Chapter 24 - Statement of Cash Flows

I. General Points

A. Purpose: To provide information about an entity's cash receipts and cash payments during a period

B. Three different types of cash flows have been identified:

1) Cash Flows from Operating Activities – concerned with activities that affect net income; can be thought of as cash basis income
2) Cash Flows from Investing Activities – relate to the use of cash to obtain productive assets or other noncash assets
3) Cash Flows from Financing Activities – relate to how cash was obtained to finance the business entity

Be sure you can classify various activities into these three categories.

C. In preparing the statement of cash flows, you are essentially preparing one large reconciliation of beginning-of-period cash to end-of-period cash. We will accomplish this by converting accrual financial statements (balance sheet and income statement) to the cash basis.

II. Preparing the Statement of Cash Flows – Operating Activities Section

A. Key Idea: Accrual accounting has recorded transactions that do not involve cash receipts or payments (e.g. credit sales, depreciation). The objective is to eliminate the effects of these accounting accruals (the noncash part of the transaction) which produces cash flow as the end result.

B. Two different methods are available to adjust accrual income to a cash basis.

1) Direct Method

-- Compute cash flow from operating activities (CFO) by adjusting each item on the income statement by its accrual component (typically computed with reference to a related balance sheet account).

-- End result is 2 classes of CFO: cash receipts and cash payments. Each of these categories can then be further broken down into specific sources of cash receipts and payments. Typical categories include cash collected from customers, cash paid to suppliers, cash paid for operating expenses, cash paid for interest, and cash paid for taxes.

-- Computation of these (and other) categories are discussed in class. Further, a handout explaining the reason for the adjustments made is available.

-- FASB encourages that firms use this method because it is more consistent with the purpose of the statement of cash flows. If this method is used, a reconciliation of net income to cash flow should be shown in a separate schedule.

2) Indirect Method

-- Start with net income and adjust net income for items that affect net income but do not affect cash.

-- End result is the same as under the direct method except that specific categories of cash receipts and cash payments do not exist.

-- Computation of CFO under the indirect method is discussed in class. Additionally, you are responsible for understanding why the adjustments are made.

-- GAAP permits the use of the indirect method. In fact, this method is overwhelmingly employed in practice.

C. Other Issues

1) Depreciation and other noncash transactions (e.g. amortization of discounts/premiums, amortization of intangible assets) must be considered in preparing CFO.
2) Allowance for Doubtful Accounts – If this account exists and a company uses the indirect method, net the allowance account and gross receivables and perform all computations on net receivables. If the direct method is used, each account must be analyzed separately and its income affects adjusted accordingly (possible accounts to adjust: sales, operating expenses).
3) Not all current assets and current liabilities require adjustments to net income. For example, the purchase of short-term available for sale investments is an investing activity while the purchase of short-term trading securities is an operating activity.
4) Gains and Losses must be considered in adjusting net income under the indirect method.
5) Any significant noncash transactions should be disclosed in a separate schedule.

III. Preparing a Statement of Cash Flows – Other Issues

A. Investing and Financing Activities Section

1) Proper classification of an item as an investing or financing activity is essential.
2) Typically, computation of cash flow involved is based on an analysis of the changes in the balance sheet accounts. This analysis may be aided by additional information not found on the financial statements.

B. Worksheet

-- A worksheet approach is available that adds structure to the task of preparing a statement of cash flows. This approach is especially useful in complex situations.