LIBBY CHAPTER 12 ADOBE CONNECT LIVE

A Statement of Cash Flows (SCF) is a crucial financial statement that provides important information about a company, and it is the only financial statement prepared on a *cash basis*.

The Balance Sheet, Income Statement, and Statement of Stockholder's Equity are all *accrual basis documents.*

The Operating Activities section of a SCF prepared on the indirect method is not intuitive.

Students must learn the format and understand how accrual accounting works in order to understand, and prepare, the Operating Activities section.

Cash or Cash and Cash Equivalents

A statement of cash flows can be prepared either on a (1) cash or (2) cash and cash equivalents basis. ***We will use the cash basis when preparing a SCF***

> A **cash equivalent** is a short-term, highly-liquid investment with an original maturity of less than three months.

Format

A statement of cash flows has the following general format:

Company Name
Statement of Cash Flows
For the Period Ended December 31, 20XX

Cash Flows From Operating Activities

Cash Flows From Investing Activities

Cash Flows From Financing Activities

Increase (Decrease) in Cash

Cash at Beginning of Period

Cash at End of Period

Schedule of Significant NonCash Financing and Investing Activities

Schedule of Significant Noncash Investing and Financing Activities

Some important transactions may be significant investing and financing transactions but may not involve cash.

For example, a company might purchase property, plant, and equipment (investing activity) in exchange for a note payable (financing activity).

> **If a company has these types of noncash transactions, then they are reported on as supplement to the statement of cash flows as an attached schedule.**

How Balance Sheet Classifications Map Into Statement of Cash Flows Classifications

Account	SCF Activity (1)
Cash	
Assets	
Current assets	
Receivables, inventory, prepaid expenses, trading securities,	Operating
Available-for-sale securities	Investing
Long-term assets	Investing
Liabilities	
Current liabilities	
Accounts payable, accrued liabilities, trade notes payable	Operating
Current maturities long-term debt, non-trade notes payable	Financing
Long-term liabilities	Financing
Stockholders' equity	
Contributed capital	
Common stock, preferred stock, paid-in-capital	Financing
Retained earnings	
Net income	Operating (2)
Dividends	Financing

(1) **The general rule is listed.** Each account must be examined individually to identify any operating, financing, and investing activities.

(2) Classified as operating because the SCF Operating Activities section prepared under the indirect method starts with Net Income.

Indirect Method in the Operating Activities Section

Almost all U.S. companies present the operating activities section using the ***indirect method***. **We will use it exclusively.**

Operating activities section starts with net income, which is accrual-based..

- **Adjustments are made to reconcile from net income to cash flow from operations.**
- Those adjustments include
    1. noncash expenses (income)
    2. loss (gains)
    3. changes in operational current asset and current liability accounts.

Investing and Financing Activities Sections

In these sections, the SCF lists inflows of cash (e.g., sales of assets, issuance of debt) and outflows of cash (e.g., purchase of investments, dividends paid).

Note: in the investing and financing activities section, cash inflows may be aggregated and cash outflows may be aggregated, <u>but cash inflows and cash outflows may not be netted together.</u>

JAMES SMITH & COMPANY
Statement of Cash Flows
For the Year Ended December 31, 2015

Cash Flows From Operating Activities		
Net Income		$ 76,000
Adjustments to reconcile from net income to cash flow from operations: Add (Subtract)		
Depreciation Expense	$22,000	
Gain on Sale of Plant & Equipment	(30,000)	
Gain on Retirement of Debt	(17,000)	
Increase in Net Accounts Receivable	(13,000)	
Decrease in Inventory	32,000	
Increase in Accounts Payable	28,000	
Increase in Commissions Payable	8,000	
Decrease in Interest Payable	(10,000)	20,000
Net Cash Flow From Operating Activities		96,000
Cash Flows From Investing Activities		
Sale of Plant & Equipment	80,000	
Purchase of Land	(25,000)	
Net Cash Flow From Investing Activities		55,000
Cash Flows From Financing Activities		
Sale of Stock	11,000	
Payment of Dividends	(37,000)	
Retirement of Bonds	(100,000)	
Net Cash Flow From Financing Activities		(126,000)
Net Increase (Decrease) in Cash		25,000
Beginning Cash Balance		50,000
Ending Cash Balance		$ 75,000

Schedule of Significant Non-Cash Activities

Issue Bonds in Exchange for Land	$ 25,000

Statement of Cash Flows Template (Indirect Method)
MEMORIZE THIS TEMPLATE

Most Statements of Cash Flows contain similar information. The following identifies most of the information usually contained in a statement of cash flows.

Company Name
Statement of Cash Flows
For the Year Ended December 31, 2015

Cash Flow From Operating Activities
Net Income
Add (Deduct) amounts to reconcile from net income to cash flow from operations

1a. Non-cash expenses: *depreciation, depletion, amortization, impairments*, sometime referred to in shorthand as DDA&I
1b. (Non-cash revenues) e.g., *investment income* for securities accounted for under the equity method
2a. Losses on sale of assets
2b. (Gains) on sale of assets
3a. Changes in operational current assets. deferred income tax assets, operational current liabilities, deferred income taxes payable**

Net Cash Flow from Operating Activities

**** Follow the heuristic.**

Here is a mental rule that you can help to remember how the adjustments to operational current assets and operational current liabilities are made. Memorize this heuristic.

- If the increase or decrease in the operational current asset or current liability account was a **debit** during the year (e.g., increase in current asset or decrease in current liability), then think of the needed offset as a **credit** to (a reduction in) cash. This is the case in the example above.
- If the increase or decrease in the operational current asset or current liability account was a **credit** during the year (e.g., decrease in current asset or increase in current liability), then think of the needed offset as a **debit** to (an addition to) cash.

Continued

Cash Flow From Investing Activities*

Add cash received from sales of assets
(Deduct cash paid to purchase investments, fixed assets, and intangible assets)
Net Cash Flow from Investing Activities

Cash Flow From Financing Activities*

Add cash received from issuing debt or stock
(Deduct cash used to repurchase debt or retire stock)
(Deduct cash dividends paid)
Net Cash Flow from Financing Activities

Net increase (decrease) in Cash
Beginning Cash Balance
Ending Cash Balance

Significant Noncash Financing and Investing Activities (This schedule must accompany the statement of cash flows)

*Note: in the investing and financing activities section, cash inflows may be aggregated and cash outflows may be aggregated, **but cash inflows and cash outflows may not be netted together.**

Disclosures for Interest Paid and Income Taxes Paid

GAAP requires that when using the indirect method, the company must report the amounts of cash paid for income taxes and for interest.

These amounts may be reported at the bottom of the statement of cash flows, but *usually presented in the notes to the financial statements.* Therefore, these amounts are not required to be on the SCF.

Interest Paid, Interest Received, and Income Taxes Paid

In the statement of cash flows, interest paid, interest received, and income taxes paid are treated as operational activities.

On the income statement, interest expense and interest income are included in other expense and other income, respectively, and both are shown below the caption of operating income.

Also, income tax expense is not used to compute operating income.

So, in summary, some items are treated as affecting cash flow from operational activities that are not treated as affecting operating income on the income statement.

- Interest paid
- Interest received
- Income taxes paid

RECAP: ADJUSTMENTS IN OPERATING ACTIVITIES SECTION, INDIRECT METHOD

The types of **operating activity section reconciling items** can be grouped into three types:

Non-Cash Expenses and Revenues

These items affected net income, but did not affect cash.

- **Add non-cash expenses** (e.g., depreciation expense, amortization expense, impairment charges) (because they decreased net income but not cash)
- **Deduct non-cash revenues** (income from equity method investments)

Gains and Losses

- Almost always, gains and losses are associated with non-operating activities (e.g., gains/losses on sales of fixed assets).
  - **Deduct Gains** (because they increased net income)
  - **Add Losses** (because they decreased net income)

Changes in the Balances of Operating Current Asset and Current Liabilities**

- If the increase or decrease in the operational current asset or current liability account was a **debit** during the year (i.e., *increase in current asset or decrease in current liability)*, then think of the needed offset as a **credit** to (reduction in) cash.
- If the increase or decrease in the operational current asset or current liability account was a **credit** during the year (i.e., *decrease in current asset or increase in current liability*), then think of the needed offset as a **debit** to (addition to) cash.

Ratios

The text introduces two important cash flow ratios: quality of income ratio and capital acquisitions ratio.

Quality of Income Ratio

$$\text{Quality of Income ratio} = \frac{\text{Cash flow from operating activities}}{\text{Net Income}}$$

This ratio represents the *extent to which net income is associated with cash flows from operations*: i.e., the portion of net income that was equal to cash flow from operations.

It shows the ***amount cash flow from operations per dollar of net income*.**

Capital Acquisitions Ratio

$$\text{Capital Acquisitions Ratio} = \frac{\text{Cash flow from operating activities}}{\text{Cash paid for property, plant, and equipment}}$$

The capital acquisitions ratio reflects the *amounts of cash paid to expand productive capacity that could have been paid out of operating cash flows*.

If the ratio is greater than 1.0, then the company is generating enough operating cash flow to cover its investments in new property, plant, and equipment.

Note: the denominator in the ratio can be expanded to include amounts paid for natural resources and intangible assets.

SCF Example Problem.

Use the following information to prepare a statement of cash flows for Stable Equipment Company for the year ended December 31, 2014:

Net income for the year 2014	$5,000.
Accounts receivable decreased	$2,000,
Inventories increased	$4,000,
Accounts payable decreased	$7,000.
Depreciation expense	$8,000.

During the year, a piece of land held for future expansion was sold for its book value of $8,000 and a new service truck was purchased for $14,000.

The company borrowed $18,000 on a two-year note from the bank. Dividends of $6,000 were paid in cash. Preferred stock was issued to retire $7,000 of long-term notes payable.

The beginning cash balance was $10,000, and the ending balance was $20,000.

Prepare (In Good Form) a Statement of Cash Flows using the Indirect Method.

Stable Equipment Company
Statement of Cash Flows
For the Year Ended December 31, 2014

Operating Activities		
Net income		
Add (deduct) Items Not Affecting Cash		
Net cash flows, operating activities		
Investing Activities		
Net cash flows, investing activities		
Financing Activities		
Net cash flows, financing activities		
Net increase (decrease) in cash		
Beginning Balance		
Ending Balance		
Schedule of Significant Non-Cash Financing and Investing Activities		
		$

Analysis:

Information for Operating Activities Section

- Net income for the year 2014 $5,000
- Accounts receivable decreased $2,000 *(add back as reconciling item)*
- Inventories increased $4,000 *(subtract as reconciling item)*
- Accounts payable decreased $7,000 *(subtract as reconciling item)*
- Depreciation expense $8,000 *(add back as reconciling item)*

Information for Investing Activities Section

- During the year, a piece of land held for future expansion was sold for its book value of $8,000 (*cash inflow, no gain/loss)*
- New service truck was purchased for $14,000 (*cash outflow*).

Information for Financing Activities Section

- The company borrowed $18,000 on a two-year note from the bank (*cash inflow*)
- Dividends of $6,000 were paid in cash (*cash outflow*)

Significant Non-Cash Investing and Financing Activities

Preferred stock was issued to retire $7,000 of long-term notes payable.

Stable Equipment Company
Statement of Cash Flows
For the Year Ended December 31, 2014

Operating Activities		
Net income		$ 5,000
Add (deduct) Items Not Affecting Cash		
Depreciation expense	$ 8,000	
Decrease, account receivable	2,000	
Increase, inventory	(4,000)	
Decrease, accounts payable	(7,000)	(1,000)
Net cash flows, operating activities		4,000
Investing Activities		
Proceeds from sale of land	8,000	
Purchase new equipment	(14,000)	
Net cash flows, investing activities		(6,000)
Financing Activities		
Issue notes payable	18,000	
Paid cash dividends	(6,000)	
Net cash flows, financing activities		12,000
Net increase (decrease) in cash		10,000
Beginning Balance		10,000
Ending Balance		$ 20,000

Schedule of Significant Non-Cash Financing and Investing Activities

Issue preferred stock to retire long-term notes payable	$7,000