Statement of Cash Flows

Chapter

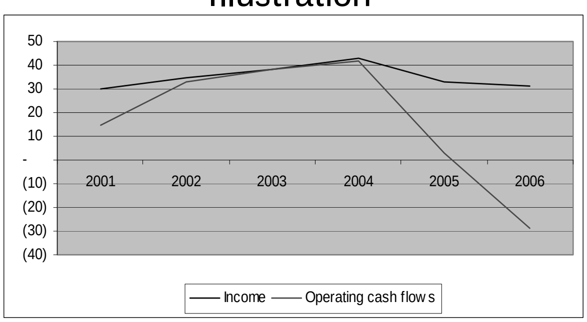
23

Overview

- BECAUSE of the SCF, users of the financial statements get the best of both worlds!
  - SCF bridges the gap created by “paper income” resulting from applying an accrual basis of accounting.
  - Reconciles GAAP income to operating cash flows and separately displays cash from investing and financing activities.

13:11

Illustration



Got any thoughts about the above chart???

Like: If the Company is showing all this income, why is the operating cash flow not tracking income?

Statement of Cash Flows- summary

This will mean more later, but a statement of cash flows is an analysis of the change in the balance sheet accounts.

- If you reconcile the change in each of your balance sheet accounts, your SCF will work!!
  - The key is presentation- Operating vs. Investing Vs. Financing activities.

Overview- how it works

Cash from operations:

- Shows the cash provided by operations
- Typical presentation called “indirect” because it reconciles the net income (accrual) to cash from operations.
- Think of it as net income, adjusted for non-cash activities, including changes in current assets

Cash from investing:

- Gross!
- Shows cash from investing activities
  - Think of it as cash from long-term assets, similar to unusual items in the income statement.

Cash from financing:

- Gross!
- Shows cash from financing activities
  - Think of it as cash from borrowing and equity transactions

23-5

STATEMENT OF CASH FLOWS EXAMPLE

[redacted] LLC
(A California Limited Liability Company)
Statement of Cash Flows
Period from March 28, 2003 (inception) through December 31, 2003

Cash flows from operating activities:		
Net income	$	112,187
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization		244,554
Change in assets and liabilities:		
Other assets		(258,841)
Accounts payable and accrued expenses		98,758
Security deposits and other liabilities		111,900
Net cash used in operating activities		308,558
Cash flows from investing activities:		
Capital expenditures		(7,909,159)
Cash flows from financing activities:		
Payments of loans payable		(78,171)
Issuance of loans payable		1,893,014
Contributions from members		6,457,000
Payments of preferred returns		(315,944)
Repairs and replacement deposits held in escrow		(213,583)
Payments of financing costs		140,965
Net cash provided by financing activities		7,883,281
Net increase in cash and cash at end of period	$	282,680
Supplemental and cash flow information:		
Cash paid for interest	$	521,657

Noncash investing and financing activities:
New borrowings of $9,227,027 were funded directly through the assumption of a subordinate loan payable.

See accompanying notes to financial statements.

23-6

13:11

Operating section- Indirect Method

- Reconciles net income to cash flows from operations by:
  - Starts with net income and seeks to reconcile that number to the cash actually generated from operations
  - Removes non-cash items, like depreciation & amortization
  - Removes items which will be presented in the investing and financing sections separately
    - i.e remove gains from sales of long-term assets
  - Shows changes in current assets
    - Think about it- if A/R increased $100k, how does this impact cash?

23-7

Operating section illustration

ASSUMED ACTIVITY:	
Opening balance	1,000,000
Sales on credit	10,000,000
Cash sales	100,000
Collections	9,500,000

	Accounts Receivable		NET INCOME	
Opening balance	1,000,000			
Sales on credit	10,000,000			(10,000,000)
Cash sales				(100,000)
Collections		(9,500,000)		
Ending	1,500,000			(10,100,000)
Change in A/R	500,000			

HOW THE STATEMENT OF CASH FLOWS WOULD APPEAR:	
Net income	10,100,000
Adjustments to reconcile net income to cash provided by operations:	
Increase in accounts receivable	(500,000)
Cash provided by operations	9,600,000

LETS CHECK IT- FROM ABOVE	
We collected	9,500,000
We made cash sales	100,000
	9,600,000

23-8

Investing section

Now that the operating section reflects ONLY operating activities, this section shows just the cash from investing activities (principally buying and selling long-term assets)

- Presented gross-for instance a sale of a fixed asset for a gain:
  - The gain is shown as a reduction from net income in the operating section
  - The proceeds are shown as a source of cash
  - This works out to reflect the change in fixed assets. See next slide

23-9

Investing illustration

Fixed asset			
Beginning of year	100,000		
Sold	(100,000)		
Ending	-		
Accumulated depreciation			
Beginning of year	70,000		
Cy Depreciation expense	5,000		
Sold	(75,000)		
Ending	-		
How much did fixed assets change by?	30,000		
In the operating section we pull out the		**In the statement of cash flows we have accounted for the**	
non-cash depreciation expense:		**change of $30,000:**	
Depreciation expense	5,000	Operating section adjustments:	
Gain on sale	75,000	Depreciation back-out	5,000
		Gain back-out	(75,000)
Sell the thing for $100k:		INVESTING section: Proceeds from sale	100,000
Purchase price	100,000	WOW- PRESENTING IT THIS WAY REFLECTS THE	30,000
NBV at sale	(25,000)	CHANGE!	
Gain on sale	75,000		
In the investing section we show:			
Cash proceeds from sale of fixed assets	100,000		

23-10

13:11

Financing section

- Now that the operating section reflects ONLY operating activities, this section shows just the cash from financing activities (principally cash received and paid to borrow money and complete equity transactions)
- Presented gross-for instance borrow $1 million and repay $250,000 under a line of credit:
  - The borrowings of $1million are shown as cash provided by financing (positive cash);
  - The repayment of $250,000 is shown as a repayment (negative cash)
  - NOTICE that combined they represent the change in that

23-11

FINANCING ACTIVITY EXAMPLE

Remember that we are trying to reconcile the change in each of the balance sheet accounts.

So if debt increased by $10, but the company's activity were to borrow $1 million and repaid $999,990 (net $10 change), the statement of cash flows would reflect the "activity" and would look like this:

Cash flows from financing activities:	
Borrowings from bank	$1,000,000
Repayments under loans	$ 999,990
Cash flows from financing activities	$ 10

23-12

SO HOW DO WE DO IT?

First, you need:
- Balance sheet
- Income statement
- Equity statement

Then, you compute the change in each item on the balance sheet.

For each change, allocate to:
- Operating, investing or financing

Then you post them all over the the statement of cash flows!

	12/31/2004	12/31/2003	CHANGE	Operating	Net Income	Unaccounted For
Cash	10,000	12,000	(2,000)	N/A		n/a
A/R	70,000	65,000	5,000	(5,000)		-
Inventory	500,000	425,000	75,000	(75,000)		-
Fixed assets	-	-				
Accumulated depr.	-	-				
TOTAL ASSETS	580,000	502,000				
A/P	75,000	70,000	5,000	5,000		-
Debt	400,000	400,000	-			
common stock	10,000	10,000	-			
retained earnings	95,000	22,000	73,000		73,000	-
TOTAL LIAB & EQTY	580,000	502,000				
	-	-				-
NET INCOME FOR 2004 WAS		73,000		B/C all accounted for, we are ready to do SCF!		

XYZ, Inc.
Statement of Cash Flows
Year Ended December 31, 2004

Cash flows from operating acitivities:	
Net income	73,000
Adjustments to reconcile net income to net cash from operations	
Increase in accounts receivable	(5,000)
Increase in inventory	(75,000)
Increase in accounts payable	5,000
Net cash USED in operating activities	(2,000)
Cash flows from investing and financing activities:	
NONE IN THIS EXAMPLE	-
Net decrease in cash	(2,000)
Cash at the beginning of the year	12,000
Cash at the end of the year	10,000

13:11

OKAY, MORE DIFFICULT

Prepare the statement of cash flows for ABC, Inc. based on the following information:
- The comparative balance sheet and income statement are on the next slide.
- Equity transactions are as follows:
  - Sold stock for $10,000 cash
  - Declared and paid dividends of $5,000
- Long-term assets and liabilities
  - Borrowed $100,000, repaid $50,000
  - Purchased a warehouse with $1 million in cash and assumed an existing $8 million loan;
  - Sold equipment for $200,000 resulting in a gain of $190,000 (net book value was 10,000 representing 500,00 of equipment with 490,000 of accumulated depreciation).

BALANCE SHEET & INC. STMT.

ABC, Inc.
Balance Sheets
December 31

	2004	2003
Cash	225,000	100,000
Accounts receivable	265,000	250,000
Inventory	1,000,000	500,000
Prepaid expenses	10,000	12,000
Total current assets	1,500,000	862,000
Fixed assets		
At cost	18,500,000	10,000,000
accumulated depreciation	(6,210,000)	(6,500,000)
	12,290,000	3,500,000
Lease commissions		
At cost	1,250,000	1,250,000
accumulated amortization	(725,000)	(700,000)
	525,000	550,000
Total assets	14,315,000	4,912,000
Accounts payable	433,000	500,000
Accrued expenses	150,000	175,000
Current portion of debt	50,000	50,000
LT Debt	10,050,000	2,000,000
Common stock	110,000	100,000
Retained earnings	3,522,000	2,087,000
Total liabilities & Equity	14,315,000	4,912,000

ABC, Inc.
Income statement
Year Ended December 31, 2004

Sales	10,000,000
COS	7,000,000
Gross Profit	3,000,000
SG&A expense	750,000
Interest expense	
Depreciation expense	200,000
Amortization expense	25,000
Income from recurring op's	2,025,000
Gain on disposal of f. assets	190,000
Income before income taxes	2,215,000
Income tax provision	775,000
Net income	1,440,000

Equity transactions are as follows:
Sold stock for $10,000 cash
Declared and paid dividends of $5,000
Long-term assets and liabilities:
Borrowed $100,000, repaid $50,000
Purchased a warehouse with $1 million in cash and assumed an existing $8 million loan;
Sold equipment for $200,000 resulting in a gain of $190,000 (net book value was 10,000 representing 500,00 of equipment with 490,000 of accumulated depreciation).

	Change	To Operating	Gain	Deprec. & Amort.	Cash Purchase	N-Cash Purchase	Proceeds sale asset	Borrow	Repay	Stock Sale	Dividends	Net incom	LEFTOVER
Cash	125,000	n/a											n/a
Accounts receivable	15,000	(15,000)											-
Inventory	500,000	(500,000)											-
Prepaid expenses	(2,000)	2,000											-
Fixed assets, net	8,790,000		(190,000)	200,000	(1,000,000)	(8,000,000)	200,000						-
Cap. Com At cost	(25,000)			25,000									-
Accounts payable	(67,000)	(67,000)											-
Accrued expenses	(25,000)	(25,000)											-
All debt	8,050,000					8,000,000		100,000	(50,000)				-
Common stock	10,000									10,000			-
Retained earnings	1,435,000										(5,000)	1,440,000	-

ABC, Inc.
Statement of Cash Flows
Year ended December 31, 2004

Cash flows from operating activities:	
Net Income	1,440,000
Adjustments to reconcile net income to net cash from operating activities:	
Depreciation & amortization	225,000
Gain on disposal of fixed asset	(190,000)
Increase in accounts receivable	(15,000)
Increase in inventory	(500,000)
Decrease in prepaid expenses	2,000
Decrease in accounts payable	(67,000)
Decrease in accrued expenses	(25,000)
Cash provided by operating activities	870,000
Cash flows from investing activities	
Purchase of warehouse	(1,000,000)
Proceeds from sale of fixed assets	200,000
Cash used in investing activities	(800,000)
Cash flows from financing activities	
Borrowings	100,000
Repayments	(50,000)
Stock sold for cash	10,000
Dividends paid	(5,000)
Cash provided by financing activities	55,000
Net increase in cash	125,000
Cash at the beginning of the year	100,000
Cash at the end of the year	225,000
Supplemental disclosure of non-cash investing and financing activity	
Portion of warehouse purchase funded by assumption of debt	8,000,000

SOLUTION

DIRECT VS. INDIRECT

Everything we just did is the "Indirect" method. The INDIRECT METHOD which is by far the most common.

There is a "Direct" method as well.

- The only difference is in the operating section- financing and investing sections are exactly the same either way
- The indirect method is called "indirect" because it reconciles net income to cash from operations—i.e indirectly determines cash from operations by starting with a non-cash-based number and reconciling to the cash-based number:
  - Strength: highlights the differences between net income and operating cash flows
- The direct method is called "direct" because it only shows the cash flows, rather than reconciling to them.
  - Strength: prominently displays cash receipts and payments.

13:11

DIRECT METHOD: LOOKS LIKE

Cash flows from operating activities:	
Cash received from customers	$765,000
Cash payments:	
To suppliers	(550,000)
For operating expenses	(148,000)
For income taxes	(48,000)
Net cash provided by operating activities	$ 19,000

Illustration of the two:

	Indirect	Direct
OPERATING SECTION	Net income	Cash received from customers
	Adjustments to net income, such as	Cash paid for inventory
	Depreciation	Cash paid for operating expenses
	Gains on l-term assets	Cash paid for income taxes
	Changes in current assets & liabilities	
	THE ABOVE ITEMS ADD UP TO THE SAME AMOUNT OF OPERATING CASH FLOWS	
INVESTING SECTION	SAME FOR BOTH	
FINANCING SECTION	SAME FOR BOTH	

How do you compute:

You simply perform a roll-forward for the operating assets and liabilities. (works on the same premise as reconciling from net income, but in reverse)

If a Company has sales of $1,000,000 and accounts receivable went from $100,000 to $110,000, then cash received from customers is:

Beginning A/R	$ 100,000
Plus sales	1,000,000
Less Ending	(110,000)
Cash received MUST be	$ 990,000

REQUIRED DISCLOSURE ETC.

- If reconciling cash and cash equivelants, use the term cash and cash equivelants in the SCF
- Show cash paid for interest, and cash paid for income taxes at the bottom of the statement
- Don’t forget to disclose non-cash investing and financing activities at the bottom of the statement

13:11