Financial Accounting
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Lecture – 94
7.5 Cash Flows from Operating Activities (Part 2)

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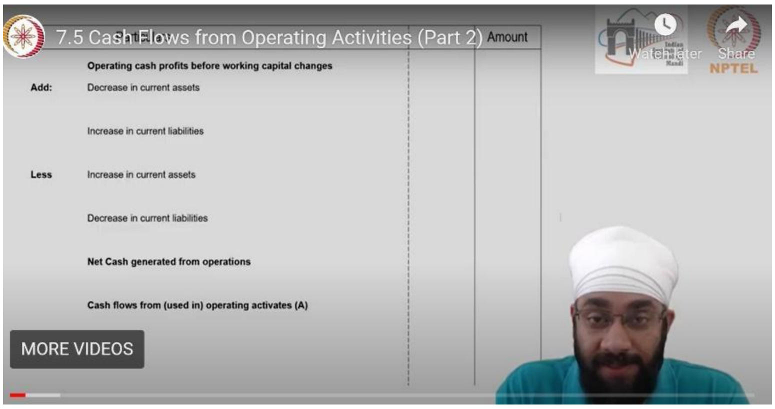

This is a continuation of the previous video. In the last video we looked at the calculation of cash operating profit.

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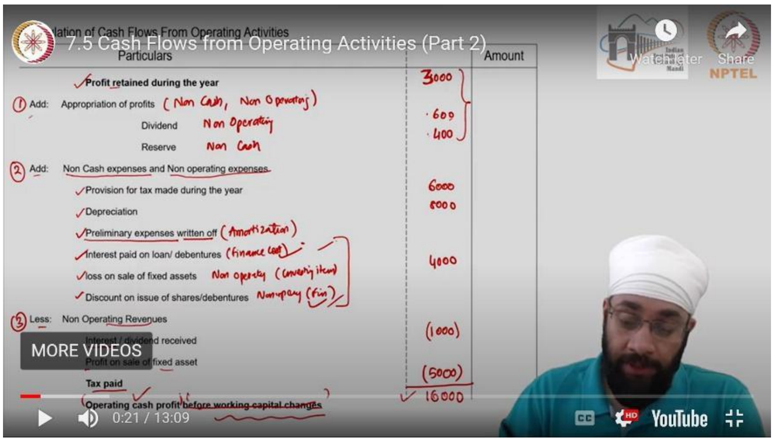

And, we found this out to be 16,000. I am going to write that number here: 16,000 is the cash operating profit. However, there are working capital changes which need to be made to this number to reach at the final number which is cash flows from operating activities. Now, what are these working capital changes and why do you need to adjust for these working capital changes?

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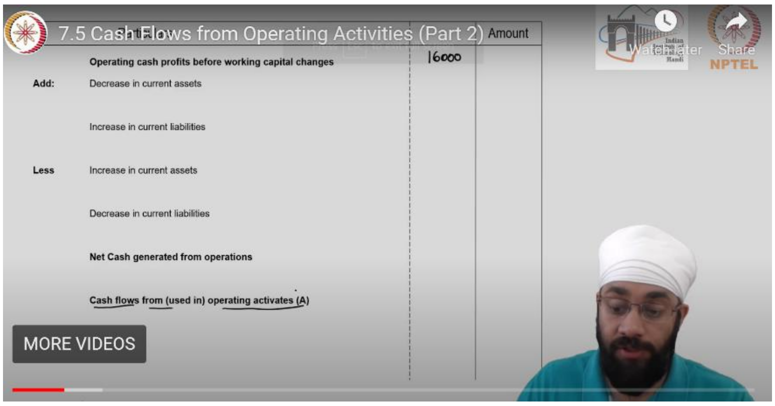

You see on the screen, the balance sheet associated with the income statement and let us talk about working capital. We know that working capital refers to the money which is temporarily blocked in the business. Now, where do you block the money? You block the money in current assets. How do you block the money? You buy stock and the stock is unsold: the money is blocked. You have bills to be received, bills receivables, which means goods have been sold and money has not been received and which is also called debtors (but there can be some differences you know in these two- but typically companies club everything and they say receivables) or trade receivables. So, money has to be recovered from the customers or people to whom we have provided services and this money has not been recovered, but you on the other hand have paid for it so money is blocked here. Then you could have prepaid expenses. Prepaid expenses mean money has been paid for but the services are still to be received: we have paid it in advance so, again money has been blocked here. And finally, you have cash and bank balance, but right now the statement that we have in mind is the cash flow statement. That statement will explain this change, how 5000 come into being and this is 2019-20 that is why I am going in this direction. In the last year cash was 15000, now cash is 20000, why? That is what we are after.

So, in the working capital changes, current assets actually use up your funds. On the other hand, current liabilities (for example, you have creditors here), the creditors actually give you some cash. It happens when you purchase from your vendors and you do not pay them. That is kind of saving, the cash you would have paid them, but they said pay us after 2 months. So, you have received that cash for 2 months from the creditors. You can also think of it in the following way: you purchase goods from the creditors you paid to him now cash has gone out and then the creditor comes back and says hey take this cash back pay me after 2 months. So, the creditor has given you this cash for 2 months you can use it and then when you recover from your customers you can pay to the vendor. You know just to think of it like that: you do not pay to the vendor and then it does not come to you, it does not happen like that. So, creditors or if there are outstanding expenses (expenses you do not pay after the expenses have become due), you are saving that cash with you, you are not paying it out, it is a liability as well. So, this is how we think about current assets and current liabilities, current assets kind of block your money and current liabilities provide you some money. So, the idea is to convert current assets into cash as soon as possible, you want to sell the stock, you want to recover the money, you want to get the services of prepaid expenses. So, this is what is referred to as working capital. Now, what are working capital changes? That is the next question. Let us start with the debtors here we have debtors. Receivables were 20,000. So, from 20000 now the receivables are 16000. What does it mean? Last year when you started the financial year 2019, 20,000 rupees were to be recovered from the customer. At the end of the financial year only 16000 need to be recovered. There is a change of 4000, there is a reduction of 4000. What does this mean? This means you have recovered this amount. In the beginning of the year, you were saying 20000 has to be recovered. Now, you are saying only 16,000 has to be recovered. So, during the year you must have recovered 4000 in cash. That means this is a cash flow which has not been shown anywhere. So, that is why we need to make working capital changes, we need to say that we have recovered money from the debtors. Decrease in the debtor, decrease in the receivables, results in cash coming in to the business. So, decrease in receivables is decrease in current assets and that is an inflow. So, here in the working capital changes, decrease in current assets- I am going to write receivables or the debtors here -decrease in current assets or decrease in debtors equal to 4000. This needs to be added to the cash operating profit because receiving from the debtors is also operating cash inflow, you sold the goods, this is operating income and this is cash income. So, we should show it here. So, we have done debtors. Let us look at bills receivable which go up from 2000 to 6000. So, bills receivable was 2000 and now it is 6000; there is an increase of 4000. What does this mean? This means bills were to be received 2000 and now there are 4000 rupees worth of more bills which need to be recovered from the customers, meaning you actually did not receive this money and there is more money to be recovered. These bills you must have paid on your own and now to be recovered. So, this 4000, the increase in the debtors, is an outflow of cash for the business because you paid for these bills, but your customer has not paid you these bills. So, 4000 increase in the current assets, I will write bills receivable 4000, this needs to be deducted. So, if you notice any decrease in the current asset, it is a source of cash. So, this is a cash inflow and that is why we are adding it and any increase in the current asset is a cash outflow and therefore, we are deducting it. As discussed earlier as well, when you create more current assets, you are blocking your money, that is an outflow of cash and that is exactly what we are making adjustments for.

The third current asset that we have is prepaid expense. Prepaid expenses are going down from 3200 to 2000. So, any decrease in the current asset is a source. So, I am going to write prepaid expenses. So, actually the difference is, it is going down by 1200. So, I will write 1200 here, it is a source and I am going to do a separate tutorial on understanding these changes and classifying them as an inflow or outflow as well. So, look out for the following videos where I discuss these things in detail. Now let us move on to the current liabilities side. You have creditors, creditors are going up from 2019 to 20. We are moving from right to left because the financial years are shown in that way. There is an increase in the creditors. It means 12,000 were to be paid to the suppliers, now 18,000 need to be paid to the supplier; there is an increase of 6000 in the money to be paid. If money to be paid has increased; that means, you did not pay for it; that means, you saved that cash and hence is an inflow of cash. So, increase in creditor or increase in current liability is also a source of cash. So, creditors are going up by 6000 and we are categorizing this as a source of cash. I will write cash inflow, you do not have to write it, but just for your information right now.

Then you have outstanding expenses, they were 7200 and now they are only 5500. At the beginning of the year, you had to pay 7200 rupees worth of expenses. Now, you only have to pay 5500, how? You paid some of the expenses. How much expenses did you pay? 1700, this is a decrease. So, if current liability is going down; that means, you met the liability you have paid for the liability. So, 1700 is a decrease in current liabilities bills payable. This is a cash outflow, that is it.

Now we have adjusted for working capital changes. There were changes in the current assets, current liabilities: some went up, some went down. Accordingly, we treated them either as inflow or outflow and now we have adjusted those. So, this number now gives us cash generated from operations, or cash flow from, or used in operating activities. So, here all you have to do is sum this up: this is 20,000, this is 21,200, this is 27,200. Now, you deduct from this 5,700 and you have your cash flow from the operating activities. This comes out to be 21,500, hoping the math is correct. 21500 is your cash inflow because this is a positive number. We do not have to write this now. So, cash flow from operating activities, this is section A of the cash flow statement of this sample. Coming to the example that we are doing, there were two steps involved in preparation of the first section of the cash flow statement.

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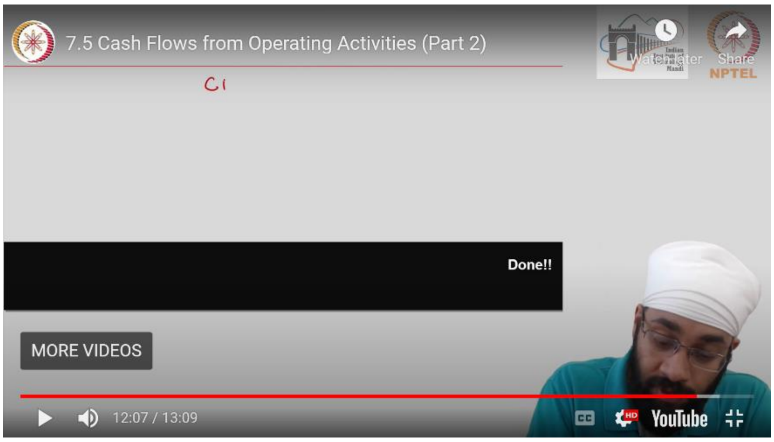

So, cash flow statements section A which is cash flow from operating activities, just to summarize. The first thing is the cash operating profit that you calculated. And then you made some working capital changes. That is the overall structure and this gives you the number which is cash inflow or outflow from the operating activities of the business. This is the result of section A. And that is it. I will see you in the next video. There are a bunch of tutorials which I will do to help you understand the preparation of this first section a little bit more and this first section is the most complicated of the three. Once you do this, the other two sections are going to be very easy. I will see you in the next video.