

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