OBJECTIVE OF FINANCIAL ACCOUNTING

- *The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions.*

II) WHAT ARE THE MAIN REASONS FOR KEEPING ACCOUNTS?

- Accounts are kept to provide information about the business. The need to provide answers to the following questions:
- ● how much profit or loss has the business made?
- ● how much money does the company owe?
- ● will the company have sufficient funds to meet its commitments?
- ● what is the value of the business and what are its net assets?
- ● what (if applicable) is the stock market value of our shares and do they represent good value for investors and potential investors
- ● is the business financially stable?
- ● what is the growth potential for the business?
- ● to meet statutory and regulatory requirements
- ● to ensure proper record keeping, and financial control
- ● to aid planning and objective measuring
- ● any other reasonable reason

IDENTIFY THE MAIN CHARACTERISTICS OF USEFUL INFORMATION

- Understandable, relevant, reliable and comparable
- concept of maximisation of shareholder wealth and the conflicts which exist between various stakeholder groups

FUNDAMENTAL CONCEPTS OF ACCOUNTING

- Accounting is the language of business and it is used to communicate financial information.
- In order for that information to make sense, accounting is based on 12 fundamental concepts.
- These fundamental concepts then form the basis for all of the Generally Accepted Accounting Principles (GAAP).

ACCOUNTING CONCEPTS

- ENTITY
- MONEY MEASUREMENTS
- GOING CONCERN
- COST
- DUAL ASPECT
- OBJECTIVITY
- TIME PERIOD
- CONSERVATISM
- REALIZATION
- MATCHING
- CONSISTENCY
- MATERIALITY

IDENTIFY THE GROUPS OF BUSINESS ACTIVITIES FOR FINANCIAL REPORTING

- **Operating activities** are transactions that involve the firm's everyday lines of production and trade. Sales and their related costs are typically a firm's primary operating activities. Other examples of operating activities include paying taxes and buying short-term assets and taking on short-term liabilities to support the firm's ordinary business.
- **Investing activities** are the firm's transactions to acquire or dispose of long-term assets. Purchases and sales of property, plant and equipment are investing activities, as are purchases and sales of securities issued by others.
- **Financing activities** are transactions through which the firm raises or repays capital. These include issuing or repaying debt, issuing or repurchasing stock, and paying dividends to shareholders.

CLASSIFY ACCOUNTS INTO THE FINANCIAL STATEMENT ELEMENTS.

- **Assets** are the firm's economic resources.
- **Liabilities** are creditors' claims on the firm's resources.
- **Owners' equity** includes paid-in capital (common and preferred stock), retained earnings, and other comprehensive income.
- **Revenue** includes sales, investment income, and gains.
- **Expenses** include the cost of goods sold, selling and administrative expenses, depreciation, interest and tax expenses, and losses.

EXPLAIN THE PROCESS OF RECORDING BUSINESS TRANSACTIONS

- Keeping the accounting equation in balance requires **double-entry accounting**, in which a transaction has to be recorded in at least two accounts
- *Purchase equipment for $10,000 cash. Property, plant and equipment (an asset) increases by $10,000. Cash (an asset) decreases by $10,000.*
- *Borrow $10,000 to purchase equipment. PP&E increases by $10,000. Notes payable (a liability) increases by $10,000.*

INFORMATION FLOWS THROUGH AN ACCOUNTING SYSTEM IN FOUR STEPS

- **Journal entries** record every transaction, showing which accounts are changed by what amounts. A listing of all the journal entries in order by date is called the "general journal."
- The **general ledger** sorts the entries in the general journal by account.
- At the end of the accounting period, an **initial trial balance** is prepared that shows the balances in each account. If any adjusting entries are needed, they will be recorded and reflected in an **adjusted trial balance**.
- The account balances from the adjusted trial balance are presented in the **financial statements**.

CAPITAL AND REVENUE EXPENDITURE

- **CAPITAL EXPENDITURE**
- Outlay resulting in the increase or acquisition of an asset or INCREASE in the earning capacity of a business
- **REVENUE EXPENDITURE**
- Outlay as is necessary for the MAINTENANCE of earning capacity including the upkeep of the fixed assets in a fully efficient state.

- **Q1 (a) (i) What is accounting?**
- (ii) **What are the main reasons for keeping accounts?**
- **(b) (i) Why might the following stakeholders be interested in financial information about** a company?
- (1) Managers of the company
- (2) Shareholders of the company
- (3) Trade creditors
- (4) Employees
- (5) Government departments and government agencies
-

STAKEHOLDERS

- Internal stakeholders
- ● Managers of the company
- ● Employees
- ● Directors
- External stakeholders
- ● Shareholders
- ● Trade creditors (suppliers)
- ● Providers of finance
- ● Trade unions
- ● Financial analysts and advisers
- ● Government and their agencies, including The Inland Revenue
- ● The public
- ● Trade debtors (customers)

FINANCIAL AND MANAGEMENT ACCOUNTING

Financial Accounting	Management Accounting
legally required – - deals with the past - - uses prescriptive standards -reporting need – -- external scrutiny -mainly financially based – -- precision needed (e.g. bookkeeping) - - limited flexibility -	-not legally required -- deals with the future -- no prescription -- decision-making/planning and control use - no external scrutiny - other non financial factors considered - - less precision needed - - adapted to the needs of the individual business

WHY DO WE NEED ACCOUNTING STANDARDS

- Development of accounting standards 1942 by chartered accountants in UK

Statement of Standard Accounting Practices (SSAP)

Financial Reporting Standards (FRS)

International Accounting Standards (IAS)

International Financial Reporting Standards (IFRS)

1970S – ACCOUNTING STANDARD COMMITTEE (ASC)

- To narrow differences
- Disclosure of information and departures
- Development of New accounting standards
- Improving accounting standards
- Focus on HARMONISATION
- Reliability
- Comparability
- Materiality

DOUBLE ENTRY BOOKKEEPING PRINCIPLE

- For the accounts to remain in balance, a change in one account must be matched with a change in another account. These changes are made by debits and credits to the accounts.
- **Debit accounts** = Asset and Expenses (also debit money received into bank accounts)
- **Credit accounts** = Gains (income) and Liabilities (also credit money paid out of bank accounts)

- The following accounts have a normal balance of debit:
- Assets
- Accounts receivable: debts promised by other entities but not yet paid
- Drawings by the owners on equity
- Expenses

- The following accounts have a normal balance of credit:
- Liabilities
- Accounts payable and taxes payable, notes or loans payable: debts promised to outsiders but not yet paid
- Revenue
- Capital

Double entry principle

- The following table summarizes how debits and credits affect the different elements of the accounts.
- ▲ = increase, ▼ = decrease
-

Account	Debit	Credit
Assets	▲	▼
Expenses	▲	▼
Liabilities	▼	▲
Equity	▼	▲
Revenue	▼	▲

Prepare a Journal entry and Ledger

- Mr. fisher started business with 10000 of his own money in business account in march 1
- on 3 march, he bought a van, paying 3000 by cheque
- on 8 march, he purchased goods for resale from Mr Hunter for 1000 credit
- On 12 march, he paid 500 to Mr. hunter by cheque

Classification of ledger accounts

- Personal accounts
  - Debtors and creditors
- Impersonal accounts
  - Real accounts-
    - assets, land, vehicles, equipment
  - Nominal accounts-
    - income, purchase, expenses

Example 1

- Debbie starts in business on 1 Jan 2000. her transactions are
- Jan 6: Debbie pays £1000 of her own money into business bank account
- Jan 9: Debbie buys a small second hand car for £600, paying by cheque.
- Jan 12: Debbie draws £100 cash from bank, for business use.
- Jan 13: Debbie buys hairdressing supplies for £60 cash
- Jan 16: Debbie buys petrol for £10 cash and earns £60 cash from her clients
- Jan17: she earns £70 in cheques from clients, which she deposits in the bank immediately.
- Balance off all account as at 31 Jan. (pp33.34)

Q2 At the end of March 2009, the bookkeeper of Kendal Ltd extracted a trial balance that included a number of errors. The trial balance is shown below:

	DR £	CR £
Purchases	13,200	
Sales		46,750
Rent paid	500	
Wages	1,100	
General expenses	650	
Carriage in		700
Carriage out	900	
Salaries	1,750	
Premises	31,000	
Fixtures and fittings	860	
Debtors		740
Creditors	210	
Bank overdraft	190	
Cash	110	
Drawings		240
Capital		4,600
	50,470	53,030

Required:

(a) Identify which of the above figures are on the wrong side of the trial balance. **(5 marks)**

Answers and discussions

- Carriage in (£700)
- - Debtors (£740)
- - Creditors (£210)
- - Bank overdraft (£190)
- - Drawings (£240)

1 The following balances have been extracted from the books of Millom Co Ltd, as at 31 December 2005.

	£
Creditors	18,900
Sales	240,000
Land at cost	54,000
Buildings at cost	114,000
Bank (overdrawn)	18,000
Furniture/fittings at cost	66,000
Depreciation – buildings	18,000
Depreciation – furniture/fittings	30,000
Discounts received	5,292
Profit b/d 1 Jan 2005	6,000
Provision for doubtful debts	2,448
Cash in hand	696
Stock – 1 Jan 2005	42,744
Rates	6,372
Wages and salaries	24,000
Insurance	5,688
Returns inwards	1,116
General expenses	1,308
Purchases	131,568
5% debentures	48,000
Ordinary shares	120,000
General reserve	30,000
Debtors	89,148

	£	£
creditors		18,900
sales		240,000
land – cost	54,000	
buildings – cost	114,000	
bank (overdrawn)		18,000
furniture/fittings at cost	66,000	
dep – buildings		18,000
dep – furniture/fittings		30,000
dis received		5,292
profit b/d 1-1-05		6,000
provision for doubtful debts		2,448
cash in hand	696	
stock – 1-1-05	42,744	
rates	6,372	
wages/salaries	24,000	
insurance	5,688	
return inwards	1,116	
gen expenses	1,308	
purchases	131,568	
5% debentures		48,000
ordinary shares		120,000
gen reserve		30,000
debtors	89,148	
	536,640	536,640

Q1 Rush and Aldridge are in partnership sharing profits and losses in the ratio 3:2 respectively. The following list of balances has been extracted from the books, of the business, for the year ended 30 November 2006.

		£
land at cost		120,000
fixtures and fittings (cost)		70,000
fixtures and fittings (depreciation)		20,000
creditors		17,000
debtors		21,000
balance at bank (cr)		7,500
bank loan		20,000
provision for bad debts		1,000
sales		98,000
purchases		39,000
stock (1-12-05)		11,000
rent and rates		3,000
insurance		1,500
salaries and wages		13,700
office expenses		2,800
heating and lighting		1,750
advertising		900
capital account	– Rush	80,000
	– Aldridge	50,000
current account	– Rush (cr)	3,850
	– Aldridge (dr)	(2,000)
drawings	– Rush	3,700
	– Aldridge	7,000

	DR £	CR £
Land – cost	120,000	
Fixtures and fittings	70,000	
Fixtures and fittings – dep		20,000
Creditors		17,000
Debtors	21,000	
Balance at bank		7,500
Bank loan		20,000
Provision for bad debts		1,000
Sales		98,000
Purchases	39,000	
Stock – 1-12-04	11,000	
Rent and rates	3,000	
Insurance	1,500	
Salaries and wages	13,700	
Office expenses	2,800	
Heating and lighting	1,750	
Advertising	900	
Capital – Rush		80,000
Capital – Aldridge		50,000
Current – Rush		3,850
Current – Aldridge	2,000	
Drawings – Rush	3,700	
Drawings – Aldridge	7,000	
Total	297,350	297,350

STRUCTURE OF P & L A/C

- Revenue/Sales 1000000
- COGS (600000)
- Gross Profit 400000

Trading Account

- SG&A (190000)
- Depreciation (10000)
- Operating Profit 200000
- Interest Exp (10000)
- Profit before tax 190000
- Tax 20% (38000)
- Net Income/Profit 152000

TRADING ACCOUNT

Sales			11000
Less sales return			(1000)
Net sales/ turnover			10000
Cost of goods			
Opening stock		5000	
Purchases	3000		
Less purchase returns	(1000)		
	2000		
Add carriage inwards	1000	3000	
		8000	
Less closing stock		2000	6000
Gross profit			4000

DEPRECIATION

- Straight line method
- Reducing balance method
  - Fixed percentage
  - double declining

- depreciation (expenses) is reduced from gross profit at year end. Charged to P&L a/c
- Total Depreciation is reduced from the PP&E in balance sheet

EXAMPLE OF P&L

Discount allowed	32
Discount received	267
Gross profit	83497
Salaries	44216
Bank charges	193
Office expenses	1361
Rent	19421
Bad debts	937
Carriage outwards	5971
Plant and machinery	50000
Note. Deprecation of plant is 10%	
Note; rent owning due is 2000	
Note office expense included £250 paid as advance for next year.	

EXAMPLE OF P&L

Gross profit	83497	
Discount received	267	83764
Expenses SG&A		
Salaries	44216	
Bank charges	193	
Office expenses	1361 -250	
Discount allowed	32	
Rent	19421 + 2000	
Bad debts	937	
Carriage outwards	5971	
Depreciation	50000 * 10%	
		78881
Net Profit		4883

Q3 The following list of balances has been extracted from the books of Adrian Phil trader, as at 30 June 2008.

	£	£
Land – cost	90,000	
Premises – cost	10,600	
Vehicles – cost	6,400	
cumulative ~~Provision for~~ depreciation		
– premises		3,180
– vehicles		1,280
Stock (1 July 2007)	3,820	
Purchases	17,800	
Sales		36,700
Wages	3,920	
Heating	740	
Insurance	360	
Rent	270	
Rates	1,010	
Admin expenses	1,050	
Debtors	2,400	
Creditors		1,980
Bank	620	
Drawings	11,000	
Capital		106,850
	149,990	149,990

The following additional information is also available:

1. Stock at 30 June 2008 £4,660.
2. At 30 June 2008 wages outstanding £80.
3. At 30 June 2008 insurance expenses prepaid £60.
4. Depreciation for the year to 30 June 2008 is to be provided as follows:
   – premises – 10% on cost
   – vehicles – 20% on net book value (NBV)

Q3 (a) Adrian Phillips. Trading and Profit and Loss Account for the period ended 30th June 2008

		£	£
	Sales		36,700
	Opening stock	3,820	
Add:	Purchases	17,800	
		21,620	
Less:	Closing stock	(4,660)	
Cost of goods sold			(16,960)
Gross profit			19,740
Less: Business expenses			
	-Wages	4,000	
	-Heating	740	
	-Insurance	300	
	-Rent	270	
	-Rates	1,010	
	-Admin	1,050	
	-Depreciation		
	-Premises	1,060	
	-Vehicles	1,024	
			(9,454)
Net profit			10,286

Q1 Mrs Phillips has a small jewellery business that she operates in her local area. The following balances have been taken from her books on 30 June 2006.

	£
Capital (1 July 2005)	34,600
Office furniture	1,460
Cash drawings (for personal use)	5,000
Stock (1 July 2005)	14,970
Purchases	168,200
Sales	200,600
Rent	1,450
Lighting and heating	490
Insurance	300
Salaries and wages	6,500
Stationery	740
Telephone and postage	520
General expenses	2,400
Bad debts written off	620
Debtors	18,600
Creditors	7,600
Balance at bank (dr)	6,800
Vehicles	14,750

The following information needs to be taken into account.

(i) Stock at 30 June 2006 was valued at £11,650.
(ii) Rent owed at 30 June 2006 was £110.
(iii) Telephone prepaid at 30 June 2006 was £140.
(iv) Both office furniture and vehicles are to be depreciated by 20% of their book value.

Question 1

(a) Mrs Phillips Trading and Profit and Loss Account for the period ended 30th June 2006

	£	£
Sales		200,600
Opening stock	14,970	
+ Purchases	168,200	
	183,170	
– Closing stock	(11,650)	
Cost of goods sold		(171,520)
Gross profit		29,080
Less: expenses		
Rent	1,560	
Lighting and heating	490	
Insurance	300	
Salaries & wages	6,500	
Stationery	740	
Telephone & postage	380	
General expenses	2,400	
Bad debts	620	
Depreciation		
– office furniture	292	
– vehicle	2,950	
		(16,232)
Net profit		12,848

BALANCE SHEET

- Asset = Liability + Equity (Capital)
- Assets are probable current and future economic benefits
- Liabilities are probable future sacrifices of economic benefit. Obligations, transfer of assets in the future.

	£	£	£
Fixed Assets			
Land	90,000	----	90,000
Premises	10,600	(4,240)	6,360
Vehicles	6,400	(2,304)	4,096
	107,000	(6,544)	100,456
Current assets			
Stock		4,660	
Debtors		2,400	
Prepayments		60	
Cash - bank		620	
		7,740	
Current liabilities			
Creditors	1,980		
Accruals	80	(2,060)	
Working capital		5,680	
Net Assets		106,136	
Financed by:			
Capital (01-07-07)	106,850		
Add: net profit	10,286		
	117,136		
less: drawings	(11,000)		
		106,136	

) Mrs Phillips Balance Sheet as at 30th June 2006

	£	£	£
Fixed Assets			
– Office furniture	1,460	(292)	1,168
– Vehicle	14,750	(2,950)	11,800
	16,210	(3,242)	12,968
Current assets			
Stock		11,650	
Debtors		18,600	
Cash (Bank)		6,800	
Prepayment		140	
		37,190	
Current liabilities			
Creditors	7,600		
Rent owing	110	(7,710)	
			29,480
			42,448
Financed by:-			
Capital			
Balance at 1 July 2005			34,600
Net profit for the year			12,848
			47,448
less : cash drawings			(5,000)
			42,448

EASY TO REMEMBER??

- Debit what comes in (goods, assets)
- Credit what goes out (goods, assets)

- Debit the receiver (Debtor, asset)
- Credit the giver (creditor, Liability)

- Debit all expenses
- Credit all incomes (revenue)

BALANCE SHEET

- Asset = Liability + Equity (Capital)
- Assets are probable current and future economic benefits
- Liabilities are probable future sacrifices of economic benefit. Obligations, transfer of assets in the future.

BALANCE SHEET

- Fixed assets
  - Less depreciation
- Current assets
  - Stock
  - Cash
  - Bank
  - Debtors
  - prepayments
- Current liability
  - Creditors
  - Outstanding/accruals
- Working capital (CA-CL)

Fixed assets	Cost	Depreciation	Net value
Land, building	50000	5000	45000
Current assets			
Debtors	3000		
Stock	7000		
Cash	10000		
Bank	20000		
Prepayments	6000	46000	
Current liability			
Creditors	35000		
Outstanding/accruals	5000	40000	
Working capital			6000

- Long-term Liability
  - Creditors
  - Loans from Bank
  - Debentures
- Capital
  - Share capital
  - Reserves
  - Net profit
  - Dividends
  - Less drawings
- Fixed assets + WC – Long term Liability = Capital

Long term liability			
Creditors	3000		
Loans	5000		
debentures	1000	9000	
Net total assets			42000
capital			
Share capital	22000		
reserves	8000		
Net profit	10000		
dividends	4000		
Less drawing	2000		42000

DEPRECIATION

- Depreciation is the reduction in the value of an asset due to usage, passage of time, wear and tear, technological outdating or obsolescence, depletion, inadequacy, rot, rust, decay or other such factors.
- *Salvage(scrap) value* is the estimated value of an asset at the end of its useful life.

DEPRECIATION CALCULATION

- Straight line depreciation
- Fixed amount depreciated each year

$$\text{Annual Depreciation Expense} = \frac{\text{Cost of fixed asset} - \text{Scrap Value}}{\text{Life span}(years)}$$

Eg. Asset cost 45,000. it will be used for 5 years and scrap value at the end will be 5000. what amount will be depreciated in a straight line method?

REDUCING BALANCE (ACCELERATED)

- Depreciation methods that provide for a higher depreciation charge in the first year of an asset's life and gradually decreasing charges in subsequent years are called **accelerated depreciation methods**. This may be a more realistic reflection of an asset's actual expected benefit from the use of the asset: many assets are most useful when they are new. One popular accelerated method is the **reducing-balance method**. Under this method the Book Value is multiplied by a fixed rate.

- Asset cost 45,000. depreciation for 5 yrs. reducing balance depreciation to be made at 30%.
- Year 1. Value 45000
  - Depreciation @30% = 13500
  - Year 2 beginning NBV = 31500
  - Depreciation @30% = 9450
  - Year 3 beginning NBV= 22050
  - Depreciation @30% = 6615
  - Year 4 beginning NBV = 15435
  - Depreciation @30%= 4630.5
  - Year 5 beginning NBV = 10804.5
  - Depreciation @30% = 3241.35
  - End of 5 year NBV = 7563.15

BREAKEVEN ANALYSIS

- Sales 1000pcs @2 20000
- COGS 1000pcs @1.5 15000
- Gross Profit 1000 pcs 5000

- UNIT BREAKDOWN
- Sale price per unit = 2
- Cost (variable) = 1.5
- Contribution per unit= .5

BREAKEVEN

- Sales per unit = 25
- Variable cost
  - Material per unit = 7
  - Labor per unit = 8
  - Total variable cost 15
- Contribution 10

- Fixed Cost
  - Rent 200
  - Salaries 200
  - Total Fixed Cost 400

BREAKEVEN

- Breakeven = Total Fixed Cost
  - ________________
- . Contribution per unit

- = 400/10 = 40 units

- Which means if he sells 40 units @ 25 (total income is 1000), he will make zero profit (expenses for 40 unit @ 15 = 600 plus fixed cost 400 equal 1000).

- Sales revenue = 4
- Variable cost = 2

- Fixed cost = 8000

- Breakeven = ???

- How many will he have to sell to make a profit of £100?

- Quantity required for profit =
- Fixed cost + required profit
- ____________________
- Contribution per unit
- 8000 + 100
- _________ = 4050
- 2

- Jacket factory has fixed cost of £50000. it produces 10000 jackets. Each jacket has a variable cost of £5. the jackets are sold for £15 per piece
- Find the contribution per unit
- Find the breakeven point
- How many jackets does it need to sell to make a profit of £2000 ?

- Sold goods with cash 8000
- cash Dr 8000
- sales cr 8000
- sold goods on credit
- Debtor dr 8000
- Sales cr 8000
- What happened to cash…??
- Any effect on profit and loss a/c?
- (sales amount increased). What does it mean?

- Purchased goods with cash 8000
- Goods purchase Dr 8000
- Cash cr 8000
- Purchased goods on credit
- Goods purchase dr 8000
- Creditor a/c 8000
- What happened to cash…??
- Any effect on profit and loss a/c?

- Inventory in the beginning was 100
- Inventory in the end was 150
- What does this mean?
- What increased and what decreased (assume all was cash transaction).

CASH FLOW AND PROFIT EFFECT

R	**Effect**	**On**
	Profit	Cash
Repayment of loan		
Sale on credit		
Buy asset with cash		
Receive cash payment from debtor		
Depreciation of asset		
Buy stock with cash		

R	Effect	On
	Profit	Cash
Repayment of loan	None	decrease
Sale on credit	Increase	None
Buy asset with cash	None	Decrease
Receive cash payment from debtor	None	Increase
Depreciation of asset	Decrease	None
Buy stock with cash	None	decrease

IDENTIFY THE GROUPS OF BUSINESS ACTIVITIES FOR FINANCIAL REPORTING

- **Operating activities** are transactions that involve the firm's everyday lines of production and trade. Sales and their related costs are typically a firm's primary operating activities. Other examples of operating activities include paying taxes and buying short-term assets and taking on short-term liabilities to support the firm's ordinary business.
- **Investing activities** are the firm's transactions to acquire or dispose of long-term assets. Purchases and sales of property, plant and equipment are investing activities, as are purchases and sales of securities issued by others.
- **Financing activities** are transactions through which the firm raises or repays capital. These include issuing or repaying debt, issuing or repurchasing stock, and paying dividends to shareholders.

CASH FLOW FROM OPERATING ACTIVITIES (CFO)

- sometimes referred to as "cash flow from operations" or "operating cash flow," consists of the inflows and outflows of cash resulting from transactions that affect a firm's net income. It includes most of the operating expensed (SG&A), prepayments and outstanding payments, and changes in the balance of those items.

CASH FLOW FROM INVESTING ACTIVITIES (CFI)

- consists of the inflows and outflows of cash resulting from the acquisition or disposal of long-term assets and certain investments. It includes cash spent on buying new assets, and cash received on selling old assets.

CASH FLOW FROM FINANCING ACTIVITIES (CFF)

- consists of the inflows and outflows of cash resulting from transactions affecting a firm's capital structure. It includes items like dividends paid. Increase in capital raised.

Operating Activities	
Inflows	*Outflows*
Cash collected from customers	Cash paid to employees and suppliers
Interest and dividends received	Cash paid for other expenses
Sale proceeds from trading securities	Acquisition of trading securities
	Interest paid
	Taxes paid
Investing Activities	
Inflows	*Outflows*
Sale proceeds from fixed assets	Acquisition of fixed assets
Sale proceeds from debt & equity investments	Acquisition of debt & equity investments
Principal received from loans made to others	Loans made to others
Financing Activities	
Inflows	*Outflows*
Principal amounts of debt issued	Principal paid on debt
Proceeds from issuing stock	Payments to reacquire stock
	Dividends paid to shareholders

- The **direct method** presents operating cash flow by taking each item from the income statement and converting it to its cash equivalent by adding or subtracting the changes in the associated balance sheet accounts.
- Cash collected from customers is typically the main component of CFO. Cash collections are calculated by adjusting sales revenues for changes in accounts receivable and changes in unearned (deferred) revenue.
- Cash used in the production of goods and services (cash inputs) is calculated by adjusting cost of goods sold (COGS) for any change in inventory and any change in accounts payable.
- Cash operating expenses are calculated by adjusting selling, general, and administrative (SG&A) expenses for the changes in any related accrued liabilities and/or prepaid expenses.
- Cash paid for interest is calculated by adjusting interest expense for any change in interest payable.
- Cash paid for taxes is calculated by adjusting income tax expense for any change in taxes payable and/or deferred taxes.

- A firm has net sales of $3,500,
- Net profit of $1,000,
- depreciation expense of $500,
- cost of goods sold (COGS) of $1,500,
- and cash taxes of $500.
- Also, inventory decreased by $100,
- and accounts receivable increased by $300.
- What is the firm's cash flow from operations?
- **A)** $1,200. **B)** $1,300. **C)** $1,800.

- *Direct Method*
- Net Sales +3,500
- Change in Accts. Rec. (300) a use
- COGS (1,500)
- Cash Taxes (500)
- Change in Inv. +100 a source
- CFO **1,300**

- Using the **indirect method**, operating cash flow is calculated in four steps:
- Begin with net income.
- Subtract gains or add losses that resulted from financing or investing cash flows (such as gains from sale of land).
- Add back all noncash charges to income (such as depreciation and amortization) and subtract all noncash components of revenue.
- Add or subtract changes to balance sheet operating accounts as follows:
- Increases in the operating asset accounts (uses of cash) are subtracted, while decreases (sources of cash) are added. Increases in the operating liability accounts (sources of cash) are added, while decreases (uses of cash) are subtracted.

INDIRECT METHOD

- Under the **indirect method**, net income is converted to operating cash flow by making adjustments for transactions that affect net income but are not cash transactions. These adjustments include eliminating noncash expenses (e.g., depreciation and amortization), nonoperating items (e.g., gains and losses), and changes in balance sheet accounts resulting from accrual accounting events.
- Notice that under the indirect method, the starting point is net income, the "bottom line" of the income statement.

- A firm has net sales of $3,500,
- Net profit of $1,000,
- depreciation expense of $500,
- cost of goods sold (COGS) of $1,500,
- and cash taxes of $500.
- Also, inventory decreased by $100,
- and accounts receivable increased by $300.
- What is the firm's cash flow from operations?
- **A)** $1,200. **B)** $1,300. **C)** $1,800.

ANSWER 1B

- *Indirect Method*
- Net profit +1,000
- Depreciation +500
- Change in Inv. + 100 a source
- Change in Accts. Rec. (300) a use
- CFO **1,300**

FOR THE YEAR ENDED DECEMBER 31ST, WAS AS FOLLOWS:

- Sales $3,000,000
- Purchases 1,800,000
- Inventory at Beginning 500,000
- Inventory at Ending 800,000
- Accounts Receivable at Beginning 300,000
- Accounts Receivable at Ending 200,000
- Other Operating Expenses Paid 400,000
- Based upon this data and using the direct method, what was Jefferson Corp.'s cash flow from operations (CFO)
- **A)** $900,000. **B)** $1,200,000. **C)** $800,000.

JEFFERSON

- Cost of goods sold was (beginning inventory plus purchases less ending inventory) ($500,000 + $1,800,000 − $800,000 =) $1,500,000. Cash flow from operations under the direct method is calculated by:
- Cash collections: $3,000,000
- Decrease in account receivable ($300,000 − $200,000)= 100,000
- net cash inflow is cash collection($3,000,000) + reduction of receivable ($300,000 − $200,000)) = 3,100,000.
- Less direct cash expenses: $1,800,000 (cost of goods sold plus increase in inventory) of ($1,500,000 + $300,000)
- Less other cash outflows of $400,000
- CFO = ($3,100,000 – 1,800,000 – 400,000) = $900,000

DETERMINE THE CASH FLOW FROM **FINANCING** GIVEN THE FOLLOWING TABLE.

- *Item* *Amount*
- Cash payment of dividends $30
- Sale of equipment $10
- Net income $25
- Purchase of land $15
- Increase in accounts payable $20
- Sale of preferred stock $25
- Increase in deferred taxes $5

- **A)** $15.
- **B)** $20.
- **C)** -$5.

ANSWER

- CFF = 25(Sale of Stock) − 30(Div Paid) = -$5
- All the rest are not financing activities. They are mostly operating activities

INDIRECT METHOD CFO

- Pacific, Inc.'s financial information includes the following, with "change" referring to the difference from the prior year (in $ millions):
- Net Income 27
- Change in Accounts Receivable +4
- Change in Accounts Payable +1
- Change in Inventory +5
- Change in Retained Earnings +21
- Dividends declared and paid +4

- Using the indirect method, cash flow from operations is net income less increase in accounts receivable, plus increase in accounts payable, less increase in inventory, plus loss on sale of equipment, less gain on sale of real estate.
- 27 – 4 + 1 – 5 = $19 million.
- Note: retained earnings and dividends are financing activities and not operating activities.

Mark Industries' income statement and related notes for the year ended December 31 are as follows (in $)

Sales	42,000,000
Cost of Goods Sold	(32,000,000)
Wages Expense	(1,500,000)
Depreciation Expense	(2,500,000)
Interest Expense	(1,000,000)
Income Tax Expense	(2,000,000)
Net Income	3,000,000

- During the year:
- Wages Payable increased $100,000.
- Accumulated Depreciation increased $2,500,000.
- Interest Payable decreased $200,000.
- Income Taxes Payable increased $500,000.
- Dividends of $100,000 were declared and paid.
- Mark Industries' cash flow from operations (CFO) for the year ended December 31 was:
- A) $5,900,000.
- B) $4,800,000.
- C) $4,400,000.

ANS

- Using the indirect method, net income is increased by depreciation expense, the increase in wages payable and the increase in income taxes payable, and then is reduced by the decrease in interest payable. Dividends paid are financing activities. $3,000,000 + $2,500,000 + $100,000 + $500,000 - $200,000 = $5,900,000.

- Ending cash balance =
- Beginning cash balance
- + Operating cash flow
- + Investing cash flow
- + Financing cash flow

- Operating cash flow was 20000
- Investing cash flow was -6000
- Financing cash flow was 8000
- Beginning cash balance was 5000
- What is the ending cash balance?