Two-Minute Read # 10

Foundations of Entrepreneurship

"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.

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 sources:

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

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

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:

Cash Flow Statement

For the year ended 31st March, 2021

(₹ in crore)

	2020-21	2019-20
A. Cash Flow from Operating Activities		
Net Profit Before Tax as per Statement of Profit and Loss (After exceptional item and tax thereon)	55,461	53,606
Adjusted for:		
Share of (Profit) / Loss of Associates and Joint Ventures	(516)	(107)
Premium on Buy back of Debentures	194	60
(Profit) / Loss on Sale / Discard of Property, Plant and Equipment and Other Intangible Assets (Net)	47	247
Depreciation / Amortisation and Depletion Expense	26,572	22,203
Effect of Exchange Rate Change	(1,645)	107
(Profit) / Loss on Divestment of Stake	-	11
Net Gain on Financial Assets #	(4,964)	(2,064)
Exceptional Item / Tax on Exceptional Item	(5,642)	(948)
Dividend Income	(39)	(100)
Interest Income #	(10,366)	(9,548)
Finance Costs #	21,027	21,880
Operating Profit before Working Capital Changes	**80,129**	**85,347**
Adjusted for:		
Trade and Other Receivables	186	(13,792)
Inventories	(7,769)	(6,342)
Trade and Other Payables	(43,148)	38,050
Cash Generated from Operations	**29,398**	**1,03,263**
Taxes Paid (Net)	(3,213)	(8,386)
Net Cash Flow from Operating Activities *	**26,185**	**94,877**
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 is used to fund it. 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.

Answer given by a student is right. Suppose you bought an asset for ₹10,000 a few years back. The accumulated depreciation over the years is say, ₹7,000. Therefore, the book value of the asset is (10,000 - 7,000) = ₹3,000. You sell the asset for 5,000. This means that you have made a profit of (book value - sales value) = ₹2,000. This amount is added to the profit loss account as other income. Now consider the whole thing in cash flow statement. You put net profit (which include the profit you earn by selling that piece of fixed assets) in the 'Operating activities'. You also put the entire sales value in the cash flow from 'Investment activities'. Thus, there is an excess amount in the entire cash flow (you show ₹2,000 as profit, whereas, you show ₹7,000 as positive cash flow). Factually, you should show only ₹2,000 as cash flow since that is the additional amount you receive and rest of the amount is already accounted for when you bought the asset. Therefore, ₹7,000 - ₹2,000 = ₹5,000 is shown as negative cash flow in the 'Operating activities'.