

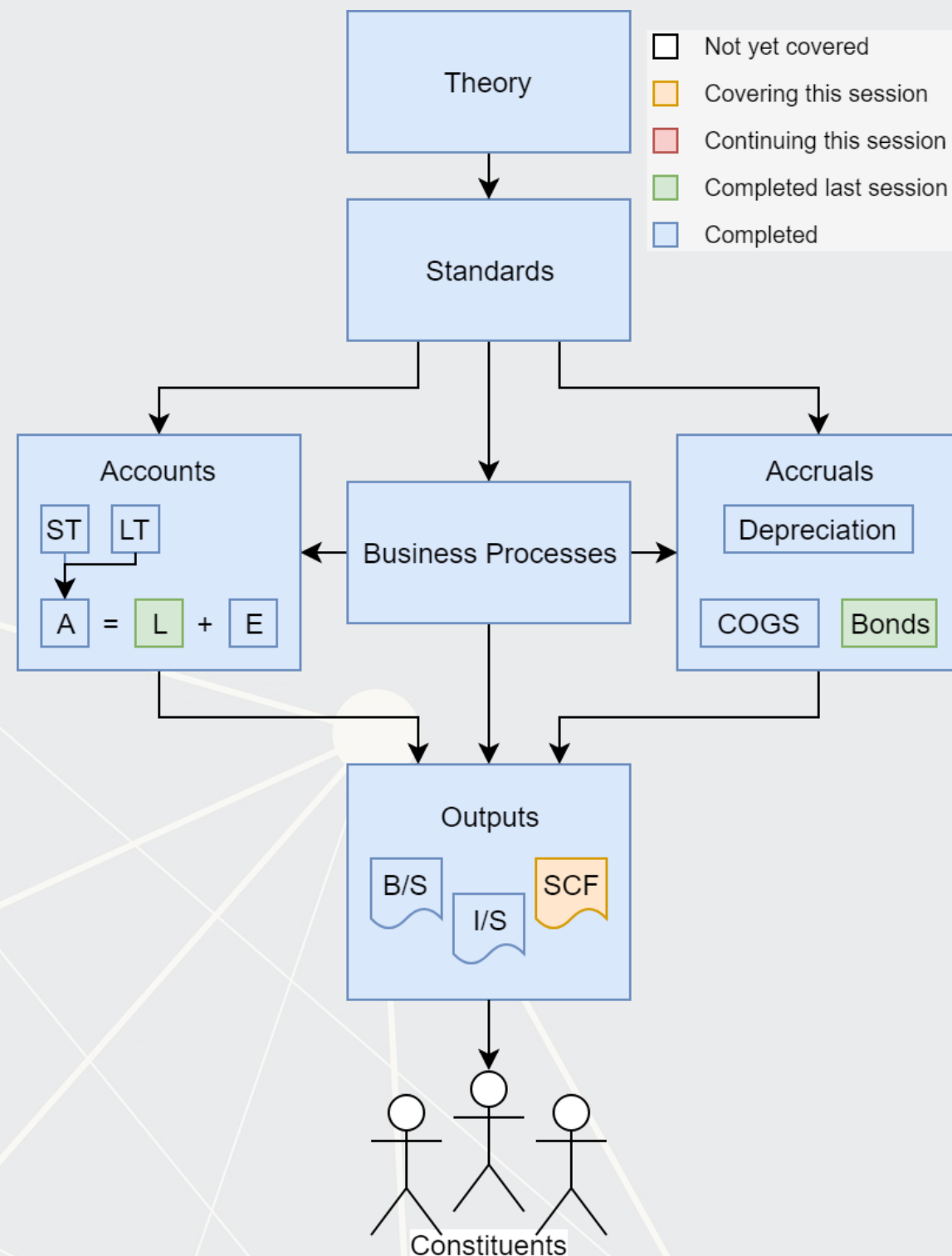
ACCT 101: Cash Flows

Session 9

Dr. Richard M. Crowley

Frontmatter

Learning objectives



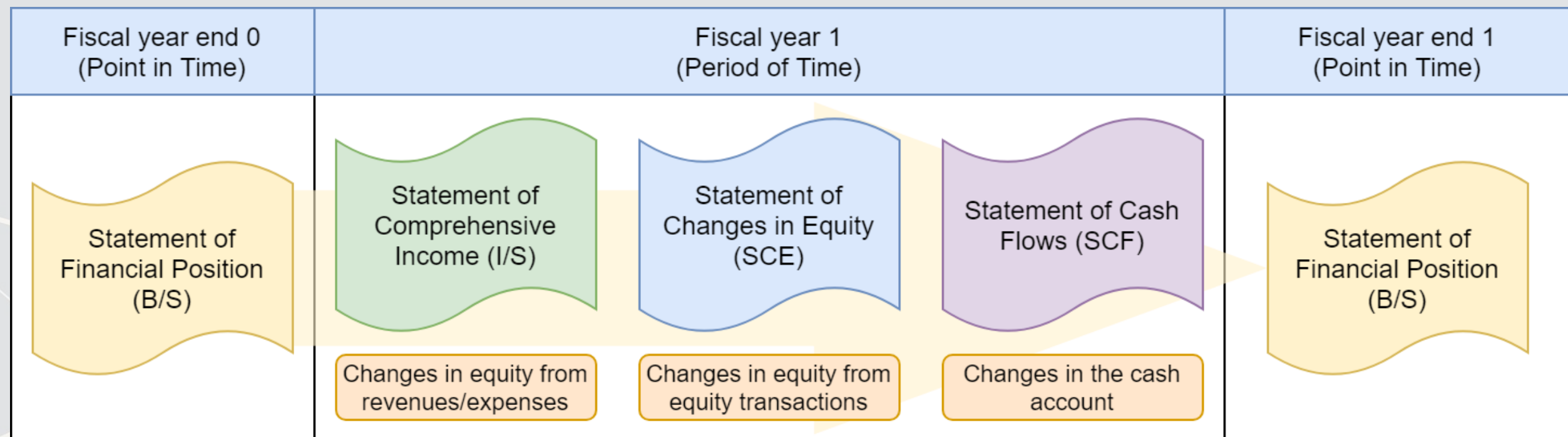
Cash Flows

1. Understand why we have a Statement of Cash Flows
2. Identify cash flows from:
 - Operations
 - Investing
 - Financing
3. Identify significant non-cash activities
4. Apply the *indirect method*

Statement of Cash Flows

What is the SCF?

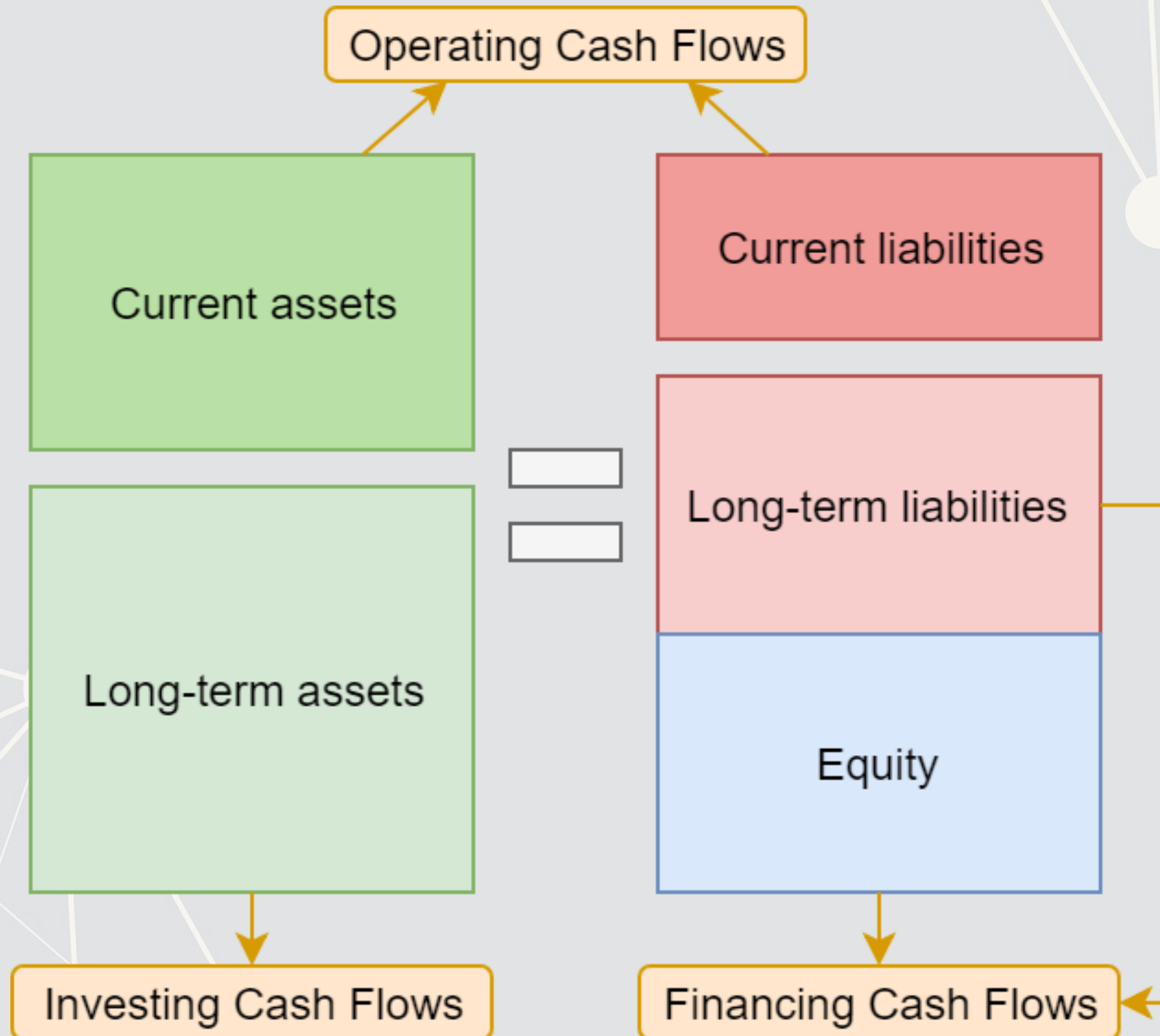
- Categorizes and presents all *cash* receipts and *cash* payments
 - Cash *inflows*: where cash came in from
 - Cash *outflows*: where cash went out to
- Describes cash changes over a period



Why use an SCF?

- Helpful in assessing companies'...
 - Ability to generate future cash flows
 - Ability to pay dividends
 - Difference between net income and change in cash
 - Investing and financing activities during the period
 - Value using DCF models (finance)
- Provides information on three types of cash flows, accounting for all cash flows of the company
 - Operating activities
 - Investing activities
 - Financing activities

SCF and the balance sheet



Special cases: Interest and dividends

- IFRS, under IAS 7.31
 - *Pick any categorization*
 - Dividends paid/received can be any cash flow type
 - Interest paid/received can be any cash flow type
 - Keep it the same year-after-year
- US GAAP specifies where to put these – follow this if you don't have a strong opinion on where to put interest and dividends
 - Inflows from dividends or interest: operating activities
 - Interest payments: operating activity
 - Dividend payments: financing activity

Operating activities

- Cash from standard business transactions
- Useful in:
 - Identifying *sustainable* cash flows
 - Management of current assets and current liabilities
 - I.e., working capital
 - Identifying liquidity issues
 - Important for loans!

Operating activities

Inflows

- Sales
- Short term investments (selling)
- Other revenues

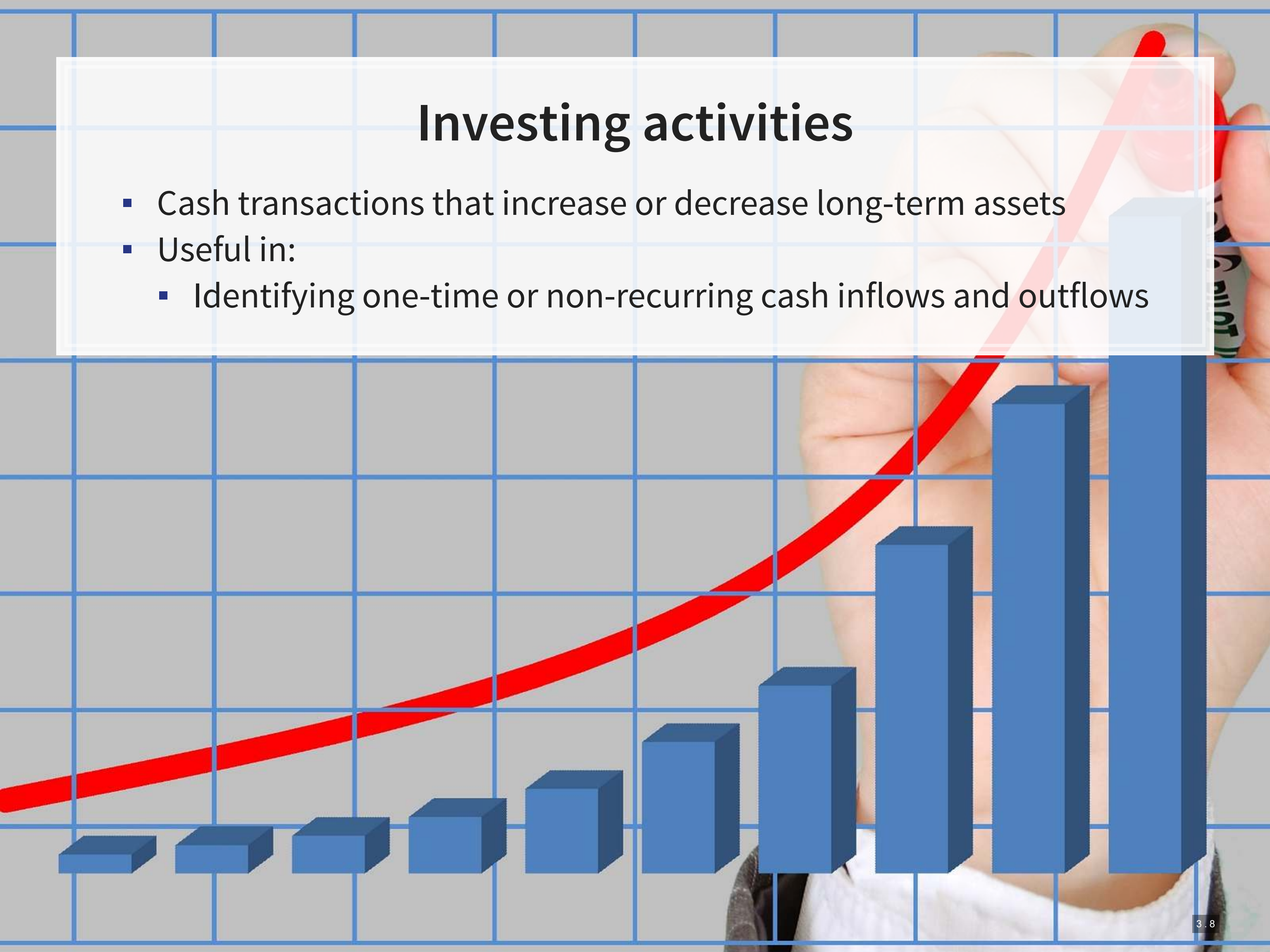
Outflows

- Short term investments (buying)
- Business expenses
 - Paying suppliers and employees
 - Taxes
 - Maintenance expense

Focus on changes in current assets, changes in current liabilities, and the income statement

Investing activities

- Cash transactions that increase or decrease long-term assets
- Useful in:
 - Identifying one-time or non-recurring cash inflows and outflows



Investing activities

Inflows

- PP&E disposal
- Selling investments in other firms
- Collection of principal on loans made

Outflows

- Purchasing PP&E
- Purchasing investments in other firms
- Making loans

Focus on PP&E

Financing activities

- Cash-based increases and decreases in long-term liabilities and shareholders' equity
- Useful in:
 - Predicting future claims on cash
 - Identifying how a company is financed
 - Internally vs. externally



Financing activities

Inflows

- Receiving loans
- Issuing stock
- Selling treasury shares

Outflows

- Paying back loans
- Buying treasury shares

Focus on long term liabilities and shareholders' equity

Significant non-cash activities

- Includes:
 - Issuing common stock in exchange for PP&E
 - Bond conversion (Bond → equity)
 - Debt issuance for PP&E
 - PP&E exchange
- Useful in:
 - Determining other future claims on cash
 - Getting a more complete picture of financing and investments
- Reported at the bottom of SCF or in supplementary schedule

Practice: Identifying cash flows

What type of cash flows are each of the following?

[Operating/Investing/Financing/Non-cash/None]

If it is a cash flow, is it an inflow or outflow?

1. Reissue treasury shares for a warehouse
2. Pay off a note payable
3. Pay interest on a bond
4. Issue new shares for \$10 each
5. Pay accounts payable
6. Record \$10,000 depreciation on PP&E
7. Sell machinery at a loss
8. Sell land
9. Pay a dividend
10. Buy a warehouse
11. Sell goods for cash

Operating cash flows

Operating cash flows

Two equivalent methods:

Indirect method

- Backs out operating cash flow by starting with net income and adjusting out accruals
- Most commonly used
- Easiest to do

Direct method

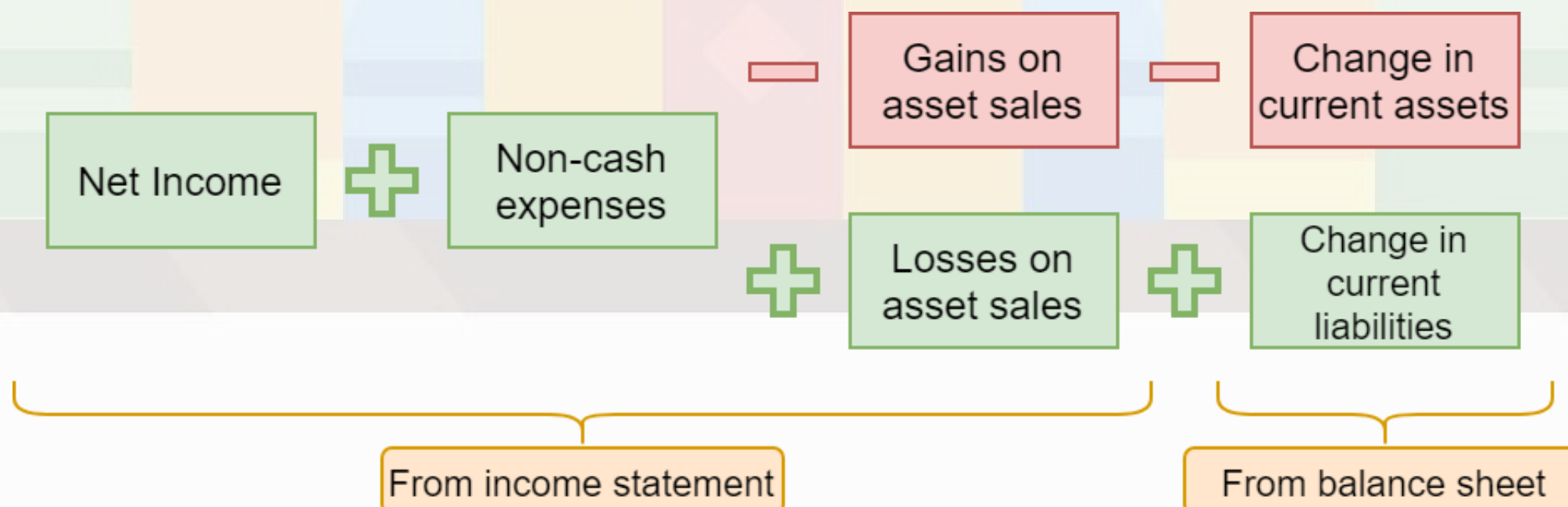
- Tracks and reports exactly where operating cash flows came from
- Preferred by IFRS
- Most useful for investors

- Both methods will get you to the same operating cash flow amount

We will cover the direct method next week when we construct an SCF

Indirect method

1. Start with net income
2. Add back non-cash expenses (i.e., pure accruals)
 - Depreciation, depletion, amortization
 - Bond discount amortization
 - Bad debt expense, warranty expense
3. Subtract out any gains from asset sales included in net income
4. Add back any losses from asset sales included in net income
5. Subtract changes in current assets, **except cash**
6. Add changes in current liabilities



Indirect method: Calculation

- Steps 1 through 4 are available in the income statement
- Steps 5 and 6 can be calculated by comparing balance sheets
 - Current year versus prior year balance sheets
 - Compare change in accounts such as...
 - A/R
 - Inventory
 - Prepaid expenses
 - Accounts Payable
 - Unearned revenue

Example: Indirect method

| Statement of Comprehensive Income Coffee Corp | | |
|--|--------------|--------------|
| | Dec 31, 20X9 | Dec 31, 20X8 |
| Revenue | 72,000 | 54,000 |
| COGS | 38,000 | 30,000 |
| Gross profit | 34,000 | 24,000 |
| Depreciation expense | 8,000 | 7,500 |
| Operating expenses | 15,000 | 14,500 |
| Net income before tax | 11,000 | 2,000 |
| Other revenues | 6,000 | 0 |
| Tax expense | 2,000 | 200 |
| Net income | 15,000 | 1,800 |

| Statement of Financial Position Coffee Corp | | |
|--|--------------|--------------|
| | Dec 31, 20X9 | Dec 31, 20X8 |
| Cash | 32,000 | 25,000 |
| A/R | 6,000 | 4,000 |
| Inventory | 10,000 | 12,000 |
| Accounts payable | 8,000 | 7,000 |
| Utilities Payable | 2,000 | 1,500 |
| Salaries Payable | 3,000 | 2,500 |

There was a 6,000 gain on asset sale during the year 20X9

To get the amount of operating cash flow for Kopi Corp, add all numbers highlighted in green and subtract all numbers highlighted in red

OCF =
 (1) NI
 (2) + Depreciation
 (3) - Gain on asset sale
 (4) + Loss on asset sale
 (5) - Δ A/R - Δ Inventory
 (6) + Δ A/P + Δ Utilities Pay. + Δ Salaries Pay.

OCF =
 (1) 15,000
 (2) + 8,000
 (3) - 6,000
 (4) + 0 [none in this problem]
 (5) - 2,000 - (-2,000)
 (6) + 1,000 + 500 + 500
 = 19,000

Practice: Indirect method

You find the following information in Kopi Corp's 20X9 and 20X8 financial statements. Based on this information, what is their operating cash flow for 20X9?

| Statement of Comprehensive Income Kopi Corp | | |
|--|--------------|--------------|
| | Dec 31, 20X9 | Dec 31, 20X8 |
| Revenue | 33,000 | 64,500 |
| COGS | 4,500 | 6,000 |
| Gross profit | 28,500 | 58,500 |
| Depreciation expense | 15,000 | 15,000 |
| Operating expenses | 20,000 | 13,000 |
| Net income before tax | (6,500) | 30,500 |
| Tax expense | 0 | 3,000 |
| Net income | (6,500) | 27,500 |

| Statement of Financial Position Kopi Corp | | |
|--|--------------|--------------|
| | Dec 31, 20X9 | Dec 31, 20X8 |
| Cash | 45,000 | 40,000 |
| A/R | 4,000 | 10,000 |
| Inventory | 6,000 | 4,500 |
| Accounts payable | 2,000 | 10,000 |
| Utilities Payable | 1,000 | 5,000 |
| Salaries Payable | 2,000 | 2,000 |

Furthermore, there was a 3,000 loss on asset sale during the year 20X9

End matter



For next week

- Do Quiz 2 on eLearn!
- Reading
 - Chapter 11 (Cash flows)
- Take a week and relax (or work on the project)
- Extra practice available
 - Cash flows eLearn quiz