Financial Accounting
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Lecture – 90
7.2 Tutorial - Types of Cash Flows

This is a tutorial. We are going to look at a list of transactions and then categorize them into investing financing or operating activities.

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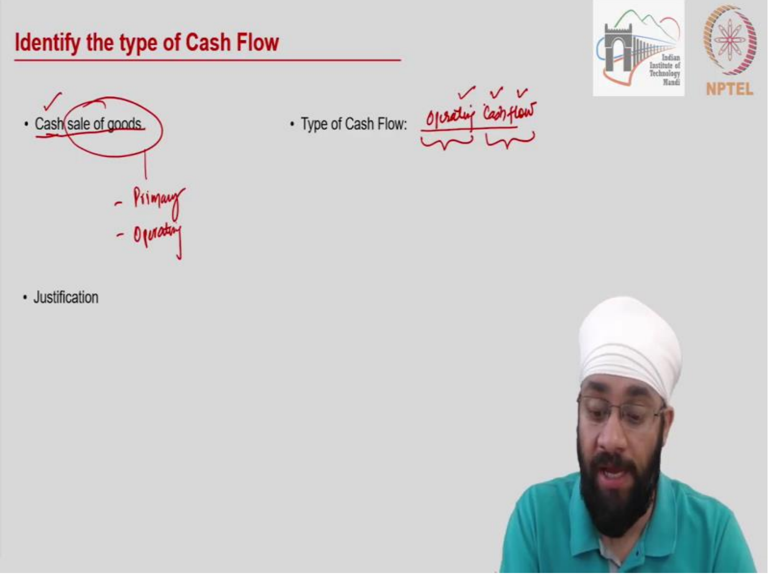

The first item that we have on the screen is cash sale of goods. We have to provide an answer here; which type of cash flow is this and we can do some working notes here. So, cash sales clearly mean cash is coming in. This first of all qualifies as a cash flow. And then you have sales of goods. The sale of goods is the primary activity of the business and hence the operating activity of the business as well. I do not think there should be any doubt about which category this transaction belongs to. So, we are going to write here operating cash flow; cash coming into the business due to sale of goods is called operating cash flow. Cash flow, because cash is coming in; operating, because this is an operating activity as a result of which cash is coming in.

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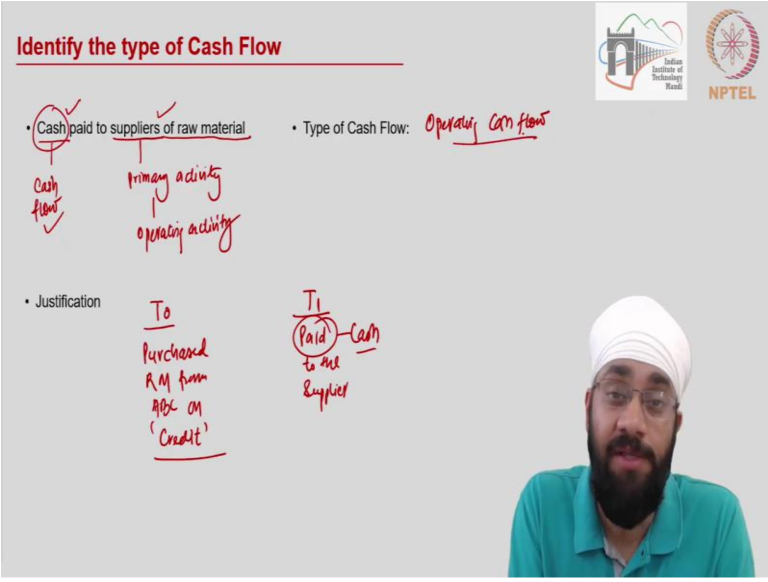

Let us go forward. You have cash paid to suppliers of raw material. Now, these suppliers are getting cash. So, certainly there is a cash flow that is involved; these suppliers would have supplied goods to the business, which are being used as raw material to convert it into the finished goods that may be the purpose of the business. Clearly this is also a primary activity of the business. If it is a primary activity, it is an operating activity; this is the purpose for which the business was created. So, any cash which is coming in is going to be called operating cash flow, operating cash flow. Note that you are paying to the suppliers; this means possibly that at some point, let us say T_0, you would have purchased raw material from your supplier, say ABC. And you would not have paid him; it must have been on credit. But this is not the transaction that is written on the screen, what is written is, at T_1, at some point in time after one month, two months, one year; you are now paying to the supplier, this is the transaction mentioned on the screen. Here cash is involved and hence this qualifies as a cash flow and that is why we are clubbing it under operating cash flow. If the transaction was credit purchases, then we would not consider it as a cash flow.

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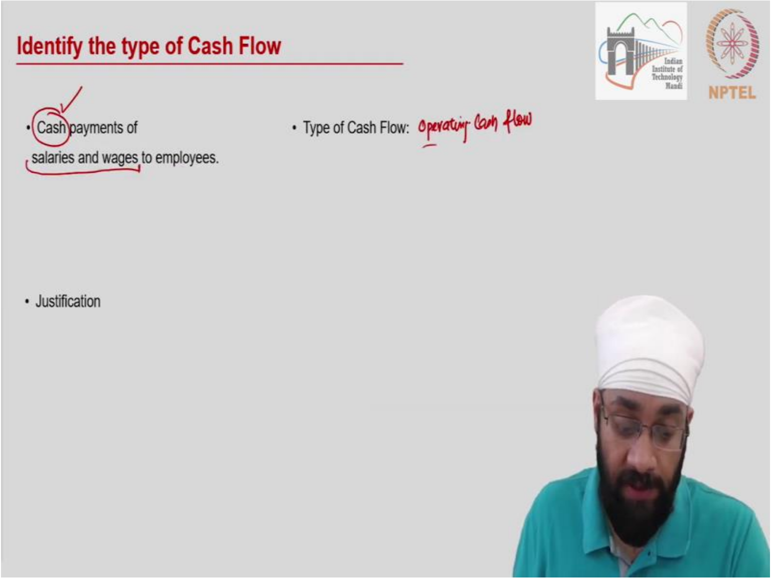

Let us move on. You have cash payment of salaries and wages to the employees of the business. It says cash; qualifies as a cash flow. And then you are paying salaries and wages to employees of the business. Well, that is again a primary activity of the business, you hire people to run the business, this is an operating activity. So, any cash resulting from this activity is going to be called operating cash flow; whether this is an inflow and outflow, I think that is pretty straightforward. So, I am not mentioning that. The idea is to only look at whether this is operating, non-operating and then if it is non-operating, then investing or financing.

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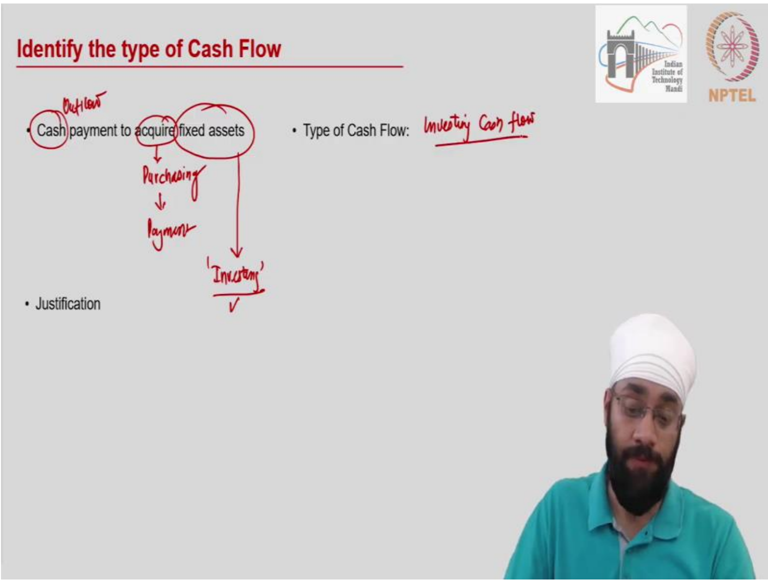

Next up you have cash payment to acquire fixed assets. Cash is involved, so it is a cash flow. You are acquiring, which means you are purchasing. When you purchase, you have to make a payment; which means this is an outflow. And you are purchasing a fixed asset. Now, purchasing the fixed asset comes under the investing activities of the business. Why? Because it helps you build up long-term revenue generation capacity. Now, you can argue that if you have to generate revenue, if you have to make sales, you have to invest in the fixed assets and they should be called operating expenses. But the idea here is to keep operating expenses to typically the short-term expenses, the regular expenses of the business. And any money committed to long term resources, long term assets in the business is going to be clubbed under the investing activities. Of course, they are going to help us generate revenue, help build the capacity; but we are just segregating the two. And we are saying how much investments are we making, because at the end of the day, you are interested in knowing the return on investment. So, we are segregating the investing activities here. Therefore, this is cash flow from investing activities.

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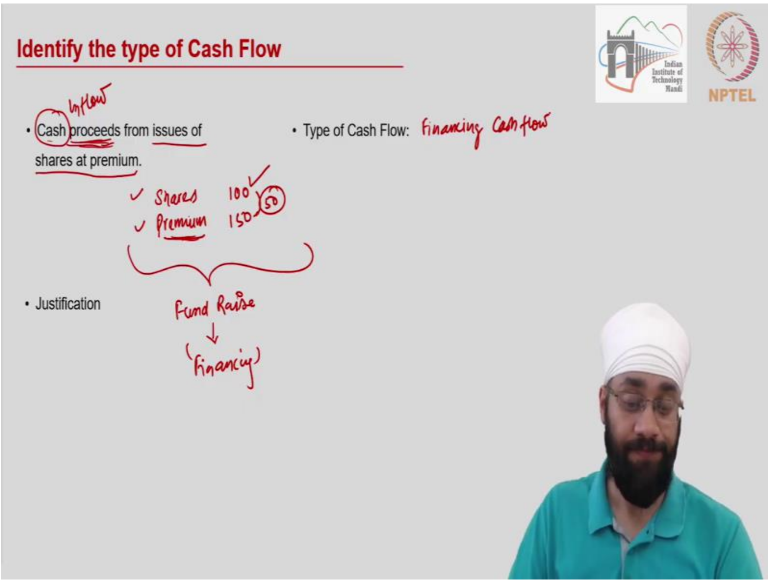

So, investing cash outflow, I will write just flow; but it is an outflow. Next up is cash proceeds from the issue of shares at a premium. So, cash is involved; proceed basically means consideration in exchange for something. What you get, you get cash. So, the proceed is a technical term used for cash being received; it is like the price being received against the goods that are being sold. So, cash proceeds from issues of shares at a premium.

So, shares are being issued. So, there are shares and there is a premium which is being earned as well; there are two items involved, two transactions involved here. So, shares are being issued and the premium basically means, the shares face value was 100; but now you know shares were issued a few years back, at this point in time the shares market value is much higher. Let us say current market value is 150; so, this additional 50 is the premium that you receive. In the books of accounts, when you sell the shares at a higher rate; you record the shares at the face value and whatever additional money you make, you record that, you deposit that in a separate account called securities premium account. And the securities here refer to shares, any financial instrument can be called as security. So, the shares have been issued, the money is coming in; so, this is an inflow. And since we are raising funds here which can be utilized for either the operating activities or investing activities, it does not matter. Right now, funds are being raised; whenever we are talking about raising the funds, we are talking about financing activities. So, this is a financing cash flow of the business. Then you have payment of dividend.

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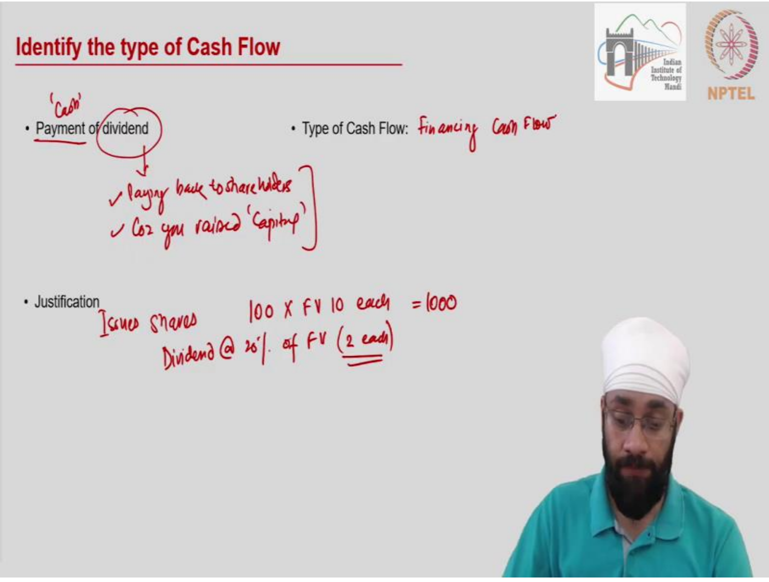

So, payment of dividend, cash is involved or I should say paid dividend to just make it 100 percent sure. What is the dividend? Dividend is return on shares. You issue shares 100 and I think we discussed this during the ratio analysis; you issue 100 shares having a face value of 10 each. So, 1000 rupees worth of capital has been issued. When you pay a dividend, you pay a dividend at the rate 20 percent of the face value. So, 2 rupees each.

That is the dividend that we are talking about. So, you are paying back to the shareholders of the company. Why are you paying them back? Because you raised the capital from them. Now, you are servicing that capital that you have raised from them. Raising the capital is a financing activity and servicing that capital, servicing that resource is also clubbed under the financing activities. So, I will call it a financing cash flow, there you go.

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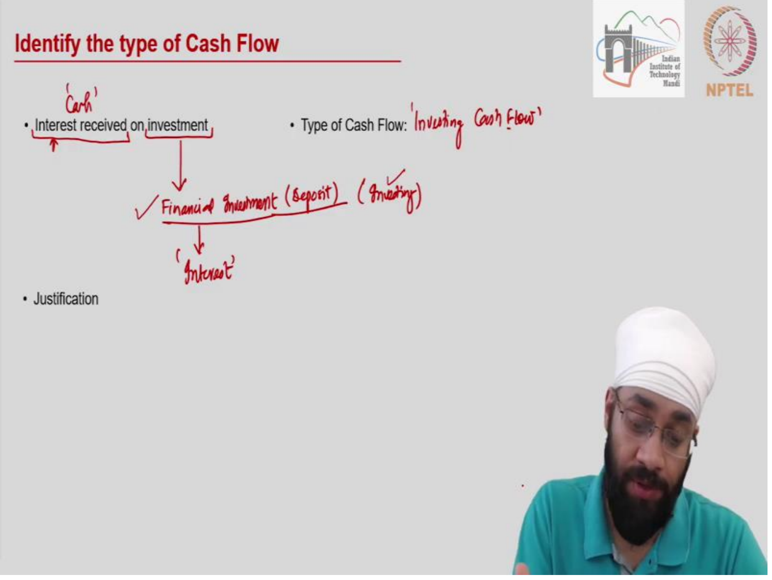

Next up is interest received on investment. Now, interest is being received. So, cash is being received due to this item called interest. You are receiving interest on an investment. Let us make an assumption that this investment is a financial investment. I mean we are not purchasing an asset, because the asset is used in the business, you do not make money through that. But financial investment means you have given a loan to somebody, another company, or you have invested in the shares of a company. So, let us say this is a deposit; you have made a deposit in a bank account. And now you are receiving interest on this deposit, that is what it means. When you make an investment, it is called an investing activity. And now you are earning a return on this investment, which should also be called an investing activity. So, this is called investing cash flow. One more time, the justification is that the investment when it was made was clubbed under investing activities. Now, you are just earning a return on that. So, this interest that you are earning is also categorized under the investing activities of the business.

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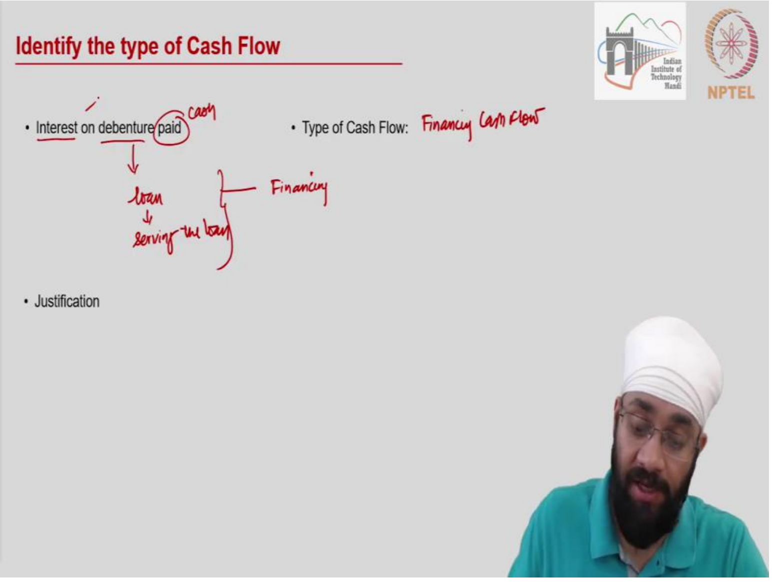

Then you have interest on debentures paid. So, if you have paid something, cash is involved. Debenture is simply a loan that was raised earlier and I have described this earlier. Debentures basically are loans taken from the public; a lot of different institutions, just like shares, except that it is a loan, it is not share capital.

So, it is a loan and now you are servicing the loan. So, you are servicing this loan. A loan when it is taken is clubbed under financing activity and hence the servicing of the loan should also be considered a financing activity. So, we are going to say this is a financing cash flow. I think this was straightforward because we have already seen a category called finance cost in the income statement.

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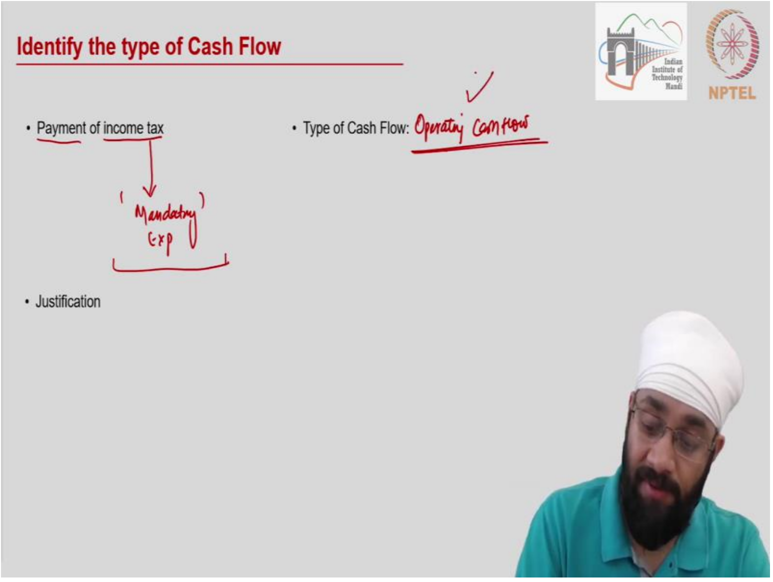

Then you have payment of income tax. Now, income tax is a mandatory expense. In fact, companies when they report their profits during the year, they report their earnings before interest and tax. They say please do not consider taxes; because the higher our income, the higher is the absolute amount of tax that we pay. So, basically income tax is mandatory expense; should you categorize them under operating, or investing, or financing? Well, we do not have any control over it. However, as a result of the operating activities of the business, we have to pay taxes. So, for the purpose of a cash flow statement, wherever we show the operating expenses; because we pay taxes as a result of the incomes and expenses of the business, we show the income tax payment under the operating activities head. It does not necessarily mean that income tax payment is an operating activity. But for the purpose of a cash flow statement, we consider tax as an operating activity. But you could very well argue that this is not why you started the business, so it is not a primary activity and so on. But you know for lack of other categories that we have; we show income tax here.

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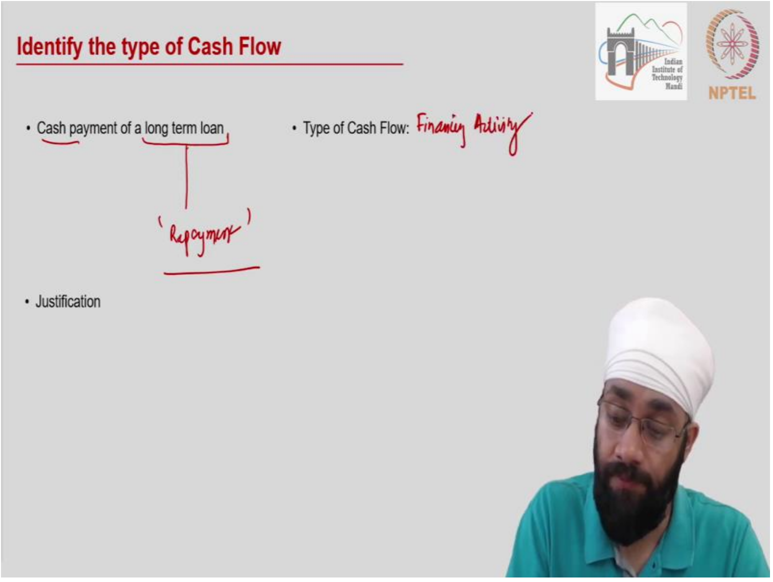

Then you have a cash payment. Again, cash is involved; a long term loan is being repaid. So, this is a repayment, the principal is being paid back. When you took the loan, you called it a financing activity. Now you are repaying the finance that you have raised, so this also should be clubbed under financing activity of the business.

That is it. So, in this tutorial, we looked at a range of transactions and we categorized them into investing, operating, or financing activities. I hope your learning has been reinforced and you have a better understanding of the three subcategories of cash flows; because we are going to make use of these three categories in preparation of the cash flow statement. I will see you in the next video.