Tata McGraw Hill Professional: Finance Made Easy Series

How to Read A CASH FLOW STATEMENT

Tata McGraw Hill Professional: Finance Made Easy Series

Financial success is the *raison d'être* of any business, and financial health of any organization is reflected in its financial statements. But, it has been observed that managerial professionals often have little understanding of finance and little time to read treatises on it. Further, financial statements are regarded as too complex to understand and left to be 'deciphered' by finance experts. Hence, cultivating a culture of awareness and transparency of finance is a prime imperative.

Finance Made Easy Series has been designed to impart management executives with adequate knowledge to understand and appreciate financial statements and their implications for the fiscal solvency of their firms. This series seeks to demystify apparently complex financial statements, and help create a finance-savvy executive class, the key to fiscally sound and successful businesses. A lucid, creative and concise exposition of financial statements—their components, jargon and computational methods—with short stories and numerical examples makes for an engaging reading for busy professionals.

Titles in the series include:

- How to Read a Balance Sheet
- How to Read an Income Statement
- How to Read a Cash Flow Statement

and many more...

Tata McGraw Hill Professional: Finance Made Easy Series

How to Read A CASH FLOW STATEMENT

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Tata McGraw Hill

Published by Tata McGraw Hill Education Private Limited, 7 West Patel Nagar, New Delhi 110 008.

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This edition can be exported from India only by the publishers, Tata McGraw Hill Education Private Limited.

ISBN (13): 978-0-07-068071-5 ISBN (10): 0-07-068071-X

Managing Director: *Ajay Shukla* Head—Professional and Healthcare: *Roystan La'Porte* Executive Publisher—Professional: *R Chandra Sekhar* Assistant Sponsoring Editor—BGR: *Dipankar Das* Production Executive: *Rita Sarkar* Manager—Sales & Marketing: *S Girish* Assistant Product Manager—BGR: *Priyanka Goel* General Manager—Production: *Rajender P Ghansela* Asst. General Manager—Production: *B L Dogra*

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Typeset at Tact Computer Graphics, A-118, St. No. 6, West Azad Nagar, Krishna Nagar, Delhi 110 051, and printed at Rashtriya printers, M-135, Panchsheel Garden, Naveen Shahdara, Delhi-110 032

Cover Design: Kapil Gupta

RCDCRRCZRXXAA

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To Our Dear Student

Preface

Financial success is arguably the primary purpose around which, all business management activities revolve. It is imperative to promote a culture of financial discipline in an organization. In order to build an economically viable company, the employees, in all departments, need to understand the financial ramifications of their action on the overall fiscal health of the organization. For this to happen, it is very important that not only finance managers, but managers in all other fields too have an adequate knowledge of the subject. The pervasiveness of such knowledge could ultimately help differentiate a successful organization from a bankrupt one.

The series of books, *Finance Made Easy Series*, has been written for management executives, to impart the knowledge required in order to understand the basic financial statements. The Finance Made Easy Series is an attempt to break the myth that financial statements such as the Income Statement, Cash Flow Statement and Balance Sheet are too complex to comprehend.

This particular book deals with Cash Flow Statement. In the race for profits, companies quite often ignore the need of having cash to maintain liquidity of the business. It is by looking at the cash flow statement that we gauge the actual liquidity position of a company, and the financial planning required for maintaining the same. This statement informs the company of regular movements in its funds, allowing it to manage daily functions more efficiently. viii Preface

Therefore, it becomes imperative for the key decision-makers of a business to have at least rudimentary knowledge about the cash flow statement, and its impact on the business. It is with this confidence that we claim that this book will be an ideal guide in helping you to manage the company funds better. We hope readers will appreciate the simple language in which this book is written to reduce all the unnecessary accounting jargons and present the concepts in an easily comprehensible format.

NEELAKANTAN RAMACHANDRAN RAM KUMAR KAKANI

Acknowledgments

Our peers at ICAI, ICWA, IIMs, XLRI, and other premier academic organizations have continuously inspired our thinking. For this book, our research associates immensely contributed to the manuscript development.

We are indebted to:

- Kamlesh Thakkar, CA
- Mary Johnny, BA
- Nutan Shashi Tigga, MA
- Prasun Mallik, MBA
- Rakesh Sinha, MBA
- Rohit N Barchha, CAI
- Vasudha Singhania, CA

We would like to thank Dipankar Das, Rita Sarkar, Sindhu Ullas and other team members of the Tata McGraw Hill Professional. In particular, we thank R. Chandra Sekhar whose skillful persuasion and editorial work helped clarify and steady our work enormously.

Finally, we are grateful to our family members including – Ananya, Chinku, Dhruva Govind, Kanan, Karuna, Kriti, Kunju, Leena, Rathis, and Vipra. Thank you all!

Comments from readers are most welcome (Email: ramkumarkakani@gmail.com).

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Introduction

Before we move on to have a good discussion on the Fund Flow and Cash Flow Statements, let us have a look on an interesting news.

"From Boo To Boo Hoo Hoo ..."

"Online retailer Boo.com bites the dust" is the screaming headlines of most pink papers and dailies. This is one of the biggest e-tailing failures to hit Europe. Cash flow problems are the stated reasons for the mishap. Losses kept on mounting in spite of rising sales. The company filed for bankruptcy, when it failed to raise another round of funding. A classic liquidity trap!

Most dot com companies in the gung-ho days (1999–2000) assumed that venture capitalists, angels, banks and others, would continue to bankroll losses in the name of building the business. The problems came, when the cash tap dried.

The question is, why did the taps dry? What has happened in the recent months that have made investors wary? The answer is - any finance student will tell you that Cash Flow is the way to value. And this never happened for Boo.com again....

Edited from http://www.indiainfoline.com/bisc/cytr/may2000. html (boo.com's failure)

What do we see above?

In the above case, we obseve that a cash crunch has led to business failure. Another interesting thing to observe is the fact, that there appears to be no real issues regarding the sales or the future prospects of the

company. The crux of the problem lies in the handling of the cash flow by the management of these type of companies. Thus, if you believe that cash flow management cannot significantly alter the financial position of a firm, then you are grossly mistaken. But do not worry as you are in elite company. Many of the top CEOs too tend to make the same mistake, unfortunately, to the peril of their companies, as we have seen in the above case.

"Cash" is the lifeblood of any company. Hence, the efficient management of cash flow becomes imperative for all concerns. Apart from ensuring liquidity, adept cash flow management can also play a role in the profitability of a company. In order to better manage the funds and cash, companies rely on a very significant accounting statement, "Cash Flow Statement". As the name says, it gives us the position and flow of the cash inside a company.



t is a known fact that every transaction alters the position of a business. An enterprise, after every transaction, is not the same as it had been before. Thus, it can be concluded that the business is in a continuous state of change, involving an uninterrupted movement of resources into the business, within the business, and out of the business. The complexity of these flows increases, with the increase in the size, and volume of the business. Directly or indirectly, all these flows take place through the medium of funds. So, let us first understand the meaning of the word 'Funds'.

Funds

Depending on the user's purpose, the term *funds* may be used differently.

Literally, it means a sum of money set aside, which can be drawn upon in times of need. Funds are generally created for a specific purpose. For example, your parents might set aside a specific sum in order to buy a house in future. This sum of money may be seen as a fund. A popular type of fund is a Mutual Fund, wherein a pool of money is created, with the specific purpose of investing it in the financial markets.

However, in respect of the Fund Flow Statement, the term fund indicates a different meaning. When used in terms of the fund flow statement, it denotes the 'working capital' of the business. The working

capital of a business stands for the 'Total Current Assets' minus the 'Total Current Liabilities'. This is what funds mean in this statement. The different connotations of the term often confuse the reader. Hence, the reader will be well advised to forget every other definition of the word for understanding financial statements.

Funds

• In respect of the Fund Flow Statement, the term funds, quite simply, stand for the working capital of the business. The working capital denotes the 'Total Current Assets' less 'Total Current Liabilities' of the business

Bholuram: Hey Finnova! In the above definition of "funds", I find few terms that were also used in the book on *How to Read a Balance Sheet*. You know I am a *bhullakar* (forgetful) hence, Finnova please brief me again on Current Assets, Current Liabilities and Working Capital.

Finnova: Oh! for sure, Mr. Memory Loss. On having any doubt, you can always ask me. 'Current' literally, means a flow; and in accounting, we use it in the same sense to indicate the flow through the business.

- The assets that the company looks to dispose (either by selling or by consumption) within a period of a year, are referred to as Current Assets. The Assets includes cash, inventory (stock), debtors, trade receivables, short-term investment of the company, etc.
- The liabilities of the company (amounts owed by the business to people who have lent money or provided goods or services on credit) that become due within a year, i.e. they need to be paid back within one year of creation of such a liability, are classified as Current Liabilities such as, creditors, rent payable and interest payable.
- The capital employed by a firm for conducting of its dayto-day affairs, is recorded as Working Capital. It is given by Current Assets minus the Current Liabilities of the firm

(also known as Net Working Capital). Gross Working Capital is the Total Current Assets of the company. So if a company has Current Assets of Rs. 200,000 and Curent Liabilities of Rs. 100,000, then the Gross Working Capital of the company would be Rs. 200,000, while the net working capital or the working capital we generally talk about would be Rs. 100,000.

We will now discuss another important concept, with respect to the cash flow statement, the *Operating Cycle*.

Operating Cycle

Typical business transactions move in cycles. Cash is converted into different forms of current assets and then ultimately back to cash. The operating cycle for a particular company is the time it takes, to convert these flow items back, into cash. Cash usually passes through various stages of an operating cycle during this process. Described below is a typical operating cycle for a manufacturing business.

The operating cycle starts when cash is utilized for the purchase of inventory and ends when the inventory is sold and cash is realized from the customer. In this case, the cash will pass through the stages of raw material inventory, work-in-progress inventory, finished goods inventory, accounts receivables and then will be transformed back into cash.



Fig. 1.1 Operating Cycle

In the coming chapter, we shall know more about the Working Capital and in the process, we will be able to understand the different components that make up the operating cycle.



he financial managers devote a great amount of time in the shortterm financing needs of the company, negotiating favorable credit terms, controlling movement of cash, administering accounts receivable, and monitoring inventories. Managing of short-term financial needs is termed as Working Capital Management.

Working Capital

Working Capital refers to the assets held by the business, with the objective of conversion to cash (including cash) during an operating cycle of the business. The working capital (also known as *Net Working Capital* or *Net Current Assets*) is given by Current Assets *minus* the Current Liabilities of the firm. So, for instance, if a company has Current Assets of Rs. 10 million and Current Liabilities of Rs. 9 million, then the working capital of the firm would be Rs. 1 million. The working capital of a firm is the capital employed by the firm in conducting its day to day operations. The firm tries to keep its working capital at an optimum level. Higher than required working capital results in unnecessary blockage of funds, which could have resulted in extra returns if invested somewhere else. Too low working capital may result in shortage of funds in times of need.

Working Capital = Current Assets - Current Liabilities

Flow of Funds

Let us now look at the working capital of Chota Pehlwan Sweets as detailed below.

Chota Pehlwan Sweets					
Cash	200,000	Short term loans	100,000		
Stock (Inventory)	200,000	Creditors (Payables)	200,000		
Current Assets 400,000 Current Liabilities 300,000					

Table 2.1 Working Capital (All figures in Rupees)

In the above table, we can see that Chota Pehlwan Sweets. must have needed some resources in order to finance, or procure the current assets of Rs. 400,000. Let us analyze as to what these possible resources could have been. The stock of Rs. 200,000, have been purchased on credit from some suppliers. That figure of Rs. 200,000 is reflected in the Current Liabilities of the company as Creditors. So, it can be said that current liabilities (creditors) has been used to finance the current assets (stock) of Rs. 200,000. Similarly, we can ascertain that the short-term loan of Rs. 100,000 has been used to finance cash balance of Rs. 100,000 (out of the total cash balance of Rs. 200,000). Hence, we have established that Rs. 300,000 out of the total Current Assets of Rs. 400,000, have been financed out of Current Liabilities. The portion of the Current Assets that have not been financed by Current Liabilities, i.e. Rs. 400,000 -Rs. 300,000 = Rs. 100,000, is what is represented as the Working Capital. This implies that some amount of resources are invested in current assets from sources of finance other than current liabilities. These net amount or *funds* can also be used in the business.

Now, since it's established that the funds acted as the working capital of Chota Pehlwan Sweets Ltd., therefore, it means that any change in the position of it (funds), will only take place when there is a movement in the current assets or the current liabilities of the firm. For example, if land is purchased out of a long-term loan, there is no flow of funds. This is because land is a non-current asset, and the loan is a non-current liability. These types of transactions neither affect the current liability, nor the current assets. Hence, there is no movement in the working capital position due to the given transaction. In the same example, if the purchase is made by using a short-term loan, it would result in an increase of current liability, without an equal and corresponding increase in current asset, hence decrease the working capital, or in other words, there would be an outflow of funds.

To sum it up, fund flow refers to the changes in the current assets and current liabilities. If there is an increase in the working capital of the firm, we say that there has been an inflow of funds. On the other hand, if there is a decrease in the working capital of the firm, then we say that there has been an outflow of funds. This movement is vital for understanding and managing the operations of a business.

Need for Working Capital

Since, the emphasis of this book is more on the practical rather than theoretical aspects of business, we herein present a detailed illustration, explaining the workings of a business and try to illustrate how and why working capital is needed for a business.

Example 1: Ramsons

Ramsons is a small retail outlet dealing in domestic appliances and entertainment electronics equipment, that has just been started by Ram.

- 1. His investment in the showroom, display counters, furniture and fixtures and so on, was Rs 600,000.
- 2. Ram also decided to follow the straight-line method¹ of depreciation for the fixed assets, at the rate of 10 percent per annum.

¹Refer "How to Reed a Balance Sheet" of Finance Made Easy Series.

- 3. Ramsons' estimated sales were Rs 150,000 per month. Out of which Rs 50,000 would be cash sales, and Rs 100,000, on credit, to be collected in four equal monthly installments, with the first installment collected at the time of sale.
- 4. All sales would be made on a 25 percent margin on the selling price. In other words, if selling price of a merchandise item is Rs. 100 then its cost of sales would be Rs 75.
- 5. Supply and sales constraints would warrant carrying three months sales requirement in the form of inventory. Similarly, a month's cash expense requirements had to be held in cash balance.
- 6. Subsequent purchases would receive a month's credit from suppliers.
- 7. The average monthly cash requirement for meeting operating expenses other than payment for purchases amounted to Rs 26,000.
- 8. Ram needed to withdraw Rs 4,000 per month for his personal needs.

In the above example, it is clear that Ramsons is coming out with some broad norms for managing the new business, leading to issues such as:

- 1. How much working capital would Ramsons require to start operations?
- 2. Will he need any additional funds to the working capital during the first four months?
- 3. Or will he have surplus working capital during the first four months?

We can instinctively answer these questions by saying that Ramsons needs working capital to pay for inventory, for all the expenses and for keeping safe cash balance. We can also say that Ramsons will receive funds from operations to meet most of these requirements. But to say exactly how much, we need to approach the problem a little more critically. This could be done by working out a schedule of cash receipts and cash payments on a monthly basis. It is also possible by preparing a monthly profit & loss account and balance sheet for the business.

Ramsons								
Month	Month Explanation Amount							
January	Operating expenses	26,000						
	Withdrawals	4,000						
			30,000					
February	January purchases	112,500 ²						
	Operating expenses	26,000						
	Withdrawals	4,000						
			142,500					
March	February purchases	112,500						
	Operating expenses	26,000						
	Withdrawals	4,000						
			142,500					
April	March purchases	112,500						
	Operating expenses	26,000						
	Withdrawals	4,000						
			142,500					

Table 2.2 Schedule of Cash Payments (All figures in Rupees)

Table 2.3 Schedule of Cash Receipts (All figures in Rupees)

	Ramsons						
Month	Explanation	Amount	Total				
January	Cash Sales of January month	50,000					
	Credit sales of the month (first installment of January month sales)	25,000					
			75,000				
February	Cash Sales of February month sales	50,000					
	Credit sales of the month (first installment of February month sales)	25,000					

(Contd.)

 $^{^2}$ if selling price is Rs 100, then cost of sales is Rs 75. Therefore when monthly sales is Rs 150,000, cost of sales is Rs 112,500 (i.e. 75/100*150,000).

Table 2.3 (Contd.)

	January sales (second installment of January month sales)	25,000	
			100,000
March	Cash Sales of March month sales)	50,000	
	Credit sales of the month (first installment of March month sales)	25,000	
	January sales (third installment of January month sales)	25,000	
	February sales (second installment of February month sales)	25,000	
			125,000
April	Cash Sales of April month sales	50,000	
	Credit sales of the month (first installment of April month sales)	25,000	
	January sales (fourth installment of January month sales)	25,000	
	February sales (third installment of February month sales)	25,000	
	March sales (second installment of March month sales)	25,000	
			150,000

Table 2.4 Balance Sheet as of 1st January (All figures in Rupees)

Ramsons						
Assets	Amount	Liabilities and Capital	Amount			
Fixed Assets	600,000	Capital	967,500 ³			
Inventory	337,5004					
Cash	30,000 ⁵					
Total	967,500	Total	967,500			

³We are assuming that Ramsons has not taken any loans or Long Term Liability to start the enterprise. Capital has been taken as a balancing figure.

⁴Inventory has to be three months sales requirement (Refer page no. 14-15) Monthly Sales = Rs 150, 000 & Cost of sales = Rs 112, 500. Hence, monthly inventory for three months requirement = 112,500 *3= Rs 337, 500

⁵Monthly cash requirement is Rs 30, 000.

We have assumed that the entire asset requirements at the first instance are financed by Ram's own capital. Working capital of Ramsons at the beginning of January was as follows:

Current Assets	Amount (Rs.)
Inventory	337,500
Cash	30,000
Total Current Assets	367,500
Less: Current Liabilities	0
Working Capital	367,500

Table 2.5 Working Capital of Ramsons

Based on the above information, we could also compute a schedule of cash receipts and payments of Ramsons for the four months, which will show the deficit or surplus of cash available to the business.

Ramsons							
January February March April							
Opening Balance	30,000	75,000	32,500	15,000			
Cash receipts	75,000	100,000	125,000	150,000			
Total Cash available	105,000	175,000	157,500	165,000			
Less: Cash payments	30,000	142,500	142,500	142,500			
Cash Balance	75.000	32.500	15.000	22.500			

Table 2.6 Schedule of Cash Balances (All figures in Rupees)

Using the information available, we can also prepare the profit & loss account of the business for the four-month period as below.

Tab	le 2	.7	Profit & Lo	ss Account	for the	Month	Ending	(All fig	gures in	Rupee	es)
-----	------	----	-------------	------------	---------	-------	--------	----------	----------	-------	-----

Ramsons							
31 January 28 February 31 March 30 April							
Total Sales	150,000	150,000	150,000	150,000			
Less: Cost of Sales	112,500	112,500	112,500	112,500			
Other Expenses	26,000	26,000	26,000	26,000			
Depreciation ⁶	5,000	5,000	5,000	5,000			

(Contd.)

 $^{^6\}text{Depreciation}$ for the year comes to Rs 60,000 (Rs 6, 00,000 x 10%). Therefore depreciation for the month is Rs 5,000 (Rs 60,000/12).

Total Expenses	143,500	143,500	143,500	143,500
Net Profit7	6,500	6,500	6,500	6,500
Less: Drawings ⁸	4,000	4,000	4,000	4,000
Retained Profits	2,500	2,500	2,500	2,500

Table 2.7 (Contd.)

Incorporating the changes in the assets, liabilities and owner(s) equity as a result of the transactions during the four months, we can also prepare the balance sheet of the business as at the end of each month.

Now, we can easily create a table containing the changes in the working capital of Ramsons and the possible sources of their funding.

	Ramsons									
Assets	1 January	31 January	28 February	31 March	30 April					
Current assets	367,500	487,500	495,000	502,500	510,000					
Less. Current Liabilities	0	112,500	112,500	112,500	112,500					
Working Capital	367,500	375,000	382,500	390,000	3,97500					
Change in Working Capital	0	7500	7500	7500	7500					
Funds	from Oper	ation (All fig	gures in Rupe	es)						
Net Profit	6,500	6,500	6,500	6,500						
Add: Depreciation9	5,000	5,000	5,000	5,000						
Total Funds generated from operations	11,500	11,500	11,500	11,500						
Less : Withdrawals	4,000	4,000	4,000	4,000						
Net additions to Working Capital	7,500	7,500	7,500	7,500						

Table 2.8 Schedule of Working Capital (All figures in Rupees)

⁷Here we are ignoring Corporate Income Tax.

⁸Ramsons monthly withdrawal has been considered as a dividend and not as salary.

⁹Depreciation is just an allocation of fair proportion of the depreciable amount in each accounting period during the expected useful life of the assets, it is not an actual outflow of funds, and hence we add back depreciation to arrive at the total funds generated from operations.

Table 2.9 Balance Sheet as at the End of Year (All figures in Rupees)

Mar 30 Apr	2,500 112,500			2,500 112,500	7,500 967,500	7,500 10,000	5,000 977,500	7,500 1,090,000
28 Feb	112,500			112,500	967,500	5,000	972,500	,085,000 1
31 Jan	112,500			112,500	967,500	2,500	970,000	1082,500 1
1 Jan	0			0	967,500		967,500	967,500
Liabilities & Capital	Accounts Payable			Current Liabilities	Capital	Add: Retained earnings	Owners Equity	Total Liabilities & Capital
30 Apr	22,500	150,000	337,500	510,000	600,000	20,000	580,000	1,090,000
31 Mar	15,000	150,000	337,500	502,500	600,000	15,000	585,000	1,087,500
28 Feb	32,500	125,000	337,500	495,000	600,000	10,000	590,000	1,085,000
31 Jan	75,000	75,000	337,500	487,500	600,000	5,000	595,000	1,082,500
1 Jan	30,000		337,500	367,500	600,000		600,000	967,500
Assets	Cash	Receivable	nventory	Current Assets	ixed Assets	ess: Depreciation	Vet Fixed Assets	otal Assets

Reconciling Increase in Working Capital

In the above example, we were following the changes in the working capital, and we noticed that these changes were due to only funds generated by operations. It is easy for us to track the changes in the working capital over the periods, starting with the beginning of the business and ending with the close of April.

Ramsons	
Working capital as on January 1	367,500
Add: additions during the January	7,500
Working capital as on February 1	375,000
Add: additions during the February	7,500
Working capital as on March 1	382,500
Add: additions during the March	7,500
Working capital as on April 1	390,000
Add: additions during the April	7,500
Working capital as on May 1	397,500

Table 2.10 Working Capital Requirement (All figures in Rupees)

In this chapter we have seen how the fund flows. In the next segment, we will discuss the need for investment in fixed assets and current assets.



Capital Invested in Business

In the Ramsons example, we saw that Ramsons kept reinvesting the extra funds generated back into the business. And as the money ploughed back, Ramsons generated profits. Often, this ploughing back of profits is known as *retained earnings*. Where has Ramsons invested the money? It is easy to answer this question too, because the balance sheet of the business shows us what Ramsons has done with the money to start with. Refer to the first balance sheet and you will find that Ramsons had fixed assets, shop room and facilities, inventory, goods or merchandise purchased for resale, and some cash for meeting expenses and personal needs. In the later balance sheet, we observe the current assets of the company increasing progressively. So, Ramsons invested its money in increasing its working capital. We review these current assets items, and progressively enhance our understanding.

Need to Invest in CASH

It is difficult to perceive cash kept in a vault as an investment Rather, you would be thinking how can cash itself be an investment? But you will realize that a certain minimum amount of cash is necessary for any business. Take a simple case: if you are a retailer, will you probably send a customer away, who does not have the exact change? You can only entertain him if you keep the change. The change you keep is your investment in cash. Similarly, you will have to pay your employees and

suppliers on a specific time. In order to do that, you need to keep some cash. This amount or cash will help you meet the day-to-day requirements. The amount is determined after taking into account the regularity, and the cash inflow and outflow and also the uncertainties related to these. Obviously, as your business grows, the need for cash will also grow. The need for cash will also be influenced by your *need* for investment in other assets.

Need to Invest in RECEIVABLES

In most business situations, it's necessary to grant credit to customers. This could be either because of competition, or because of the custom of trade. When granting a credit, (a good), or a service is provided to the customer, and instead of immediately paying cash, the customer promises to pay it at a later date. For example, a large portion of Ramsons sales are due to the credit (installments) they are offering. This amount represents an asset for the business, as this is the amount that it owns from the customer, who now becomes its debtor. This amount is shown in the Balance Sheet as accounts receivable/debtors/sundry debtors. The opportunity aspect of this credit granted is that, you are deferring the receipt of cash to the extent of the receivables amount.

Need to Invest in INVENTORY

You can appreciate the need for carrying inventory. In order to carry on operations unhindered, we need to have a sufficient amount of merchandise on hand. The availability and regularity of supply, the frequency of client orders and so on, will determine the quantum we have to keep in store. All the same, we should carry some inventory in most cases. Inventory is also held, whenever there is a time lag between procurement, and use of inventory of materials & supplies like in manufacturing enterprises.

Similar is the case with non-merchandise inventory, such as office and factory supplies. We have to carry a minimum stock of these items to ensure smooth operations. We also know that there are several expenses that are to be paid before we actually use the services, such as rent, insurance and so on. In other words, we invest our money in these items of assets in order to ensure smooth operations.

Need to Invest in FIXED (NON-CURRENT) ASSETS

We have seen the importance of current assets. They are very important for operating the business. Now, the necessity for having adequate fixed facilities to conduct the business is clear. The amount we have invested, in our example of Ramsons, for the shop, furniture and fixtures, are for creating the facilities required for carrying on the business. As the business expands, it may be required to extend the fixed capacity of the business. For example, suppose a bottling plant has setup a machine that can produce 100,000 bottles per week. With an expanding business, a need may be felt to increase the capacity to 200,000 bottles per week. In such a case, the management will have to invest additional resources to procure the extra machines to set up additional capacity.

It is also necessary for us to understand that the need for fixed asset investments and current asset investments will vary from business to business. A trading company may require very little investment in fixed assets and a very large investment in current assets. A capital intensivemanufacturing unit may need large investments in factory, technology and equipment. Fixed Asset requirements are also known as jump investments as they are determined by specific firms at given levels or their volumes of activity.

Determining the Working Capital Requirement

Understanding the existing capital needs, and how are they financed, will help us in comprehending the process of financing of the business, and the flows of funds within the business. The first question we have to answer is how much working capital is needed to start the operations. We could determine the amount of working capital required and compare

the same with the existing (estimated) working capital to see, whether it is sufficient or whether there is any excess available.¹⁰

Lets again look at the Ramsons example.

Operating requirements of the business:

- 1. One month's cash expenses, other than payment to creditors, to be kept in cash.
 - A minimum of Rs 30,000 of average cash on hand.
- 2. Keep three months' sales requirement in inventory.
 - During the first month, they start with three months sales' worth of inventory.
 - Sale per month is Rs 150,000.
 - Sold at a gross margin of 25 percent on sales.
 - Therefore, inventory required to be maintained is three times 75 percent of the monthly sales.
 - Rs $150,000 \times 0.75 \times 3 = \text{Rs } 337,500.$
- 3. Every month, one-third of the sales are made on cash, and two-third of the sales are on credit.
- 4. The credit sales are to be collected in four installments.
 - Cash collection during the month will be cash sales.
 - One-fourth of the credit sales of the period and one-fourth of three previous months will be taken as credit sales (being monthly installments received from customer).
- 5. During the first month, we will collect from sales for cash, Rs 50,000, and from the first installment of 25 percent of the credit sales:

 Table 3.1
 First Month Sales and Cash Collections (All figures in Rupees)

Ramsons								
	Details	Amount						
Cash Sales	50,000							
Credit Sales	100,000							
Total Sales		150,000						
Cash Sales	50,000							
First installment in cash	25,000							
Total Cash Collection		75,000						

¹⁰Please note that there are more complex tools used by professionals to determine the capital requirements but they are beyond the scope of this book.

Credit period allowed on the sales will be as follows:

Total amount of credit granted on one month's sales, is the total sales of the month, less the first installment to be paid by the buyer. This means, Ramsons effectively, makes credit sales of Rs 75,000 per month. This Rs 75,000 will be collected in three equal monthly installments.

Particulars/ Installment	Amount	1 st	2 nd	3 rd	4 th
Cash Sale	50,000				
Credit Sale	1,00,000	25,000	25,000	25,000	25,000
Due		75,000	50,000	25,000	0

Table 3.2

This will mean:

- From the date of sale, till the payment of the second installment, Rs 75,000 is due for one month. A credit of Rs 75,000 is granted for one month.
- From the date of the second installment, till the payment of the third installment, Rs 50,000 is due for one month. A credit of Rs 50,000 is granted for two months.
- From the date of the third installment, till the payment of the fourth installment, Rs 25,000 is due for one month. A credit of Rs 25,000 is granted for three months.

Therefore, we could summarize Ramsons need for funds for current asset financing to start operations at the beginning of the period, as follows:

3 months inventory	Rs 337,500
One month expenses as cash	30,000
	Rs 367,500

Table 3.3

During the first month, Ramsons will make one-third of the total sales generating Rs 50,000, in cash. The remaining two third of the sales will be on installment credit, where Rs 25,000 will be collected in cash and Rs 75,000 will be collected in three further installments. Thus, we need some additional funds to finance our granting credit to the customers.

Similarly, we would need to replenish the inventory and make payments for the expenses. We shall examine these with the help of the balance sheet, and profit & loss account of Ramsons, for the first four months.

Future Capital Requirements

Any business including Ramsons would require additional capital for two purposes:

- 1. Financing additional non-current assets; and
- 2. Financing additional working capital.

Investment in fixed assets is required to expand the capacity, or to improve the current facilities for operation. Usually, additions to investments are judged on the basis of their ability to reduce the present costs, or to increase the present output (sales).

If Ramsons invests in another shop, or in an expansion of the existing shop, it will require funds for an investment in the fixed assets, and also for increasing the current assets. We also notice that whenever an additional investment is to be made in non-current assets, we have to use the funds (working capital) available. Similarly, when our non-current assets are sold, the sale provides funds, or results in a source of funds.

Additional working capital is required to finance an increased holding of inventory, increased credit to customers and increased cash holding requirement.

Table 3.4Change in Balance Sheet over the Previous Period as at theEnd of Year (All figures in Rupees)

Ramsons									
Assets	31	28	31	30	Liabilities	31	28	31	30
	Jan	Feb	Mar	Apr	& Capital	Jan	Feb	Mar	Apr
Cash	45,000	-42,500	-17,500	7,500	Accounts	112,500	0	0	0
					Payable				
Receivable	75,000	50,000	25,000	0					

(Contd.)

Capital Invested in Business 23

Table 3.4 (Contd.)
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Inventory	0	0	0	0					
Current assets	120,000	7,500	7,500	7,500	Current Liabilities	112,500	0	0	0
Fixed Assets	0	0	0	0	Capital	0	0	0	0
Less: Depreciation ¹¹	5,000	5,000	5,000	5,000	Add: Retained Earnings	2,500	2,500	2,500	2,500
Net fixed assets	-5,000	-5,000	-5,000	-5,000	Owners Equity	2,500	2,500	2,500	2,500
Net Change in Assets side	115,000	2,500	2,500	2,500	Net Change in Liabilities & Capital side	115,000	2,500	2,500	2,500

Let us try to review the five balance sheets of Ramsons to see the changes and evaluate the working capital situation. We can achieve this by, first, finding out the changes in each item, over the previous period.

The changes in the fixed assets are represented by the accumulated depreciation only. There were no additions to fixed assets during the period. Reduction in the fixed assets due to depreciation is a non-cash transaction.

On the liability side also, there was no transaction involving longterm liabilities or capital. The only change in the long-term items is the increase in the retained earnings.

Thus, all the changes are in the area of the working capital. The net change in the working capital, as we have seen earlier, is an increase of Rs 7,500 per period. How did this come about? This leads us to the changes in the current assets and current liabilities. There was no change in the inventory during the period. The only items which experienced change are cash and receivables. The current liability saw changes in the accounts payable in the first period. The increase in the receivables needed funds to finance it, and this was provided in parts by the increase in payables, thereby having not much impact on the working capital. Whenever an increase in the current assets is offset by an equal increase in the current liabilities, the net impact on the funds required for working capital is zero.

¹¹Depreciation is a non-cash transaction as it is just an allocation of fair proportion of the depreciable amount in each accounting period during the expected useful life of the assets.

This means that the only other item that could have financed the change in working capital would be the funds generated by operations.

The operations provided a net profit of Rs 6,500 during each period. We have made an expiration of fixed assets in the amount of Rs 5,000 per month. Depreciation is a non-fund transaction, meaning, no cash goes away from the entity, and hence, the fund provided by operations will include that too. Thus, operations generated Rs 11,500 per period. The owner regularly withdrew cash of Rs 4,000 per period, leaving in the business, additional resources of Rs 7,500 per period, which is the change in the working capital.

Table 3.5

	1 January	31 January	28 February	31 March	30 April
Working Capital	367,500	375,000	382,500	390,000	397,500

Thus in the above example, we have seen how the funds from operations, provided an additional working capital to finance a required cash holding. Hence, the source for additional working capital was the funds from operations, and the cash withdrawal, were the application of funds.

We can summarize the normal uses of funds (working capital) as follows:

- Acquisition of new non-current assets (fixed assets or intangible assets like technology license);
- 2. Repayment of non-current debt (say, long-term loans);
- 3. Profit distribution to owners;
- 4. Increase in the balance of working capital (current assets current liabilities).

If the operations are unsuccessful, they may use funds (and even need more funds) rather than provide funds. The following are included within application of funds, in the fund flow statement.

Table 3.6

Uses/Applications of Fund
Dividends (or withdrawals by owners)
Increase in working capital

Capital Invested in Business 25

Table 3.6 (Contd.)

Purchase of fixed assets

Purchase of long term investment

Redemption of debentures/bonds

Repayment of long term loans

Redemption of redeemable preference share capital

Possible Sources of Working Capital

We have seen that working capital is required to finance that portion of current assets, which are not financed by current liabilities. We also studied that the investments represented by current assets are converted into cash during the operating cycle. Under normal circumstances, every unit of investment in working capital is converted to cash at the end of the cycle.

When we are looking at the possible sources of working capital, the most important source represents 'internal generations'. The very idea of internal sources implies that there is something 'external' as well.

The figure below shows various sources of Working Capital.



Fig. 3.1 Sources of Working Capital

Internal Sources

When we are looking for sources of funds, it is natural to start from home. What do we have? While examining the need for working capital,

we could also make an assessment as to whether the existing working capital is sufficient or not. Thus, the first internal source is any excess working capital asset i.e., any existing current assets that might be put to better use. For example, if a company has a short-term investment in marketable securities (like highly liquid mutual funds, or government securities) then the firm could liquidate the same, and put these funds to spruce up its working capital management.

The second internal source is disposal of any non-current assets. If we have any non-current assets, which do not have any use, they could be disposed off, thereby generating funds for additional working capital. This, however, is not a regular and continuing source of funds, as there would be a limit to the amount of non-current assets that can be disposed off.

We have seen earlier that every profitable sale brings with it, funds in excess of what was expended on the goods sold. In other words, a profit generated by the business contributes towards additional working capital. But that figure may be slightly undervalued. This is because whenever we record a profit generating revenue item, we deduct all the expenses, which have been incurred to earn the revenue, so that we gain profit at the end of the day. Now, there may be a few items which though were counted as expense (example depreciation), but did not involve any real outflow of funds. Hence, the profit measured does not reflect the actual amount of funds available.

Therefore, in order to assess the actual fund generated from current operations, we must add with profits, all those items of 'expense' not involving the use of funds, during the current period. One common example of such an item is depreciation. Another example is amortization expense for the year.

> **Bholuram**: Hey Finnova, I recall coming across the terms Amortization and Depreciation in our earlier book *How to Read a Balance Sheet*. Can I say that you are depreciating my brains by cramming with financial jargons.
Finnova: No Bholu!! It will be amortization. Let me recapture the definitions of amortization and depreciation for you:

- Valuation of the fixed assets is usually made on the basis of their original cost. However, since the assets have a limited life, the cost will expire along with the expiration of the life. Thus, the valuation of the asset is reduced in proportion to the expired life of the asset. Such expired cost is referred to as 'depreciation' in accounting.
- Many intangible assets have a limited life too. Examples are patent rights, franchise rights and so on. Since they have a limited useful life, the cost of acquiring such assets has to be transformed into expired costs over such useful life. This process of expiration of the cost of an intangible asset is called 'amortization'.

In reality, the material effect of amortization and depreciation is almost the same.

In your case, since I consider your brain as an intangible asset (albeit, minute) hence, I will call it amortization than depreciation.

External Sources

External sources of funds are resources raised from outside the organization, to augment funds availability for any of the uses discussed earlier. Normally, there are only two ways of doing the same:

- 1. By the owners contributing additional capital, that is, by raising more capital through a medium like issue of new equity shares.
- 2. By increasing long-term borrowings, for example, by taking long-term loans from a bank or through issue of debentures/bonds.

The sources of funds as they are usually presented in the fund flow or working capital statement are summarized below:

Table 3.7

Sources of Funds
Additional long term borrowing
Funds from Operations ¹²
New issue of share capital
New issue of debentures/bonds
Sale of long term investments (another non-current assets like fixed assets)
Sale proceeds of fixed assets

Let us move to next chapter discussing factors affecting Fund Flow in an organization.

¹²Funds from Operations, as we have already seen, consist of the net profit for the year, as increased by the non-cash, non-operating expenses, and reduced by non-cash, non-operating incomes. It will be discussed in greater details later.

4

Factors Affecting Fund Requirements

 Γ rom the discussions we have had earlier, it is not difficult to fathom that there are innumerable factors affecting the fund or net working capital requirements. Herein, we discuss some of them:

- Nature and Type of Business: A firm that provides brokerage services may require less working capital than a firm, which carries on a business of merchandising. The merchandising firm would require working capital to carry inventory, give credit and so on. Similarly, a manufacturing firm may require more working capital than a retailer. The manufacturing company will have to carry inventory of raw materials, work-in-process and finished goods.
- Sales Volume: Working capital requirements are directly influenced by the sales volume. With growth in the sales volume, we need to carry more inventories, increase the volume of customer's receivables, as also the operating expenses. It may be that all the expenses do not move up proportionally, however, we will have to finance some of these increases. It is also possible that granting extended credits could bring about an increase in the sales volume. In other words, by investing more funds, we could increase the volume of sales.
- Seasonality of Operations: Fund requirements for the business may be seasonal. Say for example, in industries using agricultural raw materials (such as, Turmeric and Groundnut), it would be more advantageous during the harvest season. The materials that are required for year round production might be procured during a few

months. In case of consumer retailing (such as a television manufacturer), it may be necessary to hold large inventories during a festive season. Most of the fund requirements are restricted to a limited period, and if we provide funds on a permanent basis, then we may have idle funds during most part of the year.

- Length of the Operating Cycle: Yet another important aspect, which may condition the fund requirement, is the velocity of circulation of the current assets. In other words, the length of the operating cycle will influence the need for funds. The shorter is the duration of an operating cycle, faster will be the conversion of money invested in current assets into cash and hence, lesser would be the need for the net working capital. So, heavy engineering firms and construction giants need to plan their working capital over a long period given their long operating cycles.
- **Suppliers:** The net working capital fund requirement is also influenced by the terms of the suppliers. The credit terms extended by the suppliers will determine the amount of additional funds required.

A firm, which carries a month's inventory and grants only a month's credit to its customers, will need to fund the inventory cost of two months' sales. If it could avail two months' credit from the suppliers, the need for funding inventory and receivables will be nil.

The following illustration should help our discussion:

Example: 2 Hemant Ltd

Hemant Ltd. is a small firm engaged in the trade of plastic bottles. The firm carries an average balance of Rs 10,000 of accounts payable, payable in 30 days, and an average accounts receivable of Rs 15,000, receivable in 45 days. What would be the working capital requirements of the firm?

Solution:

Assuming continuous flow of business to the firm, it will have to keep a net working capital for the differences of the receipts from customers and fund required for meeting the payables. The computation in such a case will be as follows:

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Fund required to meet payable due within 30 days	Rs 10,000
Less: Funds received from customers within 30 days:	Rs 10,000
Received in 45 days, that is, Rs 15,000 × 30/45	
Fund required in the form of additional net working capital	NIL

Hence, the firm would need no new working capital. Now, if we assume the time taken for the collection of receivables as 90 days, the situation will be:

Table 4.2

Fund required to meet payable due within 30 days	Rs 10,000
Less: Funds received from customers within 30 days:	Rs 5,000
Received in 45 days, that is, Rs 15,000 × 30/90	
Fund required in the form of additional net working capital	Rs 5,000

We could summarize the discussion we had with respect to the need for working capital by saying that the ability of the firm to circulate cash in its operating cycle is the vital and important factor in determining the amount of working capital required. In other words, the firm tries to circulate its cash as fast as possible through the following cycle:



Fig. 4.1 Cash Flow Cycle

However, the exact amount needed to be invested in all these will be determined by the period and quantum of the holding of each of these elements. This, in turn, is also influenced by the factors we discussed in this section such as the type and pace of business, etc.



Fund Flow Statement

A Fund Flow Statement is also known as a 'Statement of Sources and Application of Funds' or 'How Came and Where Gone Statement'. The term "flow" implies a continuous movement, or circulation. It's a major change in a particular component during an accounting period. It is the flow of the funds, which results in changes of the financial statements from the preceding accounting period. This can easily be depicted using a picture.



Fig. 5.1 Changes in Fund Flow

The Funds Flow Equations

The Fund Flow Statement is based on the following equation:

Sources of Funds – Applications of Funds = Change in Working Capital

The above equation clarifies a well known fact. It says that the difference between the sources and application of funds in a business, will determine the change in working capital of a firm. If sources of funds are greater than the application of funds, then we would have an increase in the working capital of the firm, whereas, if the application of funds is more than the sources of funds, then there would be a decrease in the working capital of the firm.

The Format

To prepare a Fund Flow Statement, we will have to compute funds from operation and also create a statement of changes in the working capital. The following figures give you an idea of the components of a Fund Flow Statement.



Fig. 5.2 Components of Fund Flow Statement

Funds Flow from Operations

Funds from operations, also known as trading profits or trading income, are an important source of fund, especially for established firms. 'Profit' here, would mean the excess of revenue over all other expenses. This profit is there irrespective of the fact that the sale was a cash sale or a credit sale. If an item of Rs 500 is sold for cash for Rs 750, there is a profit of Rs 250. This transaction here consists of two elements, i.e.:

- a) reduction of stock by Rs 500 (working capital/flow item)
- b) increase in profit by Rs 250 (non-current item).

Here, we receive cash Rs. 750. Up to Rs. 500, the reduction in one current asset (stock) will be balanced via an increase in the other item (cash), hence keeping the working capital unchanged for that portion. However, with the extra Rs. 250 cash earned, the working capital would increase. This Rs. 250 profit is nothing but the funds from operations of the particular firm.

However, there are certain items, which though classified as expenses, do not incur any real outflow of funds. They are mere accounting entries in the books of accounts, which though reduce the profits but do not involve any funds outlay. An often sighted example would be that of depreciation or amortization. While we do make adjustments for depreciation in our books, there is no actual payment that a business makes as a result of depreciation. So, the logical thing would be adding back the depreciation figure to the profits of the company to find out the actual increase in funds on account of fund flow from operations.

Hence all those incomes and expenses, which do not form part of the normal operations of the business, need to be adjusted. So, all such items, such as profit/loss arising out of sales of fixed assets, income arising out of investments need to be adjusted for. We will subtract all the non operational income that has been considered, when calculating the profits of the company. Similarly, we will add all the expenses – that are of a non operational nature - to the profits of the company to get the funds from operations. Therefore the final figure obtained after adding non cash expenses, subtracting non operational income, and adding non operational expenses, to the profits of the company, is what's known as the funds from operations.

Bholuram: Hey Finnova. You are complicating things. You said "the normal operations of the Business.....".What do you mean by the normal operations of the Company?

Finnova: Look Bholu, a firm is normally set up to perform a particular business activity. It regularly performs that activity and derives profit by the virtue of performing that activity. Such operations, forming the core of the business are known as normal operations and such income, derived from the main-line of the business is known as operating income / operating profit. Apart from this core activity, a firm may also end up deriving profit from certain other noncore activities of the business. These activities fall outside the purview of the normal operations of the business and any income derived from these are known as non-operating income. To give you an example, a grocery store may derive some income, both from selling vegetables and from interest that it earns as a result of its having a bank saving account. Here, income derived from selling of vegetables is classified as operating income, while interest income earned is a nonoperating income.

Bholuram: So, I can say that currently Finnova is doing an abnormal operation)

Finnova: Shut up. Don't confuse others (as well as yourself).

Example 3: Chottu Mottu

Chottu Mottu Limited					
Particulars	Details	Amount			
Sales net		350.00			
Other income*		10.00			
Total Revenue		360.00			
Less: Cost of goods sold		150.00			
Gross profit		210.00			
Less: operating expenses					
Personnel	60.00				
Depreciation & amortization	11.90				
Other expenses	13.10	85.00			
Operating profit		125.00			
Less: Interest		15.00			

Table 5.1Profit and Loss Account for the Year Ended December 31,2009 (All figures in Rupees (Millions))

(Contd.)

Table 5.1 (Contd.)

Profit before taxes	110.00
Less: Income tax provision	 55.00
Net profit after tax	55.00
Less: Dividends	20.00
Net Profit Retained	35.00

*Other income includes Rs. 1 million profits on sale of furniture. Note: Furniture and fixtures costing Rs 2 million, with accumulated depreciation of Rs 1 million, were sold for cash at Rs 2 million.

Based on the discussion we had, the fund flow statement would show funds from operations of Chottu Mottu Ltd. as follows:

Table 5.2Fund from Operations for the year Ended December 31, 2009(All figures in Rupees (Millions))

Chottu Mottu Limited					
Particular	Details	Amount			
Operations:					
Net income	55.00				
Add: depreciation & amortization	11.90	66.90			
Less: Profit on Sale of furniture		1.00			
Total funds provided from operations		65.90			

Hence, we observe that the funds from operations are equal to the net profit for the period increased by the non-cash and non-business expenses that were taken in the profit & loss account (for example depreciation, expenses written off, loss on sale of fixed assets and investments) and reduced by non-cash non-business income taken in the profit & loss account (for example profit on sale of fixed assets, investments, profit from revaluation of fixed assets and other non-operating incomes).

Example 4: M/s Johnny Lever and Sons

From the following profit & loss account of M/s Johnny Lever and Sons, calculate the amount of funds from operation.

Table 5.3 Profit and Loss Account for the year ending 31st March 2009(All figures in Rupees)

M/s Johnny Lever and Sons					
Particulars Amount Particulars Amo					
To Salary	10,000	By Gross Profit	150,000		
To Depreciation	25,000	By Profit on sale of Plant	50,000		
To Loss on sale of Machinery	50,000	By Interest	40,000		
To Office Expenses	40,000	By Dividend	10,000		
To Net Profit	125,000				
Total	250,000		250,000		

Suggested Solution

We calculate the funds from operations in the following way:

 Table 5.4
 Statement of Funds from Operations (All figures in Rupees)

M/s Johnny Lever and Sons					
Particulars	Details	Amount			
Net Profit as per Profit & Loss Account		125,000			
Add: Non-Cash and Non-Operating expenses					
Depreciation	25,000				
Loss on sale of machinery	50,000	75,000			
		200,000			
Less: Non-Operating incomes					
Profit on sale of Plant	50,000				
Interest income	40,000				
Dividend income	10,000	100,000			
Funds from Operation 100,000					

The above funds from operation represent the funds generated from the normal business operations of M/s Johnny Lever and Sons.

Statement of Changes in the Working Capital

In understanding the financial statements of a company, one of the first steps involved, is the study of the changes in the current financial position of the company, and the reasons for the changes. We make an attempt at studying these changes and their causes by using the data contained in the summarized comparative balance sheet of Chottu Mottu Limited.

Chottu Mottu Limited						
Assets	December 31, Year 2	December 31, Year 1	Liabilities & Capital	December 31, Year 2	December 31, Year 1	
Current assets			Current Liabilities & Provisions			
Cash	19.05	10.87	Acceptance	4.74	3.02	
Receivable	32.25	20.28	Accounts payable	27.16	18.75	
Loans and advances	42.58	33.82	Advances against sales	26.60	20.28	
Other current assets	17.20	15.93	Other liabilities	8.86	7.95	
Inventory	120.92	99.10	Interest accrued but not due on loans	2.64	2.00	
Total Current Assets	232.00	180.00	Total Current Liabilities	70.00	52.00	
			Provisions:			
Fixed Assets			For taxation	25.55	20.45	
Plant and equipment at cost	152.00	133.00	Proposed dividend	2.25	2.25	

 Table 5.5
 Balance Sheet as of December 31, Year 2 (All figures in Rupees (Millions))

(Contd.)

Table 5.5 (Contd.)

Assets	December 31, Year 2	December 31, Year 1	Liabilities & Capital	December 31, Year 2	December 31, Year 1
Less: Accumulated Depreciation	71.00	60.00	For bonus	3.40	2.35
Net Plant and equipment	81.00	73.00	Other provision	3.80	2.95
			Total Provisions	35.00	28.00
Furniture & Fixtures at cost	14.50	8.60	Total current liabilities & Provisions	105.00	80.00
Less: Accumulated Depreciation	2.00	2.30			
Net Furniture & Fixtures	12.50	6.30	Long Term Liabilities		
			Bank loans	40.00	32.14
			Debentures 10.5%	25.50	25.50
			Loans from Financial Institutions	24.50	22.36
			Total Long Term Liabilities	90.00	80.00
Investments	2.00		Total liabilities	195.00	160.00
Intangible Assets			Capital		
Technical assistance fees	3.00	1.00	Authorized: 5,00,000 shares of Rs 100 each	<u>50.00</u>	<u>50.00</u>
Less: Amortization	0.50	0.30	Issued, Subscribed and Paid Up: 3,73,100 shares of Rs 100 each	37.31	37.31

(Contd.)

Table 5.5 (Contd.)

Assets	December 31, Year 2	December 31, Year 1	Liabilities & Capital	December 31, Year 2	December 31, Year 1
Net Intangible Assets	22.50	0.70	Reserves and Surplus	97.69	62.69
			Total Shareholders' funds	135.00	100.00
Total Assets	330.00	260.00	Total Liabilities & Capital	330.00	260.00

Note: Furniture and fixtures costing Rs 2 million, with accumulated depreciation of Rs 1 million, were sold for cash at Rs 2 million.

The net change in working capital can be computed easily by subtracting the net working capital at the end of the year from the net working capital at the beginning of the year:

 Table 5.6
 Statement of Changes in Working Capital (All figures in Rupees (Millions))

Chottu Mottu Limited						
	Year 1	Year 2				
Current assets	180.00	232.00				
Less: Current liabilities	80.00	105.00				
Working capital	100.00	127.00				
Working capital at the end of the year 2		127.00				
Working capital at the close of the year 1		100.00				
So, Increase in Working capital		27.00				

The increase of Rs 27 million in the working capital of Chottu Mottu Limited, does not tell us much in terms of the operations of the business. This change could be the net result of changes in all the accounts covered by current items. There could have been qualitative changes resulting from the depletion of liquid items of current assets and increases in nonliquid items such as inventory. In order to clarify these possibilities, we try to analyze the changes in each of the working capital accounts.

A statement of changes in the working capital helps us in locating where these changes took place. At the first instance, we try to show the increases/decreases in the individual items and then, we try to classify them in terms of increases and decreases in the working capital. Since

working capital is measured by subtracting current liabilities from current assets, any increase in the current assets and any decrease in the current liabilities cause an increase in the working capital. Similarly, any decrease in the current assets and any increase in the current liabilities represent a decrease in the working capital.

The statement of changes in the working capital of Chottu Mottu Limited below shows that the increase in the current assets amounted to Rs 52 million, a major part of the increase arising out of cash, receivables and inventory. The decrease in the working capital came about mostly from the increased accounts payable, advances from customers and tax payable. The total amount from this increase in current liabilities amounted to Rs 25 million. Thus, the net increase in the working capital was Rs 27 million.

Chottu Mottu Limited						
Particulars	Year 2	Year 1	Particulars		Working Capital	
			Increase	Decrease	Increase	Decrease
Current assets						
Cash	19.05	10.87	8.18		8.18	
Receivable	32.25	20.28	11.97		11.97	
Loans and	42.58	33.82	8.76		8.76	
advances						
Other current assets	17.20	15.93	1.27		1.27	
Inventory	120.92	99.10	21.82		21.82	
Total Current	232.00	180.00	52.00		52.00	
Assets						
Current Liabilities						
& Provisions						
Acceptance	4.74	3.02	1.72			1.72
Accounts payable	27.16	18.75	8.41			8.41
Advances against	26.60	20.28	6.32			6.32
sales						
Other liabilities	8.86	7.95	0.91			0.91

Table 5.7 Change in Working Capital (All figures in Rupees (Millions))

(Contd.)

Particulars	Year 2	Year 1	Particulars		Particulars Working C	
			Increase	Decrease	Increase	Decrease
Current Liabilities	70.00	52.00	18.00			18.00
Provisions:						
For taxation	25.55	20.45	5.10			5.10
Proposed dividend	2.25	2.25	0.00			0.00
For bonus	3.40	2.35	1.05			1.05
Other provision	3.80	2.95	0.85			0.85
Total Provisions	35.00	28.00	7.00			7.00
Total Current Liabilities & Provisions	105.00	80.00	25.00			25.00
Working Capital	127.00	100.00	27.00			

Table 5.7 (Contd.)

Changes in the Financial Position

An analysis of the changes in the working capital items could convey us insightful things. If it has increased, where has the increased working capital been invested, and if it has decreased, from where have the funds been released. The profit & loss account gives the results of the operations and their impact on the position of the business.

As the title indicates, a fund flow statement integrates the profit and loss account with the balance sheet changes, tracing the flow of funds through the organization.

It is usually divided into the two logical divisions: The inflows during the periods and the outflows during the period. The division showing the sources of funds summarizes all those transactions which had the net effect of increasing the working capital. Uses of funds, on the other hand, deal with all those transactions, which had the effect of decreasing the working capital. The following figure captures the dynamics of a fund flow statement.



Fig. 5.3 Dynamics of Fund Flow Statement

Now, that we have reasonable awareness with respect to the different items that constitute the fund flow statement, we continue the example of Chottu Mottu Limited and attempt to prepare its funds flow statement.

Fund Flow Statement Illustrated

From a comparative balance sheet and profit & loss account, we can obtain most of the information we require, for the preparation of a fund flow statement. We have studied that changes in the net working capital amount are caused by the changes in the non-working capital items. This could be easily seen from the summarized balance sheet of Chottu Mottu Limited.

We have seen that the net working capital amount increased by Rs 27 million during year 2, (refer to page no. 42–43). In other words, this implies that the sources of working capital from non-current sources should exceed non-current uses by Rs 27 million.

Chottu Mottu Limited									
Particulars	Year 2	Year 1	Chang balance	es in sheet	Particulars	Year 2	Year 1	Change balance	es in sheet
Assets			Source	Use	Liabilities			Source	Use
Working capital ¹³ (Current Assets – Current Liabilities)	127.00	100.00		27.00	Long-term Liabilities:				
Fixed Assets:					Bank loans	40.00	32.14	7.86	
Plant and equipment at cost	152.00	133.00		19.00	10.5% debentures	25.50	25.50		
Furniture and fixtures at cost	14.50	8.60		5.90	Loans from financial institutions	24.50	22.36	2.14	
Investments	2.00	0.00		2.00	Depreciation and amortization				
Intangible assets:					Plant and equipment	71.00	60.00	11.00	
					Furniture and fixtures	2.00	2.30		0.30
Technical assistance fees	3.00	1.00		2.00	Technical assistance fees	0.50	0.30	0.20	
					Share capital	37.31	37.31		
					Reserves and surplus	97.69	62.69	35.00	
	298.50	242.60		55.90		298.50	242.60	56.20	0.30

Table 5.8 Changes in Balance Sheet Items (All figures in Rupees (Millions))

Note: Furniture and fixtures costing Rs 2 million, with accumulated depreciation of Rs 1 million, were sold for cash at Rs 2 million.

The summarized balance sheet shows the net change in each account. That is, it does not show the increases and decreases separately. Furniture and fixtures, for example, have increased by a net amount of Rs 5.90 million. This increase shows an application of funds. In reality, the change in this account did not represent an acquisition of furniture alone. We

¹³The components of current assets and current liabilities are clubbed under Working Capital as shown on page no. 39–41.

purchased furniture and fixtures worth Rs 7.90 million (an application of funds) and also sold off furniture and fixtures for cash at Rs 2.00 million (a source of funds).

One can observe that construction on sources and uses of funds statement for the year needs additional information. Some of this additional information is available from the profit & loss account details. Some other information, like sales proceeds of assets are to be obtained from other records of the company such as notes to accounts, etc.

Chottu Mottu Limited			
Sources of funds:			
Funds from operations:			
Net Profit	55.00		
Less: Profit on sale of assets	1.00		
	54.00		
Add: Depreciation and amortization			
Plant	11.00		
Furniture and fixtures	0.70		
Technical assistance fee	0.20		
Total funds from operations		65.90	
Funds generated from sale of furniture and fixtures		2.00	
Additional bank loan		7.86	
Additional loans from financial institutions		2.14	
Total Sources of funds		77.90	
Uses of funds			
Dividends	20.00		
Purchase of plant	19.00		
Purchase of furniture	7.90		
Investments	2.00		
Technical assistance fees	2.00		
Total non working capital uses		50.90	
Working capital increase		27.00	
Total Uses of funds		77.90	

 Table 5.9
 Summarized Fund Flow Statement (All figures in Rupees (Millions))

Here, we can see that operations were the major source of fund which in turn, was used by the company for purchase of plant, furniture etc., and to pay dividends. It shows that the company's idea of CAPEX had, and will help it in earning, through operations.

One can appreciate the company's financial position much better by using the above financial statement. For example, one can easily start understanding the firm by raising simple issues such as:

- 1. What were the major sources of funds? What is the proportion of longterm sources vis-à-vis short-term sources? Are the sources sustainable in the future?
- 2. What are the major uses of funds? Are the funds for the long-term benefit of the company?
- 3. What are sources of funds that were used for the payment of dividends?
- 4. Is the firm approximately following a policy of using long-term sources, for long-term purposes, and short-term sources, for short-term requirements?

While analyzing companies, one should remember that these financial statements, including the balance sheet, profit & loss account and fund flow statement, are like pieces of a puzzle and hence, drawing extreme conclusions based on only one financial statement, should be avoided.



In the recent times of high company failures, cash flow statement has come to acquire a significance of its own. The key reason is very simple - whereas it is comparatively easier to tamper with the Income Statement and Balance Sheet items of a company (with the help of innovative accounting practices), the manipulation of the cash balances has proved to be a much tougher exercise. So, it is very difficult to manipulate a statement of cash flow. Now let us have a glimpse of Cash Flow Statement from a listed company's annual report, namely Sathavahana Ispat Limited. The company is a midsized pig iron manufacturer based in Andhra Pradesh.

Sathavahana Ispat Limited					
	2008-09	2007-08			
A. CASH FLOW FROM OPERATING ACTIVITIES		2			
Net Profit before tax and extraordinary items	2,068.00	5,152.00			
Adjustments for:					
Depreciation (net)	1,457.00	1,498.00			
Interest Expense	2,591.00	1,941.00			
Interest Income	(525.00)	(244.00)			
Others Adjustments	45.00	460.00			

Table 6.1Cash Flow Statement for FY 2008 and 2009 (All figures in
Rupees (Lakhs))

(Contd.)

The Cash Flow Statement 49

Table 6.1 (Contd.)

Sathavahana Ispat Limited				
Operating profit before working capital changes	5,636.00	8,807.00		
Adjustments for:				
(Increase) in Sundry Debtors	(2,261.00)	(145.00)		
(Increase)/Decrease in Inventories	4,713.00	(8,320.00)		
Increase/(Decrease) in Current Liabilities	(5,707.00)	7,423.00		
(Increase) in Loans & advances	(696.00)	(270.00)		
Cash generated from operations	1,685.00	7,495.00		
Taxes Paid	(1,111.00)	(1,127.00)		
Interest paid	(2,591.00)	(1,941.00)		
Net cash inflow/(outflow) from operating activities	(2,017.00)	4,427.00		
B. CASH FLOW FROM INVESTING ACTIVITIES				
Purchase of fixed assets	(1,673.00)	(3,619.00)		
Sale of fixed assets	244.00	4.00		
Interest Received	566.00	147.00		
Net cash outflow from investing activities	(863.00)	(3,468.00)		
C. CASH FLOW FROM FINANCING ACTIVITIES		8		
Proceeds from long term borrowings	427.00	(1,697.00)		
Proceeds of Share Capital	-	3,410.00		
Increase in bank borrowings	1,213.00	886.00		
Net cash inflow from financing activities	1,640.00	2,599.00		
Net increase/decrease in cash and cash equivalents	(1,240.00)	3,558.00		
Cash and cash equivalents at the beginning of the year	3,631.00	75.00		
Cash and cash equivalents at the end of the year	2,391.00	3,633.00		

Note: The negative figures are presented in brackets.

After seeing the above Cash Flow Statement, few things for sure are understood:

- 1. The above Cash Flow Statement is for the FY2009, which has been compared with its preceding FY2008. Hence, one can say that it covers two accounting periods.
- 2. The cash flows (i.e. cash receipts and cash payments) has been categorized under three different activities:
 - Operating Activities
 - Investing Activities and
 - Financing Activities

3. Finally, it also shows opening and closing cash positions of the accounting periods (refer to last rows).

Thus, a Cash Flow Statement helps to answer the following type of questions:

- How did cash position change, compared to the accounting profits reported based on the income statements?
- How were the proceeds of the long term bond or debt issued used?
- How was the expansion in the plant and machinery financed?
- How much money was borrowed during the year?
- From where did the company bring in and spend out the cash?
- What is the company using extra cash for?
- Has the company's operating activities generated enough cash to support the CAPEX¹⁴ (Capital Expenditure) and payment of dividends?
- If not then how has the CAPEX and payments of dividends been dealt out? etc.

Table 6.2	Analysis of Cash Flow Statement (All figures in Rupees
	(Crores))

Sathavahana Ispat Limited					
	FY 2009	FY 2008			
Major Sources	Borrowing 16	Operations 44 Share Capital 34			
Major Uses	Operations 20	CAPEX 36			
	CAPEX 14	Net Repayment of Loans 8			
CFO ¹⁵ > CAPEX?	No	Yes			
CAPEX > Depreciation?	Depreciation (15) > CAPEX (14)	CAPEX (36) > Depreciation (15)			
Sources of Cash for CAPEX	Borrowing	Share Capital			
Other Major Items Affecting Cash Flows	Interest Income 5	Interest Income 1			
Trends					
CFO	Negative 20	44			
CAPEX	Decrease 14	36			
Net Borrowing	Net Borrower	Net Payer			

¹⁴ Capital expenditures (CAPEX) are expenditures creating future benefits. A capital expenditure is incurred when a business spends money either to buy fixed assets or to add to the value of an existing fixed asset with a useful life that extends beyond the taxable year. Example: Acquisition of fixed assets.

¹⁵CFO is Net cash inflow/ (outflow) from operating activities.

So, one can observe that a lot of important information and cues for above types of questions get answered by analyzing a statement of cash flow. For, example we can see that Sathavahana Ispat is doing well. It is also expanding vigorously. It is funding the same using external equity (in 2008) and debt (in 2009).

The Need for a Cash Flow Statement

The need for a cash flow statement also stems out of the inherent limitations of the balance sheet and the profit and loss account. Some of the limitations of these statements are:

- They concentrate only on the accounting profits of the firm. Hence, the cash component, which provides liquidity to the firm and is integral to the survival of the business, is not given due importance.¹⁶
- There is no clear demarcation between the operational and nonoperational aspects of the business. Hence, it may become relatively difficult for a user of the financial statement to clearly identify the fundamental earning capability of a company.
- There are a variety of ways and means available to compute certain items of the P&L account and the balance sheet such as depreciation, value of inventory etc., which leads to confusion and a scope for manipulation of figures. Items of the cash flow are comparatively standardized and give a clearer picture.

The above mentioned shortcomings are taken care of by the cash flow statement. It provides the firm with detailed information regarding the flow of cash in business and the current state of liquidity that the firm is in. It is also helpful to other stakeholders of the business such as investors, creditors and shareholders, who get a sense of the amount of risk and return to be expected from the business. It also clearly demarcates the activities of the business into operational, investing and financing activities to convey a simpler and easily digestible picture to the user. Thus one can say that a cash flow statement gives rich information not only regarding

¹⁶The Balance Sheet paints a static picture of the business. It provides information about the business at a particular point of time, and fails to convey the dynamism and the movement in the various assets and liabilities of the business.

its solvency position but also relationship between a company's profitability with its various types of activities (both operational and nonoperational).

Cash and Cash Equivalents

When we prepare a cash flow statement, we seek to track the movement of cash, and cash equivalents. The items that fit the description of cash, and cash equivalents are as follows:

- Cash, as we understand in general terms, i.e. the amount of cur-0 rency available with us
- Demand deposits with the bank, i.e. any amount deposited with О the bank that is free to withdraw whenever we so desire. (Examples: Saving account and current account with Banks).
- Short term, highly liquid investments that can be readily converted 0 to cash. (Example: a 15-day bank fixed deposit).

Example 5: Hindustan Unilever Limited

Let us analyze the following cash flow statement of the Hindustan Unilever Limited taken from its annual report for the year 2008-09.

Hindustan Unilever Limited				
	31.03.2009 (15 month)	31.12.2007 (12 month)		
A. CASH FLOW FROM OPERATING ACTIVITIES				
Net Profit before tax and extraordinary items	3,025.00	2,146.00		
Adjustments for:				
Depreciation (net)	195.00	138.00		
Interest Expense	25.00	25.00		
Interest Income	(81.00)	(64.00)		
Dividend Income	(71.00)	(103.00)		
Others Adjustments	(48.00)	(63.00)		
	•	(Contd)		

Table 6.3 Cash Flow Statement (All figures in Rupees (Crorse))

Table 6.3 (Contd.)

Hindustan Unilever Limited					
	31.03.2009 (15 month)	31.12.2007 (12 month)			
Operating profit before working capital changes	3,045.00	2,079.00			
(Increase) in Sundry Debtors	(152.00)	(40.00)			
(Increase)/Decrease in Inventories	(575.00)	(399.00)			
Increase/(Decrease) in Current Liabilities	398.00	561.00			
Cash generated from operations	2,716.00	2,201.00			
Taxes Paid	(634.00)	(493.00)			
Others Adjustments	(55.00)	(30.00)			
Net cash inflow/(outflow) from operating activities	2,027.00	1,678.00			
B. CASH FLOW FROM INVESTING ACTIVITIES					
Purchase of fixed assets	(636.00)	(329.00)			
Sale of fixed assets	178.00	181.00			
Purchase of Investments	(12,482.00)	(14,151.00)			
Sale of Investments	13,670.00	15,148.00			
Dividend Received	70.00	103.00			
Interest Received	77.00	70.00			
Net cash outflow from investing activities	877.00	1,022.00			
C. CASH FLOW FROM FINANCING ACTIVITIES					
Proceeds from borrowings	1,280.00	-			
Repayments of borrowings	(909.00)	-			
Dividend paid	(1,677.00)	(2,291.00)			
Interest paid	(25.00)				
Buyback of Shares		(626.00)			
Net cash inflow from financing activities	(1,331.00)	(2,917.00)			
Net increase/decrease in cash and cash equivalents	1,573.00	(217.00)			
Cash and cash equivalents at the beginning of the year	201.00	417.00			
Cash and cash equivalents at the end of the year	1,774.00	200.00			

Note: The negative figures are presented in brackets

Suggested Solution

Here we present you the simple format for analyzing a cash flow statement of a company:

	31.03.09 (15 months)	31.12.07 (12 months)
Major Sources	Operations – 2027	Operations - 1678
	Net Borrowing - 371	Investments - 997
Major Uses	Dividend - 1677	Dividend - 2291
	CAPEX ²² - 458	Buyback - 626
		CAPEX – 148
CFO ²³ > NI	Depreciation – 195	Depreciation – 138
Reasons :	A/P up ²⁴ - 398	A/P up - 561
	But :	But :
	A/R up ²⁵ – 152	A/R up – 40
	Inventory up - 575	Inventory up - 399
CFO > CAPEX?	Yes	Yes
CFO > CAPEX + Dividend	No	No
Trends		
Income	Up	2146
CFO	Up	1680
CAPEX	Up	148
Dividends	Down	2291
Net Borrowing	Net Borrower	Nil

Table 6.4	Analysis of Cash Flow Statement (All figures in Rupees
	(Crores))

Note: A/*P* = *Accounts Payable*

A/R = Accounts Receivable

NI = Net Income

Though the company has good flow of funds from operations, but it has been utilizing the funds for CAPEX & dividend through sale of investments and operations, which is not a good sign.



Format

n a cash flow statement, the objective is to provide information on the changes during an accounting period, in cash and cash equivalents, and to classify the cash flows under three standard headings namely operating activities, investing activities, and financing activities.

Operating Activities

The idea is to convey to the user of the cash flow, the cash generated solely as a result of the operating activities of the business, and hence, all the non-operating cash flows are adjusted to get purely the operating cash flow of the company. Examples of operating activities include, cash received from customers (cash inflow) and cash payments to suppliers and vendors (cash outflow). So, the profit adjusted for depreciation, gains and/or losses on sale of non-current assets, tax paid and working capital changes (such as increases or decreases in pre-paid expenses, inventories, receivables and payables), come under operating activities.

Investing Activites

Purchases of non-current assets and proceeds on the sale of non-current assets are called investing activities. Examples of cash inflow by way of

investing activities include, purchase of machinery, land and long term investments. Examples of cash outflow by way of investing activities would be items such as disposal of real estate, old machinery and sale of long term investments.

Financing Activities

Examples of cash inflow due to financing activities would include issues of new debentures and issue of new equity shares. Repayment of loans, payment of interest (on loans) and dividends (to equity shareholders) would be good examples of cash outflow due to financing activities.

So, a cash flow statement is needed to identify and explain the difference between profits and cash, and thus, provides the user with a mechanism for providing additional information on its business activities and makes a better assessment of the current liquidity of a business.

Bholuram: Hey Finnova, can you tell me the basic deifference between cash flow statement and fund flow statement ?

Finnova: Why not Bholu, In a cash flow statement, the difference between the sources and application of cash represent the closing cash balance, whereas in a fund flow statement, the difference in sources and applications of funds, represents the increase or decrease in the working capital. Secondly, cash flow statement helps to assess the firm's capacity to meet short term obligations, whereas, funds flow statement helps to assess firm's capacity to meet its long term obligations.

Bholuram: Just a minute Finnova. After assessing my stomach I feel there is an urgent need to fill it with short-term consumption inventory (stock in use). Hence please give me a break.

Preparing Cash Flow Statement: An Introduction

In this section, we will give you a brief introduction to the process of preparing a cash flow statement. All of the cash flow activities are supposed to be segregated into three heads; viz., operating activities, investing activities and financing activities. The sum of these activities reflects the net increase or decrease in the cash and cash equivalents.

Let us now understand each of the activities that form a part of the cash flow statement.

Operating Activities

There are two ways of calculating the cash flow from operating activities, viz., the direct method and the indirect method. The amount of cash provided by or used by operating activities is the same, no matter whichever method is used.

Under the direct method, gross receipts and gross payments of cash are disclosed, that is, the amount of cash received from customers, and the amount of cash paid to suppliers and employees are disclosed. In other words, all transaction due to the operating activities resulting in cash inflows and outflows are tabulated in a systematic fashion.

Under the indirect method, the profit & loss account is adjusted for the effects of transactions of non-cash and non-operating nature. So, in this method, we start with the net income in the income statement. Cash transactions omitted from income are added. Non-cash transactions included in the income are removed. One can observe that this method is slightly similar to arriving at the funds from operations from a company's accounting profit, while preparing a funds flow statement (refer Chapter 5).



Fig. 7.1 Computing Cash Flow using Indirect Method



So to sum it up, we present below simple formats of direct and indirect methods of presenting 'Statement of Cash Flow'.

Direct Method		
Receipts from Debtors and Customers	XXXX	
Payments to Creditors and Suppliers	(XXXX)	
Payments towards Expenses	(XXXX)	
Taxes Paid	(XXXX)	XXXX
Cash Flow from Operating Activities (A)	XXXX	
Proceeds from sale of Fixed Assets	XXXX	
Purchase of Fixed Assets and Investments	(XXXX)	
Dividend Received	XXXX	
Interest received	XXXX	XXXX
Cash Flow from Investing Activities (B)	XXXX	
Proceeds from borrowings	XXXX	
Proceeds from issue of shares	XXXX	
Payment of long term borrowings	(XXXX)	
Payment of dividends	(XXXX)	XXXX
Cash Flow from Financing Activities (C)	XXXX	
Net Cash Flow during the year = (A+B+C)	XXXX	
Add: Opening Balance of Cash and Cash E	XXXX	
Closing Balance of Cash	 XXXX	

Note: The negative figures are presented in brackets.

Indirect Method

To find out Cash from operations in **indirect method**, we should add back all the non operating expenses to and subtract all the non operating incomes from the current year's profit and subsequently should give effects toward the changes in **Working Capital**.

Profit before taxation and extraordinary itemsX	XXX	
Add:		
Adjustment (non-cash & non-operating items)		
Depreciation	XXXX	
Interest Expense	XXXX	
Interest Income	(XXXX)	
Dividend income	(XXXX)	
Operating Profit before Working Capital changes	XXXX	
Add: Decrease in Current Assets (sources)	XXXX	
Increase in Current Liability (sources)	XXXX	
Less: Increase in Current Assets (application)	(XXXX)	
Decrease in Current Liability (application)	(XXXX)	
Cash Generated from operations		XXXX
Less: Income Taxes paid		(XXXX)
Cash Flow from Operating Activities	(A)	XXXX
Cash Flow from Investing Activities		
Proceeds from sale of Fixed Assets	XXXX	
Purchase of Fixed Assets and Investments	(XXXX)	
Dividend Received	XXXX	
Interest received	XXXX	XXXX
(B)		XXXX

Cash Flow from Financing Activities	
Proceeds from borrowings	XXXX
Proceeds from issue of shares	XXXX
Payment of long term borrowings	(XXXX)
Payment of dividends	(XXXX)
(C)	XXXX
Net Cash Flow during the year = (A+B+C)	XXXX
Add: Opening Balance of Cash and Cash	XXXX
Equivalents	
Closing Balance of Cash	XXXX

We present below a simple illustration of preparing a cash flow statement using Direct Method.

Example 6: Rewanchal Software

The following are the list of transactions for Rewanchal Software Limited (RSL) of the financial year 2009:

- On March 1, Rewanchal & others invested Rs 50,000 in cash in RSL.
- On March 2, Rewanchal took a loan of Rs 20,000 from Venugopal. Being a friend, Venugopal does not demand any interest on the loan amount, and asks it to be repaid in six months time.
- On March 3, RSL purchased for cash two computers, each costing Rs 29,000.
- On March 4, RSL purchased supplies especially stationary for Rs 6,000 on credit.
- On March 19, RSL completes its maiden sale of software to a retail store and receives a price of Rs 12,000.
- On March 21, RSL pays Rs 2,000 to its creditors for supplies.

- On March 29, RSL pays salaries to its employees, amounting to Rs 4,000 and as office rent Rs 1,200.
- On March 30, RSL delivers a software package for a shoe shop. The customer agrees to pay the price of Rs 8,000 a week later.
- On March 31, Rewanchal withdraws Rs 3,500 for his personal use.

At the end of the month you are required to prepare its statement of cash flow:

Suggested Solution

The first and second transactions of raising owner's equity and taking a loan would be part of its financing activities. This can be dubbed as cash inflows.

The third transaction involving RSL purchasing two computers would be part of its investing activities. This is the cash outflow. The fourth transaction would not lead to any change in its cash position, and hence, would not be part of its cash flow statement for the month.

The next transaction on March 19, wherein RSL completes its maiden sale of software to a retail store and receives a price of Rs 12,000 would be part of its operating cash inflow. On March 21, RSL pays Rs 2000 cash (part of its payables) to its supplier resulting in an operating cash outflow.

RSL pays salaries to its employees, amounting to Rs 4,000 and as office rent Rs. 1,200 resulting in operating cash outflow.

RSL delivers a software package for a shoe shop worth Rs 8,000 and the customer agrees to pay the price a week later. This transaction would result in neither a cash inflow nor a cash outflow, and hence, there would be no change in our statement of cash flow for the month.

On March 31, the owner withdraws Rs 3,500 from the profits of the company. We consider the same to be dividend resulting in a cash outflow due to the firms financing activities.

A summary of all the above transactions would be:
Table 7.1Statement of Cash Flow for the Period 1st to 31st March, '09(All figures in Rupees)

Rewanchal Software Limited						
Cash Flows from Operating Activities:						
Cash received from customers	12,000					
Cash paid to suppliers, rent, and employees	(7,200)					
Net cash provided by operating activities		4,800				
Cash Flows from Investing Activities						
Purchase of office equipment	(58,000)					
Net cash provided by investing activities		(58,000)				
Cash Flows from Financing Activities						
Capital invested by owner, Equity	50,000					
Withdrawal by owner	(3,500)					
Loan	20,000	0				
Net cash provided by financing activities		66,500				
Net increase (decrease) in cash position		13,300				
Beginning cash balance		0				
Cash balance at the end		13,300				



Bholuram: Hey Finnova, I am confused in separating items like interest received, interest paid, dividend received and dividend paid into various activities.

Finnova: Don't worry Bholu, I will help you. Look, interest received on long term investments is an investing activity, and any interest paid on loans and debts are financing activities. Similarly, dividend paid is an financing activity and dividend received is an investing activity. If a financial enterprise, dealing in securities, receives the dividend, then it will be an operating activity as its main operations is dealing in securities and not investing in it.

Now, can you tell me where will the fees you would pay me go in my cash flow statement?

Bholuram: Of course, operating activities.

Finnova: Correct!! You are on track.

Example 7: Shikari Shambu Security

Shikari Shambu was running an investigating agency, Shikari Shambu Security Services Limited. From the summary cash account of the firm, prepare the cash flow statement for the year ended 31.3.2009.

Shikari Shambu Security Services Ltd.						
Receipts	Amount	Payments	Amount			
Cash balance as on 1.4.08	100	Cash purchases during the year	2,000			
Issue of equity shares	150	Factory expenses incurred	250			
Issue of preference shares	150	Wages & salary paid	150			
Cash sales for the period	2,300	Income tax paid	50			
Sale of fixed assets	600	Dividend paid	150			
		Repayment of loan	400			
		Balance on 31.3.09	300			
Total	3,300	Total	3,300			

 Table 7.2
 Summary Cash Account for the Year Ended 31.3.2009 (All figures in Rupees)

Suggested Solution

As we read in the chapter, preparation of the cash flow statement can be done using two methods, viz., the direct method and the indirect method. Only the calculation of cash flow from operating activities is different under both the methods, though the results are the same.. We use the direct method here. The direct method requires the gross receipts and payments to be disclosed. Accordingly, our cash flow statement would be:

	Shikari Shambu Security Services Ltd.				
	Particulars	Amount			
(A)	Cash Flow From Operating Activities				
	Receipt from customers (cash sales)	2,300			
	Payment to suppliers (cash purchases)	(2,000)			
	Payment for factory expenses	(250)			
	Payment for salary & wages	(150)			
	Income tax paid	(50)			
	Total (A)	(150)			
(B)	Cash Flow from Investing Activities				
	Sale of fixed asset	600			
	Total (B)	600			
(C)	Cash Flow from Financing Activities				
	Issue of equity shares	150			
	Issue of preference shares	150			
	Repayment of loan	(400)			
	Dividend paid	(150)			
	Total (C)	(250)			
	Total Cash Flow for the Period (A) + (B) + (C)	200			
	Add: Opening cash balance	100			
	Closing cash balance	300			

Table 7.3	Cash Flow Statement for the Year Ended 31.3.2009 (All
	figures in Rupees)

Note: The negative figures are presented in brackets.

The company has shown a very weak performance wherein, the cash has been generated through the sale of fixed assets and through issue of shares rather than through operations. The cash was basically utilized for repayment of loan and for paying the dividends.



Solved Illustrations

Example 8: Ganguram Constructions Pvt. Ltd.

From the following balance sheet, prepare the fund flow statement.

.Ganguram Constructions Pvt. Ltd.						
Assets	Year 2008	Year 2009	Liabilities	Year 2008	Year 2009	
Current Assets	Amount	Amount	Current Liabilities	Amount	Amount	
Cash & Bank balances	10,000	20,000	Sundry Creditors	10,000	55,000	
Sundry Debtors	25,000	50,000				
Stock	10,000	15,000				
Total Current Assets	45,000	85,000	Total Current Liabilities	10,000	55,000	
Fixed Assets			Long Term Liabilities			
Land	30,000	50,000	Long term Loans	15,000	20,000	
Building	20,000	20,000				

Table 8.1 Balance Sheet as at 31st March (All figures in Rupees (Lakhs))

Table 8.1 (Contd.)

Ganguram Constructions Pvt. Limited					
Assets	Year 2008	YearLiabilitiesYearY2009200820			
Total Fixed Assets	50,000	70,000	Total Long Term Liabilities	15,000	20,000
			Shareholders' Funds		
			Equity Share Capital	25,000	25,000
			Preference Share	10,000	10,000
			Profit & Loss Account	35,000	45,000
			Total Shareholders' Funds	70,000	80,000
Total Assets	95,000	155,000	Total Liabilities	95,000	155,000

Suggested Solution

In order to prepare the fund flow statement, we have to calculate the change in the working capital first. This can be described in the following way:

Table 8.2Statement of Changes in Working Capital (All figures in
Rupees (Lakhs))

M/s Ganguram Constructions Pvt. Limited						
Particulars	Year 2008	Year 2009	Increase in Working Capital	Decrease in Working Capital		
Current Assets:						
Closing Stock	10,000	15,000	5,000			
Sundry Debtors	25,000	50,000	25,000			
Cash in Hand	10,000	20,000	10,000			
Total (A)	45,000	85,000				

(Contd.)

Table 8.2 (Contd.)

_ . .

M/s Ganguram Constructions Pvt. Limited					
Particulars	Year 2008	Year 2009	Increase In Working Capital	Decrease In Working Capital	
Current Liabilities					
Sundry Creditors	10,000	55,000		45,000	
Total (B)	10,000	55,000			
Working Capital (A) – (B)	35,000	30,000			
Decrease in Working Capital		5,000	5,000		
Total	35,000	35,000	45,000	45,000	

Based on the above figures, we can easily prepare the funds flow statement.

Table 8.3	Fund Flow	Statement	(All figures	in Rupees	(Lakhs))
-----------	-----------	-----------	--------------	-----------	----------

M/s Ganguram Constructions Pvt. Limited							
Particulars	Amount						
Sources:							
Funds From Operation (Increase in the Profit)	10,000						
Increase in Loan	5,000						
Decrease in the Working Capital	5,000						
Total (A)	20,000						
Applications:							
Land Purchased	20,000						
Total (B)	20,000						

We can interpret from the above fund flow statement that it is investing in land, with a hope for future opportunity and growth prospects.

Example 9: Munna Bhai Enterprises

From the information provided by Munna Bhai Enterprises, we can prepare a statement of changes in working capital and the fund flow statement for the year.

Munna Bhai Enterprises							
Assets	Year 2008	Year 2009	Liabilities	Year 2008	Year 2009		
Current Assets	Amount	Amount	Current Liabilities	Amount	Amount		
Cash in Hand	10,000	2,000	Sundry Creditors	3,00,000	2,00,000		
Bank Balances	20,000	8,000	Provision for Taxes	10,000	15,000		
Sundry Debtors	2,10,000	1,80,000	Proposed Dividend	50,000	60,000		
Stock	4,00,000	4,50,000					
Total Current Assets	6,40,000	6,40,000	Total Current Liabilities	3,60,000	2,75,000		
Fixed Assets							
Fixed Assets	8,00,000	11,00,000					
Less : Accumulated Depreciation	1,60,000	2,70,000					
Total Fixed Assets	6,40,000	8,30,000					
Other Assets			Shareholders' Funds				
Investments	1,60,000	6,70,000	Equity Share Capital	9,80,000	17,15,000		
			General Reserves	1,00,000	1,50,000		
Total Other Assets	1,60,000	6,70,000	Total Shareholders' Funds	10,80,000	18,65,000		
Total Assets	14,40,000	21,40,000	Total Liabilities	14,40,000	21,40,000		

Table 8.4 Balance Sheet as at 31st March 2009 (All figures in Rupees)

It is also known that machinery costing Rs 100,000, with an accumulated depreciation of Rs 30,000 was sold for Rs 60,000.

Suggested Solutions

By this time, it is quite clear that we can easily prepare a statement of changes in working capital, if we are able to identify the current assets and the current liabilities. This is because the statement of changes in working capital presents the net change in the working capital for the period. Our statement of changes in working capital for Munna Bhai Enterprises is as follows:

Munna Bhai Enterprises							
Particulars	Year 2008	Year 2009	Increase in Working Capital	Decrease in Working Capital			
Current Assets:							
Closing Stock	400,000	450,000	50,000				
Sundry Debtors	210,000	180,000		30,000			
Cash in Hand	10,000	2,000		8,000			
Bank Balance	20,000	8,000		12,000			
Total (A)	640,000	640,000					
Current Liabilities:							
Sundry Creditors	300,000	200,000	100,000				
Provision For taxes	10,000	15,000		5,000			
Proposed Dividends	50,000	60,000		10,000			
Total (B)	360,000	275,000					
Working Capital (A) – (B)	280,000	365,000					
Increase in Working Capital	85,000			85,000			
Total	365,000	365,000	150,000	150,000			

Table 8.5 Statement of Changes in Working Capital (All figures in Rupees)

Now, before preparing the fund from operation statement and the fund flow statement, we have to calculate the amount of depreciation charged for the year and also the amount of profit or loss on account of sale of machinery. For this, we need to prepare a machinery account in the following manner.

Table 8.6	Changes in the Machinery Account for the Year 2009 (All figures in
	Rupees)

Munna Bhai Enterprises					
Particulars	Amount				
Balance of Fixed Assets as at 2008	800,000				
Less: Cost of Machinery sold	100,000				
Balance in fixed assets group after sale	700,000				
Amount of Fixed assets as at 2009	1,100,000				
Difference being additional purchase in the Year	400,000				

The written down value of the machinery is the cost minus the accumulated depreciation up to the point of sale. The sale price of the machinery, minus the written down value of the machinery sold, was Rs 60,000 - [Rs 100,000 - Rs 30,000]. Loss on sale of machinery comes to Rs 10,000.

Based upon the same logic, we have to calculate the amount of depreciation for the year

Table 8.7 Depreciation for the Year 2009 (All figures in Rupees)

Munna Bhai Enterprises					
Particulars	Amount				
Opening Balance of Accumulated Depreciation	160,000				
Less: Accumulated depreciation of machinery sold	30,000				
Balance in the accumulated depreciation account	130,000				
Closing balance as on 2009	270,000				
Difference being depreciation for the year	140,000				

Table 8.8 Funds From Operations for the Year 2009 (All figures in Rupees)

Munna Bhai Enterprises					
Particulars	Amount				
Profit for the Year (Increase in General reserves)	50,000				
Add: Depreciation	140,000				
Non-operational activity (loss on machine)	10,000				
Funds From Operations	200,000				

Table 8.9 Fund Flow Statement for the Year 2009 (All figures in Rupees)

Munna Bhai Enterprises						
Particulars Amount						
Sources:						
Funds from Operation	200,000					
Proceeds from Sale of Machinery	60,000					
Proceeds from Issue of Shares	735,000					
Total (A)	995,000					
Applications:						
Purchase of Machinery	400,000					
Purchase of Investment	510,000					
Increase in Working Capital	85,000					
Total (B)	995,000					

We can say that the enterprise has been using its funds in assets that would generate the funds in future. The enterprise is good at managing its working capital fund and also in generating funds from operations.

Example 10: Mungeri Lal & sons

Mungeri Lal was a farmer, managing a small farm. He saw no future in traditional cultivation (using chemicals) and shifted to organic farming (under contract) for a big multinational. His last two year's financial statements are given below:

Mungeri Lal & Sons							
Assets	Year 2009	Year 2008	Liabilities	Year 2009	Year 2008		
Current Assets	Amount	Amount	Current Liabilities	Amount	Amount		
Cash & Bank	20,000	15,000	Sundry Creditors	10,000	0		
Sundry Debtors	20,000	15,000					
Stock	15,000	10,000					
Total Current Assets	55,000	40,000	Total Current Liabilities	10,000	0		

Table 8.10 Balance Sheet as at 31st March 2009 (All figures in Rupees)

Table 8.10 (Contd.)

Mungeri Lal & Sons						
Assets	Year 2009Year 2008LiabilitiesYear 2009Year 2008					
Fixed Assets			Long Term Liabilities			
Land	80,000	70,000	Loan from Bank of 30,000 15,000 Rajasthan			
Total Fixed Assets	80,000	70,000	Total Long Term Liabilities	30,000	15,000	
			Shareholders' Funds			
			Capital	95,000	95,000	
			TotalShareholders' Funds	95,000	95,000	
Total Assets	1,35,000	1,10,000	Total Liabilities	1,35,000	1,10,000	

Table 8.11 Profit & Loss Account for the year ended March 2009 (All figures in Rupees)

Mungeri Lal & Sons					
Particulars	Amount	Amount			
Sales		10,000			
Less: Cost of goods sold					
Material Consumed	6,000				
Gross margin		4,000			
Less: Other operating expenses	4,000				
Profit		Nil			

Based on the information given above – please prepare the fund flow statement for him.

Suggested Solution

Based on the above data, we go ahead and prepare the fund flow statement of Mungeri Lal & Sons:

	Mungeri Lal & Sons					
	Particulars					
(A)	Sources:					
	Funds From Operation	Nil				
	Loan from Bank of Rajasthan	15,000				
	Total	15,000				
(B)	Applications:					
	Land	10,000				
	Change in Working Capital (Balancing Figure)	5,000				
	Total	15,000				

Table 8.12 Fund Flow Statement for the Year 2009 (All figures in Rupees)

Here we can see that the company's source of funds has been through bank finance, which has been used for purchase of land & in maintaining its working capital. It doesn't show a good sign. The company's operation is contributing nothing towards the firm funds requirement.

Example 11: M/s Abdul Nayeem & Co.

M/s Abdul Nayeem & Co. provides you with this profit & loss account and balance sheet for the previous two years. The directors are interested in tracking down the activities that generated cash inflows during the year ending March 31, 2009. Prepare a cash flow statement based upon the following details.

M/s Abdul Nayeem & Co.								
AssetsYearYearLiabilitiesYearYear2008200920082008								
400,000	500,000	Equity share capital	250,000	500,000				
200,000	Nil	Preference share capital	50,000	20,000				
150,000	300,000	Debentures	100,000	40,000				
41,000	200,000	Long term Borrowing		30,000				
	Year 2008 400,000 200,000 150,000 41,000	Year 2008 Year 2009 400,000 500,000 200,000 Nil 150,000 300,000 41,000 200,000	Year 2008Year 2009Liabilities400,000500,000Equity share capital200,000NiiPreference share capital150,000300,000Debentures41,000200,000Long term Borrowing	Year 2008 Year 2009 Liabilities Year 2008 400,000 500,000 Equity share capital 250,000 200,000 Nil Preference share capital 50,000 150,000 300,000 Debentures 100,000 41,000 200,000 Long term Borrowing				

Table 8.13Balance Sheet as at 31st March (All figures in Rupees
(Thousands))

Table 8.13 (Contd.)

M/s Abdul Nayeem & Co.								
Assets	s Year Year Liabilities Year Year 2008 2009							
		Net Profit	100,000	119,000				
Reserves & Surplus 291,000 291,								
Total 791,000 1000,000 Total 791,000 1000,00								

Table 8.14 Profit & Loss Account for the Year Ending 31st March 2009 (All figures in Rupees (Thousands))

M/s Abdul Nayeem & Co.							
Particulars	Amount	Particulars	Amount				
To Purchases (Cash)	15,000	By Sales (cash)	30,000				
To Salaries & Wages	5,000	By Interest Received	10,000				
To Income Tax	1,000	By Dividend Income	15,000				
To Debenture Interest	6,000						
To Dividend (Preference Share)	3,000						
To Dividend (Equity Share)	6,000						
To Net Profit	19,000						
Total	55,000	Total	55,000				

Suggested Solution:

Table 8.15 Cash Flow Statement for the Year Ended 31.3.2009 (All figures in Rupees (Thousands))

M/s Abdul Nayeem & Co.	
Particulars	Amount
(A) Cash Flow From Operating Activities	
Sale of goods	30,000
Paid to suppliers	(15,000)
Paid to employees	(5,000)
	(Contd)

(Contd.)

Table 8.15 (Contd.)

M/s Abdul Nayeem & Co.	
Particulars	Amount
Income tax paid	(1,000)
Total (A)	9,000
(B) Cash Flow From Investing Activities	
Dividend received	10,000
Interest received	15,000
Sale of investments	200,000
Purchase of fixed assets	(100,000)
Purchase of machinery	(150,000)
Total (B)	(25,000)
(C) Cash Flow From Financing Activities	
Issue of equity shares	250,000
Long term borrowings	30,000
Debentures redeemed	(60,000)
Preference shares redeemed	(30,000)
Debenture interest paid	(6,000)
Dividend (Preference shares)	(3,000)
Dividend (Equity shares)	(6,000)
Total (C)	175,000
Total Cash Flow for the Period (A) + (B) + (C)	159,000
Add: Opening cash balance	41,000
Closing cash balance	200,000

The company has good prospect to grow, it seems it's on an expansion phase by investing in fixed assets and machineries. Paying dividends regularly and maintains positive flow from operations.

Summary

In this book, we developed the idea of flows of funds within the organization. Starting with the funds requirement for an organization, we traced the sources and uses of funds.

We have tried to study the important sources of funds, namely the funds generated from operations, sale of fixed assets, long-term borrowings and issue of new capital. Similarly, important uses of funds were traced to acquisition of fixed assets, payment of dividends, repayment of loans and capital etc. The whole exercise reveals the areas in which, funds are deployed and the sources from which, they are obtained. We also learned how to go about constructing the fund flow statement with the help of published accounting information.

We then looked at the various advances made by accounting bodies on the flow of funds. It was identified that a stand-alone fund flow statement had shortcomings in providing a few insights into a business entity's present and future financial position, especially from the liquidity perspective. The discussion then pointed out that a statement of cash flow does away with these shortcomings in a fund flow statement. Finally, we also learned about the statement of cash flow and its preparation. Using multiple illustrations, we analyzed a few statements of cash flow from real life.

Exercises

1. Answer the following by completing the blank.

1.1 An increase in the following items can be a source of funds:

- a. -----
- b. -----
- с. -----

1.2 An increase in the following items can be a use of funds:

- a. -----
- b. -----
- С. -----
- 1.3 A decrease in the following items can be a use of funds:
 - a. -----
 - b. -----
 - с. -----
- 1.4 A decrease in the following items can be a source of funds:
 - a. -----
 - b. -----
 - C. -----

2. Answer the following Multiple Choice Questions

A. Khisco Limited paid income tax on Capital Gains resulting from disposal of capital assets. This amount would be shown in the statement of cash flow as a deduction in ______ type of activities:

Exercises 79

- a. Operating activities
- b. Investing activities
- c. Financial activities
- d. None of the above
- B. Idledays Financial Services Limited, a non-banking financial services company, made a total loan of Rs. 420 Crore during the financial year 2009. This amount will be classified as part of:
 - a. Operating activities
 - b. Investing activities
 - c. Financial activities
 - d. None of the above
- C. Shehardhan Brokerages Limited, a stock broking firm received Rs. 143 lakhs as premium for forward contracts entered for dealing in equity shares. This amount would be classified as:
 - a. Operating activities
 - b. Investing activities
 - c. Financial activities
 - d. None of the above
- D. Daruwala Limited made an investment in its subsidiary Soda-Batliwala Limited. This would be shown as part of _____
 - ____ in the Statement of Cash Flow:
 - a. Operating activities
 - b. Investing activities
 - c. Financial activities
 - d. None of the above
- - a. Operating Activities, Net Cash Inflow of Rs. 100 Crore
 - b. Operating Activities, Net Cash Outflow of Rs. 100 Crore

- c. Financing Activities, Net Cash Inflow of Rs. 100 Crore
- d. Financing Activities, Net Cash Outflow of Rs. 100 Crore



- 1.1 a. Issues of Share
 - b. Issue of Debentures
 - c. Long Term Loans
 - d. Non Operating Revenue Receipts (Dividend received)
 - e. Fund from Operations
- 1.2 a. Purchase of Fixed Assets
 - b. Purchase of Investments
 - c. Non Operating Revenue expenses (Dividend paid and payment of Taxes)
 - d. Increase in Working Capital
- 1.3 a. Shares
 - b. Debentures
 - c. Long Term Loans
 - d. Operations
- 1.4 a. Fixed Assets
 - b. Investments
 - c. Working Capital
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 - B. (c)
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 - D. (b)
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