

## **Learning Module 4: Analyzing Statements of Cash Flows 1**

### **LOS 4a: describe how the cash flow statement is linked to the income statement and the balance sheet**

Financial statements are interconnected, each serving a unique function in providing detailed information about a company's financial activities. The four primary financial statements are:

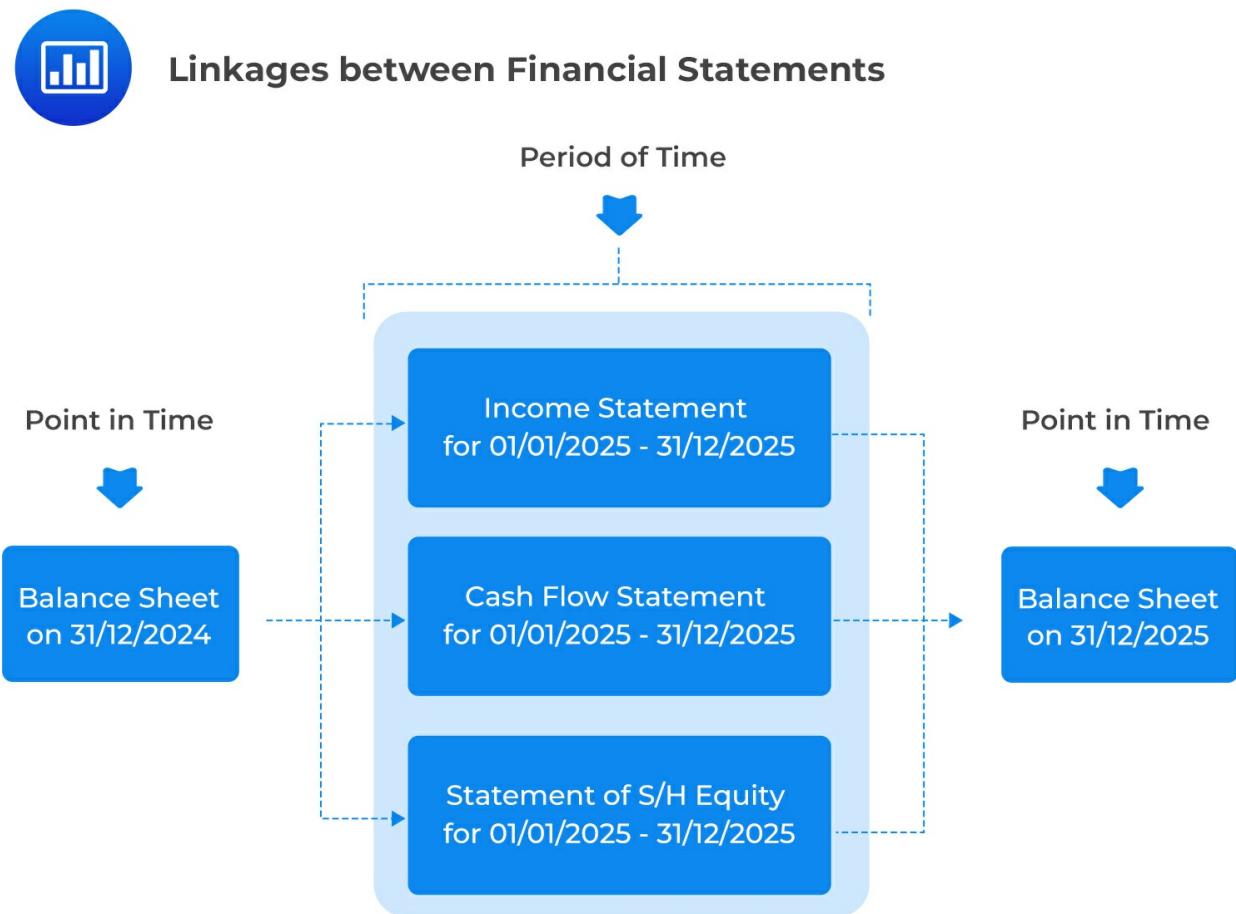
The four primary financial statements are interconnected, each serving a unique function in providing detailed information about a company's financial activities. These statements include:

- ***Balance Sheet:*** Captures the financial status of a company at a specific moment. It details the company's assets and how these assets are funded through liabilities and shareholders' equity, representing "permanent" or "stock" accounts.
- ***Income Statement:*** Shows the company's financial performance over a period, bridging two balance sheet dates. Comprising revenues, expenses, gains, and losses, the income statement differs from the balance sheet in that it records transactions over time, hence categorized as a "flow" statement. When prepared under IFRS or US GAAP, it utilizes accrual accounting, which means the reported figures may not directly correspond to cash transactions.
- ***Statement of Cash Flows:*** Outlines the changes in cash and cash equivalents, including restricted cash, from one balance sheet date to the next. It organizes cash movements into operating, investing, and financing activities, presenting a timeline of cash inflows and outflows, thus qualifying as another "flow" statement.
- ***Statement of Shareholders' Equity:*** Details changes in the company's equity between balance sheet periods. It lists key equity components, such as common stock and retained earnings as shown on the balance sheet, alongside descriptions of transactions that affected these components, like share issuance or the results of net income or losses. Similar to the income and cash flow statements, this is also considered a "flow" statement due to its focus on changes over time.

Understanding the linkages among the cash flow statement, income statement, and balance sheet is helpful in assessing a company's financial health and is instrumental in detecting accounting irregularities.

## Linkages between Financial Statements

The balance sheet dates are linked by the income statement, cash flow statement, and the statement of shareholders' equity, as shown below:



For example, the beginning and ending balance sheet amounts of cash and cash equivalents are linked through the cash flow statement. Specifically, the statement of cash flows shows the change in the cash balance during the reporting period, according to the following equation:

*Beginning cash balance + Cash inflows from operating, investing, and financing activities - Cash outflows from operating, investing, and financing activities = Ending cash balance*

An example involving a statement of shareholders' equity involves the retained earnings, as shown below:

*Beginning Retained Earnings (balance sheet item) + Net Income (Income statement item) - Dividends (cash flow item) = Ending Retained Earnings (balance sheet item)*

## **Linkages Between Current and Current Liabilities**

Current assets and current liabilities offer insights into a company's operational choices and activities. Discrepancies between accrual and cash accounting methods in recording these transactions often lead to increases or decreases in these short-term assets or liabilities. For instance, when revenues recognized on an accrual basis exceed actual cash receipts, accounts receivable will increase. Conversely, if expenses recognized accrue faster than cash is disbursed, this will likely result in a reduction in accounts payable or other accrued liabilities.

Furthermore, when a company receives payments in advance for services or products to be delivered in the future, it records the cash as an asset but also acknowledges a liability for the impending delivery, commonly known as deferred revenue. This liability is then removed from the books as revenue is recognized upon fulfilling the delivery obligations.

Additionally, a company's investing activities are generally associated with changes in the long-term assets section of the balance sheet, whereas financing activities typically impact the sections dealing with equity and long-term debt.

Generally, both the income statement and the statement of cash flows play crucial roles in linking the activities reflected in current assets and liabilities with the broader financial picture, demonstrating the interconnectedness of these financial statements in representing a company's fiscal health and operational efficiency.

For instance, the beginning and the ending accounts receivable are connected as follows:

*Beginning Accounts Receivable + Revenue - Cash collected from customers = Ending Accounts*

*Receivable*

## Question

When computing the ending cash balance reported on the balance sheet, which of the following is *most likely* accurate?

- A. Cash receipts are subtracted from the beginning cash balance.
- B. Cash payments are subtracted from the beginning cash balance.
- C. Cash receipts and payments are added to the beginning cash balance.

## Solution

**The correct answer is B.**

Cash payments are subtracted from the beginning cash balance in deriving the ending cash balance.

**A is incorrect.** Cash receipts are added to, not subtracted from, the beginning cash balance.

**C is incorrect.** Cash payments are subtracted from, not added to, the beginning cash balance.

## **LOS 4b: describe the steps in the preparation of direct and indirect cash flow statements, including how cash flows can be computed using income statement and balance sheet data**

The first step in preparing the cash flow statement involves the determination of the total cash flows from operating activities. The cash flow from the operations section of the cash flow statement can be presented using either the direct or indirect method.

The direct method of cash flow presentation details the primary categories of gross cash receipts and cash disbursements, while the indirect method starts with net income and adjusts for non-cash transactions to reconcile to net cash flow from operating activities.

Note that the cash flows associated with investing and financing activities remain the same, regardless of whether the direct or indirect method is used for presenting operating cash flows.

Companies typically report operating cash flow using the indirect method, but understanding the components of this information allows you to deconstruct an indirect cash flow statement and reconstruct it into an approximate direct cash flow statement. Although this reconstructed statement may not be perfectly precise, it provides a useful alternative perspective.

## **Steps in Preparing Cash Flow from Operating Activities**

While discussing the preparation of direct and indirect cash flow statements, we shall use the income statement and comparative balance sheet of a hypothetical tea processing company, Kenya Tea Development Agency (KTDA).

### **Exhibit A: Income Statement**

KTDA Income Statement Year Ended 31 December 2023 (in '000)	
Revenue (net)	\$25,456
Cost of goods sold	\$11,345
Gross profit	\$14,111
Salary and wage expense	\$4,200
Depreciation expense	\$1,100
Other operating expenses	\$3,750
Total operating expenses	\$9,050
Operating profit	\$5,061
Other revenues (expenses):	
Gain on sale of equipment	\$220
Interest expense	(\$250)
Total other revenues (expenses)	(\$30)
Income before tax	\$5,031
Income tax expense	\$1,510
Net income	\$3,521

## Exhibit B: Balance Sheet

KTDA Balance Sheet as of 31 December 2023 and 2022 (in '000)			
Item	2023	2022	Net Change
Cash	\$1,327	\$1,254	\$73
Accounts receivable	1,025	986	39
Inventory	4,025	3,856	169
Prepaid expenses	134	179	(45)
Total current assets	6,411	6,275	136
Land	560	560	0
Buildings	3,800	3,800	0
Equipment	9,000	8,700	300
Less: accumulated depreciation	(3,600)	(3,300)	(300)
Total long-term assets	9,760	9,760	0
Total assets	\$16,171	\$16,035	136
Accounts payable	3,700	3,400	300
Salary and wage payable	90	80	10
Interest payable	65	75	(10)
Income tax payable	60	55	5
Other accrued liabilities	1,150	1,120	30
Total current liabilities	5,065	4,730	335
Long-term debt	3,000	3,500	(500)
Common stock	4,000	4,500	(500)
Retained earnings	4,106	3,305	801
Total liabilities and equity	\$16,171	\$16,035	136

## Operating Activities Under the Direct Method

We begin determining the amount of money received from customers, then cash paid to suppliers and employees, and also cash paid for other operating expenses, income taxes, and interest expenses.

- ***Determination of the Amount of Cash Received from Customers (Cash collections)***

Revenue is adjusted by the net change in accounts receivable during the accounting period. If accounts receivable increase during the period, then the revenue on an accrual basis is higher than cash receipts from customers, and vice versa.

There are two methods of determining cash received from customers. The first method is to adjust revenue by the net change in accounts receivable so that:

$$\text{Revenue} \\ \text{Cash received from customers} = \text{less (plus) increase (decrease)} \\ \text{in accounts receivable}$$

Alternatively, we can use the relationship between the balance sheet and income items as follows:

$$\text{Beginning accounts receivable} + \\ \text{Cash received from customers} = \text{Revenue} \\ \text{Ending accounts receivable}$$

Using the results of the KTDA company, we get the following results (in '000):

Method 1	
Revenue	\$25,456
Less: Increase in accounts receivable	(39)
Cash received from customers	<u>\$25,417</u>

Method 2

Beginning accounts receivable	\$986
Plus: Revenue	25,456
Minus: Ending accounts Receivable	1,025
Cash collected from customers	\$25,417

- **Determining Amount that was Paid to Suppliers**

In identifying purchases from suppliers, the cost of goods sold is adjusted for the change in inventory during the accounting period. If inventory increased during the period, then purchases during the period exceeded the cost of goods sold and vice versa. Once the purchase amount has been determined, the cash paid to suppliers can be calculated by adjusting purchases for the change in accounts payable. If all purchases were made in cash, accounts payable will not change, and the cash outflows will equal purchases. However, if accounts payable increased during the year, then purchases on an accrual basis will be higher than they would ordinarily be on a cash basis, and vice versa.

Mathematically, this can be expressed as:

$$\text{Purchases from suppliers} = \frac{\text{Cost of goods sold less (plus)} \\ \text{decrease (increase) in inventory}}{}$$

Therefore,

$$\text{Cash paid to suppliers} = \frac{\text{Purchases from suppliers less (plus)} \\ \text{increase (decrease) in accounts payable}}{}$$

We can also use the relationship between the balance sheet and income items as follows:

$$\text{Cash paid to suppliers} = \frac{\text{Beginning accounts payable} + \\ \text{Purchases} - \\ \text{Ending accounts receivable}}{}$$

The effect of purchases from supplies on inventory can be seen in the following relationship, which depicts the relationship between balance sheet and income statements:

$$\text{Purchases from supplies} = \frac{\text{Ending inventory} - \text{Beginning inventory}}{\text{Cost of goods sold}}$$

Using the balance sheet and income statement of KTDA, we have the following result:

Cost of goods sold	\$11,345,000
Plus: Increase in inventory	\$169,000
Equals purchases from suppliers	\$11,514,000
Less: Increase in accounts payable	\$300,000
Cash paid to suppliers	<u>\$11,214,000</u>

- **Determining Amount that was Paid to Employees**

In determining the cash paid to employees, salary and wages expense is adjusted by the net change in salary and wages payable for the year. If the salary and wages payable increase during the year, then salary and wages expense on an accrual basis will be higher than the amount of cash paid for this expense, and vice versa.

Mathematically, we can express the amount paid to employees as:

$$\text{Cash paid to employees} = \frac{\text{Salary and wages expense less (plus)}}{\text{increase (decrease) in salary and wages payable}}$$

Alternatively, we can calculate the amount paid to employees as follows:

$$\text{Cash paid to employees} = \frac{\text{Beginning salary and wages payable} +}{\text{Salary and wages expense} -} \\ \text{Ending salary and wages payable}$$

Using the balance sheet and income statements of hypothetical company KTDA, we get the following results:

Salary and wages expense	\$4,200,000
Less: Increase in salary and wages payable	\$10,000
Cash paid to employees	<u>\$4,190,000</u>

- **Determining Amount That was Paid for Other Operating Expenses**

In determining the amount of cash paid for other operating expenses, the other operating expenses amount on the income statement is adjusted by the net changes in prepaid expenses and accrued expense liabilities for the accounting period. If prepaid expenses increase during the period, other operating expenses on a cash basis will be higher than on an accrual basis, and vice versa. If the accrued expense liabilities increase during the period, other operating expenses on a cash basis will be lower than on an accrual basis, and vice versa.

As such, other operating expense is calculated as:

$$\text{Cash paid for other operating expenses} = \begin{array}{l} \text{Other operating expenses} \\ \text{less (plus) decrease (increase)} \\ \text{in prepaid expenses} \\ \text{less (plus) increase (decrease)} \\ \text{in other accrued expenses} \end{array}$$

Using the results of the KTDA company, cash paid for other operating expenses is calculated as follows:

Other operating expenses	\$3,750,000
Plus: Increase in inventory	\$169,000
Less: Increase in other accrued liabilities	\$30,000
Cash paid for other operating expenses	<u>\$3,889,000</u>

- ***Determining the Amount That was Paid for Interest***

In determining cash paid for interest, interest expense must be adjusted by the net change in interest payable for the period. If interest payable increases during the period, then interest expense on an accrual basis will be higher than the amount of cash paid for interest, and vice versa.

Therefore, the amount paid for interest can be expressed as:

$$\text{Cash paid for interest} = \begin{array}{l} \text{Interest expense less (plus)} \\ \text{increase (decrease) in interest payable} \end{array}$$

Alternatively, we can calculate the cash paid of interest as:

$$\text{Cash paid for interest} = \frac{\text{Beginning interest payable} + \text{Interest expense} - \text{Ending interest payable}}{}$$

Using the KTDA's financial statements, cash paid for interest is calculated as:

Interest expense	\$250,000
Plus: Decrease in interest payable	\$10,000
Cash paid for interest	<u>\$260,000</u>

- **Determining Amount that was Paid for Income Taxes**

In determining the cash paid for income taxes, the income tax expense amount on the income statement is adjusted by the net changes in taxes receivable, taxes payable, and deferred income taxes for the period. If taxes receivable or deferred tax assets increase during the accounting period, income taxes on a cash basis will be higher than on an accrual basis, and vice versa. If taxes payable or deferred tax liabilities increase during the period, income tax expense on a cash basis will be lower than on an accrual basis, and vice versa.

As such,

$$\text{Cash paid for income taxes} = \frac{\text{Income tax expense less (plus)} \\ \text{increase (decrease) in income tax payable}}{}$$

KTDA's cash paid for income taxes is calculated as follows:

Income tax expense	\$1,510,000
Less: Increase in income tax payable	\$5,000
Cash paid for income taxes	<u>\$1,505,000</u>

## Operating Activities Under the Indirect Method

Under the indirect method, net income is reconciled with operating cash flow by adjusting net income for:

- **Non-operating activities.** For example, an amount reflecting the sale of equipment would be removed from the operating cash flow section and shown in the investing

section of the cash flow statement;

- **Non-cash expenses.** For example, depreciation expense would be added back to net income because it is a non-cash deduction in the computation of net income and
- **Changes in operating working capital items,** which include increments and decrements in the current operating asset and liability accounts. Changes in these accounts arise from applying accrual accounting and not cash accounting, i.e., recognizing revenue when earned and expenses when incurred instead of when cash is received or paid. An increase in a current operating asset account is subtracted from net income, while a net decrease is added to net income.

A summary of the adjustment to the net income is given in the following table below:

Item	Additions	Subtractions
Non-cash Items		- Amortization of bond premium
Non-Operating Items	<ul style="list-style-type: none"> <li>- Loss on sale or write-down of assets</li> <li>- Loss on investments under equity method</li> <li>- Loss on retirement of debt</li> </ul>	<ul style="list-style-type: none"> <li>- Gain on retirement of debt.</li> <li>- Gain on sale of assets.</li> <li>- Income on investments accounted for under equity method</li> </ul>
Deferred Tax Liability	Increase in deferred income tax liability.	Decrease in deferred income tax liability.
Changes in Working Capital	<ul style="list-style-type: none"> <li>- Decrease in current operating assets such as accounts receivable, inventory and prepaid expenses.</li> <li>- Increase in current operating liabilities such as accounts payable and accrued expense liabilities</li> </ul>	<ul style="list-style-type: none"> <li>- Increase in current operating assets.</li> <li>- Decrease in current operating liabilities</li> </ul>

Returning to KTDA's financial statements, indirect cash flow from operating activities is

calculated as follows:

Cash flow from operating activities:	
Net income	\$3,521,000
Depreciation expense	\$1,100,000
Gain on sale of equipment	\$(220,000)
Increase in accounts receivable	\$(39,000)
Increase in inventory	\$(169,000)
Decrease in prepaid expenses	\$45,000
Increase in accounts payable	\$300,000
Increase in salary and wage payable	\$10,000
Decrease in interest payable	\$(10,000)
Increase in income tax payable	\$5,000
Total adjustments	\$1,022,000
Cash flow from operating activities	<u>\$4,543,000</u>
Increase in other accrued liabilities	\$30,000
Net cash provided by operating activities	<u>\$4,573,000</u>

Recall that the cash flows associated with investing and financing activities remain the same, regardless of whether the direct or indirect method. As such, for the KTDA company, cashflow from investing and financing activities is as follows:

Cash flow from investing activities:	
Cash received from sale of equipment	\$220,000
Cash paid for purchase of equipment	<u>\$(1,000,000)</u>
Net cash used for investing activities	<u>\$(780,000)</u>
Cash flow from financing activities:	
Cash paid to retire long-term debt	\$(500,000)
Cash paid to retire common stock	\$(500,000)
Cash paid for dividends	\$2,720,000
Net cash used for financing activities	<u>\$(3,720,000)</u>
Net Increase in cash	\$73,000
Cash balance, 31 December 2022	\$1,254,000
Cash balance, 31 December 2023	<u>\$1,327,000</u>

## Cash Flow from Investing Activities

Recall that the cash flows associated with investing and financing activities remain the same, regardless of whether the direct or indirect method. Returning to the hypothetical KTDA

company, cashflow from investing is as follows:

<u>Cash flow from investing activities:</u>	
Cash received from sale of equipment	\$220,000
Cash paid for purchase of equipment	<u>\$(500,000)</u>
Net cash used for investing activities	<u>\$(280,000)</u>

In order to determine the cash flow from the sale of equipment, we look into the equipment and the accumulated depreciation accounts, as well as the gain on the sale of equipment. Suppose we assume that all the depreciation is linked to the equipment. In that case, we can calculate cash received from the sale of equipment using historical cost and accumulated depreciation of the equipment sold, as well as the information regarding gain on the sale of equipment from the income statement.

If KTDA made an equipment purchase of USD 500,000 during the period, the historical cost of the equipment sold is calculated as follows:

Beginning balance equipment	\$8,700,000
Plus: equipment purchased	\$500,000
Minus ending balance equipment	<u>(\$9,000,000)</u>
Equals: historical cost of equipment sold	<u>\$200,000</u>

The accumulated depreciation is calculated as follows:

Beginning balance accumulated depreciation	\$3,300,000
Plus depreciation expense	\$1,100,000
Minus ending balance accumulated depreciation	<u>(\$3,600,000)</u>
Equals: Accumulated depreciation on equipment sold	<u>\$200,000</u>

Therefore, the cash received from the sale of equipment is calculated as follows:

Historical cost of equipment sold	\$200,000
Less: Accumulated depreciation on equipment sold	\$200,000
Equals: book value of equipment sold	\$0
Plus: gain on sale of equipment	\$220,000
Equals: cash received from sale of equipment	<u>\$220,000</u>

## Cash Flow from Financing Activities

Like cash flow from investing activities, cash flows associated with financing activities remain the same, regardless of whether the direct or indirect method is used. Returning to the hypothetical KTDA company, cashflow from financing is as follows:

Cash flow from financing activities:	
Cash paid to retire long-term debt	\$(500,000)
Cash paid to retire common stock	\$(500,000)
Cash paid for dividends	\$(2,720,000)
Net cash used for financing activities	<u>\$(3,720,000)</u>
Net Increase in cash	\$73,000
Cash balance, 31 December 2022	\$1,254,000
Cash balance, 31 December 2023	\$1,327,000

Note that the dividends paid is calculated using the following formula:

$$\text{Beginning retained earnings} + \text{Net Income} - \text{Dividends} = \text{Ending Retained Earnings}$$

Based on the above formula, the KTDA's cash paid for dividends is calculated as follows:

Beginning balance of retained earnings	\$3,305,000
Plus: Net income	\$3,521,000
Equals: total before distributions	\$6,826,000
Minus: ending balance of retained earnings	\$4,106,000
Equals: dividends paid	<u>\$2,720,000</u>

## Question

Which of the following steps is *least likely* included in the direct method for preparing cash flows from operations?

- A. Adjusting net income for non-cash expenses.
- B. Determining how much cash was paid for income taxes.
- C. Identifying how much cash was received from customers.

## Solution

**The correct answer is A.**

Adjusting net income for non-cash expenses is one of the indirect methods for preparing cash flows from operations.

Options B and C present steps that are involved in the direct method of calculating cashflows from operating activities.

## **LOS 4c: demonstrate the conversion of cash flows from the indirect to direct method**

Sometimes, a company may prepare the cash flow from the operations section of its cash flow statement using an indirect method. However, users of its financial statements may desire to review the direct-format cash flow from operations. This may arise from the need to review, for example, trends in the cash the company paid to its suppliers and the cash it received from its customers.

It is possible to convert the indirect method to the direct method. The accuracy of this conversion will depend on the accuracy of the adjustments made using data available in published financial reports.

### **Steps in Converting Cash Flows from Indirect Method to Direct Method**

In converting cash flows from the indirect method to the direct method, the following three-step process is applied:

- Net income is disaggregated into total revenues and total expenses;
- Non-operating and non-cash items are removed from aggregated revenues and expense amounts, and the remaining items are broken down into relevant cash flow items and
- Accrual revenues and expenses are converted into cash flow receipts and payments by adjusting for changes in working capital accounts.

### **Example: Demonstrating Conversion from Indirect to Direct Method of Reporting Cash Flow from Operating Activities**

Recall the balance sheet and the income statement of the hypothetical tea processing company, KTDA:

#### **Exhibit A: Income Statement**

KTDA Income Statement Year Ended 31 December 2023 (in '000)	
Revenue (net)	\$25,456
Cost of goods sold	\$11,345
Gross profit	\$14,111
Salary and wage expense	\$4,200
Depreciation expense	\$1,100
Other operating expenses	\$3,750
Total operating expenses	\$9,050
Operating profit	\$5,061
Other revenues (expenses):	
Gain on sale of equipment	\$220
Interest expense	(\$250)
Total other revenues (expenses)	(\$30)
Income before tax	\$5,031
Income tax expense	\$1,510
Net income	\$3,521

## Exhibit B: Balance Sheet

KTDA Balance Sheet as of 31 December 2023 and 2022 (in '000)			
Item	2023	2022	Net Change
Cash	\$1,327	\$1,254	\$73
Accounts receivable	1,025	986	39
Inventory	4,025	3,856	169
Prepaid expenses	134	179	(45)
Total current assets	6,411	6,275	136
Land	560	560	0
Buildings	3,800	3,800	0
Equipment	9,000	8,700	300
Less: accumulated depreciation	(3,600)	(3,300)	(300)
Total long-term assets	9,760	9,760	0
Total assets	\$16,171	\$16,035	136
Accounts payable	3,700	3,400	300
Salary and wage payable	90	80	10
Interest payable	65	75	(10)
Income tax payable	60	55	5
Other accrued liabilities	1,150	1,120	30
Total current liabilities	5,065	4,730	335
Long-term debt	3,000	3,500	(500)
Common stock	4,000	4,500	(500)
Retained earnings	4,106	3,305	801
Total liabilities and equity	\$16,171	\$16,035	136

Also, recall that we prepared the indirect cash flow from the operating activities as follows:

Cash flow from operating activities:	
Net income	\$3,521,000
Depreciation expense	\$1,100,000
Gain on sale of equipment	(\$220,000)
Increase in accounts receivable	(\$39,000)
Increase in inventory	(\$169,000)
Decrease in prepaid expenses	\$45,000
Increase in accounts payable	\$300,000
Increase in salary and wage payable	\$10,000
Decrease in interest payable	(\$10,000)
Increase in income tax payable	\$5,000
Total adjustments	\$1,022,000
<b>Cash flow from operating activities</b>	<b>\$4,543,000</b>
Increase in other accrued liabilities	\$30,000
<b>Net cash provided by operating activities</b>	<b>\$4,573,000</b>

To convert the above cash flows from operating activities from the indirect method to the direct method, we shall follow the three steps outlined above:

### **Step 1: Disaggregated net Income into total revenues and total expenses**

Total Revenue	\$25,676,000
Total Expenses	<u>\$22,155,000</u>
Net Income	<u>\$3,521,000</u>

### **Step 2: Remove all Non-operating and non-cash items from aggregated revenues and expense amounts, and break down the expenses into relevant cash flow items:**

Total Revenue less Non-operating item revenues:	
(25,676,000 – 220,000) =	\$25,456,000
Total Expenses less Noncash item expenses	
(22,155,000 – 1,100,000) =	\$21,055,000
Cost of goods sold	\$11,345,000
Salary and wage expenses	\$4,200,000
Other operating expenses	\$3,750,000
Interest expense	\$250,000
Income tax expense	\$1,510,000
<b>Total</b>	<b>\$21,055,000</b>

**Step 3: Convert Accrual revenues and expenses into cash flow receipts and payments by adjusting for changes in working capital accounts.**

This step was dealt with in the previous LOS. So here are the cash flow receipts and payments as previously calculated:

Cash paid from customers	\$25,417,000
Cash paid to suppliers	\$11,214,000
Cash Paid to Employees	\$4,190,000
Cash paid for other operating expenses	\$3,889,000
Cash paid for income tax	\$1,505,000
Cash paid for interest	\$260,000
<u>Net Cash provided by operating activities</u>	<u>\$4,573,000</u>

## Question

Which of the following is *most likely* the starting point for converting cash flows from operating activities from indirect to direct?

- A. Net income.
- B. Cash flow from operations.
- C. Cash received from customers.

## Solution

**The correct answer is A.**

The first step in the three-step process for converting cash flows from the indirect method to the direct method is the disaggregation of net income into total revenues and expenses.

## **LOS 4d: contrast cash flow statements prepared under International Financial Reporting Standards (IFRS) and US generally accepted accounting principles (US GAAP)**

The most significant difference is that IFRS gives companies more flexibility regarding how interest is paid or received, how dividends paid or received are reported, and how income tax expense is classified. Despite the flexibility provided by IFRS, companies must use a consistent classification each year. Besides, they must separately disclose the amounts of interest and dividends received and paid and where the amounts are reported.

### **IFRS vs. US GAAP Cash Flow Statements**

The elements below summarize the significant differences between how the cash flow statement is prepared under IFRS and US GAAP.

#### **IFRS Requirements**

- Interest received may be classified either as an operating activity or an investing activity.
- Interest paid may be classified as an operating or financing activity.
- Dividends received may be classified either as an operating activity or an investing activity.
- Dividends paid may be classified as an operating or financing activity.
- Income tax expense is generally classified as an operating activity. Despite this, a portion of it may be allocated for investing in or financing activities if specifically related to those activities.
- Bank overdrafts are classified as part of cash and cash equivalents.<sup>1</sup>
- The direct or indirect method may be used to report cash flow from operating

activities. However, of the two, the direct method is generally encouraged.

## **US GAAP Requirements**

- Interest received must be classified as an operating activity.
- Interest paid must be classified as an operating activity.
- Dividends received must be classified as an operating activity.
- Dividends paid must be classified as a financing activity.
- Income tax expense must be classified as an operating activity.
- Bank overdrafts are not considered part of cash and cash equivalents. Instead, they are classified as financing activities.
- Either the direct or indirect method may be used for reporting cash flow from operating activities. It is noteworthy, though, that the direct method is encouraged. However, unlike under IFRS, a reconciliation of net income to cash flow from operating activities must be provided regardless of the method used.

A summary of the above differences is summarized in the following table:

Item	IFRS	US GAAP
Interest received	Either an operating or investing activity	Operating activity
Interest paid	Either an operating or financing activity	Operating activity
Dividends received	Either an operating or investing activity	Operating activity
Dividends paid	Either an operating or financing activity	Financing activity
Income tax	Generally an operating activity, but a portion is allocated to investing or financing activities if it is specifically identifiable with those activities	Operating activity
Bank overdrafts	Part of "cash and cash equivalents"	Financing activity
Reporting method	<ul style="list-style-type: none"> <li>-Either direct or indirect method may be used for reporting cash flow from operating activities.</li> <li>-Although the direct method is encouraged.</li> </ul>	<ul style="list-style-type: none"> <li>-Either direct or indirect method may be used for reporting cash flow from operating activities.</li> <li>-Although the direct method is encouraged.</li> <li>-Unlike under IFRS, however, a reconciliation of net income to cash flow from operating activities must be provided regardless of the method used.</li> </ul>

## Question #1

Which of the following statements is inaccurate?

- A. Under IFRS, dividends paid may be classified as an operating or financing activity, while under US GAAP, it can only be reported as a financing activity.
- B. Under IFRS, interest paid may be classified as an operating or financing activity, while under US GAAP, it can only be reported as a financing activity.
- C. Under IFRS, dividends received may be classified as an operating or an investing activity, while under US GAAP, it can only be reported as an operating activity.

### Solution

**The correct answer is B.**

Under IFRS, interest paid may be classified as an operating or financing activity. However, under US GAAP, it can only be reported as an operating activity, not a financing activity.

Options A and C give accurate statements.

## Question #2

A company paid \$500,000 as dividends during the year. How would that company classify this payment on the cash flow statement under IFRS and US GAAP?

- A. It would be classified as a financing cash outflow under both accounting standards.
- B. Under IFRS, it would be classified as an operating or as a financing cash flow. Under US GAAP, it would be classified as a financing cash flow.
- C. Under IFRS, it would be classified as an operating or as a financing cash flow. Under US GAAP, it would be classified as an operating cash flow.

## **Solution**

**The correct answer is B.**

Activity: Dividends paid

IFRS Classification: Operating/Financing

US-GAAP Classification: Financing