Financial Accounting
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Lecture – 100
7.12 Tutorial - Cash Flows from Financing Activities

This is a tutorial on Cash Flows from financing activities, the third subsection of the Cash Flow Statement.

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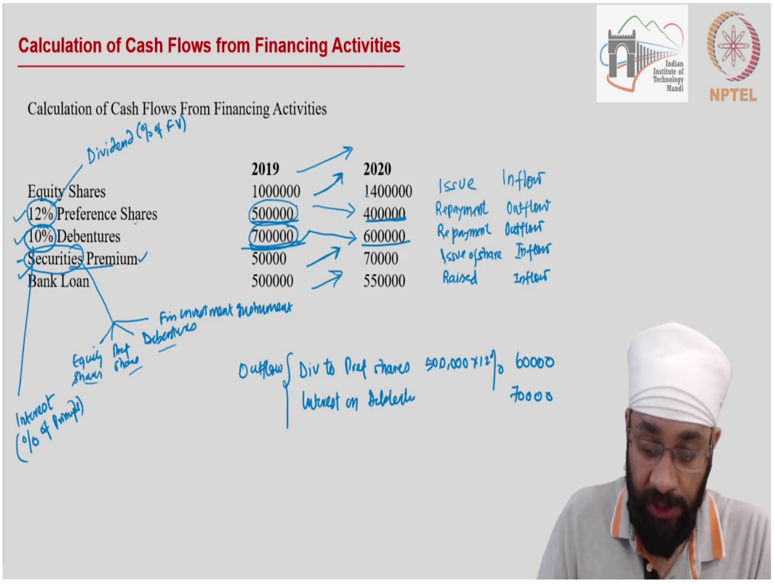

We are going to use this information on the liability side. We have been given selected information, not a full-fledged balance sheet and income statement. Using this we are going to prepare the third subsection and we will identify the net cash used in or from the financing activities of this company.

The key learning in this tutorial is going to be that even without the balance sheet and income statement, you can figure out the cash flows from financing activities and there are a couple of hidden points which we will need to identify to prepare the cash flows.

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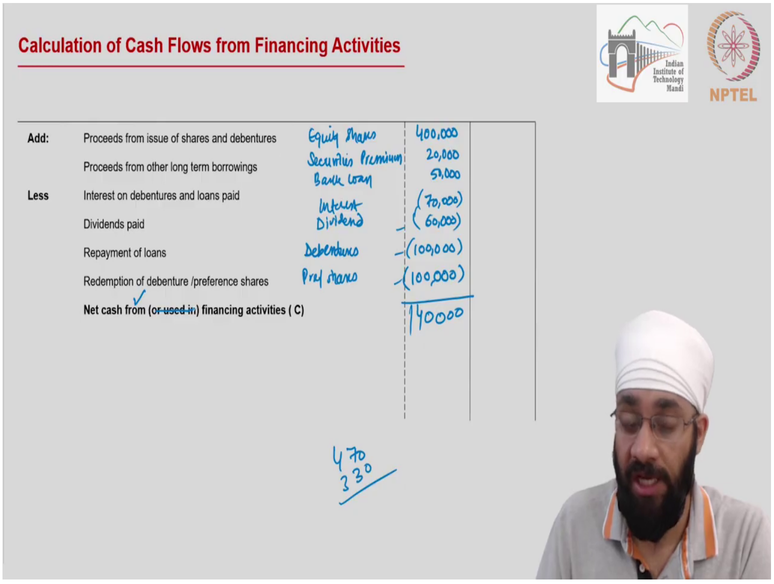

So, we are going to use the same format. Let us look through these numbers. Now, here the direction of change is from left to right, you have 2019 given first and then 2020. The equity shares are going up which means there has been a new issue of equity shares and this brings in cash flow to the business. The preference shares are actually going down which means there has been a repayment or redemption of preference shares which means the cash has gone out of the business.

There are debentures 700,000 to 600,000. This is also going down; that means, there has been a repayment, this is also an outflow. Securities premium is going up. So, there is an issue of shares due to which there is an increase in cash flows and in a while, I will explain what is the security premium. Then, bank loan also goes up which means bank loan has been raised. This is also an inflow.

Now, let me explain this securities premium account. I think I have mentioned it once before, the word securities is a generic term which is used to refer to all the different types of shares. So, equity shares, preference shares, even the debentures or any other financial investment instruments are covered in this umbrella term called securities. On one hand if you take a bank loan you provide a security, you provide a collateral, you use the term security for that as well, but here securities refer to financial instruments which can be of different types. And, when you issue them at a higher price compared to their book value, the additional money that you get, in addition to the book value is called a premium and it is being earned on the issue of security. So, they call it a securities premium account.

So, this money which is this balance which is going up is because you are issuing new shares as well. So, 400,s000 worth of shares are being issued and you are getting a premium of additional 20,000 that is what it means and essentially the security premium belongs to the shareholders, it is part of the shareholders funds, the net worth of the company.

In addition to this, there are a couple of other points. 12 percent preference shares, what does it mean? This 12 percent refers to the dividend rate. The preference shares have a fixed rate of dividend and 12 percent is the rate of dividend, but 12 percent of what? 12 percent of face value; this is the percentage of face value of the preference share not the percentage of profit, that is to be understood.

Then 10 percent debentures refers to the interest rate on debentures. I am going to write it here. This is the interest rate as a percentage of the principal amount. So, just like we calculate interest on the principal, in case of preference shares you calculate the dividend on the face value which is a kind of principal that the shareholders put into the business.

So, 12 percent preference shares means 12 percent interest dividend will have to be paid by the company during the year, but on what amount? Let me write dividend to preference shares at the rate 12 percent, but what is the amount? We are going to assume that this was the balance in the beginning of the year and at the end of the year you repaid some amount of preference shares. Therefore, the dividend will have to be paid to everybody, since the beginning, whosoever has kept the money in the business. So, on 500,000 you will pay 12 percent. So, 500,000 into 12 percent is the dividend for the preference shares and the interest on debentures in the same way is 10 percent. So, you will pay it on the opening balance again. You pay back this 100,000 rupees worth of debentures, but we assume that this happens at the end of the financial year.

So, you had used this money during the year, you will have to pay interest on the amount which was at the beginning the opening balance of this account. So, this comes out to be 70,000 and this comes out to be 60. These are the outflows that were not directly given.

Now, if you had a profit and loss account you would see dividend paid, interest on debentures there, but here you had the percentages given and you have to understand, you have to guess/estimate that this amount must also have been paid. Of course, there can be more things which are not given here, but using this information these are the different points that we can derive.

Let us just transfer these numbers to the statement. So, equity shares additional 400,000 being issued issue of shares. So, equity shares 400,000 then you have preference shares which are being repaid 100,000, repayment of preference shares. This is repayment, so this is an outflow. Then you have debentures which are being repaid as well 100,000. These are debentures.

Then you have a securities premium which brings in 20,000. So, 20,000 I will write securities premium. Bank loan is going up 50,000. So, raised bank loan and then are the payments of dividend and interest – 60,000 is the dividend and this is a negative number and interest is 70,000. So, interest being paid 70,000, that is it.

All we have to do now is sum these up. So, this comes out to be 470,000 and this is 330,000 that is it. So, 140,000 is the net cash inflows. Cash from, we will cut this off, so cash flows from the financing activities is 140,000, using the information that was provided to us. So, that is how the third subsection in the cash flow statement is prepared..