

Financial Accounting

Prepared by Dr. Sara Ahmed

MGM 611

Lecture 9





مجموعة جامعة
الجميع الذكية
للتعليم القابضة

MIDOCEAN
UNIVERSITY
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Reporting of the Cash Flows

Lecture 9

MGM 611

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www.midocean.ae

**TOPIC
09**

LEARNING OBJECTIVES

- Distinguish between operating, investing, and financing activities, and describe how noncash investing and financing activities are disclosed.
- Analyze the statement of cash flows and apply the cash flow on total assets ratio.
- Prepare a statement of cash flows.
- Compute cash flows from operating activities using the indirect method.
- Determine cash flows from both investing and financing activities.

Purpose of the Statement of Cash Flows

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

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

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

Importance of Cash Flows

What explains the change in the cash balance?

Where does a company spend its cash?

How does a company receive its cash?

Why do income and cash flows differ?

Measurement of Cash Flows



Cash equivalents are...

- **short-term, highly liquid investments.**
- **readily convertible into cash.**
- **sufficiently close to maturity so that market value is unaffected by interest rate changes.**

Learning Objective

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

Classification of Cash Flows

The Statement of Cash Flows includes the following three sections:

- **Operating Activities**
- **Investing Activities**
- **Financing Activities**



Operating Activities



Investing Activities



Financing Activities



Noncash Investing and Financing (FULL DISCLOUSER PRINCIPLE)

Examples of Noncash Investing and Financing Activities

- Retirement of debt by issuing equity stock.
- Conversion of preferred stock to common stock.
- Lease of assets in a capital lease transaction.
- Purchase of long-term assets by issuing a note or bond.
- Exchange of noncash assets for other noncash assets.
- Purchase of noncash assets by issuing equity or debt.

Learning Objective

Prepare a statement of cash flows.

Format of the Statement of Cash Flows

COMPANY NAME Statement of Cash Flows For <i>period</i> Ended <i>date</i>		
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	\$	#
Cash (and equivalents) balance at prior period-end		#
Cash (and equivalents) balance at current period-end	\$	#
Separate schedule or note disclosure of any “noncash investing and financing transactions” is required.		

Preparing the Statement of Cash Flows

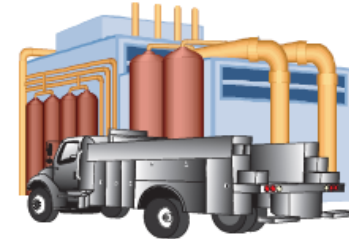
Step 1 Compute net increase or decrease in cash



Step 2 Compute net cash from operating activities



Step 3 Compute net cash from investing activities



Step 4 Compute net cash from financing activities

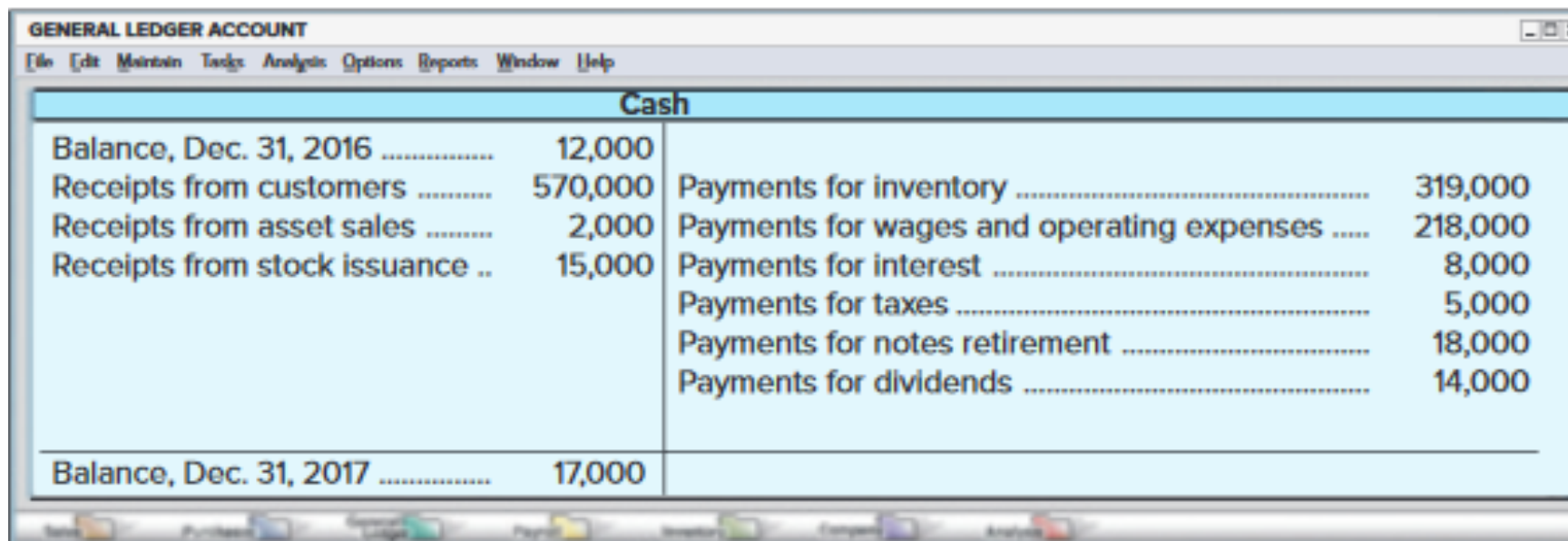


Step 5 Prove and report beginning and ending cash balances



Analyzing the Cash Account

The Cash account is a natural place to look for information about cash flows from operating, investing, and financing activities.

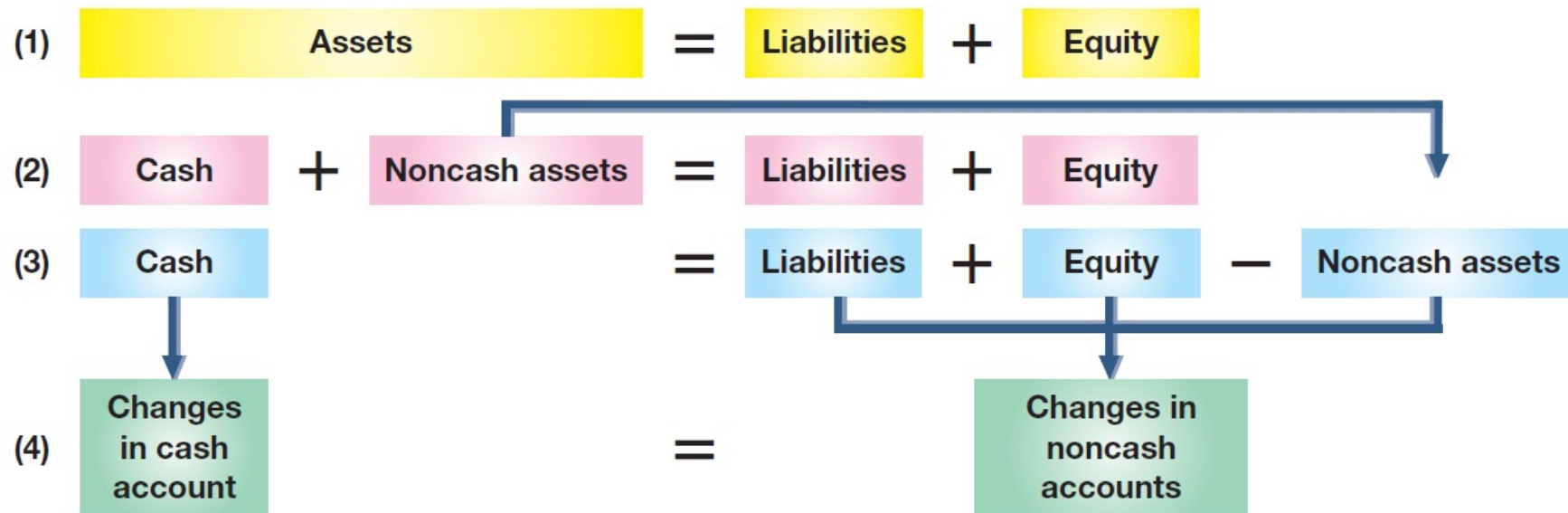


The screenshot shows a software window titled "GENERAL LEDGER ACCOUNT" with a menu bar (File, Edit, Maintain, Tools, Analysis, Options, Reports, Window, Help). The main area displays the "Cash" account with a T-account format. The left side lists debits (increases in cash) and the right side lists credits (decreases in cash). The ending balance for 2017 is 17,000.

Cash			
Balance, Dec. 31, 2016	12,000		
Receipts from customers	570,000	Payments for inventory	319,000
Receipts from asset sales	2,000	Payments for wages and operating expenses	218,000
Receipts from stock issuance ..	15,000	Payments for interest	8,000
		Payments for taxes	5,000
		Payments for notes retirement	18,000
		Payments for dividends	14,000
Balance, Dec. 31, 2017	17,000		

Analyzing Noncash Account

A second approach to preparing the statement of cash flows is analyzing noncash accounts.



Information to Prepare the Statement

Information to prepare the statement of cash flows usually comes from three sources:

Comparative
Balance Sheets

Current
Income Statement

Additional
Information

XYZ Company Balance Sheet December 31, 20X1		
Assets		Liabilities
Current assets	Operating	Current liabilities
Plant assets	Investing	Long-term liabilities
		Equity
Total assets		Financing
		Total liabilities and equity

Cash Flows from Operating

Indirect and Direct Methods of Reporting

Cash flows from operating activities	
Cash received from customers	\$570,000
Cash paid for merchandise	(319,000)
Cash paid for wages and other operating expenses	(218,000)
Cash paid for interest	(8,000)
Cash paid for taxes	(5,000)
Net cash provided by operating activities	<u>\$20,000</u>

**Direct
Method**

**Indirect
Method**

Cash flows from operating activities	
Net income	\$ 38,000
Adjustments to reconcile net income to net cash provided by operating activities	
Increase in accounts receivable	(20,000)
Increase in merchandise inventory	(14,000)
Increase in prepaid expenses	(2,000)
Decrease in accounts payable	(5,000)
Decrease in interest payable	(1,000)
Increase in income taxes payable	10,000
Depreciation expense	24,000
Loss on sale of plant assets	6,000
Gain on retirement of notes	(16,000)
Net cash provided by operating activities	<u>\$20,000</u>

The net cash amount provided by operating activities is identical under both the direct and indirect methods.

Learning Objective

Applying the Indirect
Method of Reporting.

GENESIS Balance Sheets December 31, 2017 and 2016			
	2017	2016	Change
Assets			
Current assets			
Cash	\$ 17,000	\$ 12,000	\$ 5,000 Increase
Accounts receivable	60,000	40,000	20,000 Increase
Inventory	84,000	70,000	14,000 Increase
Prepaid expenses	6,000	4,000	2,000 Increase
Total current assets	167,000	126,000	
Long-term assets			
Plant assets	250,000	210,000	40,000 Increase
Accumulated depreciation	(60,000)	(48,000)	12,000 Increase
Total assets	<u>\$357,000</u>	<u>\$288,000</u>	
Liabilities			
Current liabilities			
Accounts payable	\$ 35,000	\$ 40,000	\$ 5,000 Decrease
Interest payable	3,000	4,000	1,000 Decrease
Income taxes payable	22,000	12,000	10,000 Increase
Total current liabilities	60,000	56,000	
Long-term notes payable	90,000	64,000	26,000 Increase
Total liabilities	150,000	120,000	
Equity			
Common stock, \$5 par	95,000	80,000	15,000 Increase
Retained earnings	112,000	88,000	24,000 Increase
Total equity	207,000	168,000	
Total liabilities and equity	<u>\$357,000</u>	<u>\$288,000</u>	

These financial statements will help us prepare the statement of cash flows for Genesis using the indirect method.

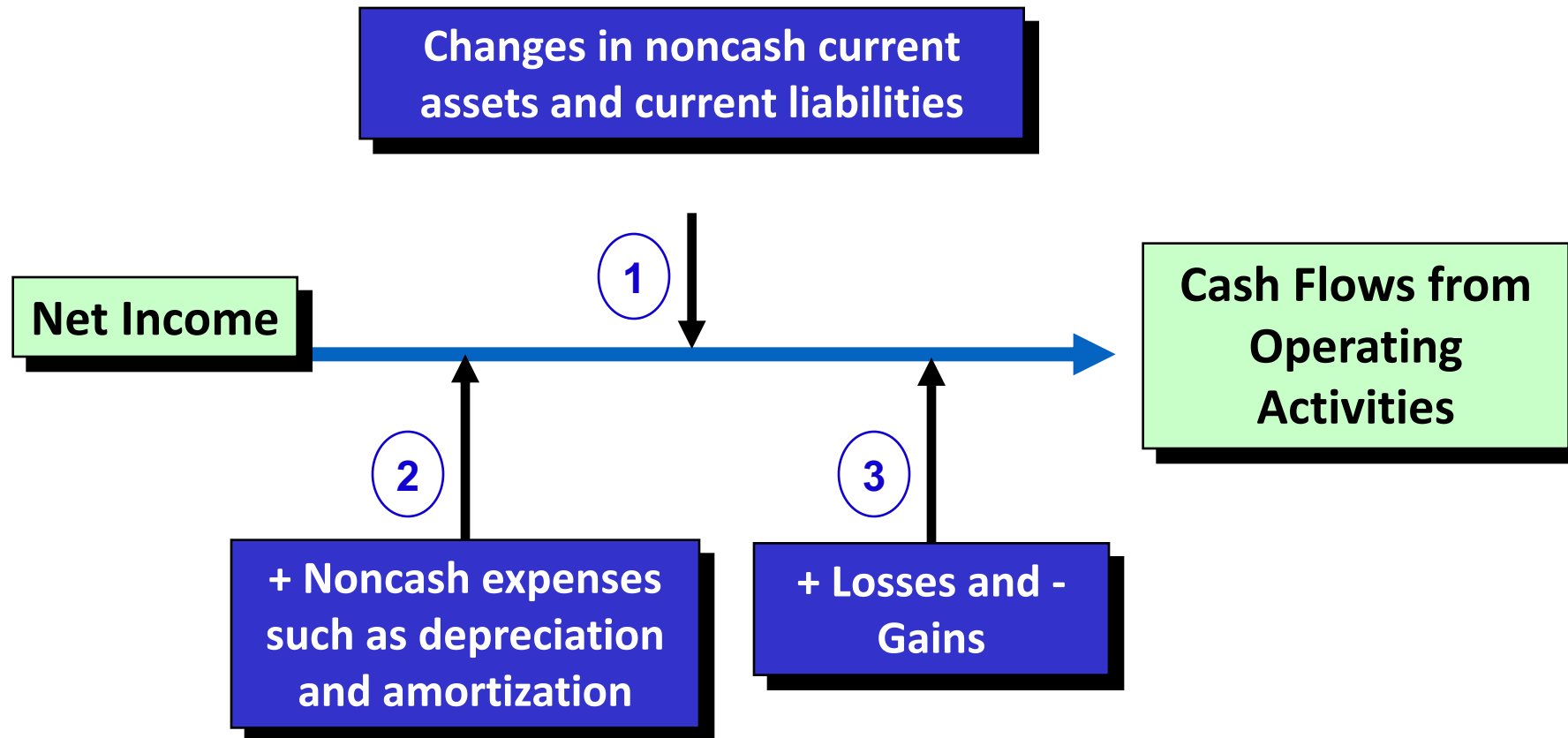
GENESIS Income Statement For Year Ended December 31, 2017	
Sales	\$590,000
Cost of goods sold	\$300,000
Wages and other operating expenses	216,000
Interest expense	7,000
Depreciation expense	24,000
	(547,000)
	43,000
Other gains (losses)	
Loss on sale of plant assets	(6,000)
Gain on retirement of notes	16,000
	10,000
Income before taxes	53,000
Income taxes expense	(15,000)
Net income	<u>\$ 38,000</u>

Applying the Indirect Method of Reporting

Additional information on Genesis Inc.'s 2017 transactions:

- a. The accounts payable balances result from inventory purchases.**
- b. Purchased \$60,000 in plant assets by issuing \$60,000 of notes payable.**
- c. Sold plant assets with a book value of \$8,000 (original cost of \$20,000 and accumulated depreciation of \$12,000) for \$2,000 cash, yielding a \$6,000 loss.**
- d. Received \$15,000 cash from issuing 3,000 shares of common stock.**
- e. Paid \$18,000 cash to retire notes with a \$34,000 book value, yielding a \$16,000 gain.**
- f. Declared and paid cash dividends of \$14,000.**

Applying the Indirect Method



Adjustments for 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.

Use this table when adjusting Net Income to Operating Cash Flows.

Adjustments for Changes in Current Assets and Current Liabilities

Net income	\$ 38,000
Adjustments to reconcile net income to net cash provided by operating activities	
Income statement items not affecting cash	
Depreciation expense	24,000
Loss on sale of plant assets	6,000
Gain on retirement of notes	(16,000)

Adjustments for Operating Items Not Providing or Using Cash

Net income	\$ 38,000
Adjustments to reconcile net income to net cash provided by operating activities	
Increase in accounts receivable	(20,000)
Increase in inventory	(14,000)
Increase in prepaid expenses	(2,000)
Decrease in accounts payable	(5,000)
Decrease in interest payable	(1,000)
Increase in income taxes payable	10,000

Adjustments for Nonoperating Items

GENESIS		
Statement of Cash Flows—Operating Section under Indirect Method		
For Year Ended December 31, 2017		
Cash flows from operating activities		
Net income		\$ 38,000
Adjustments to reconcile net income to net cash provided by operating activities		
Income statement items not affecting cash		
① Depreciation expense	24,000	
Loss on sale of plant assets	6,000	
Gain on retirement of notes	(16,000)	
Changes in current assets and liabilities		
Increase in accounts receivable	(20,000)	
Increase in inventory	(14,000)	
② Increase in prepaid expenses	(2,000)	
Decrease in accounts payable	(5,000)	
Decrease in interest payable	(1,000)	
Increase in income taxes payable	10,000	
Net cash provided by operating activities		<u>\$20,000</u>

Summary of Adjustments for Indirect Method

Common adjustments to net income when computing net cash provided or used by operating activities under the indirect method:

Net Income (or Loss)

① Adjustments for operating items not providing or using cash

+ Noncash expenses and losses

Examples: Expenses for depreciation, depletion, and amortization; losses from disposal of long-term assets and from retirement of debt

– Noncash revenues and gains

Examples: Gains from disposal of long-term assets and from retirement of debt

② Adjustments for changes in current assets and current liabilities

+ Decrease in noncash current operating asset

– Increase in noncash current operating asset

+ Increase in current operating liability

– Decrease in current operating liability

Net cash provided (used) by operating activities

Learning Objective

Determine cash flows
from both investing and
financing activities.

Cash Flows from Investing

A three-stage process to determine cash provided or used by investing activities:

Identify changes in
investing-related
accounts

Explain these changes
using reconstruction
analysis

Report their cash flow
effects

Cash Flows from Investing

GENESIS Balance Sheets December 31, 2017 and 2016			
	2017	2016	Change
Assets			
Current assets			
Cash	\$ 17,000	\$ 12,000	\$ 5,000 Increase
Accounts receivable	60,000	40,000	20,000 Increase
Inventory	84,000	70,000	14,000 Increase
Prepaid expenses	6,000	4,000	2,000 Increase
Total current assets	167,000	126,000	
Long-term assets			
Plant assets	250,000	210,000	40,000 Increase
Accumulated depreciation	(60,000)	(48,000)	12,000 Increase
Total assets	<u>\$357,000</u>	<u>\$288,000</u>	
Liabilities			
Current liabilities			
Accounts payable	\$ 35,000	\$ 40,000	\$ 5,000 Decrease
Interest payable	3,000	4,000	1,000 Decrease
Income taxes payable	22,000	12,000	10,000 Increase
Total current liabilities	60,000	56,000	
Long-term notes payable	90,000	64,000	26,000 Increase
Total liabilities	150,000	120,000	
Equity			
Common stock, \$5 par	95,000	80,000	15,000 Increase
Retained earnings	112,000	88,000	24,000 Increase
Total equity	207,000	168,000	
Total liabilities and equity	<u>\$357,000</u>	<u>\$288,000</u>	

This analysis reveals a \$40,000 increase in plant assets from \$210,000 to \$250,000 and a \$12,000 increase in accumulated depreciation from \$48,000 to \$60,000.

Cash Flows from Investing

Item b: Genesis purchased plant assets of \$60,000 by issuing \$60,000 in notes payable to the seller.

Reconstruction	Plant Assets	60,000	
	Notes Payable		60,000

Item c reports that Genesis sold plant assets costing \$20,000 (with \$12,000 of accumulated depreciation) for \$2,000 cash, resulting in a \$6,000 loss.

Reconstruction	Cash	2,000	
	Accumulated Depreciation	12,000	
	Loss on Sale of Plant Assets	6,000	
	Plant Assets		20,000

We also reconstruct the entry for Depreciation Expense using information from the income statement.

Reconstruction	Depreciation Expense	24,000	
	Accumulated Depreciation		24,000

Cash Flows from Financing

A three-stage process to determine cash provided or used by financing activities:

**Identify changes in
financing-related
accounts**

**Explain these changes
using reconstruction
analysis**

**Report their cash
flow effects**

Cash Flows from Financing

GENESIS Balance Sheets December 31, 2017 and 2016			
	2017	2016	Change
Assets			
Current assets			
Cash	\$ 17,000	\$ 12,000	\$ 5,000 Increase
Accounts receivable	60,000	40,000	20,000 Increase
Inventory	84,000	70,000	14,000 Increase
Prepaid expenses	6,000	4,000	2,000 Increase
Total current assets	167,000	126,000	
Long-term assets			
Plant assets	250,000	210,000	40,000 Increase
Accumulated depreciation	(60,000)	(48,000)	12,000 Increase
Total assets	<u>\$357,000</u>	<u>\$288,000</u>	
Liabilities			
Current liabilities			
Accounts payable	\$ 35,000	\$ 40,000	\$ 5,000 Decrease
Interest payable	3,000	4,000	1,000 Decrease
Income taxes payable	22,000	12,000	10,000 Increase
Total current liabilities	60,000	56,000	
Long-term notes payable	90,000	64,000	26,000 Increase
Total liabilities	150,000	120,000	
Equity			
Common stock, \$5 par.	95,000	80,000	15,000 Increase
Retained earnings	112,000	88,000	24,000 Increase
Total equity	207,000	168,000	
Total liabilities and equity	<u>\$357,000</u>	<u>\$288,000</u>	

This analysis reveals: an increase in notes payable from \$64,000 to \$90,000.

Cash Flows from Financing

Item e: Notes with a carrying value of \$34,000 are retired for \$18,000 cash, resulting in a \$16,000 gain.

Reconstruction	Notes Payable	34,000	
	Gain on retirement of debt		16,000
	Cash		18,000

Cash Flows from Financing

Item d: Issued 3,000 shares of common stock at par for \$5 per share.

Reconstruction	Cash	15,000	
	Common Stock		15,000

Item f: Cash dividends of \$14,000 are paid.

Reconstruction	Retained Earnings	14,000	
	Cash		14,000

GENESIS
Statement of Cash Flows (Indirect Method)
For Year Ended December 31, 2017

Cash flows from operating activities		
Net income	\$ 38,000	
Adjustments to reconcile net income to net cash provided by operating activities		
Income statement items not affecting cash		
Depreciation expense	24,000	
Loss on sale of plant assets	6,000	
Gain on retirement of notes	(16,000)	
Changes in current assets and liabilities		
Increase in accounts receivable	(20,000)	
Increase in inventory	(14,000)	
Increase in prepaid expenses	(2,000)	
Decrease in accounts payable	(5,000)	
Decrease in interest payable	(1,000)	
Increase in income taxes payable	10,000	
Net cash provided by operating activities		\$20,000
Cash flows from investing activities		
Cash received from sale of plant assets	2,000	
Net cash provided by investing activities		2,000
Cash flows from financing activities		
Cash received from issuing stock	15,000	
Cash paid to retire notes	(18,000)	
Cash paid for dividends	(14,000)	
Net cash used in financing activities		(17,000)
Net increase in cash	\$ 5,000	
Cash balance at prior year-end	12,000	
Cash balance at current year-end	<u>\$17,000</u>	

Summary Using T-Accounts

Cash			
(1) Net income	38	(4) Gain on retirement of notes	16
(2) Depreciation	24	(5) Increase in accounts receivable	20
(3) Loss on sale of plant assets	6	(6) Increase in inventory	14
(10) Increase in income taxes payable	10	(7) Increase in prepaid expense	2
		(8) Decrease in accounts payable	5
		(9) Decrease in interest payable	1
Net cash provided by operating activities	20	(4) Cash paid to retire notes	18
(3) Cash received from sale of plant assets	2	(13) Cash paid for dividends	14
(12) Cash received from issuing stock	15		
Net increase in cash	5		

Data to prepare
statement of
cash flows

Accounts Receivable		Inventory		Prepaid Expenses		Plant Assets	
Beg.	40	Beg.	70	Beg.	4	Beg.	210
(5)	20	(6)	14	(7)	2	(3)	20
End.	60	End.	84	End.	6	(11)	60
						End.	250

Accumulated Depreciation		Accounts Payable		Interest Payable		Income Taxes Payable	
	Beg.	Beg.	Beg.	Beg.	Beg.	Beg.	Beg.
(3)	12	(8)	5	(9)	1	(10)	10
	24		40		4		12
End.	60	End.	35	End.	3	End.	22

Long-Term Notes Payable		Common Stock		Retained Earnings	
	Beg.		Beg.		Beg.
(4)	34		80	(13)	14
	60		15		38
End.	90	End.	95	End.	112

Learning Objective

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

Analyzing Cash Sources and Uses

Most managers stress the importance of understanding and predicting cash flows for business decisions.

(\$ thousands)	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 plant assets			26,000
Purchase of plant 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>

Cash Flow on Total Assets

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

$$\text{Cash flow on total assets} = \frac{\text{Operating cash flows}}{\text{Average total assets}}$$



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