Financial Accounting
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Lecture – 96
7.7 Tutorial - Cash Flows from Operating Activities (Part 1)

In this tutorial we are going to learn to prepare the first section of the cash flow statement. We will take some data and try to repeat the process which is used to calculate cash flows from the operating activities of the business.

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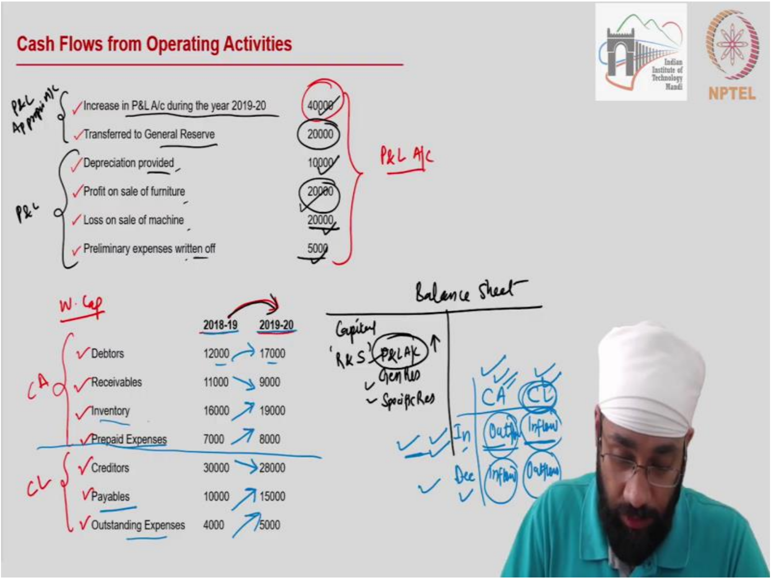

So, on the slide you see some details; you have an increase in profit and loss account during a financial year, transfer to general reserve, depreciation, profit on sale of asset; furniture, loss on sale of a fixed asset, we have preliminary expenses written off. So, these are the items that are taken from a profit and loss account and profit and loss appropriation account as well. So, profit and loss account details are given to you; using these details we will do the adjustments to the profit during the year. We have done this process before; this is a repetition; this is a tutorial. And then we have some more information on debtors, receivables, stock, prepaid expenses, creditors, payable and outstanding.

So, these are current assets and current liabilities. You have been given working capital details as well and you can figure out the changes over the financial year as well. So, all the information that you require has been given, you do not have an income statement given to you or a profit and loss account, you do not have a balance sheet. This is loose information provided to you; can you prepare the cash flows resulting from the operating activities of a business?

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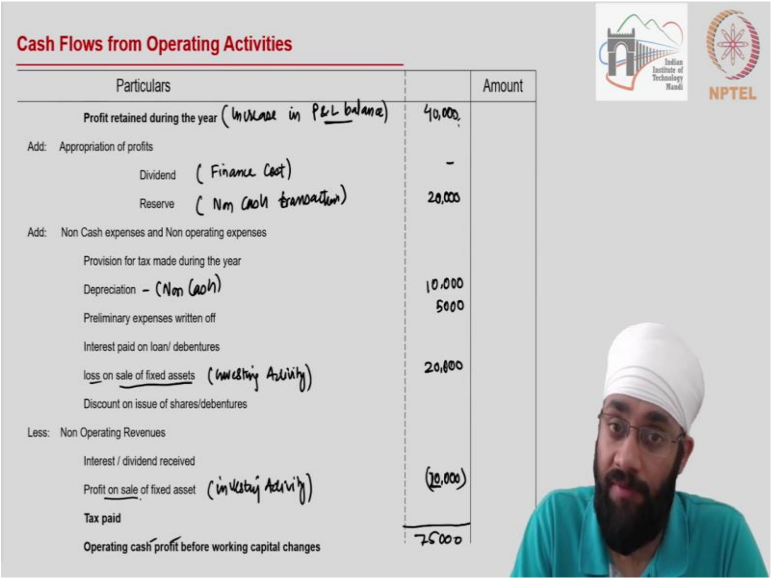

So, let us attempt this problem. This is the format and we begin with profit retained during the year. This is the increase in the profit and loss account in the balance sheet. So, let me reiterate that; in the balance sheet, you have share capital and you have reserves and surpluses; this is what we have discussed till now, the format. And these reserves and surpluses, the shareholders' funds as we say it, can have different specific reserves in it. One of the reserves is called a profit and loss account, you can have general reserves, you can have specific reserves and although I am writing specific, there will be a name for this reserve. So, after transferring all the profit, distributing all the profit to various stakeholders; whatever is left is retained in the business and this retention is shown in the profit and loss account.

So, what is the increase in the profit and loss account, what is the retained earnings during the year is shown here and should be used in this format here. So, 40000 is the profit retained during the year or you could call it increase in the P and L balance during the year. So, profit and loss balance does not refer to the profit after tax only; this is after you do the appropriations as well, that is the point I want to drive home.

So, this is done. Let me go to the format first. We are going to add to this profit, the appropriation of profit. Why are we adding back appropriation of profit? Because the dividend which is paid, is not an operating item, is not an operating expense. It is a financing expense and the transfer to reserve is not a cash expense, it is a noncash expense. I will just mention it here for your reference. So, dividends is a finance cost, is a financial activity, and reserves is a noncash transaction. Let us look at these. The list here and accordingly pick the relevant details. Transfer to general reserve; 20,000. So, this 20,000 has to be added back to the increase in the profit during the year. Then, you do not have any dividends; straight go to depreciation, profit, preliminary expenses. These items are typically shown in the P and L, the second section of the profit and loss account and these are the P and L appropriation account. So, nil here. Then you add noncash expenses or non-operating expenses, provision for tax, during the year. Do we have provision for tax? No, we do not have provision, we only have depreciation to begin with 10,000. So, depreciation 10,000, I am going to write it here. Preliminary expenses written off is 5000, so, we are writing it here. Depreciation is noncash and is an operating expense and we are calculating profit; cash profit from operating activities. So, even the operating expenses which are noncash expenses, we will not consider them in this section of the cash flow statement. This is done, then you have a loss on sale of machinery; this is 20,000. So, loss on sale of fixed asset 20,000 to be added, why is this being added? Well, sale of fixed assets is not an operating item, this is an investing item; so, this is investing activity. So, it should not be shown. Any profit or loss resulting from sale of fixed assets is not an operating item. You should not show it here. This is done; depreciation has been taken; now you have profit. Profit should be deducted. So, profit on the sale of fixed assets, the amount is 10000. Now, this profit will be shown on the credit side of the profit and loss account. It will increase the profit during the year. That means the profit for the year has been increased by 10,000 due to a non-operating income, non-operating gain, which has been earned during the year and this is also an investing activity. So, we should not show it in the operating cash flow and we are deducting it from the profit number during the year. Profit on sale of furniture is 20,000. I should write 20 here; loss was also 20 and preliminary expenses taken care of. That is it.

So, in this section, in order to calculate operating cash profit these are the items, these are the details that are with us. Using this, we will calculate the net profit; the operating cash profit before working capital changes. So, this 75000 comes out to be the cash operating profit. However, this is not the cash from all operating activities; this is only cash resulting from the activities which we have considered on this page. There are other items which are not present in the profit and loss account and we have to consider those. What are those items? Well, those items are working capital changes.

Debtors have gone up. Now, I need to recall the rules of current asset, current liability, increase, and decrease. So, if current assets go up; we consider that as an outflow. If current assets decrease, that is an inflow and the opposite is true for current liabilities.

So, I have drawn this table on the side and I am just going to look at each and mechanically using this rule, I am going to post various account balances. So, debtors from 18-19 to 19-20; we have to be careful about the direction as well. So, this is going up; current assets are increasing by 5000, this is an outflow.

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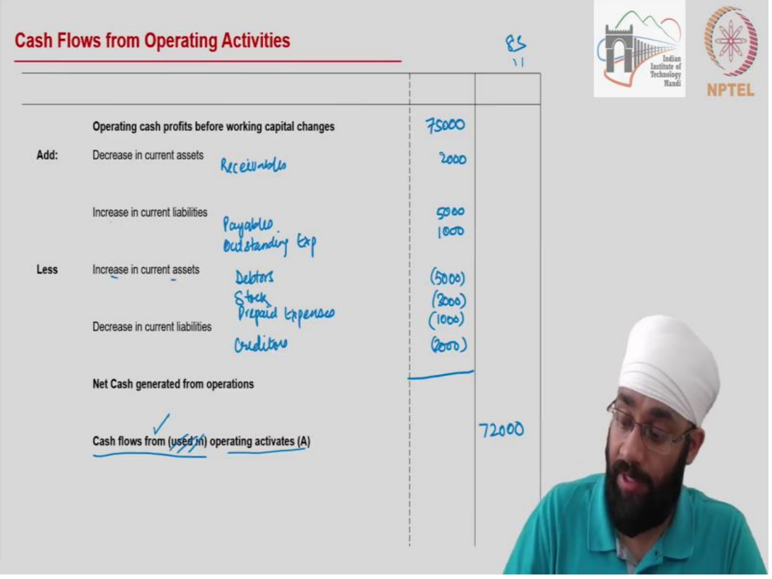

So, this is 5000; increase in the current asset 5000 will go here, we will deduct it; this was debtors. So, I will write debtors. Next, receivables are going down, current assets are decreasing. So, this is 2000 inflow due to receivables. Next up, stock inventory is going up by 3000; current asset increase is an outflow. So, stock 3000 and outflow; stock 3000 posted. Then, you have prepaid expenses. These are also going up, current asset going up is an outflow 1000; 1000 prepaid expenses. We are done with all the current assets now. Let us look at current liabilities. Creditors are going down by 2000, current liability decreasing is an outflow; so, 2000 creditors decrease in current liabilities. Next, payables are going up; current liability going up is an inflow. So, 5000 payables is an inflow. And finally, you have outstanding expenses which are also going up, again current liability going up is an inflow; so 1000 outstanding expenses. Done; that is it. Now, we have adjusted; we have made adjustments for the working capital changes. The operating cash profit before working capital changes from the previous slide. I am just bringing it forward, 75000 and we have to just add it or deduct it. So, deduct 11000, you have 72. So, 72000 is the cash flows from operating activities, this is a positive number we do not have to consider the use of parentheses.

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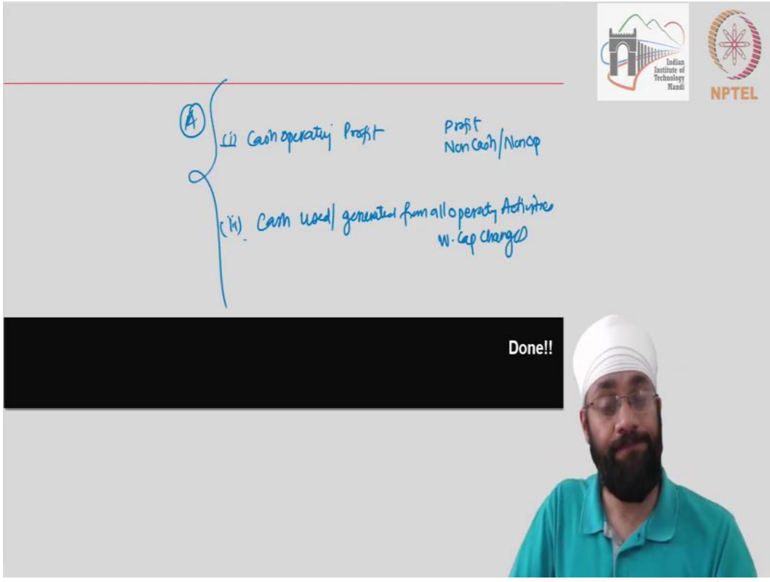

That is it! That is how you calculate cash flows from operating activities. One more time, you have two sections; the first section here has two subsections. In the first subsection, you look for cash operating profit. In the second subsection, you look for the cash used in or generated from all operating activities.

In the first subsection, you consider the profit during the year and you adjust for noncash items, non-operating items which can be either incomes or the expenses. And then in the second section, you consider the working capital changes; that is it.

I will see you in the next video.