

II. OPERATING ACTIVITIES CASH FLOWS ANALYSIS

This analysis began with the assumption that the four key Income Statement components (Sales, Cost of Goods Sold, Operating Expenses, and Income Tax Expense) all represented cash flows, with Sales being an inflow(+) and the others outflows(-). Since this assumption was incorrect, adjustments were required. For example, because receivables increased, cash was not collected from all Sales, and a negative adjustment to cash inflow from Sales was necessary. Because inventories decreased, not all cost of goods sold represented a cash outflow, and a negative adjustment to cash outflow from cost of goods sold was necessary. Similar adjustments to the 3 key outflows as depicted below were also necessary.

INFLOW(+) FROM SALES	AMOUNT	ACCOUNT ADJUSTMENT	NET INFLOWS AND OUTFLOWS
Assume all Sales were for Cash	\$479,600		
Adjust for Accounts Receivable Increases by (-)	-40,000	(A)	
Adjust for Accounts Receivable Decreases by (+)			
Inflows from Sales	<u>\$439,600</u>		#1
OUTFLOW(-) FROM COST OF GOODS SOLD			
Assume all Cost of Goods Sold were Cash	\$285,000		
Adjust for Inventory Increases by (+)			
Adjust for Inventory Decreases by (-)	-10,000	(B)	
Adjust for Accounts Payable Increases by (-)	-10,000	(C)	
Adjust for Accounts Payable Decreases by (+)			
Outflows(-) from Cost of Goods Sold	<u>\$265,000</u>		#2
OUTFLOWS(-) FROM OPERATING EXPENSES			
Assume all outflows from Operating Expenses were Cash	\$110,000		
Adjust for Prepaid Expense Increases by (+)	+ 9,000	(D)	
Adjust for Prepaid Expense Decreases by (-)			
Adjust for Accrued Liability Increases by (-)			
Adjust for Accrued Liability Decreases by (+)	+ 2,000	(E)	
Adjust for Non-Cash expenses like depreciation by (-)	-22,000	(F)	
Outflows from Operations	<u>\$ 99,000</u>		#3
OUTFLOWS(-) FROM INCOME TAXES			
Assume all income taxes were an outflow	\$ 20,000		
Adjust for Increases in income taxes payable by (-)			
Adjust for Decreases in income taxes payable by (+)	+3,000	(G)	
Outflows from Income Taxes	<u>\$23,000</u>		#4

III. REPORTING CASH FLOWS FROM OPERATING ACTIVITIES

The Direct Method of reporting cash flows from operating activities is based upon the net inflow and outflow from the 4 key components of the Income Statement calculated and numbered above. Adjustments are then made to include operating cash flows from interest earned and interest expense.

The Indirect Method of reporting cash flows from operating activities assumes that all income represented a cash inflow and adjusts as lettered above. Non-operating activities such as the sale of assets and investments are then removed with losses increasing operating activity cash flows because they had originally lowered net income. Gains would decrease cash flow from operations.

DIRECT METHOD

INDIRECT METHOD

Future Horizons Corporation Operating Activities Cash Flows Schedule For the Year Ended December 31, 2002				Future Horizons Corporation Operating Activities Cash Flows Schedule For the Year Ended December 31, 2002			
Operating Activities Cash Flows				Operating Activities Cash Flows			
Cash Receipts from				Net Income			
Sales	#1	\$439,600					\$ 46,600
Interest Earned		<u>1,000</u>	\$440,600	Adjustments to Income			
Cash Payments For				Accounts Receivable Increased	(A)	(\$40,000)	
Cost of Goods Sold	#2	\$265,000		Inventory Decreased	(B)	10,000	
Operating Expenses	#3	99,000		Accounts Payable Increased	(C)	10,000	
Income Taxes	#4	23,000		Prepaid Expenses Increased	(D)	(9,000)	
Interest Expense		<u>10,000</u>	<u>397,000</u>	Accrued Liabilities Decreased	(E)	(2,000)	
Operating Activities Cash Flow		<u>\$ 43,600</u>		Depreciation a Non-Cash Expense	(F)	22,000	
				Income Taxes Payable Decreased	(G)	(3,000)	
				Non-Operating Adjustments			
				Loss on Sale of Investments		5,000	
				Loss on Sale of Plant Assets		<u>4,000</u>	<u>-3,000</u>
				Operating Activities Cash Flows			<u>\$43,600</u>

ANALYSIS

Future Horizons had income of \$46,600 and cash increased by only \$5,000. Since operating activities resulted in a cash inflow of \$43,600, cash flows from Investing and Financing Activities must have been a negative \$38,600 (\$43,600 - \$5,000). Cash flows from Investing and Financing Activities will be explored in the next Learning Unit.