Statement of Cash Flows

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.

\[ A = L + E \]

- 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 - SO IT'S LIKE AN INCOME STATEMENT ON THE CASH BASIS.

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

The first line of indirect method statement of cash flows is always: NET INCOME!!

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 there is a $10k sale on credit, does this impact net income? How about cash?
      - Net income, adjusted for the change in A/R will deal with this!!

Convert Net Income to Cash

Is depreciation expense included in net income?
- YES

Does depreciation expense impact cash?
- NO

So we add depreciation expense back.

Are all sales reported on the income statement collected in cash yet?
- NO

Could we have collected some cash this year that relates to sales reported in the prior year net income?
- YES

So we need to adjust sales to the cash collected. The change in receivables does this for us.

Same for COS, etc.
SCF - Operating

Statement of Cash Flows

Cash flows from operations
Cash flows from Investing
Cash flows from Financing

Income Statement

Revenues
Expenses
Gains and Losses
= Net Income

Convert to Cash

Operating section illustrated

BEGINNING BALANCES:

<table>
<thead>
<tr>
<th>Cash</th>
<th>Accounts Receivable</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0</td>
<td>500,000</td>
</tr>
</tbody>
</table>

ACTIVITY THIS PERIOD

Make $250k of sales on credit
Accounts Receivable 250,000
Sales 250,000
Collect $600,000 on open accounts receivable
Cash 600,000
Accounts receivable 600,000

250,000  500,000       -
250,000      600,000
600,000
-         250,000  150,000       600,000

HOW MUCH CASH DID WE GET FROM OPERATIONS?

Cash collected from customers 600,000

VS. HOW MUCH NET INCOME-- 250,000. THE DIFFERENCE IS TIMING OF GAAP INCOME RECOGNITION VS. CASH BASIS

ANOTHER WAY:

 Beginning A/R 500,000
 Add: Sales 250,000
 If no collections 750,000
 Ending 150,000
 Therefore, collections 600,000

STATED ANOTHER WAY: SALES - INCREASE + DECREASE IN A/R IS CASH FROM SALES!

WHAT WAS THE CHANGE IN A/R?

$350,000 DECREASE

500 Beginning
-150 Ending
350 Decrease

FROM ABOVE - SCF PRESENTATION

NAME OF CO. INC.
STATEMENT OF CASH FLOWS
FOR THE PERIOD __________

Cash flows from operations:
Net income 250,000
Adjustments to reconcile net income to cash provided by operations:
Change in accounts receivable 350,000
Cash provided by operations 600,000
06:17

**Operating section illustration**

**Assumed Activity:**

- Opening balance
- Sales on credit
- Cash sales
- Collections

**Accounts Receivable:**

- Opening balance 1,000,000
- Sales on credit 10,000,000
- Cash sales 100,000
- Collections 9,500,000

**Change in A/R:**

- Ending 1,500,000
- Change in A/R 500,000

**Ending:**

- 1,500,000
- (100,000)

**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

**We collected:**

- 9,500,000

**We made cash sales:**

- 100,000

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**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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**PRESENTATION**

**STEP ONE:** REMOVE INVESTING ACTIVITIES FROM NET INCOME:

- Depreciation expense
- Gain on sale of fixed assets

**STEP TWO:** SHOW ONLY THE AMOUNTS IMPACTING CASH AS AN INVESTING ACTIVITY

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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
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!
OKAY, MORE DIFFICULT

Prepare the statement of based on the following information:

```
<table>
<thead>
<tr>
<th>12/31/2004</th>
<th>12/31/2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>72,000</td>
</tr>
<tr>
<td>A/R</td>
<td>70,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>500,000</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>1,100,000</td>
</tr>
<tr>
<td>Accumulated depr.</td>
<td>(810,000)</td>
</tr>
<tr>
<td>TOTAL ASSETS</td>
<td>932,000</td>
</tr>
<tr>
<td>A/P</td>
<td>175,000</td>
</tr>
<tr>
<td>Debt</td>
<td>350,000</td>
</tr>
<tr>
<td>common stock</td>
<td>250,000</td>
</tr>
<tr>
<td>retained earnings</td>
<td>157,000</td>
</tr>
<tr>
<td>TOTAL LIAB &amp; EQTY</td>
<td>932,000</td>
</tr>
</tbody>
</table>

• Net income $75,000, which includes $10,000 of depreciation expense
• Debt increase of $50,000 comprised of $125,000 of new borrowings and $75,000 of repayments
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XYZ, Inc.
Statement of Cash Flows
Year Ended December 31, 2004

Cash flows from operating activities:
- Net income 75,000
- Adjustments to reconcile net income to net cash from operations:
  - Depreciation expense 10,000
  - Increase in accounts payable 105,000
  - Increase in inventory (75,000)
  - Net cash provided by operating activities 110,000

Cash flows from investing activities:
- Purchase fixed assets (100,000)

Cash flows from financing activities:
- New debt borrowings 125,000
- Repayment of debt (75,000)
- Net cash provided by financing activities 50,000

Net increase in cash 60,000
Cash at the beginning of the year 12,000
Cash at the end of the year 72,000

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 $ 19,000

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</td>
<td>Cash paid for inventory</td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>Cash paid for operating expenses</td>
<td></td>
</tr>
<tr>
<td>Gains on long-term assets</td>
<td>Cash paid for income taxes</td>
<td></td>
</tr>
<tr>
<td>Changes in current assets &amp; liabilities</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The above items add up to the same amount of operating cash flows.

<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>

How do you compute-DIRECT:

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