The statement of cash flows is one of the four financial statements. The financial statements are the balance sheet, income statement, statement of retained earnings and statement of cash flows. Out of the statements, the statement of cash flows is clearly the most difficult to prepare. As you go through this material, take it slow and really concentrate on the three sections of the cash flow statement and what kinds of things go into each section.

The statement of cash flows can be prepared by the indirect or the direct method, both are GAAP approved. Clearly GAAP prefers the direct method, but most companies use the indirect method. The reason for this is that the indirect method uses the accrual method of accounting and makes adjustments to net income to reflect the actual cash flows. The direct method works off of a cash basis. This is a problem because GAAP tells us that we must account for our books on an accrual basis, so then to have to convert our records from a GAAP basis to a cash basis is a lot of extra work. For this class, I am recommending that you focus your time and energy on learning the method used in business, the indirect method.

The three sections of the statement of cash flows are the operating, investing and the financing sections. You can determine if you are at least on the right track if the ending cash balance on the statement of cash flows agrees to the ending balance on the balance sheet. If the two numbers agree, then in total your statement of cash flows is correct, but you could have errors within each of the sections. Good formatting requires that each new column starts with a dollar sign and that the final number in the right hand column has a dollar sign and a double underline. The header should be centered perfectly to the page, and the date line needs to give a date range, example “For the year ended”.

Knowing what to put into each section can get a little tricky. Basically, every account in the general ledger that has a cash impact needs to be represented on the statement of cash flows. Here is a general summary of how that breaks down:

Current Assets and Current Liabilities= Operating section
Long Term Assets = Investing section
Long Term Liabilities = Financing section
Capital Stock = Financing section

Retained earnings = operating & financing
Revenue accounts (included in Net Income) = operating
Expense accounts (included in Net Income) = operating

When using the indirect method, the operating section starts off with net income and then items are used to adjust net income from an accrual basis to a cash basis. I have a mnemonic to help you adjust the net income in the operating section:

Operating Section (indirect method)	Add to Net Income	Subtract from Net Income
Net Income is adjusted for the following items:		
G Gains / Losses-	Losses	Gains
L Non Cash Current Assets & Current Liabilities (change in the account)	Decrease Increase	Increase Decrease
A Amortization/Depreciation	Add to NI	
D Bond Discount Bond Premium	Increase	Decrease

The section starts with net income from the income statement. Any gains are subtracted from NI and losses are added back. For current assets and current liabilities, we look at the dollar change in the account from the start to end of the year. If a current asset account increased over the year, then the dollar change is deducted from net income. If a current asset account decreased over the year, then the dollar change is added to net income. If a current liability account increased, then the dollar change is added to net income. If a current liability account decreased, then the dollar change is subtracted from the net income. Amortization and depreciation are always added back to net income. Bond discounts amortization is added to net income and a bond premium amortization is subtracted from Net income. That mnemonic will help you to prepare the operating section.

The investing and financing sections are identical for the indirect and direct method. The direct method would require an additional schedule that is a reconciliation of net income. This reconciliation is actually the operating section for the indirect method. Both the direct and indirect methods require that significant non-cash transactions be disclosed in a separate schedule. The indirect method requires an additional schedule that outlines interest expense and income tax expense.

Keep in mind that the preparation of statement of cash flows is very difficult. You are really going to have to study hard and really practice the homework exercises and problems in order to master this topic. The more homework you do, and compare your work to the solutions manual, and learn from your mistakes, the easier this material will become. There are a number of great resources to help you to learn this material. I have provided you with detailed lecture notes as well as Voice Lecture power point files and solutions answers. Other resources are the publishers PowerPoint files and instructor summary.

References

Spiceland, J. D., Sepe, J. F., & Nelson, M. N. (2010). *Intermediate accounting* (6th ed.). Boston, MA: McGraw-Hill Irwin.