Managerial Accounting

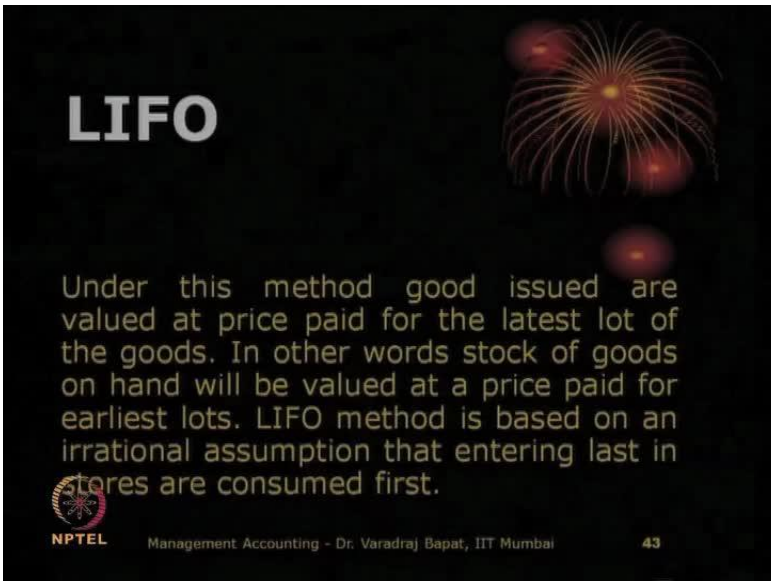
Prof. Dr. Varadraj Bapat
School of Management
Indian Institute of Technology, Bombay

Module - 5 & 6
Lecture - 9
Inventory Valuation, Cash Flow

In our last session, we were talking about inventory valuation. We have already finished our discussion on depreciation. We have also finished our discussion on goodwill and its amortization. In inventory valuation, we have seen the rule that inventory should be valued cost or net realizable value whichever, is less. We have also seen what and how to determine the cost. So, cost consists of the cost of purchase plus, the cost of carriage inward plus cost of changing the condition. Then, we also look at the market value. So, market value is, you have a net realizable value, which is calculated as market value minus, the estimated expenditure on sale. So, the valuation principle for the valuation of stock is cost or net realizable value whichever, is less. Now, what happens is when you have large inventory, it is also difficult to determine the cost. So, there are various methods for determining the cost. One is known as specific identification method. Then, there is a FIFO method or first in first out method, which we have discussed in our last session.

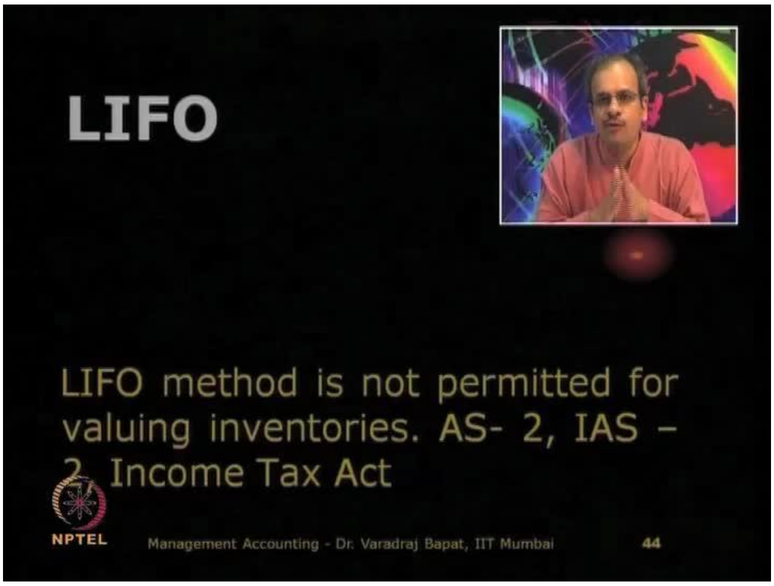
So, in specific identification method, we exactly know which item is where. So, we are able to calculate the cost of that item. In case of FIFO method, you do not know exactly, which item, but we use the concept of first in first out. So, amongst many items, the items which are received first are assumed to be issued out first. So, the latest items are there in the stock. Now, let us go to the next method, which is known as method. So, method is popularly known as last in first out.

(Refer Slide Time: 02:03)



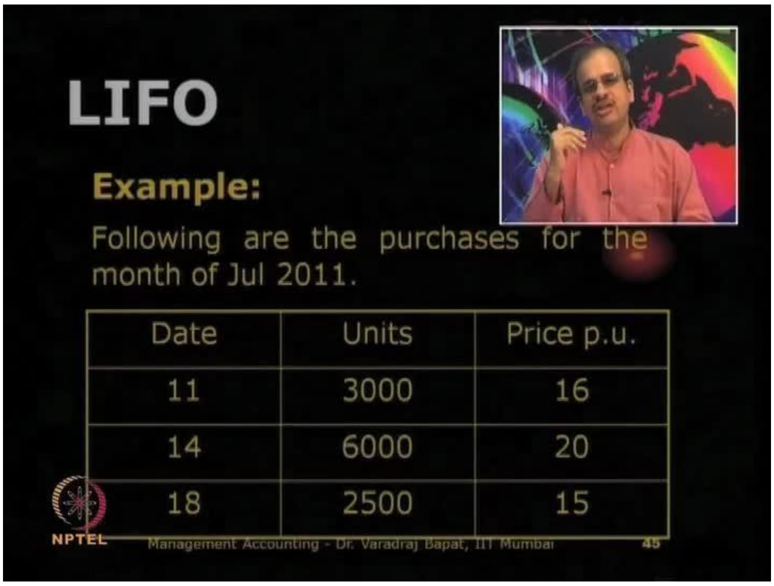
Under this method, the goods which are issued are valued at price paid for the latest lots. So, in other words, what we assume is if we have many goods coming in on different dates, the ones which are received last, are issued out immediately. Consequently, ones which are received earlier always, remain in stock. This is somewhat, an irrational assumption. So, whatever is latest purchased, immediately sold out, whereas, the earlier lots still remain with us in the Go down; that is the assumption under.

(Refer Slide Time: 02:48).



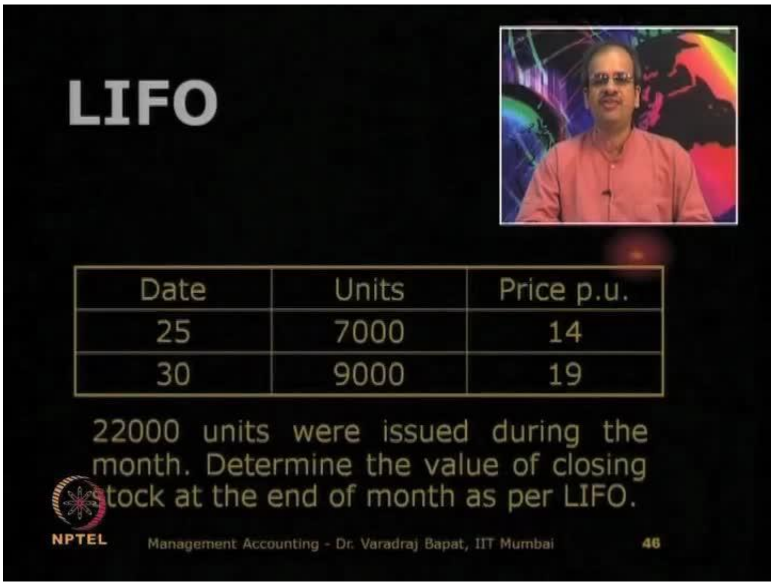
Since, it is not very logical assumption; it is not a permitted method for valuation either, under accounting standard 2 or under international accounting standard 2. As per income tax law also, one is not allowed to use. What happens is under, since the latest goods are issued out immediately, the older lots remains with us. The market value of older lot is not likely to be close to the current market value. That is why; there is a difference in the latest price and the value of stock. That is why usually, method is not recommended. Let us have an example.

(Refer Slide Time: 03:35).



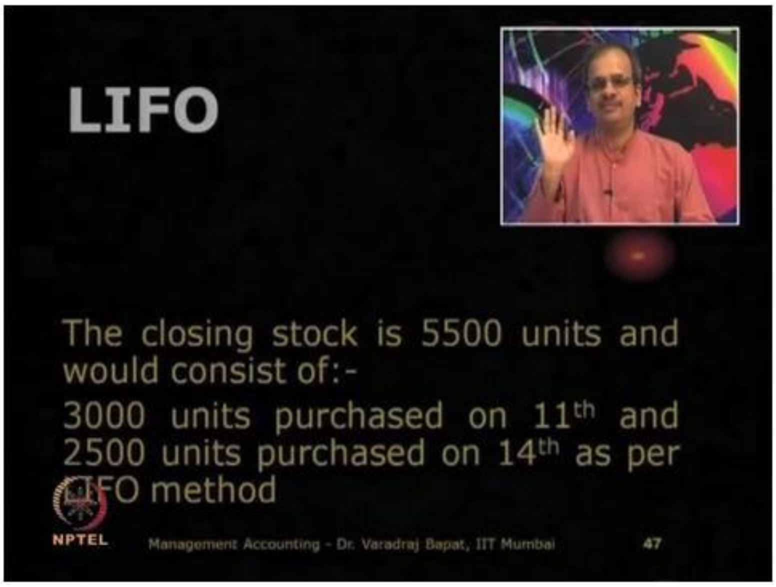
Then, it will be more clear to you. So, in this example, in the month of July, certain purchases are given. You can see here on the date 11, 14, 18, 25 th and 30 th, different units are purchased.

(Refer Slide Time: 03:46)



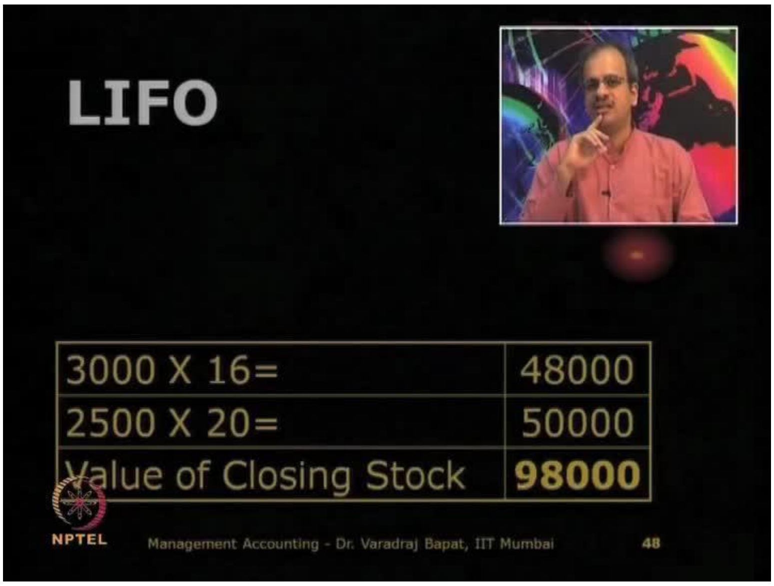
Out of that, 22000 units are issued. We have to determine the value of closing stock at the end of the month. Have a look at the items. So, how will you determine the value? As we did in last example, first we have to calculate the number of units.

(Refer Slide Time: 04:11)



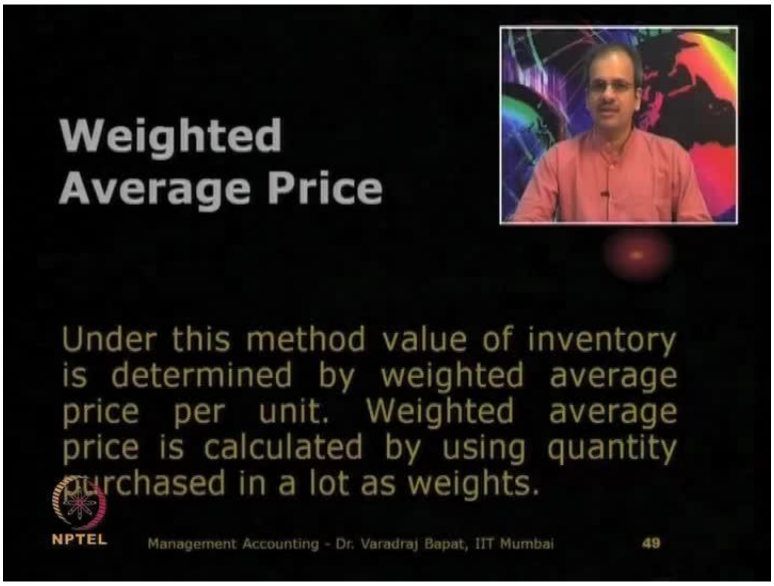
So, number of units in hand are 5500. So, you can see here that on different dates, we have purchased the units of 27500, out of which, 22 are issued. So, closing stock consists of 5500 units. In the latest units are issued out. So, the units which are purchased on 30 th, 25 th, 18 th, etc. are issued out, and a units which are latest in there. So, units purchased on 14 th and 11 th are assumed to be on hand. So, entire stock of 11 th is still in hand and part of stock of 14 th; that is 2500 units are in hand. So, 3000 units purchased on 11 th and 2000 units purchased of 14 th as per the method.

(Refer Slide Time: 05:08).



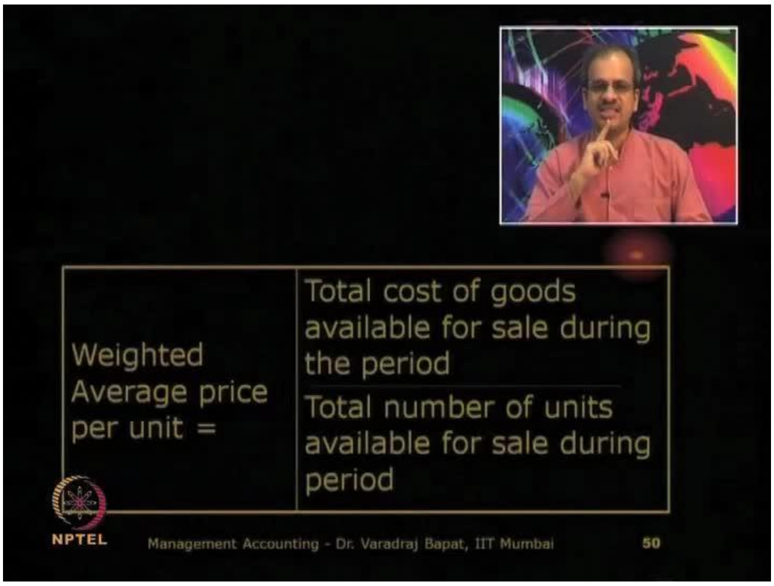
So, this is the valuation; 3000 at 16 and 2500 at 20; the value of closing statement comes to 98000.

(Refer Slide Time: 05:16)



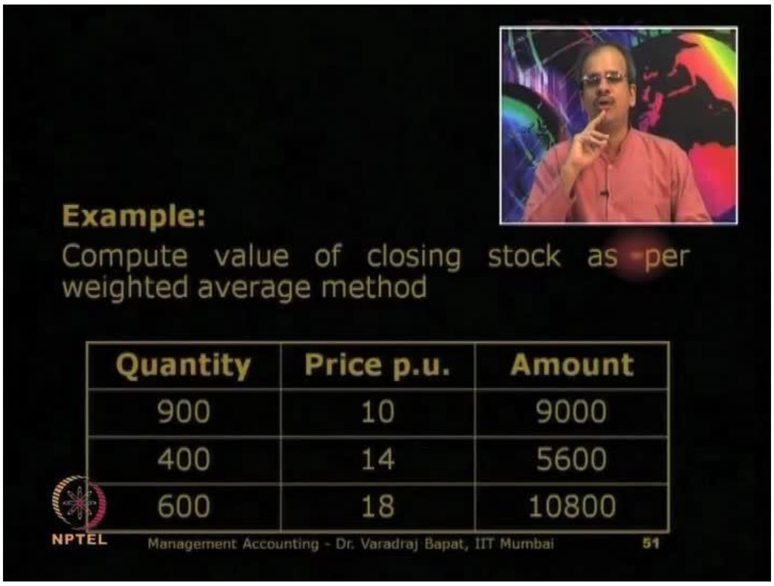
You will realize that under LIFO method, the stock which is being valued is somewhat, not close to the latest prices; whereas, under FIFO method, since the current goods are in hand, they are close to current market prices. Now, there is also another method, which is known as weighted average. So, instead of only taking the latest stock or very old stock, in weighted average method, the weighted average price is calculated. So, the quantity purchased is used as a weight. That quantity into price; we used to determine the weighted average price and then at that price, the goods are issued, and the same price is used for valuing the stock. So, this is that; weight is calculated.

(Refer Slide Time: 06:08)

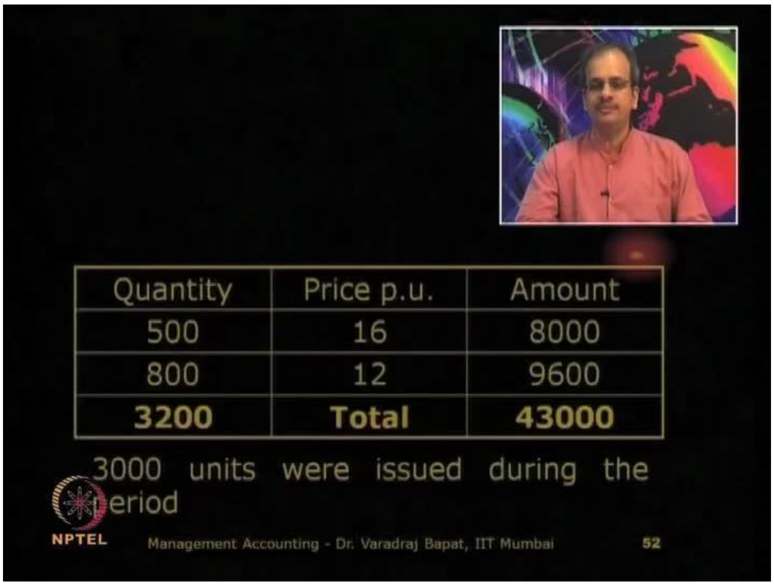


The total cost of goods available divided by total number of units available for sale during the period; this is the weighted average price per unit you can look at the example.

(Refer Slide Time: 06:22)

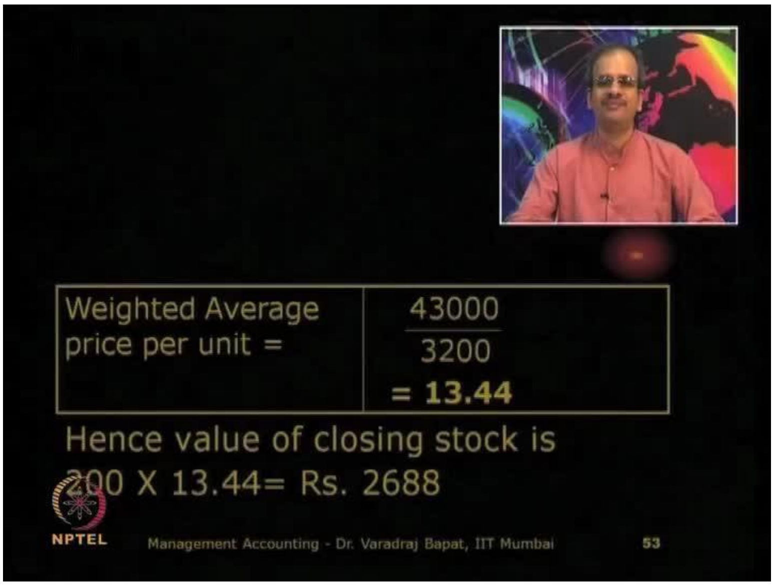


(Refer Slide Time: 06:24)



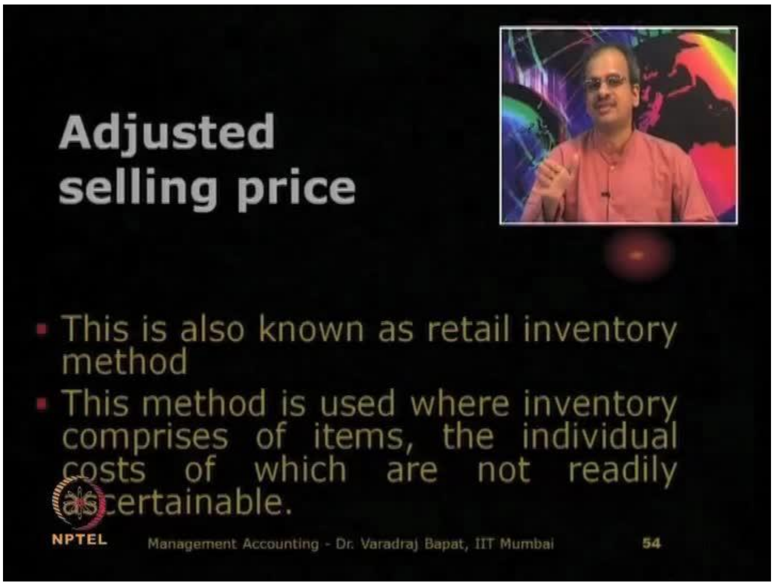
Suppose, these five purchases are there; we have 900 units at 10; 4000 at 14; 600 at 18 and so on. So, total purchases are 3200; the total cost of purchase is 43000, and in that period, 300 units were issued. So, calculate the value of stock. How to calculate? As you can clearly see, 3200 units have come in, out of which, 3000 are in hand; remaining 200 are, sorry, 3000 are issued; remaining 200 are in hand. So, instead of using, now, can you tell me which method can be used? Suppose, if you are using FIFO or LIFO, you would have only picked up the earliest or the latest stock. In weighted average, we will find the weighted average price of all the items, and that will be used for valuing the stock.

(Refer Slide Time: 07:26)



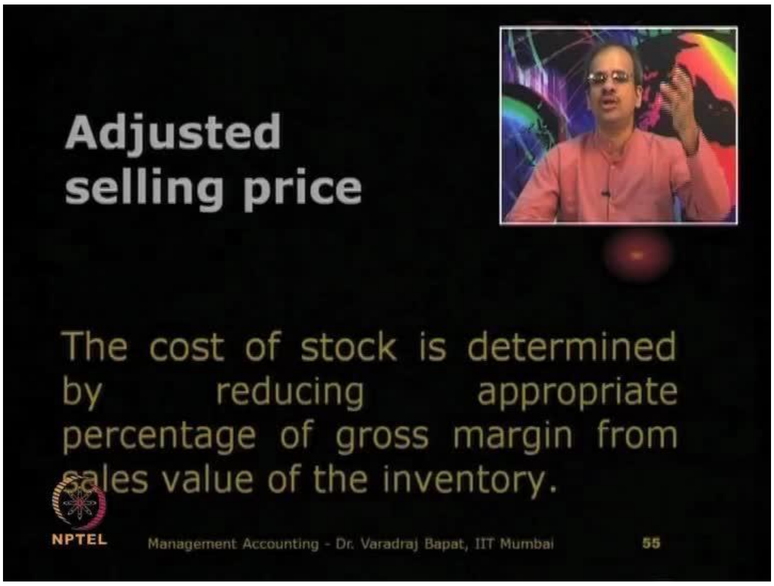
So, weighted average price, you can see here; it is 43 upon 3200. So, 13.44 per unit and the value of closing stock is 400 into 13.44; so 2688. This is one of the systematic methods. So, accounting standard as well as income tax act, allows the companies to use either, FIFO or weighted average.

(Refer Slide Time: 07:52)



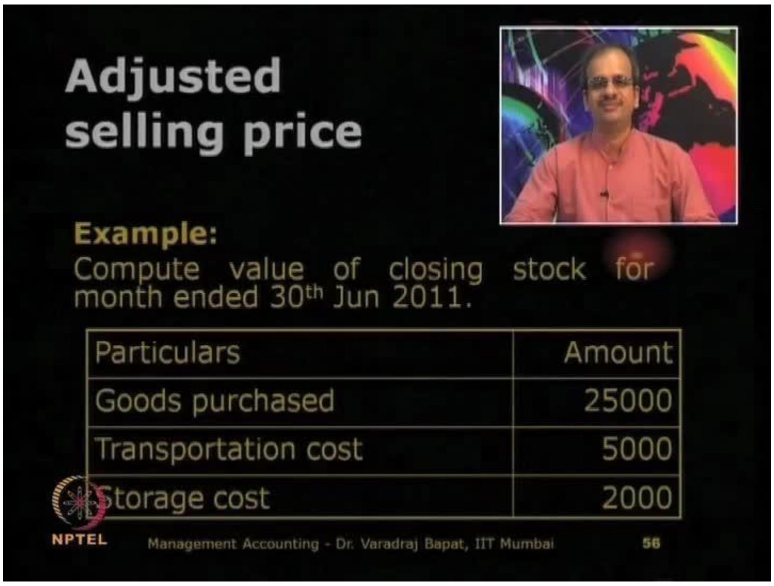
There are also, some more methods that is known as adjusted selling price. Now sometimes, it is very difficult to even know the cost of the items, because items are purchased at number of times. There might not be a proper record of the cost of items, purchased at different times, but they may be aware of the selling prices. Especially, in retail industry, because the MRP is given on the pack; it may be easy to know the selling price; it may not be so easy to know the cost. So, in such cases, what is done is based on the selling prices, the cost is calculated. That is why it is known as adjusted selling price method.

(Refer Slide Time: 08:38)



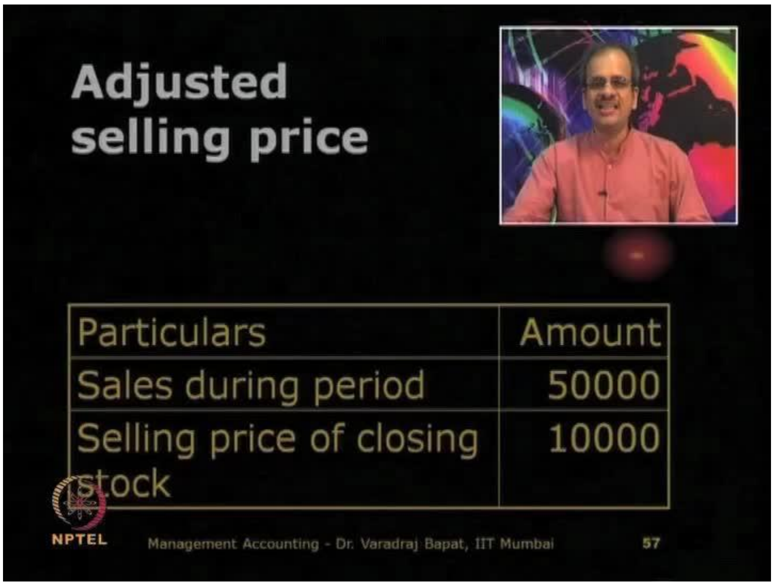
So, what is done is you know the market price. You reduce the profit, which will give you the cost.

(Refer Slide Time: 08:50)



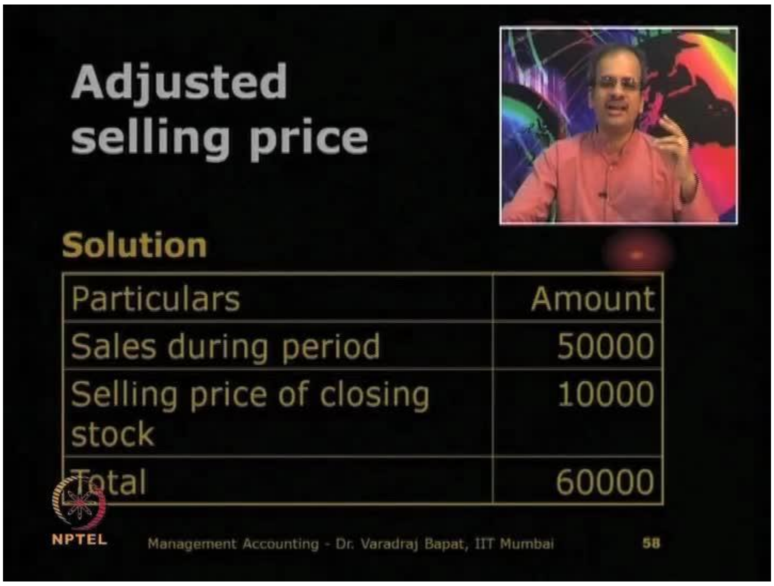
So, let us have a look at an example. You are given goods purchase, transport cost, storage cost, sales and selling price of the closing stock.

(Refer Slide Time: 09:01)



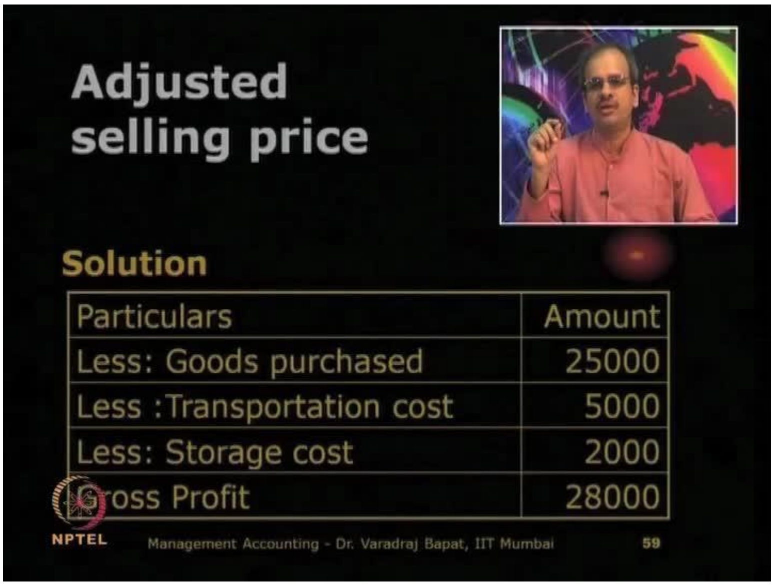
So, you know that your total cost is 25, 5 and 2, and out of these stocks, your sales are 50000 plus, you have a stock of 10000. Calculate the value of closing stock. So, how will you calculate the value of closing stock; any guesses? You cannot show the value at 10000, because that is a selling price. So, using the margin available, you will try to estimate the cost of these items.

(Refer Slide Time: 09:41)



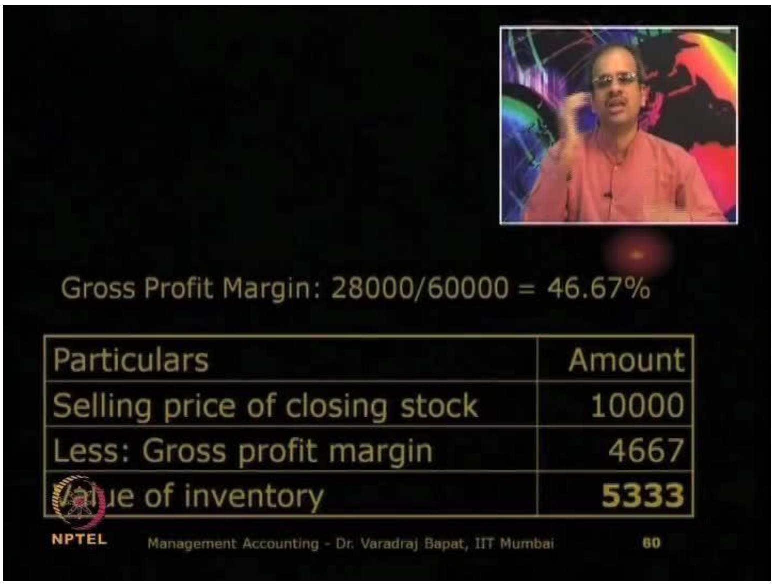
We know that the sale, 50 plus selling price of the closing stock. So, total amount available for sale is 60. The goods which are in hand, consists of 25 to 5.

(Refer Slide Time: 09:57)



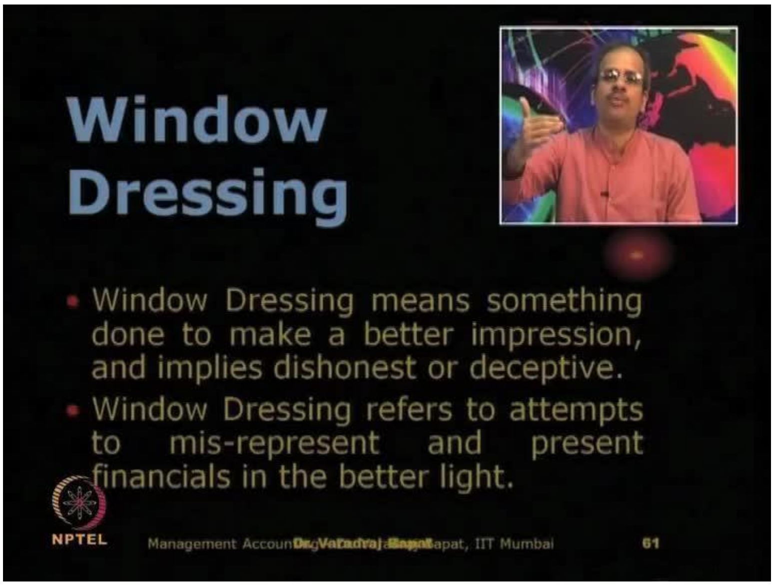
So, we will reduce this cost. So, out of 60, we will reduce 25, 5 and 2, and get a gross profit of 28000. Now, we will calculate the gross margin. So, you have got 28000 upon 60000.

(Refer Slide Time: 10:15)



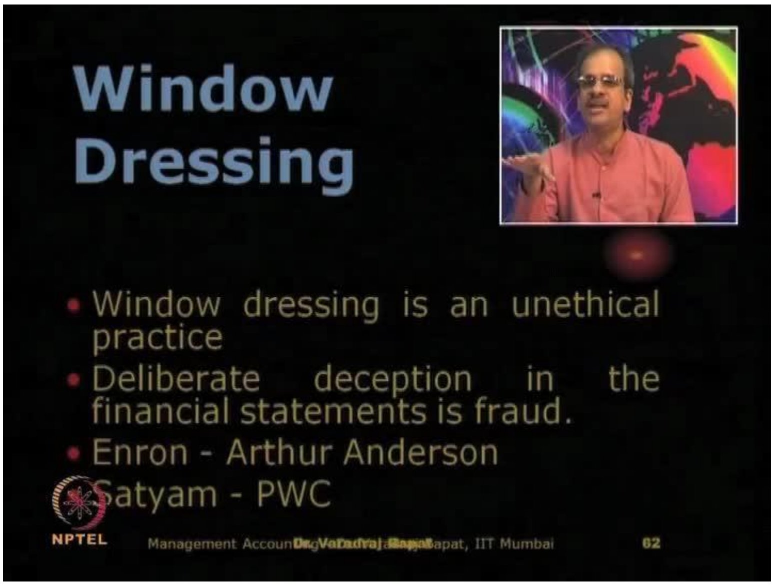
So, 46 percent is a margin on the selling prices. Now, we know that the selling price of the closing stock is 10000. We will reduce 46.67 percent; that is 4667. So, value of inventory is 5333. Here, you can see that since, there may be large number of items; it may be very difficult to know the cost of each item. So, we have calculated, estimated a selling price at 10; we have reduced the profit margin. So, we get the cost of inventory as 5333. This is also, one of the methods of valuation of inventory. Now, let us go at a new concept; that is known as window dressing.

(Refer Slide Time: 10:57)



Now, window dressing means; this is totally new; nothing to do with inventory. We are taking it in row, because many times the stock and depreciation are manipulated to do window dressing. So, window dressing is something, which is done to make a better impression, and it implies dishonest or deceptive presentation. So, if you do not have a very good balance sheet to show, you manipulate the figures and show a very good picture of yourself or your company; that is something known as window dressing. So, these are the attempts to misrepresent and present the financial position in better line. So, you are showing much better assets than what you have, or you are showing a more amount of profit than what you have actually earned. Then, that is known as window dressing. Now naturally, this is an unethical practice.

(Refer Slide Time: 12:06)

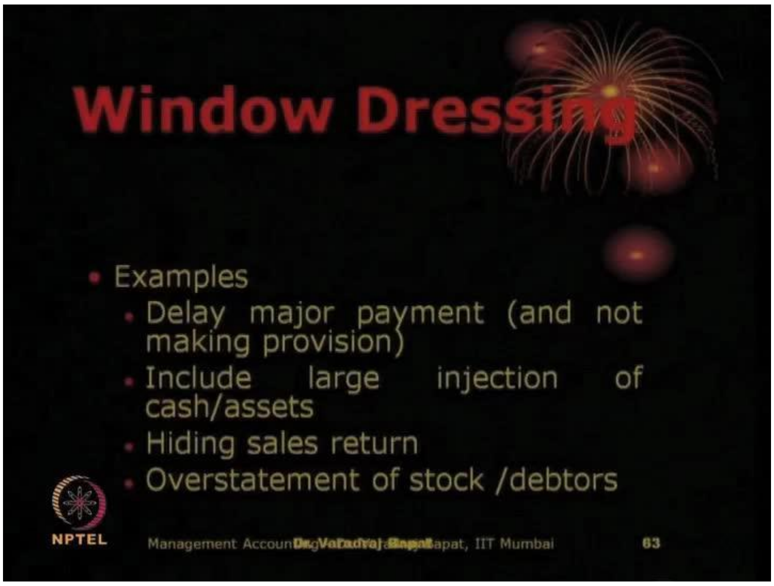


If there is a deliberate deception in the financial statement, it amounts to fraud. Usually, window dressing is a fraud, which is done on the investors and also, on other stake holders. Whenever, you think of window dressing, I think you have, you must have heard of a name Enron. This was a very famous rather, infamous case of window dressing, known all over the word; one of the biggest frauds. So, Enron was a power company, having projects in 40 to 45 companies all over the world. What Enron was doing; they were tremendously, inflating the cost of their projects. Everywhere, they were showing high value of assets. Actual value of assets was much lower. Their auditor was Arthur Anderson. So, Arthur Anderson was an auditing firm, which was doing the audit of Enron. They were also found at fault. Enron, as well as Arthur Anderson, have to close their shop, and their businesses were taken over. Their promoters and directors have been sent to jail. This is one of the very big crimes from very big fraud in the recent time. Do you have any other example in mind in India?

Do you remember any fraud, which was done in say, in last 3, 4 years? I hope you remember the name Satyam. Satyam, wherein, Ramalingam Raju was the CEO; this was known to be one of the top IT companies in India. However, it was found that the balance sheet of Satyam was completely, manipulated. There was no problem with their operations or with their business, but the financial position which, they were showing in the balance sheet was extremely, over stated. There again, their auditors were PWC. I am showing the name of the auditor, because along with the management, it is the duty of the auditor to check the financial statement and certify them as true and fair.

So, if there is a window dressing done by the company, first of all, the management, their CEO is at fault. Their auditors are also at fault, if they are not able to find out the window dressing, which is very apparent. In case of Satyam, price water house coopers, one of the top audit firms, was the auditor. The investigation is on, both on Satyam management and p w c for their manipulations. There may be number of frauds. Many other cases also, you might have heard of. How is window dressing done; a few examples.

(Refer Slide Time: 14:52)



Now, window dressing may be done by delay in the major payment and not making the proper provision. It may include large class injections, hiding of sales, over stating of debtors and so on. What happens is sometimes, some big liability is due. Company does not pay it, neither makes a provision for it. So, automatically, the expenditure is under stated; reliabilities are also under stated. So, you have more profits and you appear to have more net assets. This is an example of delay in and failure to make provisions. Sometimes, suddenly, promoters put in huge amount of cash in the company. They show that cash as sales. So, sales are inflated; cash is inflated. So, company makes an impression that they have a high profit.

Actual profitability position is not that good. Sometimes, there is a hiding of sales return. So, company make sales; company tries to push the sales to customers; records them as revenue, but the goods come back and those sales returns are not recorded. So, sales are over stated. Naturally, the profits are also over stated. Sometime, the stock and debtors are over stated. We were discussing about valuation of stock. This is one of the easy ways to manipulate, because company may adopt a wrong method or company may deliberately, add some expenditure, which is day-to-day in nature as a cost of conversion of stock. So, the cost will get inflated. Naturally, the value of stock will also get inflated. Sometimes, the market value of stock falls, but company does not show it in the books. So, it shows the stock at cost. The actual rule is it should be cost or net realizable value whichever, is low.

But if the market value has come down say, there are some defective goods or some outdated goods, but the market value is not reported. The stock is shown as cost. Again, the profits, as well as the balance sheet position, are inflated. One more way is by manipulating depreciation. So, if company deliberately, shows a long life of assets; let us say company has purchased computers. The life of the assets is likely to be only 2 years, but they estimate it to be 10 years. So, what will happen is they will show lesser depreciation. Lesser depreciation means there will be more profits and also, higher value of asset in the balance sheet. So, these are the various ways by which, the financial statements are manipulated, which amounts to window dressing. It is a deliberate deception made by the management and investors. Analysts have to be very careful to see that the balance sheet which, they are studying is not manipulated.

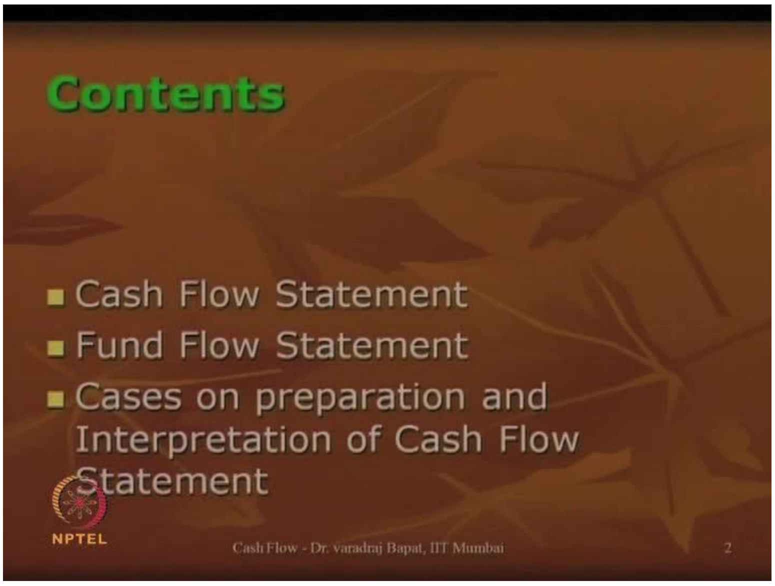
Thank you so much. We will start with the new module in the next session.

Thank you.

We are going to discuss a very interesting topic, today. That is known as cash flow statements. If you remember initially, we had discussed various financial statements and at that time, we had talked of three important financial statements. Do you remember those? Of those there statements, we have discussed two, and one more, we will be discussing right now. What are the first two statements, which we have discussed? The first statement, we have discussed was balance sheet; the second one, we discussed a little bit, is income statement or profit and loss account, and today, we are going to discuss cash flow statement. These three are one of the most important statements, and if you go to website of any listed company, you can see these three statements on their website. In every annual report also, you will find that profit and loss account, balance sheet and cash flow statement, are prominently published.

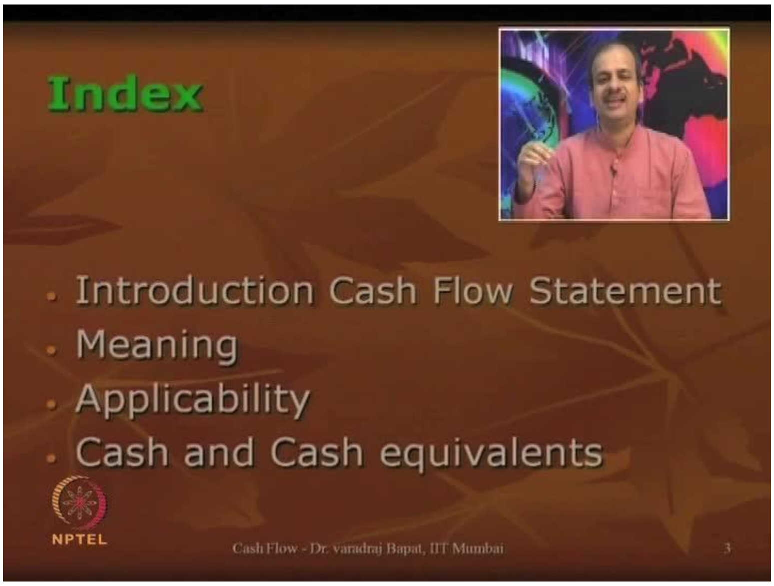
Today, we are going to see what is mean by cash flow statement; why it is important; why does the law mandate that it should be disclosed to the people? We will also see a few cases as to how it can be made. There is s a statement, which is close to cash flow statement, which is known as fund flow statement. In fact, cash flow statement has emerged from fund flow statement. So, we will slightly also, throw light on what is a fund flow statement. Now, as the name suggests, this is the statement of cash flow. So, we are essentially, looking at how is cash coming and how it is being spent, or how it is going out. Even before, we talk about it, we should also know what is meant by cash, and once, we go for preparation, we will see how the cash flows are categorized. Now, let us go into a little bit of it.

(Refer Slide Time: 20:13)



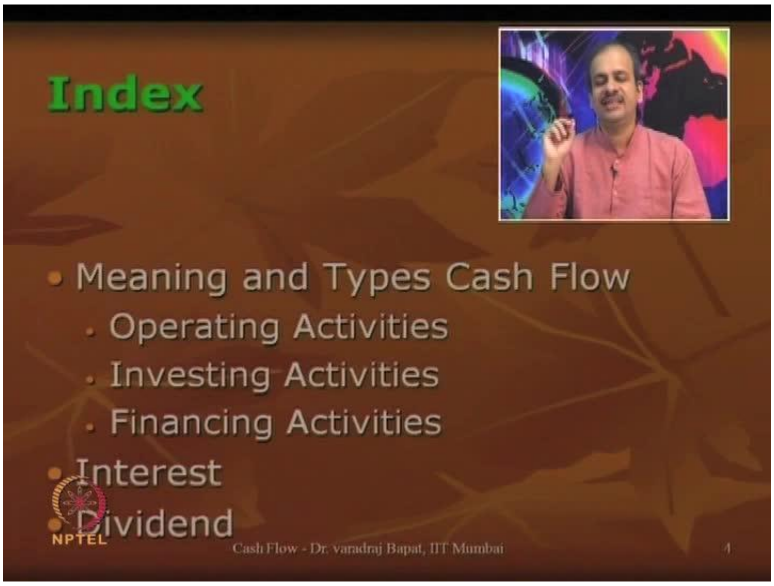
So, the contents of the module are cash flow statement, fund flow statement, followed by some cases on preparation of cash flow statement.

(Refer Slide Time: 20:26)



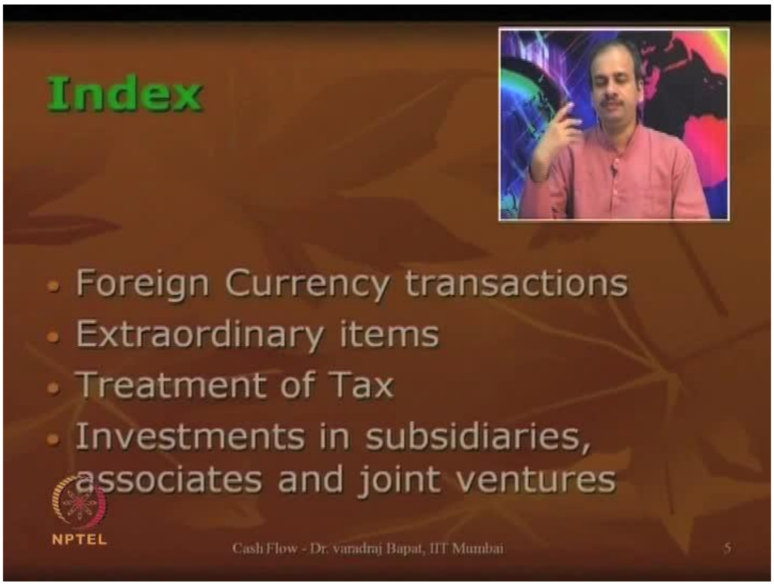
Particularly today, we are going to start with the introduction, meaning of cash flow statement, applicability, what is cash and cash equivalent.

(Refer Slide Time: 20:34)



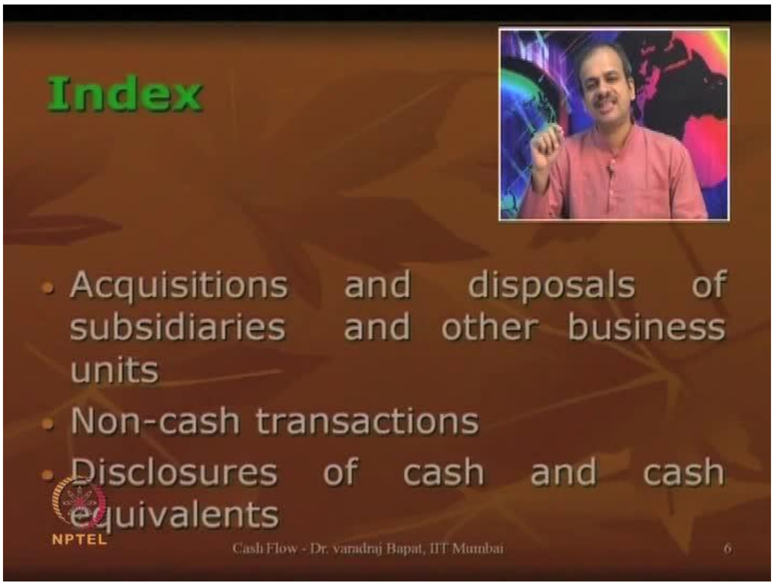
Then, we will talk about categorization of cash flows, which is very important. So, categorization is usually, done into three activities; your operating activity, investing activity and financing activity. So, all the cash flows are going to be classified essentially, into any one of these three. We will also see some of the important items like interest and dividend.

(Refer Slide Time: 21:00)



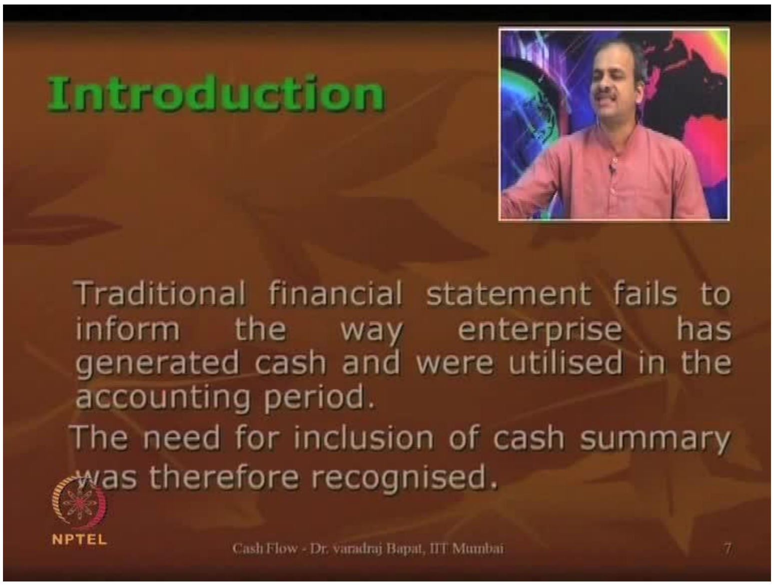
Then, we will talk about how to deal with foreign exchange transactions. There are some extraordinary items; how to deal with tax and how to show investment in subsidiaries, associate companies and joint ventures.

(Refer Slide Time: 21:18)



Then, we will discuss what is, how to deal with acquisition and disposal of subsidiaries. We will talk also, about non cash transactions; how to show cash and cash equivalents; this is going to be the coverage of this module.

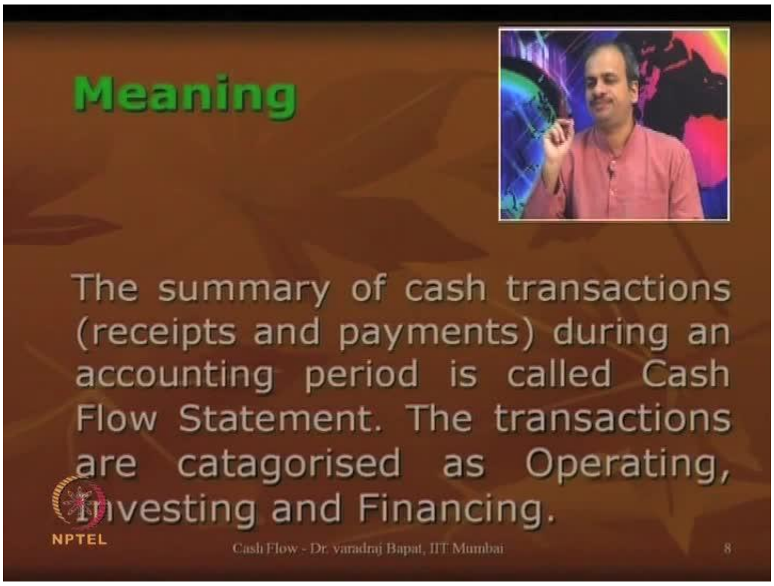
(Refer Slide Time: 21:38)



Now, let us see what exactly, is cash flow statement and why it is important. Typically, as we discussed just now, financial statements include balance sheet and profit and loss account. Now, what do you understand by balance sheet? What is shown in the balance sheet? Does anyone remember what is balance sheet? I think most of you remember that there are two sides to balance sheet. There is assets and at the other side, there are liabilities. So, balance sheet is a statement, which gives assets and liabilities as on a particular date. If you go little more elaborative, you can say that it is a statement, which gives financial position as on a particular date; this is about balance sheet. Then, what is profit and loss account or income statement? It is a statement, which gives you profits and losses, obviously. But to know profit and loss, first of all, it tells you what are the incomes. By what way, the money has come in and it also, says what are the expenses; how and what expenses have been incurred.

So, profit and loss account essentially, compares incomes and expense, and gives you profit or loss, and it is a statement for a particular period. Now, once you know these two, why there is a need to have a third statement, which is a cash flow statement. So, as you know, income and expense will be shown in profit and loss, but will it tell you how much cash has come in or gone out? Not necessarily; it will throw some light to know how the money is coming, but you will not know exactly, how much cash is coming. You will also not know how much cash has been spent. You will know the expenditure, but expense might have been paid or it might be outstanding; both will be shown in P and L. Same thing is true about income. Income might have been received or it may be due or accrued. It will be shown in P and L. So, if you really want to know how much cash is coming in and going out, we need a separate statement. That led to emergence of a separate statement, which gives you summary of cash; that is known as cash flow.

(Refer Slide Time: 24:11)



So, you can see here, cash flow is a summary of cash transactions, or in other words, it is a summary of receipts and payments, during a particular accounting period. All the cash flows are categorized as operating, investing and financing. A little later, we will see what is operating, investing, financing, but even before that, now, you know what is a cash flow statement; is it similar to P and L account or is it is it somewhat, similar to balance sheet? What do you feel? I think you would guess it rightly; it is very close to profit and loss account.

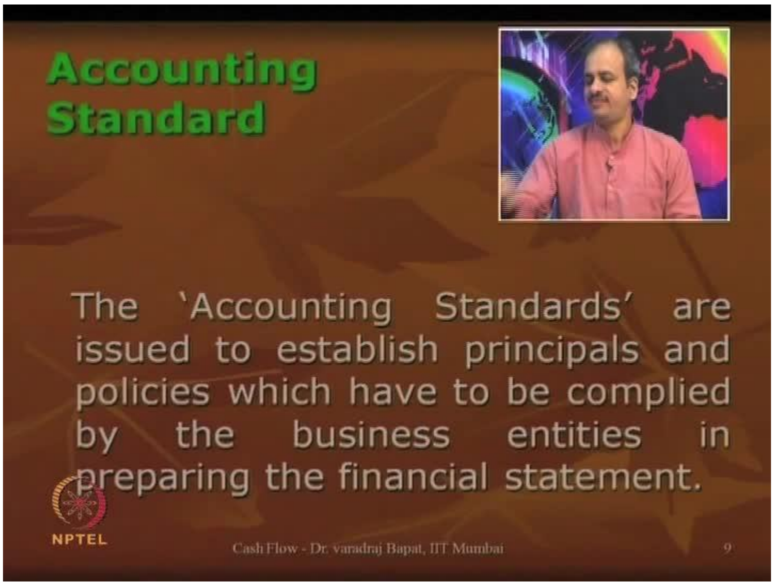
So, you can note two similarities. One, both are period statements; profit and loss account is also for a particular year or a quarter. Cash flow is also for a particular year or a quarter; that is one thing. Secondly, since, cash flow gives you receipts and payments, many of the transactions will be there in profit and loss account. Can you give a few examples, which is a receipt also, and which is an income also? Can you give any one example? I think one obvious example is sale of goods. So, if you sell goods probably, you receive cash. So, it is a sale and in cash flow, it is shown as a receipt. Same way, on expense side; just try to think of two or three expenses. Suppose salary; salary is an expense. Is it a payment also? Yes, because salary is expended and it is paid to employees. So, again, if you take an example of an expense like salary, it is a payment. Same way, any other expense; can you think of? Suppose travelling expense; it is an expense and you have to pay for it. So, again, it is a payment. So, you will realize that many of the items, which are receipts and payments also, appear in the P and L account. So, there is lot of similarity between P and L and cash flow. Now, are there any items, which emerge from balance sheet and appear in cash flow statement? Just think a bit; I think you will be able to guess. So, many items of P and L do appear in cash flow, but are there any items from balance sheet, which should come in cash flow?

Suppose, I purchase a new machinery; will it come in P and L account? No, because it is not a day-to-day expense; it is a purchase of fixed asset. So, it will go in balance sheet and it should also, appear in cash flow statement, because I have to pay for it. So, I have paid money. I have purchased machinery. It goes to balance sheet. So, items like purchase of fixed asset will come in balance sheet and will come in cash flow; that is where, you will realize that P and L and cash flow are not same. Though there are some similarities, items like fixed assets will come from balance sheet and will appear in P and L. Any other example, can you think of? Just give a thought. Suppose, I take a loan; where will it go? Will it come in P and L account? Answer is no. The loan taken creates a new liability.

So, liability will be shown in the balance sheet and from increase in the liability, you will know that money has come in, in the form of a loan. So, loan received is an item, common in balance sheet and cash flow. Like that, there are number of items. That is why cash flow statement is not exactly, same as P and L. It has some items, which are day-to-day in nature, which emerge from P and L; it has some items, which come from a long term type of transactions, which come from balance sheet. Now, if you look at the categories, can you guess out of these three; operating, investing and financing; which items must be coming from P and L and which items must be coming from balance sheet? I think as the name suggests, operating are the day-to-day items.

So, usually, they are very close to P and L; whereas, investing and financing are more to do with long term activities, which come from balance sheet. We are going to discuss more about them, but this was just a initial idea for you as to how does the cash flow relate to other two major statements, which are P and L and balance sheet. So, you will realize that cash flow is not a repetition of P and L and balance sheet; it is serving a different purpose. Then, what is the purpose does it serve; what do you get by reading cash flow statement?

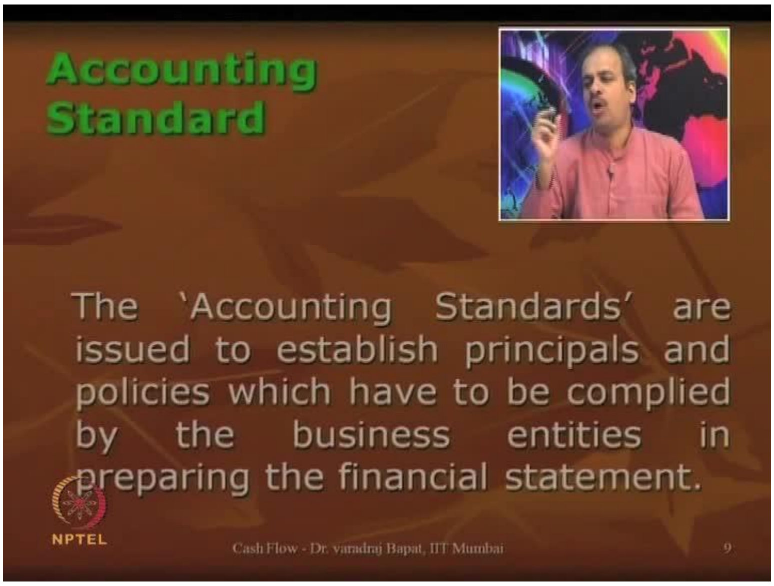
(Refer Slide Time: 29:48)



Anyone has a guess that if you read a cash flow statement of a business in detail, what do you understand? As you can see here, since, cash flow is a summary of receipts and payments, you will immediately, know that what are the ways the money or the cash is being generated by the company, and what are the ways it is being paid or spent by the company. We will also get an idea as to the net income or the net receipt of cash through operating activities, investing and financing activities. We will also come to know that whether, there are changes in the cash balances. All these information, you will get from cash flow statement. That is the reason why government has made it mandatory for all the listed companies to come out with cash flow statement, along with their P and L and balance sheet.

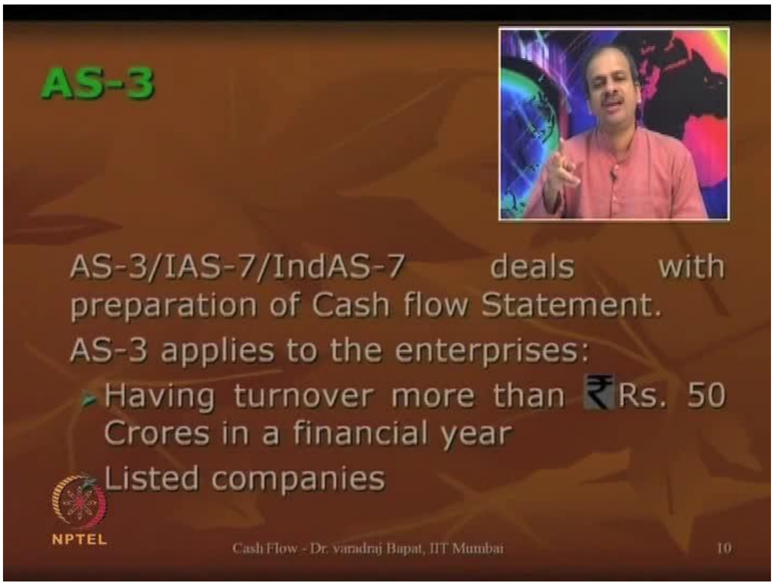
Now, is it compulsory for all the companies to make cash flow, and because of which accounting standard, it is compulsory? The answer is no. It is not compulsory for every company, but it is always desirable, because cash flow will give lot of information, which will be useful to the management to manage the liquidity position of the business. It will also help outsiders to understand how the business is using its cash.

(Refer Slide Time: 31:24)



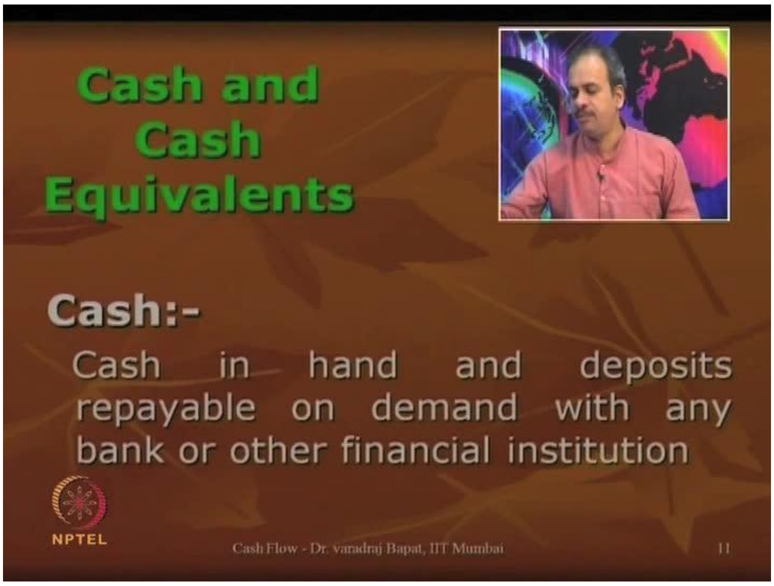
Now, let us see what are the requirements? As you all know that accounting standards in a way, guide the management of the company as to what should be disclosed, and how the transactions should be recorded. So, accounting standards are issued to establish principles and policies, which have to be complied for making the financial statements. We have already learnt about accounting standard, IFRS, GAAP and so on.

(Refer Slide Time: 31:56)



Let us see what is a relevant, what are the relevant standards for cash flow. Originally, accounting standard 3; AS-3, as we call it; was the standard, which used to tell you how to make cash flow statement. If you look at international standard, there is international accounting standard; IAS-7, which gives principles for operation of cash flow statement. Similar Indian standard, which is the latest series of Indian standards, known as IndAS; IndAS-7 deals with preparation of cash flow statement. Now, AS-3 tells you that this accounting standard is applicable to all those companies, who have turnover in excess of 50 crore. So, for all the bigger companies or for all the bigger entities, it is required. Secondly, it is also required for all listed companies, irrespective of their turnover. So, I had asked you a question; whether, it is compulsory for all? Answer is no, but for a bigger entity, either listed or having turnover above 50 crore, it is mandatory, and it is very much desirable for all enterprises or all entities to make it for their own understanding.

(Refer Slide Time: 33:18)



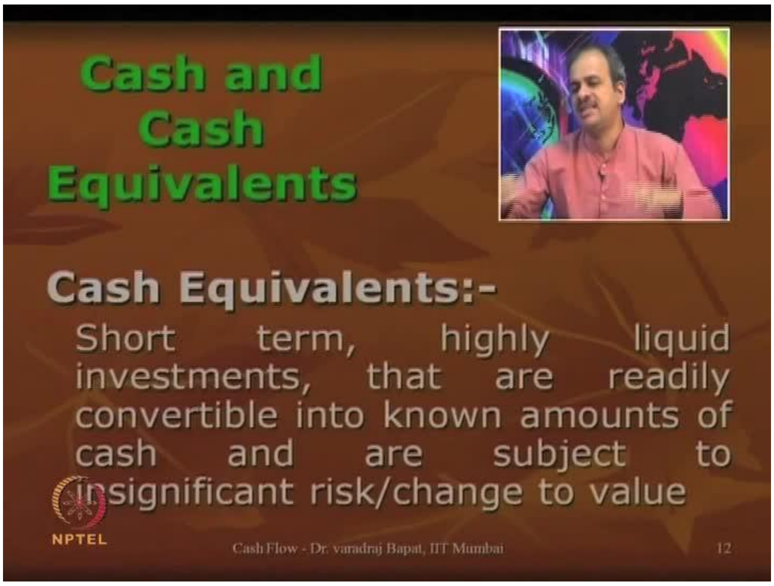
Now, when we say cash flow statement, we should know what is meant by cash. What will be considered as cash for this purpose? So, can you guess now, what is cash? Obviously, the currency is cash. So, whatever the money, which you have in your pocket in the form of currency note, is something which is called as cash in day-to-day practice. Apart from that, anything else is also used as cash. Definitely, your bank balance is as good as cash. Anytime, you want, you can withdraw and spend or you can give a check and make the payment. So, cash balance does include cash; it also includes bank balances. There are various payment mechanisms like credit card, debit card, ATMs, but they are actually, using only your bank facilities. So, balances in bank and cash are covered as cash, as far as cash flow statement is concerned. Are there anything else, any other money which you can use as cash? Yes, accounting standard calls it cash equivalent.

So, it is not exactly cash, but it is very similar or very close to cash. So, let us go to definition of cash and cash equivalents. Cash includes cash in hand and deposits, repayable on demand with any bank or financial institution. That is what is bank balances, but it may not include balances in fixed deposits. It should be balance in your current account or saving account, because you can withdraw it any time. So, in short, it is cash is cash balance plus, bank balance. Now, what is cash equivalent? Can you guess now that which are the items of investment, which you can easily use as cash?

Whenever, you need money, you can convert them into cash or you can simply, exchange it and give it to other persons. Are there any other things? What they could be? Just think over. Can the gold qualify as cash equivalent, because it has a high liquidity? When you want money perhaps, you can sell it or get loan against it. Are there any other items? Again, give think of some other items, which are very liquid, which you can easily sell. Will the shares qualify as cash equivalents, because again, shares of listed company; you can sell at any time in the market. Is the money in the fixed deposit account with the bank qualify as cash equivalent, because perhaps, whenever you need money, you can withdraw it; you can break your FD and withdraw the money or you can take a loan from the bank against that FD. Will it qualify as cash equivalent? Do you think of any other items, which could be equal or very similar to cash? As far as gold is concerned, the answer whether, it is cash equivalent or no; the answer is it is not a cash equivalent. Same way, shares are also not a cash equivalent. Now, why? It is true that gold is a highly liquid. It is also, true that shares are highly liquid, but is the price assured? Do you know at what price it can be sold? You know currently, gold prices are hovering around 30000 per 10 grams. Is there any guaranty that at the same price, you can sell it? It may become 32000 after say, 6 months or it may become, come down to 25000.

So, prices are changing as per the market trends for both shares and for gold. So, they cannot be called as cash equivalent. Cash equivalent means, I should know that yes, I have deposited 100000 in bank; I can withdraw 100000 at anytime; I will get exactly the same money. Then, it is cash equivalent. So, gold or shares do not qualify. Will the FD in bank qualify? Perhaps, yes, if it is a short term in nature, because I should have no restriction on my withdrawals. Then, it can qualify as cash equivalents. Now, let us see what are the principles?

(Refer Slide Time: 38:03)

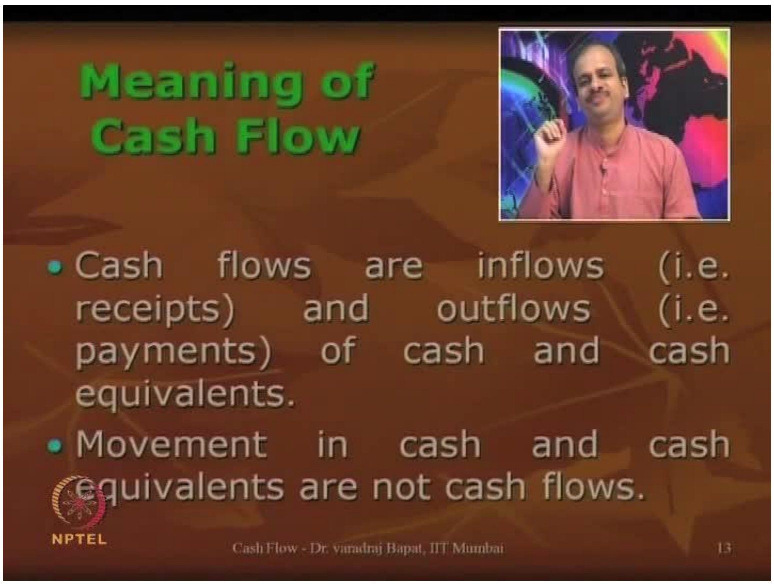


This is the definition; it is a short term, highly liquid investment that can be readily, converted into known amount of cash, and are subject to insignificant risk of change of value. So, gold does qualify as a highly liquid investment; it can be readily converted, but it has a high risk. So, even if it has a low risk, we will not qualify. If the risk is almost 0 only, we will call it cash equivalent. So, items like gold an shares are ruled out. FD could be considered provided, it is liquid. Can you give some other examples now, which are covered in cash equivalent? One example I will give. Usually, one bank keeps money with other bank, which is known as money at call or money at short notice. So, whenever say, I am a bank; I kept deposit with some other bank. If I need money, I will get it within 24 hours. It is that liquid and the fixed money as is assured. Then, it is called as cash equivalent. There could be some other security say, like treasury bills, which are issued by the government; are they cash equivalent?

The answer is no, because prices fluctuate in the market, but banks do keep some money with Reserve bank of India. That qualifies as cash equivalent, because whenever, the bank is in trouble, they can withdraw that money from RBI. So, I hope you are clear now, what is cash and what is cash equivalent. So, cash flow statement is essentially, flow of cash; essentially, the flow of cash plus, cash equivalent. Henceforth, whenever we use term cash; it means cash and cash equivalent. So, cash, bank, cash equivalents; altogether is known as cash balance of the company and any movement of that cash balance will qualify as a cash flow.

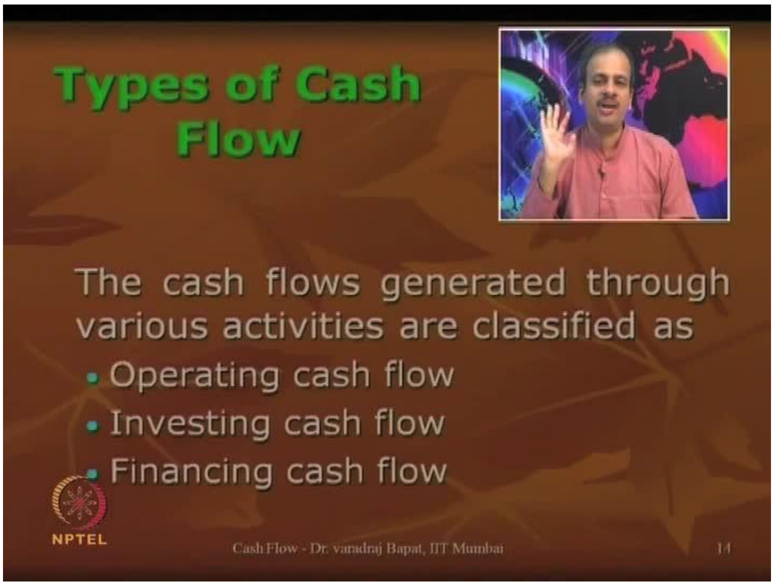
So, here is the definition now cash flows are inflows or outflows of cash and cash equivalent. We also call these inflows as receipts and outflows as payments. Any movement in cash or cash equivalent will not qualify as cash flow.

(Refer Slide Time: 40:12)



So, what is an example of movement within cash and cash equivalent? Let us say, I have surplus cash; I deposit into bank, or I need cash; I withdraw it from bank. This is a movement inside cash and cash equivalent. So, total balance of cash plus cash equivalent remains same. So, it will not be considered as a cash flow. So, what we are talking of; cash being paid for something, outside the cash and cash equivalent. We are buying some assets; we are giving loan or we are receiving money from someone; all these are cash flows. I think it is pretty commonsense. So, we will go ahead.

(Refer Slide Time: 41:14)



Now, a very important thing in the cash flow statement; that is classification of activities. We have already seen that in any cash flow statement, all activities need to be classified into operating, investing and financing. Now, first of all, why is this classification required, because cash flow statement is not just a list of all moneys coming in and going out. Users should also know that from where, the money is coming and what will be its impact on business. That is why GAAP has made three categories, which are compulsory. These three categories are operating, investing and financing. So, any item which is going to be shown in cash flow statement, should be shown in any one of these three only; we have to categorize. So, for making cash flow statement or for reading and understanding cash flow statement, it is very important that we know what are the categories. Now, you can guess and give me some examples as to what is an operating cash flow. From the name, I think you can make up; you can understand what is the meaning and try to give me few examples. Initially, we have talked about relation of cash flow with P and L and also, with balance sheet. At that time also, some hint was given; just think a bit. Can you think of an example of operating cash flow?

Suppose, I am a retailer; I have sold goods for cash; is it an operating cash flow? Yes, it is a very common example for any company; if they sell goods, get the cash immediately; that is an example of operating cash flow. Any other example? Now, suppose, I sell goods; I do not receive cash; it is a sell on credit. Will it qualify as an operating cash flow? The answer is no, because first of all, it is not a cash flow. I have not yet received cash. I have sold the goods; money will come after say, a week or a month, etc. So, it is not a cash flow. Any other example? Now, I have sold goods say, with a credit period of one week. So, after one week, I receive money from debtors or from my customers. Is this receipt of money from customers, a cash flow? The answer is yes. Now, it will fall in which category?

You are right; it should qualify as an operating cash flow. So, examples of operating cash flow; one is sell of goods; second is receiving money from debtors or from customers. Give me three more examples of operating cash flows. If you give a slight thought, I think you can give ten examples. It is very simple, very common sense. Think of some expenses, now. So, one simple example which, we have already discussed is payment of salary. So, salary paid is an operating cash flow. Anything else? Payment of rent; payment to suppliers against their sale of goods or against the purchase of goods; that is an operating cash flow. Any other, can you give two more examples? If I am a software company, I give my software on license. So, I will receive some license fee; that is an operating cash flow.

If I pay say, for maintenance, it is an operating cash flow. So, in cash flow, we are not going to categorize receipts and payments, separately. All activities which are related to operations will be categorized as operating cash flow. Before we go for operations, please try to give me examples of investing and financing flows. Let us say two examples each. We have earlier talked of one case. Suppose, I pay money and purchase a new machinery; which will be the category of cash flow? Is it a day-to-day activity? The answer is no; it is not that every day, I will purchase machine. I will purchase the machine and I will use it for 2, 3, 4, 5 years.

So, it is a long term kind of investment, which will go into balance sheet. So, it is an investing cash flow. One more example of investing cash flow; it is similar to purchase of machine. If I purchase shares of other company, it is an investing cash flow. When I say purchase, also sale; purchase of machine is an outflow; sale of machine is a inflow, but both fall in investing category. So, in investing cash flows, you will also have sale of machinery. You will also have sale of shares of other company. So, these are a few examples of investing. Now, may be one or two examples of financing. To run the company naturally, I need money. Where from money comes? One way is I may issue my shares. So, if I am a company, I issue shares to investors and I receive money; that is for financing.

So, it is a financing activity or I may approach a bank, take a loan; it is a financing activity. Now, when I take loan, I have to repay also. So, repayment of loan is also a financing activity. So, these are the few examples of financing. In our next module, we will see little more into this, but right now, we can say that operating, investing, financing; all the activities, we have to classify into these three.

Thank you so much.