Financial Accounting
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Lecture – 101
7.13 Preparing Cash Flow Statement

Alright, now you are through with the three subsections of the Cash Flow Statement. You know what goes where in the three subsections. Now, it is time for us to prepare a cash flow statement at one go using the information from the balance sheet of the 2 years.

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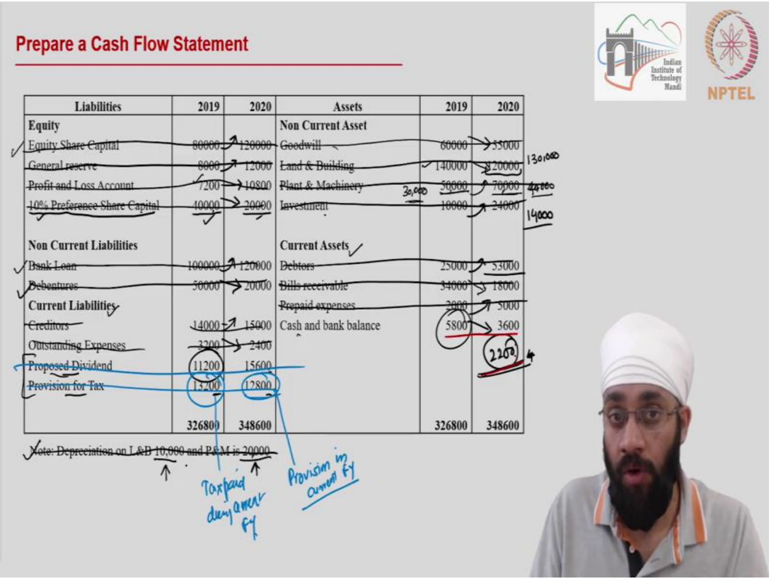

On the screen, you see a balance sheet where we have balances for 2019 and 20. We are going to use the balance sheet.

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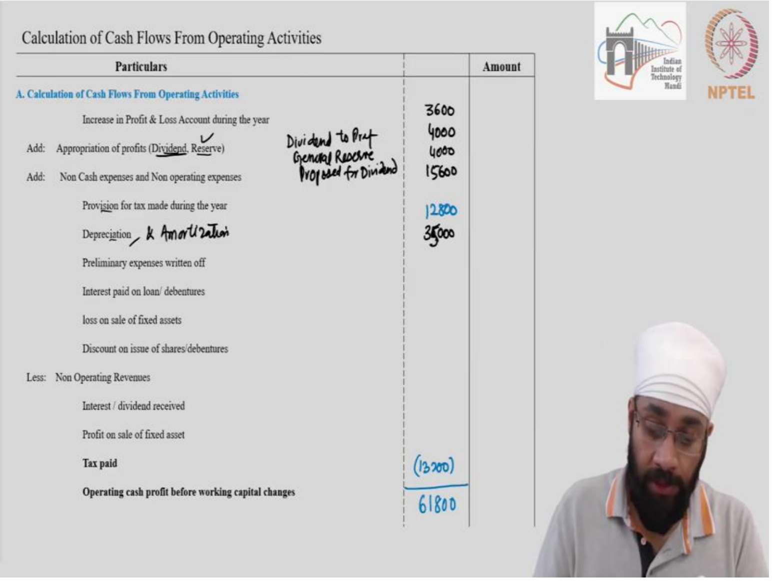

And this is all we have. We do not have an income statement here. We are going to use all the numbers from here and transfer the changes into operating activities here, and the investing activities section B, and finally, the financing activities.

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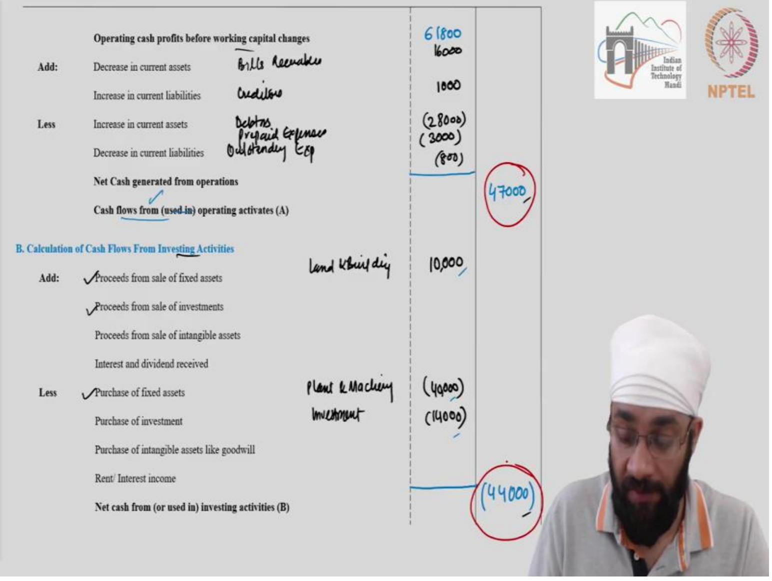

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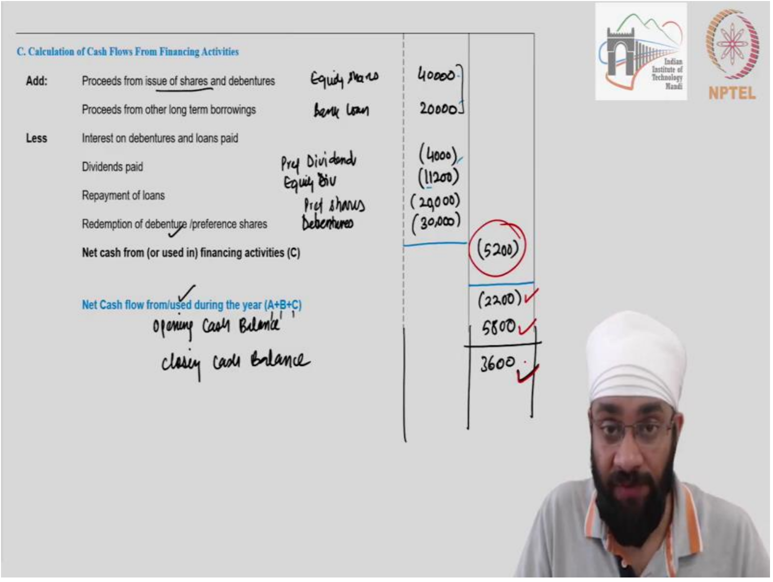

And then we sum up the totals of the three subsections to figure out the net change in cash during the year.

So, let us begin. We start with the profit and loss account, the increase in this account during the year. So, the profit and loss account goes up from 7,200 to 10,800. This is the change in the profit and loss account which means that after all the appropriation of profit transfer to general reserve, payment of dividends to equity shareholders, preference shareholders, the remaining profit, the retained profit was added to this profit and loss account. So, 7,200 was the profit retained till the previous year. And at the end of this year the profit retained is 10800 which means the difference between these two numbers is the profit that was retained in this year and that is the number we are after. So, this comes out to be 3,600. So, 3,600 is the profit and loss balance, the amount of profit which was added to the profit and loss account. And then, we are going to add to it the appropriation of profit, any dividend or transfer to reserve. So, let us look for this information, is there any dividend? Well, the preference shares say that there is a 10 percent dividend on the preference shares. We do not have the income statement, but we know the preference dividend is fixed and it has to be paid. So, 10 percent would have been paid on the opening balance at the beginning of the year and this 20,000 at the is the balance at the end of the year.

So, we are going to assume that the repayment has been done for the preference shares, but the repayment has been done at the end of the year. So, the dividend will have to be paid at the opening balance of the preference shares. So, 4,000 as the dividend has to be added back. So, dividend to preference shareholders 4,000 to be added back. Also, if the dividend has been paid then it should certainly be shown as a cash outflow, but this dividend is not an operating activity, this is a financing activity. So, in the financing activities there will be an outflow for the dividend which has been paid. So, I am going to go to the outflows from financing activities and I will write preference dividend paid 4000 and I am going to put this in the parenthesis because this is an outflow.

So, what I am doing is, I am going through each item and then wherever they belong I am just posting those items there. So, preference share capital, this item has been posted and I am going to cross these two off because we are done with these two. Next, we should also post this 20,000 right now. So, there is a reduction in the preference share capital which means this money is being repaid. So, 20,000 cash outflows in financing activities, 20,000. This is preference shares.

Next item in the operating cash flow from operating activities which are non-cash expenses. So, is there any provision for tax, depreciation? Let us look for such items. By the way, we missed one which was a reserve. So, let us do that as well. So, there has been an increase in the reserve by 4,000 which means you transferred the profit to the reserve. This is a non-cash item; we have to add back 4,000. So ,4000 is the general reserve, you did not pay this money to anybody. So, actual profit during the year is higher by 4,000 that is what we are writing. I am crossing it off because I have transferred this to the relevant place where it needed to be. Then, we are looking for any non-cash transactions which is depreciation, and for depreciation we go to the asset side of the balance sheet to look for the fixed assets and there is also a note which is given to us. It says depreciation on land and building is 10,000, plant and machinery is 20,000. We can simply pick these numbers and say depreciation during the year is 30,000. So, depreciation is 30000. We have to add it back because we did not pay this money to anybody and we are after cash operating profit. We will add this non-cash expense back. So, this has been taken care of. We do not need to worry about this.

And then you have goodwill, in the fixed assets goodwill is going down which means goodwill is being amortized as well. So, 5000 goodwill. I am going to make this 35,000 because typically they show all of this under one head.

So, 35,000 is the amortization, goodwill is done. Now, land and building was 140,000, now it is 120,000; it is going down by 20,000. And on land and building the depreciation is 10,000.

So, the opening balance should have gone down by only 10,000. Therefore, at the end of the end of this year in 2020 the balance in the land and building account should have been 130,000, but it is 120,000 which means additional 10000 rupees worth of land and building must have been sold. There is no other explanation for this. So, there is a sale of land and building 10,000 and we are going to show that in the investing activities because this is sale of fixed assets. So, proceeds from the sale of fixed assets here. So, this is 10,000 and this is an inflow, land and building done. So, this is investing activity; any transaction relating to fixed assets go to this second subsection in the cash flow statement.

Now, I can cross this off because I have taken care of all the relevant items here. Plant and machinery were 50,000 at the beginning and 70,000 at the end, there is clearly an increase in the balance. So, 20,000 rupees worth of increase you could say this is a purchase. However, we also have information about depreciation which says 20,000 rupees worth of depreciation was charged that means the value of plant and machinery has to be reduced by 20000. So, only 30000 is the value. And then at the end of the year the balance is 70000. So, this means you have purchased plant and machinery not worth 20,000, but worth 40,000. So, from 30,000 it has gone up to 70,000. So, 40,000 is the purchase of plant and machinery. And I am going to go to the second subsection and purchase of fixed asset, plant and machinery and the amount is 40,000. And this is an outflow, I will put this in the parenthesis, done. So, I will cross this off as well.

Then you have investment. Investment goes up from 10,000 to 24,000. 14,000 rupees worth of investment is being purchased. There is no depreciation charged on investments. These are simply financial instruments where a company would invest money. So, 14,000 is a purchase of investment. So, purchase of investment here is an outflow of 14,000. That is it, I will cross this off and we are done.

Now, there is only one item left on the liability side in the top half, so just for my mental satisfaction let me do this first. Equity share capital goes up from 80,000 to 120,000 which means more shares have been issued against which cash inflow has taken place. So, 40,000 is the cash inflow due to equity shares and we are going to put this here, issue of shares. So, equity shares have been issued and the amount is 40,000 and this is a positive number because this is an inflow, done.

So, now, we are done with the first section in the balance sheet. Let us look at the rest of the items here as well. Now, bank loan is also going up by 20,000, you are raising a bank loan. Now, bank loan raised will go to financing activities, the amount was 20,000 here. And then you have debentures which are going down which means you are paying the debentures. So, 30,000 is the payment being made to the debenture holders. So, redemption of debentures here, 30,000, negative number, let me write it here debentures rebate. So, these two are also done. Now, we are left with current assets and current liabilities. And we know that current assets and current liabilities are taken care of in the first section of the cash flow statement.

These are the working capital changes that have to be taken into account. So, we are going to go to the working capital changes. So, this is the section here. Let us take each of these items one by one and do the necessary treatment. So, creditors are 14,000 and 15,000, so liability going up is an inflow increase in creditors is an inflow of 1000.

Then, you have outstanding expenses going down which means you are paying them, so it is an outflow the amount the amount is 800; outstanding expenses 800 is being paid for. So, this is done and this is done. Then, you have proposed dividend and provision for tax and I am going to keep these separate because this will need some discussion. Let me finish the working capital changes.

So, on the other side, in the asset side we have debtors which are going up which means you are blocking more money, you are selling more goods on credit to the customers, you are not recovering the money. So, the increase in debtors is 28,000. This is money being blocked. So, these are debtors. This is done now

Bills receivables are going down. So, decrease in current assets meaning we have recovered the bills, so this is an inflow and the amount comes out to be 16,000. This is done. And then you have prepaid expenses which are going up meaning more expenses are being paid in advance, this is a cash outflow. 3000 outflow, let me write it here. I will say prepaid expenses. Here you go. All the current assets have been taken care of.

Now, we are left with cash and bank balance. There is a change in the cash and bank balance, this is going down. This is going down by 2200; it is the change in the cash . The purpose of the cash flow statement is to explain this change. We do not put this balance in the working capital changes because we are trying to explain. This is the purpose of the cash flow statement to explain these changes.

Now, we have these two items: proposed dividend and provision for taxes. So, in this case we do not have exact information on what is the actual amount of dividend being paid or what is the actual amount of tax being paid. But we do know that there are provisions for both dividends and taxes. Proposed dividend is also the provision which is being created. And there is some balance in this account in the last year and at the end of the current year. Again, both these provisions are essentially part of the profit. From the profit you create a reserve, you start calling it provision for tax, provision for dividend. So, it is a kind of reserve.

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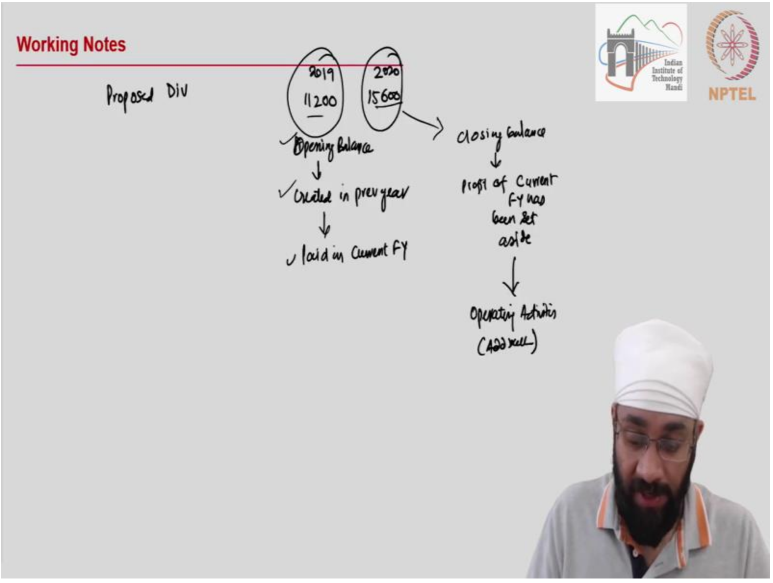

So, what we are going to do is for the proposed dividend and provision for tax, we are going to assume, I have a sheet for working notes, the proposed dividend we had 2019 balance and 2020 balance, the amounts are 11,200 and 15,600 here. So, the assumption we are going to make is that this is the balance of the previous year, this is the opening balance. This is the opening balance since this is the opening balance this provision was created last year. And since this was created last year, once you create the provision, what is the purpose of creating a provision? The purpose is you set money aside and then you pay it when that contingency arises, and dividend is actually not a contingency that you will have to pay, it is just that there is a process which is followed.

You first create a provision and then you pay after some time. So, this is the opening balance. This was created in the previous year which means this will be paid in this year. Paid in the current financial year. This is what we are going to assume. On the other hand, here, this is the closing balance. This means that this much amount of profit of the current financial year has been set aside, this is what it means. So, from the profit this year, 15,600 was taken out and kept aside. And during the year the actual dividend which was paid is this, 11,200 which is the opening balance. So, we are going to use these two numbers and we know where these things are going to go. So, this number would be added back in the operating activities because this is a non-cash expense. So, operating activities, we have to add back. This is the provision that has been created this year.

So, you would have reduced the profit in this year, but you have to increase the profit because this is not actually the dividend being paid. And also, because this is not an operating item. So, 15,600 to be added back. Here you have provision for dividend. So, the dividend will be here. So, provision for dividend here. And the balance is the balance of the previous year which is 11,200; the current year 15600 here.

And now, the actual dividend which is being paid is the previous year's balance 11,200 and this will go to financing activities. So, equity dividend 11,200 is the actual dividend being paid during this year. So, that is the assumption we make as we move forward. In one of the following videos, I will say what to do if you know actually how much dividends are actually being paid. Right now, we are making an assumption, alright.

Likewise, provision for tax, we are going to do the same thing. We are going to assume that this balance here 2020 balance is the provision that was created in this year, provision in current financial year, this is a non- cash item. So, 12,800 was money set aside, not actually paid. So, we are going to add this back. So, 12,800 is the provision for tax. So, the amount is 12800, I will write it here. There is no significance of the different ink here. And the previous balance is the actual tax paid during the year. This is tax paid during the current financial year 132,00; this is a negative number, done. Both these items have been taken care off as well. This is the big mess, do not mind that. But we have all the numbers that we require in the three subsections of the cash flow statement.

Now, we have to figure out what is the outcome of each of these three subsections. After doing the calculations we figure out that 61,800 is the cash inflow. So, this is a positive number. This is the operating cash profit before the working capital changes happen. So, 16,800 is the cash operating profit during the year.

Now, we go to the next section where the working capital changes are made and let us see what number comes out. So, 61800, I will bring it here just for convenience and we will do the math again. After we do these calculations, we have 47,000 as the cash flow from operating activities.

This is the result of section A, first section A, 47,000 is the cash flows from operating activities. Now, we go to the second subsection and we do the math. This should be simpler. So, you have 10,000 coming in, but you have 54,000 that are being spent. So, 44,000 are being spent on the investing activities of the business.

Let us now go to the final section. And all we need to do is to do the summation here. So, this comes out to be 60,000 and this is 50, 60, 61, 200, 65, 200 you have 5200 as the outflow. So, now all you have to do is to sum the section A, B, and C's totals and you have 47000, 44000 which gives you 3000 and negative, so 5200. So, this is 2200 and this is a negative number.

So, this is net cash flow used during the year A plus B plus C. So, this is the cash that has gone out of the business. Now, to verify that this whole process that we did was correct, we will use the opening balance. So, opening cash balance and cash balance would include cash and cash equivalents. Cash equivalents will include bank balance and also the marketable securities.

So, the opening cash balance in the balance sheet was 5,800. So, we started with 5,800 in the beginning and the changes during the year are 2,200. So, if you sum this up just increase this template a little bit, you are left with the closing balance which is equal to the amount 3,600, which is the closing balance as well, works out.

So, what we did in this question was that we divided this 3,600, which we knew well in advance. We divided this 2,200, not 3,600. 22,00 was the change in the cash. Let me just take a different ink here. So, the net change in the cash balance during the year was 2,200 and we are trying to explain the reasons for these changes.

The first reason for the change in the cash balance of the business is that 47,000 rupees were brought in by the operating activities. The second reason is that 44,000 were spent in the investing activities. The third reason is that 5,200 were spent in the financing activities of the business. So, you started with 5,800 in the beginning and net you spent 2,200 during the year. Therefore, you are left with 3,600 at the end of the year.

That is how the cash flow statement is prepared. And that is pretty much what I wanted to discuss in this video.