

# Statement of Cash Flows

## Chapter 13



# Objective 1

Classify cash flows as operating, investing,  
or financing activities



# Financial Statement

- Income statement
- Balance sheet
- Statement of stockholders' equity
- Statement of cash flows

# Statement of Cash Flows

- Shows overall increases or decreases in cash during the period.
- Shows how the company *generated* and *used* cash during the period.
- Helps stakeholders evaluate cash generation and usage.
- Helps managers determine if sufficient cash is available.

# Cash and Cash Equivalents

- Cash generally includes
  - Petty cash
  - Checking accounts
  - Savings accounts
- Also includes very safe, highly liquid assets that are readily convertible into cash
  - Money market funds
  - Certificates of deposit maturing in less than three months
  - U.S. treasury bills

# Cash Generating Activities

- The statement of cash flows classifies all business transactions into three different types of activities
  - Operating activities
    - Day-to-day profit-making activities
  - Investing activities
    - Involves buying or selling long-term assets
  - Financing activities
    - Generate capital for the company or pay it back

# Exhibit 13-2: Operating Activities

## Common Sources and Uses

### Operating Activities

(Cash flows related to the primary, day-to-day profit-making activities of the company; these activities affect net income, current assets, and current liabilities)

- Cash received from sale of services or merchandise
- *Cash received from interest income*
- *Cash received from dividend income*
- Cash paid to purchase inventory
- Cash paid for selling, general, and administrative expenses
- *Cash paid for interest expense*
- Cash paid for income taxes

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#### *Non-cash adjustments to net income (indirect method):*

- Depreciation and amortization expense
- Gain or loss on sale of property, plant, or equipment

# Exhibit 13-2: Investing Activities

## Common Sources and Uses

### Investing Activities

(Cash flows related to buying and selling investments; these activities affect long-term assets)

- Cash received from sale of property, plant, or equipment
- Cash received from collection of long-term loans
- Cash received from sale of long-term equity (stock) investments
- Cash paid to purchase property, plant, or equipment
- Cash paid for purchasing long-term equity (stock) investments



# Exhibit 13-2: Financing Activities

## Common Sources and Uses

### Financing Activities

(Cash flows related to generating and repaying capital; these activities affect long-term liabilities and stockholders' equity accounts)

- Cash received from issuing long-term debt (such as notes and bonds)
- Cash received from issuing stock
- Cash received from using a line of credit
- Cash used to pay back long-term debt
- *Cash used to pay dividends*
- Cash used to buy back company stock (treasury stock)

# Difficult Items to Remember

- **Interest income and dividend income:** Both classified as cash flows from operating activities because they affect (increase) net income.
- **Interest expense:** Classified as an operating activity because it affects (decreases) net income.
- **Certain revenues and expenses (depreciation and amortization and gain or loss on sale of property, plant, and equipment):** Classified as an operating activities as they affect net income, yet do not generate or use cash.
- **Payment of dividends:** Classified as a financing activity.

# Noncash Investing and Financing Activities

- Investing or financing activities not involving cash

Example:

- Purchase property, plant, or equipment by issuing common stock
- Bonds or notes payable may be extinguished by converting them to common stock

# Operating Activities:

## Two Methods of Presenting

- Direct method: Lists the receipt and payment of cash for specific operating activities
  - Cash receipts from customers
  - Cash payments (to suppliers) for inventory
  - Cash payments (to employees) for salaries and wages
  - Cash payments for insurance
- Indirect method: Begins with the company's net income and is reconciled back to the cash basis
  - Adjusts for:
    - noncash revenues (such as gains on sale) or expenses (such as depreciation).
    - changes in the current asset and current liability accounts.

# Objective 2

Prepare the statement of cash flows using the indirect method



# Statement of Cash Flows— Indirect Method

- Begin with Net Income
- Adjust for:
  - Noncash expenses and revenues
    - Depreciation, amortization, depletion, gains, and losses
  - Changes in the current asset accounts
  - Changes in the current liability accounts

General Rule	Increase	Decrease
Current Assets	-	+
Current Liabilities	+	-

# Changes in current asset accounts

- Account Receivable: An **increase** in AR indicates that more sales were made than were collected.
- Prepaid Insurance: An **increase** in prepaid insurance indicates that the company paid more for insurance than was recorded as insurance expense.
- Inventory: The **increase** in inventory indicates that the company sold less merchandise inventory than it purchased.
- All the above cases, NI should be **subtracted**.

# Changes in current liability accounts

- Interest Payable: A **decrease** in interest payable indicates that the company paid out more than it expensed for interest expense during the year.
- Wages Payable: A **decrease** in wage payable indicates that company paid out more than it expensed for wage expense during the year.
- All the above cases, NI should be **subtracted**.



# Exhibit 13-12: Interpreting Cash Flows

	A	B	C
1	SportsTime, Inc.		
2	Statement of Cash Flows—Operating Activities Section (Indirect Method)		
3	For the Year Ended December 31, 2014		
4			
5	<b>Operating Activities:</b>		
6	Net income		\$ 937,300
7	Adjustments to reconcile net income to cash basis:		
8	Depreciation expense	\$ 142,000	
9	Gain on sale of equipment	(1,000)	
10	Increase in accounts receivable	(35,000)	
11	Decrease in inventory	25,000	
12	Increase in prepaid insurance	(5,000)	
13	Decrease in accounts payable	(40,000)	
14	Increase in wages payable	8,500	
15	Decrease in interest payable	(5,000)	
16	Increase in income taxes payable	26,700	
17	Decrease in other accrued expenses payable	(13,000)	
18	Total reconciling adjustments		103,200
19	Net cash provided by operating activities		1,040,500
20			

# Cash Flows from Investing Activities

- Look for changes in three long-term asset accounts
  - Property, Plant, and Equipment
  - Accumulated depreciation (a contra asset to Property, Plant, and Equipment)
  - Investments
- Compute changes to find cash sources and uses

Beginning Long-term assets + **Purchases** – Assets sold =  
Ending Long-term assets

# Cash Flows from Financing Activities

- Look for changes in the company's long-term liabilities, common stock, and retained earnings accounts
  - Bonds, mortgages, notes payable
    - Any change in long-term liabilities can be explained by new borrowings or the repayment of principal on existing debt
  - Preferred and common stock
  - Dividends payable
  - Treasury stock
  - Retained earnings

**Beg. Balance + Issuances – Repayments = Ending balance**

**Beg. Balance, RE + NI - Dividends declared = Ending balance, RE**

# Exhibit 13-14: Interpreting the Statement of Cash Flows

21	<b>Investing Activities:</b>		
22	Cash used to purchase property, plant, and equipment	\$ (540,000)	
23	Proceeds from the sale of equipment	3,000	
24	Cash used to purchase investments in stock	(100,000)	
25	Net cash used by investing activities		(637,000)
26			
27	<b>Financing Activities:</b>		
28	Proceeds from bond issuance	\$ 100,000	
29	Repayment of long-term debt	(300,000)	
30	Cash payments for dividends	(125,000)	
31	Net cash used by financing activities		(325,000)
32	Net increase in cash		78,500
33	Cash, beginning of the year		125,000
34	Cash, end of the year		\$ 203,500
35			

# Free Cash Flow

- The amount of excess cash a business generates after taking into consideration the capital expenditures necessary to maintain its business
  - Used for:
    - Expansion
    - Pay Dividends
    - Pay down debt
    - Any other business purpose

Cash flow from operating activities

– Capital expenditures

= Free cash flow

# Steps for Using the Indirect Method

- Step 1. Begin the operating section with the company's net income and add back any noncash expenses (such as depreciation or losses on the sale of property, plant, and equipment) and subtract any noncash revenues (such as gains on the sale of property, plant, or equipment). This information is found on the company's income statement.
- Step 2. Adjust net income for all changes in current asset and current liability accounts (other than the Cash account) that are found on the company's comparative balance sheet:
- Add back decreases in current asset accounts and increases in current liability accounts.
  - Subtract increases in current asset accounts and decreases in current liability accounts.
- Step 3. Prepare the investing section by analyzing the changes in all long-term asset accounts found on the company's comparative balance sheet. Separately list all cash transactions that took place during the year affecting these accounts (such as buying and selling property). Any gains or losses on sales, depreciation, or amortization of these assets has already been accounted for in the operating section.
- Step 4. Prepare the financing section by analyzing the changes in all long-term liability and equity accounts found on the company's comparative balance sheet. Separately list all cash transactions that took place during the year affecting these accounts (such as issuing new debt or paying down existing debt, selling stock, buying treasury stock, or paying dividends).
- Step 5. Present a subtotal of the amount of cash provided or used by each of the three types of activities (operating, investing, and financing). Use the subtotals to find the overall increase or decrease in cash during the year. Then add the increase to (or subtract the decrease from) the company's beginning cash balance to arrive at the ending cash balance shown on the company's balance sheet.

# Now turn to S13-3

Merriweather Corporation began the year with accounts receivable, inventory, and prepaid expenses totaling \$69,000. At the end of the year, Merriweather had a total of \$78,000 for these current assets. At the beginning of the year, it owed current liabilities of \$43,000, and at year-end, current liabilities totaled \$38,000.

Net income for the year was \$86,000. Included in net income was a \$3,000 gain on the sale of land and depreciation expense of \$10,000.

Show how Merriweather should report cash flows from operating activities for the year. The company uses the indirect method.

# S13-3

Operating Activities		
Net income		\$ 86,000
Adjustments to reconcile net income to cash basis:		
Depreciation expense	\$10,000	
Gain on sale of land	(3,000)	
Increase in current assets	(9,000)	
Decrease in current liabilities	<u>(5,000)</u>	<u>(7,000)</u>
Net cash provided by operating activities		\$79,000



# Now turn to S13-5

Sherman Company reported the following financial statements for 2013 and 2014:

	A	B	C
1	<b>Sherman Company</b>		
2	<b>Income Statement</b>		
3	<b>For the Year Ended December 31, 2014</b>		
4			
5	Sales revenues		\$ 4,750,000
6	Less: Cost of goods sold		2,880,000
7	Gross profit		1,870,000
8	Less operating expenses:		
9	Salaries and wages expense	\$ 320,000	
10	Insurance expense	12,000	
11	Depreciation expense	77,000	
12	Other operating expenses	120,000	
13	Total operating expenses		529,000
14	Operating income		\$ 1,341,000
15	Plus other income and less other expenses:		
16	Interest expense	6,100	
17	Other income and expenses	0	
18	Total other income and expenses		6,100
19	Income before income taxes		\$ 1,334,900
20	Less: Income tax expense		403,000
21	Net income		\$ 931,900
22			

Compute the following investing cash flows:

- Purchases of plant assets (all were for cash). There were no sales of plant assets.
- Proceeds from the sale of investments. There were no purchases of investments.

# S13-5 (cont.)

	A	B	C
1	<b>Sherman Company</b>		
2	<b>Comparative Balance Sheets</b>		
3	<b>December 31, 2014 and 2013</b>		
4	<b>Assets</b>	<b>2014</b>	<b>2013</b>
5	Current assets:		
6	Cash	\$ 589,000	\$ 464,000
7	Accounts receivable	73,000	17,000
8	Inventory	960,000	200,000
9	Prepaid insurance	4,800	4,800
10	Total current assets	\$ 1,626,800	\$ 685,800
11			
12	Property, plant, and equipment	\$ 1,230,000	\$ 1,180,000
13	Less: Accumulated depreciation	(286,000)	(209,000)
14	Investments	42,000	62,000
15	Total assets	\$ 2,612,800	\$ 1,718,800
16			
17	<b>Liabilities</b>		
18	Current liabilities:		
19	Accounts payable	\$ 21,000	\$ 44,000
20	Wages payable	17,000	19,000
21	Interest payable	2,700	5,300
22	Income taxes payable	275,080	38,000
23	Other accrued expenses payable	21,000	14,000
24	Total current liabilities	\$ 336,780	\$ 120,300
25			
26	Long-term liabilities	65,000	80,000
27	Total liabilities	\$ 401,780	\$ 200,300
28			
29	<b>Stockholders' equity</b>		
30	Common stock	\$ 721,000	\$ 778,000
31	Retained earnings	1,490,020	740,500
32	Total stockholders' equity	\$ 2,211,020	\$ 1,518,500
33			
34	Total liabilities and equity	\$ 2,612,800	\$ 1,718,800
35			

# S13-5

	Beginning PP&E	\$ 1,180,000
+	Purchases of PP&E	\$ 50,000
–	<u>PPE sold</u>	<u>\$ 0</u>
=	Ending PP&E	\$ 1,230,000

	Beginning Investments	\$ 62,000
+	Purchases of Investments	\$ 0
–	<u>Investments sold</u>	<u>\$ 20,000</u>
=	Ending Investments	\$ 42,000

# S13-6

Use the data given in Short Exercise 13-5 for the Sherman Company to compute the following financing cash flows:

- a. New borrowing or payment of long-term notes payable. Sherman Company had only one long-term note payable transaction during the year.
- b. Issuance of common stock or retirement of common stock. The company had only one common stock transaction during the year.
- c. Payment of cash dividends (same as dividends declared).

a)

Beginning balance, Long-term liabilities	\$ 80,000
Plus: Cash proceeds from new debt issuance	\$ -0-
Less: Repayment of principal on existing debt	<u>\$ 15,000</u>
End balance, Long-term liabilities	\$ 65,000

# S13-6 (cont.)

b)

Beginning balance, Common Stock	\$ 778,000
Plus: Sale of common stock	\$ -0-
Less: Repurchase of common stock	<u>\$ 57,000</u>
Ending balance, Common Stock	\$ 721,000

c)

Beginning balance, Retained earnings	\$ 740,500
Plus: Net income	\$ 931,900
Less: Dividends declared during the year	<u>\$ 182,380</u>
Ending balance, Retained earnings	\$ 1,490,020

## S13-6 (cont.)

Financing Activities:		
Repayment of debt principal	\$ (15,000)	
Repurchase of common stock	\$ (57,000)	
Cash payments for dividends	\$ (182,380)	
Net cash used by investing activities		\$ (254,380)

# Objective 3

Prepare the statement of cash flows using the direct method



# Exhibit 13-16: Statement of Cash Flows

## Prepared Using the Direct Method

- Lists the receipt and payment of cash for specific operating activities
  - Cash receipts from customers
  - Cash payments (to suppliers) for purchase of inventory
  - Cash payments (to employees) for salaries and wages

5	Operating Activities:	Ref.*		
6	Cash receipts from customers	(1)	\$ 9,465,000	
7	Cash payments for inventory	(2)	(7,140,000)	
8	Cash payments for insurance	(3)	(30,000)	
9	Cash payments for salaries and wages	(4)	(571,500)	
10	Cash payments for interest expense	(5)	(65,000)	
11	Cash payments for income taxes	(6)	(375,000)	
12	Cash payments for other operating expenses	(7)	(243,000)	
13	Net cash provided by operating activities			1,040,500



# Determining Cash Receipts and Payments

- Analyze *every* current asset and current liability account
- Incorporate related information from the income statement

## Cash received from customers:

Beginning balance, Accounts receivable (from balance sheet)

+ Sales revenue (from income statement)

- **Cash collections of accounts receivable**

Ending balance, Accounts receivable (from balance sheet)

# Determining Cash Receipts and Payments

## Cash payments for inventory

Beginning balance, Inventory (from balance sheet)

Plus: **Purchases of inventory** (by cash or credit)

Less: Cost of goods sold (from income statement)

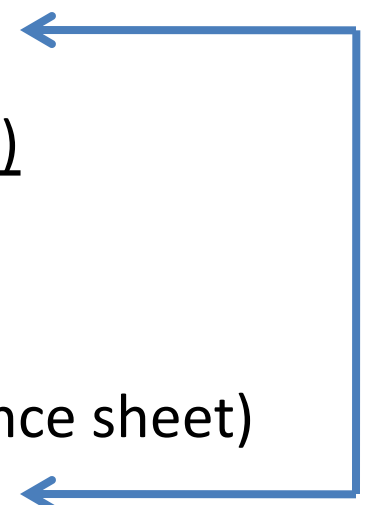
Ending balance, Inventory (from balance sheet)

Beginning balance, Accounts payable (from balance sheet)

Plus: Purchases of inventory

Less: **Cash payments for inventory**

Ending balance, Accounts payable (from balance sheet)



# Determining Cash Receipts and Payments

## Cash payments for insurance

Beginning balance, prepaid insurance (balance sheet)

Plus: **Payments for insurance**

Less: Insurance expense (income statement)

Ending balance, prepaid insurance (balance sheet)

# Determining Cash Receipts and Payments

## Cash payments for salaries and wages

Beginning balance, wages payable (balance sheet)

Plus: Salaries and wages expense (income statement)

Less: **Payments for salaries and wages**

Ending balance, wages payable (balance sheet)

# Determining Cash Receipts and Payments

Cash payments for interest expense

Beginning balance, interest payable (balance sheet)

Plus: Interest expense (income statement)

Less: **Payments for interest**

Ending balance, interest payable (balance sheet)

# Determining Cash Receipts and Payments

## Cash payments for income taxes

Beginning balance, Income taxes payable (balance sheet)

Plus: Income tax expense (income statement)

Less: **Payments for income taxes**

Ending balance, income taxes payable (balance sheet)

# Determining Cash Receipts and Payments

## Cash payments for other operating expenses

Beginning balance, Other accrued expenses payable (balance sheet)

Plus: Other operating expenses (income statement)

Less: **Payments for other operating expenses**

Ending balance, Other accrued expenses payable (balance sheet)

# Now turn to E13-18A

Medway Spas provides the following data for the year just ended December 31.

Payment of note payable .....	\$ 6,000	Payments to employees .....	\$ 62,000
Depreciation expense .....	\$ 4,700	Proceeds from sale of land.....	\$ 42,500
Purchase of equipment .....	\$ 9,000	Payment of dividends.....	\$ 13,500
Purchase of treasury stock .....	\$ 11,000	Payments to suppliers .....	\$ 64,000
Gain on sale of land .....	\$ 1,500	Increase in salaries payable .....	\$ 11,500
Cost of goods sold.....	\$110,000	Payment of income tax .....	\$ 8,000
Proceeds from issuance of common stock....	\$ 13,000	Collections from customers.....	\$148,000
Beginning balance, cash .....	\$ 12,000	Sales revenue .....	\$170,000

## Requirement

Prepare the operating activities section of Medway Spas' statement of cash flows for the year just ended, using the direct method for operating cash flows.



# E13-18A

Operating Activities:		
Cash receipts from customers	\$ 148,000	
Payments to suppliers	(64,000)	
Payments to employees	(62,000)	
Payment of income tax	<u>(8,000)</u>	
Net cash provided by operating activities		\$ 14,000
Investing Activities:		
Proceeds from sale of land	\$ 42,500	
<i>Purchase of equipment</i>	<u>(9,000)</u>	
Net cash provided by investing activities		33,500
Financing Activities:		
<i>Payment of note payable</i>	(6,000)	
<i>Purchase of treasury stock</i>	(11,000)	
<i>Proceeds from sale of common stock</i>	13,000	
Payment of dividends	(13,500)	
Net cash used by financing activities		<u>(17,500)</u>

# E13-18A (cont.)

Net cash used by financing activities		<u>(17,500)</u>
Net increase in cash		30,000
Cash, beginning of the year		<u>12,000</u>
Cash, end of the year		<u>42,000</u>

# End of Chapter 13





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