

CONCEPT: OPERATING ACTIVITIES – INDIRECT METHOD

- The **indirect method** finds the cash flows from operating activities by starting with net income from the income statement
 - Note: the **indirect** or **direct** method only deal with operating activities

<u>Indirect Method</u>	
1. Start with Net Income	Net Income is found on the _____
2. Addback Noncash Expenses	Noncash expenses reduce income, but did not reduce cash Most common → _____
3. Remove Effects of Gains/Losses	Gains _____ net income, but are not a cash amount To remove the effect of a gain, we must _____ net income Losses _____ net income, but are not a cash amount To remove the effect of a loss, we must _____ net income
4. Changes in Current Assets (except Cash)	Increase to a current asset → _____ cash Decrease to a current asset → _____ cash
5. Changes in Current Liabilities	Increase to a current liability → _____ cash Decrease to a current liability → _____ cash

ABC COMPANY
Comparative Balance Sheets
As of December 31

	2018	2017	Change in Account Balance
Assets			
Current Assets			
Cash	\$ 55,000	\$ 33,000	
Accounts Receivable	20,000	30,000	
Inventory	30,000	21,000	
Property, Plant, and Equipment			
Land	130,000	20,000	
Equipment	187,000	50,000	
Accumulated Depreciation – Equipment	(14,000)	(6,000)	
Total Assets	\$ 408,000	\$ 148,000	
Liabilities			
Current Liabilities			
Accounts Payable	\$ 28,000	\$ 12,000	
Income Taxes Payable	6,000	8,000	
Long-term Liabilities			
Bonds Payable	130,000	20,000	
Stockholders' Equity			
Common Stock	80,000	60,000	
Retained Earnings	164,000	48,000	
Total Liabilities and Stockholders' Equity	\$ 408,000	\$ 148,000	

ABC COMPANY
Income Statement
For the Year Ended December 31, 2018

Sales revenue		\$ 517,000
Cost of goods sold	\$ 160,000	
Operating expenses (excluding depreciation)	111,000	
Depreciation expense	9,000	
Loss on disposal of plant assets	3,000	
Interest expense	<u>42,000</u>	<u>325,000</u>
Income before income taxes		192,000
Income tax expense		<u>47,000</u>
Net income		<u>\$ 145,000</u>

EXAMPLE: Use the indirect method to find cash flows from operating activities for ABC Company

Cash Flows from Operating Activities

Net Income

Adjustments to reconcile net income to cash flows from
operating activities

Net cash provided (used) by operating activities

1. Start with Net Income
2. Addback Noncash Expenses
3. Remove effects of Gains/Losses

Assume we sold equipment that cost \$8,000 with Accumulated Depreciation of \$1,000. We received \$4,000 in cash on sale.

4. Changes in Current Assets (except Cash)
5. Changes in Current Liabilities

PRACTICE: A company reported net income of \$250,000. Depreciation and amortization totaled \$120,000. In total, Current assets excluding cash increased by \$25,000 and current liabilities increased by 16,000. The company also had a gain on the sale of equipment of \$4,000. Using the indirect method, what are cash flows from operating activities?

- a) \$357,000
- b) \$365,000
- c) \$375,000
- d) \$383,000

PRACTICE: A company had net income of \$240,000. Depreciation expense was \$36,000. During the year, the accounts receivable and Inventory increased \$12,000 and \$25,000, respectively. Accrued expenses and prepaid expenses decreased by \$3,000 and \$14,000, respectively. There was also a gain on the sale of equipment of \$4,000. How much cash was provided by operating activities?

- a) \$246,000
- b) \$260,000
- c) \$263,000
- d) \$292,000