Financial Accounting
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Lecture – 89
7.1 Types of Cash Flows

Alright, let us get started with understanding the cash flow statement. The first thing that we are going to discuss is the type of cash flows.

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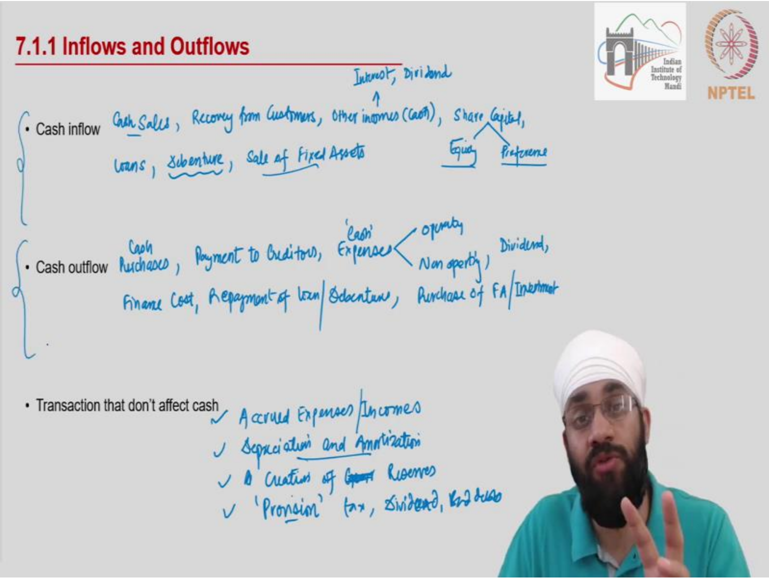

There are different types of transactions in a business. We need to categorize them into: transactions which bring money into the business and transactions which take money out of the business. So, let us brainstorm on where all you get the cash from. You get the cash coming into the business primarily when you sell the goods. So, through sales you get cash. However, it is possible that you are selling goods on credit in which case you are not receiving the cash right now. That means we are essentially talking about cash sales: sales for which would receive immediate cash. And for sales for which you recover money later from the customers you can call them recovery from customers or received from customers at a later point in time when the payments are received from the customers. So, these are two primary sources of cash in a business. Oher than this, you could possibly receive income from any other source. Let me write any other incomes, again cash and not the accrued incomes. If you have received the income, receive the cash against the income, that is the part of the transaction that we are talking about here. Other than this, you could possibly raise new capital, shareholders can bring in money. So, share capital can bring money into the business. You could also raise loans, loans from banks, loans from other financial institutions. Debenture is also a kind of loan that you take, not from one institution, but multiple institutions, or multiple individuals. You could also have equity shares or preference shares. The share capital can be divided into two and in addition to this you could sell some assets during the year because its life has ended or its utility is no more in the business. So, let us say the sale of fixed assets of the business here.

I think primarily these are the cash flows. Then what I was thinking of was other incomes which can be from different sources: you could earn interest on the deposits from the bank or you could have a dividend which you earn on the investment in shares etc. So, these are the categories of cash inflows. There may be one or two more, here and there, but largely this covers how cash comes into the business.

Now, how does cash go out of the business? Well, all the things which are opposite of this. When we have cash sales here we can write the opposite of this which is purchases. When you purchase and you pay in cash that is what we are talking about. Also, you have to pay to vendors which is later after the purchase has been done, payment to creditors.

Expenses can be operating or non-operating and they can be direct, indirect: all the expenses which are paid in cash. We are not talking about the accrued expenses; meaning the expense had become due, but you have not paid them; we are only talking about expenses for which you pay in cash. So, these are the outflows. In addition to this we may pay a dividend to the shareholders. So, any dividend paid and payment of interest on the loan. So, let me write finance cost, financial expenses, this includes all the interest. Then you have loans, you could pay the loans; repayment of loans or debentures; sale of fixed assets- the opposite of that is purchase, purchase of fixed assets- or any other investment that you make. When you make the investment at that time cash goes out. Do not get confused by saying hey I am purchasing an asset that is a good thing for business.

Good things are separate; we are talking about what happens to cash. You purchase an asset, but in exchange cash is going out of the business. So, these are the items of cash outflow, the transactions which affect cash immediately not later on.

Now, are there any transactions which do not affect cash, but we still record them in the business? Yes, there are. There are accrued expenses or outstanding expenses. There are accrued incomes, incomes earned but not received incomes.

There are transactions like depreciation; in depreciation we do not pay any vendor any amount of money. We are just writing down, we are just writing off, we are just reducing the book value of a given asset and that is it, we are not paying anybody. So, depreciation does not affect the cash balance of the business. And, if you remember the journal entry for depreciation, it is Depreciation A/c (Dr.), To the asset A/c, which means cash account is not involved at all. Depreciation and amortization, as discussed earlier, (amortization is depreciation on intangible assets) are similar in nature except that they apply on different types of fixed assets.

Other than this there can be creation of reserves, let me write reserves. Reserves can be general or specific. So, creation of reserves basically means you make some profit during the year and then out of the profit you create a separate head of sales and reserve. I am going to use this money for some purpose whenever that purpose arrives or for various different purposes whenever those purposes arise. So, this money is not given to anybody right now. Thus, any creation of reserves does not affect the cash in the business. Also, you can create a business provision which is again a kind of specific reserve that you create to meet your liabilities or possible liabilities in the short run. So, provisions could be on a payment of tax, on payment of dividend, or for bad debts. The purpose is basically to have the money when it is required. So, just put aside some money and you call it a provision because typically any reserve created for short-term, for more specific purposes we call it provision.

So, now, we have seen transactions which involve cash and which do not involve cash. Clearly there are a number of transactions in each of these three categories. And, in the cash flow statement we are going to use the data from the final accounts, from the balance sheet and income statement, and then we are going to say that let us forget about the net profit during the year; because that is not equal to the cash that you make, and I will emphasize that, clarify that point going forward in the course as well. The idea is to segregate the non-cash transactions from the cash transactions and say that if we leave out the non-cash, then what are the other transactions which affected the cash and how.

So, let us move forward.

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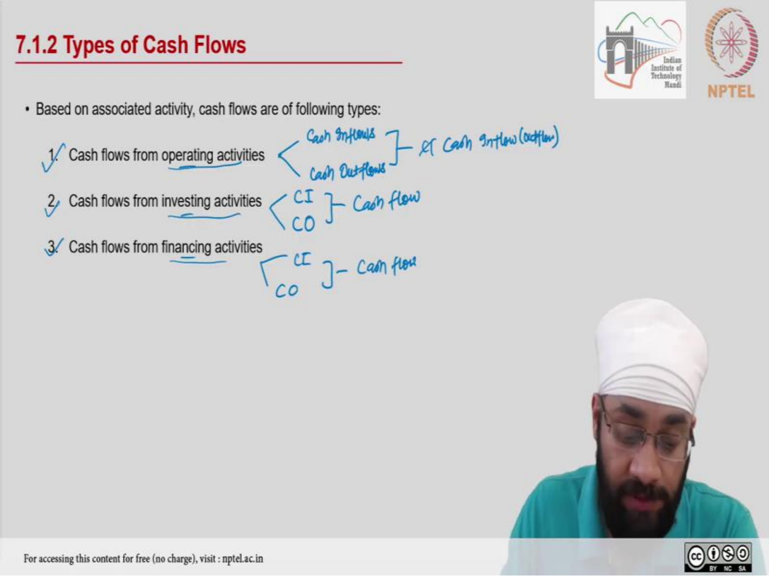

After having understood the inflows and the cash transactions which bring in the money and take out the money, we will now divide the inflows and outflows into three sub-categories and those three categories are operating, investing and financing.

So, what we are saying is that the cash comes into the business due to operating activities of the business. So, there can be cash inflows due to operating activities. However, there can also be cash outflows. So, there can be cash outflows due to operating activities. Can you tell me what is the amount that came into the business or the net amount after the operating activities?

If you take into consideration only the primary activities of the business, the main activities of the business did we make cash or did we lose cash? So, the net result of this is going to be that you either have cash inflow or outflow, one of the two. Can you tell me the net outcome of the operating activities of the business?

Likewise, can you tell me the net result which means cash flow which could either be inflow or outflow? So, cash flow resulting from investing activities of the business and likewise cash flows resulting from the financing activities of the business. And this categorization has been provided in the accounting standards which are followed.

So, you know this is the required statement as well and we have you know there is a format which we have to template which we have to follow and I will introduce you to that as well. So, to summarize till now we are saying that we have to categorize the transactions into cash and non-cash transactions, and then within the cash transactions we will divide, we will sub categorize the transactions into cash flows from operating, investing and financing activities.

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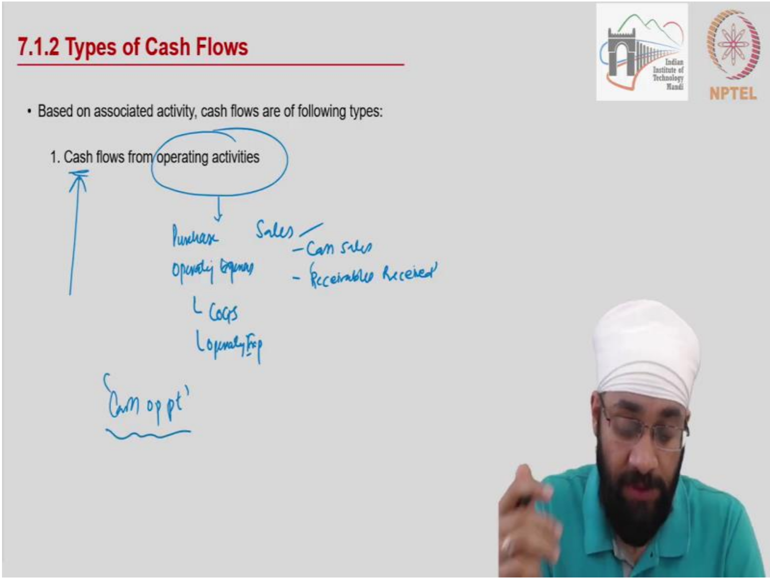

Let me talk a little bit more about each of these three activities. What are the operating activities of the business? Operating activities of the business are purchase and sales. All the operating expenses which typically include cost of goods sold and rest of operating expenses as we have discussed earlier.

In terms of inflows, you have sales, cash sales and you can also recover from the customer. So, receivables received, not only receivables; actually when the customer makes the payment that is what we are talking about here because cash is of importance here.

So, for operating activities we are looking at cash flows as a result of only these activities. Whatever else can be fitted into the definition of operating activities of the business. Again, we have discussed the concept of operating expenses and operating incomes, now we are saying what is the result of the operating incomes and expenses. Tell me the operating profit, but not only operating profit we are saying operating cash profit. So, what is the cash operating? Cash operating profit during the year is the term of interest in this first sub category.

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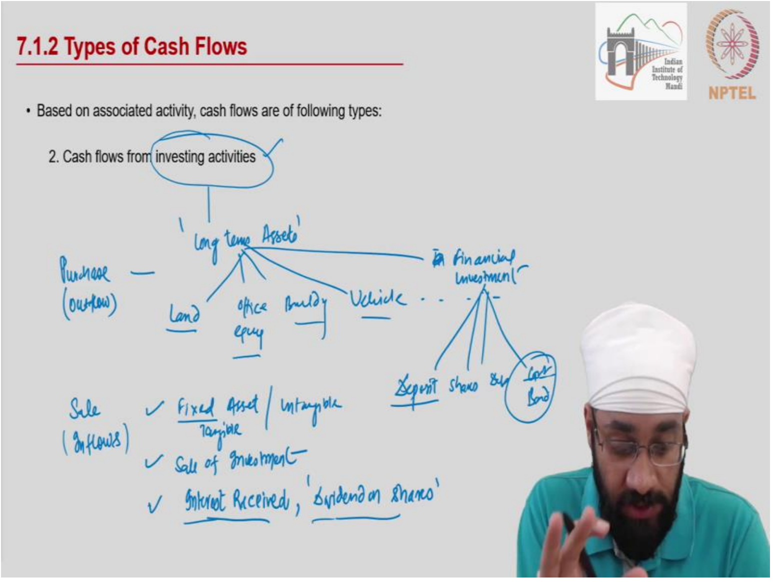

Let us go to the second category which says cash flows from investing activities. Where does business invest the money? The business invests their money in the long-term assets of the business. What are these long-term assets? Well, you have land, you have office equipment, you have buildings, you have vehicles and what not. So, the list can just go on.

You can also have specifically the financial investment that you make. Let me write financial investment and financial investments can further be into different instruments, options that are there. So, you could deposit it into the bank, you could purchase shares of another company. You could purchase debentures of another company, you could put your money in other advanced financial instruments as well government bonds for example, can also be a financial investment. So, purchase of assets or financial investment does not matter, as long as you are putting money in an investment activity, we count that under this subcategory: cash flow from investing activities. Now, purchasing this is the purchase which means this will result in outflow. There will be in flows from investing activities as well. What are the inflows? The inflows are going to be when you sell these assets. It is possible that you have to sell the land or office equipment or building vehicle. You do not start the business to buy and sell fixed assets of course. But, once in a while, whenever the situation demands, you may want to sell these fixed assets and not only fixed assets there can be intangible intangibles as well. So, fixed assets can be tangible or intangible assets, investments could be sold as well. So, sale of investment and in addition to this you could also have return coming in on the financial investments that you have. So, if you have invested in deposits, you will get interest.

So, any interest money that you receive is a cash inflow due to investing activities of the business. So, interest received, you can have dividend on the shares that you have purchased in another company, or again interest on the bonds you can categorize that here. So, the inflows do not only come from the sale of a given asset, but also the interest that you receive, the return that you make on those financial investments as well. This is the second category.

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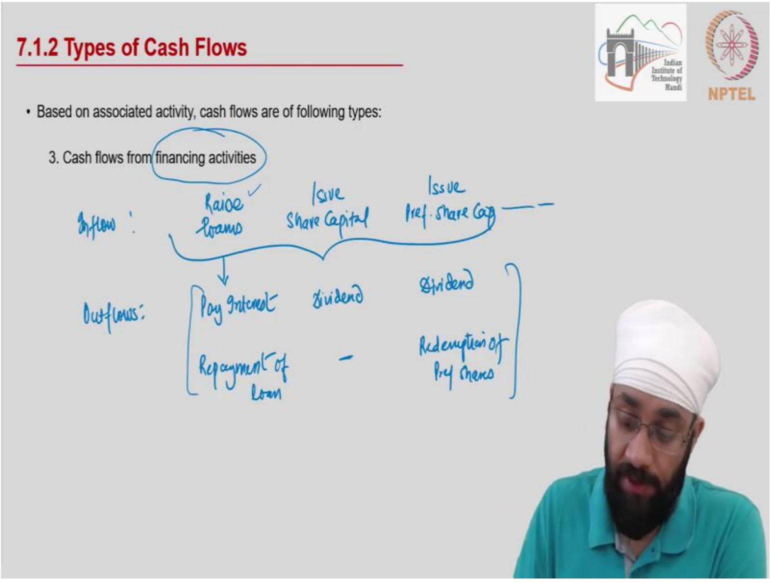

Now, let us go to the third category which is called financing activities. What are the financing activities of the business? Financing means basically bringing in money to support long-term growth in the business. How do you get that money? You get that money through loans by issuing share capital, by issuing preference share capital preference share capital ok.

So, when you issue a share capital let us say the issue of share capital and issue of preference share capital or you can raise a loan from a bank, all of these things are going to bring money into the business. So, money comes into the business due to sale of goods and also when you raise a loan: both are sources of cash to the business. But, when you raise a loan it is a financing activity not an operating activity. When you sell goods, it is an operating activity and not a financing activity. That is the kind of distinction we are that we are trying to create here. So, are there any other sources of long-term funds we could mention here. There can also be outflows due to financing activities.

Well, if you have raised loans you will have to pay interest on the loan. So, any interest that is paid is going to be shown here. If you have issued shares to the people to the investors you will have to pay a dividend same for preference shares. You have to pay these people; you have to service the debt, you have to service the equity as well and then you could repay the loan.

So, repayment or payment of the principal amount, the EMIs that you give, although EMI has both interest and the principal involved. So, together you could call these EMIs. So, repayment of loan; equity capital is typically not redeemed; the preference capital can be redeemed. So, redemption simply is a repayment: the word is used for preference share capital.

So, redemption of preference shares. Typically, preference shares have a lifetime of 5 years 10 years then you repay that. There you go. So, financial activities: these are the activities which will be classified as financing activities.

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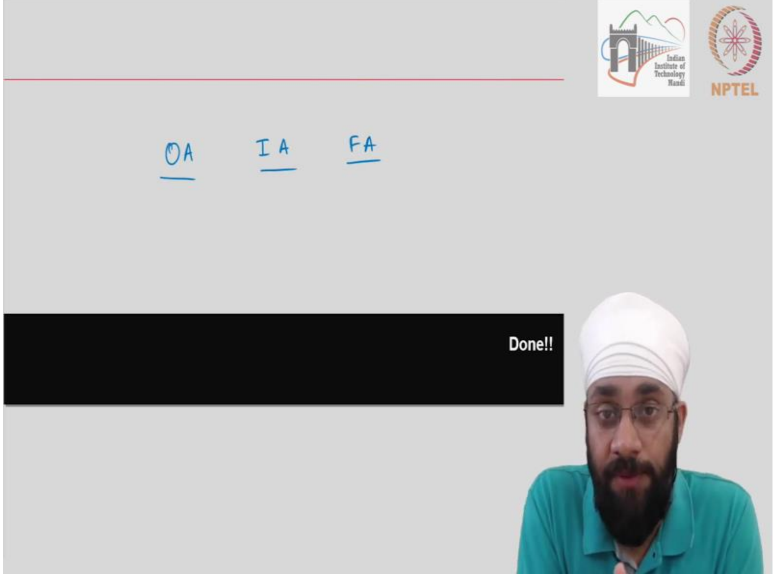

So, you have a fair bit of idea about the operating activities of the business, investing activities of the business, and financing activities of the business. We are also going to do a tutorial where we look at a list of transactions and then we categorize it and then we will go on to looking at more details of the cash flow statement.

I will see you in the next video.