


Chapter 5, Module 2

Slide 1

Chapter 5 Module 2

AMIS 211
Introduction to Financial Accounting

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Hi everyone. Welcome back.

Now that we have gone through the basics of the Cash Flow Statement—and really the previous module was pretty much a review of what we had seen in prior chapters—let’s take that one step further.

And, let’s actually talk about how to put a Cash Flow Statement together.

If you go to the next slide with me...

Slide 2

Chapter 5 Module 2: Statement of Cash Flows

Betty DeRose, Inc. Statement of Cash Flows For the Period Ended Dec. 31, 2004		
Cash flows from operating activities (List of individual items)	<u>XX</u>	
Net cash provided (used) by operating activities		XXX
Cash flows from investing activities (List of individual inflows and outflows)	<u>XX</u>	
Net cash provided (used) by investing activities		XXX
Cash flows from financing activities (List of individual inflows and outflows)	<u>XX</u>	
Net cash provided (used) by financing activities		<u>XXX</u>
Net change in cash		XXX

You will see on this slide (Slide 2) just a basic illustration of what the Cash Flow Statement will look like.

Remember, we have our cash flows divided into three (3) different categories: 1) Operating, 2) Investing, and 3) Financing.

So, you start at the top and you have your cash flows from Operating Activities.

And then, we will list each individual cash flow.

This will enable us to calculate the cash that is either provided or used by the Operating Activities.

And, we follow that same procedure for Investing Activities and then for Financing Activities.

If you have a Net Positive cash flow in any one category; that is referred to as Cash Provided by that activity.

For example: in our Operating Activities, if—once we take all the inflows and then subtract all the outflows—the Net Cash Flow is positive; that is called Net Cash Provided by Operating Activities.

On the other hand, if—let’s say—in our Investing Activities, we spent more cash than we brought in for that category, then the Net Cash would be referred to as Net Cash Used by Investing Activities.

Once you get your Net Cash either “Provided” or “Used” for each category, you just add them together. And, that gives us our Net Change in Cash.

A little bit later in the chapter, we will go through a couple of examples where we will put together full-blown Cash Flow Statements and they will look very much like what is on this slide (Slide 2) right here.

Let’s go ahead to the next slide.

Slide 3

<p><i>Chapter 5 Module 2: Operating Activities</i></p> <p>The major purpose of the operating activities section of the cash flow statement is to</p> <p>Convert net income from an accrual basis to a cash basis</p> <ul style="list-style-type: none">▶ The net cash provided (used) by operating activities represents what the net income of the company would have been had the company used a cash accounting basis rather than accrual accounting▶ This conversion can be done by two methods:<ul style="list-style-type: none">● direct method● indirect method

And, we need to spend some time talking about that first category of cash flows: 1) Operating Activities.

These ones are probably going to be the ones that require the most amounts of work and effort on your part to get down and be able to calculate. They are also probably the most important of the three (3) categories of cash flows.

So, I have a question for you:

What is the main purpose of the Operating Activities section of the Cash Flow Statement?

Remember what they are: they are the cash effects of items that impact Net Income.

The main purpose is to take that Net Income –an Accrual number—take it from the Income Statement and convert it to a cash number—convert the Accrual-Based Net Income to a Cash-Basis Net Income Number.

In other words: what we want to do is: be able to do is: to take the Net Income and eliminate all the effects of GAAP. Let's get rid of all those Accruals and Deferrals that are in there and just get down to the cash.

The Operating Activities section--the Net Cash Provided or Used from Operating Activities simply represent what our Net Income would have been had we followed a Cash Basis of Accounting rather than an Accrual Basis of Accounting.

That is very important.

It is basically telling us how much cash is being generated from our operations.

Now, there are two (2) ways of actually doing this conversion—two (2) ways of converting the Accrual Number to a Cash Number: 1) the Direct Method and 2) the Indirect Method.

And, either method can be used in configuring the cash flows from Operating Activities on the Statement of Cash Flows.

Let's go ahead to the next slide.

Slide 4

Chapter 5 Module 2: Operating Activities

The *operating activities* section of the statement of cash flows can be presented in 2 different ways:

- 1. Direct Method**
 - 2. Indirect Method**
- **Both methods arrive at the same total amount for 'net cash provided (used) by operating activities'**
 - **The methods differ in disclosing the items that make up the total amount.**
 - **The choice of methods affects only the operating activities section; the investing and financing activities sections are the same.**

And, let's talk a little bit more about these two (2) methods of converting Accrual Income into Cash Net Income: the 1) Direct Method and the 2) Indirect Method as we both know.

A couple of key points:

One: both methods should result in the same Net Cash Provided from Operations.

Now, you are going to go about it in a different way, but at the end of the day, both methods should show the same Net Cash Provided from Operations.

Where they are different is: in their presentation.

They go about calculating that number in two completely different ways and they will show that different presentation on the actual Cash Flow Statement.

But, when it is all said and done, the two different ways of doing that calculation should result in the same number if we have done it correctly.

Finally, this idea of Direct and Indirect Methods for preparing the Operating Activities section of the Cash Flow Statement is for the Operating Activities only.

This has no effect or no impact whatsoever on the other two categories: Investing and Financing. There is no Indirect and Direct way of preparing Financing Activities or Investing Activities. There is only one way of doing that.

The idea of having two different presentations—Indirect and Direct—is only for cash flows from Operating Activities.

Let's go to the next slide.

Slide 5

Chapter 5 Module 2: Direct Method

- The FASB prefers the direct method but allows the use of either method.
- When the direct method is used, the net cash flow from operating activities as computed using the indirect method must also be reported in a separate schedule.
- The direct method involves listing each specific cash flow. An example is shown on the next slide.

And, let's spend a couple of minutes and talk about 1) the Direct Method.

The Direct Method is actually the method preferred by FASB—our standard-setting body—the Financial Accounting Standards Board (FASB).

FASB prefers that companies follow the Direct Method but they allow the use of the Indirect Method.

If a company is following the Direct Method, they are required—in a Supplemental Schedule to the Cash Flow Statement—to show the Indirect Method.

So, you are really going to have them both in there.

But, if you are following the Direct Method on the body of the Cash Flow Statement, you will need a Schedule that goes with that Statement showing the calculations under the Indirect Method.

Finally, we are going to need—under the Direct Method—to list out each specific cash inflow and outflow by its category.

So, the Direct Method will actually show each individual specific inflow and outflow on the body of the Statement.

And, if you go to the next slide...

Slide 6

<i>Chapter 5 Module 2: Direct Method</i>		
Cash collected from customers		340,000
Cash payments:		
to suppliers for inventory purchases	100,000	
to employees as salaries	85,000	
to creditors as interest	40,000	
to the government as taxes	25,000	250,000
Net cash provided by operating activities		90,000

Let's look at an example of what I mean by that.

You can see what the Direct Method would look like.

Start with your Cash Collections from Customers. And, then you list out each specific cash outflow—Cash Paid for Purchases of Inventory; Cash Paid for Salaries; Cash Paid for Interest; Cash Paid for Taxes—to calculate the Net Cash Provided by Operating Activities.

What you see here on the slide (Slide 6); that is the Direct Method.

Go to the next slide with me.

Slide 7

Chapter 5 Module 2: Indirect Method

- The indirect method is used extensively in practice.
- Most companies favor the indirect method for the following reasons:
 - **it is easier to prepare**
 - **it focuses on the differences between net income and net cash flow from operating activities**
 - **it tends to reveal less company information to competitors**
- The indirect method starts with net income and makes a series of adjustments to convert the accrual net income into cash net income. An example is shown on the next slide.

And, let's look at the Indirect Method:

Whereas FASB prefers use of the Direct Method, industry or companies prefer use of the Indirect Method. It is extensively used in practice.

The reason that they prefer the use of the Indirect Method is: it is just easier for them. They already have that information available so that they can just easily put it into the Cash Flow Statement.

Finally, at least in the eyes of the organization, it reveals less information about their operations to their competitors.

Now, this Indirect Method—the way in which it is going to be prepared—is: we are not going to list out each cash flow like we did with the Direct Method. We are going to start instead with Net Income. You take it right from the Income Statement.

You start with Net Income and then you are going to make a series of adjustments to convert that Net Income into a Cash-Basis Number.

And, if you go to the next slide with me, you can see an example of what the Indirect Method would look like.

Slide 8

<i>Chapter 5 Module 2: Indirect Method</i>		
Net income		59,000
Adjustments to reconcile net income to cash flow from operations		
Depreciation expense	9,000	
Loss on sale of equipment	3,000	
Decrease in accounts receivable	10,000	
Increase in inventory	(5,000)	
Increase in accounts payable	16,000	
Decrease in income taxes payable	(2,000)	31,000
Net cash provided by operating activities		90,000

You start with Net Income and see it is \$69,000.

And then, we are going to make a series of adjustments.

For this module, we are not too worried about what those adjustments are. We will come back in a later module and we will talk much more in depth about the specific adjustments that need to be made for the Indirect Method.

Notice that I have set this up so that the Net Cash Provided from Operations is \$90,000. It is the same under both this Indirect Method—which you see on this slide (Slide 8) as well as the Direct Method. If you go back to the example a few slides ago (on Slide 6), you will see it is the same number (\$90,000).

The difference is in the presentation.