The Fundamentals of Accounting

VIFM
Virginia Institute of Finance and Management

Learning Objectives

- Understand the role and importance of the financial statements.
- Define various financial statement terms.
- Explain the format of the income statement, balance sheet, and cash flow statement.
- Record financial statement transactions.
- Understand how transactions move through the financial statements.
- Prepare simple financial statements.

The Cash Flow Statement

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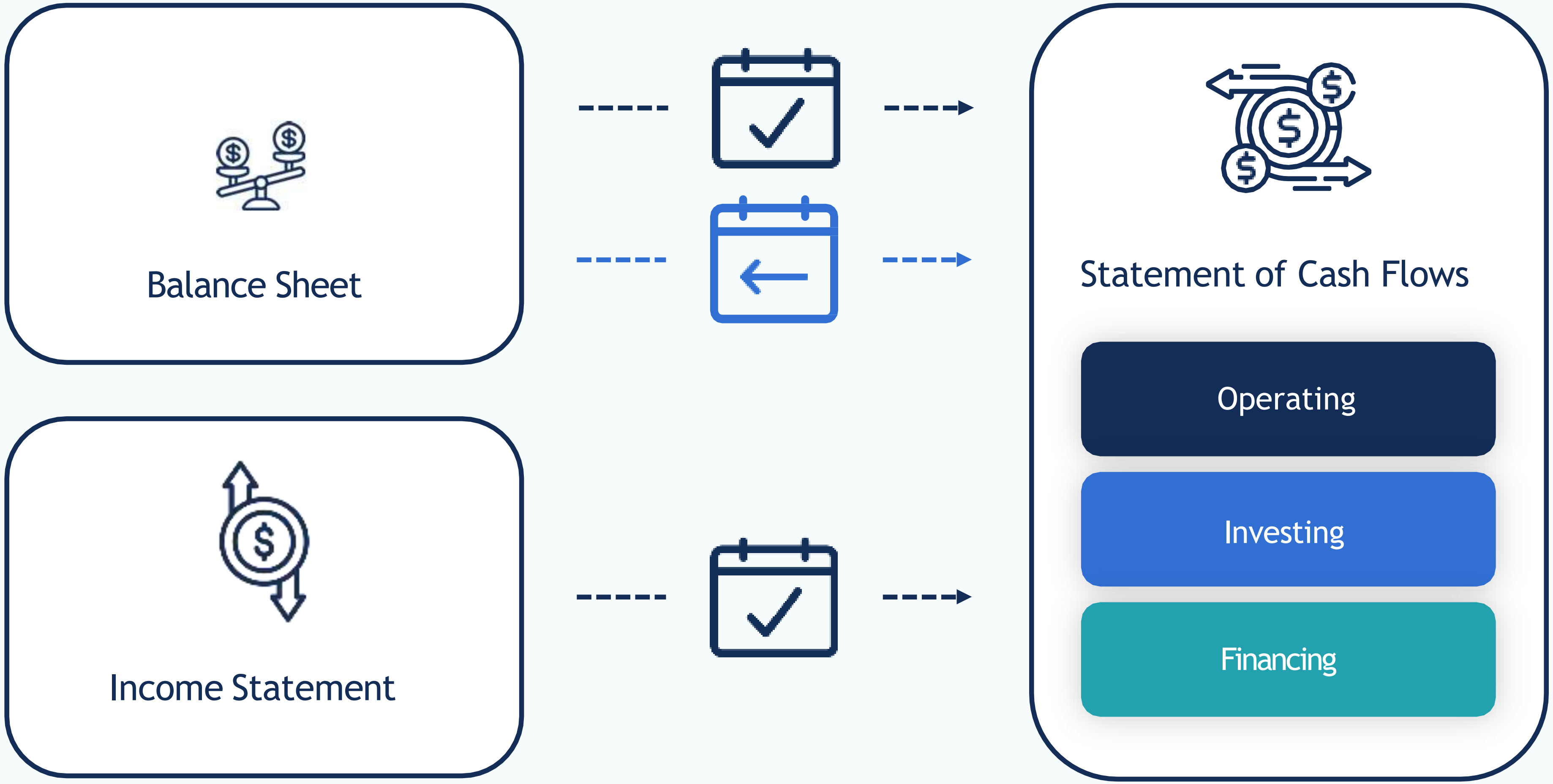
The Three Key Financial Statements

Cash is an important asset. Much of a company's success depends on its ability to efficiently manage the cash flows.



The Role of the Cash Flow Statement

Although preparing a cash flow statement is not a requirement, it provides some valuable information.

The balance sheet does not provide much insight into how efficiently and effectively cash is being generated and used.

Understanding where cash comes from and how it has been utilized is very useful for both management and potential investors.

There are many transactions that have an impact on cash: issuing shares, borrowing debt, revenue generation, purchases, debt payments, repurchase or outstanding shares.

Priority Versus Cash

The accrual concept recognizes revenues and costs as business earns or incurs them, not as it receives or pays money.

It includes them in the relevant period's income statement, and as much as possible, matches them with each other.

Income Statement

Estimated

Incurred

Statement of Cash Flows

Received

Paid

Matching Over Time

A five-day transit pass costs 40 & is paid in cash on Monday

How much is the daily cost of travel on Thursday?

- On a cash flow basis
- On a matching/accrual basis

Which basis better reflects the costs?

- Or cash inflows and outflows
- Or an individual journal

Cash flow basis 0, because the cash expense happened on Monday.

Matching/Accrual basis 0/5 days = ® expense per day

Cash flow basis is better for planning cash inflows and outflows.

Matching/Accrual basis is better for planning the daily cost.

Methods for Creating a Cash Flow Statement

There are two methods that can be used to create a cash flow statement: direct method and indirect method.

VS

Direct Method

The direct method can be tricky and requires much more detail, which can make it more time-consuming.

Indirect Method

The indirect method adjusts net income by adding or subtracting changes in non-cash items and working capital to calculate cash flow from operating activities.

Indirect Method

There are three main sections on the cash flow statement.

Operating Cash Flow

Operating transactions that relate directly to the generation of revenue for the company.

Investing Cash Flow

Investing transactions include decisions around the purchase or sale of assets that support the operations.

Financing Cash Flow

Financing transactions are based on management's decisions to fund business activities (e.g., issuing equity or raising debt financing).

Working Capital

One of the trickiest parts of the cash flow statement is understanding how changes in working capital impact cash flow.

Working Capital

All figures in USD thousands unless stated	Year 1	Year 2
Accounts Receivable	7,550	35,000
Inventory	6,100	74,000
Accounts Payable	16,250	35,000
Unearned Revenue	10,520	5,600
Net Change in Working Capital	13,120	(81,520)

Cash Flow Statement

All figures in USD thousands unless stated	Year 1	Year 2
Operating Cash Flow		
Net Earnings	47,240	27,151
Plus: Depreciation and Amortization	4,550	9,550
Adjust for Changes in Working Capital	13,120	(81,520)
Cash from Operations	**64,910**	**(44,819)**

We need to look at what has changed and determine if that indicates an increase or decrease in cash flow.

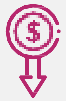
Changes in Working Capital

Accounts Receivable

Year 1: 46,000
Year 2 : 51,000

Net cash decrease: 5,000

Accounts Receivable

Increases	Deceases
	

Balance Sheet

All figures in USD thousands unless stated	Year 1	Year 2
Assets		
Current Assets		
Cash	37,715	37,186
Accounts Receivable	46,000	51,000
Inventory	82,250	78,050
Total Current Assets	165,965	166,236
Non-Current Assets		
Property Plant and Equipment (PPE)	155,000	155,000
Accumulated Depreciation-PPE	(39,150)	(54,650)
Net Carrying Value	115,850	100,350
Total Assets	**281,815**	**266,586**
Liabilities		
Current Liabilities		
Accounts Payable	64,580	65,536
Unearned Revenue	5,214	2,314
Total Current Liabililties	69,794	67,850
Long Term Debt	50,000	-
Total Liabilities	119,794	67,850
Shareholder's Equity		
Equity Capital	70,000	70,000
Retained Earnings	92,021	128,736
Total Shareholder's Equity	162,021	198,736
Total Liabilities and Shareholder's Equity	**281,815**	**266,586**
	-	-

Changes in Working Capital

Inventory

Year 1: 82,250

Year 2: 78,050

Net cash increase: 4,200

Inventory

increase	Decrease

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Account Payable	
Increase	Decrease

Accounts Payable

Year 1: 64,580

Year 2: 65,536

Net cash increase: 956

Changes in Working Capital

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	-	-

Unearned Revenue

Increase | Decreases

Unearned Revenue

Year 1: 5,214

Year 2: 2,314

Net cash decrease: 2,900

Cash from Investing

The second section of the cash flow statement is cash from investing.

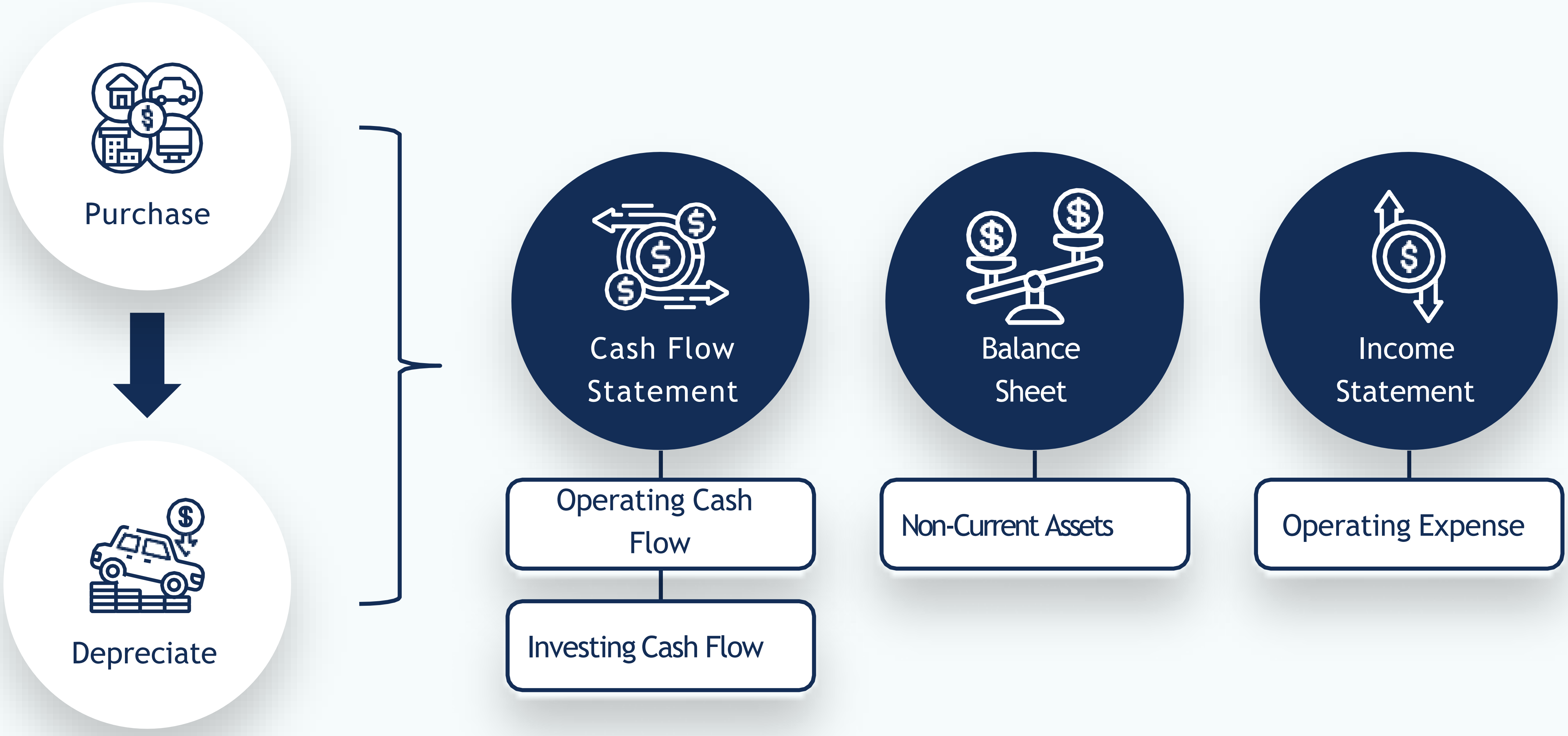
Cash Flow Statement

All figures in USD thousands unless stated	Year 1	Year 2	Year 3	Year 4	Year 5
Investing Cash Flow					
Investments in Property and Equipment	(45,500)	(50,000)	–	(59,500)	–
Cash from Investing	**(45,500)**	**(50,000)**	**–**	**(59,500)**	**–**

In each of these cases, this investment is considered a cash outflow.

These investments are often referred to as CAPEX, which is short for capital expenditures.

How Investing Activities Hit the Three Financial Statements



How Investing Activities Hit the Three Financial Statements

Let’s imagine that a company has an equipment purchase in Year 1 for a company car.

Equipment was purchased for 45,500

Equipment has a useful life of 10 years.

Equipment has a no salvage value.

Straight-Line Depreciation Approach

Equation

$$= \frac{\text{Cost - Salvage Value}}{\text{Useful Life}}$$

Depreciation

$$= \frac{45{,}500 - 0}{10}$$

$= 4{,}550$ a year

How Investing Activities Hit the Three Financial Statements

Let’s imagine that a company has an equipment purchase in Year 1 for a company car.

Income Statement

Depreciation Expense: (4,550)

Income Statement

All figures in USD thousands unless stated	**Year 1**
Revenue From Operations	
Sales Revenue	763,127
Cost of Goods Sold	(343,407)
Gross Profit	419,720
Operating Expenses	
Selling Costs	(23,850)
Administrative Costs	(4,550)
Salary Costs	(325,000)
Total Operating Expenses	(353,400)
Earnings Before Interest and Tax (EBIT)	66,320
Financing Costs and Tax	(19,080)
Net Income/(Loss)	**47,240**

How Investing Activities Hit the Three Financial Statements

Let’s imagine that a company has an equipment purchase in Year 1 for a company car.

Income Statement

Depreciation E:pense: (4,550)

Balance Sheet

Historical Cost: 45,500

Depreciation Expense: (4,550)

Balance Sheet

All figures in USD thousands unless stated	**Year 1**
Assets	
Current Assets	
Cash	139,410
Accounts Receivable	7,550
Inventory	6,100
Total Current Assets	153,060
Non-Current Assets	
Property Plant and Equipment (PPE)	45,500
Accumulated Depreciation-PPE	(4,550)
Net Carrying Value	40,950
Total Assets	**194,010**
Liabilities	
Current Liabilities	
Accounts Payable	16,250
Unearned Revenue	10,520
Total Current Liabililties	26,770
Long Term Debt	50,000
Total Liabilities	76,770
Shareholder's Equity	
Equity Capital	70,000
Retained Earnings	47,240
Total Shareholder's Equity	117,240
Total Liabilities and Shareholder's Equity	**194,010**
	-

How Investing Activities Hit the Three Financial Statements

Let’s imagine that a company has an equipment purchase in Year 1 for a company car.

Income Statement

Depreciation Expense: (4,550)

Balance Sheet

Depreciation Expense : (4,550)

Historical Cost: 45,500

Cash flow Statement

Add Back Depreciation Expense: 4,550

CAPEX Cash Outflow: (45,500)

Cash Flow Statement

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Operating Cash Flow	
Net Earnings	47,240
Plus: Depreciation and Amortization	4,550
Adjust for Changes in Working Capital	13,120
Cash from Operations	**64,910**
Investing Cash Flow	
Investments in Property and Equipment	(45,500)
Cash from Investing	**(45,500)**
Financing Cash Flow	
Issuance (repayment) of debt	50,000
Issuance (repurchase) of equity	70,000
Payment of dividends	-
Cash from Financing	**120,000**
Net Increase (decrease) in Cash	139,410
Opening Cash Balance	-
Closing Cash Balance	**139,410**

Cash from Financing

The cash from financing section has two main areas: debt financing and equity financing.

Cash Flow Statement

All figures in USD thousands unless stated	Year 1	Year 2
Financing Cash Flow		
Issuance (repayment) of debt	50,000	(50,000)
Issuance (repurchase) of equity	–	–
Payment of dividends	(5,000)	(5,000)
Cash from Financing	**45,000**	**(55,000)**

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Debt

Borrow	Repayment

Payments can be either principal payments, interest payments, or a combination of both.

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Debt	
Borrow	Repayment

50,000 (50,000)

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Equity

Issue Shares

Repurchase

Pay Dividends

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Equity

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Repurchase

Pay Dividends

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