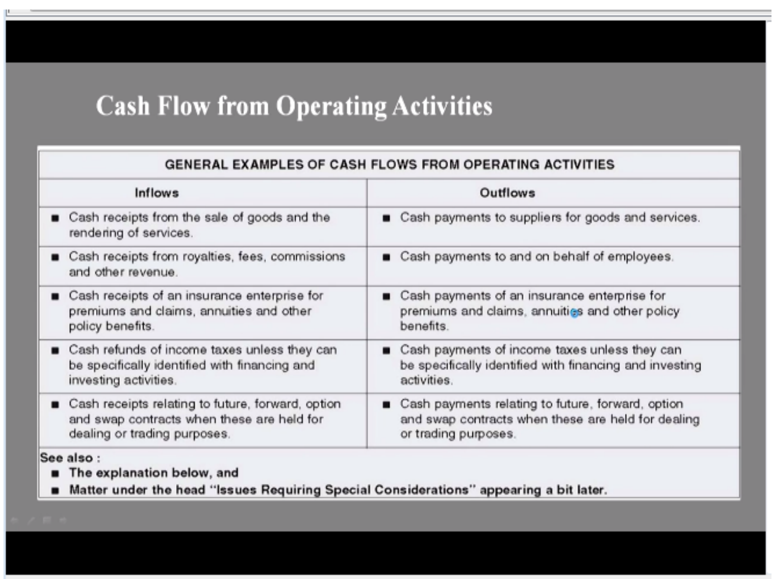

On the other side they have given the cash out flow from the operations, so here what will be included as a cash flow from operations cash receipts from the sale of goods and rendering service, this is the major business of the company not investing or the financing activities. So, why cash is flowing more from the investing and financing rather than from operations this is serious question to be asked or to be answered.

Second thing is cash receipts from the royalties, fees, commission and the other revenues if we have some technology. We have say rented it out or maybe we are giving some consultancies services with regard to the product we are manufacturing or maybe we are getting some commission which is out of the existing business of the process of the existing business, then it is operating income, cash receipts of an insurance enterprise for premiums and claims.

Because the main business of the insurance company is the insurance receiving the premium and say cash receipts often insurance company an enterprise for the premiums and claims annuities and the other policy benefits. So, any inflow an account to the premium and such other inflows are coming to the insurance company they are operations of the insurance company. Similarly cash refunds of the income tax unless they can be specifically identified with the financing and investing activities.

We have paid extra tax because we pay advance tax in India, so if we have paid extra tax and if at the end of the year when it the settlement takes place. So, if it is found the firm as paid the extra tax and the extra tax is refunded by the income tax department. Then also it is part of the operations and then is the last is the one cash receipts relating to future, forward options and swap contracts when these are held for dealing or trading purposes.

So, if the firm has purchased just to minimize it is risk or maybe say for any other purpose then that investment or cash inflow coming out of these derivative products future forward options and swaps these contracts. That will also be known as the inflows coming from operations, cash inflows generated from the operations. Similarly they have categorically say given a list of cash outflows which will be treated as the cash outflow from operations.

Cash payment to the suppliers for goods and services when we are buying raw material we are making the cash payment to suppliers is certainly obviously a operating out flow cash payments to and on behalf of employees making the payment of salaries even the utilities payment, electricity bills water bills all these bills. Cash payment of an insurance enterprise for premiums, claims, and annuities and other policy benefits.

Naturally when they are receiving premium as inflow there when they are paying claims it is out flow from the insurance companies. Cash payment of income tax unless they can be specifically identified with the financing and investing, if it is not on accounting of investing and financing if it is only on account of operations that payment of the income tax is cash out flow on account of operations.

And lastly cash payments relating to the futures, forwards, options and swaps contour swap contracts when these are held for dealing or trading purposes right. So these are clearly defined and devised this income cash flow statement part that is the cash flow from operations which will specify the cash flow from operations. So, here under these different inflows and outflows categories, we will have to prepare the cash flow statement calling it the cash flow statement and cash flow from and to the operations.

And what will be considered as cash flow coming from, inflow coming from operations is any of the inflows coming under these 5 categories and any of the outflows these under 5 heads. So, that will be only considered as the operating cash flow shows to have an idea that how strong the firms operations are larger junk of the cash to the firm must be flowing in from it is operations because it is a manufacturing firm neither it is investing nor it is financing firm right. So, this is the detailed list of the say sources which are inflows and the application which are outflows of the cash.

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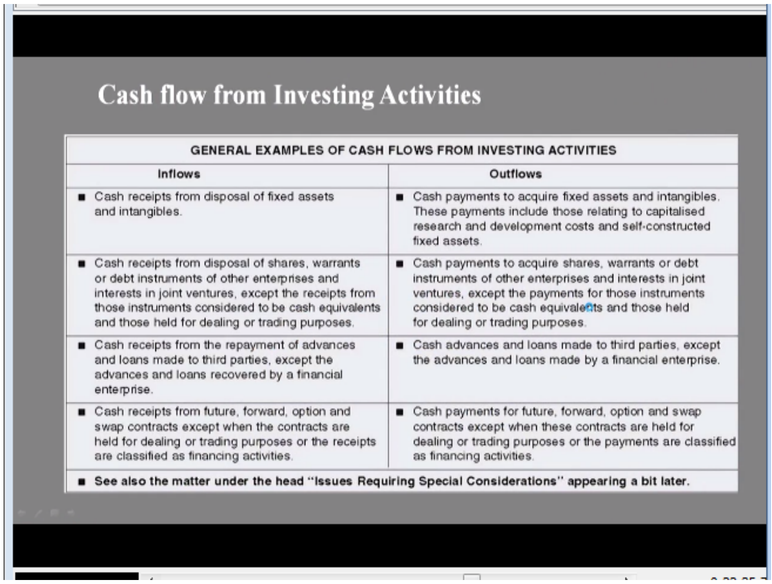

GENERAL EXAMPLES OF CASH FLOWS FROM INVESTING ACTIVITIES	
Inflows	**Outflows**
■ Cash receipts from disposal of fixed assets and intangibles.	■ Cash payments to acquire fixed assets and intangibles. These payments include those relating to capitalised research and development costs and self-constructed fixed assets.
■ Cash receipts from disposal of shares, warrants or debt instruments of other enterprises and interests in joint ventures, except the receipts from those instruments considered to be cash equivalents and those held for dealing or trading purposes.	■ Cash payments to acquire shares, warrants or debt instruments of other enterprises and interests in joint ventures, except the payments for those instruments considered to be cash equivalents and those held for dealing or trading purposes.
■ Cash receipts from the repayment of advances and loans made to third parties, except the advances and loans recovered by a financial enterprise.	■ Cash advances and loans made to third parties, except the advances and loans made by a financial enterprise.
■ Cash receipts from future, forward, option and swap contracts except when the contracts are held for dealing or trading purposes or the receipts are classified as financing activities.	■ Cash payments for future, forward, option and swap contracts except when these contracts are held for dealing or trading purposes or the payments are classified as financing activities.
■ **See also the matter under the head "Issues Requiring Special Considerations" appearing a bit later.**	

Then we talk about the next part cash flow from investing activities what will be treated as the cash inflow and outflow from investing activities and towards the investing activities. Cash receipts from disposal of the fix assets if you are selling any planned building machinery even land cash flow generating from these sale of these fix as it is known as the cash inflow from the investing activities.

Cash receipts from disposal of shares, warrants or debentures in debenture instruments or often the other enterprises and interest in joint ventures except the receipts from those instruments considered to be cash equivalent and those held for dealing or trading purposes. Then is the cash receipts from the payment of advances and loans made 2 third parties right any kind of the loan if it is given. Then it will be investing activity except advances and loans recovered by a financial enterprise.

If any manufacturing firm has given the loan to the other enterprises and if they recover that out of the reserves they have surplus is they have given the loan and if they recover that loan that will be also the inflow on account of investing activities. And then is the last one is the cash receipts from future forward options swaps, contract except when contracts are held for dealing or trading purpose or the receipts or are classified as financing activities.

If they are for the operating activities or for financing activities then not under this but normally if they are being use as the investment instruments. If the firm has surplus income or reserves free reserves available and those reserves are being invested here in these different derivative instruments. Then those instruments are being purchased not only for hedging of the operational risk but only for investment purpose.

So, in that case that inflow will also be known as the inflow coming from investments. Similarly the outflows here cash payment to acquire fix asset when you want to buy land, plant, building machinery. Naturally we have to sell out ash and that will be the cash out flow on account of investing activities. Cash payment to acquire shares warrant if you want to make investment in the shares and warrants of the other companies or other enterprises. Now rather ventures then it will also be known as the cash outflow on account of investing activities.

Because in that case the firm is investing it is a surplus cash into the say shares warrants or such other financial instruments or debt bonds of the other companies. Cash advances and loans made to third parties accept the advances and loans made by the financial enterprises and lastly the cash payments for the future forward option swaps contracts accept when they are being bought for the say strengthening or say diverting the operational risk when they are simply being bought for the investment purpose.

Any cash which is flowing out for making this kind of investment is known as the cash outflow on account of investing activities. And lastly the cash flow from cash flow examples of the cash flow from financing activities. So, inflow there are the sources of inflow cash proceeds from issuing shares or other similar instruments.

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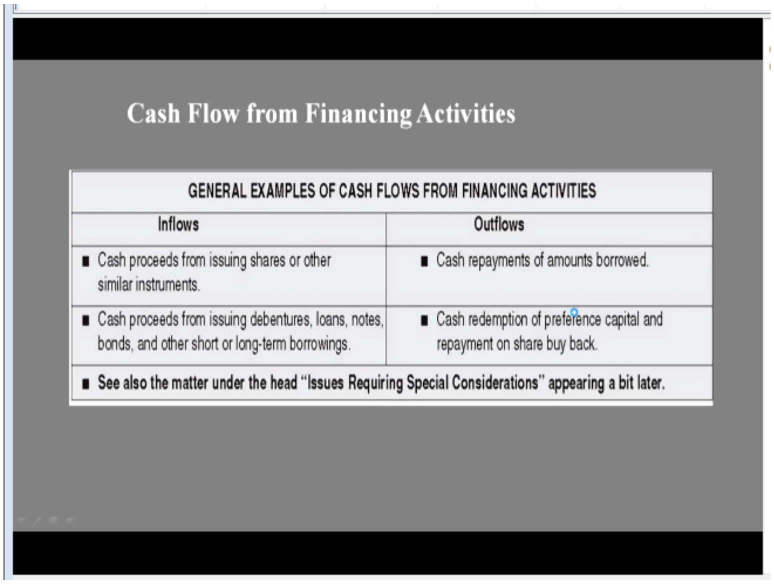

If the company is issuing the shares in the market cash is flowing in buy selling or issuing the shares in the market naturally that cashes being generated for financing is operations for. So, that is not the operating activity that is basically a financing activity. Cash proceeds from issuing the debentures loans, so they are the 2 kind of instruments from where the cash can be generated. One is the shares and stocks second is the bonds or the debentures, one by buying bonds one the person who is buying that instrument becomes the honor of the company.

And the second person buying the second instrument that is the debenture of bond he becomes the say lender to the company right, so creditor to the company or lender to the company. So, out of cash which is coming in either out of shares and shares and stocks or similar instruments whether is a equity share or the preference share or from bonds and debentures both these sources will be contributing or will be known as the financing inflows or inflow coming from the financing activities of the firm.

And cash out flow is cash payment, repayment of the amounts burrowed if we for example are buying back the shares and paying back the amount to the buyer from whom we have purchasing the shares or maybe any kind of the debutant is being paid or any other kind of the payment which is relating to the shares or debentures is being made that is again the cash outflow on account of the financing activities.

And this similar to the cash redemption of the preference capital and repayment of buy back of the shares, so similarly if we are dealing the debentures. Because debentures and bonds and preferences they are issued only for a limited period of time right there only should for a limited period of times. After that period of time they have to redeemed or bought back. Similarly equity shares also can be bought back by the companies.

So, if you are repaying any loan which we have borrowed or be are redeeming any bonds share that is a preference shares or buying back the equity shares. Any cash is flowing out on account of that is known as the cash outflow on account of the financing activities. So, very clear cut division has to be there how much cash is coming from operations, how much cash is coming from investments, how much cash is coming from financing activities.

So, that 1 can easily make out that what is the source of the major source of the cash, if the cash is coming largely from operations company's good, companies financial health is good. But if it is reverse is happening there more cash is coming from investing and financing activities, less cashes coming from operations that to when a company is a manufacturing concern it may there is something wrong about that company fishy about that company.

We must need to look into the details and as a creditor or as a lender of the funds to this company we have to be very very careful right. And then before we close this class discussion we will like to have some discussion on the liquidity management what you call it as liquidity, liquidity here be divide into 3 components cash when you keep pure cash as cash then it called as pure liquidity the firm has a pure liquidity. Sometime what happens that we look forward that in the next one week or next 15 days or for next 1 month.

We do not require cash beyond a particular amount and if we are going to have some surplus cash during that period of time. So, we convert that cash by investing into short term marketable securities maybe call deposits or maybe some say weekly securities or maybe inter corporate deposits which can be got back in a very short span of time they are called as the marketable securities or the very short time securities.

They are also liquid as and when you want to convert these securities into cash you can do that. So, but that is also liquidity but that is called as the backup liquidity, so we make investment into the securities marketable securities on the basis of expected rate of return and be constructive portfolio where we invest.

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These surplus funds or this surplus cash partly into risky securities, partly into less risky securities or no risky securities, so that income is also managed risk is also managed. So, we keep either cash or we keep marketable securities or sometime we keep both. We keep cash+marketable securities some amount of the cash is kept as cash to pay for the future operations or maybe the requirement to meet the cash requirements of the firm as and when they become due and remaining is converted into marketable securities.

So, that maybe maintain the liquidity in the firm in the form of pure liquidity and the backup liquidity. So, that if we are able to meet our requirements with the help of cash, then fine. But if there is a shortage of the cash then we can or if there is a surplus cash then after keeping certain amount of the cash as cash balance will be invested into marketable securities. So, that tomorrow if cash falls the short for making the payment.

Then we can easily sell the securities in the market convert that cash and we can pay our obligations. So, firm is able to meet all it is financial obligations. And it is not considered as technically insolvent. So, liquidity means cash+marketable securities pure liquidity and the backup liquidity. So, we must stop here for this class and next time when we meet or we go to the next class.

Then I will start talking to about the cash management models there we will discuss 2 important very interesting models of cash management or facilitating the cash management which are called as certainty model and the uncertainty models. So, these certainty model and uncertainty model these models are very interesting and very helping to learn the see efficient cash management but these models both the models I will discuss with you in the next class, thank you very much.