

WHAT DO I SEE ON CASH FLOW STATEMENTS?

LEARNING OBJECTIVES

After completing this module you will be able to:

- Identify the purposes and structures of direct and indirect cash flow statements and some of the ways managers, investors, and others use them.
- Compare and contrast operating, investing and financing cash flow line items on real companies' cash flow statements.
- Apply a hierarchical approach to assessing companies' current cash flows, which will help you predict future cash flows and develop a more informed assessment of the quality of companies' earnings.



Key take-aways:

- One of the key functions of cash-flow statements is to help users predict a company's future cash flows and assess the quality of net income. This is accomplished in two ways: (1) cash-flow statements help users predict future cash flows by explaining the change in cash as reported on the balance sheet and (2) they reconcile differences between net income and cash from operations, which helps users assess the quality of net income and predict when income will be converted to cash.
- Cash flow statements explain balance sheet changes in cash in terms of operating, investing, and financing activities: net cash inflows (outflows) from operating activities, plus net cash inflows (outflows) from investing activities, plus net cash inflows (outflows) from financing activities, plus or minus adjustments for exchange rate variations on foreign cash balances.
- Financing cash flows primarily result from transactions with owners (e.g., dividend distributions, stock issues, and stock repurchases), issuing debt, and repaying debt principal (Interest payments are not financing cash flows under U.S. GAAP; they are operating cash flows. Under IFRS, companies may report interest payments as operating or financing cash flows.)
- Investing cash flows are primarily associated with buying or selling property, plant, and equipment, intangibles, and most types of investment securities. They also include cash flows associated with buying or selling complete companies.
- Operating cash flows mostly pertain to ongoing activities in a company's primary business including events associated with research and development, purchasing, manufacturing, sales, marketing, distribution, customer collections, and support. GAAP defines operating activities as a residual concept to include all activities that are not investing or financing activities. As a result, cash from operations includes a few items that have very little to do with operating activities such as tax payments.

- There are two types of cash flow statements: Direct and Indirect. The two methods are the same *except* for the line items in the operating section. Direct cash flow statements' operating section line items report the cash flows that combine to get net cash from operations, such as customer collections and supplier payments. Indirect cash flow statements' operating section line items reconcile net income to net cash from operations, where net cash from operations = net income + reconciliation adjustments. Reconciliation adjustments are either non-cash items only or they combine non-cash items with cash flows.
- On indirect cash-flow statements, the line items above net cash from operations are reconciliation adjustments and help explain the reasons net income differs from cash from operations. Generally, they are not cash flows. Investing and financing sections of cash-flow statements primarily correspond to direct cash inflows and outflows. The few exceptions are beyond the scope of this chapter.
- Figure 1 illustrates how cash flow statements can be analyzed hierarchically: Level 1: Change in cash and cash equivalents is at the top of the hierarchy. This is the same as the change in cash and cash equivalents on the balance sheet.
- Level 2 splits the change in cash and cash equivalents into major categories: net cash from operating activities, net cash from investing activities, net cash from financing activities, net cash from exchange rate variations on foreign cash balances. This allows users to get a better assessment of the sources of cash inflows and the uses of cash outflows.
- Level 3 centers on line items. Cash flow statement line items can help users predict future cash flows and reconcile differences between net income and cash from operations, which helps users assess the quality of net income and predict when income will be converted to cash.
- The challenging aspect of indirect cash flow statements is interpreting the reconciliation adjustments. To accomplish this, we will go behind the numbers in the next module.

Key terms:

- **Financing activities** - Activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.¹ Financing cash flows primarily result from transactions with owners (e.g., dividend distributions, stock issues, and stock repurchases), issuing debt, and repaying debt principal. (Interest payments are not financing cash flows under U.S. GAAP; they are operating cash flows. Under IFRS, companies may report interest payments as operating or financing cash flows.)
- **Investing activities** - Activities related to the acquisition and disposal of long-term assets and other investments not included in cash equivalents.² Investing cash flows are primarily associated with buying or selling property, plant, and equipment, intangibles, and most types of investment securities. They also include cash flows associated with buying or selling complete companies.
- **Operating activities** - Activities related to the principal revenue-producing activities of the entity and other activities that are not investing or financ-

¹ IASB 7, ¶ 6

² IASB 7, ¶ 6

ing activities.³ Operating cash flows mostly pertain to ongoing activities in a company's primary business including events associated with research and development, purchasing, manufacturing, sales, marketing, distribution, customer collections, and support.

- **Reconciliation adjustment** - A line item in the operating section of an indirect method cash flow statement that partially explains why net income differs from net cash from operating activities.

Key formulas:

- **Reconciliation Equation** net cash from operations = net income + reconciliation adjustments

3 IASB 7, ¶ 6

Figure 1 Hierarchical Analysis of Cash flow Statements

This figure illustrates how cash flow statements can be analyzed hierarchically.

BISCHOFF GLOBAL SPORTSWEAR STATEMENT OF CASH FLOWS		
For years ended December 31, 2012 and 2013		
(In Millions)	2013	2012
Cash flows from operating activities		
Net profit	\$89	\$76
Adjustments		
(Gain) loss on sale of PP&E	(3)	(3)
Depreciation	32	28
Accounts receivable	(10)	(46)
Inventories	(27)	(32)
Prepaid expenses	15	13
Accounts payable	(22)	(21)
Accrued liabilities	(12)	(10)
Other	34	20
Net cash provided by (used in) operations	96	25
Cash flows from investing activities		
Payments for property, plant, and equipment	(20)	(17)
Proceeds from disposal of property, plant, and equipment	15	14
Other investing cash flows	(80)	(37)
Net cash provided by (used in) investing activities	(85)	(40)
Cash flows from financing activities		
Proceeds from issue of share capital	10	7
Proceeds from borrowings	10	9
Payment of dividends	(20)	(18)
Other financing cash flows	5	4
Net cash provided by (used in) financing activities	5	2
Net increase (decrease) in cash during year	16	(13)
Other	2	2
Cash and Cash equivalents at start of year	13	24
Cash and Cash equivalents at end of year	\$31	\$13

Change in cash and cash equivalents

Major Categories

Line Items

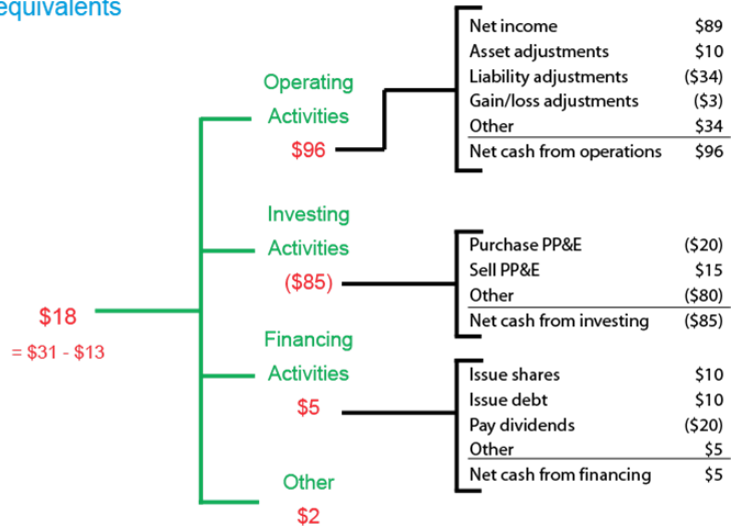


Figure 2 Direct and Indirect Cash flow Statements

This figure illustrates how direct and indirect methods differ for cash flow statements.

Things you need to know about indirect cash flow statements

Ways direct and indirect cash flow statements differ

- Except for net cash from operations, the operating sections are completely different
 - Direct cash flow statements report the cash flows that are combined to get net cash flows from operations
 - Indirect cash flow statements reconcile net income to net cash from operations
 - Net cash from operations = net income + reconciliation adjustments
- The reconciliation adjustments are either non-cash items only or they combine non-cash items with cash flows
- Indirect cash flow statements do two things
 - They explain the changes in cash, albeit not as thoroughly as direct cash flow statements
 - They reconcile net income to net cash from operations on the statement, rather than in the notes

Actual Qantas Direct Cash Flow Statement

The QANTAS GROUP
Consolidated Cash Flow Statement
for the year ended 30 June 2011

Notes	Qantas Group	
	2011 \$M	2010 \$M
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash receipts in the course of operations	15,545	14,376
Cash payments in the course of operations	(13,727)	(13,125)
Interest received	180	149
Interest paid	(239)	(194)
Dividends received from associates and jointly controlled entities	21	16
Income tax refunded	2	129
Net cash from operating activities	1,782	1,351
CASH FLOWS FROM INVESTING ACTIVITIES		
Payments for property, plant and equipment and intangible assets	(2,407)	(1,688)
Interest paid and capitalized on qualifying assets	(90)	(44)
Proceeds from disposal of property, plant and equipment	86	27
Proceeds from the sale and leaseback of non-current assets	30	74
Deconsolidation of controlled entity	(100)	-
Proceeds from disposal of controlled entity, net of cash disposed	19	-
Proceeds from the disposal of jointly controlled entity	5	-
Payment for controlled entity acquired, net of cash acquired	(21)	-
Payments for investments in associate and jointly controlled entity	15	(14)
Net cash used in investing activities	(2,478)	(1,645)
CASH FLOWS FROM FINANCING ACTIVITIES		
Payments for treasury shares	(65)	(16)
Proceeds from borrowings	1,359	1,352
Repayment of borrowings	(784)	(974)
(Payments)/proceeds from swaps	(1)	1
Net receipts from aircraft security deposits	-	22
Dividends paid to non-controlling interests	(1)	(4)
Net cash from financing activities	508	381
Net (decrease)/increase in cash and cash equivalents held	(188)	87
Cash and cash equivalents at beginning of the year	3,704	3,617
Effect of exchange rate changes on cash and cash equivalents	(20)	-
Cash and cash equivalents at end of the year	3,496	3,704

The above consolidated cash flow statement should be read in conjunction with the accompanying notes

Qantas' 2011 annual report, page 84, www.qantas.com.au

Hypothetical Qantas Indirect Cash Flow Statement

The QANTAS GROUP
Consolidated Cash Flow Statement
for the year ended 30 June 2011

Notes	Qantas Group	
	2011 \$M	2010 \$M
CASH FLOWS FROM OPERATING ACTIVITIES		
Statutory profit for the year	249	116
Add: depreciation and amortization	1,249	1,199
Add: dividends received from associates and jointly controlled entities	21	16
Add: share based payments	59	21
Add: amortization of deferred financing fees	18	15
Add: net impairment of property, plant and equipment	44	48
Add: net loss on disposal of investments and related transaction costs	20	-
Add: net loss on disposal of property, plant and equipment	1	15
Add: changes in the fair value of financial instruments	124	478
Less: amortization of deferred lease benefits	(11)	(17)
(Less: interest payments on liabilities held at fair value	(113)	(94)
Add/(less): realized hedging loss/(gain) on operating cash flows	60	(292)
I (Less)/add share of net (profit)/loss of associates and jointly controlled entities	(22)	4
I Add/(less): other items	9	(51)
Movements in operating assets and liabilities		
- (increase)/decrease in receivables	(35)	58
- (Increase) in inventories	(51)	(69)
- Decrease in current tax receivable	-	128
- (Increase) in other assets	(6)	(64)
- Increase/(decrease) in payables	48	(83)
- Decrease in revenue received in advance	(5)	(107)
- Increase/(decrease) in provisions	51	(32)
- Increase in deferred tax liabilities	72	62
Net cash from operating activities	1,782	1,351
CASH FLOWS FROM INVESTING ACTIVITIES		
Payments for property, plant and equipment and intangible assets	(2,407)	(1,688)
Interest paid and capitalized on qualifying assets	(90)	(44)
Proceeds from disposal of property, plant and equipment	86	27
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Figure 3 Accounting is not a spectator sport — it's game time

This figure lists Scenic route menus for additional information.

