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.

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

Statement of Cash Flows Example

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?

Operating section illustration
**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

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**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 $1 million 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

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**Investing illustration**

<table>
<thead>
<tr>
<th>Fixed asset</th>
<th>Beginning of year</th>
<th>100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Ending</td>
<td>25,000</td>
</tr>
<tr>
<td>Less:</td>
<td>Depreciation</td>
<td>75,000</td>
</tr>
<tr>
<td></td>
<td>Accumulated depreciation</td>
<td>70,000</td>
</tr>
<tr>
<td></td>
<td>Gain on sale</td>
<td>100,000</td>
</tr>
<tr>
<td></td>
<td>Gain back-out</td>
<td>75,000</td>
</tr>
<tr>
<td></td>
<td>Selling</td>
<td>100,000</td>
</tr>
<tr>
<td></td>
<td>Depreciation</td>
<td>75,000</td>
</tr>
<tr>
<td></td>
<td>Gain on sale</td>
<td>100,000</td>
</tr>
<tr>
<td></td>
<td>Selling</td>
<td>100,000</td>
</tr>
</tbody>
</table>

**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 repay $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
**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!

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**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 $500,000 of equipment with $490,000 of accumulated depreciation).

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### ABC, Inc. Balance Sheets

<table>
<thead>
<tr>
<th>December 31</th>
<th>2004</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$230,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>$280,000</td>
<td>$250,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>$1,200,000</td>
<td>$500,000</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>$12,000</td>
<td>$12,000</td>
</tr>
<tr>
<td>Total current assets</td>
<td>$1,500,000</td>
<td>$862,000</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>$10,000,000</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Lease commissions</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Accumulated amortization</td>
<td>$750,000</td>
<td>$750,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>$14,195,000</td>
<td>$4,912,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$425,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Accrued expenses</td>
<td>$150,000</td>
<td>$175,000</td>
</tr>
<tr>
<td>Current portion of debt</td>
<td>$50,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>LT Debt</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Common stock</td>
<td>$110,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>$3,522,000</td>
<td>$2,087,000</td>
</tr>
<tr>
<td>Total liabilities &amp; Equity</td>
<td>$14,195,000</td>
<td>$4,912,000</td>
</tr>
</tbody>
</table>

### ABC, Inc. Income Statement

<table>
<thead>
<tr>
<th>Year Ended December 31, 2004</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Cost of Goods Sold</td>
<td>$7,000,000</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>$3,000,000</td>
</tr>
<tr>
<td>Depreciation Expense</td>
<td>$250,000</td>
</tr>
<tr>
<td>Gain on Disposal of Fixed Assets</td>
<td>$190,000</td>
</tr>
<tr>
<td>Income Before Income Taxes</td>
<td>$2,215,000</td>
</tr>
<tr>
<td>Income tax provision</td>
<td>$750,000</td>
</tr>
<tr>
<td>Net Income</td>
<td>$1,465,000</td>
</tr>
</tbody>
</table>

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**ABC, Inc. Statement of Cash Flows**

**Year Ended December 31, 2004**

**Cash Flows from operating activities:**

- 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 activities:**

- None in this example.

**Cash Flows from financing activities:**

- Net decrease in cash: $(2,000)
- Cash at the beginning of the year: $12,000
- Cash at the end of the year: $10,000

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### XYZ, Inc.

Statement of Cash Flows

**Year Ended December 31, 2004**

**Cash Flows from operating activities:**

- 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 activities:**

- None in this example.

**Cash Flows from financing activities:**

- Net decrease in cash: $(2,000)
- Cash at the beginning of the year: $12,000
- Cash at the end of the year: $10,000

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**Equity transactions are as follows:**

- Sold stock for $10,000 cash
- Declared and paid dividends of $5,000
- 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 $500,000 of equipment with $490,000 of accumulated depreciation).
**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.

**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 $10,000

Illustration of the two:

<table>
<thead>
<tr>
<th>OPERATING SECTION</th>
<th>INDIRECT</th>
<th>DIRECT</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income</td>
<td>Cash received from customers</td>
<td></td>
</tr>
<tr>
<td>Adjustments to net income, such as cash paid for inventory</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>Cash paid for operating expenses</td>
<td></td>
</tr>
<tr>
<td>Cash (or loss) on investments</td>
<td>Cash paid for income taxes</td>
<td></td>
</tr>
<tr>
<td>Changes in current assets and liabilities</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>INVESTING SECTION</th>
<th>SAME FOR BOTH</th>
</tr>
</thead>
<tbody>
<tr>
<td>FINANCING SECTION</td>
<td>SAME FOR BOTH</td>
</tr>
</tbody>
</table>

The above items add up to the same amount of operating cash flows.
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 equivalents, use the term cash and cash equivalents 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

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