Financial Accounting
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Lecture – 102
7.14 Identifying hidden information (Part 1)

In this video, I am going to discuss three items which are not directly visible all the time in the balance sheet or income statement of the company, but they do have a telling on the cash flows of the business and we need this information to prepare the cash flow statement.

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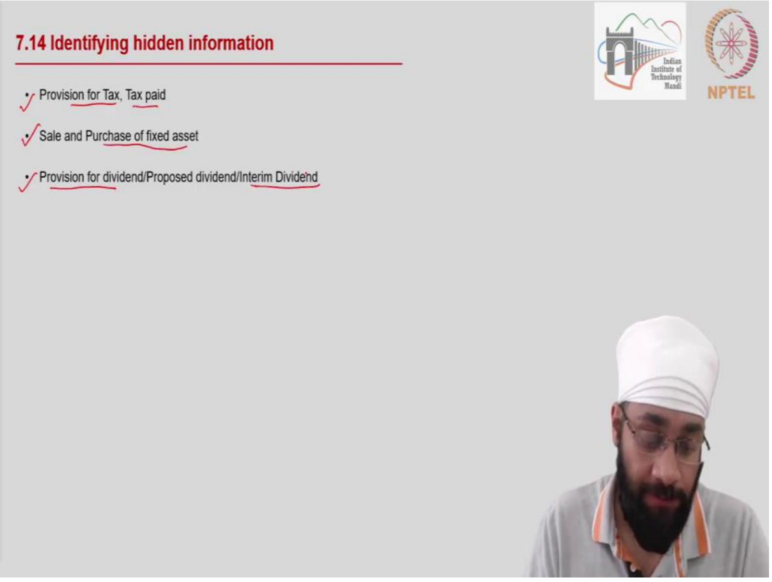

So, I am going to talk about these three items: provision for tax versus tax paid, sale and purchase of any fixed asset and finally, the provision for dividend vs. the dividend actually paid, also an item called interim dividend.

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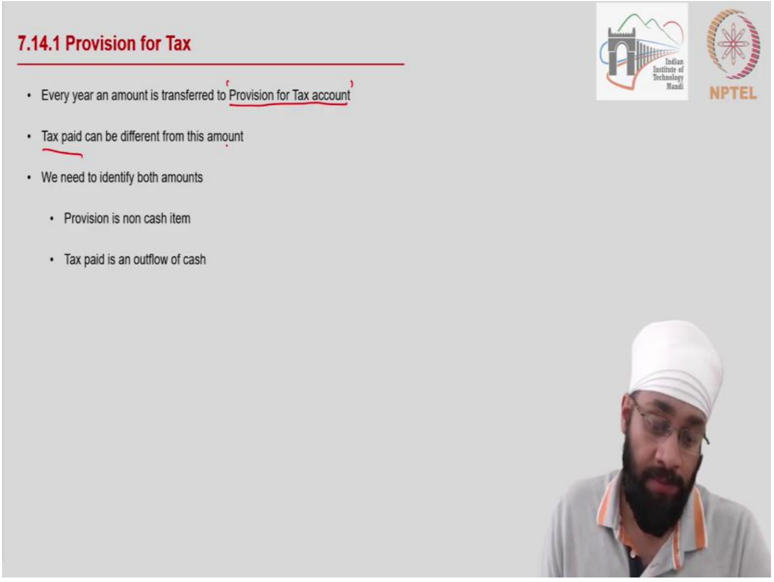

So, let us go over these three items one by one. We start with provision for tax. Now, what happens is that an amount is set aside every year, and you call this amount which is set aside, put into an account which is called provision for tax.

Now, provision for tax, as I explained earlier, the tax liability is determined at a later stage. The accounts have to be closed, financial year ends, but the tax liability goes into the next year, that is when it is determined. It takes more time.

Therefore, the provision that you create versus the tax that you pay ,they can be two different numbers. And what we are essentially trying to do here is as and when you know that this is the actual amount of tax paid, then you have to make adjustments to the cash flow statements to reflect the actual cash received or paid during the year.

So, we will look at three cases to understand how provision should be treated and actual tax expense should be treated although you have some insight from the previous practice problem that we solved.

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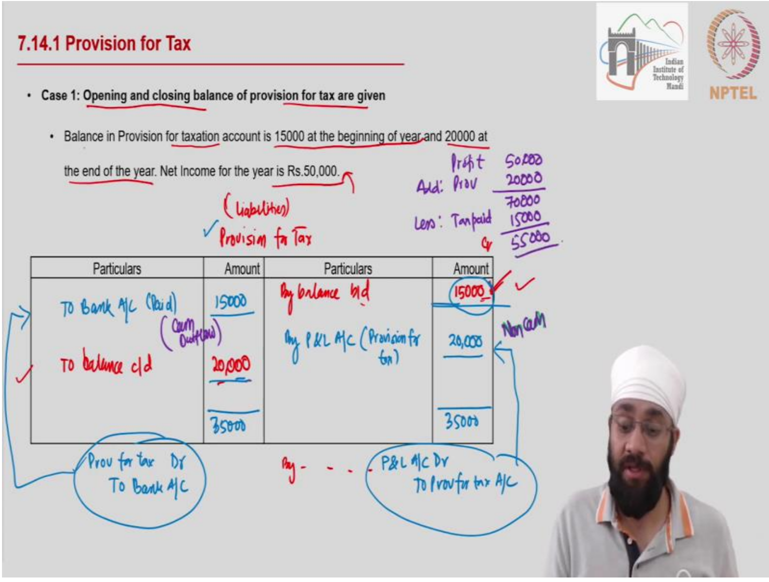

So, the first case is that you have an opening and closing balance of provision for tax. They can be given in the balance sheet or you know in general as an additional information. These numbers may be given to you.

So, for example, the balance in the taxation account is 15,000 at the beginning of the year and 20,000 at the end of the year and the net income for the year is 50,000. Now, what we have to do is to tell what amount should be added back to the profit and what amount should be taken out as an actual amount of the tax.

So, in order to do this, we prepare the provision for tax account. So, this is a provision for tax account and since this is a liability side account balance, it has a credit balance. So, we are going to begin with the opening balance here By balance brought down was 15,000 and the closing balance on the opposite side, To balance carried down this is 20,000. This is the balance in the provision for tax account.

So, the idea is that you put some money in the provision. Let’s say there was 15,000 at the beginning already in the provision account; that means, this must be left over from the previous year. So, in the provision account you put some money and the actual amount to be paid can be less and then you have a closing balance in that account and that closing balance from the previous year has been brought here.

The reason we are writing this on the credit side is because this is a liability. In the previous year the closing balance would have been calculated like this. This is a credit balance written on the debit side. But this is the credit balance and then of course, it has to go to the next year. You will write here By balance brought down 20,000 for the next period. Likewise, we are bringing the balance of the previous year forward to this year and that is how we are starting the account on the right hand side on the credit side, alright.

Now, you have not been given any information here about what is the actual tax that is paid during the year or what is the new provision that is created during the year. That information has not been given to you or the easiest thing that you could do is you can say the provision was 15,000 and now it is 20,000. So, 5,000 more has been transferred into the provision, but that is not how we do it. Tax has to be paid; some amount of tax advance tax has to be paid during the year. So, we have to figure that out.

So, the assumption that we make is as follows. We are going to say whatever is the balance in the beginning is the actual tax that is paid during the year and when tax is paid the journal entry is provision for Tax Account (Dr.), To Bank Account. So, I am going to write To Bank Account here and this is the tax actually paid during the year and we are saying the opening balance in the provision for tax account is what is being paid.

And, on the other hand, whatever is left is the balance left. So, 35,000 is the total and you have 20,000 here essentially the closing balance. This is the amount of new provision. So, this is a profit and loss account and this is the provision created during the year provision for tax. Now, understand these two journal entries. The first journal entry is provision for tax account debit and we are writing, To Bank Account.

This is the payment of the tax to the bank account, cash is going out and money is being taken from the provision account. On the other hand, when you create a provision; when you create a provision you take money from the profit. So, the profit and loss account is debit. If you remember the profit and loss appropriation in the profit and loss account you write provision for tax on the debit side.

What is the journal entry? Profit and loss account debit to a provision for tax account. All we are doing is posting these entries here. So, this entry is being posted here, this entry is being posted here that is it. So, I am repeating the assumption that the previous year's balance is being paid in this year and this year's closing balance is the amount of new provision which is being created.

Now, why is this distinction required? Because this is a non-cash item. This is a non-cash item, and this needs to be added back to profit and this is the cash outflow. This is the actual cash outflow which should be deducted from the cash flow from the operating activities. This is one case where you have only the opening and closing balances.

So, what you are going to do is you will say net profit during the year is 50,000 add back into this the provision that you made during the year which is 20,000 therefore, the profit is 70,000, cash profit is 70,000. And, you deduct from this the tax which has been paid during the year which is 15,000. Therefore, you have 55,000 as the cash operating profit during the year, this is the purpose.

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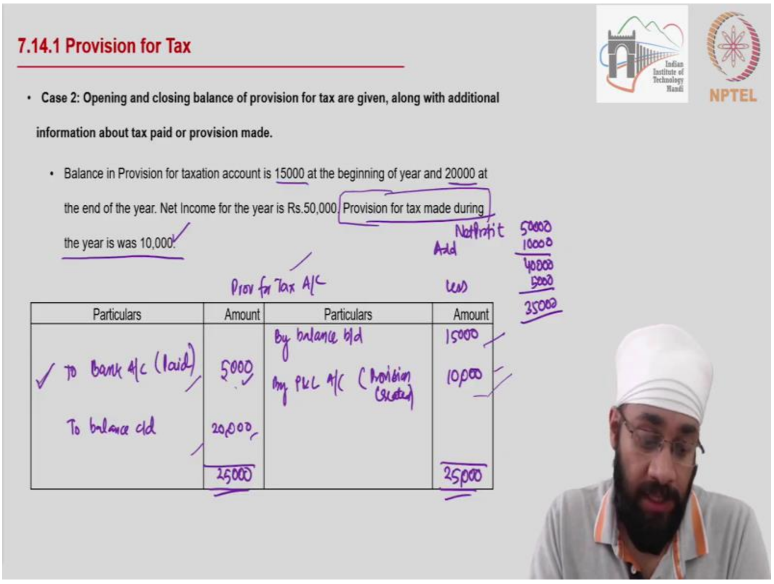

Let us go to the second case. The second case can be that in addition to the opening and closing balances, you have been given the information about the provision that was created during the year. So, this makes things simpler for us. We are again going to start with the opening balance, By balance brought down, which was 15,000 and the closing balance is 20,000. So, to balance carried down. Now, we have been given this information that the provision made during the year is actually 10,000 and the journal entry is profit and loss account debit to the provision for tax account. So, profit and loss account, this is the provision created during the year and this amount is 10,000. Now, we do not have to do any guess work. The amount has been given and accordingly we will figure out the balance in this account; so, 25,000. Now, the total should be 25,000, but the balance is only 20,000 where is the remaining 5,000? Well, the remaining 5,000 has been paid to bank account. This is tax paid during the year and this is the hidden information that was not available to us.

So, the same format provision for tax is going to have these four items: opening balance, closing balance, provision created and the tax actually paid. Now, if the tables were turned and you are not given provision created, but tax paid you can figure out the provision created. So, these are the four items, this is the zero-sum game in that sense. So, whichever information is provided, you write that down and figure out the hidden information.

Now, accordingly in the net profit which is 50,000 you are going to add back the provision that was created which is 10,000. So, this will give you 40,000 and then you will deduct from this the actual tax paid which is only 5,000. So, cash operating profit will be 35,000 that is the use case for this provision for tax. So, that is what I wanted to discuss about the first item.

I will stop here and I will continue the discussion on the next item in the next video.