ACCT 101 – Statement of Cash Flows
Lecture Notes – Chapter 12 – Prof. Johnson

The statement of cash flows is a required component of financial statements.

BASICS OF CASH FLOW REPORTING

Purpose of the Statement of Cash Flows
The statement of cash flows is one of the five financial statements required by GAAP. The other four required financial statements are:
1. Income Statement
2. Retained Earnings Statement or Statement of Stockholders' Equity
3. Balance Sheet
4. Statement of Comprehensive Income

The statement of cash flows answers one question the other four financial statements do not: how did the company generate, and spend, its cash?

Measurement of Cash Flows
Cash flows are defined to include both cash (monies in checking accounts and bank savings accounts) and *cash equivalents*. Cash equivalents include:

- Money market funds
- Highly-liquid investments with original maturities of less than 3 months, such as bank certificates of deposit and U.S. Treasury bills.

Classification of Cash Flows
The Statement of Cash Flows shows cash inflows and cash outflows, organized into three different business activities. These three business activities are summarized below.

Name of activity	*Accounts analyzed*	*What the activity presents*
Operating activities	Operating assets and liabilities. These include most current asset and liability accounts.	The net cash flows generated, or used, by the business in their core operations. We will use the indirect method of presenting operating activities. This method reconciles net income to net cash flow from operating activities.
Investing activities	Long-term assets	The cash inflows and outflows from sales and purchases of long-term assets, such as

		equipment, patents, and long-term investments.
Financing activities	Long-term liabilities and stockholders' equity.	The cash inflows and outflows from issuance of debt; repayment of debt; issuance of stocks; dividends paid; and stock repurchases.

Noncash Investing and Financing Activities
Businesses sometime engage in transactions not affecting cash. For example, a business can purchase equipment by issuing a long-term note payable to the vendor. In this case, cash is not affected, and this transaction would not be reported in the body of the statement of cash flows. This transaction, referred to as a noncash investing and financing activity, would instead be disclosed either at the bottom of the statement of cash flows or in a note to the financial statements.

CASH FLOWS FROM OPERATING ACTIVITIES

Using the indirect method of reporting operating activities
Nearly all companies report operating activities using the indirect method. This is because the indirect method is easier to compute—although you may disagree after completing the homework!

(In class, we will go over a skeleton format that will be much easier to remember than the more formal one shown below.)

The following template should prove helpful to you in preparing the operating activities of the statement of cash flows using the indirect method.

Net Income	$XXX	
Adjustments to reconcile net income to net cash provided by operating activities		
Decrease in operating assets **	X	
Increase in operating liabilities +	X	
Increase in operating assets **	(X)	
Decrease in operating liabilities +	(X)	
Depreciation Expense	X	
Loss on sale of assets or debt retirement	X	
Gain on sale of assets or debt retirement	<u>(X)</u>	
Net Cash Provided by Operating Activities		$XXXX

**Examples: A/R, Inventory, prepaid assets, and trading securities.

+ Examples: A/P, accrued liabilities, and unearned rent; excludes dividends payable.

If the indirect method is used, income taxes paid and interest paid must be disclosed in a footnote to the financial statements.

For example, assume Michelle Company reported the following for its most recent fiscal year:
Net income, $200,000
Depreciation expense, $50,000
Increase in accounts receivable, $10,000
Decrease in merchandise inventory, $2,000
Increase in prepaid expenses, $1,000
Decrease in accounts payable, $9,000
Increase in wages payable, $3,000
Loss on sale of equipment, $1,000

The operating activities would report the following, using the indirect method:

Cash flows from operating activities		
Net income	$200,000	
Adjustments to reconcile net income to net cash provided by operating activities		
Increase in accounts receivable	(10,000)	
Decrease in merchandise inventory	2,000	
Increase in prepaid expenses	(1,000)	
Decrease in accounts payable	(9,000)	
Increase in wages payable	3,000	
Depreciation expense	50,000	
Loss on sale of equipment	1,000	
Net cash provided by operating activities		$236,000

CASH FLOWS FROM INVESTING ACTIVITIES

Investing activities include cash *inflows* from:
- Sale of long-term assets
- Sale of investments (except trading securities)
- Collections of notes receivable

Investing activities include cash *outflows* from:
- Purchase of long-term assets
- Purchase of investments (except trading securities)
- Loaning cash to others

Obtaining the data for the investing activities section involves three steps:
1. Calculate the increase or decrease in the long-term asset accounts
2. Reconstruct the changes in the accounts
3. Report their effects in the investing activities

As an example, assume the balance of Equipment for Michelle Company was $100,000 at the beginning of the year, and $120,000 at the end of the year. We can say Equipment increased by $20,000 during the year.

However, a detailed reconstruction of Equipment revealed the following:

Equipment, beginning of year	$100,000
Purchases of equipment	30,000
Sales of equipment	(10,000)
Equipment, end of year	$120,000

The equipment sold had an original cost of $10,000 and accumulated depreciation of $4,000, so its book value was $6,000. Assuming the equipment was sold for $5,000, a loss of $1,000 on sale of equipment was incurred.

The investing activities section for Michelle Company would report the following:

Cash flows from investing activities		
Cash received from sale of equipment	$5,000	
Cash paid for purchase of equipment	(30,000)	
Net cash used in investing activities		(25,000)

The loss on sale of equipment of $1,000 would be added to net income in operating activities.

CASH FLOWS FROM FINANCING ACTIVITIES

Financing activities include cash *inflows* from:

- Issuing stock
- Issuing debt

Financing activities include cash *outflows* from:

- Purchasing treasury stock
- Retiring stock by purchase
- Debt payments
- Dividend payments

For example, if a company issued stock for $50,000 but repaid debt of $20,000, the financing activities section would report the following.

Cash flows from financing activities		
Cash received from issuing stock	$50,000	
Cash paid to retire debt	(20,000)	
Net cash provided by financing activities		30,000

PROVING CASH BALANCES

After preparing the operating, investing and financing activities of the statement of cash flows, one final step remains. We must report the beginning and ending balances of cash and cash equivalents, and prove that the net change in cash is explained by summing the operating, investing, and financing activities.

Assume the beginning of year cash balance for Michelle Company was $100,000, and the end of year cash balance was $341,000. The net increase in cash would be $241,000. Michelle Company's statement of cash flow, once completed, would appear as follows.

Cash flows from operating activities		
Net income	$200,000	
Adjustments to reconcile net income to net cash provided by operating activities		
Increase in accounts receivable	(10,000)	
Decrease in merchandise inventory	2,000	
Increase in prepaid expenses	(1,000)	
Decrease in accounts payable	(9,000)	
Increase in wages payable	3,000	
Depreciation expense	50,000	
Loss on sale of equipment	1,000	
Net cash provided by operating activities		$236,000
Cash flows from investing activities		
Cash received from sale of equipment	$5,000	
Cash paid for purchase of equipment	(30,000)	
Net cash used in investing activities		(25,000)
Cash flows from financing activities		
Cash received from issuing stock	$50,000	
Cash paid to retire debt	(20,000)	
Net cash provided by financing activities		30,000
Net increase in cash		241,000
Cash and cash equivalents at prior year-end		100,000
Cash and cash equivalents at current year-end		$341,000

The cash and cash equivalents balance at current year-end must agree with the balance for cash and cash equivalents reported on the balance sheet.