ACC1701XA
SEMESTER 1 2025 / 2026

POST LECTURE SUPPLEMENT

LECTURE 11

ADDITIONAL EXPLANATIONS ON CFO (Indirect Method)

In the lecture, I have explained the various adjustments relating to the changes in non-cash current assets and current liabilities when we are trying to convert the accrual basis **Profit before Tax** into a cash basis **cash from operations (CFO)**.

Below is a summary (and also some additional explanation) of the logic and intuition behind the various adjustments in the CFO that I went through in class. While it is important to understand the logic behind what we are doing, but for the exam, I suggest that you keep the handy summary table we went through in lecture to help you adjust your CFO correctly.

I will be using numbers from the ***Rizz Tea Company*** example to explain.

(A) Depreciation

The recording of depreciation is made through the journal entry:

Dr Depreciation Expense → *Taken into the IS (part of PBT)*
    Cr. Accumulated Depreciation

For Rizz Tea, depreciation expense of $8,891 has been taken into the PBT but this is a non-cash expense, therefore to convert the PBT into cash basis, we will have to **add** this amount back to the PBT to get to the CFO.

(B) Changes in Current Assets & Current Liabilities

1. Increase in AR of $4,549.
   Movement of AR account: ***Beg AR + Credit Sales – Cash Collected = End AR***
   Assume there's only one transaction during the year which increased the AR balance through credit sales, that journal entry would have been:

   Dr AR $4,549
       Cr Sales Revenue $4,549 → *Taken into the IS (part of PBT)*

   Under accrual accounting, the 4,549 would be included as part of PBT. However, this is a non-cash transaction. So, to convert the PBT into cash basis, we will have to **deduct** away this amount from the PBT to get to the CFO as we did not receive any cash for it.

*Note: A decrease in AR would be adjusted the opposite way (i.e. **added** into the PBT to get to the CFO, to reflect the cash that was received during the period).*

2. <u>Increase in Inventories $858.</u>
   Movement of Inventory account: ***Beg Inventory + Purchases – COGS = End Inventory***
   Assume there's only one transaction during the year which increased this inventory balance through a purchase by cash:

Dr Inventories	$858	
Cr Cash		$858

   This inventory is still there at the end of the period, which means that it wasn't sold and so we have not recorded an expense (COGS) for it. As such, it is not going to be in the PBT. However, this inventory has already been paid in cash, so we have to **deduct** away this amount from PBT to get to the CFO as cash has been paid out.

3. <u>Decrease in Prepaid expenses $6,457.</u>
   Movement of Prepaid account: ***Beg Prepaid + Cash Paid – Expense = End Prepaid***
   Assume this is prepaid rent, and there's only one transaction during the year to reduce this prepaid rent through the recording of rent expense for the period. The journal entry would have been:

Dr Rent Expense	$6,457		→ *Taken into the IS (part of PBT)*
Cr Prepaid Rent		$6,457	

   Under accrual accounting, the rent expense of $6,457 would be included as part of PBT. However, this is a non-cash transaction. So, to convert the PBT into cash basis, we will **add** this amount back to PBT.

4. <u>Decrease in Accounts Payable $1,798.</u>
   Movement of Payable account: ***Beg Payable + Expense – Cash Paid = End Payable***
   Assume there's only transaction during the year which reduced this balance through payment of existing payable to suppliers, that journal entry would have been:

Dr Accounts Payable	$1,798	
Dr Cash		$1,798

   Cash was used, but there was no recording of any additional expense because we are just paying off existing payables, so this amount is not reflected in the PBT. Therefore, to convert the PBT into cash basis, we have to **deduct** away this amount from the PBT to account for the cash used.

   *Note: An increase in Payable would be adjusted the opposite way. Increase in Payable means that an expense was recorded but on credit so the expense is already reflected in the PBT, but we did not pay for it in cash. Therefore, we have to **add** it back to the PBT to get to the CFO.*

5. Decrease in Accrued Expenses $396.
   Logic is similar to the Payables example above. Let's assume this is for accrued wages (i.e. wages payable), and there's one transaction that reduced it:

Dr Wages payable	$396	
Cr Cash		$396.

   Cash was used, but there was no recording of any additional expense so it's not going to be in PBT. Therefore, we have to **deduct** this amount from PBT to get to our CFO.

(C) Gain/Loss on disposal of PPE

PPE relates to investing activities which is reported under CFI and not CFO. So, we have to remove it from the PBT to get to the CFO. For loss, we will **add** back to PBT, and for gain, we will **deduct** from PBT.

(D) Income Taxes/ Interest & Dividends

1. For interest income, some are wondering why we deduct it first and then adding it back in. The deduction is to remove the accrual-basis interest income from our PBT. The adding back in is to record the **actual** cash received in relation to this interest income.

   *Note: If it is interest expense, then the reverse happens. We first add it back into PBT, and then figure out how much interest expense was actually paid in cash for the period, and then **deduct** that amount from PBT.*

   To figure out how much cash was actually paid/received for interest, use the account movement analysis of Interest Receivable (for interest income) or Interest Payable (for interest expense).
   For Rizz Tea, we can figure out the actual interest received in cash using the movement of the interest receivable account:
   Beg interest receivable + interest income – interest received = End interest rec.
   $0 + $860 (from the IS) – interest received = $450
   ➔ Interest received = $860 - $450 = $410

   After first deducting accrual based interest income of $860 from PBT, we will add back $410 into PBT to record the actual interest that was received in cash during the period.

2. Some may now wonder why we don't do the same for income taxes (as in add it back in and then deduct the actual taxes paid). That's because our starting point is PBT (**Profit BEFORE TAX)** so it already does not include the income tax recognized in the period under the accrual basis. So, the only thing to do is to simply figure out the actual taxes paid in cash during the period and then **deduct** it away from PBT.

For Rizz Tea, we can figure out the actual taxes paid in cash using the movement of the income tax payable account:

Beg tax payable + tax recognized – tax paid = Ending tax payable

$12k + $14,055 (from the IS) – tax paid = $15k

➔ Tax paid = $12k + $14,055 – $15k = $11,055
