Accounting Fundamentals Lesson 10

10.0 Cash Flow Statement

The balance sheet reports financial position, and balance sheets from two periods show whether cash increased or decreased. But that doesn't tell why the cash balance changed.

The income statement reports net income and offers clues about cash, but the income statement doesn't tell why cash increased or decreased.

We need a third financial statement…

The statement of cash flows reports cash flows, cash receipts, and cash payments, to show where cash came from and how it was spent.

- Receipts - where cash came from
- Payments - how cash was spent

The statement of cash flows serves four purposes:

1. Predicts future cash flows - Past cash receipts and payments are reasonably good predictors of future cash flows.

2. Evaluates management decisions - Businesses that make wise decisions prosper, and those that make unwise decisions suffer losses.

3. Determines ability to pay dividends and interest - Stockholders want dividends on their investments. Creditors demand interest and principal on their loans.

4. Shows the relationship of net income to cash flows

Cash Flow Categories:

Businesses engage in three types of business activities:

- Operating
- Investing
- Financing activities.

The statement of cash flows reports cash flows under these headings.

Operating activities create:

- Revenues
- Expenses
- Gains
- Losses

These operating activities represent the core of the organization elements and make up net income. It is the most important of the three categories.

Investing activities increase and decrease long-term assets such as:

- Computers
- Land
- Buildings
- Equipment
- Investments in other companies.

Purchase and sales of these assets are investing activities. Investing activities are important, but they are less critical than operating activities.

Financing Activities include:

- Issuing stock
- Borrowing money
- Buying and selling treasury stock
- Paying cash dividends

These cash flows relate to long-term liabilities and equity. Financing activities obtain cash from investors and creditors.

There are two ways to format operating activities on the statement of cash flows:

- The indirect method
- The direct method

The indirect method - reconciles from net income to net cash provided by operating activities.

The direct method - reports all cash receipts and cash payments from operating activities.

Both methods will produce the same figure for cash from operating activities, but will use different computations. Investing and financing activities are not affected by either method.

Indirect Method:

Preparing a statement of cash flows by the indirect method requires four steps:

From the income statement, take net income, depreciation, depletion, and amortization expense, and any gains or losses on the sale of long-term assets.

From the comparative balance sheets, compute the increase or decrease in each current asset and current liability account.

Where the changes in balance sheet accounts should be entered on your statement of cash flows:

A change in this balance sheet category	...is reported in this section of the cash flow statement
Current Assets*	Operating Activities
Current Liabilities	Operating Activities
Long-term Assets	Investing Activties
Long-term Liabilities	Financing Activities
Stockholders' Equity	Financing Activities

* This refers to current assets other than Cash.

1. Cash Provided From or Used By Operating Activities

This section of the cash flow statement reports the company's net income and then converts it from the accrual basis to the cash basis by using the changes in the balances of current asset and current liability accounts, such as:

- Accounts Receivable
- Inventory
- Supplies
- Prepaid Insurance
- Other Current Assets
- Notes Payable
- Accounts Payable
- Wages Payable
- Payroll Taxes Payable
- Interest Payable
- Income Taxes Payable
- Unearned Revenues
- Other Current Liabilities

In addition to using the changes in current assets and current liabilities, the operating activities section has adjustments for depreciation expense and for the gains and losses on the sale of long-term assets.

Cash Flow Template: Operating

Cash Flows From Operating Activities	
Net income	
Adjustments to reconcile net income to net cash provided by operating activities:	
+	Depreciation/depletion/amortization expense
+	Loss on sale of long-term assets
-	Gain on sale of long-term assets
-	Increases in current assets other than cash
+	Decreases in current assets other than cash
+	Increases in current liabilities
-	Decreases in current liabilities
=	**Net cash provided by (used for) operating activities**

2. Cash Provided From or Used By Investing Activities

This section of the cash flow statement reports changes in the balances of long-term asset accounts, such as:

- Long-term Investments
- Land
- Buildings
- Equipment
- Furniture & Fixtures
- Vehicles

Investing activities involve the purchase and/or sale of long-term investments and property, plant, and equipment.

Cash Flow Template: Investing

	Cash Flows from Investing Activities
+	Sales of long-term assets
-	Purchases of long-term assets
+	Collections of notes receivable
-	Loans to others
=	**Net cash provided by (used for) investing activities**

3. Cash Provided From or Used By Financing Activities

This section of the cash flow statement reports changes in balances of the long-term liability and stockholders' equity accounts, such as:

- Notes Payable (generally due after one year)
- Bonds Payable
- Deferred Income Taxes
- Preferred Stock
- Paid-in Capital in Excess of Par-Preferred Stock
- Common Stock

- Paid-in Capital in Excess of Par-Common Stock
- Paid-in Capital from Treasury Stock
- Retained Earnings
- Treasury Stock

Financing activities involve the issuance and/or the repurchase of a company's own bonds or stock as well as short-term and long-term borrowings and repayments.

Cash Flow Template: Financing

Cash Flows from Financing Activities	
+	Issuance of stock
-	Purchase of treasury stock
+	Borrowing
-	Payment of notes and bonds payable
-	Payment of dividends
	Net cash provided by (used in) financing activities

4. Supplemental Information

This section of the cash flow statement discloses the amount of interest and income taxes paid. Also reported are significant exchanges not involving cash.

The direct method:

Using the direct method, the accountant shows the items that affected cash flow, such as cash collected from customers, interest received, cash paid to suppliers, etc. whereas the indirect method adjusts net income for any revenue and expense item that did not result from a cash transaction.

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) prefer the direct method of reporting operating cash flows because it provides clearer information about the sources and uses of cash.

Even with this being the case, the indirect method is still used by the vast majority of companies over the direct method because it requires fewer computations.

Under the direct method, the statement of cash flows is prepared in three steps.

1. Operating activities are listed first under the direct method. Cash collections from customers and cash receipts of interest and dividends are all listed as receipts, while payments to suppliers, payments to employees, and payments for interest expense and income tax expense are all shown as payments. Unlike the indirect method, depreciation, depletion, and amortization expense are not listed on a direct-method statement of cash flows.

2. Investing activities that are considered inflows of cash include purchasing plant assets and investments, proceeds from selling plant assets and investments, and collection of notes receivable. Making loans to other companies is classified as an outflow of cash.

3. Financing activities that are inflows of cash include any proceeds for issuance of stock and debt (notes and bonds payable). Payment of debt and purchases of the company's own stock, as well as paying any dividends, are considered outflows of cash under the direct method.

If a company makes an investment that does not require cash, this transaction would not be reported as a cash payment. Companies may choose to report these activities in a separate schedule under the statement of cash flows.

EMERSON CORPORATION Statement of Cash Flows (Indirect Approach) For the Year Ending December 31, 20X5		
Cash flows from operating activities:		
Net income		$1,000,000
Add (deduct) noncash effects on operating income		
Depreciation expense	$ 120,000	
Gain on sale of land	(150,000)	
Increase in accounts receivable	(250,000)	
Decrease in inventory	40,000	
Increase in accounts payable	70,000	
Decrease in wages payable	(30,000)	(200,000)
Net cash provided by operating activities		$ 800,000
Cash flows from investing activities:		
Sale of land	$ 750,000	
Purchase of equipment	(150,000)	
Net cash provided by investing activities		600,000
Cash flows from financing activities:		
Proceeds from issuing stock	$ 80,000	
Dividends on common	(50,000)	
Repayment of long-term loans	(900,000)	
Net cash provided by financing activities		(870,000)
Net increase in cash		$530,000
Cash balance at January 1, 20X5		170,000
Cash balance at December 31, 20X5		$ 700,000
Noncash investing/financing activities:		
Issued preferred stock for building		$ 300,000
Supplemental information:		
Cash paid for interest		$ 100,000
Cash paid for income taxes		300,000

EMERSON CORPORATION
Statement of Cash Flows (Direct Approach)
For the Year Ending December 31, 20X5

Cash flows from operating activities:		
Cash received from customers		$ 3,000,000
Less cash paid for:		
Merchandise inventory	$1,050,000	
Wages	480,000	
Interest	100,000	
Other operating expenses	270,000	
Income taxes	300,000	(2,200,000)
Net cash provided by operating activities		$ 800,000
Cash flows from investing activities:		
Sale of land	$ 750,000	
Purchase of equipment	(150,000)	
Net cash provided by investing activities		600,000
Cash flows from financing activities:		
Proceeds from issuing stock	$ 80,000	
Dividends on common	(50,000)	
Repayment of long-term loans	(900,000)	
Net cash used in financing activities		(870,000)
Net increase in cash		$ 530,000
Cash balance at January 1, 20X5		170,000
Cash balance at December 31, 20X5		$ 700,000
Noncash investing/financing activities:		
Issued preferred stock for building		$ 300,000