

Lecture 9: The Cash Flow Statement

- Cash Flow Statement provides additional information about the business' cash activities
- Reports (summarises) the changes in a business' cash during an accounting period
- Shows cash inflows and outflows for an accounting period classified into operating, investing or financing activities.
- Shows users:
 - Where the business got its cash from
 - What the business did with it

Cash Flows vs Accounting Flows

- Cash Flow Statement reports cash inflow and outflow transactions
- Cash inflows refers to 'transactions that resulted in increases in cash'
- Cash outflows refers to 'transactions that resulted in decreases in cash'
- Cash inflows and outflows are not the same as accounting flows, e.g. we record a credit sale as revenue for the income statement at the time of sale, but we would not record the cash inflow on the Cash Flow Statement until the cash was received.
- The Cash Flow Statement explains the change in the business' cash for the period by summarising its cash inflows and outflows.

Beginning Cash Balance + Cash Inflows - Cash Outflows = Ending Cash Balance

Cash Inflows and Outflows

Cash Inflows (Receipts)

- Decreases in assets other than cash
- Increases in liabilities
- Increases in owner's equity

Cash Outflows (Payments)

- Increases in assets other than cash
- Decreases in liabilities
- Decreases in owner's equity

CLASSIFICATION OF THE CASH FLOW STATEMENT

- The Cash Flow Statement classifies a business' cash flows into three categories according to the type of activity that causes the cash inflow or outflow:
 1. Cash flows from operating activities
 2. Cash flows from investing activities
 3. Cash flows from financing activities

A. Cash Flows from Operating Activities

- Operating activities include primary activities of buying, selling and delivering goods for sale as well as providing services. They include support activities such as administration.
- There are two methods of calculating cash flows from operating activities:
 - The direct method
 - The indirect method

Direct Method:

- Business may report operating cash inflows in as many as three categories:
 - Collections from customers
 - Collections of interest
 - Other operating receipts
- And cash outflows in as many as four categories:
 - Payments to suppliers
 - Payments to employees
 - Payments of interest
 - Other
- Involves subtracting operating cash outflows from operating cash inflows to determine net cash from operating activities

Indirect Method:

- Net income is adjusted to obtain net cash flow from operating activities

B. Cash Flows from Investing Activities

- Investing activities include lending money and collecting on the loans, investing in other companies and buying and selling property equipment
- Cash flows related to investing activities often involve changes in non-current assets

C. Cash Flows from Financing Activities

- Financing activities include obtaining capital from owner and providing owner with return on investment as well as obtaining capital from banks/lenders/financers and repaying amounts borrowed.
- Generally, cash flows from financing activities involve changes in non-current liabilities and owner's equity accounts.

Calculating Cash Flows

Collections from Customers

- A business can make sales for cash or for credit, so its sales revenue account contains both cash and credit sales for the period.
- Accounts receivable account contains increases due to credit sales and decreases due to collections of account receivable.
- If the accounts receivable account decreases during a period, then the business has collected more cash from customers than the amount of current credit sales made.
- If the accounts receivable account increases during a period, then the business has collected less cash from customers than the amount of current credit sales made.
- It follows that we can calculate cash collections from customers for a period by taking the balance of the sales revenue account and adjusting it for the change in accounts receivable:

$$\text{Cash collections from customers} = \text{sales revenue} +/- \text{change in accounts receivable}$$

Payments to Suppliers and Employees

- Payments to suppliers and employees can be calculated used the same logic.
Cash payments to suppliers = COGS +/- change in inventory +/- change in accounts payable

ANALYSIS OF THE CASH FLOW STATEMENT

- The cash flow statement helps financial statement user to evaluate a business with respect to:
 - Solvency
 - Debt servicing ability
 - Ability to generate cash to cover operating activities
 - Ability to finance expansion
- Internal users like managers can compare the cash flow statement to their cash budget to help evaluate performance and plan for the future.
- We can use cash flow statement data in conjunction with data from the income statement and balance sheet to calculate measures of cash operating performance and return
- We look at three ratios:
 - Operating cash flow margin
 - Cash return on total assets
 - Cash return on owner's equity

1. *Operating Cash Flow Margin* - measures how much net cash the business generates from each dollar of net sales:
$$\text{OPERATING CASH FLOW MARGIN} = \text{NET CASH FLOW PROVIDED BY OPERATING ACTIVITIES} / \text{NET SALES}$$
2. *Cash Return on Total Assets* - measures how well the business is using its resources to generate net cash from operating activities
$$\text{CASH RETURN ON TOTAL ASSETS} = \text{NET CASH PROVIDED BY OPERATING ACTIVITIES} + \text{INTEREST PAID} / \text{AVERAGE TOTAL ASSETS}$$

3. *Cash Return on Total Owner's Equity* - measures how much net cash from operating activities the business generated with each dollar of owner's equity
CASH RETURN ON TOTAL OWNER'S EQUITY = NET CASH PROVIDED BY OPERATING ACTIVITIES /
AVERAGE OWNER'S EQUITY

Evaluation Using Cash Flow Ratios...

- *Is the business generating sufficient cash to support its current operating activities?*
- *Is the business generating sufficient cash to support an expansion of its operations?*
- *If you were a bank, would you lend to the business?*