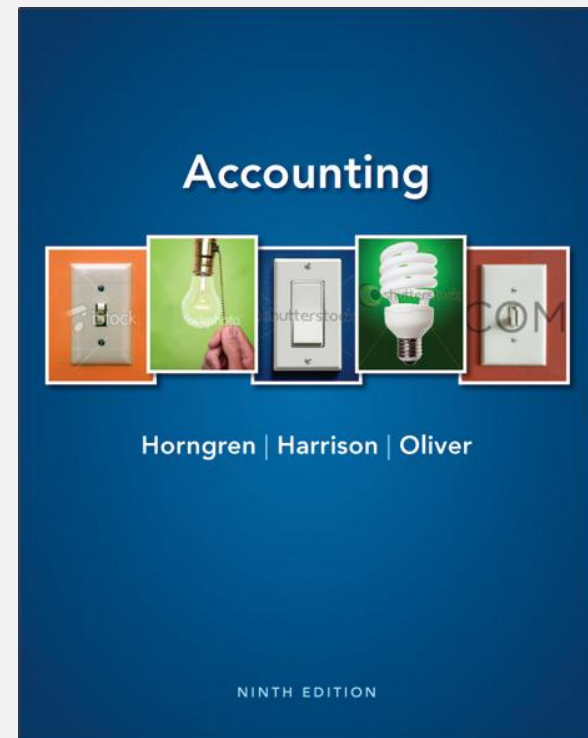


# The Statement of Cash Flows

## Chapter 14



# Learning Objectives

- 1 Identify the purposes of the statement of cash flows
- 2 Distinguish among operating, investing, and financing cash flows
- 3 Prepare the statement of cash flows by the indirect method
- 4 Identify noncash investing and financing activities

# Learning Objectives

- 5** Analyze cash flows
- 6** Prepare the statement of cash flows by the direct method (Appendix 14A)
- 7** Prepare the indirect statement of cash flows using a spreadsheet (Appendix 14B)



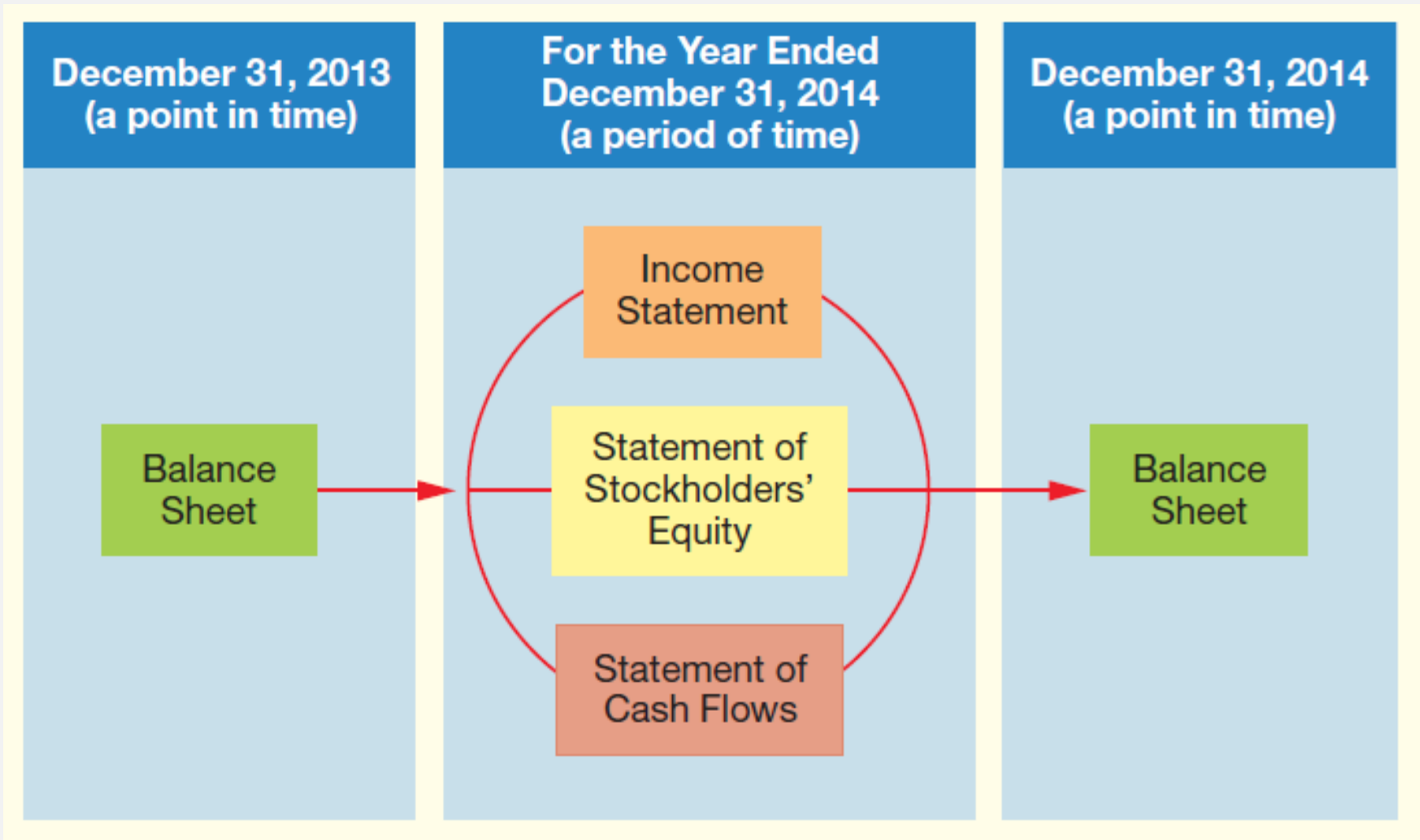
# 1

Identify the purposes of the statement of cash flows

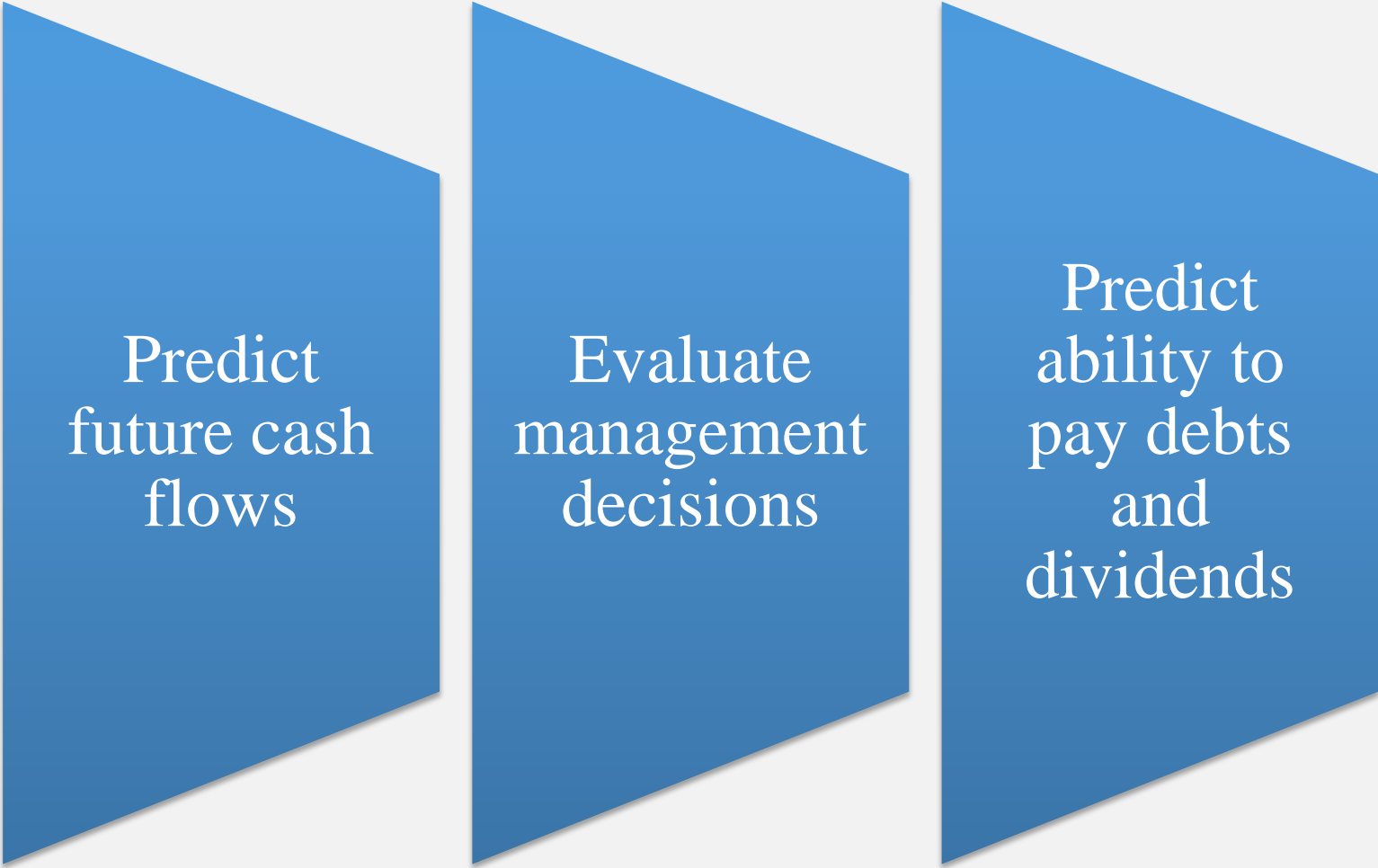
# Statement of Cash Flows

- The comparative balance sheet reports financial position
  - ▶ Shows whether cash increased or decreased
  - ▶ Does not show *why* cash changed
  - ▶ Covers a specific moment in time
- The statement of cash flows reports cash flows
  - ▶ Shows where cash came from (receipts) and how cash was spent (payments)
  - ▶ Reports why cash increased or decreased during the period
  - ▶ Covers a span of time and is dated the same as the income statement
  - ▶ The communicating link between income statement and balance sheet

# Timing of the Financial Statements



# Use of Cash Flow Information



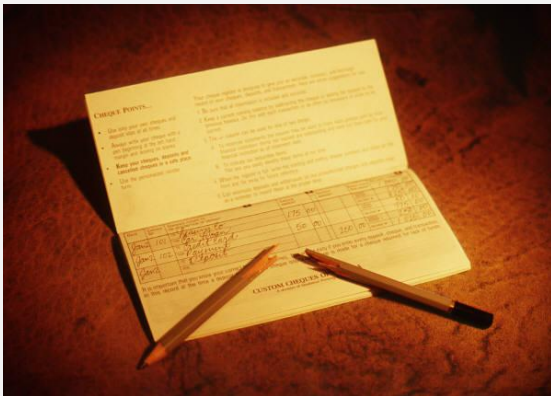
Predict  
future cash  
flows

Evaluate  
management  
decisions

Predict  
ability to  
pay debts  
and  
dividends

# Cash Equivalents

- Highly liquid investments
- Can convert into cash three months or less
- So close to cash it is considered as equals
- Examples:
  - ▶ Money-market accounts
  - ▶ Investments in U.S. government securities







# 2

Distinguish among operating, investing, and financing cash flows

# Basic Types of Cash Flow Activities

Operating

- Day-to-day operations

Investing

- Long-term assets

Financing

- Equity & Long-term liabilities

# Operating Activities

- Most important category
  - ▶ Reflects the day-to-day operations
  - ▶ Determines the future of an organization
- Generate revenues, expenses, gains, and losses
- Affect net income on the income statement
- Affect current assets and current liabilities on the balance sheet



# Investing Activities

- Increase and decrease long-term assets
  - ▶ Computers, software, land, buildings, and equipment
- Include purchases and sales of these assets
  - ▶ Include long-term loans receivable from others (non-trade) and collections of those loans
- Include purchases and sales of long-term investments



# Financing Activities

- Increase and decrease long-term liabilities and equity
- Include issuing stock, paying dividends, and buying and selling treasury stock
- Include borrowing money and paying off loans



# Operating, Investing and Financing Activities and the Balance Sheet

|                  |                       |
|------------------|-----------------------|
| Current assets   | Current liabilities   |
| Long-term assets | Long-term liabilities |
|                  | Owners' equity        |

# Two Formats for Operating Activities

- Indirect method

- ▶ Starts with net income; adjusts it to net cash provided by operating activities
- ▶ Used by most companies

- Direct method

- ▶ Restates income statement in terms of cash
- ▶ Shows cash receipts and payments from operating activities

- Use different computations, but same operating cash flows

- No effect on investing and financial cash flows

# Example: Indirect

|   |             |             |
|---|-------------|-------------|
| Cash flows from operating activities:   |             |             |
| Net income  |             | \$ 40,000   |
| Adjustments to reconcile net income to net cash provided by operating activities: |             |             |
| Depreciation  | \$ 20,000   |             |
| Gain on sale of plant assets  | (10,000)    |             |
| Increase in accounts receivable   | (17,000)    |             |
| Decrease in inventory   | 2,000       |             |
| Increase in accounts payable  | 40,000      |             |
| Decrease in accrued liabilities   | (5,000)     | 30,000      |
| Net cash provided by operating activities   |             | \$ 70,000   |
| Cash flows from investing activities:   |             |             |
| Acquisition of plant assets   | \$(310,000) |             |
| Cash receipt from sale of plant asset   | 50,000      |             |
| Net cash used for investing activities  |             | (260,000)   |
| Cash flows from financing activities:   |             |             |
| Cash receipt from issuance of common stock  | \$ 120,000  |             |
| Cash receipt from issuance of notes payable                                       | 90,000      |             |
| Payment of notes payable  | (10,000)    |             |
| Purchase of treasury stock  | (20,000)    |             |
| Payment of dividends  | (10,000)    |             |
| Net cash provided by financing activities   |             | 170,000     |
| Net decrease in cash  |             | \$ (20,000) |
| Cash balance, December 31, 2013   |             | 42,000      |
| Cash balance, December 31, 2014   |             | \$ 22,000   |



# Example: Direct

|  |             |                    |
|--|-------------|--------------------|
| <b>Cash flows from operating activities:</b> |             |                    |
| Receipts:                                    |             |                    |
| Collections from customers                   | \$ 269,000  |                    |
| Interest received                            | 12,000      |                    |
| Dividends received                           | 9,000       |                    |
| Total cash receipts                          |             | \$ 290,000         |
| Payments:                                    |             |                    |
| To suppliers                                 | \$(135,000) |                    |
| To employees                                 | (56,000)    |                    |
| For interest                                 | (15,000)    |                    |
| For income tax                               | (14,000)    |                    |
| Total cash payments                          |             | (220,000)          |
| Net cash provided by operating activities    |             | 70,000             |
| <b>Cash flows from investing activities:</b> |             |                    |
| Acquisition of plant assets                  | \$(310,000) |                    |
| Cash receipts from sale of plant assets      | 50,000      |                    |
| Net cash used for investing activities       |             | (260,000)          |
| <b>Cash flows from financing activities:</b> |             |                    |
| Cash receipts from issuance of common stock  | \$ 120,000  |                    |
| Cash receipts from issuance of notes payable | 90,000      |                    |
| Payment of notes payable                     | (10,000)    |                    |
| Purchase of treasury stock                   | (20,000)    |                    |
| Payment of dividends                         | (10,000)    |                    |
| Net cash provided by financing activities    |             | 170,000            |
| <b>Net decrease in cash</b>                  |             | <b>\$ (20,000)</b> |
| Cash balance, December 31, 2013              |             | 42,000             |
| Cash balance, December 31, 2014              |             | \$ 22,000          |

## S14-3: CLASSIFYING ITEMS ON THE INDIRECT STATEMENT OF CASH FLOWS

Destiny Corporation is preparing its statement of cash flows by the *indirect method*. Destiny has the following items for you to consider in preparing the statement:

|           |                                    |           |                                    |
|-----------|------------------------------------|-----------|------------------------------------|
| <b>O+</b> | a. Increase in accounts payable    | <b>O+</b> | f. Loss on sale of land            |
| <b>F-</b> | b. Payment of dividends            | <b>O+</b> | g. Depreciation expense            |
| <b>O-</b> | c. Decrease in accrued liabilities | <b>O-</b> | h. Increase in inventory           |
| <b>F+</b> | d. Issuance of common stock        | <b>O+</b> | i. Decrease in accounts receivable |
| <b>O-</b> | e. Gain on sale of building        | <b>I-</b> | j. Purchase of equipment           |

Identify each item as a(n):

- Operating activity—addition to net income (O+), or subtraction from net income (O–)
- Investing activity—addition to cash flow (I+), or subtraction from cash flow (I–)
- Financing activity—addition to cash flow (F+), or subtraction from cash flow (F–)
- Activity that is not used to prepare the indirect cash flow statement (N)



# 3

Prepare the statement of cash flows by the indirect method

# Cash Flow Steps

Gather the income statement and both the current and prior year's balance sheets.

Step 1: Lay out statement format

Step 2: Compute the change in cash from the comparative balance sheet

Step 3: Take the figures—Net Income, depreciation, and any gains or losses—from the income statement

Step 4: Complete the statement of cash flows

# Cash Flows from Operating Activities: Indirect Method

± Cash flows from operating activities:

Net income

Adjustments to reconcile net income to net cash provided by operating activities:

+ Depreciation / 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

# Gather Income Statement

|                              |           |           |
|------------------------------|-----------|-----------|
| Revenues and gains:          |           |           |
| Sales revenue                | \$286,000 |           |
| Interest revenue             | 12,000    |           |
| Dividend revenue             | 9,000     |           |
| Gain on sale of plant assets | 20,000    |           |
| Total revenues and gains     |           | \$317,000 |
| Expenses:                    |           |           |
| Cost of goods sold           | \$156,000 |           |
| Salary and wage expense      | 56,000    |           |
| Depreciation expense         | 20,000    |           |
| Other operating expense      | 16,000    |           |
| Interest expense             | 15,000    |           |
| Income tax expense           | 14,000    |           |
| Total expenses               |           | 277,000   |
| Net income                   |           | \$ 40,000 |

Items from the  
income statement not  
affecting cash

# Comparative Balance Sheet

|   | 2014             | 2013             | Increase<br>(Decrease) |
|---|------------------|------------------|------------------------|
| <b>Assets</b>                                     |                  |                  |                        |
| Current:  |                  |                  |                        |
| Cash  | \$ 22,000        | \$ 42,000        | \$ (20,000)            |
| Accounts receivable                               | 90,000           | 73,000           | 17,000                 |
| Inventory   | 143,000          | 145,000          | (2,000)                |
| Plant assets, net                                 | 460,000          | 210,000          | 250,000                |
| <b>Total assets</b>                               | <b>\$715,000</b> | <b>\$470,000</b> | <b>\$245,000</b>       |
| <b>Liabilities</b>                                |                  |                  |                        |
| Current:  |                  |                  | —                      |
| Accounts payable                                  | \$ 90,000        | \$ 50,000        | \$ 40,000              |
| Accrued liabilities                               | 5,000            | 10,000           | (5,000)                |
| Long-term notes payable                           | 160,000          | 80,000           | 80,000                 |
| <b>Stockholders' Equity</b>                       |                  |                  |                        |
| Common stock                                      | 370,000          | 250,000          | 120,000                |
| Retained earnings                                 | 110,000          | 80,000           | 30,000                 |
| Treasury stock                                    | (20,000)         | 0                | (20,000)               |
| <b>Total liabilities and stockholders' equity</b> | <b>\$715,000</b> | <b>\$470,000</b> | <b>\$245,000</b>       |

# Changes in Current Assets (other than cash) and Current Liabilities

| Effect on cash      | If an increase | If a decrease |
|---------------------|----------------|---------------|
| Current assets      | —              | +             |
| Current liabilities | +              | —             |



# Cash Flows from Operating Activities

Refer to the balance sheet for changes in the accounts

|   |           |           |
|---|-----------|-----------|
| Cash flows from operating activities:   |           |           |
| Net income  |           | \$ 40,000 |
| Adjustments to reconcile net income to net cash provided by operating activities: |           |           |
| Depreciation  | \$ 20,000 |           |
| Gain on sale of plant assets  | (10,000)  |           |
| Increase in accounts receivable   | (17,000)  |           |
| Decrease in inventory   | 2,000     |           |
| Increase in accounts payable  | 40,000    |           |
| Decrease in accrued liabilities   | (5,000)   | 30,000    |
| Net cash provided by operating activities   |           | \$ 70,000 |

Operations provided net cash flow of \$70,000.  
This amount exceeds net income of \$40,000.

# Cash Flows from Investing Activities

- Sales and acquisitions of long-term assets
  - ▶ Plant assets and investments
- Analyze accounts to determine activity
  - ▶ Use of T-account is helpful
- If gain or loss appears on the income statement, a long-term asset has been sold

± Cash flows from investing activities:

+ Cash receipts from sales of long-term (plant) assets (investments, land, building, equipment, and so on)

– Acquisition of long-term (plant) assets

Net cash provided by (used for) investing activities

# Computing Acquisitions and Sales of Plant Assets

- Combine all the plant assets into a single Plant assets account

| Plant assets, net |         |
|-------------------|---------|
| 12/31/13 Bal      | 210,000 |
| Acquisitions      | 310,000 |
| 12/31/14 Bal      | 460,000 |

|                              |        |
|------------------------------|--------|
| Depreciation (from Inc Stmt) | 20,000 |
| Cost of sold assets (COSA)   | ?      |

- Find the cost of the sold assets
  - ▶ The missing value in our net T-account

# Cash from Selling Plant Assets

- Solve cash received using the T-account and journal entry

|              |         | Plant assets, net            |        |
|--------------|---------|------------------------------|--------|
| 12/31/13 Bal | 210,000 |                              |        |
|              |         | Depreciation (from Inc Stmt) | 20,000 |
| Acquisitions | 310,000 | Cost of sold assets (COSA)   | 40,000 |
| 12/31/14 Bal | 460,000 |                              |        |

- Adding the cost of the sold asset to the gain yields cash received

|   |  |       |        |
|---|--|-------|--------|
| Cash (A+)   |  | ????? |        |
| Gain on sale of plant assets (from the income statement) (R+) |  |       | 10,000 |
| Plant assets, net (from the T-account—COSA) (A-)              |  |       | 40,000 |

# Computing Cash Flows from Investing Activities Summary

## Cash Receipts

|                           |                              |   |                           |   |                      |    |                           |   |                           |
|---------------------------|------------------------------|---|---------------------------|---|----------------------|----|---------------------------|---|---------------------------|
| From sale of plant assets | Beginning plant assets (net) | + | Acquisition               | - | Depreciation expense | -  | Book value of assets sold | = | Ending plant assets (net) |
|                           | Cash receipt                 | = | Book value of assets sold | { | + Gain on sale       | or | - Loss on sale            |   |                           |

## Cash Payments

|                                 |                              |   |             |   |                      |   |                           |   |                           |
|---------------------------------|------------------------------|---|-------------|---|----------------------|---|---------------------------|---|---------------------------|
| For acquisition of plant assets | Beginning plant assets (net) | + | Acquisition | - | Depreciation expense | - | Book value of assets sold | = | Ending plant assets (net) |
|---------------------------------|------------------------------|---|-------------|---|----------------------|---|---------------------------|---|---------------------------|

# Cash Flows from Financing Activities

- Issuances of and payments on long-term notes payable
- Issuances of stock and purchases of treasury stock
- Payments of dividends

## ± Cash flows from financing activities:

+ Cash receipts from issuance of stock

+ Cash receipts from sale of treasury stock

– Purchase of treasury stock

+ Cash receipts from issuance of notes or bonds payable (borrowing)

– Payment of notes or bonds payable

– Payment of dividends

Net cash provided by (used for) financing activities

# Long-Term Notes Payable

- Review balance sheet for differences
  - ▶ Note increase in Long-term notes payable
- If new issuances or payments are known, the other can be calculated
  - ▶ If unknown, review account for debits and credits
- With knowledge of a new note, note payments can be calculated

| Long-term notes payable |        |                  |         |
|-------------------------|--------|------------------|---------|
|                         |        | 12/31/13 Bal     | 80,000  |
| Note payments           | 10,000 | New notes issued | 90,000  |
|                         |        | 12/31/14 Bal     | 160,000 |

# Issuances of Stock and Purchases of Treasury Stock

- Review balance sheet for differences
  - ▶ Note change in Common stock of \$120,000
- If either new issuances or purchases are known, the other can be calculated
  - ▶ If unknown, review account for debits and credits

| Common stock |   |              |         |
|--------------|---|--------------|---------|
|              |   | 12/31/13 Bal | 250,000 |
| Retirements  | 0 | Issuance     | 120,000 |
|              |   | 12/31/14 Bal | 370,000 |



# Issuances of Stock and Purchases of Treasury Stock

- Review balance sheet for differences
  - ▶ Note change in Treasury stock of \$20,000
- If either new issuances or purchases are known, the other can be calculated
  - ▶ If unknown, review account for debits and credits

| Treasury stock |        |       |   |
|----------------|--------|-------|---|
| 12/31/13 Bal   | 0      |       |   |
| Purchases      | 20,000 | Sales | 0 |
| 12/31/14 Bal   | 20,000 |       |   |

# Computing Dividend Payments

- Review balance sheet for differences in Retained earnings
  - ▶ Note change in Retained earnings
- Retained earnings is changed by net income, net losses and dividends
  - ▶ Net income of \$40,000 is indicated on the income statement
  - ▶ Cannot have both income and loss

| Retained earnings     |              |         |
|-----------------------|--------------|---------|
|                       | 12/31/13 Bal | 80,000  |
|                       | Net income   | 40,000  |
| Dividend declarations | 10,000       |         |
|                       | 12/31/14 Bal | 110,000 |

# Net Change in Cash and Cash Balances

= Net increase (decrease) in cash during the year

+ Cash at December 31, 2013

= Cash at December 31, 2014

|  |   |   |   |  |   |                      |
|--|---|---|---|--|---|----------------------|
| Net cash provided by<br>Operating activities | - | Net cash used for<br>Investing activities | + | Net cash provided by<br>Financing activities | = | Net decrease in Cash |
| 70,000                                       | - | 260,000                                   | + | 170,000                                      | = | (20,000)             |

|                                 |                  |
|---------------------------------|------------------|
| Net decrease in cash            | \$ (20,000)      |
| Cash balance, December 31, 2013 | 42,000           |
| Cash balance, December 31, 2014 | <u>\$ 22,000</u> |

## S14-5: COMPUTING CASH FLOWS FROM OPERATING ACTIVITIES—INDIRECT METHOD

One Way Cellular accountants have assembled the following data for the year ended September 30, 2012:

|   |         |  |           |
|---|---------|--|-----------|
| Payment of dividends                      | \$6,100 | Net income                                 | \$ 55,000 |
| Depreciation expense                      | 20,000  | Purchase of equipment                      | 39,000    |
| Cash receipt from sale of land            | 34,000  | Decrease in current liabilities            | 19,000    |
| Cash receipt from issuance of common stk. | 30,000  | Increase in current assets other than cash | 14,000    |

Prepare the operating activities section using the indirect method for One Way Cellular's statement of cash flows for the year ended September 30, 2012.

# S14-5 : COMPUTING CASH FLOWS FROM OPERATING ACTIVITIES—INDIRECT METHOD

## One Way Cellular Statement of Cash—Partial Year Ended September 30, 2012

|  |                 |                 |
|--|-----------------|-----------------|
| Cash flows from operating activities   |                 |                 |
| Net income:  |                 | \$55,000        |
| Adjustments to reconcile net income to<br>net<br>cash provided by operating activities |                 |                 |
| Depreciation   | \$20,000        |                 |
| Increase in current assets other than<br>cash  | (14,000)        |                 |
| Decrease in current liabilities  | <u>(19,000)</u> | <u>(13,000)</u> |
| Net cash provided by operating activities  |                 | <u>\$42,000</u> |

## **S14-6 : COMPUTING CASH FLOWS—INDIRECT METHOD**

Use the data in Short Exercise 14-5 to complete this exercise.

Prepare One Way Cellular's statement of cash flows using the indirect method for the year ended September 30, 2012. Stop after determining the net increase (or decrease) in cash.

## S14-6: COMPUTING CASH FLOWS—INDIRECT METHOD

### One Way Cellular

### Statement of Cash Flows—Partial

Year Ended September 30, 2012

#### Cash flows from operating activities

|             |  |          |
|-------------|--|----------|
| Net income: |  | \$55,000 |
|-------------|--|----------|

Adjustments to reconcile net income to  
net

cash provided by operating activities

|              |          |  |
|--------------|----------|--|
| Depreciation | \$20,000 |  |
|--------------|----------|--|

|   |          |  |
|---|----------|--|
| Increase in current assets other than<br>cash | (14,000) |  |
|---|----------|--|

|                                 |                 |                 |
|---------------------------------|-----------------|-----------------|
| Decrease in current liabilities | <u>(19,000)</u> | <u>(13,000)</u> |
|---------------------------------|-----------------|-----------------|

|   |  |                 |
|---|--|-----------------|
| Net cash provided by operating activities |  | <u>\$42,000</u> |
|---|--|-----------------|

## S14-6 : COMPUTING CASH FLOWS—INDIRECT METHOD

**One Way Cellular**  
**Statement of Cash Flows—Partial**  
**Year Ended September 30, 2012**

|  |                |                  |
|--|----------------|------------------|
| Net cash provided by operating activities  |                | <u>\$ 42,000</u> |
| Cash flows from investing activities:      |                |                  |
| Acquisition of equipment                   | \$ (39,000)    |                  |
| Cash receipt from sale of land             | <u>34,000</u>  |                  |
| Net cash used for investing activities     |                | <u>(5,000)</u>   |
| Cash flows from financing activities:      |                |                  |
| Cash receipt from issuance of common stock | \$ 30,000      |                  |
| Payments of cash dividends                 | <u>(6,100)</u> |                  |
| Net cash provided by financing activities  |                | <u>23,900</u>    |
| Net increase in cash                       |                | <u>\$ 60,900</u> |





# 4

Identify noncash investing and financing activities

# Noncash Investing and Financing

- Investing and financing activities that do not affect cash
- Some examples are:
  - ▶ Acquired building by issuing stock
  - ▶ Acquired land by issuing note payable
  - ▶ Paid note payable by issuing common stock
- Reported in separate schedule or in a note
- Key—Cash not listed in entry to record transaction

| Noncash investing and financing activities:      |  |                  |
|--|--|------------------|
| Acquisition of building by issuing common stock  |  | \$300,000        |
| Acquisition of land by issuing note payable      |  | 70,000           |
| Payment of note payable by issuing common stock  |  | 100,000          |
| Total noncash investing and financing activities |  | <u>\$470,000</u> |

## S14-9 : COMPUTING THE CHANGE IN CASH; IDENTIFYING NONCASH TRANSACTIONS

Judy's Makeup Shops earned net income of \$22,000, which included depreciation of \$14,000. Judy's acquired a \$119,000 building by borrowing \$119,000 on a long-term note payable.

1. How much did Judy's cash balance increase or decrease during the year?

|   |          |
|---|----------|
| Net income                                | \$22,000 |
| Depreciation                              | 14,000   |
| Purchase of building with long-term notes | <u>0</u> |
| Increase in cash                          | \$36,000 |

## **S14-9 : COMPUTING THE CHANGE IN CASH; IDENTIFYING NONCASH TRANSACTIONS**

2. Were there any noncash transactions for the company? If so, show how they would be reported in the statement of cash flows.

Yes, acquisition of building with long-term note payable reported in non-cash investing and financing activities.



## Analyze cash flows

# Measuring Cash Adequacy: Free Cash Flow

- Cash available from operations after:
  - ▶ Paying for planned investments in long-term assets
  - ▶ Paying dividends to shareholders

$$\text{Free cash flow} = \text{Net cash provided by operating activities} - \text{Cash payments planned for investments in long-term assets} - \text{Cash dividends}$$

- Used to manage operations
- If investment opportunity is available, cash is free to invest

## S14-10: COMPUTING FREE CASH FLOW

Cooper Lopez Company expects the following for 2012:

- Net cash provided by operating activities of \$158,000.
- Net cash provided by financing activities of \$60,000.
- Net cash used for investing activities of \$80,000 (no sales of long-term assets).
- Cash dividends paid to shareholders was \$10,000.

1. How much free cash flow does Lopez expect for 2012?

$$\text{NCOA} - \text{Payments for planned invest.} - \text{Payments of cash dividends} = \text{Free cash flow}$$

$$\$158,000 - 80,000 - 10,000 = \$68,000$$



# 6

Prepare the statement of cash flows by the direct method (Appendix 14A)



# The Direct Method

- Preferred by FASB
- Provides clearer information about cash receipts and payments
- Normally not used by private companies
  - ▶ Takes more computations
- Only operating activities presentation changes
  - ▶ Net cash flow from operating activities has the same amount of cash
  - ▶ Investing and Financing sections not changed

# Direct Method Format

- Net cash provided is the same as indirect method

|   |             |            |
|---|-------------|------------|
| Cash flows from operating activities:     |             |            |
| Receipts:                                 |             |            |
| Collections from customers                | \$ 269,000  |            |
| Interest received                         | 12,000      |            |
| Dividends received                        | 9,000       |            |
| Total cash receipts                       |             | \$ 290,000 |
| Payments:                                 |             |            |
| To suppliers                              | \$(135,000) |            |
| To employees                              | (56,000)    |            |
| For interest                              | (15,000)    |            |
| For income tax                            | (14,000)    |            |
| Total cash payments                       |             | (220,000)  |
| Net cash provided by operating activities |             | 70,000     |

# Direct Method Cash Flow Steps

- STEP 1: Lay out the operating section by the direct method
- STEP 2: Use the comparative balance sheet to determine the increase or decrease in cash
- STEP 3: Use the available data to prepare the statement of cash flows
- Reports only transactions with cash effects
- Essentially a cash-basis income statement

# Converting Income Statement Amounts

- First item on income statement

- ▶ Sales

- ▶ Total of all sales, whether for cash or on account

- ▶ Yields cash collected from customers

- Formula

Sales revenue

– Increase in Accounts receivable

Cash collections from customers

or

Sales revenue

+ Decrease in Accounts receivable

Cash collections from customers

# Cash Collections from Interest

- Second item on income statement
  - ▶ Interest revenue
  - ▶ Related account is Interest receivable
  - ▶ Receivable account indicates some not received
- Formula

Interest revenue

– Increase in Interest receivable

Cash collections from interest

or

Interest revenue

+ Decrease in Interest receivable

Cash collections from interest

# Cash Collections from Dividends

- Third item on income statement
  - ▶ Dividend revenue
  - ▶ Related account is Dividend receivable
  - ▶ Receivable account indicates some not received
- Formula

$$\begin{array}{r} \text{Dividend revenue} \\ - \text{Increase in Dividend receivable} \\ \hline \text{Cash collections from dividends} \end{array}$$

or

$$\begin{array}{r} \text{Dividend revenue} \\ + \text{Decrease in Dividend receivable} \\ \hline \text{Cash collections from dividends} \end{array}$$

# Cash Paid for Inventory

- Payments to suppliers include all payments for inventory and operating expenses
- Formula

$$\begin{aligned} & \text{Cost of goods sold} \\ & - \text{Decrease in Inventory} \\ & - \underline{\text{Increase in Accounts payable}} \\ & = \text{Cash paid for Inventory} \end{aligned}$$

$$\begin{aligned} & \text{Cost of goods sold} \\ & + \text{Increase in Inventory} \\ & + \underline{\text{Decrease in Accounts payable}} \\ & = \text{Cash paid for Inventory} \end{aligned}$$

# Cash Paid for Operating Expenses

- Payments to suppliers include all payments for inventory and operating expenses
- Formula

$$\begin{aligned} & \text{Other operating expenses} \\ + & \text{ Decrease in Accrued liabilities} \\ = & \text{Cash paid for operating expenses} \end{aligned}$$

$$\begin{aligned} & \text{Other operating expenses} \\ - & \text{ Increase in Accrued liabilities } \\ = & \text{Cash paid for operating expenses} \end{aligned}$$



# Payments to Suppliers

- Payments to suppliers include all payments for inventory and operating expenses
- Formula

$$\begin{aligned} & \text{Cash paid for Inventory} \\ + & \text{Cash paid for operating expenses} \\ = & \text{Cash paid to suppliers} \end{aligned}$$

# Payments to Employees

- Payments to employees includes salaries, wages, other employee compensation
- Formula

$$\begin{aligned} & \text{Salary expense or Wages expense} \\ & + \text{ Decrease in Accrued salaries } \\ & = \text{Cash paid to employees} \end{aligned}$$

$$\begin{aligned} & \text{Salary expense or Wages expense} \\ & - \text{ Increase in Accrued salaries } \\ & = \text{Cash paid to employees} \end{aligned}$$

# Payments for Interest Expense

- Payments for interest include all payments of interest on notes and bonds
- Formula

$$\begin{aligned} & \text{Interest expense} \\ & + \text{ Decrease in Accrued interest } \\ & = \text{Cash paid for interest} \end{aligned}$$

$$\begin{aligned} & \text{Interest expense} \\ & - \text{ Increase in Accrued interest } \\ & = \text{Cash paid for interest} \end{aligned}$$

# Payments for Income Taxes

- Payments for income taxes for all payments of taxes on income
- Formula

$$\begin{aligned} & \text{Income tax expense} \\ + & \text{ Decrease in Income tax payable} \\ = & \text{Cash paid for income tax} \end{aligned}$$

$$\begin{aligned} & \text{Income tax expense} \\ - & \text{ Increase in Income tax payable} \\ = & \text{Cash paid for income tax} \end{aligned}$$

# Net Cash Provided by Operating Activities

- Add them all together

|   |             |            |
|---|-------------|------------|
| Cash flows from operating activities:     |             |            |
| Receipts:                                 |             |            |
| Collections from customers                | \$ 269,000  |            |
| Interest received                         | 12,000      |            |
| Dividends received                        | 9,000       |            |
| Total cash receipts                       |             | \$ 290,000 |
| Payments:                                 |             |            |
| To suppliers                              | \$(135,000) |            |
| To employees                              | (56,000)    |            |
| For interest                              | (15,000)    |            |
| For income tax                            | (14,000)    |            |
| Total cash payments                       |             | (220,000)  |
| Net cash provided by operating activities |             | 70,000     |



# 7

Prepare the indirect statement of cash flows  
using a spreadsheet (Appendix 14B)

# Indirect Statement Using a Spreadsheet

- Companies face complex accounting situations
- Spreadsheet can help
  - ▶ Four column spreadsheet
- Includes beginning and ending account balances
- The center left and right columns are for transactional analysis

|                       | Balance          | Transaction   |               | Balance          |
|-----------------------|------------------|---------------|---------------|------------------|
| Panel A—Balance Sheet | 12/31/2013       | Analysis      |               | 12/31/2014       |
| Cash                  | \$ 42,000        |               | \$ 20,000 (n) | \$ 22,000        |
| Accounts receivable   | 73,000           | (d) \$ 17,000 |               | 90,000           |
| Inventory             | 145,000          |               | 2,000 (e)     | 143,000          |
| Plant assets, net     | 210,000          | (h) 310,000   | 20,000 (b)    |                  |
|                       |                  |               | 40,000 (c)    | 460,000          |
| Total assets          | <u>\$470,000</u> |               |               | <u>\$715,000</u> |

# Transactional Analysis

- a. Net income of \$40,000 is the first operating cash inflow
- b. Next come the adjustments to net income
- c. Removes the gain on the sale of assets
- d. Entries D–G balance changes in current assets and liabilities
- h. Long-term asset changes
- i. Change in Common stock
- j. Entries J–K balance changes in Long-term liabilities
- l. L–M balance changes in Retained earnings and Treasury stock
- n. Final item is the Net decrease in cash



# Transactional Analysis

- Each letter matches an item in the statement of cash flows

|  |                                      |               |               |           |
|--|--------------------------------------|---------------|---------------|-----------|
| Cash                                       | Change in cash from beginning to end |               | \$ 20,000 (n) | \$ 22,000 |
| Accounts receivable                        | 73,000                               | (d) \$ 17,000 |               | 90,000    |
| Inventory                                  | 145,000                              |               | 2,000 (e)     | 143,000   |
| Plant assets, net                          | 210,000                              | (h) 310,000   | 20,000 (b)    |           |
|  |                                      |               | 40,000 (c)    | 460,000   |
| Total assets                               |                                      |               |               | \$715,000 |
| Accounts payable                           |                                      |               | 40,000 (f)    | \$ 90,000 |
| Accrued liabilities                        | 10,000                               | (g) 5,000     |               | 5,000     |
| Long-term notes payable                    | 80,000                               | (k) 10,000    | 90,000 (j)    | 160,000   |
| Common stock                               | 250,000                              |               | 120,000 (i)   | 370,000   |
| Retained earnings                          | Net Income Starting point            |               | 40,000 (a)    | 110,000   |
| Treasury stock                             | 0                                    | (l) 20,000    |               | (20,000)  |
| Total liabilities and stockholders' equity | \$470,000                            | \$372,000     | \$372,000     | \$715,000 |

|   |     |           |               |
|---|-----|-----------|---------------|
| Net income  | (a) | \$ 40,000 |               |
| Adjustments to reconcile net income to net cash provided by operating activities: |     |           |               |
| Depreciation  | (b) | 20,000    |               |
| Gain on sale of plant assets  |     |           | \$ 10,000 (c) |
| Increase in accounts receivable   |     |           | 17,000 (d)    |
| Decrease in inventory   | (e) | 2,000     |               |
| Increase in accounts payable  | (f) | 40,000    |               |
| Decrease in accrued liabilities   |     |           | 5,000 (g)     |
| Net cash provided by operating activities   |     |           |               |
| Cash flows from investing activities:   |     |           |               |
| Acquisition of plant assets   |     |           | 310,000 (h)   |
| Cash receipt from sale of plant asset   | (c) | 50,000    |               |
| Net cash used for investing activities  |     |           |               |
| Cash flows from financing activities:   |     |           |               |
| Cash receipt from issuance of common stock  | (i) | 120,000   |               |
| Cash receipt from issuance of notes payable                                       | (j) | 90,000    |               |
| Payment of notes payable  |     |           | 10,000 (k)    |
| Purchase of treasury stock  |     |           | 20,000 (l)    |
| Payment of dividends  |     |           | 10,000 (m)    |
| Net cash provided by financing activities   |     |           |               |
|   |     | \$362,000 | \$382,000     |
| Net decrease  |     | 20,000    |               |

Each letter matches an item in the statement of cash flows

Change in cash from beginning to end

# Chapter 14 Summary

- The statement of cash flows explains why the cash balance does not equal net income (loss) from the income statement.
- Cash on the statement of cash flows includes cash equivalents.
- Cash equivalents are assets so close to being cash that they are treated like cash. The statement helps users predict future cash flows, evaluate management decisions, and predict the company's ability to pay debts and dividends.

# Chapter 14 Summary

- Operating activities reflect the day-to-day business operations. Operating activities affect current assets and current liabilities.
- Investing activities report purchase and sales of long-term assets, such as buildings and long-term (nontrade) loans receivable.
- Financing activities reflect the capitalization of the business and include increases and decreases in long-term liability and equity accounts, paying dividends, and treasury stock transactions.

# Chapter 14 Summary

- Only the operating activities section is presented differently between the indirect and direct methods.
- The indirect cash flow statement begins with operating activities. Net income (or net loss) from the income statement is the first item listed.
- Then, adjustments are made based on changes in current asset and current liability accounts to derive cash provided by (used for) operating activities.

# Chapter 14 Summary

- Then, investing activities are reported, showing cash used to purchase or cash received from selling long-term assets.
- Finally, financing activities are reported, showing cash used to pay long-term liabilities, to pay cash dividends, or to purchase treasury shares AND cash received from issuing new long-term liabilities or issuing stock.
- The total of the cash flows from the three activities (operating, investing, and financing) equals the change in the cash balance.

# Chapter 14 Summary

- Companies make investments that do not require cash. They also obtain financing other than cash. Such transactions are called noncash investing and financing activities and appear in a separate part of the cash flow statement.
- Free cash flow measures the amount of cash available from normal operations after paying for planned investments in long-term assets and after paying cash dividends to shareholders.

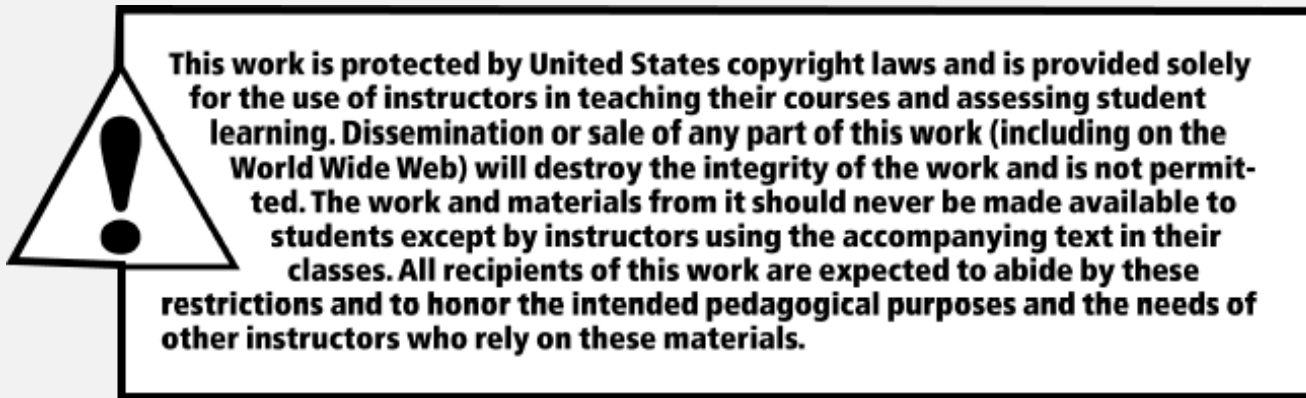
# Chapter 14 Summary

- Appendix 14A - The Financial Accounting Standards Board (FASB) prefers the direct method of reporting cash flows from operating activities. The direct method provides clearer information about the sources and uses of cash than does the indirect method.
- Appendix 14B - The T-account approach works well as a learning device. In practice, however, most companies face complex situations. In these cases, a spreadsheet can help in preparing the statement of cash flows.





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