

Financial Accounting



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Sixth Edition



Chapter 12

Reporting and Analyzing Cash Flows

Conceptual Learning Objectives

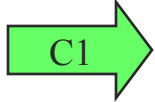
C1: Distinguish between operating, investing, and financing activities, and describe how noncash investing and financing activities are disclosed.

[Analytical Learning Objectives]


A1: Analyze the statement of cash flows and apply the cash flow on assets total ratio.

Procedural Learning Objectives

- P1: Prepare a statement of cash flows.
- P2: Compute cash flows from operating activities using the indirect method.
- P3: Determine cash flows from both investing and financing activities.
- P4: Appendix 12A – Illustrate use of a spreadsheet to prepare a statement of cash flows (see text for details).
- P5: Appendix 12B – Compute cash flows from operating activities using the direct method.



Purpose of the Statement of Cash Flows



**How does a
company obtain its
cash?**

**Where does a
company spend its
cash?**

**What explains the
change in the cash
balance?**



C1

Importance of Cash Flows

How did the business fund its operations?

Does the business have sufficient cash to pay its debts as they mature?

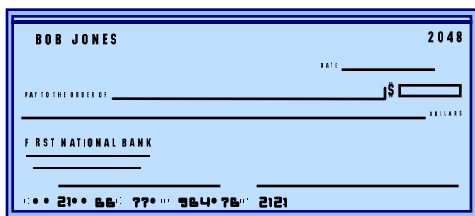
Did the business make any dividend payments?

Did the business borrow any funds or repay any loans?

C1

Measurement of Cash Flows

Cash
Equivalents



Cash

Currency



- Short-term, highly liquid investments.
- Readily convertible into cash.
- Sufficiently close to maturity so that market value is unaffected by interest rate changes.



Classifying Cash Flows

The statement of cash flows includes the following three sections:

- **Operating activities**
- **Investing activities**
- **Financing activities**



Operating Activities

Inflows

- Receipts from customers
- Cash dividends received
- Interest from borrowers
- Other

Outflows

- Salaries and wages
- Payments to suppliers
- Taxes and fines
- Interest paid to lenders
- Other

Investing Activities

Inflows

- Selling long-term productive assets
- Selling equity investments
- Collecting principal on loans
- Other

Outflows

- Purchasing long-term productive assets
- Purchasing equity investments
- Purchasing debt investments
- Other



Financing Activities

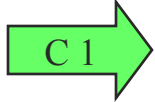
Inflows

- Issuing its own equity securities
- Issuing bonds and notes
- Issuing short- and long-term liabilities


Outflows

- Pay dividends
- Purchasing treasury stock
- Repaying cash loans
- Paying owners' withdrawals





Noncash Investing and Financing



Items requiring separate disclosure include:

- **Retirement of debt by issuing equity securities.**
- **Conversion of preferred stock to common stock.**
- **Leasing of assets in a capital lease transaction.**



Format of the Statement of Cash Flows



Company Name	
Statement of Cash Flows	
For Period Ended Date	
Cash flows from operating activities:	
[List of individual inflows and outflows]	
Net cash provided (used) by operating activities	\$ #####
Cash flows from investing activities:	
[List of individual inflows and outflows]	
Net cash provided (used) by investing activities	#####
Cash flows from financing activities:	
[List of individual inflows and outflows]	
Net cash provided (used) by financing activities	#####
Net increase (decrease) in cash	<hr/> \$ #####
Cash (and equivalents) balance at beginning of period	#####
Cash (and equivalents) balance at end of period	<hr/> \$ ##### <hr/>



Format of the Statement of Cash Flows

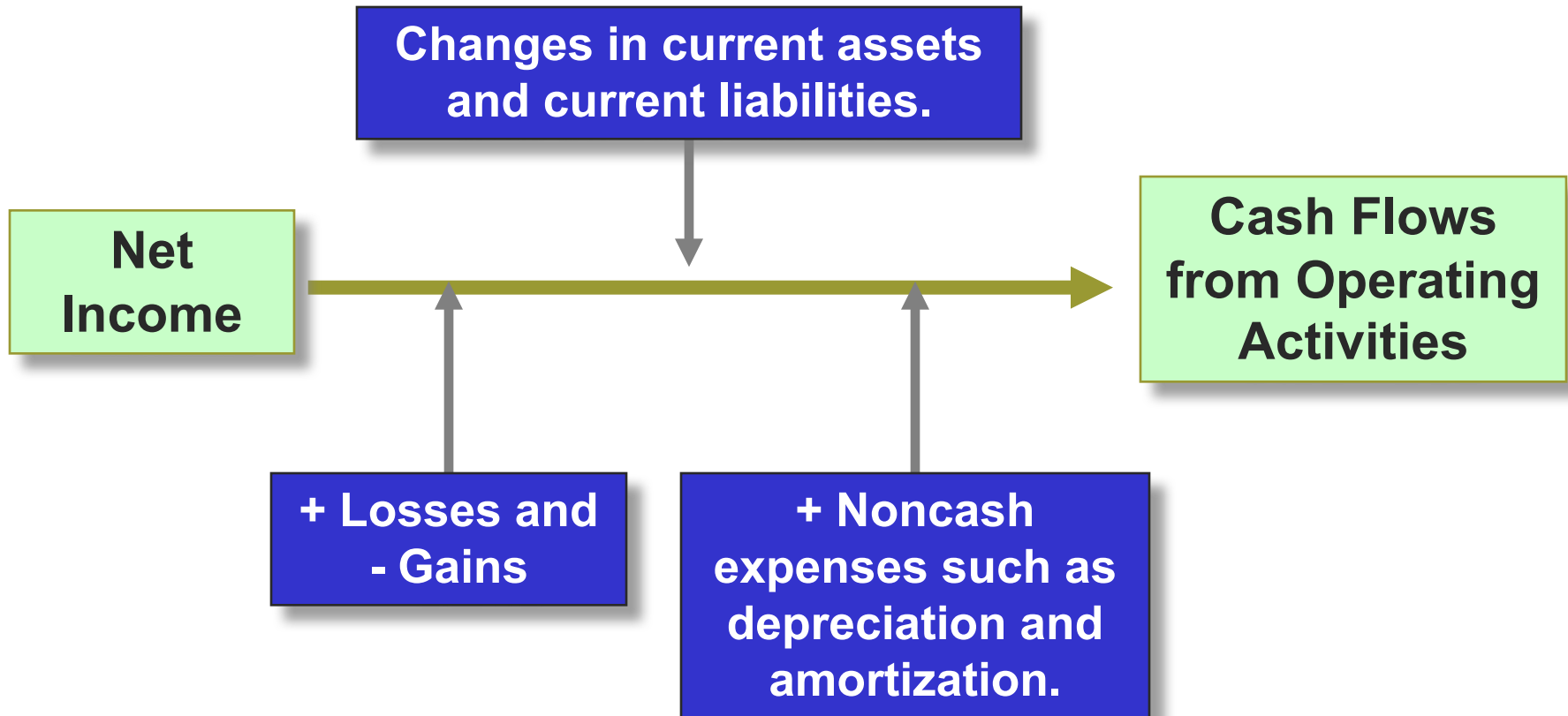


There are two acceptable methods to determine cash flows from operating activities:

- **Direct method**
- **Indirect method**

P2

Indirect Method



97.5% of all companies use the indirect method.

Indirect Method

	Change in Account Balance During Year	
	Increase	Decrease
Current Assets	Subtract from net income	Add to net income
Current Liabilities	Add to net income	Subtract from net income

Use this table when adjusting net income to operating cash flows.

Preparing the Statement of Cash Flows – Indirect Method

Let's look at the **indirect method** for preparing the cash flows from operating activities section.



Indirect Method

Example – East, Inc.



- East, Inc. reports \$125,000 net income for the year ended December 31, 2011.
- Accounts receivable increased by \$7,500 during the year and accounts payable increased by \$10,000.
- During 2011, East reported \$12,500 of depreciation expense.

What is East, Inc.'s operating cash flow for 2011?

Indirect Method Example – East, Inc.

P2

Net income

\$ 125,000

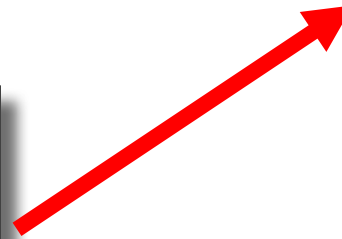
**For the indirect
method, start with
net income.**

Indirect Method Example – East, Inc.

P2

Net income	\$ 125,000
Add: Depreciation expense	12,500

Add noncash expenses such as depreciation, depletion, amortization, or bad debt expense.



Indirect Method

Example – East, Inc.

P2

Net income	\$ 125,000
Add: Depreciation expense	12,500
Deduct: Increase in accounts receivable	(7,500)

	Change in Account Balance During Year	
	Increase	Decrease
Current Assets	Subtract from net income	Add to net income
Current Liabilities	Add to net income	Subtract from net income


Indirect Method

Example – East, Inc.


P2

Net income	\$ 125,000
Add: Depreciation expense	12,500
Deduct: Increase in accounts receivable	(7,500)
Add: Increase in accounts payable	<u>10,000</u>

	Change in Account Balance During Year	
	Increase	Decrease
Current Assets	Subtract from net income	Add to net income
Current Liabilities	Add to net income	Subtract from net income

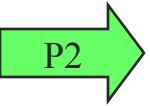


Indirect Method Example – East, Inc.



Net income	\$ 125,000
Add: Depreciation expense	12,500
Deduct: Increase in accounts receivable	(7,500)
Add: Increase in accounts payable	<u>10,000</u>
Cash provided by operating activities	<u><u>\$ 140,000</u></u>

If we used the direct method, we would get the same \$140,000 for cash provided by operating activities.



Indirect Method

Let's prepare a statement of cash flows for B&G Company using the **indirect method**.

Indirect Method

Example – B&G Company

B&G Company Comparative Balance Sheets December 31			
	2011	2010	Increase or (Decrease)
Assets			
Cash	\$ 63,000	\$ 22,000	\$ 41,000
Accounts receivable	85,000	76,000	9,000
Inventories	170,000	189,000	(19,000)
Land	75,000	100,000	(25,000)
Equipment	270,000	200,000	70,000
Accumulated depreciation-equipment	(66,000)	(32,000)	(34,000)
Total Assets	\$ 597,000	\$ 555,000	\$ 42,000
Liabilities and Stockholders' Equity			
Accounts payable	\$ 39,000	\$ 47,000	(8,000)
Bonds payable	150,000	200,000	(50,000)
Common stock, \$1 par	209,000	174,000	35,000
Retained earnings	199,000	134,000	65,000
Total Liabilities and Stockholders' Equity	\$ 597,000	\$ 555,000	\$ 42,000

Indirect Method

Example – B&G Company

Additional Information for 2011:

- Net income was \$105,000.
- Cash dividends declared and paid were \$40,000.
- Bonds payable of \$50,000 were redeemed for \$50,000 cash.
- Common stock was issued for \$35,000 cash.

Indirect Method

Example – B&G Company

B&G Company
Statement of Cash Flows
For the Year Ended December 31, 2011

Cash flows from operating activities

Net income

\$ 105,000

Adjustments to accrual-basis net income:

Add noncash expenses and losses.

Subtract noncash revenues and gains.

Start with accrual-basis net income.

Then, analyze the changes in current assets and current liabilities. →

	Change in Account Balance During Year	
	Increase	Decrease
Current Assets	Subtract from net income.	Add to net income.
Current Liabilities	Add to net income.	Subtract from net income.

Indirect Method

Example – B&G Company

B&G Company		
Statement of Cash Flows		
For the Year Ended December 31, 2011		
Cash flows from operating activities		
Net income		\$ 105,000
Adjustments to accrual-basis net income:		
Depreciation expense	\$ 34,000	
Increase in accounts receivable	(9,000)	
Decrease in inventory	19,000	
Decrease in accounts payable	(8,000)	
Total adjustments	36,000	
Net cash provided by operating activities		141,000
Cash flows from investing activities		

Here's the completed operating section. Next, let's complete the investing section.

Indirect Method

Example – B&G Company

B&G Company		
Statement of Cash Flows		
For the Year Ended December 31, 2011		
Cash flows from operating activities		
Net income		\$ 105,000
Adjustments to accrual-basis net income:		
Depreciation expense	\$ 34,000	
Increase in accounts receivable	(9,000)	
Decrease in inventory	19,000	
Decrease in accounts payable	(8,000)	
Total adjustments		<u>36,000</u>
Net cash provided by operating activities		<u>141,000</u>
Cash flows from investing activities		
Proceeds from sale of land	25,000	
Purchase of equipment	(70,000)	
Net cash used by investing activities		<u>(45,000)</u>
Cash flows from financing activities		

Here's the completed investing section. Next, let's complete the financing section.

Indirect Method

Example – B&G Company

B&G Company		
Statement of Cash Flows		
For the Year Ended December 31, 2011		
Cash flows from operating activities		
Net income		\$ 105,000
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Total adjustments		36,000
Net cash provided by operating activities		141,000
Cash flows from investing activities		
Proceeds from sale of land	25,000	
Purchase of equipment	(70,000)	
Net cash used by investing activities		(45,000)
Cash flows from financing activities		
Proceeds from issuance of common stock	35,000	
Redemption of bonds	(50,000)	
Payment of dividends	(40,000)	
Net cash used by financing activities		(55,000)

Here's the completed financing section. Next, let's prove the cash balances.

Indirect Method

Example – B&G Company

B&G Company		
Statement of Cash Flows		
For the Year Ended December 31, 2011		
Cash flows from operating activities		
Net income		\$ 105,000
Adjustments to accrual-basis net income:		
Depreciation expense	\$ 34,000	
Increase in accounts receivable	(9,000)	
Decrease in inventory	19,000	
Decrease in accounts payable	(8,000)	
Total adjustments		36,000
Net cash provided by operating activities		141,000
Cash flows from investing activities		
Proceeds from sale of land	25,000	
Purchase of equipment	(70,000)	
Net cash used by investing activities		(45,000)
Cash flows from financing activities		
Proceeds from issuance of common stock	35,000	
Redemption of bonds	(50,000)	
Payment of dividends	(40,000)	
Net cash used by financing activities		(55,000)
Net increase in cash		41,000
Cash, January 1, 2011		22,000
Cash, December 31, 2011		\$ 63,000

Indirect Method

Example – B&G Company

B&G Company		
Statement of Cash Flows		
For the Year Ended December 31, 2011		
Cash flows from operating activities		
Net income		\$ 105,000
Adjustments to accrual-basis net income:		
Depreciation expense	\$ 34,000	
Increase in accounts receivable	(9,000)	
Decrease in inventory	19,000	
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Total adjustments		36,000
Net cash provided by operating activities		141,000
Cash flows from investing activities		
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Purchase of equipment	(70,000)	
Net cash used by investing activities		(45,000)
Cash flows from financing activities		
Proceeds from issuance of common stock	35,000	
Redemption of bonds	(50,000)	
Payment of dividends	(40,000)	
Net cash used by financing activities		(55,000)
Net increase in cash		41,000
Cash, January 1, 2011		22,000
Cash, December 31, 2011		\$ 63,000

Analyzing Cash Sources and Uses

Cash Flows of Competing Companies

<i>all numbers in thousands</i>	BMX	ATV	Trex
Cash provided (used) by operating activities	\$ 90,000	\$ 40,000	\$ (24,000)
Cash provided (used) by investing activities:			
Proceeds from sale of operating assets			26,000
Purchase of operating assets	(48,000)	(25,000)	
Cash provided (used) by financing activities:			
Proceeds from issuance of debt			13,000
Repayment of debt	(27,000)		
Net increase (decrease) in cash	<u>\$ 15,000</u>	<u>\$ 15,000</u>	<u>\$ 15,000</u>



A1

Cash Flow on Total Assets

Used, along with income-based ratios, to assess company performance.

$$\text{Cash flow on total assets} = \frac{\text{Cash flow from operations}}{\text{Average total assets}}$$

Preparing the Statement of Cash Flows – Direct Method

Let's look at the **direct method** for preparing the cash flows from operating activities section.

Direct Method

Example – B&G Company

Cash			
Balance, Jan. 1, 2011	22,000	Payments for merchandise	150,000
Receipts from customers	466,000	Payments for wages	145,000
Receipts from sale of land	25,000	Payments for interest	10,000
Receipts from stock issuance	35,000	Payments for taxes	20,000
		Payments for equipment	70,000
		Payments for bond retirement	50,000
		Payments for dividends	40,000
Balance, Dec. 31, 2011	63,000		

We analyze the cash account to prepare the statement under the **direct method**. Let's use B&G's cash account to prepare the company's statement of cash flows.

Direct Method

Example – B&G Company

For the Year Ended December 31, 2011

Cash flows from operating activities		
Cash received from customers	\$ 466,000	
Cash paid for merchandise	(150,000)	
Cash paid for wages	(145,000)	
Cash paid for interest	(10,000)	
Cash paid for taxes	(20,000)	
Net cash provided by operating activities		141,000
Cash flows from investing activities		
Proceeds from sale of land	25,000	
Purchase of equipment	(70,000)	
Net cash used by investing activities		(45,000)
Cash flows from financing activities		
Proceeds from issuance of common stock	35,000	
Redemption of bonds	(50,000)	
Payment of dividends	(40,000)	
Net cash used by financing activities		(55,000)
Net increase in cash		41,000
Cash, January 1, 2011		22,000
Cash, December 31, 2011	\$	63,000

End of Chapter 12

