

Cash Flows From Operations

How do you think companies afford larger cash payments than their current year income? It's actually pretty common, but where do they get the money from? For example, how would apparel company LiliLime pay for a \$140 million cash dividend when it only made \$50 million net income? Let's study the operating activities of the statement of cash flow to answer the question.

It's the end of the period, and apparel company LiliLime has done very well this quarter, reporting record-breaking net positive income. Specifically, the operational portion of the business has seen great success. The CEO approaches you before the company-wide quarter-end meeting, and asks if you can prepare a statement of cash flows to present at the meeting, as a way to show everyone how financially healthy LiliLime is. He hands you this quarter's income statement and balance sheet, and asks you to just prepare a statement for the operational cash flows.

Let's first review how a statement for operating activities is made.

In accrual-basis accounting, cash flow from operating activities can be calculated using the direct or the indirect way. The direct way means the firm keeps track of all of its cash payments and cash receipts, and accounts for cash inflows and outflows by adding up all the cash transactions that way. However, most companies use the indirect way where cash-flow from operating activities is calculated by taking net income and eliminating the non-cash transactions.

Because in accrual-basis accounting, we record revenues and expenses into net income when they are incurred, and not when cash exchanges hands, the net income value at the end of the period is not representative of the actual cash a firm may have on hand.

As such, to adjust for items from net income to net cash flows using the indirect method, we require three types of adjustments:

1. Noncash charges that we charged to net income, but don't actually affect how the cash flows in real life. Examples of this include depreciation and amortization, where they had a negative effect on our net income, but didn't require us to pay the costs in cash, so we add it back to our cash flows.
2. Gains and losses on the disposal of plant assets. When we make a gain on disposing of a plant asset, we accounted for it by adding to our net income. However, from this alone we don't know where or when the cash actually came into the firm, so we adjust by deducting any gains from disposal, and adding any losses from disposal.
3. Changes in noncash current asset and current liability accounts. Current asset accounts include accounts receivable, inventory, prepaid expenses, and more. Current liability accounts include accounts payable, taxes payable, and more. For current asset accounts, we deduct amounts that

were increases in the current asset account, and add amounts that were decreases in the current asset account. Conversely, for current liability accounts, we add what were increases to the current liability account, and deduct what were decreases.

If it feels like we're doing the complete opposite of what your intuition tells you, that's because we are. For the majority of the course so far, we were working up to converting our operating activities to net income. But now, we are looking at the cash side of things, and just because we have increased our net income through a sale doesn't mean that the firm has received the cash payment for that sale. Therefore, when we adjust for cash flows, we are really adjusting the net income to cash flows, which you can think of the "gains or losses incurred" to "gains and losses actually paid."

For example, let's say a company earned \$20 million in revenue, of which \$10 million was in cash and the rest in accounts receivable, and used \$10 million in expenses, of which \$5 million was paid in cash, and the rest in accounts payable.

When thinking about "net income," we know that it is \$20 million in revenue - \$10 million in expenses = \$10 million in net income. However, cash flow is different. If accounts receivable from revenues was not yet received, and accounts payable from expenses was not paid yet, actual cash left at the company is cash inflow of \$10 million - cash outflow of \$5 million = \$5 million in net cash. This is because most revenues and expenses affect net income and cash flow of the same year, while some revenues and expenses affect net income and cash flow in different financial years.

In our cash flows analysis, we are concerned solely with how much cash we hold as a firm. This is done most easily by retracing our net income activities, where we remove all assumptions about cash paid with our net income, then using follow up additional information to forecast the actual cash we have on hand.

To summarize, let's first begin by identifying if the below transactions would be an addition of deduction from net income, and provide an intuition behind it:

- Decrease in accounts payable
 - Let's say company X had \$10K A/P last year, and has \$5K A/P this year. This decrease in A/P means that company X has paid out \$5K in A/P with cash. This in turn means that there was a cash outflow of \$5K, which needs to be deducted from net income
- Increase in accounts receivable
 - Company X had \$10K A/R last year, and has \$20K A/R this year. This \$10K increase in A/R means that the company has made revenue, which they recorded as an increase to their net income. However, because this is the only amount of cash to be received in the future, but wasn't actually received yet, thus \$10K is deducted from net income in the adjustment.

- Increase in inventories
 - An increase in inventory is like the above accounts receivable, a current asset. Therefore, if inventory increases, it would be deducted from net income in the adjustment, because a company needs to pay out cash to increase their inventory. Any other current asset account, such as prepaid expenses will also work in the same way.
- Depreciation expenses
 - Depreciation expenses is an expense we incur every year on the use of equipment and it is subtracted as an expense in the net income calculation. However, depreciation involves no “cash” payments, and needs to be added back to net income to cancel the subtraction as an expense.

Hopefully, you now understand the intuition behind the addition and subtraction of assets and expenses.

It is now time to create the statement of cash flow for LiliLime. Let’s begin by retrieving some information from the balance sheet.

Your job is to now prepare a statement of cash flow for just the operating activities for the year ended December 2021. Pause this video to work on this exercise and play again to see the solution.

Here is the solution. Note that we don’t adjust for bonds payable here because it’s part of a company’s financing activities, but you would have to account for that change if you were putting together a full statement of cash flows!

Amazing! You now know how to create the Statement of Cash Flow for operating activities. LiliLime’s CEO thanks you for helping him prepare for his quarter end meeting. The next steps are to combine your new knowledge on operating activities with the investing and financing activities to create the entire Statement of Cash Flows.