Financial Accounting
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Lecture – 95
7.6 Tutorial - Changes in working capital

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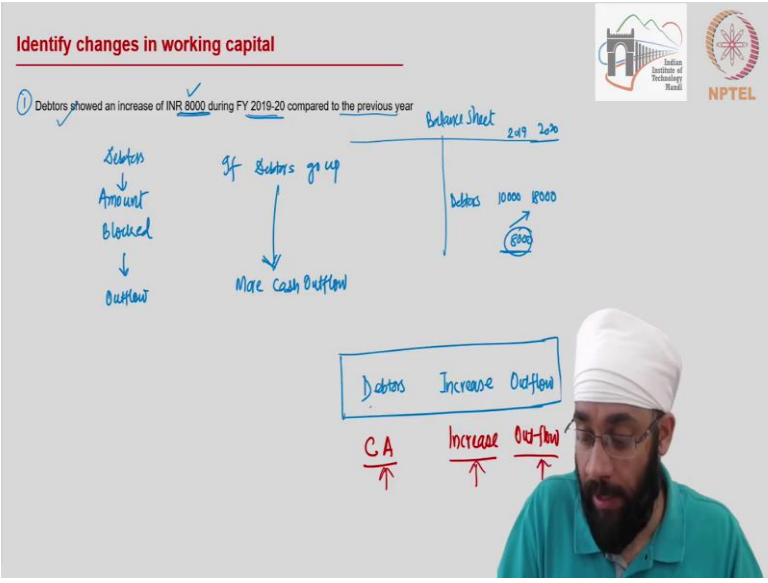

This is a tutorial on working capital changes. We are going to look at a list of transactions which indicate changes in the current assets or current liabilities and then we are going to say whether this results in an increase in the cash of the business (inflow) or decrease in the cash of the business (outflow).

So, let us look at this first transaction. It says debtors showed an increase of 8000 during this financial year compared to the previous year. Imagine that there is this balance sheet and in the balance sheet you have numbers for two years and you have debtors shown there. You have 2019 numbers and 2020 numbers and there is an increase of 8000. Let us say debtors were 10,000 and now they are 18,000. So, there is an increase of 8000 and this transaction here is only giving information about the increase, not the two balances. Typically, you would be given a balance sheet and using the balance sheet you have to calculate the changes. Here we only have the change. So, debtors show an increase of 8000 during this financial year. Now is this an inflow of cash? Or is this an outflow of cash and why? These are the questions that we are going to answer in this video. So, debtors mean the amount has been blocked. You sold goods to the business; money has to be received. The amount blocked is equal to the outflow of cash because you would have paid for the goods that you sold to the customer and they have not paid you. So, this is an outflow. If this goes up, if the debtors are going up; then what is happening is that you are selling more. But you are not receiving the money, more amount is being blocked which means more outflow. This results in more cash outflow. In this case, yes, this is what is happening. 8000 rupees worth of more debtors means that there is an outflow in the business.

We are discussing working capital changes. Working capital is made up of current assets and current liabilities. We look at each of the current assets: we are looking at one type of current asset which is debtors. The conclusion is that if the debtors increase, this will result in an outflow. This is the learning from this slide.

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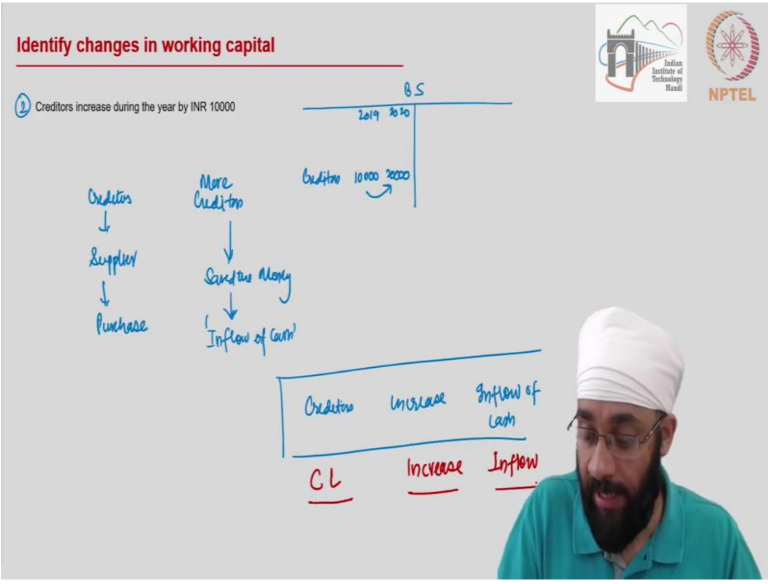

Let us go on to next page. I have another item here. This says creditors increase during the year by 10,000. Again, imagine the balance sheet where you have creditors data for 2 years and there is an increase of 10,000. So, from 10000, the balance has changed to 20000: creditors are suppliers. From these suppliers you purchase goods, raw material, everything else and you have to pay. When you do not pay, they become the creditors. So, if creditors are increasing that means you have saved the money, you have not paid them. In the previous video I spoke about how you can think about this that you paid to creditors and the creditor came back and said please keep the money, pay me after 2 months. Then you have the inflow, only except that does not happen. You just assume that you saved the money, you do not need to pay to the creditor which means this is an inflow of cash. So, the conclusion, the learning from this slide is that when creditors increase it results in inflow of cash. This is the learning from this slide and let me compare this to the learning from the previous slide where debtors, current assets, were increasing. This was an outflow here while creditors, current liability increasing is an inflow. So, these are two different things: increase in debtors is outflow and increase in creditors is inflow.

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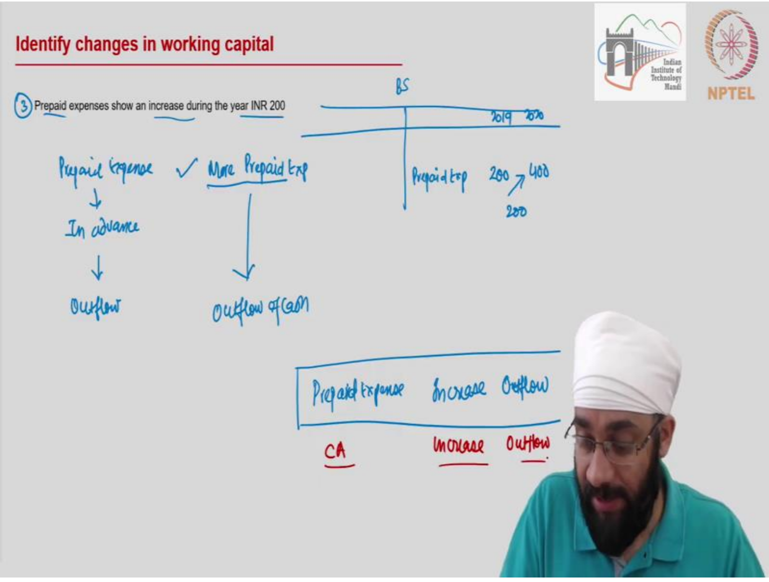

Let us look at another transaction. This is not a transaction, but another account balance. Prepaid expenses show an increase. Prepaid expenses are shown on the asset side. So, prepaid expenses had a balance of let us say 200, now the balance is 400, this was 2019 and this is 2020. So, there is an increase of 200. So, prepaid expense means that you paid in advance meaning cash is certainly going out before the benefit is being received. So, this means that there is an outflow. You are paying in advance; the benefit has not been received. Therefore, whenever you see an increase, whenever there are more prepaid expenses, actually this is quite clear, this should result in outflow of cash. The learning from the slide is that when the current asset named prepaid expenses, whenever it increases, it results in outflow of the cash and that is it.

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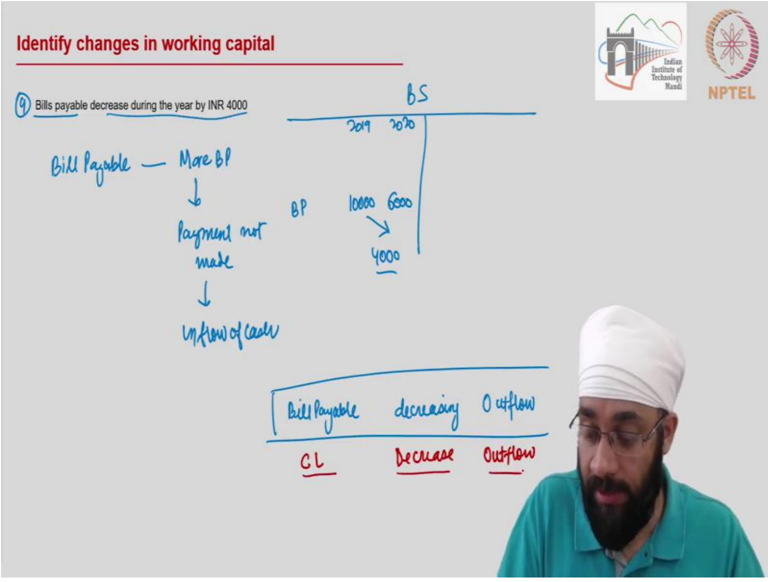

Let us look at bills payable. This is item number 4. Bills payable are going to be shown in the balance sheet under the current liabilities. Bills payable are decreasing by 4000. Let us say they were 10,000 and now they are only 6,000, this is 2019 and 2020. When there is a decrease of 4000 what does it mean? Bills payable represent a liability which means you have not paid. When the bills payable are more; that means you have not made the payment. So, more bills payable means, payment not made. If payment is not made, you save that cash in the business which means this is an inflow of cash. So, these are outstanding expenses in a way: you could call them that as well, but there can be slight differences. Businesses use nomenclatures to club various expenses under different heads. What is the learning? The learning is when you have a liability called bills payable and when it is decreasing; that means, you have paid for it and if you paid for it this is an outflow. There you go.

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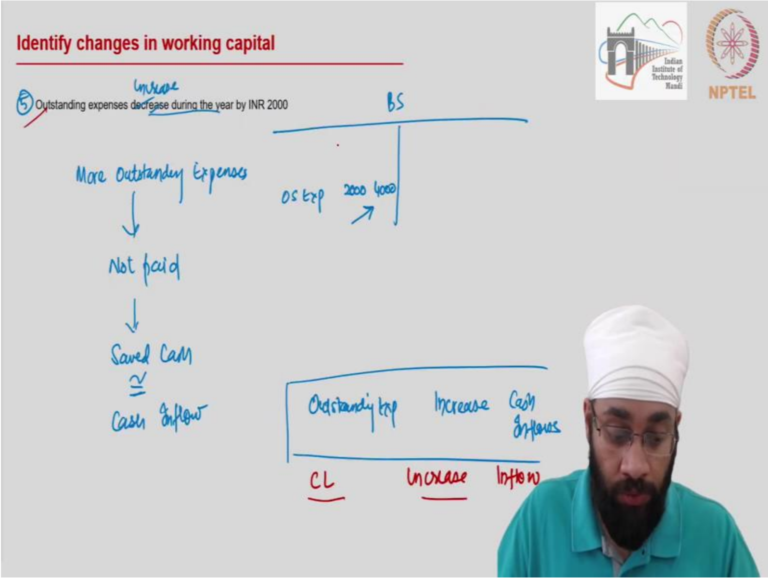

Let us look at outstanding expenses, number 5. Outstanding expenses decrease during the year as well. The bills payable were decreasing as well; maybe we should take an increase just to distinguish otherwise it will be a repetition. So, in the balance sheet under the current liabilities you have outstanding expenses they are increasing from 2000 to 4000 there is an increase. So, when there are more outstanding expenses it means that you have not paid, but you have received the benefit for it. Not paid means you have saved the cash, which is equivalent to cash inflow. What is the learning from the slide? The learning is that whenever you have outstanding expenses and they are increasing it results in cash inflows.

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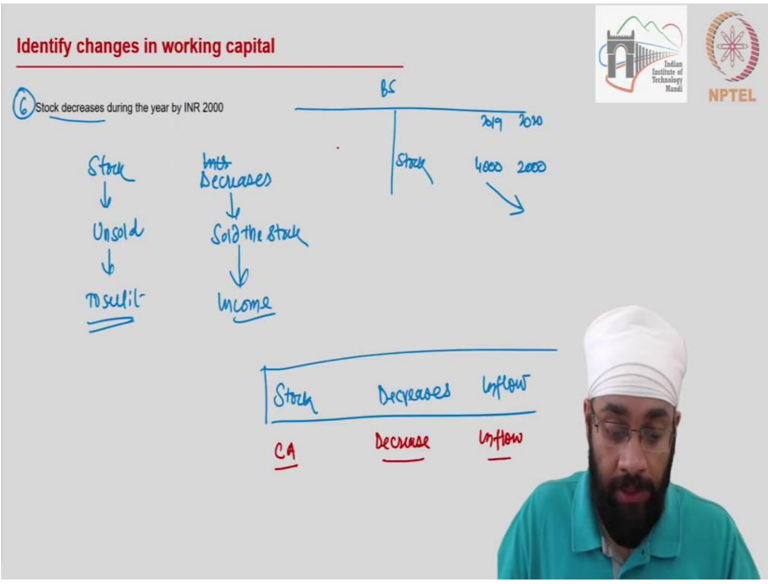

This is the learning from this slide. One more item on stock is decreasing in the balance sheet; in 2019 unsold stock was 4000 and now you have stock worth only 2000, it is going down. The idea is to sell it as soon as possible, when you sell it you make cash. So, whenever stock decreases; that means, you have sold the stock and when you have sold the stock it would have brought in income. This is an inflow. So, the learning is that when stock decreases between 2 years, it brings in cash for the business. So, there are inflows for the business.

These were some of the transactions that I wanted to look at. Now we will summarize all the transactions, all the items account balances, that we saw and we will try to find out a pattern. What is the pattern that is being followed; is there any pattern at all? So, let us start with debtors. What are debtors? Debtors are current assets. Is current assets increase an inflow or outflow? Current assets increase outflow. Then you have current liability; there is an increase and this is an inflow. Then you have a current asset again; this is an increase and this is an outflow, this is a current liability and there is a decrease and this is an outflow. Outstanding expenses are also current liability, there is an increase and this is an inflow. I hope you are seeing the pattern. This is a current asset decrease and there is an inflow.

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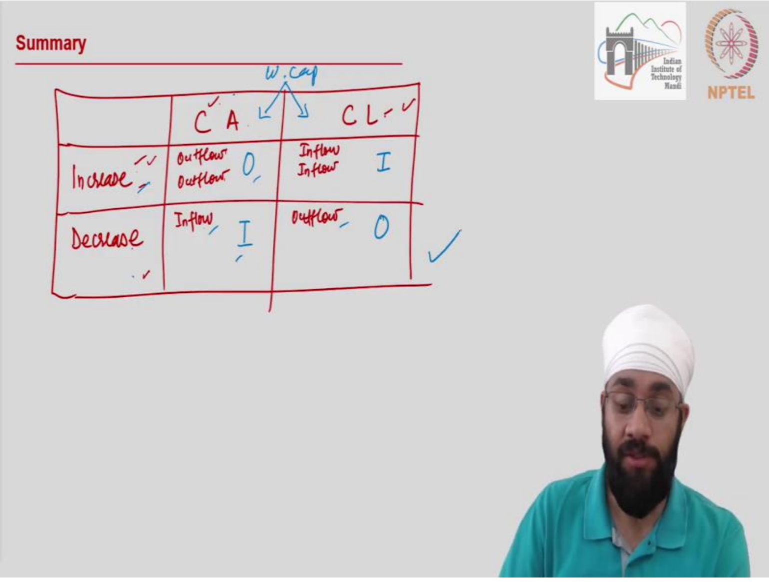

So, there are two categories of items involved in working capital: there are current assets and there are current liabilities and you know two changes are happening in two directions. Either there is increase in the current assets or current liabilities or there is a decrease in current assets or current liabilities. So, this kind of becomes a 2 by 2 matrix. This is how you can understand the changes in working capital now in a better way.

So, what is happening? When current assets increase what is the effect on the cash flows? So, we are going to take these one by one. In this transaction, current asset decreasing is inflow. So, current asset decreasing is inflow in transaction 5. In number 4 item, current liability decrease, outflow and number 4 this is done. Number 3: current asset increase, this should be outflow. Two more to go: number 2 is creditors current liability increase and inflow, current liability increase, this is also inflow. And the first was current asset increasing and outflow current asset increase and outflow. There you go. We looked at 6 items 1, 2, 3, 4, 5 and 6 and this is the trend we are seeing. If current assets increase it always results in outflows although you could argue that there is only one and one here and these numbers are not sufficient. But if you were to take more current assets and current liabilities you will see the same pattern. So, this is an outflow. So, I will say *O*, this is an inflow, this is an inflow and this is an outflow. Now you have to figure out a way to remember all of this if you have to prepare the statement, but gradually it should come intuitively to you. Current assets going down is increase and current assets increasing is an outflow and it is opposite for the current liabilities.

So, you have to kind of memorize this matrix, but that is the learning from this video; we have looked at the changes in working capital which is made up of current assets and current liabilities. And, these changes result in either the inflows of cash or the outflow flow of cash and these adjustments need to be made in the first section of the cash flow statement of a company.

In the first section there are two parts: there is calculation of cash operating profit and after that we adjust for changes in working capital and that is where this tutorial is going to be helpful.

I will see you in the next tutorial.