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MANU



VINU



**CONVERSATION
BETWEEN
MANU AND VINU
ABOUT
CASH FLOW STATEMENT
AND ITS USEFULNESS**

Manu	Hi Vinu! How are you?														
Vinu	Fine Manu!														
Manu	How is your Financial Analysis Job going on?														
Vinu	Manu, now I am in the process of analysing Financial Statements of a particular customer. His Financials vis-a-viz reality is taking me for a ride!														
Manu	Why? What's the problem?														
Vinu	<p>He is showing good progress in his business with Growth in Sales and Profits. But that's on papers. In reality,</p> <ul style="list-style-type: none"> • He doesn't have sufficient funds to meet his expenses. • He couldn't service Bank Loans on time. • Many of his cheques issued to suppliers get bounced. • He pays salary to his employees with great delay. <p>How all these can happen if he is making so much profit? I have a doubt whether he is giving bogus financial report?</p>														
Manu	Vinu! I don't know what the exact background of your customer is. But one thing I can tell you! It is not necessary that he should have cash to meet his expenses / requirements, since because he is making profit.														
Vinu	That sounds strange!!!!														
Manu	But that's the reality! Profit is not cash!														
Vinu	Come on yaar! What are you talking?														
Manu	True Vinu! Profits are not cash and register it in your mind strongly!														
Vinu	Ok! I understand that if you say something, it would be with logic. But tell me that logic!														
Manu	<p>Ok. Answer this simple question: Let's say you have the following Profit and Loss Statement:</p> <table border="1" data-bbox="263 1668 957 1960"> <thead> <tr> <th></th> <th>Rs. In Crs</th> </tr> </thead> <tbody> <tr> <td>Sales</td> <td>100.00</td> </tr> <tr> <td>Less:</td> <td></td> </tr> <tr> <td>Raw Material Consumed</td> <td>(60.00)</td> </tr> <tr> <td>Labour Cost</td> <td>(10.00)</td> </tr> <tr> <td>Power and Fuel</td> <td>(5.00)</td> </tr> <tr> <td>Depreciation</td> <td>(5.00)</td> </tr> </tbody> </table> <p>What should be profit?</p>		Rs. In Crs	Sales	100.00	Less:		Raw Material Consumed	(60.00)	Labour Cost	(10.00)	Power and Fuel	(5.00)	Depreciation	(5.00)
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Vinu	Sales is 100.00 Crs	
	expenses are 80.00 Crs	
	So profits should be 20.00 Crs.	
Manu	Fine! With this limited information, tell me what could be the cash balance?	
Vinu	Sales 100.00 Crs	
	Expenses 80.00 Crs	
	So Cash Balance should also be 20.00 Crs	
Manu	This is your mistake!	
	Don't you remember Financials are prepared following accrual concept wherein	
	<ul style="list-style-type: none"> • Expenses will be accounted when accrued, whether it is paid or not; • Income will be recognised whether it is received or not. 	
Vinu	Yes. Agreed. But here we don't have any such item or you have not told me anything about that!	
Manu	True! But you also didn't notice the effect of depreciation. Whether depreciation has cash outflow ?	
Vinu	No! It is only book entry to account for fixed assets by charging against profits over the period of its life.	
Manu	So what could be the profit before depreciation?	
Vinu	It may be	
	Profit	20.00
	Add: Depreciation	5.00
	Profit before Depreciation	25.00
Manu	Ya! That's correct and that profit can be called as Cash Profit!	
Vinu	Oh! Is this the cash balance?	
Manu	Don't jump for conclusion. Again I am repeating! Profit is not cash!	
Vinu	Ok! Ok!	
Manu	Do you think all the sales can be made for cash?	
Vinu	No! In order to be competitive and attract new customers, credit should be given!	
Manu	Correct! Let's say, 75% of sales are on credit!	
Vinu	Then in that case, 100 Crs x 75% = 75 Crs should be credit sales.	
Manu	So, what is your Cash Sales?	
Vinu	Total Sales	100.00
	Less: Credit Sales	75.00
	Cash Sales	25.00
Manu	When you give credit, you can also get credit! Is it not?	
Vinu	Sure!	
Manu	But it happens in market that you give more credit to attract customers but you receive only less credit from your suppliers! Because, suppliers would be generally big players and they go by fixed norms! Your other expenses would be basically power, labour, and other operating expenses where you cannot have much credit.	
Vinu	True!	
Manu	So let us assume, 50% of your expenses are on credit.	

Vinu	My total expenses are Rs.80 Crs. So 50% of it is.....																					
Manu	Stop! Don't consider all expenses. It includes depreciation also which is a non cash item.																					
Vinu	Correct! Total expenses are Rs.75 Cr (excluding depreciation of 5 Crs). 50% of 75 Crs is Rs.37.50 Crs																					
Manu	So, what is your Cash Payments?																					
Vinu	<table border="1"> <tr> <td>Total Expenses</td> <td>75.00</td> <td></td> </tr> <tr> <td>Less: Credit available for expenses (50%)</td> <td>37.50</td> <td></td> </tr> <tr> <td>Cash Expenses</td> <td>37.50</td> <td></td> </tr> </table>			Total Expenses	75.00		Less: Credit available for expenses (50%)	37.50		Cash Expenses	37.50											
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Manu	Now you have both your Cash Expenses and Cash Sales. Can you prepare a Comparison table?																					
Vinu	<p>Ya! I can do that.</p> <table border="1"> <thead> <tr> <th>Particulars</th> <th>As per P&L Account</th> <th>Actual Cash Flow</th> </tr> </thead> <tbody> <tr> <td>Sales</td> <td>100.00</td> <td>+25.00</td> </tr> <tr> <td>Less:</td> <td></td> <td></td> </tr> <tr> <td>Raw Material Consumed</td> <td>(60.00)</td> <td rowspan="3">-37.50</td> </tr> <tr> <td>Labour Cost</td> <td>(10.00)</td> </tr> <tr> <td>Power and Fuel</td> <td>(5.00)</td> </tr> <tr> <td>Depreciation</td> <td>(5.00)</td> <td>No Cash Flow</td> </tr> </tbody> </table>			Particulars	As per P&L Account	Actual Cash Flow	Sales	100.00	+25.00	Less:			Raw Material Consumed	(60.00)	-37.50	Labour Cost	(10.00)	Power and Fuel	(5.00)	Depreciation	(5.00)	No Cash Flow
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Manu	<p>Look at the table!</p> <p>You made sales of Rs.100 Crs where as you received only Rs.25 Crs.</p> <p>You have incurred expenses of 75 Crs (excluding depreciation) where as you paid only 37.50 Crs.</p> <p>So what is your cash balance?</p>																					
Vinu	<p>Cash balance?</p> <table border="1"> <tr> <td>a) Cash Sales</td> <td>25.00</td> </tr> <tr> <td>b) Less: Cash Expenses</td> <td>(37.50)</td> </tr> <tr> <td>c) Shortage (a-b)</td> <td>-12.50</td> </tr> </table> <p>I don't have cash balance!!!!!!</p>			a) Cash Sales	25.00	b) Less: Cash Expenses	(37.50)	c) Shortage (a-b)	-12.50													
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Manu	But you had profit of Rs.20 Crs!																					
Vinu	Ha ha! I am caught! Now I understand profit has no relevance to cash balance or cash generation!!!																					
Manu	<p>No! Modify that statement!</p> <p>Profit has relevance but it alone does not decide cash balance or say cash generation!</p>																					
Vinu	<p>Ok! In this case, how come cash balance can be negative?</p> <p>It is Negative 12.50 Cr.</p>																					
Manu	<p>Don't say Negative 12.50 Cr.</p> <p>Cash can never be negative figure.</p> <p>What happened to you is you realised Rs.25 Crs from cash sales and PAID cash expenses of</p>																					

	Rs.37.50 Crs. You cannot pay 37.50 Crs without cash with you. Yes or No?														
Vinu	Yes! I cannot pay 37.50 Crs without cash with me. But how I got 37.50?														
Manu	You generated 25 Crs. You had shortage of Rs.12.50 Cr You should have managed that shortage with some other sources!														
Vinu	Some other sources?? How come?														
Manu	Common yaar! Do you think, cash is generated or brought into the business only through sales? There are various other ways for mobilising cash for the business.														
Vinu	Correct! Cash can be brought into the business through a) Raising Capital; b) Raising Long Term Loans; c) Raising Short Term Loans; d) Selling Assets; e) Selling Investments.														
Manu	Good! What was your Shortage from Operations?														
Vinu	It was Rs.12.50 Cr														
Manu	Now let us assume, you have funded this shortage by bringing in capital of Rs.25 Crs														
Vinu	Rs.25 Crs???														
Manu	Yes! Now arrive at your cash position														
Vinu	It is <table border="1" data-bbox="263 1164 880 1361"> <tr> <td>a) Cash Sales</td> <td>25.00</td> </tr> <tr> <td>b) Less: Cash Expenses</td> <td>37.50</td> </tr> <tr> <td>c) Shortage (a-b)</td> <td>-12.50</td> </tr> <tr> <td>d) Add: Fresh Capital</td> <td>25.00</td> </tr> <tr> <td>e) Surplus</td> <td>12.50</td> </tr> </table> I have surplus of Rs.12.50.	a) Cash Sales	25.00	b) Less: Cash Expenses	37.50	c) Shortage (a-b)	-12.50	d) Add: Fresh Capital	25.00	e) Surplus	12.50				
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Manu	Correct! Now also assume you purchase Plant and Machinery for Rs.20 Crs and work out your cash position.														
Vinu	It should be <table border="1" data-bbox="263 1529 880 1800"> <tr> <td>a) Cash Sales</td> <td>25.00</td> </tr> <tr> <td>b) Less: Cash Expenses</td> <td>37.50</td> </tr> <tr> <td>c) Shortage (a-b)</td> <td>-12.50</td> </tr> <tr> <td>d) Add: Fresh Capital</td> <td>25.00</td> </tr> <tr> <td>e) Surplus</td> <td>12.50</td> </tr> <tr> <td>f) Less: Purchase of P&M</td> <td>20.00</td> </tr> <tr> <td>g) Shortage</td> <td>-7.50</td> </tr> </table> Again I am landing in shortage.	a) Cash Sales	25.00	b) Less: Cash Expenses	37.50	c) Shortage (a-b)	-12.50	d) Add: Fresh Capital	25.00	e) Surplus	12.50	f) Less: Purchase of P&M	20.00	g) Shortage	-7.50
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Manu	Don't worry! Raise loan for Rs.7.50 Crs and work out your cash position.														
Vinu	<table border="1" data-bbox="263 1886 880 2004"> <tr> <td>a) Cash Sales</td> <td>25.00</td> </tr> <tr> <td>b) Less: Cash Expenses</td> <td>37.50</td> </tr> <tr> <td>c) Shortage (a-b)</td> <td>-12.50</td> </tr> </table>	a) Cash Sales	25.00	b) Less: Cash Expenses	37.50	c) Shortage (a-b)	-12.50								
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	f) Less: Purchase of P&M	20.00	
	g) Shortage	-7.50	
	h) Bank Loan	7.50	
	i) Cash Balance	-	
Manu	Did you noticed, your balance is Nil now.		
Vinu	<p>Yes! Now i understand.</p> <p>I had shortage of 12.50 Cr from Operations.</p> <p>But that was supported out of fresh capital of 25 Crs.</p> <p>With the balance money available ($25-12.50=12.50$), I went for purchasing Plant and Machinery 20 Crs.</p> <p>Again I faced shortage of Rs.7.50 Crs.</p> <p>So, I had to finance the shortage through Bank Loan of Rs.7.50 Crs</p>		
Manu	<p>Correct!</p> <p>The cash you generated from running or operating your business is called as Cash Generated from Operating Activity. In your case, it is deficit of Rs.12.50 Cr.</p>		
Vinu	True!		
Manu	<p>To Support cash deficit in operations and also to support purchase of plant and machinery, you raised finance from two sources</p> <p>Capital – 25 Crs</p> <p>Loan – 7.50 Crs</p> <p>They are Cash Generated from Financing Activity</p>		
Vinu	Correct!		
Manu	<p>You have invested Rs.20 Crs in purchase of P&M.</p> <p>So you have not generated any cash from Investment Activity but rather consumed cash.</p>		
Vinu	Correct!		
Manu	Can you capture all these cash flows as per activities		
Vinu	Cash Flow from Operating Activity	-12.50	
	Cash Flow from Investing Activity	-20.00	
	Cash Flow from Financing Activity	32.50	
Manu	<p>Good! This is you abridged Cash Flow Statement. It tells that, you have mobilised 32.50 Crs and have used 20 Crs for Investing Activity and 12.50 Crs for Operating Activity.</p> <p>Now you will appreciate why the companies can suffer despite making profits.</p>		
Vinu	<p>Yes! In this case, though I have made profit but have not generated cash. I was functioning only with the support of capital funds provided by financing activity. Apart from that I also used all the balance capital funds for acquiring Plant and Machinery along with Bank Loan.</p>		
Manu	Correct! Now you are getting the pulse of it.		

	This is the purpose of preparing Cash Flow Statement. It would give much information which P&L and Balance Sheet will not give on the face of reading. That's why Cash Flow Statement and its Analysis are given high importance by Investors and all stake holders.
Vinu	So, how ideal Cash Flow should be?
Manu	In the initial period, cash can be provided by Financing Activity to Operating Activity and Investment Activity. But gradually, the cash flow from Operating Activity should become positive and it should provide for repaying financing cash flows and also support Investment activities.
Vinu	Ya! Cash flow from operating activity should be positive and it indicates the very purpose of running any business. If this cash flow is positive, we will have source for funding investment and financing activities.
Manu	Correct!
Vinu	But Manu, the cash flow statements which I have seen are lengthy in nature. It would not be like the one which we have discussed.
Manu	We have discussed the cash flow which can be prepared under direct method. But what we see in Industry would be cash flow prepared in Indirect Method.
Vinu	What was that?
Manu	Those cash flow statements are prepared from the information available in Profit and Loss Statement and Balance Sheet in Indirect Way. Profit and Loss Statement will be perused to find out the cash profits. Profits reported in P&L Statement are computed using accrual and matching concept. So, that profit is after providing for various non cash items.
Vinu	Non Cash items like?
Manu	Non Cash Items like a) Credit Sales b) Credit Purchases c) Outstanding Expenses d) Accrued Incomes
Vinu	Correct!
Manu	These items will also have presence in Balance Sheet in the form of current assets and current liabilities in various names. So movement of those items will also be provided in Cash Flow Statement to know the exact cash generated from operating activity.
Vinu	Ya! In our example Sales were Rs.100 Crs. whereas Debtors created out of Sales is 75 Crs. Our profit is 20 Crs, No No...Cash profit is 25 Crs but it is calculated based on Total Sales (cash & credit) and so it will not reflect cash generation. So we have to deduct non- cash sales from Cash Profits which is in the form of Debtors - 75 Crs. Is that right?
Manu	You are right! By deducting increase in current asset (in our case, debtors) from cash profits, we are communicating to the readers, that though our company has earned cash profit of Rs.25 Crs from Sales of Rs.100 Crs, please bear in mind we have not realised 75 Crs worth of Debtors. So

	we are deducting it!!!										
Vinu	Very true!										
Manu	In the same way, if we carry creditors, or say, creditor's increases, then to that extent there is no cash outflow. So, that will be added with cash profits to communicate to the readers, cash position is more than the cash profits!										
Vinu	Correct! In our case, cash profit is Rs.25 Crs. We also have unpaid expenses (creditors) of Rs.37.50 Crs. So this should be added to cash profits!										
Manu	You are right! Can you tabulate cash generated from your operating activity based on our discussion?										
Vinu	Ya! <table border="1" data-bbox="263 555 965 743"> <tr> <td>Profit</td> <td>20.00</td> </tr> <tr> <td>Add: Depreciation</td> <td>5.00</td> </tr> <tr> <td>Less: Increase in Current Assets (Debtors)</td> <td>(75.00)</td> </tr> <tr> <td>Add: Increase in Current Liabilities (Creditors)</td> <td>37.50</td> </tr> <tr> <td>Net Cash from Operating Activities</td> <td>(12.50)</td> </tr> </table> <p>Is it correct?</p>	Profit	20.00	Add: Depreciation	5.00	Less: Increase in Current Assets (Debtors)	(75.00)	Add: Increase in Current Liabilities (Creditors)	37.50	Net Cash from Operating Activities	(12.50)
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Net Cash from Operating Activities	(12.50)										
Manu	Very Much! Also remember you will see some more additions and subtractions in real cash flow statements.										
Vinu	Like?										
Manu	Additions for <ul style="list-style-type: none"> • Interest Expenses; • Loss on Sale of Asset; Deductions for <ul style="list-style-type: none"> • Interest Income; • Dividend Income; • Profit on Sale of Asset; 										
Vinu	When these items obviously decide the profits, why these should be added back or deducted?										
Manu	I agree that they decided profits! But they are not out of operational activities of the business. In cash flow from operating activity, focus is on finding cash generated from operating activity. So any activity, which is not part of operating activity, but already included in profits will be removed by either adding back or deducting!										
Vinu	Ok! Let me understand that! Interest is paid on Financing Source – So it is a Financing Activity. But it is already considered as expense for arriving at profit. So, we remove this interest by adding back! Is that right?										
Manu	Correct! Loss / Profit on Sale of Asset are result of Investing Activity! So we remove them from profits either by adding / deducting under Cash Flow from Operating Activities.										
Vinu	True! Dividend / Interest income are also part of Investing Activity! So we should remove them from profits by deducting under Cash Flow from Operating Activities.										
Manu	So remember, when you do this adjustment (adding / deducting) under Operating Activity, you are doing it, because you want to show them under respective activity!										

Vinu	Ya! Interest added back in Operating Activity should be shown as deduction in Financing Activity. Dividend / Interest Income deducted in Operating Activity should be shown as addition in Investing Activity.
Manu	Very Good! So now you know how to prepare Cash Flow Statement too!
Vinu	How about the other activities Manu?
Manu	Other activities don't involve much complication! You have to ensure only cash flows are captured and non-cash items are ignored. Sometimes assets can be purchased by issue of shares instead of cash. Then in those cases, purchase of asset will not figure under Investment activity.
Vinu	Understood! What would be the effect, if a company issues bonus shares?
Manu	In that case also, there is no cash flow. Because of Bonus Issue, there may be increase in Share Capital but there will not be any cash inflow. So that will not find place in Cash Flow Statement!
Vinu	Understood! So the focus is on cash inflows and outflows and all non-cash items are knocked off!
Manu	Exactly! Cash flow statement is a great tool for Investors, Bankers and other stake holders! It would communicate, whether you generate funds from business or you are dependent on Investment and Financing Activities for running your operations!
Vinu	True! If business is run with support of cash inflows from Investment activities it indicates company is selling its assets to fund its operations! So it would raise serious question on Going Concern right?
Manu	Yes! Similarly, if cash flows from Financing Activities continuously increases to support operating activity, it is also not a healthy sign because company is dependent on other funds to support its operations and it would become dangerous if the company is too dependent on borrowed funds.
Vinu	Ya! I think single reading of Cash Flow Statement would give complete cash flow movement of business.
Manu	Absolutely and it is very important for any stake holder to read cash flow statement before investing or lending, because CASH IS KING.

Author:

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Chartered Accountant

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