

Chpt 12 STATEMENT OF CASHFLOWS

LO 1: Discuss the usefulness and format of the statement of cash flows.

USEFULNESS OF THE STATEMENT OF CASH FLOWS

- **Statement of Cash Flows:** reports the cash receipts and cash payments from operating, investing, and financing activities during a period.
- Provides information to help assess:
 1. Entity's ability to generate future cash flows.
 2. Entity's ability to pay dividends and meet obligations.
 3. Reasons for difference between net income and net cash provided (used) by operating activities.
 4. Cash investing and financing transactions during the period.

CLASSIFICATION OF CASH FLOWS

OIF I can pass accounting...

Operating,
Investing, and
Financing

1. **Operating Activities:** the cash effects of transactions that create revenues and expenses.
(Income Statement Items)

Cash inflows:

- From sale of goods or services.
- From interest received and dividends received.

Cash outflows:

- To suppliers for inventory.
- To employees for wages.
- To government for taxes.
- To lenders for interest.
- To others for expenses.

2. **Investing Activities:** cash transactions that involve.....
- The purchase or disposal of investments and property, plant, and equipment.
 - Lending money and collecting the loans.

(Long-Term Assets)

Cash inflows:

- From sale of property, plant, and equipment.
- From sale of investments in debt or equity securities of other entities.
- From collection of principal on loans to other entities.

Cash outflows:

- To purchase property, plant, and equipment.
- To purchase investments in debt or equity securities of other entities.
- To make loans to other entities.

3. **Financing Activities:**
- Obtaining cash from issuing debt and repaying the amounts borrowed.
 - Obtaining cash from stockholders, repurchasing shares, and paying dividends.

(Long-Term Liabilities and Stockholders' Equity)

Cash inflows:

- From sale of common stock.
- From issuance of debt (bonds and notes).

Cash outflows:

- To stockholders as dividends.
- To redeem long-term debt or reacquire capital stock (treasury stock).

SIGNIFICANT NONCASH ACTIVITIES

- Companies report noncash activities in either a
 1. Separate schedule (bottom of the statement).
 2. Separate note to the financial statements.
- Examples include:
 - Direct issuance of common stock to purchase assets.
 - Conversion of bonds into common stock.
 - Issuance of debt to purchase assets.
 - Exchanges of plant assets.

FORMAT OF THE STATEMENT OF CASH FLOWS

COMPANY NAME Statement of Cash Flows For the Period Covered		
Cash flows from operating activities		
(List of individual items)	<u>XX</u>	
Net cash provided (used) by operating activities		XXX
Cash flows from investing activities		
(List of individual inflows and outflows)	<u>XX</u>	
Net cash provided (used) by investing activities		XXX
Cash flows from financing activities		
(List of individual inflows and outflows)	<u>XX</u>	
Net cash provided (used) by financing activities		<u>XXX</u>
Net increase (decrease) in cash		<u>XXX</u>
Cash at beginning of period		<u>XXX</u>
Cash at end of period		<u>XXX</u>
Noncash investing and financing activities		
(List of individual noncash transactions)		<u>XXX</u>

LO 2: Prepare a statement of cash flows using the indirect method.

- Statement of cash flows is prepared differently from the three other basic financial statements.
- Three sources of information:
 1. **Comparative balance sheets:** indicates the amount of changes in asset, liability, and stockholders; equity accounts from the beginning to the end of the period.
 2. **Current income statement:** helps determine the amount of net cash provided or used by operating activities during the period.
 3. **Additional information:** Such information includes transaction data that are needed to determine how much cash was provided or used during the period.

THREE MAJOR STEPS TO PREPARE THE STATEMENT OF CASH FLOWS

Step 1: Determine net cash provided/used by **operating activities** by converting net income from an accrual basis to a cash basis.

Step 2: Analyze changes in noncurrent asset and liability accounts and record as **investing and financing activities**, or disclose as noncash transactions.

Step 3: Compare the **net change in cash** on the statement of cash flows with the change in the cash account reported on the balance sheet to make sure the amounts agree.

STEP 1: **OPERATING** ACTIVITIES

- **TWO METHODS: DIRECT AND INDIRECT. THESE NOTES FOCUS ON INDIRECT.**
- Companies favor the **INDIRECT METHOD** for two reasons:
 1. Easier and less costly to prepare.
 2. Focuses on differences between net income and net cash flow from operating activities.
- Both methods result in the **SAME AMOUNT** of cash flow from operating activities. They differ in the way they report cash flows from operating activities.

Direct Method		Indirect Method	
Cash flows from operating activities:		Cash flows from operating activities:	
Cash received from customers.....	\$ 7,500	Net income	\$3,050
Cash payments for expenses		Increase in accounts payable	400
and payments to creditors	(4,600)	Increase in supplies	(550)
Net cash flow from operating activities	<u>\$ 2,900</u>	Net cash flow from operating activities	<u>\$2,900</u>

↑ the same ↑

INDIRECT METHOD

***Goal is determine net cash provided/used by operating activities by converting net income from accrual basis to cash basis.**

Steps for the Indirect Method

1. **Start with NET INCOME** (going to convert accrual net income into cash from operations)
2. **ADD (+) noncash expenses** such as depreciation, amortization, and depletion.
3. **ADD (+) losses on sale of long-term assets.**
4. **DEDUCT (-) gains on sale of long-term assets.**
5. **Analyze changes to noncash CURRENT ASSET and CURRENT LIABILITY ACCOUNTS.**
 - A. **DEDUCT increases in current asset account.**
 - B. **ADD decrease in current asset account.**

Current Assets INCREASE  , then you are going to DECREASE  Net Income.

Current Assets DECREASE  , then you are going to INCREASE  Net Income.

Example:

	YR 2	YR 1
Accounts Receivable	\$1,000	\$3,000

***SINCE ACCOUNTS RECEIVABLE WENT DOWN, WE ARE GOING TO INCREASE NET INCOME BY \$2,000 BECAUSE WE ARE COLLECTING CASH THIS PERIOD FOR REVENUE ALREADY RECOGNIZED IN A PRIOR PERIOD AND IS NOT REFLECTED IN YR 2 NET INCOME.**

Current Assets	1. Cash 2. Accounts Receivable 3. Inventory 4. Prepaids 5. Supplies 6. Investments (short-term).	"Cash and other resources that are expected to be sold, collected, or used WITHIN one year or company's operating cycle , whichever is longer." Companies list current asset accounts in the order they expect to convert them into cash.
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- C. **ADD increases in current liability account.**
- D. **DEDUCT decrease in current liability account.**

Example:

Current Liabilities INCREASE  , then you are going to INCREASE  Net Income.

Current Liabilities DECREASE  , then you are going to DECREASE  Net Income.

Ex)	YR 2	YR 1
Accounts Payable	\$7,000	\$5,000

***ACCOUNTS PAYABLE INCREASED BY \$2,000 FROM YR 1 TO YR 2 SO WE ARE GOING TO INCREASE NET INCOME BY \$2,000 TO GET CASH FROM OPERATIONS.**

Current Liabilities	1. Accounts Payable 2. Salaries and Wages Payable 3. Income Taxes Payable 4. Interest Payable 5. Notes Payable (1 year or less). 6. Current maturities of long-term obligations	"Obligations due to be paid or settled WITHIN one year or the operating cycle , whichever is longer."
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Cash flows from operating activities		Cash flows from operating activities	
Net Income	\$XXX	Net Income	\$XXX
Adjustments to reconcile net income to net cash provided by operating activities:		Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation Expense	XXX	Depreciation Expense	XXX
Amortization Expense	XXX	Amortization Expense	XXX
Depletion Expense	XXX	Depletion Expense	XXX
Loss on disposal of plant assets	XXX	Loss on disposal of plant assets	XXX
Gain on disposal of plant assets	(XXX)	Gain on disposal of plant assets	(XXX)
Increase in current asset account	(XXX)	Increase in current asset account	(XXX)
Decrease in current asset account	XXX	Decrease in current asset account	XXX
Increase in current liability account	XXX	Increase in current liability account	XXX
Decrease in current liability account	(XXX)	Decrease in current liability account	(XXX)
Net cash provided by operating activities	<u>\$XXX</u> If POSTIVE	Net cash used by operating activities	<u>\$(XXX)</u> If NEGATIVE

INDIRECT METHOD FOR OPERATING ACTIVITIES SECTION (EXAMPLE PROBLEM)

Lake Johnson Company reported net income of \$190,000 for the current year. Depreciation recorded on buildings and equipment amounted to \$90,000 for the year. Balances of the current asset and current liability accounts at the beginning and end of the year are as follows:

	<u>End of Year</u>	<u>Beginning of Year</u>
Cash	\$120,000	\$100,000
Accounts receivable	70,000	50,000
Inventory	50,000	80,000
Accounts payable	35,000	30,000

Instructions

Prepare the cash flows from the operating activities section of the statement of cash flows using the indirect method.

Net income	\$190,000
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation expense	90,000
Increase in accounts receivable	(20,000)
Decrease in inventory	30,000
Increase in accounts payable	5,000
Net cash provided by operating activities	<u>\$295,000*</u>
*(Net inc. + dep. exp – inc. in A/R + dec. in inven. + inc. in A/P)	

***Notice that the change in cash of \$20,000 (\$120,000 end of year - \$100,000 beginning of year) is not on the operating activities section. The whole statement of cash flows will explain the \$20,000 increase in cash.**

STEP 2: INVESTING ACTIVITIES

***Analyze changes in noncurrent asset and liability accounts and record as investing and financing activities, or disclose as noncash transactions.**

- THINK CHANGES IN **NON-CURRENT (LONG-TERM) ASSETS** (Property, plant, equipment, investments in stocks or bonds of other entities, loans to other entities, and collection of a nontrade receivable (EXCLUDING interest))

DECREASE  **in cash**

Purchase of long-term assets (Ex: buildings, equipment, land)

Purchase of long-term investments

Lending money

(PAYING CASH which means CASH GOES DOWN)

INCREASE  **in cash**

Sale of long-term assets (Ex: buildings, equipment, land)

Sale of long-term investments

Collection of long-term loan

(RECEIVING CASH which means CASH GOES UP)

*****BE CAREFUL.....**Sell Equipment for \$2,000 with a \$50 GAIN.

- *Equipment sold for \$2,000 is shown as an INCREASE in cash in the Investing section and the \$50 GAIN is a DECREASE in the Operating section.

Long-Term Investments	1. Investments in stocks and bonds of other corporations that are held for more than one year. 2. Long-term assets such as land or buildings that a company is not currently using in its operating activities. 3. Long-term notes receivable.	"Notes receivable and investments in stocks and bonds that the company intends to hold onto for MORE THAN the longer of one year or operating cycle." Also, they ARE NOT used in the company's operating activities.
Plant Assets (Property, Plant, and Equipment)	1. Equipment 2. Machinery 3. Buildings 4. Land 5. Delivery Vehicles 6. Furniture.	"Tangible assets that are both long-lived and used in operating the business." All plant assets (EXCLUDING Land) depreciate over their useful lives. • Depreciation: allocating the cost of assets to a number of years. • Accumulated Depreciation: total amount of depreciation expensed thus far in the asset's life.

Cash flows from investing activities:

Cash inflows from investing activities

\$ XXX

Cash used for investing activities

(XXX)

Net cash flow from investing activities

\$XXX

STEP 2 (Cont.): FINANCING ACTIVITIES

- THINK CHANGES IN **LONG-TERM LIABILITIES AND SHAREHOLDER'S EQUITY**. Money obtained to run a business from loans (long-term liabilities) or issuing stock (ownership in the company.)

DECREASE **in cash**

Payback long-term loans
 Redemption of bonds payable
 Purchase treasury stock (Buying back the company's own stock.)
 Payment of dividends
(PAYING CASH which means CASH GOES DOWN)

INCREASE **in cash**

Issuance or sale of common or preferred stock
 Issuance of bonds payable or long-term notes payable
(RECEIVING CASH which means CASH GOES UP)

Long-Term Liabilities	1. Bonds Payable 2. Notes Payable (more than 1 year) 3. Mortgage Payable. 4. Lease Liabilities 5. Pension Liabilities	"Obligations NOT DUE within one year or the operating cycle, whichever is longer."
Equity	1. Common stock 2. Preferred Stock 3. Paid-in Capital 4. Retained Earnings (income retained for use in the business)	"The owner's claim on assets."

Cash flows from financing activities:

Cash inflows from financing activities	\$ XXX	
Cash used for financing activities	<u>(XXX)</u>	
Net cash flow from financing activities		\$XXX

Step 3: Finish Statement of Cash Flows

*Compare **the net change in cash** on the statement of cash flows with the change in the cash account reported on the balance sheet to make sure the amounts agree.

COMPUTER SERVICES COMPANY				
Comparative Balance Sheets December 31				
<u>Assets</u>	<u>2017</u>	<u>2016</u>	<u>Change in Account Balance Increase/Decrease</u>	
Current assets				
Cash	\$ 55,000	\$ 33,000	\$ 22,000	Increase
Accounts receivable	20,000	30,000	10,000	Decrease
Inventory	15,000	10,000	5,000	Increase
Prepaid expenses	5,000	1,000	4,000	Increase

- In this situation, Computer Services Company should have a Statement of Cash Flows that explains how the company went from \$33,000 in 2016 to \$55,000 in 2017.
- The Operating, Investing, and Financing section of the statement of cash flows should sum to the \$22,000 increase in cash.

*****NONCASH INVESTING AND FINANCING ACTIVITIES LIKE BUYING EQUIPMENT BY ISSUING A NOTE DO NOT INVOLVE CASH, BUT ARE STILL IMPORTANT. THEY ARE SHOWN ON THE BOTTOM OF THE STATEMENT OF CASHFLOWS OR IN A DISCLOSURE NOTE.**

Because such transactions indirectly affect cash flows, they are reported in a separate section that usually appears at the bottom of the statement of cash flows.

List of Noncash Investing and Financing Activities

- Retirement of debt by issuing equity stock.
- Conversion of preferred stock to common stock.
- Lease of assets in a capital lease transaction.
- Purchase of long-term assets by issuing a note or bond.
- Exchange of noncash assets for other noncash assets.
- Purchase of noncash assets by issuing equity or debt.

INDIRECT METHOD STATEMENT OF CASH FLOW COMPREHENSIVE TEMPLATE**Cash flows from operating activities**

Net Income		\$XXX	
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Adjustments to reconcile net income to net cash provided by operating activities:

Depreciation Expense	XXX		
Amortization Expense	XXX		
Depletion Expense	XXX		
Loss on disposal of plant assets	XXX		
Gain on disposal of plant assets	(XXX)		
Increase in current asset account	(XXX)		
Decrease in current asset account	XXX		
Increase in current liability account	XXX		
Decrease in current liability account	(XXX)	XXX or (XXX)	
Net cash provided by operating activities		\$XXX	If POSTIVE
(Net cash used by operating activities if (NEGATIVE))			

Cash flows from investing activities

Purchase of long-term assets	(XXX)		
Purchase of long-term investments	(XXX)		
Loaning out money	(XXX)		
Sale of long-term assets	XXX		
Sale of long-term investments	XXX		
Collection of long-term loan	XXX		
Net cash provided by investing activities		\$XXX	If POSTIVE
(Net cash used by investing activities if (NEGATIVE))			

Cash flows from financing activities

Payback long-term loans	(XXX)		
Redemption of bonds payable	(XXX)		
Purchase treasury stock (Buying back the company's own stock.)	(XXX)		
Payment of dividends	(XXX)		
Issuance or sale of common or preferred stock	XXX		
Issuance of bonds payable or long-term notes payable	XXX		
Net cash provided by investing activities		\$XXX	If POSTIVE
(Net cash used by financing activities if (NEGATIVE))			

Net increase (decrease) in cash	XXX or (XXX)
Cash at beginning of period	XXX
Cash at end of period	\$XXX

INDIRECT METHOD STATEMENT OF CASH FLOW COMPREHENSIVE EXAMPLE

The following information is available for Magic Corporation for the year ended December 31, 20X7:

Collection of principal on long-term loan to a supplier	\$16,000
Acquisition of equipment for cash	10,000
Proceeds from the sale of long-term investment at book value	22,000
Issuance of common stock for cash	20,000
Depreciation expense	25,000
Redemption of bonds payable at carrying (book) value	34,000
Payment of cash dividends	6,000
Net income	30,000
Purchase of land by issuing bonds payable	40,000

In addition, the following information is available from the comparative balance sheet for Magic at the end of 20X7 and 20X6:

	<u>20X7</u>	<u>20X6</u>
Cash	\$148,000	\$91,000
Accounts receivable (net)	25,000	15,000
Prepaid insurance	<u>19,000</u>	<u>13,000</u>
Total current assets	<u>\$192,000</u>	<u>\$119,000</u>
Accounts payable	\$ 30,000	\$19,000
Salaries and wages payable	<u>6,000</u>	<u>7,000</u>
Total current liabilities	<u>\$ 36,000</u>	<u>\$26,000</u>

Instructions

Prepare Magic's statement of cash flows for the year ended December 31, 20X7, using the indirect method.

***Objective of the statement of cash flow will be to explain how cash increased by \$57,000 from \$91,000 in 20X6 to \$148,000 in 20X7. The next page shows the solution to the problem. Notice that the cash from operating, investing, and financing activities sum up to that \$57,000 difference in cash. Also, the sum of cash from operating, investing, and financing activities + beginning cash equal the current year's cash balance on the balance sheet. This shows how the financial statements are interrelated.

MAGIC CORPORATION
Statement of Cash Flows
For the Year Ended December 31, 20X7

Cash flows from operating activities		
Net income		\$30,000
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation	\$25,000	
Increase in accounts receivable	(10,000)	
Increase in prepaid insurance	(6,000)	
Increase in accounts payable	11,000	
Decrease in salaries and wages payable	(1,000)	<u>19,000</u>
Net cash provided by operating activities		49,000
Cash flows from investing activities		
Collection of long-term loan	16,000	
Proceeds from the sale of investments	22,000	
Purchase of equipment	<u>(10,000)</u>	
Net cash provided by investing activities		28,000
Cash flows from financing activities		
Issuance of common stock	20,000	
Redemption of bonds	(34,000)	
Payment of dividends	<u>(6,000)</u>	
Net cash used by financing activities		(20,000)
Increase in cash		57,000
Cash at beginning of period		<u>91,000</u>
Cash at end of period		<u>\$148,000</u>
Noncash investing and financing activities		
Purchase of land by issuing bonds		<u>\$40,000</u>

LO 3: Use the statement of cash flows to evaluate a company.

- **Free cash flow:** describes the cash remaining from operations after adjustment for capital expenditures and dividends.

$$= \text{Net Cash Provided by Operating Activities} - \text{Capital Expenditures} - \text{Cash Dividends}$$

Free Cash Flow Example

Information for two companies in the same industry, Tucker Corporation and Wiggins Corporation, is presented here.

	<u>Tucker Corporation</u>	<u>Wiggins Corporation</u>
Cash provided by operating activities	\$140,000	\$140,000
Net earnings	200,000	200,000
Capital expenditures	60,000	90,000
Dividends paid	5,000	10,000

Instructions

Compute the free cash flow for each company.

	Tucker Corporation	Wiggins Corporation
Cash provided by operating activities	\$ 140,000	\$ 140,000
Less Capital expenditures	\$ (60,000)	\$ (90,000)
Less Dividends paid	\$ (5,000)	\$ (10,000)
Free Cash Flow	\$ 75,000	\$ 40,000

Tucker Corporation has a larger amount of cash remaining than Wiggins Corporation after adjustment for capital expenditures and dividend payments. Therefore, Tucker has a greater cash-generating ability than Wiggins Corporation.