

## **Chapter 6 Appendix: Statement of Cash Flows**

We have discussed the income statement, the statement of owner's equity, and the balance sheet. The income statement reflects revenues and expenses for the period and indicates whether the business has earned a net income or a net loss for the period. The statement of owner's equity reflects the owner's interest in the business at the end of the period by adding any additional investments and net income and subtracting any withdrawals and net loss from the owner's beginning investment in the business. The balance sheet reflects the assets, liabilities, and owner's equity of the business at the balance sheet date.

None of the statements discussed so far explain how much cash was generated and used by the business or provide a detailed analysis of the change in the cash balance. Cash is a major asset needed by the enterprise to survive. Owners of a business must have cash to meet payrolls, to pay suppliers, and to meet other obligations. Without cash, there are no resources to pay the bills or acquire goods and services.

To fulfill this need, the Financial Accounting Standards Board requires the statement of cash flows. The purpose of the statement of cash flows is to provide relevant information about the cash receipts and cash payments of a business entity during a fiscal period. This purpose is achieved by explaining the change in the entity's cash balance during the period. The statement of cash flows is thoroughly explained in Chapter 25. The intent of the presentation here is to introduce you to the concepts underlying the preparation of this statement.

Illustration 1 on the next page is a simplified version of the statement of cash flows for Carter Consulting Services.

**Illustration 1 (direct method)**  
 Carter Consulting Services  
 Statement of Cash Flows  
 Month Ended December 31, 2004

<u>Cash Flows from Operating Activities</u>		
Cash from services provided	\$21,000	
Cash from accounts receivable	3,000	
Payment of salaries	(5,000)	
Payment of utilities expense	<u>(600)</u>	
Net cash provided by operating activities		\$18,400
 <u>Cash Flows from Investing Activities</u>		
- 0 -		
 <u>Cash Flows from Financing Activities</u>		
Cash withdrawal by owner	<u>( \$3,000)</u>	
Net cash used for financing activities		<u>(3,000)</u>
Net increase in cash		\$15,400
Cash Balance, December 1, 2004		<u>49,000</u>
Cash Balance, December 31, 2004		<u><u>\$64,400</u></u>

The first section of the statement of cash flows explains the cash flows from **operating activities**. These are cash flows that result from Carter Consulting Services' routine, day-to-day business activities, such as selling products and services, paying suppliers, paying employee salaries, and paying other expenses. Carter Consulting Services generated \$21,000 cash from selling services for cash, and \$3,000 cash from collecting cash from services that were sold on account. These activities resulted in a net cash inflow to the business of \$24,000. Carter Consulting Services paid cash of \$5,000 for salaries expense and \$600 for utilities expense. These transactions resulted in a net cash outflow from the business of \$5,600. Overall, the company generated \$18,400 of cash from its operating activities for the month.

The second section of the statement of cash flows explains the cash flows from **investing activities**. Investing activities include buying and selling long-term assets such as land, buildings, and equipment. Carter Consulting Services did not engage in any investing activities during December.

The third section of the statement of cash flows explains the cash flows from **financing activities**. Financing activities involve either receiving cash from, or paying cash to, the owner and creditors of the business. For example, the owner may invest more money in the business or withdraw money from the business. The business may also borrow money from a bank or repay a loan. Linda Carter withdrew \$3,000 of cash from the business. The net amount of cash used by financing activities was \$3,000.

Adding the three sections of the statement ( $\$18,400 + \$0 - \$3,000$ ) results in a net increase in the cash balance of \$15,400. When this is added to the \$49,000 cash balance on December 1, 2004, we obtain the cash balance of \$64,400 on December 31, 2004.

The **direct** and **indirect methods** are the two widely used methods of reporting cash generated from operating activities on the statement of cash flows. The direct method is used in Illustration 1 for Carter Consulting Services. Under the direct method, all revenue and expenses reported in the income statement are adjusted in the Cash Flows from Operating Activities section by reporting the cash amount actually received or paid out for each item. The direct method is preferred by the Financial Accounting Standards Board.

Under the indirect method, net income is treated as the primary source of cash in the Cash Flows from Operating Activities section and is adjusted for changes in current assets and liabilities associated with net income, noncash expenses, and other items. This method is used by the majority of entities because of its more simple approach.

Illustration 2 on the next page shows the indirect method. For a detailed discussion of the statement of cash flows, see Chapter 25.

**Illustration 2 (indirect method)**  
 Carter Consulting Services  
 Statement of Cash Flows  
 Month Ended December 31, 2004

<u>Cash Flows From Operating Activities</u>	
Net income	\$18,317
Adjustments to reconcile net income to net cash provided by operating activities:	
Depreciation expense	\$ 583
Changes in noncash current assets and current liabilities:	
Increase in accounts receivable	(4,000)
Decrease in supplies	500
Decrease in prepaid rent	<u>3,000</u>
Total adjustments	<u>83</u>
Net cash provided by operating activities	\$18,400
 <u>Cash Flows from Investing Activities</u>	
	- 0 -
 <u>Cash Flows from Financing Activities</u>	
Cash withdrawal by owner	<u>(\$3,000)</u>
Net cash used for financing activities	(3,000)
<u>Net Increase in Cash</u>	\$15,400
Cash Balance, December 1, 2004	<u>49,000</u>
Cash Balance, December 31, 2004	<u>\$64,400</u>