

Case Study: Statement of Cash Flows

by Sophia



WHAT'S COVERED

This tutorial will cover the preparation of a statement for cash flows in the context of a case study, using a hypothetical subject company.

Our discussion breaks down as follows:

1. Case Study: Legacy Clothing

Our case study subject company, Legacy Clothing, is a sole proprietorship, which is a type of company that is owned by a single individual, and where that individual and the business are legally treated as the same.

The purpose of Legacy Clothing as a business is to own and operate clothing/merchandise stores. Think of it like a department store chain, selling men's, women's, and children's clothing and other related items.

Legacy Clothing has locations throughout Washington, DC, and they have a staff of 50 people employed in their stores.

Legacy Clothing	
Type of company	Sole proprietorship
Business purpose	Own and operate clothing/merchandise stores
Business location(s)	Washington, D.C. Staff of 50 people

Legacy Clothing needs a statement of cash flows to help them understand the business cash position--how the business used cash in the form of cash payments that were made, and how the business generated cash, referring to the cash receipts that the business received.

We can categorize this activity into three main areas in order to fully understand the cash performance:

- Operating: Activities found on the income statement
- Investing: Transactions involving the sale or purchase of long-term assets, loaning money, and collecting the principal amounts of monies loaned
- Financing: Cash received from financing to fund operations, as well as cash paid to owners

2. Case Study: Statement of Cash Flows

Now, let's turn our attention to preparing a statement of cash flows for our subject company, Legacy Clothing, keeping in mind those three main areas of business.

Here is our statement of cash flows for Legacy Clothing. Note, the starting point for our statement of cash flows is our header, where we put our company name, "Statement of Cash Flows," and, since this is a period-based or activity-based statement, "For the period ending December 31, 2012."

Legacy Clothing Statement of Cash Flows For the period ending December 31, 2012		
Cash flows from operating activities		
Net income		
Adjustments to reconcile net income		
cash provided by operating activities		
Depreciation expense		
Decrease in Accounts Receivable		
Increase in Merchandise Inventory		
Increase in Supplies		
Decrease in Accounts Payable		
Increase in Sales Tax Payable		
Decrease in Unearned Revenue		
Net cash provided by operating activities		
Cash flows from investing activities		
Purchase of building		
Net cash used by investing activities		
Cash flows from financing activities		
Loan received from Major Bank		
Owner draws		
Net cash provided by financing activities		
Net increase in cash		
Beginning cash balance		
Ending cash balance		

2a. Operating Activities

The first section is the cash flows from operating activities.

Legacy Clothing Statement of Cash Flows For the period ending December 31, 2012		
Cash flows from operating activities		
Net income		→ \$ 304,000
Adjustments to reconcile net income		
cash provided by operating activities		
a) Depreciation expense	\$ 15,000	
b) Decrease in Accounts Receivable	50,000	
c) Increase in Merchandise Inventory	(50,000)	
d) Increase in Supplies	(5,000)	
e) Decrease in Accounts Payable	(10,000)	
f) Increase in Sales Tax Payable	5,000	
g) Decrease in Unearned Revenue	(5,000)	
Net cash provided by operating activities		→ 304,000
Cash flows from investing activities		
Purchase of building	_____	
Net cash used by investing activities	_____	
Cash flows from financing activities		
Loan received from Major Bank	_____	
Owner draws	_____	
Net cash provided by financing activities	_____	
Net increase in cash		_____
Beginning cash balance		_____
Ending cash balance		_____

We start with net income of \$304,000, then make the following adjustments to reconcile net income to cash provided by operating activities:

a) The first adjustment we make, typically, is for depreciation expense. Depreciation is a non-cash event, and since that expense was recorded to determine net income, we need to add it back.

Next is our current assets.

b) If there was a decrease in our accounts receivable, that means that we collected on our accounts receivable, so it needs to go up, adjusted for the cash that we received.

c) An increase in merchandise inventory means that we purchased merchandise inventory; it was a cash event. Therefore, we need to subtract that out.

d) The same applies to supplies; if we purchased supplies, it was a cash event and we need to subtract it out.

Now, let's look at our current liabilities.

e) If there was a decrease in accounts payable, that means that we paid off our accounts payable. It was a cash outflow, so we need to subtract it.

f) If there was an increase in sales tax payable, that means that we recorded an expense for sales tax, which is included here. However, since it wasn't paid, we need to add it back.

g) The decrease in unearned revenue is similar to our decrease in accounts payable, in that it was simply an adjustment when we moved unearned revenue into revenue, because we've already received the cash. Therefore, we need to subtract out this \$5,000 from our net income.

Now you will see that all of these transactions offset, meaning our net cash provided by operating activities was \$304,000.

2b. Investing Activities

Moving down to our investing activities, the only thing that Legacy Clothing did was purchase a new building. This is a cash outflow, because they spent cash on that building.

In this case, we have net cash used by investing activities, because it is a cash outflow.

Legacy Clothing Statement of Cash Flows For the period ending December 31, 2012		
Cash flows from operating activities		
Net income		\$ 304,000
Adjustments to reconcile net income		
cash provided by operating activities		
Depreciation expense	\$ 15,000	
Decrease in Accounts Receivable	50,000	
Increase in Merchandise Inventory	(50,000)	
Increase in Supplies	(5,000)	
Decrease in Accounts Payable	(10,000)	
Increase in Sales Tax Payable	5,000	
Decrease in Unearned Revenue	(5,000)	-
Net cash provided by operating activities		304,000
Cash flows from investing activities		
Purchase of building	(350,000)	
Net cash used by investing activities		(350,000)
Cash flows from financing activities		
Loan received from Major Bank		
Owner draws		
Net cash provided by financing activities		
Net increase in cash		
Beginning cash balance		
Ending cash balance		

2c. Financing Activities

The next section reflects cash flows from financing activities. In this case, Legacy Clothing received a loan from a major bank in order to purchase that building. This is a cash inflow, meaning they brought cash in to make that purchase.

In addition, the owners pulled money out of the business, which is a cash outflow.

So, if we total those together, we see that net cash provided by financing activities equals \$250,000.

Legacy Clothing		
Statement of Cash Flows		
For the period ending December 31, 2012		
Cash flows from operating activities		
Net income		\$ 304,000
Adjustments to reconcile net income		
cash provided by operating activities		
Depreciation expense	\$ 15,000	
Decrease in Accounts Receivable	50,000	
Increase in Merchandise Inventory	(50,000)	
Increase in Supplies	(5,000)	
Decrease in Accounts Payable	(10,000)	
Increase in Sales Tax Payable	5,000	
Decrease in Unearned Revenue	(5,000)	-
Net cash provided by operating activities		304,000
Cash flows from investing activities		
Purchase of building	(350,000)	
Net cash used by investing activities		(350,000)
Cash flows from financing activities		
Loan received from Major Bank	300,000	
Owner draws	(50,000)	
Net cash provided by financing activities		250,000
Net increase in cash		
Beginning cash balance		
Ending cash balance		

Now, if we total all three of those sections together--net cash provided by operating activities, net cash used by investing activities, as well as net cash provided by financing activities--it gives us a change in cash of \$204,000.

Legacy Clothing Statement of Cash Flows For the period ending December 31, 2012		
Cash flows from operating activities		
Net income		\$ 304,000
Adjustments to reconcile net income		
cash provided by operating activities		
Depreciation expense	\$ 15,000	
Decrease in Accounts Receivable	50,000	
Increase in Merchandise Inventory	(50,000)	
Increase in Supplies	(5,000)	
Decrease in Accounts Payable	(10,000)	
Increase in Sales Tax Payable	5,000	
Decrease in Unearned Revenue	(5,000)	
Net cash provided by operating activities		304,000
Cash flows from investing activities		
Purchase of building	(350,000)	
Net cash used by investing activities		(350,000)
Cash flows from financing activities		
Loan received from Major Bank	300,000	
Owner draws	(50,000)	
Net cash provided by financing activities		250,000
Net increase in cash		204,000
Beginning cash balance		
Ending cash balance		

The final step is to take that net change in cash and add our beginning cash balance, which gets us to our ending cash balance--in this case, \$324,000.

Remember, this ending cash balance will equal the cash balance on our balance sheet.

Legacy Clothing Statement of Cash Flows For the period ending December 31, 2012		
Cash flows from operating activities		
Net income		\$ 304,000
Adjustments to reconcile net income		
cash provided by operating activities		
Depreciation expense	\$ 15,000	
Decrease in Accounts Receivable	50,000	
Increase in Merchandise Inventory	(50,000)	
Increase in Supplies	(5,000)	
Decrease in Accounts Payable	(10,000)	
Increase in Sales Tax Payable	5,000	
Decrease in Unearned Revenue	(5,000)	-
Net cash provided by operating activities		304,000
Cash flows from investing activities		
Purchase of building	(350,000)	
Net cash used by investing activities		(350,000)
Cash flows from financing activities		
Loan received from Major Bank	300,000	
Owner draws	(50,000)	
Net cash provided by financing activities		250,000
Net increase in cash		204,000
Beginning cash balance		120,000
Ending cash balance		324,000



SUMMARY

Today we introduced our **case study** company, **Legacy Clothing**, a department store selling men's, women's, and children's clothing and other related items. We learned how to prepare a **statement of cash flows** for our subject company, reviewing all line items reported within **operating activities**, **investing activities**, and **financing activities**.

Source: Adapted from Sophia instructor Evan McLaughlin.