Statement of Cash Flows

The Statement of Cash Flows (or cash flow statement) is one of the main financial statements used by investors. It shows the *cash* generated and used during a specific time period. Ideally a company should generate positive cash flows; this will make it more likely to find investors for the future. The positive or negative net cash flow identified at the end of the statement of cash flows is equal to the total change in the cash account balance.

The cash flow statement reports the cash inflows and outflow in three categories:

1. Operating activities – reports the accrual net income and adjusts it for changes in current asset and current liability accounts
2. Investing activities – Reports the purchase and sale of fixed assets, marketable securities, and any other investment accounts
3. Financing activities – reports the changes to ownership equity and payment or borrowing of long-term liabilities

The cash flow statement can be prepared using the indirect method where differences in the balance sheet accounts for two time periods are compared. The first step is to determine if the changes in each account represent an increase or decrease of cash. An increase of cash (also called an "inflow" or "source of cash") is added when converting accrual net income to cash net income. A decrease of cash (also called an "outflow" or "use of cash") is subtracted when converting accrual net income to cash net income.

For instance, if accounts receivable increased from one period to the next, then revenue would also have increased. The revenue would overstate the amount of cash received and the net income would be higher than it would be in cash basis accounting. To adjust the income, the increase in A/R represents a decrease to net income. It is an outflow of cash. This is true for any other asset account – an increase in an asset account corresponds to an outflow of cash; a decrease corresponds to an inflow of cash.

If a liability increased, (for example, A/P), that means we are borrowing cash to finance a purchase or pay expenses. The actual expenses or purchases paid in cash are less than the total reported accrual operating expenses; this means the accrual net income is lower than it would be in cash basis accounting. The increase in a current liability is a source of cash (inflow), and added to net income when converting to the cash basis.

There are some items that are only ever an inflow or outflow of cash: depreciation expense, capital gain/loss, dividends, and net income/loss. Dividends are paid out, so they represent an outflow of cash. Net income is an inflow of cash into the business. Capital gains and losses occur from the sale of long-term assets. If there is a capital gain it would increase the net income, but not the cash, so to adjust to the cash basis, we would treat it as an outflow of cash (and inflow for a capital loss).

The table on the next page summarizes changes in accounts and whether they are inflows or outflows of cash.

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Description	Change in Account	Inflow or Outflow of Cash
Asset	Increase	Outflow
Asset	Decrease	Inflow
Liability/Common Stock	Increase	Inflow
Liability/Common Stock	Decrease	Outflow
Depreciation		Inflow
Capital Gain		Outflow
Capital Loss		Inflow
Net Income		Inflow
Net Loss		Outflow
Dividends		Outflow

Once each account change in the two balance sheets has been recognized as an inflow or outflow of cash (Note: CASH and RETAINED EARNINGS in the balance sheet are NOT recognized as inflows or outflows and can be ignored), the next step is to categorize the type of cash flow each change belongs to.

<u>Cash Flow from Operating Activities</u>
Net income/net loss
Current assets (NOT marketable securities!)
Current liabilities (NOT loans! NOT notes payable!)
Depreciation
Capital gain/capital loss

<u>Cash Flow from Investing Activities</u>
Long-term assets (fixed assets)
Marketable securities
All investments

<u>Cash Flow from Financing Activities</u>
Long-term liabilities
Loan/Notes payable
Current mortgage payable
Common stock
Dividends

In order to prepare the statement of cash flows, you would list each section as above with the amount of inflow (+ amount) or outflow (- amount) of cash for each item. You would calculate the net cash flow for each section at the end. Then take the sum of all three sections to get the net cash flow increase or decrease. This number should match the change in the cash account balance. You then list the beginning and ending cash balance for the year to prove that the sum of the net cash flow increase/decrease and the beginning cash balance gives the ending cash balance.

Practice Problems

1. Indicate whether each given change in account balance represents an inflow or outflow of cash and its categorization in the cash flow statement (operating, financing, or investing).

Activity	Cash Inflow or Outflow?	Section
Accounts receivable increase		
Interest payable increase		
Payment of cash dividend		
Purchased equipment		
Common stock increase		
Prepaid expenses decrease		
Unearned revenue decrease		
Sale of marketable securities		
Capital loss		
Current mortgage payable decrease		
Sale of long-term investment		
Borrowing on note payable		
Common stock decrease		
Inventory increase		
Wages payable decrease		
Mortgage payable increase		
Accumulated depreciation		
Sale of land		

2. Net income is $353,000; depreciation expense is $42,000; accounts receivable increased $1,080; credit card receivables decreased $2,100; prepaid insurance increased $3,440; inventory decreased $4,500; accounts payable increased $5,200; wages payable decreased $2,900. Prepare a statement for net cash flow from operating activities.

3. A Nanaimo resort showed the following changes in current accounts during the annual operating period ending December 31, 2009. Net income for 2009 was $141,100. Cash dividends of $154,00 were paid out. Prepare a statement of cash flows (SCF).

Assets	***31-Dec-08***	***31-Dec-09***
Current Assets		
Cash	$25,200	$29,600
Accounts receivable	12,550	12,900
Credit card receivables	9,700	8,000
Inventories	2,850	1,100
Marketable securities	2,000	3,000
Prepaid expenses	6,100	4,200
Total Current Assets	$58,400	$58,800
Property, plant, and equipment		
Land	194,000	194,000
Building	9,800,000	9,800,000
Furniture	184,000	134,000
Equipment	736,400	803,400
Accumulated Depreciation	(2,400,000)	(2,544,200)
Net Property, plant and equipment	8,514,400	8,387,200
Other Assets	509,000	609,000

Total Assets	**$9,081,800**	**$9,055,000**
Liabilities and Stockholders' Equity		
Current Liabilities		
Accounts payable	13,700	15,700
Wages payable	4,200	5,000
Notes Payable	4,900	3,700
Current mortgage payable	15,300	15,900
Total Current Liabilities	38,100	40,300
Long-term Liabilities		
Mortgage payable	7,710,200	7,704,300
Total Liabilities	**$7,748,300**	**$7,744,600**
Stockholders' Equity		
Common stock	960,000	950,000
Retained earnings	373,500	360,400
Total Stockholders' Equity	1,333,500	1,310,400
Total Liabilities and SE	**$9,081,800**	**$9,055,000**

4. Prepare an SCF for the year 2010 based on the following information. The net income for 2010 is $8,000 and dividends of $7,000 were paid.

Assets	***2009***	***2010***
Current Assets		
Cash	$15,800	$16,600
Credit card receivables	$813	$747
Accounts receivable	7,387	6,853
Inventories	4,925	6,275
Marketable securities	2,975	3,425
Total Current Assets	$31,900	$33,900
Property, plant, and equipment		
Furniture/Equipment	$15,700	$19,700
Accumulated depreciation	(4,600)	(5,600)
Net Property, plant and equipment	$11,100	$14,100
Total Assets	**$43,000**	**$48,000**
Liabilities and Stockholders' Equity		
Current Liabilities		
Accounts payable	$3,800	$6,100
Accrued expenses payable	800	700
Taxes payable	2,400	1,200
Total Current Liabilities	$7,000	$8,000
Long-term Liabilities		
Mortgage payable	$24,800	$26,800
Total Liabilities	$31,800	$34,800
Stockholders' Equity		
Common stock	$5,200	$6,200
Retained earnings	6,000	7,000
Total Stockholders' Equity	$11,200	$13,200
Total Liabilities and SE	**$43,000**	**$48,000**

Solutions

1.

Activity	Cash Inflow or Outflow?	Section
Accounts receivable increase	Outflow	Operating
Interest payable increase	Inflow	Operating
Payment of cash dividend	Outflow	Financing
Purchased equipment	Outflow	Investing
Common stock increase	Inflow	Financing
Prepaid expenses decrease	Inflow	Operating
Unearned revenue decrease	Outflow	Operating
Sale of marketable securities	Inflow	Investing
Capital loss	Inflow	Operating
Current mortgage payable decrease	Outflow	Financing
Sale of long-term investment	Inflow	Investing
Borrowing on a note payable	Inflow	Financing
Common stock decrease	Outflow	Financing
Inventory increase	Outflow	Operating
Wages payable decrease	Outflow	Operating
Mortgage payable increase	Inflow	Financing
Accumulated depreciation	Inflow	Operating
Sale of land	Inflow	Investing

2.

Net Cash Flow from Operating Activities		
Operating Activities		
Net Income	$353,000	
Accounts receivable (increased)	(1,080)	
Credit card receivables (decreased)	2,100	
Prepaid insurance (increased)	(3,440)	
Inventory (decreased)	4,500	
Accounts payable (increased)	5,200	
Wages payable (decreased)	(2,900)	
Depreciation	42,000	
Net Cash Flow, Operating Activities		$394,180

3.

Statement of Cash Flows for the year ended Dec 31, 2009		
Operating Activities		
Net income	$141,100	
Accounts receivable (increased)	(350)	
Credit card receivables (decreased)	1,700	
Inventories (decreased)	1,750	
Prepaid expenses (decreased)	1,900	
Accounts payable (increased)	2,000	
Wages payable (increased)	800	
Depreciation	144,200	
Net Cash Flow, Operating Activities		$293,100

Investing Activities		
Sale of furniture	$50,000	
Purchased equipment	(67,000)	
Invested in marketable securities	(1,000)	
Invested in other assets	(100,000)	
Net Cash Flow, Investing Activities		($118,000)
Financing Activities		
Payment on notes payable	(1,200)	
Borrowing on current mortgage payable	600	
Payment on mortgage payable	(5,900)	
Redeem capital stock	(10,000)	
Dividends paid	(154,200)	
Net Cash Flow, Financing Activities		($170,700)
Net Cash Flow increase		$4,400
Cash balance Dec 31, 2008		$25,200
Cash balance Dec 31,2009		$29,600

4.

Statement of Cash Flows for the Year Ended December 31, 2010

Operating Activities		
Net Income	$8,000	
Credit card receivables (↓ 66)	66	
Accounts receivable (↓ 534)	534	
Inventories (↑ 1,350)	(1,350)	
Accounts payable (↑ 2,300)	2,300	
Accrued expenses payable (↓ 100)	(100)	
Taxes payable (↓ 1,200)	(1,200)	
Depreciation	1,000	
Net Cash Flow, Operating Activities		$8,250
Investing Activities		
Marketable securities (↑ 450)	(450)	
Furniture/Equipment (↑ 4,000)	(4,000)	
Net Cash Flow, Investing Activities		($4,450)
Cash Flow Adjustments, Financing Activities		
Common stock issued (↑ 1,000)	1000	
Borrowing on long-term mortgage (↑ 2,000)	2,000	
Dividends paid	(6,000)	
Net Cash Flow, Financing Activities		($3,000)
Net Cash Flow		$800
Cash balance, December 31, 2008		15,800
Cash balance, December 31, 2009		$16,600