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| Chapter 12 Outline – REPORTING CASH FLOWS |
| **I. Basics of Cash Flow Reporting** |
| A. Purpose of the Statement of Cash Flows Reports cash receipts (inflows) and cash payments (outflows) for a period. This report classifies cash flows into operating, investing, and financing activities. It answers important questions such as: |
| 1. How does a company obtain its cash?  2. Where does a company spend its cash?  3. What explains the change in the cash balance?  4. Why do income and cash flows differ? |
| B. Importance of Cash Flows Information about cash flows influences decisions. It helps users decide whether a company has enough cash to pay debts, evaluate a company’s ability to pursue unexpected opportunities, and helps managers plan day-to-day operations and make long-term investment decisions. |
| C. Measurement of Cash Flows The phrase cash flows refers to both *cash* and *cash equivalents*. A *cash equivalent* must satisfy two criteria: |
| 1. Be readily convertible to a known amount of cash.  2. Be sufficiently close to its maturity date so its market value is unaffected by interest rate changes. |
| D. Classification of Cash Flows Cash receipts and cash payments are classified and reported in one of three categories: |
| 1. Operating Activities—include transactions and events that affect net income (with some exceptions such as unusual gains and losses). Specific examples: |
| a. Cash inflows from cash sales, collections on credit sales, receipts of dividend and interest revenue.  b. Cash outflows for payments to suppliers for goods and services, to employees for salaries and wages, for interest owed, to pay taxes and fines, and to pay operating expenses. |
| 2. Investing Activities—include transactions and events that come from the purchase or sale of long-term assets. Specific examples: |
| a. Cash inflows from selling intangible assets, selling plant assets, collecting principal on notes receivable, selling long-term and short-term investments, and selling notes receivable.  b. Cash outflows to buy intangible assets, buy plant assets, loan money in return for notes receivable, and to buy short-term and long-term investments. |
| 3. Financing Activities—include transactions and events that affect long-term liabilities and equity: |
| a. Cash inflows from issuing short-term and long-term debt (notes payable and bonds payable), from issuing common and preferred stock, reissuing its treasure stock, and from contributions by owners.  b. Cash outflows to pay dividends to shareholders, purchase treasury stock, pay withdrawals by owners, and to pay off its short-term and long-term debt (notes payable and bonds payable).  4. Link between Classification of Cash Flows and the Balance Sheet |
| E. Noncash Investing and Financing  Activities that do not affect cash flows include retirement of debt by issuing equity stock; conversion of preferred stock to common stock; lease of assets in a capital lease transaction;  purchase of long-term assets by issuing a note or bond; exchange of noncash assets for other noncash assets; and purchase of noncash assets by issuing equity or debt. |
| F. Format of the Statement of Cash Flows |
| 1. Lists cash flows by categories (operating, financing and investing) and identifies the net cash inflow or outflow in each category.  2. Combines the net cash flow in each of the three categories and identifies the net change in cash for the period.  3. Combines the net change in cash with the prior period ending cash to prove the current period ending cash.  4. Contains a separate schedule or note disclosure of any noncash financing and investing activities. |
| G. Preparing the Statement of Cash Flows |
| 1. There are five steps in preparing a statement of cash flows:   1. Compute the net increase or decrease in cash (bottom line or target number). 2. Compute and report net cash provided (used) by operating activities. 3. Compute and report net cash provided (used) by investing activities. 4. Compute and report net cash provided (used) by financing activities. 5. Compute net cash flow from all sources, and then *prove it* by adding it to the beginning cash balance to show that it equals the ending cash balance. |
| **Note: Noncash investing and financing activities are disclosed in either a note or in a separate schedule to the statement.** |
| 2. Sources of information for preparing the statement of cash flows: |
| a. Comparative balance sheets  b. The current income statement  c. Additional information |
| 3. Alternative approaches to preparing the statement: |
| 1. Analyzing the cash account 2. Analyzing noncash accounts   4. Information to prepare the statement |
| **II. Cash Flows from Operating** |
| A. Indirect and Direct Methods of Reporting—Two ways of reporting that apply *only* to the operating activities section.   1. Direct Method—separately lists operating cash receipts and operating cash payments. Cash payments are then subtracted from cash receipts. 2. Indirect Method—reports net income and then adjusts it for items that do not affect cash. It does not report individual items of cash inflows and cash outflows from operating activities. 3. Note that the net cash provided (used) by operating activities is *identical* under both the direct and indirect method. |
| B. Applying the Indirect Method |
| 1. Reports net income using accrual accounting, and then adjusts net income to get net cash provided or used by operating activities. |
| 2. The types of adjustments are: |
| 1. Adjustments to income statement items that do not impact cash. Includes:    1. Depreciation expense, loss on sale of plant assets, and gain on retirement of notes. 2. Adjustments for changes in current assets and current liabilities (linked to operating activities).    1. Changes in accounts receivable, inventory, prepaid expenses, accounts payable, interest payable, and income taxes payable.    2. Increases in noncash current assets are subtracted from net income.    3. Increases in current liabilities are added to net income.    4. Decreases in current liabilities are subtracted from net income |
| C. Summary Adjustments for Indirect method—see Exhibit 12.12 in text. |
| **III. Cash Flows from Investing—***identical under direct and indirect methods.*  A.Three-Step Analysis—process to determine cash provided (used) by investing activities: |
| 1. Identify changes in investing-related accounts (all noncurrent assets, and the current accounts for both notes receivable and investments in securities—excluding trading securities). 2. Determine the cash effects using T-accounts and reconstructed entries. 3. Report the cash flow effects. 4. Analyzing Noncurrent Assets |
| **IV. Cash Flows from Financing**— *identical under direct and indirect methods.*  A.Three-Step Analysis—process to determine cash provided (used) by financing activities: |
| 1. Identify changes in financing-related accounts (all noncurrent liabilities—including current portion of any notes and bonds, and the equity accounts). 2. Determine the cash effects using T-accounts and reconstructed entries. 3. Report the cash flow effects. |
| B. Analyzing Noncurrent Liabilities  C. Analyzing Equity  D. Proving Cash Balances  Last step in preparing the statement is to report the beginning and ending cash balances and provide that the net change in cash is explained by operating, investing and financing cash flows. Exhibit 12.13 in text.   |  | | --- | | **V. Decision Analysis—Cash Flow Analysis** | | A. Analyzing Cash Sources and Uses  1. Managers review cash flows for business decisions.  2. Creditor evaluate a company’s ability to generate enough cash flow to pay debt.  3. Investors assess cash flows before buying and selling stock. | | B. Cash Flow on Total Assets | | 1. Measures actual cash flows and is not affected by accounting recognition and measurement. 2. Can help estimate the amount and timing of cash flows from operating activities.   3. Computed by dividing cash flow from operations by average total assets. |   **VI. Spreadsheet Preparation of the Statement of Cash Flows (Appendix 12A)**  A spreadsheet approach may be used to help us prepare a statement of cash flows.  A. The spreadsheet has four columns containing dollar amounts. |
| 1. Columns one and four contain the beginning and ending balances of each balance sheet account. 2. Columns two and three are for reconciling the changes in each balance sheet account. |
| B. Separate sections on the working paper present (a) balance sheet items with debit balances; (b) balance sheet items with credit balances; (c) cash flows from operating activities, starting with net income; (d) cash flows from investing activities; (e) cash flows from financing activities; and (f) noncash investing and financing activities.  C. Information for sections (c)-(f) is developed in four steps in the Analysis of Changes columns: |
| 1. By adjusting net income for the changes in all noncash current asset and current liability account balances. This reconciles the changes in these accounts.  2. By eliminating from net income the effects of all noncash revenues and expenses. This begins the reconciliation of noncurrent assets.   1. By eliminating from net income any gains or losses from investing and financing activities. This involves the reconciliation of noncurrent assets and noncurrent liabilities and perhaps the recording of disclosures in sections (c)-(g). 2. By entering any remaining items, such as dividend payments, which are necessary to reconcile the changes in all balance sheet accounts.   **VII. Direct Method of Reporting Operating Cash Flows**  **(Appendix 12B)**  A. Separately list each major item or class of operating cash receipts and cash payments.  B. Classes of operating cash receipts include cash received from customers, renters, interest, and dividends.  C. Classes of operating cash payments include cash paid to suppliers, to employees and other operating expense, interest, and income taxes.  D. Subtract the cash payments from cash receipts to determine the net cash provided (used) by operating activities.  E. The items to be listed are determined by adjusting individual accrual basis income statement items to cash basis items. This is done by determining the impact from changes in their related balance sheet accounts.  F. Exhibit 12B.6 summarizes the common adjustments for the items making up net income to arrive at net cash provided (used) by operating activities under the direct method.  G. This is the method recommended (but not required) by the FASB. |
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