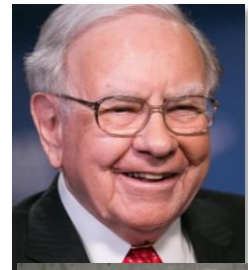




Lecture Summary # 10

"It takes 20 years to build a reputation and five minutes to ruin it. If you think about that, you'll do things differently."
- Warren Buffett



"One of the huge mistakes people make is that they try to force an interest on themselves. You don't choose your passions; your passions choose you."
- Jeff Bezos



Understanding financial statements- 5

Some essential aspects of financial statements

The principal qualitative characteristics of financial statements

- **Understandability:** the information is so organized and presented that ordinary people should be able to understand the performance of the business.
- **Relevance:** The statements must contain all the relevant information for informed decision-making by the stakeholders.
- **Reliability:** The information presented in the financial statements should be accurate and should genuinely represent the actual state of affairs of the company and have not been manipulated in any way.
- **Comparability:** The financial statements should be prepared based on standard and consistent conventions and regulations to easily compare data over the years and to compare with other companies.



Financial statements are records of the financial position or status of a business as at a point in time (the balance sheet) and during a certain period (profit & loss statement and cash flow statement). Most of the stakeholders of an enterprise have access to these financial statements to understand and assess its financial health. Thus, these statements are very important source of information, and one needs to have a fair knowledge on these statements to make sense of the data furnished in them.



Understanding Cash Flow Statement

Ideally, a company should sell its goods or services, recover the sales proceeds quickly (receive the payment against the sales), make a surplus after meeting all the expenses, use the surplus (excess in the form of profit) to create new capital assets for future growth. Additionally, the company may raise capital (fund) from different source such as:

- Additional equity capital from the owners / shareholders (equity capital),
- Loans from banks (short-term loans to meet expenses and creating current assets such as stocks, and long-term loans for creating non-current assets such as machinery, buildings, transporter, etc.),
- Loans from other corporate houses (as loans usually referred to as unsecured loans).

The company may also manage its payables (delay the payments to the suppliers) and receivables to accelerate the payments against sales (to receive the money early) and helping it manage financial liquidity. A company would be characterized as liquid if it meets the funding requirements out of traditional sources and they have no threat of running out of money in the foreseeable future.

Suppose a company has been achieving growth by selling more and more goods but is not recovering the sales proceeds quickly for whatever reason(s). Temporarily, one may get a sense as if the company has been doing well. But soon, they will run out of business even before they realize what was coming their way. Running out of cash and inability to honor payment obligations often lead to bankruptcy

The cash flow statement is a record showing all the sources and uses of cash and cash-equivalent of an enterprise in a particular period (mostly year) and the resulting cash position at the end of the period. Using the cash flow statement, one can understand how the company has managed to fund its business operation during the period and whether it is financially solvent.

In summary, the cash flow statement provides a clear picture of the cash inflows and outflows during a period showing how comfortably the business operation is being financed and the immediate- and medium-term solvency of an enterprise. Both inside (such as majority owners, top management, employees, and board members) and outside stakeholders (such

as investors, shareholders, banks, investment analysts) get a somewhat comprehensive view of the health of the enterprise. External stakeholders, in particular, can get insight into whether the company has been manipulating accounts to show a brighter picture than what has been painted.

Let us look at it with an example. The following information is for a hypothetical company.

	Amounts are in ₹ lakh				
year	2018	2019	2020	2021	2022
Sales	255	360	405	510	
Operating profit	53.55	75.6	85.05	107.1	
Profit before tax	28.3815	40.068	45.0765	56.763	
Income tax	5.6763	8.0136	9.0153	11.3526	
Profit after tax	22.7052	32.0544	36.0612	45.4104	
Depreciation	10	12	12	14	
Cash profit	32.7052	44.0544	48.0612	59.4104	
Dividend	5	5	7	10	
Gross fixed assets	100	120	120	140	
Long-term loan	80	78	75	73	
Short-term loan	30	50	70	100	
Trade receivables	34	66	97	122	
Trade payable	21	32	36	38	

Bankruptcy

The company's sales have been growing at a healthy rate for the last four years, so is the profit. The company has been paying income tax and dividends for these years. However, the company's buyers (maybe distributors or wholesalers) have been holding back the payment for a long time. Cash position has been deteriorating *ab initio* that the management could not see or realize. If they had prepared the cash flow statements from the beginning, the deteriorating cash position would be visible and corrective actions could have been initiated. Sadly, in 2022, the company will have no money to pay salary unless they can recover their money from their customers (dealers, distributors, retailers) and may face bankruptcy.

Another mistake the company has been committing is that it has been diverting the short-term fund (short-term bank loan, current in nature) to procure long-term assets (look at the increase in the gross fixed assets over the years that the company has procured out of the increase in the short-term bank loan). This fact is easily visible in the cash flow statement.

Have a look at the cash flow statement of Reliance Industries Ltd. presented below:

For the year ended 31st March, 2021

(₹ in crore)

B. Cash Flow from Investing Activities		
Purchase of Property, Plant and Equipment and Other Intangible Assets	(1,05,837)	(76,517)
Proceeds from disposal of Property, Plant and Equipment and Other Intangible Assets	2,319	964
Purchase of Other Investments	(6,89,866)	(11,56,843)
Proceeds from Sale of Financial Assets (including advance received)	6,42,551	11,73,329
Upfront Fibre Payment	-	(16,439)
Net Cash Flow for Other Financial Assets	773	1,467
Interest Income	8,400	1,441
Dividend Income from Associates	26	18
Dividend Income from Others	-	60
Net Cash Flow used in Investing Activities	(1,41,634)	(72,520)

(₹ in crore)

	2020-21	2019-20
C. Cash Flow from Financing Activities		
Proceeds from Issue of Equity Share Capital	5	18
Proceeds from Issue of Share Capital to Non-Controlling Interest / Compulsory Convertible Debentures (Net of Dividend Paid)	2,00,382	111
Net Proceeds from Right Issue	13,210	-
Share Application Money	-	1
Payment of Lease Liabilities	(1,022)	(1,062)
Proceeds from Borrowings – Non-Current	33,211	28,665
Repayment of Borrowings – Non-Current	(87,240)	(18,179)
Borrowings – Current (Net)	(29,681)	25,095
Deferred Payment Liabilities	(2)	(1,370)
Movement in Deposits	(4,700)	(2,720)
Dividend Paid (including Dividend Distribution Tax)	(3,921)	(4,592)
Interest Paid	(18,340)	(28,508)
Net Cash Flow from / (used in) Financing Activities	1,01,902	(2,541)
Net (Decrease) / Increase in Cash and Cash Equivalents	(13,547)	19,816
Opening Balance of Cash and Cash Equivalents	30,920	11,081
Add: Upon addition of Subsidiaries	24	23
Closing Balance of Cash and Cash Equivalents (Refer Note 9)	17,397	30,920

Two methods of preparing the cash flow statement: 1. Direct method, & 2. Indirect method

Under the indirect method, all the cash flow streams are divided into three groups:

1. Cash flow from Operating Activities
2. Cash flow from Investment Activities
3. Cash flow from Financing Activities

Major items under cash flow from operating activities

- i. Net profit
- ii. Depreciation & amortization
- iii. Change in inventory/ stock
- iv. Change in accounts receivable
- v. Change in account payable

Major items under cash flow from investment activities

- i. Land
- ii. Change in building
- iii. Machinery
- iv. Sold machine

Major items under cash flow from financing activities

- i. Change in long-term loan
- ii. Change in short-term loan
- iii. Change in equity
- iv. Dividend

When a company incurs a loss, money from some source must be used to fund the loss. Loss is the use or application of funds. Try to visualize how loss is manifested. Consider the same simple example of a stationery shop in your hostel room. When will there be a loss? You will incur a loss in case your total expenses exceed sales, which means that you have expensed more money than you have earned. The excess of expenditures over the sales is termed as the loss. Expenses are already funded from various sources. Therefore, loss has already been funded from multiple sources even before you estimate whether there is a loss. Thus, the loss is classified as an asset.

Accounts receivables, trade receivables, and receivables are the same. Receivables arise when you sell goods, but payments are yet to be received (you raise a bill against every sale transaction, and the customer returns a signed copy of the bill as a promise to pay). This amount (and the accumulated sum against many such transactions) is termed as receivables. Each of your buyers is known as a different 'Account' in your books of account. They are, thus, known as Accounts receivables. Alternately, as the

amount in question emerges in the process of trade, it is also known as 'Trade Receivable' to differentiate it from other receivables such as an advance given as an assurance.

The quantum of amortization is decided based on the comfort of the company, that is, based on the surplus (profit) the company is capable of generating. If a company does not make a good profit, it may not provide any amortization during that year. Alternately, if it makes a huge profit in a particular year, it may allocate a large sum during the same year. However, it is usual that quantum of profit of a company has a semblance of a trend. So, depending on the profit, the company decides to allocate an equal sum every year as amortization.