

Statement of Cash Flows – Preparation of Statement

This is the second of a two part video series on the statement of cash flows. The first video covered an introduction to the statement of cash flows. This video will explain how to prepare a statement of cash flows.

Now that we understand the different sections of the statement of cash flows, let's discuss the steps to prepare it. In step 1, we will prepare the heading, step 2, complete the operating activities section, step 3, complete the investing activities section, step 4, complete the financing activities section. In step 5, we will compute the net increase or decrease in cash, and, step 6, report beginning and ending cash.

Step 1 – Record the statements heading

Notice that the heading includes the name of the company, Sophie's Dog Washing Business, the name of the statement – statement of cash flows, and the time period, for the year ending December 31, 2008.

Step 2 – Complete the operating activities section. There are two ways to prepare the operating section, the indirect or direct method. Regardless of which method you choose the end result is the same. In this video we will only discuss the indirect method. We will start the section with net income. This net income number comes from the income statement.

After net income, we will need to identify the adjustments to reconcile net income to net cash. There are three types of adjustments. 1. adjustments for noncash current assets and current liabilities, 2. noncash revenue and expense items, and 3. nonoperating items.

The first adjustment is for noncash current assets, such as accounts receivables, inventory, and prepaid expenses. If the current asset increases during the year then the amount will be subtracted from net income. If the current asset decreases during the year then the amount will be added to net income.

There is also an adjustment needed for current liabilities, such as accounts payable, interest payable, and income taxes payable. If the current liability increases during the year then the amount will be added to net income. If the current liability decreases during the year then the amount will be subtracted from net income.

Reviewing a select portion of the balance sheet for Sophie's dog washing business, we need to identify the changes in noncash current assets and current liabilities. Accounts receivable decreased by 20,000 so we will add the decrease to net income. Inventory increased during the year, so the change in this account will be subtracted from net income. Remember that current asset increases are subtracted from net income and decreases are added to net income.

Now looking at the current liability section, accounts payable increased by 6,000 so this change will be added to net income. Interest payable decreased so this will be subtracted from net income. For current liabilities increases are added to net income and decreases are subtracted from net income. Let's transfer this information to the statement of cash flows.

There are two more adjustments that need to be made to net income, noncash revenue and expense items and nonoperating activities items. Items that are noncash expenses such as depreciation, amortization, and bad debt expenses are added to net income. Nonoperating losses are also added to net income.

Nonoperating gains are subtracted from net income.

Reviewing a select portion of the income statement for Sophie's dog washing business, we will now look for noncash revenue/expenses and nonoperating items to make the last adjustments on the operating section. Sophie's dog washing business has two adjustments: depreciation expense and gain on disposal of asset. Let's transfer this information to the statement of cash flows.

The depreciation expense will be added to net income and the gain will be subtracted from net income.

Totaling the adjustments and the net income, Sophie's dog washing business has a positive cash flow from operating of \$31,000 or net cash provided by operating activities.

After the operating section, the investing section is prepared. Step 3. Let's review some information provided by Sophie's Dog Washing Business.

Transaction a, paid \$20,000 cash for a new truck, and transaction b, sold land for a gain both relate to the investing section. Remember the investing section involves cash transactions dealing with long-term assets, short-term investments and notes receivable.

Transaction c, issued common stock for cash and transaction d, paid cash dividend, relate to the financing section. The financing section involves cash transactions involving long-term liabilities and equity. We will now transfer transaction a and b to the investing section.

In the cash flows from investing section, we will include transaction a, cash paid for purchase of truck as a negative cash flow of \$20,000. Transaction b will be recorded as cash received for sale of land as a positive cash flow of \$70,000.

This leaves a positive cash flows, or cash provided by investing activities of \$50,000.

The last section on the statement of cash flows is the financing section, or step 4.

Looking again at Sophie's Dog Washing Business, there are two transactions related to the financing section. Issued common stock and paid cash dividends. We will now transfer that information to the financing section.

Transaction c, cash received from issuing stock will be reported as a positive cash flow of \$10,000, and transaction d, cash paid for dividends will be shown as a negative cash flow of \$14,600.

This leaves a negative cash flow, or cash used by financing activities of 4,600. Notice that because this is negative, Sophie's Dog washing business had an overall outflow of cash from financing activities.

We have now prepared all three sections of the statement of cash flows, operating, investing, and financing. In step 5, we will compute the net increase or decrease in cash by adding together all of the cash flows.

Adding cash provided by operating of \$31,000 plus \$50,000 from investing and subtracting \$4,600 from financing leaves Sophie's Dog washing business with a net increase in cash of \$76,400. If our calculation would have been negative it would be a net decrease in cash. The last step, step 5, is to list cash at the beginning, and then prove cash at the end.

Cash balance at 2007 year-end, of \$12,000 would come from the balance sheet and cash at 2008 year-end should match to \$88,400.

Reporting a cash balance of \$12,000 for the beginning of the year, and adding it to the net increase in cash of \$76,400 leaves a cash balance at 2008 year-end of \$88,400. This ties with the ending cash balance on the balance sheet. If there were noncash investing and financing activities, remember that a separate schedule would also need to be prepared.

This ties with the ending cash balance on the balance sheet.

If there were noncash investing and financing activities, remember that a separate schedule would also need to be prepared before the statement of cash flows would be complete.

In closing, let's review one more time the steps required to prepare a statement of cash flows. Step 1, prepare the heading, step 2, complete the operating activities section, step 3, complete the investing activities section, step 4, complete the financing activities section. In step 5, we will compute the net increase or decrease in cash, and, step 6, report beginning and ending cash.