

Lecture IX: Cash Flow and Owner's Equity

Charles B. Moss¹

¹Food and Resource Economics Department
University of Florida

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1 Statement of Cash Flows

2 Statement of Change in Owner's Equity

The Setup

- Financial accounting has specified some accounting statements as required – namely before 1971 only the income statements and balance sheets were required under GAAP (Schroeder et al. 2011, p. 235).
- Other statements could be disclosed, but the information in those statements may not have been held to the same auditing standards.
- One statement on the fringe of being required under GAAP is the **statement of cash flows**.
 - Financial Accounting Standards Board – FASB
 - Statement of Financial Accounting Standards – SFAC

Funds statements were not uniformly prepared initially, and the method of reporting sources and application of resources depended on the concept of funds preferred by the reporting entity. In general, the concepts of funds used can be categorized as (1) cash, (2) working capital, and (3) all financial resources. Other concepts of funds, such as quick assets or net monetary assets, may also have been encountered (Schroeder et al. 2011, p. 235).

Accounting Standards

SFAC No. 1 stressed that financial reporting should provide information to help present and potential investors assess the amount, timing, and uncertainty of prospective cash receipts from interest, dividends, sale of securities, and proceeds from loans. The cash flows are seen as important because they affect an enterprise's liquidity and solvency. SFAC No. 5 indicated that a full set of financial statements should show cash flows for the period. SFAC No. 5 also described the usefulness of cash-flow reporting in assessing an entity's liquidity, financial flexibility, profitability and risk (Schroeder et al. 2011, p. 235).

- SFAC No. 5 states that the statement of cash flows should be useful in determining a company's cash-flow position, bringing us back to the difference between accrual and cash-flow accounting.

The statement of cash flows reports changes during an accounting period in cash and equivalents from the following activities: (1) cash flows from operating activities, (2) cash flows from investing activities, and (3) cash flows from financing activities (Schroeder et al. 2011, p. 239).

Two Approaches to Statement of Cash Flows

- There are two primary methods for developing a statement of cash flows: **Direct** and **Indirect**.
- The Direct method works with the cash receipts and disbursements.

Item	Value
Cash Receipts	226,800
Cash Expenditures	60,448
Net Operating Sources	168,031
Debt Payments	
Principal Payments	78,776
Interest Payments	52,058
Owner Withdrawals	35,000
Net Cash Flow	517

- The Indirect approach involves starting with accrual income and working backwards to cash flow.

Item	Value
Net Income	8,907
Source	
Depreciation	105,319
Change in Inventory	67
Uses	
Principal Payments	78,776
Distribution	35,000
Net Cash Flow	<u>517</u>

- Regardless of the approach, the fact that the net cash source for the Texas wheat farm is \$ 517 implies that this farm is having liquidity problems.
- The advantage of the Direct method over the Indirect method is the interpretation.
- The Direct method indicates that the gross margin is insufficient to cover the fixed obligations and the owner withdraws.
- That information is less obvious in the Indirect method.

Statement of Change in Owner's Equity

- From an accounting perspective, the goal of the statement of change in financial position (owner's equity) is

APB [Accounting Principles Board] 19 stated that the objectives of the SCFP [Statement of Changes in Financial Position] are to (1) complete the disclosure of changes in financial position, (2) summarize financing and investing activities, and (3) report funds flow from operations. These three items of information cannot be directly obtained from an income statement and comparative balance sheets because of the manner in which data is aggregated in these two financial statements (Wolk et al. 1992, pp. 331-2).

- The critical point here is the statement of change in owner's equity presents information on how the owner's claims changed.

Item	Value
Sources	
Net Income	8,907
Uses	
Principal Payments	78,776
Owner Distributions	35,000
Net Change in Owner's Equity	(104,869)