



AUM

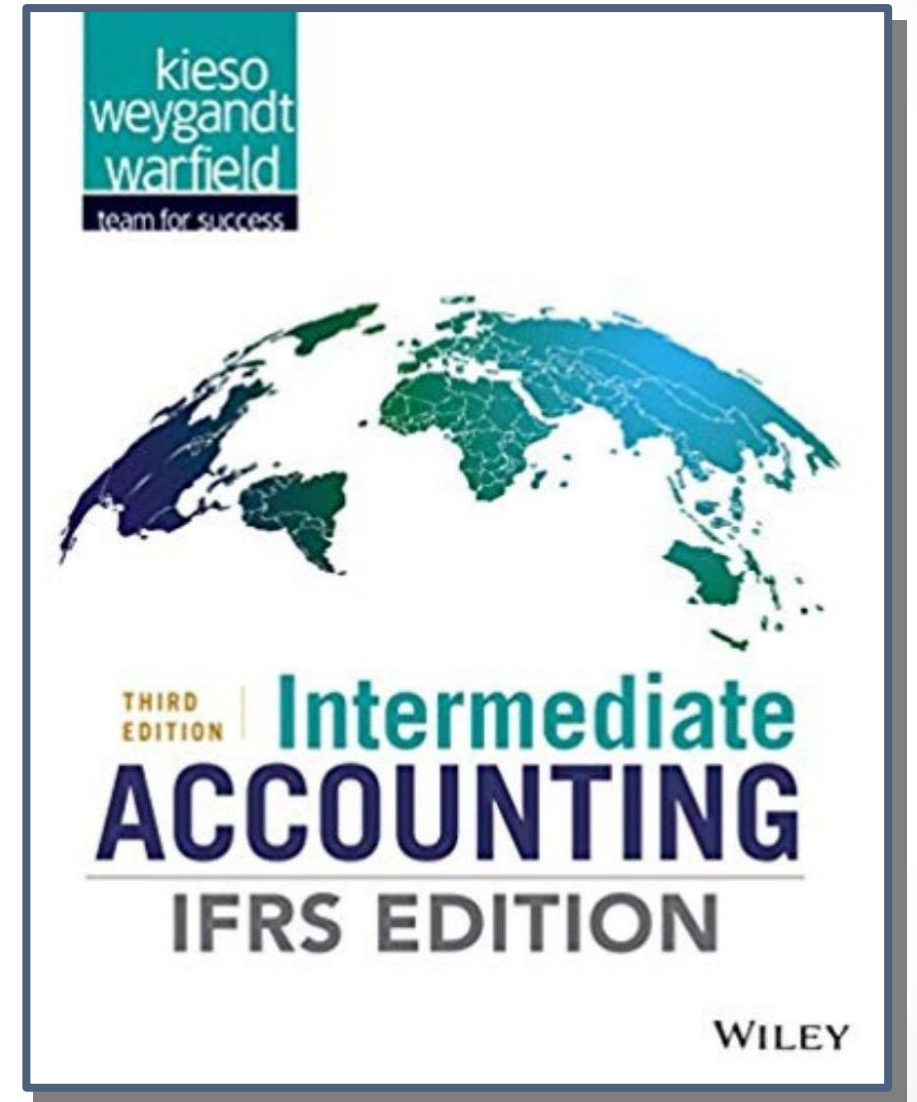
American University Of The Middle East

Intermediate Accounting I

CHAPTER 5 (Part 2)

Statement of Cash Flows

Page 5-14 to 5-22



Learning Objectives (Part 2)

LEARNING OBJECTIVES

After studying the second part of Chapter 5, you should be able to:

1. Indicate the **purpose** of the statement of cash flows.
2. Identify the **content** of the statement of cash flows.
3. **Prepare** a basic statement of cash flows.
4. Understand the **usefulness** of the statement of cash flows.

What is a Statement of Cash Flows?

An important element of the objective of financial reporting is “assessing the amounts, timing, and uncertainty of cash flows.” IASB requires the **statement of cash flows** (also called the **cash flow statement**).

Primary Purpose

To provide relevant information about the cash receipts and cash payments of an enterprise during a period.

Cash Flow Statement provides answers to the following questions:

- ▶ Where did the **cash come from**?
- ▶ What was the **cash used for**?
- ▶ What was the **change** in the **cash balance**?

Learning Objective 1 • Learning Objective 2 • Learning Objective 3 • Learning Objective 4
Identify the **content** of the STATEMENT OF CASH FLOWS.

What is a the content of the Statement of Cash Flows?

Cash Flows Statement reports cash receipts (cash in) and cash payments (cash out) during a period. **These cash flows are classified into three categories:**

- ▶ Cash flows from Operating Activities (inflows + / outflows -)
- ▶ Cash flows from Investing Activities (inflows + / outflows -)
- ▶ Cash flows from Financing Activities (inflows + / outflows -)

Basic *format* of Cash Flow Statement

STATEMENT OF CASH FLOWS	
Cash flows from operating activities	\$1,000
+ Cash flows from investing activities	(600)
+ Cash flows from financing activities	200
= Net increase (decrease) in cash during the period	600
+ Cash at beginning of year	100
= Cash at end of year	<u>\$700</u>

OPERATING Activities

- ▶ Most of the transactions that enter into the determination of net income
- ▶ Sales, Service Revenue, COGS, Expenses, Purchase of Supplies, Purchase of Inventory
- ▶ Affect **Net Income** and **Current Asstes/Liabilities**

INVESTING Activities

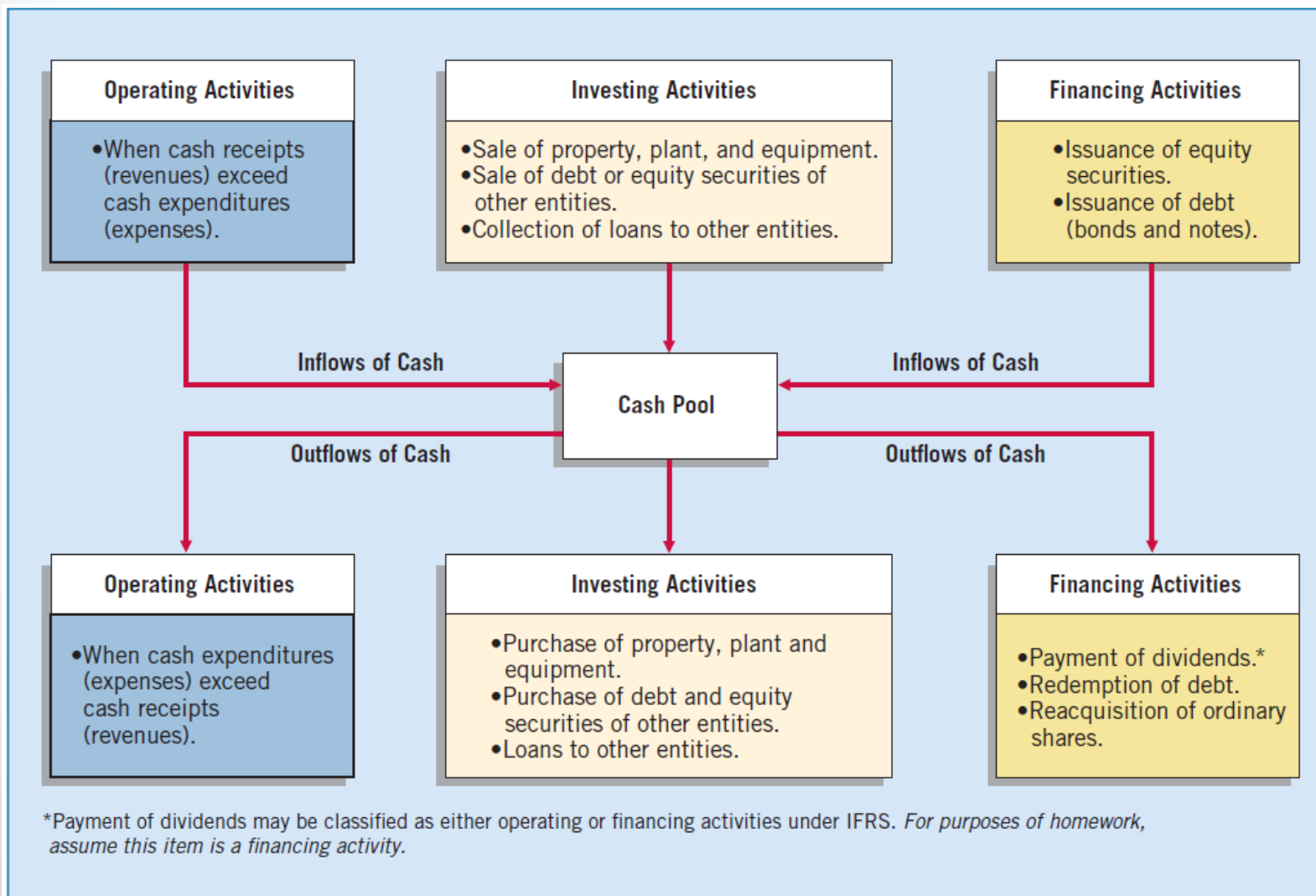
- ▶ Making and collecting loans
- ▶ Acquiring and disposing of investments
- ▶ Acquiring and disposing of property, plant, and equipment
- ▶ Affect **Non-Current Asstes**

FINANCING Activities

- ▶ Transactions involving **liability** and **equity** items
- ▶ Issuance of shares, Issuance of Bonds
- ▶ Affect **Non-Current Liabilities** and **Equity**

Learning Objective 1 • Learning Objective 2 • Learning Objective 3 • Learning Objective 4

Identify the **content** of the STATEMENT OF CASH FLOWS.



How is a Statement of Cash Flows prepared?

Where do we get the needed information?

We have to combine Information obtained from **several sources**:

- ▶ Comparative **statements of financial position** (current period and previous one)
- ▶ Current **income statement (Or Net Income)**
- ▶ **Selected transaction data**

If I need to Prepare Cash Flow statement for 2019, which Statement of financial Position do I need?

- Statement of Financial Position 2019, 2018 (2 consecutive years)

If I need to Prepare Cash Flow statement for 2019, which Income Statement do I need?

- Income Statement 2019

How is a Statement of Cash Flows prepared?

What are the steps that we need to follow?

Determine

- ▶ Net cash provided by (or used in) **operating activities**.
- ▶ Net cash provided by (or used in) **investing** and **financing activities**.
- ▶ Determine the **change** (increase or decrease) in cash **during the period**.
- ▶ **Reconcile** the change in cash **with** the **beginning** and the **ending cash balances**.

*Basic **format** of Cash Flow Statement*

STATEMENT OF CASH FLOWS	
Cash flows from operating activities	\$1,000
+ Cash flows from investing activities	2,500
+ Cash flows from financing activities	300
= Net increase (decrease) in cash	\$3,800
+ Cash at beginning of year	150
= Cash at end of year	<u>\$3,950</u>

How do we determine NET CASH FROM OPERATING ACTIVITIES?

OPERATING Activities

This step is the hardest of all steps

NET CASH FROM OPERATING ACTIVITIES represents excess of cash receipts over cash payments from operating activities.

▶ Transactions that enter into the determination of net income

Steps: (Indirect Method)

- ▶ Start with **Net Income** and convert it from **accrual basis** to **cash basis**. Requires adjustments for change in current assets and current liabilities
- ▶ **Add** to **or deduct** from net income those items in the income statement that **do not affect cash**. (depreciation, change in current assets/liabilities)
- ▶ Adjust for items that **do not belong to Operating Activity** (typically gains/losses related to non-current assets)

Requires an analysis of the **current year's income statement, comparative statements of financial position (current assets/liabilities)** and **selected transaction data**.

How do we determine NET CASH FROM INVESTING ACTIVITIES?

NET CASH FROM INVESTING ACTIVITIES represents excess of cash receipts over cash payments from **investing** activities.

Usually requires an analysis of **comparative statements of financial position (non-current assets)** and **selected transaction data**.

INVESTING Activities

- ▶ Making and collecting loans and acquiring and disposing of investments and property, plant, and equipment

How do we determine NET CASH FROM FINANCING ACTIVITIES?

NET CASH FROM FINANCING ACTIVITIES represents excess of cash receipts over cash payments from **financing** activities.

Usually requires an analysis of **comparative statements of financial position (non-current liabilities and equity)**.

Effect of net income on retained earnings is ignored, only dividends are considered.

FINANCING Activities

- ▶ Transactions involving liability and equity items

Learning Objective 1 • Learning Objective 2 • **Learning Objective 3** • Learning Objective 4
 Prepare a basic STATEMENT OF CASH FLOWS

ASSETS

Non-Current Assets

Investments	2019	2018
	52,000	74,000
Equipment	298,000	240,000
Less: Accumulated depreciation—equipment	(106,000)	(89,000)

Current Assets

Accounts receivable	180,000	185,000
Cash	157,000	78,000

TOTAL ASSETS

581,000 488,000

EQUITY & LIABILITIES

Equity

Share capital—ordinary	160,000	160,000
Retained earnings	287,000	177,000

Current Liabilities

Current liabilities	134,000	151,000
---------------------	---------	---------

TOTAL EQUITY & LIABILITIES

581,000 488,000

Operating Activities

INCOME STATEMENT
(NET INCOME)

Change in Current Assets

Change in Current Liabilities

Learning Objective 1 • Learning Objective 2 • Learning Objective 3 • Learning Objective 4
Prepare a basic STATEMENT OF CASH FLOWS

ASSETS

Non-Current Assets

Investments

2019

2018

52,000

74,000

Equipment

298,000

240,000

Less: Accumulated depreciation—equipment

(106,000)

(89,000)

Change in Non -Current Assets

Current Assets

Accounts receivable

180,000

185,000

Cash

157,000

78,000

TOTAL ASSETS

581,000

488,000

Operating Activities

Investing Activities

EQUITY & LIABILITIES

Equity

Share capital—ordinary

160,000

160,000

Retained earnings

287,000

177,000

Current Liabilities

Current liabilities

134,000

151,000

TOTAL EQUITY & LIABILITIES

581,000

488,000

Learning Objective 1 • Learning Objective 2 • Learning Objective 3 • Learning Objective 4
Prepare a basic STATEMENT OF CASH FLOWS

ASSETS	2019	2018	Operating Activities
<i>Non-Current Assets</i>			
Investments	52,000	74,000	
Equipment	298,000	240,000	
Less: Accumulated depreciation—equipment	(106,000)	(89,000)	Investing Activities
<i>Current Assets</i>			
Accounts receivable	180,000	185,000	
Cash	157,000	78,000	
TOTAL ASSETS	581,000	488,000	
EQUITY & LIABILITIES			
<i>Equity</i>			
Share capital—ordinary	160,000	160,000	} Change in Non Current Liabilities + Equity Financing Activities
Retained earnings	287,000	177,000	
<i>Current Liabilities</i>			
Current liabilities	134,000	151,000	
TOTAL EQUITY & LIABILITIES	581,000	488,000	

Significant Non-Cash Activities

If there are significant activities that do not involve cash, they should be reported in a **separate note** to the financial statements, **NOT** in the Statement itself.

Examples include:

- ▶ Issuance of ordinary shares to purchase assets.
- ▶ Conversion of bonds into ordinary shares.
- ▶ Issuance of debt to purchase assets.
- ▶ Exchanges on long-lived assets.

Why do we prepare a statement dedicated only to cash?

- ▶ Although net income provides a long-term measure of a company's success or failure, **cash is its lifeblood**.
- ▶ **Without cash, a company will not survive.**
- ▶ For small and newly developing companies, cash flow is the single most important element for survival. Even medium and large companies must control cash flow.

Information obtained from Statement of Cash Flows is used to assess a company's **Financial Liquidity** and **Financial Flexibility**

Learning Objective 1 • Learning Objective 2 • Learning Objective 3 • **Learning Objective 4**
Understand the **usefulness** of the STATEMENT OF CASH FLOWS

Financial Liquidity (often assessed using the **current cash debt coverage** ratio)

$$\text{Current Cash Debt Coverage} = \frac{\text{Net Cash Provided by Operating Activities}}{\text{Average Current Liabilities}}$$

Indicates the ability to pay off current liabilities from operations. Ratio near 1:1 is good.

Financial Flexibility (often assessed using the **cash debt coverage** ratio and Free Cash Flow)

$$\text{Cash Debt Coverage} = \frac{\text{Net Cash Provided by Operating Activities}}{\text{Average Total Liabilities}}$$

Ratio indicates the ability to repay liabilities from net cash provided by operating activities, without having to liquidate assets employed in operations.

Free Cash Flow

$$\text{Free Cash Flow} = \text{Net Cash Provided by Operating Activities} - \text{Capital Expenditures} - \text{Cash Dividends}$$

Indicates the amount of discretionary cash flows (available to use at the discretion of the company) .