Financial Accounting
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Lecture – 88
7.0 Recap and way forward

Congratulations, yet again, on completing another topic in this course. In this video, I am going to recap the previous topic and talk about the things to come.

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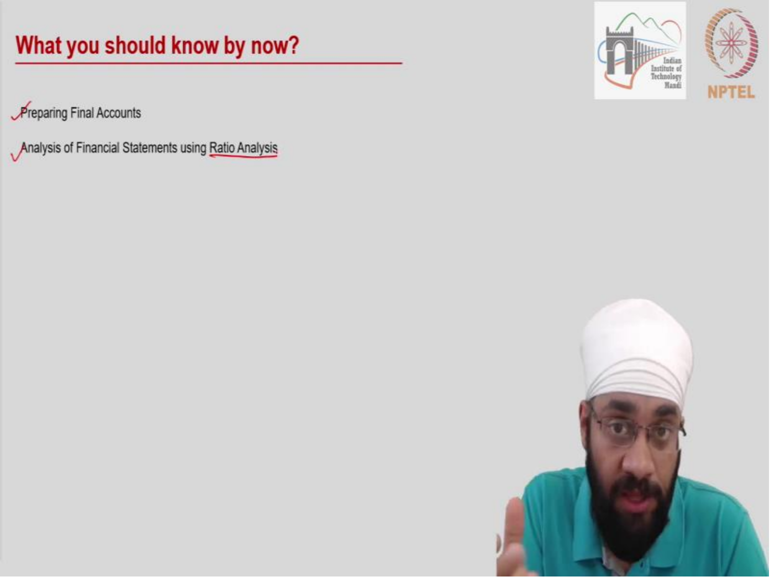

So, till now you have learnt to prepare the final accounts. You are aware of the income statement and balance sheet. And, you are also aware of the analysis technique called ratio analysis. We looked at four different categories of indicators which indicate the financial health of a company.

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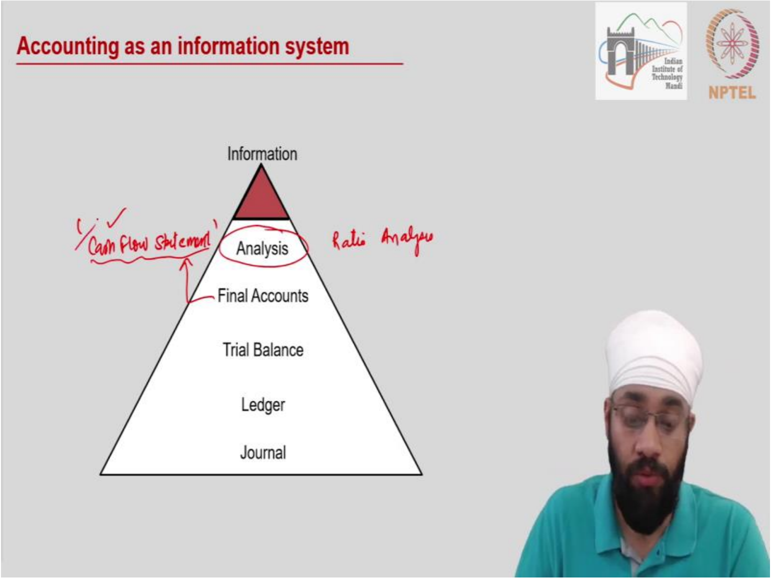

Going forward, we are going to talk about another tool of analysis. In addition to the ratio analysis, we have another tool which is called cash flow statement. It helps us analyze a little bit more from a different perspective.

Although this is a statement, and I have earlier said that this is a part of the final accounts as well, because public companies need to prepare all these three statements and disclose these statements to the public as well; however, cash flow statement is prepared based upon the income statement and balance sheet. Using the data from these two statements we do some analysis with respect to the cash position of the business. Hence, we like to think about cash flow statement essentially as an analysis statement as well. So, this is what we are going to do going forward.

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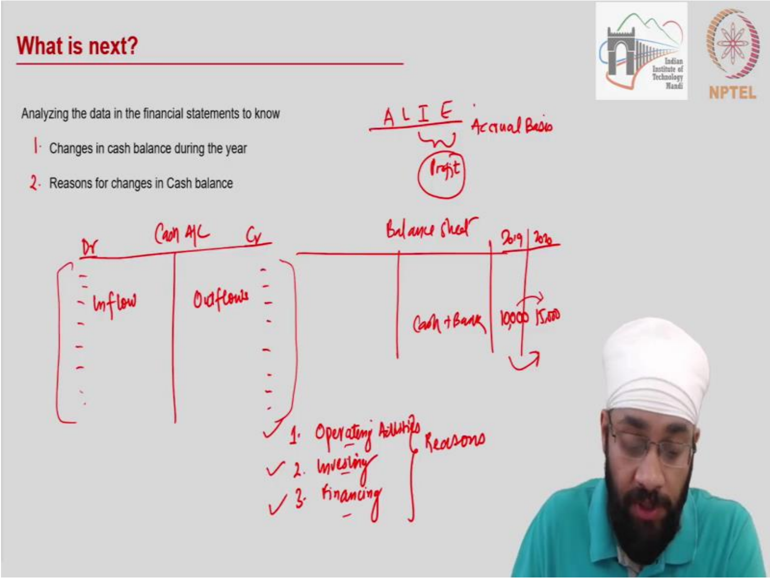

The issue with the final accounts is that assets, liabilities, incomes and expenses, all these accounts are prepared on an accrual basis. Accrual basis meaning whether or not cash is paid, whether or not cash is received, if any income or expense has become due or if you have received or delivered the benefit against those expenses or income, you have to consider those expenses and income as belonging to a given financial year. This means that the profit that you calculate in the income statement is not necessarily equal to the cash profit that you make. So that information is missing in the final accounts that we have.

The idea is to look at what are the various transactions which affect the cash of the business, how does the cash position of the business change. So, we begin with let's say a balance sheet of a company. And in the balance sheet you have data for the last 2 years and you have cash and bank balance. Let us say the cash balance changes from 10,000 to 15,000. And this was 2019; this is 2020. 2 years of data is shown in the balance sheet, and I am only looking at say asset side. So, now the question is what caused these changes? How did these additional 5000 rupees come into being? Now, during the year there will be thousands of transactions due to which cash would have come in or gone out. What is the net impact of all those transactions? The net impact is that cash goes up by 5000, but you have no detail available as to which activities.

Now, you could go to the ledger account, and look at the cash account and say these are the items which affected cash. So, let us say this is the cash account, the ledger account you have debit side and you have credit side. You have all the sources of inflow of cash on the debit side, and all the outflows of cash on the credit side. So, you could go to this account. However, this account again is going to give you a list that these are the items of inflows and these are the items of outflows. We already have this information.

What is really required to do in this new technique of analysis is to categorize the inflows and outflows into certain categories. These categories are as follows. We have an operating category, we have an investing category, and we have a financing category. What do I mean by these categories? These categories are basically the reasons due to which cash comes into the business or cash goes out of the business.

Now, operating activities, there are certain operating activities in the business which refers to the primary activities of the business day-to-day functioning, the purpose for which the business was started. If cash comes in or goes out into these activities, we say the reason for cash flow here is the operating activities. Likewise, there are certain activities which are branded as investing activities and the other category is called financing activities.

So, in this statement, we first of all look at the change in the cash balance during the 2 years, and then we identify the reasons for changes in the cash flows. The reasons are divided into three: operating reasons, investing and financing reasons. This breakdown is provided, so that the stakeholders in a business know whether the operating activities contribute cash to the business or do they take away cash from the business during a financial year, and the same for the rest of the two categories.

There you go. This is what we are going to discuss in the videos to come. I will see you in the next video.