Financial Accounting
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Lecture – 93
7.5 Cash Flows from Operating Activities (Part I)

It is time now to look at each of the three sections in the cash flow statement one by one. In this video I am going to look at the first section and tell you how the cash flows from operating activities are calculated.

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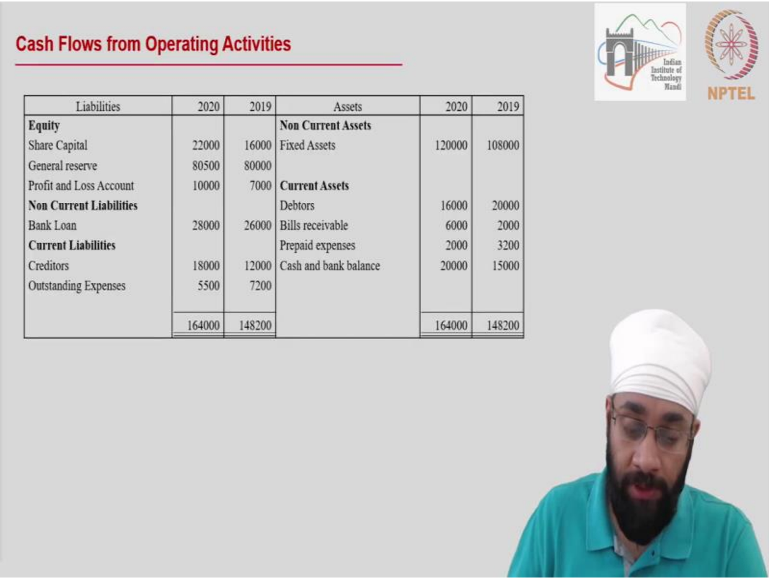

Liabilities	2020	2019	Assets	2020	2019
Equity			**Non Current Assets**		
Share Capital	22000	16000	Fixed Assets	120000	108000
General reserve	80500	80000			
Profit and Loss Account	10000	7000	**Current Assets**		
Non Current Liabilities			Debtors	16000	20000
Bank Loan	28000	26000	Bills receivable	6000	2000
Current Liabilities			Prepaid expenses	2000	3200
Creditors	18000	12000	Cash and bank balance	20000	15000
Outstanding Expenses	5500	7200			
	164000	148200		164000	148200

I am going to do that with the help of a set of financial statements. You see on the screen a balance sheet. You have all the terms that you are aware of. It is presented in the format that we know about as well, and I also have a profit and loss account. But along with the profit and loss account there is also a section on profit and loss appropriation and you have seen this statement before as well.

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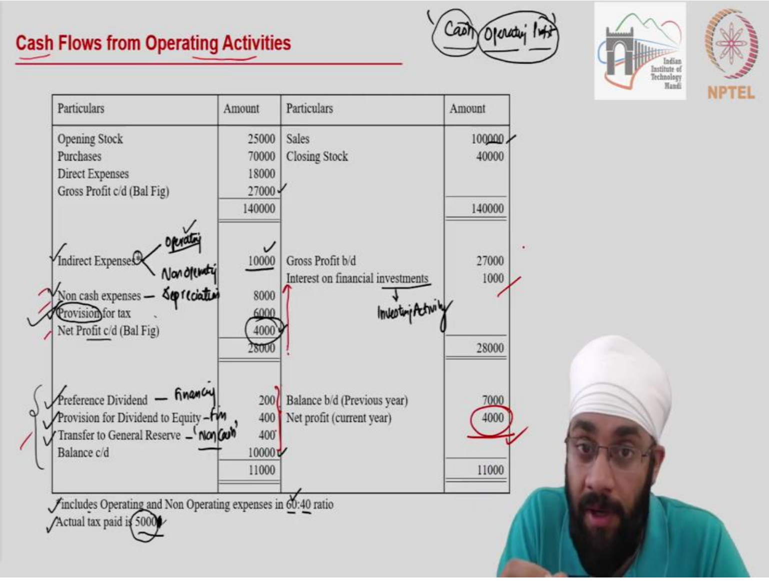

So, using this we are going to talk about the process which is used to arrive at cash flows from operating activity. Now let us look at this account. In this account you have sales, purchases, direct expenses, a number of expenses, and incomes are stated here. What is our goal? Our goal is to reach at cash operating profit. This statement gives you a profit. However, our goal is to reach at a cash operating profit during the year. In this statement, we have a gross profit number, a net profit number and a final balance in the profit and loss account. We are trying to reach at cash operating profit during the year. You already know what operating profit is. Operating profit is equal to operating incomes minus operating expenses, but we are interested in cash operating profit. Therefore, you can use cash operating incomes and deduct from it the cash operating expenses and you will have your cash operating profit for the year.

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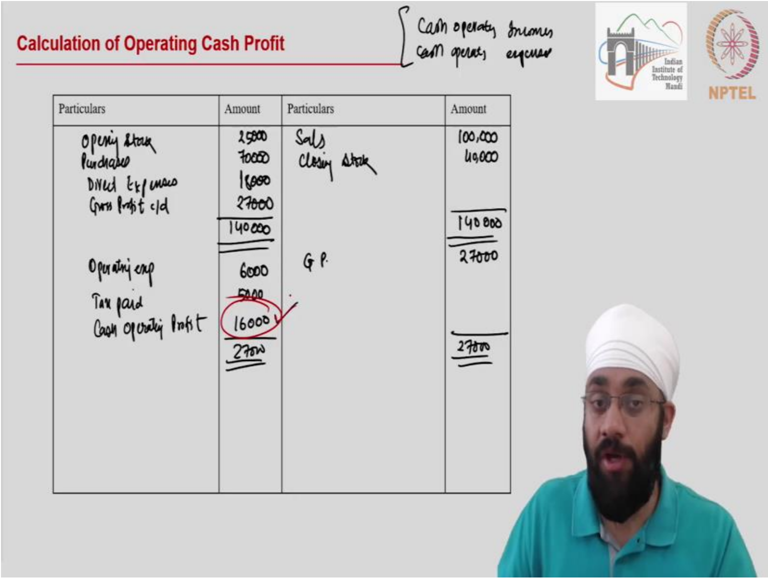

So, I have a format here which we are going to use to revise the existing statement and calculate cash operating profit. We are only going to take cash operating incomes and cash operating expenses and figure out our cash operating profit. Let us get started. Sales 100,000 and we are going to assume that these are cash sales. Then we have closing stock 40,000. So, no issues with that, this is closing stock. On the other side you have an opening stock of 25,000; you add to it the amount spent on purchases which is 70,000. Then you have direct expenses: all direct expenses are operating expenses. This is 18,000 and you have gross profit. So, till now there seems to be no problem. It seems that all the items that we have picked are operating in nature. 27,000 is the profit and you have 140,000 on the other side there you go. You start with the gross profit earned 27,000 and then you look at the rest of the expenses. Now, you have indirect expenses. We are fine with indirect expenses, but there are two types of indirect expenses: these can be operating expenses or non-operating expenses. What are we looking for? We are looking for cash operating profit, we are not going to deduct non-operating expenses. Therefore, what is the portion of 10,000 which is operating in nature? Now it says this: there is a star here, there is a note, it includes operating and non-operating in ratio of 60 to 40. So, operating expenses are 60 percent of 10,000 which is 6,000. So, we are only going to write operating expenses. Operating expenses or indirect expenses which are operating, 6,000. Then you have non-cash expenses. What are non-cash expenses? This is possibly the depreciation. We are interested in figuring out cash profit. So, cash profit is going to be equal to cash incomes minus cash expenses: depreciation is a non-cash expense. So, we are going to ignore it, we are not going to write it in the new statement that we are preparing. Then you have provision for tax. Again, this provision means you are not paying the tax, you are setting money aside for the possible amount of tax you have not yet paid. So, the bank account of the company has not gone down because of the payment of tax. So, this provision for tax we are not going to include in the statement here. Ignore this. Then you have net profit balance; our balance will be different. Let us look through the rest of the items here. You have actual tax paid which is 5,000; provision is an estimation that is the amount set aside, but the actual tax paid is 5,000. So, we will go here and we will say tax paid 5,000. 5,000 is the actual tax paid. So, this is how it works. At the end of the year you calculate your profit and then you calculate a percentage tax according to the tax slab the company is in or if there are any rebates the company is eligible for.

So, the tax liability estimation is done by the company and then it is done by the income tax authorities as well. For large companies there can be more complicated issues, some international transactions have happened. So, determination of tax liability takes time and typically it goes beyond a given financial period. But you have to close the accounts at the end of the financial year. So, you have to deduct some tax. What you do is you create a provision. You say possibly this is the amount of tax that we will need to pay and that is what is the provision here and then after the financial year ends, the tax liability is determined by the income tax authorities. There may be some back and forth there. After clarifications it turns out that 5,000 has been paid as the tax. So, we are interested in cash expenses. So, we will actually use only 5,000 and this will give us our cash operating profit. Cash operating profit 27,000. And this balance comes out to be 11,000. So, 16,000 is the actual cash and operating profit. On the other hand, we had 4,000 which was shown as the net profit earlier and we have 16,000 as the cash operating profit here.

After this you have the section on profit and loss appropriation. In the appropriations what do you do? You pay a dividend to preference shares. Is this an operating activity? No, this is not an operating activity. This is actually money being paid to the owners of the share capital, owners of the business, this is actually a financing activity. You are creating a provision for dividend. Again, this is also financing activity. You are transferring money to the general reserve. This is a non-cash transaction; you are not paying anybody right now just saving money aside. It turns out that from the next section there is no transaction which you should consider for this new account that we are preparing. We missed this one item, interest on financial investments, but again as we know this is an investing activity, this is not an operating activity. So, we will not consider this either, that is it. So, during the year the cash operating profit that was made is equal to 16,000. Now, note that you do not actually prepare this account. I did this exercise to help you understand what is meant by cash operating profit.

If you were to prepare profit and loss account to figure out cash operating profit, this is how you would do it. But in practice you do not prepare this statement; this is only for understanding. How do you prepare the statement then? The way to prepare the statement is as follows.

You start with a bottom-up approach i.e., by taking the net profit during the year, the profit that you make during the year, and then you make adjustments to it. If you remember in one of the previous videos, we looked at the cash flow statement of Reliance Industries and we started with profit during the year and then there were some adjustments which were being made. What are those adjustments? The adjustments are made to this profit figure, the adjustments are made for all the non-cash transactions, all the non-operating transactions. So, we are going to start backwards, we are going to use the profit during the year and we are going to make adjustments and then go upwards.

Whatever expenses which were not required to be deducted will be added back to this profit and the non-cash expenses will also be added back to the profit. The non-operating incomes will have to be deducted from the profit and that is how you are going to reach the number for cash operating profit.

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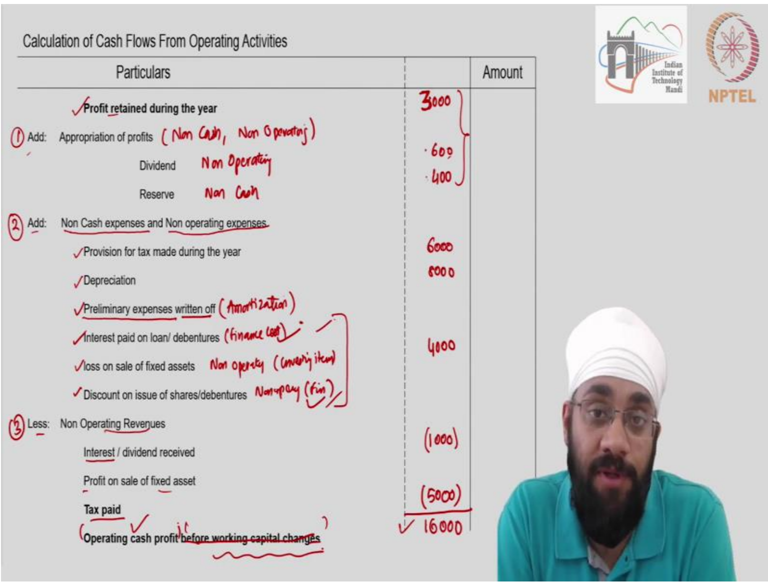

So, I will walk you through that as well. Same statement I have again for the next approach that we are going to take and this is how we are going to approach this problem. We are going to look at the number of the profit during the year and then we are going to add to it the appropriations of profit. Why are we adding appropriation of profit? Because these are either non-cash or non-operating.

The dividend which is paid is the non-operating item and the reserve is the non-cash item and we have seen here that you are taking some money out of the profit for the year. Profit for the year is 4,000, profit retained during the year is 4,000 and out of that you are taking out this money. Actually, profit made during the year is 3,000 not 4,000, the final number should be taken. So, 7,000 and 10,000, difference between these two the amount transferred to the profit and loss account. The 4,000 was further used in paying these people. So, 3,000 is the additional money that you transfer to the profit and loss account. So, this is retained profit during the years 3,000. You are going to add to it, you are going to make adjustments for the appropriation of the profit. So, the appropriations are here 1, 2, and 3. Three appropriations are given which is preference dividend and equity dividend. So, dividend is 600 and this is to be added back because we have deducted it, now we have to add it back. And transfer to general reserve is 400 this also a non-cash item. So, we added back. So, what do you get after this? You have 4,000: this is the amount of profit that you made during the year. Out of the 4,000 you had deducted, you had appropriated 1000. So, we start with this 3000. Finally, we add to it the two appropriations 600 and 400 because these are non-operating expenses and these are non-cash expenses. Then you make adjustments. So, this is the 1st section of adjustments, this is 2nd section of adjustments. We have now arrived, walking backwards from here, here. We have crossed the first stage of walking backwards: now we are at 4,000.

Now, we have to make adjustments for this non-cash item, this non-cash and non-operating expenses and non-operating incomes: we have to adjust for these. So, we are going to add non-cash expenses and non-operating expenses during the year. Now, a provision for tax made during the year I said this is a non-cash item, you do not pay to anybody. So, the provision that was made is 6,000. We are going to add back the 6,000 because you are not paying this to anybody: cash has not gone out. Please increase the profit by this amount ,you have this money with you. Then you have depreciation. Let us assume that depreciation is non-cash expense: this is 8000 and let me add this here. The other items that can exist which are non-cash in nature are preliminary expenses written off. What are preliminary expenses? Typically, when you start the business, before the start of the business, there are registration expenses, there are some other expenses which you have to do in order to register the business, in order to set the business in place. Now, all these expenses are preliminary in the sense that they are done before the business is started and the income tax laws allow that all the expenses done before the starting of the business can be treated as long term expense, as you treat the fixed assets, and then every year you can charge depreciation on these amounts. These amounts can be large as well. Preliminary expenses are being written off. This is an amortization: this is similar to depreciation. So, preliminary expenses are treated as a fixed asset because these are a lump sum amount done before the registration of the business and now you can depreciate them over a period of time in the business.

Then if you have any interest on the loan, this is the finance cost. Do we have any finance cost? We do not have, we have not been given specifically a finance cost, but we do have in the non-operating expenses which are 40 percent. So, we will take a look at that. Loss on sale of fixed assets is also a non-operating item, discount on issue of shares debentures is also a non-operating expense, or you know a finance expense basically. Actually, this is also finance cost, loss on sale of assets is actually an investing item. But again, when you have a loss that is a non-cash item, you get money from the proceeds of the asset assets, but no cash is being lost in the sale of fixed assets. We will talk more about it when we go to the investing activities. So, according to this, now we have to look for non-operating and all these are non-operating in nature and we have been given some information that non-operating expenses are 40 percent of this amount. So, 4,000 is non-operating. So, we will club all of this and say 4,000 and we will assume that non-operating will include some finance cost and some whatever else something which is not operating in nature.

So, we have added it back. The third step is to now go to the credit side and then deduct non-operating revenues. We are looking for cash operating profit we should not add any non-operating incomes. We had an income of 1000 which was non-operating in nature, this increases our profit. The 4,000 profit that we have includes 3,000 received from interest on financial investment which we should not include. So, interest earned is 1,000 and we should deduct it therefore, we are going to put it in the brackets. When we looked at the statement of reliance industries, I told you that the items in the bracket are the negative numbers, these are the outflows. So, rather than putting a negative sign we put a bracket sign, that is the format and then if you had any profit on sale or fixed asset you would also deduct that because any profit on sale of asset will also be shown as an income on the credit side. We do not have any such item. That’s it! Finally, you have tax that is actually paid. What is the tax actually paid? This is 5,000, actual tax which is paid during the year. I am going to write 5,000 and put a bracket around it to say that this is an outflow. Now, all we need to do is to sum this up. There are things which need to be added and two items which need to be deducted and we will have our operating cash profit. Ignore the rest of the statement. Operating cash profit and we have to do the summation. So, this comes out to be 16,000. So, I have 16,000 as the cash operating profit. Now before working capital changes refers to the next set of calculations that we have to do and I will explain that in a minute. Right now do not focus on that, only focus on the objective on the slide which was to calculate cash operating profit 16,000.

We used the other approach earlier when we prepared an account. Let us look at that account and say what is the cash operating profit. Well there you go, 16,000. So, if you prepare a new account and consider only the operating incomes and operating expenses cash incomes and cash expenses you get 16,000, we took an alternative approach where we went backwards.

We started from the profit earned during the year which was 3000 and then added back the expenses which we should not have deducted and deducted from it the incomes which we should not have added. That may be a mouthful. So, this is the process which is followed in practice and we have seen this in the statement, the cash flow statement of the Reliance Industries Limited as well.

So, I am going to stop here and I will do the second part of this discussion in the next video. In this video the purpose was to calculate cash operating profit and we have done that. In the next video we are going to look at the rest of the statement, what are these working capital changes and how do we make adjustments for the working capital changes. I will see you in the next video.