

Unit 27

Cash Flow Statement

ILO1. Statement of Cash Flows – General Questions

ILO2. Statement of Cash Flows - Four Key Concepts

ILO1. Statement of Cash Flows

The statement of cash is a financial documents that highlights the movement of cash, both inwards and outwards. More than this, its aim to focus on the specifics of where cash is being disbursed, and from where its is being acquired. To help our clarification, it makes sense to consider the statement of cash flows by answering the following questions:

- Is enough cash being generated from operations for the company to remain competitive?
- Can the company adequately pay its debts?
- If listed, can the company distribute its usual dividends?
- Why is there a difference between net income, and net cash flow?
- How much capital will be needed, or borrowed for the company to follow its investment strategy?

The statement of cash flows analyzes the changes in noncash balance sheets accounts, by equating it with the cash inflows and outflows. It incorporates the basic equations for assets, liabilities, and equity accounts.

ILO2. Statement of Cash Flows - Four Key Concepts

The first key concept involves the structure of the document; it is split into three sections that report cash flows, namely those from operating, investing, and financing activities. In this light, operating activities identifies cash flows related to revenue and expenses and how they affect net income. Secondly, investing activities looks at how cash is acquired or disposed of, particularly long term assets such as equipment, buildings, land, and other noncurrent assets such as long term loans etc. And thirdly, financing ventures isolated cash flows from borrowings, repayments, and completing transactions with the company owners. The table below shows this portrayal.

	Cash Inflow	Cash Outflow
Operating activities		
Collecting cash from customers	✓	
Paying suppliers for inventory purchases		✓
Paying bills to insurers, utility providers, etc		✓
Paying wages and salaries to employees		✓
Paying taxes to governmental bodies		✓
Paying interest to lenders		✓
Investing activities		
Buying property, plant, and equipment		✓
Selling property, plant, and equipment	✓	
Buying stocks and bonds as a long-term investment		✓
Selling stocks and bonds held for long-term investment	✓	
Lending money to another entity		✓
Collecting the principal on a loan to another entity	✓	
Financing activities		
Borrowing money from a creditor	✓	
Repaying the principal amount of a debt		✓
Collecting cash from the sale of common stock	✓	
Paying cash to repurchase your own common stock		✓
Paying a dividend to stockholders		✓

Fig 27.1 Cash Flow Statement

The second concept involving the statement of cash flows relates to the flows generated from operating activities. This information can be found through either the direct, or indirect methods illustrated below.

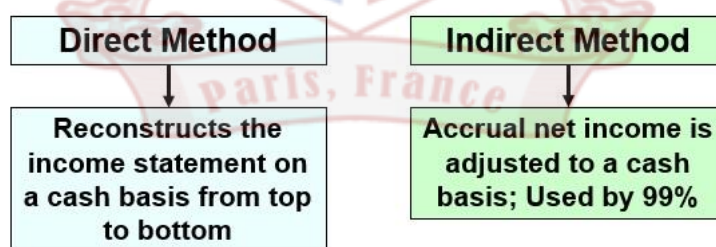


Fig 27.2 Direct vs Indirect Method

Under the direct method; as stated, the income statement is constructed from top to bottom, in other words, rather than identifying revenue, it lists cash collected from customers. Rather than stating cost of goods solds, the annotation lists cash paid to suppliers. Whereas under the indirect method the net income is amended to reflect a cash based system, in that rather than directly calculating cash sales, or cash expenses, these amounts are found indirectly by subtracting them net income along with any other transactions that do not affect cash flows.

The third key concept involves the indirect method, and how it adjusts the net incomes by providing for operating activities using the flowing three step process below.

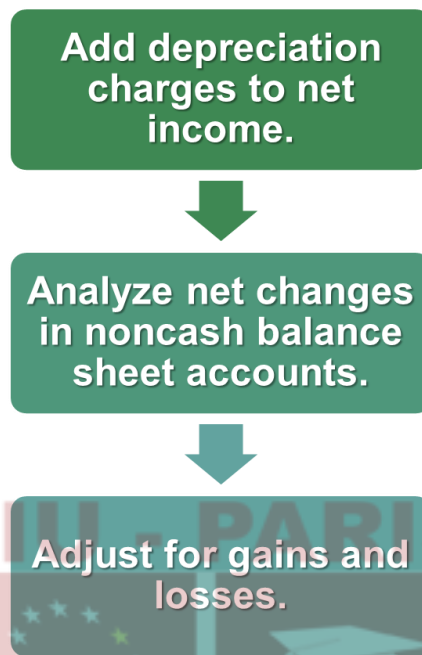


Fig 27.3 Three Step Process

In this process, the first step is to add the depreciation to the net income. However, to ensure accuracy we must recall beginning and ending balances in the Accumulated Depreciation accounts. We will use the following example.

A beginning and ending balance are found to be \$300, and \$500. We assume there is an accumulated depreciation amount for the period of \$70. We can perform the following;

$$\begin{aligned}
 \text{Beginning Balance} - \text{Debits} + \text{Credit} &= \text{Ending Balance} \\
 \$300 - \$70 + \text{Credits} &= \$500 \\
 \text{Credits} &= \$500 - \$300 + \$70 \\
 \text{Credits} &= \$270
 \end{aligned}$$

Secondly, we find the net changes in balance sheet accounts that influence net income. This process starts by identifying the change in balance for each current asset and current liability. If the balance of a current asset increases (decreases), then the amount of the increase (decrease) is subtracted from (or added to) the net income. Conversely, if the balance of a current liability increases (decreases), then the amount of the increase (decrease) is added to (or subtracted from) the net income as shown below.

	Increase in Account Balance	Decrease in Account Balance
Current Assets		
Accounts receivable	Subtract	Add
Inventory	Subtract	Add
Prepaid expenses	Subtract	Add
Current Liabilities		
Accounts payable	Add	Subtract
Accrued liabilities	Add	Subtract
Income taxes payable	Add	Subtract

Fig 27.4 Step Two

The third step is to adjust for any losses or gains on the income statement. Under United States GAAP and IFRS guidelines, any losses or gains are to be recognized in the statement of cash flows under the investing activities section.

	Increase in Account Balance	Decrease in Account Balance
Noncurrent Assets (Investing activities)		
Property, plant, and equipment	Subtract	Add
Long-term investments	Subtract	Add
Loans to other entities	Subtract	Add
Liabilities and Stockholders' Equity (Financing activities)		
Bonds payable	Add	Subtract
Common stock	Add	Subtract
Retained earnings	*	*
*Requires further analysis to quantify cash dividends paid.		

Fig 27.5 Step Three

The fourth concepts again involves the United States GAAP and IFRS guidelines which states that investing and financing sections of the statement of cash flows must reveal gross cash flows. This happens when the noncurrent asset balance increases (decreases), it signals the need to record a cash outflow (cash inflow) in the investing activities section. However, if the Bonds Payable and Common Stock accounts increase (decreases), it signals the need to record a cash inflow (cash outflow) in the financing activities section as seen in the table.

Account Activity for Property, Plant, and Equipment			
Beginning balance	\$1,000	Original cost of equipment sold	\$100
Ending balance	\$1,800	Accumulated depreciation of equipment sold	\$70
Cash proceeds from sale of equipment	\$40	Gain on the sale of equipment (included in net income)	\$10

Fig 27.6 Account for PPE

Using the tabular information, the company would record a cash inflow of \$40 due to the sale of equipment. Using our previous equation regarding beginning and ending balances, we can find the company also needs to record an outflow of \$900. This is calculated from the following;

$$\begin{aligned}
 \text{Beginning Balance} + \text{Debit} - \text{Credits} &= \text{Ending Balance} \\
 \$1,000 + \text{Debits} - \$100 &= \$1,800 \\
 \text{Debits} &= \$1,800 - \$1,000 + \$100 \\
 \text{Debits} &= \$900 \text{ (cash outflow)}
 \end{aligned}$$

We should also consider the example using the retained earnings account. To do so, we'll incorporate the following data.

Account Activity for Retained Earnings	
Beginning balance	\$2,000
Ending balance	\$3,000
Net income	\$1,200

Fig 27.7 Account for Retained Earnings

For stockholder equity, we revisit the aforementioned equations. We do this as the equity account can be used to determine that the company needs to record dividends (cash outflow) of \$200 in the financing activities. This is performed through the following calculation.

Beginning Balance – Debits + Credits = Ending Balance

$$\$2,000 - \text{Debits} + \$1,200 = \$3,000$$

$$\$3,200 = \$3,000 + \text{Debits}$$

$$\text{Debits} = \$200 \text{ (outflow)}$$



References:

1. Managerial accounting, Ray Garrison-Eric Noreen-Peter Brewer - McGraw-Hill Education, 16 ed., 2018
2. Managerial accounting, John Wild-Ken Shaw - McGraw-Hill Education, 7ed, 2019
3. Management accounting, Will Seal-Carsten Rohde-Ray Garrison-Eric Noreen - McGraw-Hill Education, 6ed. - 2019

