

Understanding Financial Statements

EIGHTH EDITION

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Statement of Cash Flows

“Joan and Joe: A Tale of Woe”

Joe added up profits and went to see Joan,
Assured of obtaining a much-needed loan.

When Joe arrived, he announced with good cheer:

“My firm has had an outstanding year,
And now I need a loan from your bank.”

Eyeing the statements, Joan’s heart sank.

“Your profits are fine,” Joan said to Joe.

“but where, oh where, is your company’s cash flow?

I’m sorry to say: the answer is ‘no’.”

--L. Fraser

Statement of Cash Flows

Provides information about cash inflows and outflows during an accounting period

Statement of Cash Flows (cont.)

- Required by SFAS #95
- Replaced the Statement of Changes in Financial Position in 1988
- Is developed from Balance Sheet and Income Statement data
- Important as an analytical tool

Statement of Cash Flows (cont.)

Why is it important???

“A positive net income on the income statement is ultimately insignificant unless a company can translate its earnings into cash, and the only source in financial statement data for learning about the generation of cash from operations is the statement of cash flows”

Objectives of the Chapter

To explain how the statement of cash flows is prepared

To interpret the information presented in the statement

Preparing a Statement of Cash Flows

- Begins with a return to the balance sheet
- Is prepared by calculating changes in all of the balance sheet accounts

Preparing a Statement of Cash Flows (cont.)

Four parts of a statement of cash flows:

1. Cash
2. Operating activities
3. Investing activities
4. Financing activities

Preparing a Statement of Cash Flows (cont.)

Cash includes

Cash & Cash equivalents (short-term
marketable securities):

T-Bills

Notes

Commercial paper

CDs

Bonds

Certificates

Preparing a Statement of Cash Flows (cont.)

Cash includes

If company separates marketable securities into two accounts: cash and cash equivalents and short-term investments, the short-term investments are:

Classified as investing activities

Preparing a Statement of Cash Flows (cont.)

Operating Activities include

- Delivering or producing goods for sale and providing services
- The cash effects of transactions and other events that enter into the determination of income

Preparing a Statement of Cash Flows (cont.)

Operating Activities Examples

- Cash flows resulting from sales of goods
- Purchase of inventories
- Payments for operating expenses

Preparing a Statement of Cash Flows (cont.)

Investing Activities include

- Acquiring/disposing of securities that are not cash equivalents
- Acquiring/disposing of productive assets
- Lending money/collecting on loans

Preparing a Statement of Cash Flows (cont.)

Financing Activities include

- Borrowing from creditors/repaying the principal
- Obtaining resources from owners
- Providing owners with a return on investment

Preparing a Statement of Cash Flows (cont.)

How Cash Flows During an Accounting Period



**Total Inflows less Total Outflows =
Change in cash for the accounting period**

Preparing a Statement of Cash Flows

(cont.)

Examples of change in cash based on business activities for companies in different industries*

\$ in millions

	<u>Operating Activities</u>	<u>Investing Activities</u>	<u>Financing Activities</u>	<u>Change in Cash</u>
Airline	\$ 2,229	(1,210)	213	1,232
Computer	(25)	118	1	94
Recreation	42	(26)	(5)	11
Retailer	1,068	332	(53)	1,347
Semiconductor	14,823	(6,362)	(9,544)	(1,083)

*Data from SEC website, www.sec.gov

Preparing a Statement of Cash Flows (cont.)

First Step:

Look at changes in balance sheet
accounts from beginning to end of
accounting period

Preparing a Statement of Cash Flows (cont.)

Next Step:

Transfer the account changes to the
appropriate area of a statement of
cash flows

Preparing a Statement of Cash Flows (cont.)

Inflow	Outflow
- Asset account	+ Asset account
+ Liability account	- Liability account
+ Equity account	- Equity account

Calculating Cash Flow from Operating Activities

Firms may use one of two methods prescribed by the FASB:

Direct Method
Indirect Method

The two methods yield identical figures for net cash flow from operating activities because the underlying accounting concepts are the same

Calculating Cash Flow from Operating Activities (cont.)

The Direct Method

Shows

- cash collections from customers
- interest and dividends collected
- other operating cash receipts
- cash paid to suppliers and employees
- interest paid
- taxes paid
- other operating cash payments

Calculating Cash Flow from Operating Activities (cont.)

The Indirect Method

Starts with net income and adjusts for

- deferrals
- accruals
- noncash items, such as depreciation and amortization
- nonoperating items, such as gains and losses on asset sales

Calculating Cash Flow from Operating Activities (cont.)

The Indirect Method

593 firms out of 600 (99%) used the indirect method in 2003 according to *Accounting Trends and Techniques*

Analyzing the Statement of Cash Flows

Is an important analytical tool for
creditors, investors and other users
of financial statement data

Analyzing the Statement of Cash Flows (cont.)

Indicates

- Firm's ability to generate cash flows in the future
- Firm's capacity to meet cash obligations
- Firm's future external financing needs

Analyzing the Statement of Cash Flows (cont.)

Indicates

- Firm's success in productively managing investing activities
- Firm's effectiveness in implementing financing and investing strategies

Cash Flow from Operations

It is possible for a firm to be highly profitable and not be able to:

Pay dividends or invest in new equipment
Service debt

Cash Flow from Operations (cont.)

It is also possible for a firm to be highly profitable and go bankrupt

Cash Flow from Operations (cont.)

How?

The problem is cash

Cash Flow from Operations (cont.)

The ongoing operation of any business depends upon its success in generating cash from operations

Analysis of the Statement of Cash Flows

Should, at a minimum cover the following areas:

- Cash flow from operating activities
- Cash inflows
- Cash outflows

Analysis of the Statement of Cash Flows (cont.)

Analyst Concerns:

- The success or failure of the firm in generating cash from operations
- The underlying causes of the positive or negative operating cash flow

Analysis of the Statement of Cash Flows (cont.)

Analyst Concerns:

- The magnitude of positive or negative operating cash flow
- Fluctuations in cash flow from operations over time

Analysis of the Statement of Cash Flows (cont.)

Examples of cash flow from operations (CFO) under the indirect method for various companies*

\$ in millions

	<u>Net Income</u>	<u>Cash from (used by) Operations</u>	<u>Primary source (use) of cash within CFO</u>
Airline	\$ 548	\$ 2,229	A/P-accrued liab.
Computer	6	(25)	(other assets)
Recreation	(107)	42	depr./int. payable
Retailer	1,106	1,068	(gain-asset sales)
Semiconductor	8,664	14,823	depreciation

*Data from SEC website, www.sec.gov

Summary Analysis of the Statement of Cash Flows

The Summary Table

Provides an approach to analyzing a statement of cash flows that can be used for any firm that provides comparative cash flow data

Summary Analysis of the Statement of Cash Flows (cont.)

The Summary Table

The information underlines the importance of internal cash generation—from operations—and the implications for investing and financing activities when this does and does not occur

Summary Analysis of the Statement of Cash Flows (cont.)

The Summary Table

- A way to common size the cash flow statement
- Shows the cash inflows as a percentage of total inflows
- Shows the cash outflows as a percentage of total outflows

Analysis of Cash Inflows

Generating cash from operations is the preferred method for obtaining excess cash to finance:

Capital expenditures and expansion

Repayment of debt

Payment of dividends

Analysis of Cash Outflows

When analyzing the cash outflows, the analyst should consider the necessity of the outflow and how the outflow was financed

Generally, it is best to finance short-term assets with short-term debt and long-term assets with long-term debt or issuance of stock

The Journey Through the Maze Continues

- Ch. 5: A Guide to Earnings and Financial Reporting Quality
- Ch. 6: The Analysis of Financial Statements