

Methods for Preparing SCF

- **Direct method**

- Lists cash receipts and disbursements by source/use of funds
- Always used for investing and financing activities
- Rarely used for operating activities

Operating CF —→ **Direct**
 —→ **Indirect**

- **Indirect method**

- Only used for operating activities
- Goal is to reconcile net income with cash from operations by removing noncash items from net income and including additional cash flows not in net income
- Almost every company uses this method for operating activities

Investing CF —→ **Direct**

Financing CF —→ **Direct**

Indirect Method Preparation

- **Start with Net Income**
- **Adjust for components of Net Income tied to noncash items or to investing activities**
 - Add back expenses or subtract revenues
 - Noncash items: Depreciation, amortization
 - Investing activities: Gains/losses on sale of PP&E or investments
- **Adjust for components of Net Income tied to assets or liabilities created through operating activities (i.e., working capital)**
 - Add or subtract change in asset/liability account balance
 - Use the balance sheet equation to determine whether to add or subtract:
Cash + Noncash Assets = Liabilities + Owners' Equity

Example of Direct vs. Indirect Method I

| | Net Income | Direct SCF | | Indirect SCF | |
|--|---------------|----------------------------|------|--------------|----|
| Sales: \$100 cash | 100 | Collections from customers | 100 | Net Income | 40 |
| COGS: \$60 inventory, acquired with cash | (60) | Payments to suppliers | (60) | | |
| Net Income | 40 | Operating CF | 40 | Operating CF | 40 |

Example of Direct vs. Indirect Method II

| | Net Income | Direct SCF | | Indirect SCF | |
|--|---------------|----------------------------|------|-----------------|----|
| Sales: \$100 cash | 100 | Collections from customers | 100 | Net Income | 30 |
| COGS: \$60 inventory, acquired with cash | (60) | Payments to suppliers | (60) | Add Deprec. Exp | 10 |
| Depreciation: \$10 | (10) | | | | |
| Net Income | 30 | Operating CF | 40 | Operating CF | 40 |

Example of Direct vs. Indirect Method III

| | Net Income | Direct SCF | | Indirect SCF | |
|---|---------------|-------------------------------|------|-----------------|------|
| Sales: \$80 cash, \$20 Accts Rec (A/R) | 100 | Collections from customers | 80 | Net Income | 30 |
| COGS: \$60 inventory, acquired with cash | (60) | Payments to suppliers | (60) | Add Deprec. Exp | 10 |
| Depreciation: \$10 | (10) | | | Incr. in A/R | (20) |
| Net Income | 30 | Operating CF | 20 | Operating CF | 20 |

Cash + Noncash Assets = Liabilities + Owners' Equity

↓ 20

↑ 20 A/R

Example of Direct vs. Indirect Method IV

| | Net Income | Direct SCF | | Indirect SCF | |
|--|---------------|-------------------------------|------|-----------------|------|
| Sales: \$80 cash, \$20 Accts Rec (A/R) | 100 | Collections from customers | 80 | Net Income | 30 |
| COGS: \$60, but purchased \$75 of inventory, \$50 paid in cash and \$25 Accts Pay | (60) | Payments to suppliers | (50) | Add Deprec. Exp | 10 |
| | | | | Incr in A/R | (20) |
| | | | | Incr in Inv | (15) |
| Depreciation: \$10 | (10) | | | | |
| Net Income | 30 | Operating CF | 30 | Operating CF | 30 |

Cash + Noncash Assets = Liabilities + Owners' Equity

↓ 15 ↑ 15 Inv (75 purch – 60 sold)

Example of Direct vs. Indirect Method IV

| | Net Income | Direct SCF | | Indirect SCF | |
|--|---------------|-------------------------------|------|-----------------|------|
| Sales: \$80 cash, \$20 Accts Rec (A/R) | 100 | Collections from customers | 80 | Net Income | 30 |
| COGS: \$60, but purchased \$75 of inventory, \$50 paid in cash and \$25 Accts Pay | (60) | Payments to suppliers | (50) | Add Deprec. Exp | 10 |
| | | | | Incr in A/R | (20) |
| | | | | Incr in Inv | (15) |
| Depreciation: \$10 | (10) | | | Incr in A/P | 25 |
| Net Income | 30 | Operating CF | 30 | Operating CF | 30 |

Cash + Noncash Assets = Liabilities + Owners' Equity

↓ 15 ↑ 15 Inv (75 purch – 60 sold)
 ↑ 25 ↑ 25 A/P