Foundations of Accounting & Finance

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Lecture – 12

Cash Flow Statement: Concept and Example (Direct Method) - Lone Pine Cafe

Introduction

In the last session, we prepared the balance sheet and income statement for Lone Pine Café A and B. We prepared two balance sheets: one on the cafe's inception date and another when it ceased operations on March 30th. Meticulously both balance sheets were compared. During this process, we also discussed sources and utilization of funds, emphasizing on their significance. Identifying the sources of funds and their utilization is crucial. If the sourced funds exceed their utilization, it indicates inefficient use, leading to financial losses, as seen in the case.

Further, we have discussed the opening and closing balance sheets, providing snapshots of Lone Pine's financial status at specific points. We have also analysed the café's performance over time by preparing an income and expenditure statement. This statement encompasses all accrued revenues and expenditures, revealing losses consistent with our calculations in the closing balance sheet. Now, we will proceed to discuss the next possible financial statement.

Cash Flow Statement: An introduction

Cash Flow statement meticulously tracks the movement of cash, as I mentioned in one of our initial sessions, possibly the first session. Unlike the income statement, which focuses on accrued income and expenditures, the cash flow statement solely highlights the flow of cash. It deals with inflow and outflow of cash and cash equivalents. Essentially, the cash flow statement classifies cash flows into three fundamental categories.

Three categories of Cash Flow Statement

1) Operating Cash Flows

The first category in the cash flow statement is cash flow arising from operations. This category tracks cash movements directly related to the core activities of the business. For example, when the company pays suppliers for goods or services, cash flows out, reflecting operational expenses. Similarly, cash inflows occur when customers make payments for goods or services, representing revenue generated from operational activities. Wages paid to employees and salaries received from customers are also included in this category as they are part of operations. In essence, this category focuses solely on cash inflows and outflows resulting from the core operations of the business.

2) Investing cash flows

Investing cash flow monitors cash movements associated with investments made by the company. For instance, when the company purchases machinery or equipment, cash flows out as an investment in fixed assets. Conversely, when the company sells old machinery, cash flows in, representing proceeds from asset disposals. Further, investments in subsidiaries, equity shares, bonds, or mutual funds result in cash outflows, while dividends received from investments represent cash inflows. It is important to note that investing activities involve the acquisition and disposal of long-term assets or investments, impacting the company's capital structure and asset base.

3) Financing Cash Flows

Financing cash flows track cash movements related to financing aspects of the company's operations and investments. For instance, when the company issues equity shares or borrows money from a bank, cash flows in as financing, providing capital for the company's activities. Conversely, when the company repays loans, pays interest, or distributes dividends to shareholders, cash flows out as financing, representing obligations to creditors and shareholders. In essence, this category monitors cash movements associated with financing the company's ventures, including changes in debt and equity financing.

These three classifications form the basis of the cash flow statement, providing insights into how cash moves within the company's operations, investments, and financing activities.

Now, why do we need these three classifications?

Sometime one needs to know the cash inflow and outflow stemming from core activities, specifically operations. Then one has to look at the cash flow from operating activities. Similarly, understanding the cash inflow and outflow resulting from investing activities is crucial. It provides valuable information regarding the allocation of resources for long-term growth and asset acquisitions. Equally important is the need to comprehend cash inflow and outflow arising from financing activities. This category indicate how the company is funding its operations and investments, impacting its capital structure and financial stability.

It is important to note that a surplus of cash in the company does not necessarily indicate success solely from operations. It could also stem from financing activities, such as borrowing money. Therefore, it is important to dissect the sources of cash inflow and outflow accurately.

An example:

Consider a scenario where a mature enterprise focuses solely on repaying existing loans and servicing debt. In this case, without major investments or expansions, the company's operational cash flow should be substantial enough to cover any machinery replacements and negative cash flows from investing activities. In addition, it should be capable of servicing financing activities, such as interest payments and loan repayments. Ideally, positive operational cash flows should exceed the company's financial obligations, allowing for excess cash. This surplus can then be utilized to cover financing outflows, such as interest payments, while still leaving room for investment in machinery or capacity augmentation through debt financing.

Lone Pine Cafe: Cash Flow Statement

Now, let us return to Lone Pine Cafe and prepare a cash flow statement for the business. We will analyse the transactions to understand the sources and uses of cash between November 02 and the end of the period.

To begin, the cafe started with a cash balance of $10,172 on November 02. When we refer to "cash," we include cash and cash equivalents, such as liquid cash, bank balances, and marketable securities. Now, let us break down the cash flow into three main categories: operations, investing activities, and financing activities.

1) **Operating cash flows**

Starting with operations, we will examine the cash flow generated by the café's day-to-day activities. This includes cash received from customers, payments to partners and part-time employees, expenses for food and beverages, utilities, and rent. The net result shows that operations generated a negative cash flow of $6,191.

2) **Investing cash flows**

Moving on to investing activities, we find that there were no cash inflows or outflows during this period. The café did not make any investments in machinery, assets, or deposits.

3) **Financing cash flows**

Next, we analyse financing activities, which involves cash flows related to borrowing and repayment of loans, as well as interest payments. The café paid $540 in interest and repaid a portion of its loan, resulting in a negative cash flow of $6,162.

As indicated in Table 1, summing up these cash flows (1341), we should arrive at the cash balance as on March 30 (311+1030).

Now, to reinforce your understanding, we will solve a case from the textbook titled "Maynard Company A and Maynard Company B." We will prepare balance sheets and income statements for these companies to understand financial statements better.

Table 1: Cash flow statement for Lone Pine for the period Nov 2 to March 30

Cash flow statement for Lone Pine for the period Nov 2 to March 30 (DIRECT)			
opening balance of cash		***10,172***	
cash flow from operations			
cash received from customers	43,480		
monthly payments to partners	-23,150		
wages to parttime employees	-5480		
F & B Supplies	-10,016		
telephone and electricity	-3,270		
miscellaneous	-255		
rent payments	-7,500		
cash flow from operations		***-6,191***	
cash flow from investing		NIL	
cash flow from financing			
interest payment	-540		
repyament of loan	-2,100		
cash flow from financing		-2,640	
cash and cash equilavents at the end of the period		1,341	
cash	***311***		
bank/ checking account	*1,030*		
	1,341		