Units 14 The Statement of Cash Flows

I. Introduction

A. **The statement of cash flows** summarizes the effects of business activity on a company's cash balance.

B. Analyzing cash flows leads to a better understanding of a company's financial position.

1. An understanding of the company's ability to pay debt and dividends is developed.
2. Cash flow analysis helps determine the company's ability to have positive cash flows in the future.
3. An understanding of a company's management capability is also enhanced.

II. Three business activities provide the format for analyzing a company's cash flows.

ACTIVITIES	CASH INFLOWS FROM	CASH OUTFLOWS FOR
Operating Activities	Sales Other Income Current Asset Decreases	Operating Expenses Interest Expense Current Asset Increases Taxes
Investing Activities	Long-Term Asset Sales Sale of Investments Loan Collections	Long-Term Asset Purchases Purchase of Investments Loan Repayments
Financing Activities	Sale of Stock Debt Issuance	Treasury Stock Purchases Debt Repayment Dividend Payments

III. Cash flows during Quick Corporation's first year of operation will be analyzed.

A. Data is from pages 5, 7, and 27. Some items have been combined.

B. Accounts receivables (net) equals accounts receivable minus allowance for bad debts.

C. Fixed assets (net) equals fixed assets minus accumulated depreciation.

Quick Company
Income Statement
For Period Ending December 31, 1997

Sales Revenue	$4,000,000
Cost of Goods Sold	2,000,000
Gross Profit	$2,000,000
Operating Expenses[1]	1,650,000
Operating Income After Taxes	$ 350,000
Other Income	150,000
Net Income	$ 500,000

[1] Depreciation expense was $300,000.

Quick Company
Balance Sheets
December 31, 1997

	12/31/97	12/31/96
Assets		
Cash	$ 1,100,000	$ 1,000,000
Accounts Receivable (Net)	1,000,000	
Prepaid Expenses	100,000	
Inventory	800,000	
Land	9,000,000	9,000,000
Fixed Assets (Net)	5,700,000	5,000,000
Total Assets	$17,700,000	$15,000,000
Liabilities and Equity		
Accounts Payable	$ 890,000	
Salaries Payable	10,000	
Notes Payable	8,500,000	$ 7,000,000
Stockholders' Equity 12/31/97	8,300,000	8,000,000
Total Liabilities and Equity	$17,700,000	$15,000,000

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IV. Cash Flows From Operating Activities

A. Cash flow analysis begins with the assumption that net income represents an increase in cash.
B. With accrual accounting, this assumption is probably incorrect. Adjustments, based on changes in balance sheet accounts, are used to trace the actual change in cash.
C. Specifically, the effects of operating activities, investing activities, and financing activities on cash are measured.
   1. For example, if more credit sales are made than collected, accounts receivables increase and a negative adjustment is necessary.
   2. If inventories decrease, the outflow associated with merchandise for resale was less than cost of goods sold. As a result, a positive adjustment is needed.
   3. Similar adjustments are required based on other components of the balance sheet.

V. The logic of cash flows from investing activities and financing activities are explained using parts E, H, and I of the next section.

VI. Statement of cash flows using information from page 28 financial statements.

A. **Net accounts receivable** increased. This means more sales were made than collected, subtract $1,000,000.
B. **Prepaid expenses** increased, subtract $100,000.
C. **Inventory increased,** which means more merchandise was purchased than went into cost of goods sold, subtract $800,000.
D. **Depreciation** is a noncash expense and did not represent a cash outflow, add $300,000.
E. **Net fixed assets** increased by $700,000 and depreciation expense was $300,000. This means fixed assets of $1,000,000 were purchased, subtract $1,000,000.
F. **Accounts payable** increased. This means not all purchases were paid, add $890,000.
G. **Salaries payable** increased. This means not all wages were paid in cash, add $10,000.
H. **Notes payable** increased, add $1,500,000.
I. **Stockholders' equity** increased $300,000. Assuming stock was not sold, and with income of $500,000, a $200,000 dividend was paid. Subtract $200,000.
J. Cash of $100,000 was added to the beginning cash balance of $1,000,000. The result was an ending cash balance of $1,100,000.

Quick Company
Statement of Cash Flows
December 31, 1997

Cash Flows From Operating Activities			
Net Income			$ 500,000
Accounts Receivable Increased	(A)	($1,000,000)	
Prepaid Expenses Increased	(B)	(100,000)	
Inventory Increased	(C)	(800,000)	
Depreciation, a Noncash Expense	(D)	300,000	
Accounts Payable Increased	(F)	890,000	
Salaries Payable Increased	(G)	10,000	(700,000)
Cash Flows From Operating Activities			($ 200,000)
Cash Flows From Investing Activities			
Fixed Assets Purchased	(E)	($1,000,000)	
Cash Flows From Financing Activities			
Notes Payable Increase	(H)	$1,500,000	
Paid Dividend	(I)	(200,000)	300,000
Net Increase (Decrease)			$ 100,000
Cash Beginning of Period			1,000,000
Cash End of Period			$1,100,000

VII. Analysis

A. Accounts receivable went up by $1,000,000 and accounts payable went up by only $890,000. While this is a new business, Lulu hopes this is not a trend.
B. A negative cash flow from operating activities is difficult to finance for a long period.
C. It looks like most of the $1,500,000 increase in notes payable was used to finance fixed assets of $1,000,000. Did the rest go into inventory, or was it used to finance a $200,000 dividend? Creditors won't like loaning Quick money to finance dividends.

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