**Fund Flow Statement**

**CONVERSATION BETWEEN MANU AND VINU**

**ABOUT FUND FLOW STATEMENT**

|  |  |
| --- | --- |
| Manu | Hi Vinu! How are you? |
| Vinu | I am not fine Manu! |
| Manu | Why? |
| Vinu | I think I didn’t take my IPCC Course seriously! |
| Manu | Common yaar! Wats up? |
| Vinu | Yesterday I was asked to prepare and present Fund Flow Statement of corporate customer who has approached our Bank for a loan. |
| Manu | Ok! |
| Vinu | I had this topic for learning in both Accounting as well as Financial Management papers. |
| Manu | Ya! I know. |
| Vinu | But I didn’t give serious look on the topics, because problems would be generally lengthy in nature and I am bit allergic to lengthy problems. |
| Manu | So? |
| Vinu | So, I skipped this entire topic and focused on the other topics and somehow sailed through the examinations! |
| Manu | Acha! You escaped academic examinations but caught red handed in real life examination! |
| Vinu | True! |
| Manu | So what are you going to do now? |
| Vinu | What I’ll do is I’ll learn from you! |
| Manu | He he...That’s my privilege! |
| Vinu | Let me ask you a fundamental question! |
| Manu | Please! |
| Vinu | When the customer already prepares Financial Statements comprising   1. Statement of Profit and Loss; 2. Balance Sheet 3. Cash Flow Statement    Why we have to prepare another statement called Fund Flow Statement to analyse the customer? It’s a waste of time! |
| Manu | Vinu! Be careful in your words! Then why that particular topic is given so much importance by having it in two examination papers and more importantly why you’re Bank is asking to analyse it? |
| Vinu | Ok! So it has something to communicate very seriously! |
| Manu | Yes! Absolutely. |
| Vinu | But before that, please tell me, why the same topic (Fund Flow Statement) in included in two examination papers? |
| Manu | Vinu! You should have asked this when you studied. Glad that at least now you have asked.   You had this topic in Accounting paper to learn **how to prepare** Fund Flow Statement.    The same topic was also included in Financial Management to learn **how to analyse** the Fund Flow Statement. |
| Vinu | Ok.... Ok...So, two target groups were kept in mind, I believe.  How to prepare – As an Accountant  How to analyse – As a user of Financial Statement. |
| Manu | Yup...Shall we move on? |
| Vinu | Yes Guruji! |
| Manu | Fund Flow Statement is a statement which will show inflow and outflow of long term funds so that reader of the financial statement will know from where funds have been generated and where they are used! |
| Vinu | Manu!!!! Please Stop!!!! Don’t teach definitions. Explain with some practical examples yaar!!! |
| Manu | Ok. Let us go through a Financial Statement tour to understand. |
| Vinu | I am ready. |
| Manu | Let’s say you want to start a business with some decent amount. How much you will be investing? |
| Vinu | One Hundred Crores. |
| Manu | Great yaar! What you will do with that? |
| Vinu | I will purchase assets! |
| Manu | What assets? |
| Vinu | Long term assets as well as Short term Assets. (Last week you taught me Working Capital J) |
| Manu | Name some assets which you will be acquiring. |
| Vinu | Fixed Assets – Rs.80 Crs;  Current Assets – Rs.20 Crs. |
| Manu | Can you prepare your Balance Sheet? |
| Vinu | Yes! I can.   |  |  |  |  | | --- | --- | --- | --- | | **Liabilities** | **Amount (Rs. In Cr.)** | **Assets** | **Amount (Rs. In Cr.)** | | Capital | 100.00 | Fixed Assets | 80.00 | | Current Assets | 20.00 | | **Total** | **100.00** | **Total** | **100.00** | |
| Manu | Good! Do you know, now you can prepare your Fund Flow Statement? |
| Vinu | Is it? |
| Manu | Yes! What are the sources of funds for you so far? |
| Vinu | So far, it’s only capital! |
| Manu | What are your uses of funds? |
| Vinu | I have two uses.   1. Fixed Assets. 2. Current Assets |
| Manu | Correct. But in Fund Flow Statement, we will show long term source of funds and long term use of funds. Now, tell me, what are your long term sources and uses. |
| Vinu | I got your point. I have one long term source whereas out of two uses, one is long term use and the other one is short term use. |
| Manu | Exactly. If your long term funds are greater than long term use, you will have surplus, and that will be used for funding your current assets. |
| Vinu | Correct. Shall I prepare Fund Flow Statement with this information? |
| Manu | Please Vinu. |
| Vinu | **Fund Flow Statement**     |  |  | | --- | --- | | **Source of Funds** | | | Capital | 100.00 | | **Total Source (A)** | **100.00** | | **Use of Funds** | | | Fixed Assets | 80.00 | | **Total Use (B)** | **80.00** | | **Surplus (A-B)** | **20.00** |     Correct me, if I am wrong! |
| Manu | You are correct! Please give the interpretation also. |
| Vinu | I have brought in Rs.100 Crs as capital of which 80 Crs (80%) has been used for creating fixed assets. I had surplus of 20 Crs (20%) which I have used for creating current assets. |
| Manu | What does this indicate? |
| Vinu | This indicates all my current assets were funded by my own money. So I don’t have liquidity pressure, because I need not pay any one in the short run. |
| Manu | Exactly! |
| Vinu | Wow! I am understanding Fund Flow Statement. |
| Manu | Wait. Let’s dig deeper. |
| Vinu | Ok. |
| Manu | What was your total current asset? |
| Vinu | It is Rs.20 Crs. |
| Manu | Can you give break up? |
| Vinu | May be Raw Material of Rs.15 Crs and Cash and Bank Balance of Rs.5 Crs |
| Manu | Ok. Expand your balance sheet with this information. |
| Vinu | Ok. Let me do that.   |  |  |  |  | | --- | --- | --- | --- | | **Liabilities** | **Amount (Rs. In Cr.)** | **Assets** | **Amount (Rs. In Cr.)** | | Capital | 100.00 | Fixed Assets | 80.00 | | **Current Assets:** | | | Raw Material | 15.00 | | Cash and Bank | 5.00 | | **Total** | **100.00** | **Total** | **100.00** | |
| Manu | Good! Now what you will do with your Raw Material and Cash Balances? |
| Vinu | I will use them for production, incur manufacturing and other expenses. |
| Manu | Ok. Let us assume, you are using Rs.13 Crs worth of RMs and Rs.4 Crs Cash balances for Production. |
| Vinu | So, my total cost of production will be Rs.17 Crs. |
| Manu | Let’s say, you sell all your production for Rs.20 Crs. |
| Vinu | Ok. So, my sales is Rs.20 Crs, Cost is Rs.17 Crs and profit is Rs.3 Crs. |
| Manu | Correct. Can you prepare your Profit and Loss statement now? |
| Vinu | Sure.   |  |  | | --- | --- | | **Income Statement** | | | Income | 20.00 | | Less: Expenses | 17.00 | | **Profit** | **3.00** | |
| Manu | Will all your sales be in cash? |
| Vinu | No way! Now days, we don’t get payments even for credit sales on time. Then where is the question of all cash sales. We can assume 60% as Credit Sales and 40% as Cash. |
| Manu | So your credit sales are going to be reflected as Debtors. |
| Vinu | Yes.  Rs.12 Crs (60% of Rs.20 Crs) will be reflecting as Debtors and my cash balance will go up by Rs.8 Crs.(40% of Rs.20 Crs). |
| Manu | When you give credit sales, you can also ask for credit purchase right? |
| Vinu | Yes. I can. But as per Balance Sheet, all my purchases are by cash only. Probably the next purchases, I’ll make it through credit. |
| Manu | Good! You are sharp now. You cannot talk about credit purchases now, because you have already made purchases through cash. |
| Vinu | Ya! |
| Manu | Now can you prepare your Balance Sheet? |
| Vinu | Yes. I will have some new entries like retained profits, debtors, change in Raw Material and Cash Balances. |
| Manu | Before that, arrive at your cash balance: |
| Vinu | |  |  | | --- | --- | | **Opening Balance** | **5.00** | | Less: Used for Manufacturing Expenses | 4.00 | | Add: Cash Sales | 8.00 | | **Closing Balance** | **9.00** | |
| Manu | Good! Go ahead with Balance Sheet! |
| Vinu | |  |  |  |  | | --- | --- | --- | --- | | **Liabilities** | **Amount (Rs. In Cr.)** | **Assets** | **Amount (Rs. In Cr.)** | | Capital | 100.00 | Fixed Assets | 80.00 | | **Current Assets:** | | | P&L (Retained Profits) | 3.00 | Raw Material | 2.00 | | Debtors | 12.00 | | Cash and Bank | 9.00 | | **Total** | **103.00** | **Total** | **103.00** | |
| Manu | Good! |
| Vinu | But Manu, where are we going? You said, you will help me preparing Fund Flow and Analysing it. But you are taking me through Accounting! |
| Manu | Don’t worry! I am doing this with an intention. Now can you prepare your fund flow statement? |
| Vinu | Now? Let me try.   Total Sources now are   1. Capital 2. Retained Profits.   I have a doubt now. Whether retained profits are long term funds? Is it not distributable to owners as dividend and is it not short term? |
| Manu | For that, tell me, whether Capital is long term fund or short term fund? |
| Vinu | Obviously, it is long term fund. It has to be paid back only in the event of winding up. |
| Manu | If Capital is long term fund, which is owners’ funds, then Retained Profits is also long term funds, because it is also payable to owners only. |
| Vinu | Correct. Retained Profits are owner funds and they are long term funds. |
| Manu | Your focus should be on profits generated and not on retained profits. Because, once profit is generated, it becomes long term funds and any usage out of it will become long term use. |
| Vinu | Correct! In our case, my focus should be on Profits generated which is Rs.3 Crs and it is a source.   Total Sources are   1. Capital   **b)Funds from Operations.** |
| Manu | Kudos for that correction. |
| Vinu | Now shall I prepare the fund flow statement? |
| Manu | Please! |
| Vinu | |  |  | | --- | --- | | **Source of Funds** | | | Capital | 100.00 | | Funds from Operations | 3.00 | | **Total Source (A)** | **103.00** | | **Use of Funds** | | | Fixed Assets | 80.00 | | **Total Use (B)** | **80.00** | | **Surplus (A-B)** | **23.00** | |
| Manu | You have surplus of Rs.23 Crs. It can be used for? |
| Vinu | It has been used for funding current assets like this:   |  |  | | --- | --- | | Raw Materials | 2.00 | | Debtors | 12.00 | | Cash and Bank | 9.00 | | **Total** | **23.00** | |
| Manu | Correct. Now let us assume we have completed one full year of operations and we get into the next year. |
| Vinu | Ok. |
| Manu | Now only the real drama starts! You now become so enthusiastic in your business operations, want to expand your business, raise more funds and want to be more vibrant. |
| Vinu | Me? Ok! I’ll leave it to your imagination! |
| Manu | Let’s say you want to purchase another Plant and Machinery at a cost of Rs.50 Crs so you can improve your sales by another Rs.50 Crs per year and profit by another Rs.5 Crs. |
| Vinu | It sounds very illogical. When I have not even stabilised with my current operations, why are you saying I should expand? |
| Manu | Vinu. It all happens in Industry. Do you know one thing? Fund flow will throw all illogical financial stuffs done by the business entities!!! |
| Vinu | Is it so? Then I am ready to expand more J |
| Manu | You are going to bring in fresh capital of Rs.10 Crs for this Plant and Machinery. |
| Vinu | But that’s only Rs.10 Crs. My requirement is Rs.50 Crs? |
| Manu | Don’t worry. You have some cash balance too. For the balance arrange some short term funds. |
| Vinu | I had cash balance of Rs.9 Crs. I am also going to raise Rs.10 Crs capital. So funds have to be arranged for Rs.31 Crs. But I have a question. Can i use short term borrowings for acquiring Plant and Machinery? |
| Manu | No! But short term borrowing is going to give you cash and you may use that and find some long term funds later as a substitute. |
| Vinu | It’s a Criminal Mistake! |
| Manu | Don’t worry. Let us go ahead! Please prepare your Balance Sheet first. |
| Vinu | |  |  |  |  | | --- | --- | --- | --- | | **Liabilities** | **Amount (Rs. In Cr.)** | **Assets** | **Amount (Rs. In Cr.)** | | Capital | 100.00 | Fixed Assets | 130.00 | | Additional Capital | 10.00 | **Current Assets:** | | | P&L (Retained Profits) | 3.00 | Raw Material | 2.00 | | Short Term Borrowing | 31.00 | Debtors | 12.00 | |  |  | Cash and Bank | - | | **Total** | **144.00** | **Total** | **144.00** | |
| Manu | Now you have to procure raw materials for this year sales.  Your last year sales were Rs.20 Crs. For that your RM was Rs.13 Crs and other expenses were Rs.4 Crs. |
| Vinu | Correct! |
| Manu | Current year also you will repeat the same plus additional sales. |
| Vinu | Correct! |
| Manu | Can you tabulate that for understanding? |
| Vinu | Will do that:   |  |  |  |  | | --- | --- | --- | --- | | **Particulars** | **With Existing Capacity** | **With New Capacity** | **Total** | | Sales | 20.00 | 50.00 | 70.00 | | RM Consumption | 13.00 | 38.00 | (51.00) | | Other Expenses | 4.00 | 7.00 | (11.00) | | **Profit** | **3.00** | **5.00** | **8.00** | |
| Manu | So it means, you are going to consume Rs.51 Crs worth of Raw Materials. |
| Vinu | Yes! |
| Manu | Do you have Raw Materials with you? |
| Vinu | My Balance Sheet says, i have Rs.2 Crs worth Raw Materials. But my requirement is Rs.51 Crs worth Raw Materials. |
| Manu | So, you have to purchase RM worth Rs.49 Crs. But you don’t have cash balance. You have to be dependent on your cash sales for purchase of RM. So, ascertain cash inflows from sales. |
| Vinu | I don’t have any information on that! |
| Manu | Then take this shock! Your Credit sales are going to increase to remain competitive in the market. Your total sales are Rs.70 Crs of which 80% is going to be on credit |
| Vinu | So, I will have debtors of Rs.56 Crs. Already I had debtors of Rs.12 Crs |
| Manu | So your total debtors will be Rs.68 Crs. But find out your cash sales. |
| Vinu | Cash sales will be Rs.70 Crs x 20% = Rs.14 Crs |
| Manu | So please prepare cash statement to know cash generation. |
| Vinu | |  |  | | --- | --- | | **Opening Balance** | **-** | | Add: Cash Sales (20% of Rs.70 Crs) | 14.00 | | **Cash Generation** | **14.00** | |
| Manu | Make use of cash generated to purchase goods and calculate how much should be purchased on credit |
| Vinu | |  |  | | --- | --- | | Raw Materials requirement | 51.00 | | Less: RM Stock available | 2.00 | | Raw Materials to be purchased | 49.00 | | Less: Cash Purchases with cash generated | 14.00 | | **Raw Material purchases to be made in Credit** | **35.00** | |
| Manu | So now you have exhausted all your cash balances! |
| Vinu | Yes Yes Yes! Alas! I also have other expenses for Rs.11 Crs! How will I pay them? |
| Manu | Those expenses will remain as Liabilities till they are paid off. |
| Vinu | True. That too current liability because of its operative nature. But why do you create all these mess? |
| Manu | Only then you will understand the real purpose of Fund Flow Statement. I am taking you through a real business scenario! |
| Vinu | Ok! |
| Manu | Now let us reconcile to prepare Balance Sheet. Will you have RM Stock? |
| Vinu | No. As per working, we consumed all RM Stock. |
| Manu | Will you have debtors? |
| Vinu | Yes. Rs.68 Crs |
| Manu | Will you have Cash Balance? |
| Vinu | No! All are consumed. |
| Manu | Correct! Now please prepare your Balance Sheet. |
| Vinu | |  |  |  |  | | --- | --- | --- | --- | | **Liabilities** | **Amount**  **(Rs. In Cr.)** | **Assets** | **Amount**  **(Rs. In Cr.)** | | Capital | 100.00 | Fixed Assets | 130.00 | | Additional Capital | 10.00 | **Current Assets:** | | | P&L (3 Crs + 8 Crs) | 11.00 | Raw Material | **Nil** | | Bank Overdraft | 31.00 | Debtors | 68.00 | | Sundry Creditors | 35.00 | Cash and Bank | - | | Expenses Payable | 11.00 |  |  | | **Total** | **198.00** | **Total** | **198.00** | |
| Manu | Can you reproduce two years balance sheet and Income statement in one place? |
| Vinu | Ya!  **BALANCE SHEET**   |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | | **Liabilities** | **Amount**  **(C.Y.)** | **Amount**  **(P.Y.)** | **Assets** | **Amount**  **(C.Y.)** | **Amount**  **(P.Y.)** | | Capital | 100.00 | 100.00 | Fixed Assets | 130.00 | 80.00 | | Additional Capital | 10.00 | - | **Current Assets:** | | | | P&L (3 Crs + 8 Crs) | 11.00 | 3.00 | Raw Material | **Nil** | **2.00** | | **Current Liability:** | | | Debtors | 68.00 | 12.00 | | Bank Overdraft | 31.00 | - | Cash and Bank | - | 9.00 | | Sundry Creditors | 35.00 | - |  | - | - | | Expenses Payable | 11.00 | - |  | - | - | | **Total** | **198.00** | **103.00** | **Total** | **198.00** | **103.00** |     **INCOME STATMENT**     |  |  | | --- | --- | | **Particulars** | **Total** | | Sales | 70.00 | | RM Consumption | (51.00) | | Other Expenses | (11.00) | | **Profit** | **8.00** | |
| Manu | In this entire exercise, we have not touched on Depreciation. Let us not touch on that now. |
| Vinu | Ok. |
| Manu | Now, try preparing the Fund Flow Statement. What are long term sources for this company now? |
| Vinu | Additional Capital of Rs.10 Crs when compared with Previous Year and Funds from Operations Rs.8 Crs |
| Manu | So your total long term funds is Rs.18 Crs |
| Vinu | Yes. |
| Manu | What are your long term uses? |
| Vinu | It is Rs.50 Crs of Plant and Machinery when compared with previous year. |
| Manu | Here comes the catch. Go ahead and prepare your Fund Flow Statement. |
| Vinu | |  |  | | --- | --- | | **Source of Funds** | | | Capital | 10.00 | | Funds from Operations | 8.00 | | **Total Source (A)** | **18.00** | | **Use of Funds** | | | Fixed Assets | 50.00 | | **Total Use (B)** | **50.00** | | **Deficit (A-B)** | **(32.00)** | |
| Manu | Now, what does your fund flow communicate? |
| Vinu | Its communicating something very basic, but very serious.   I had long term source of Rs.18 Crs   Whereas   My long term use was Rs.50 Crs   I had a deficit of Rs.32 Crs |
| Manu | It means you have used some other funds for creating long term assets. |
| Vinu | Yes |
| Manu | Which Funds? |
| Vinu | I have used the funds meant for Working Capital purposes. |
| Manu | Yes. You have committed the crime of using short term funds for long term purposes. |
| Vinu | Yes. I understand. But I am struck here. Can you elaborate this? |
| Manu | Ya.  Previous year your working capital requirement was Rs.23 Crs and that was funded fully by own funds.   But current year, your Gross Working capital fund requirement was Rs.68 Crs.  (i.e, Current Assets). But against this you had current liability of Rs.77 Crs. You had negative working capital. |
| Vinu | What does that mean? |
| Manu | It means, you have to pay Rs.77 Crs in the short term as your liability, where as you have only Rs.68 Crs as resource available to pay that! You have used short term funds to the tune of Rs.9 Crs for creating long term assets. This will have serious bearing on the operations of the company. |
| Vinu | But why? |
| Manu | Your short term funds were locked in long term assets.   Those who have lent you in short term will ask for repayment in the short term. At that point, you should have short term assets (resources) to pay short term lenders. But now your funds were locked in long term assets and you cannot dispose those assets soon.   So, short term lenders will take you for a ride.   That would be a disastrous ride, sometimes even leading to winding up of the company, if they are not paid as agreed!!! |
| Vinu | Getting your point!   Let me tabulate that:   |  |  |  | | --- | --- | --- | | **Particulars** | **Previous Year** | **Current Year** | | Current Assets | 23.00 | 68.00 | | Less: Current Liability | - | 77.00 | | Working Capital | 23.00 | (9.00) | | **Reduction in Working Capital** | **32.00** | |    I have used this reduction in Working Capital to fund Fixed Asset creation. I think this is the amount revealed by Fund Flow Statement. |
| Manu | Exactly!  Fund Flow Statement (FFS) shows how irrational you are!  You have attempted to create long term asset to the tune of Rs.50 Crs by arranging long term funds of just Rs.18 Crs and relying predominantly on short term funds of Rs.32 Crs.   FFS shows you want to run business with others funds, especially funds which can put lots of pressure on liquidity of your business.   FFS shows solvency of your business is always under pressure and threat!   FFS shows you wanted to create assets even before you stabilise in your operations!   FFS shows you are very poor in Working Capital Management!   Your FFS shows, you have cheated your banker, because you have availed cash credit but in turn used it for creating fixed assets! |
| Vinu | My God! Whether Fund Flow is such a dangerous monster? |
| Manu | Yes! If you’re activities are monstrous, illogical, detrimental, you have to be cautious about this guy – Mr. Fund Flow Statement. He is there to reveal what you do! |
| Vinu | Thanks Manu! Now I understand why banks are so serious about this statement and why it is considered as critical topic in two examination papers. Thanks a lot! |