Statement of Retained Earnings, Statement of Stockholders´ Equity and Statement of Cash Flows

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SCHOOL OF BUSINESS ADMINISTRATION IN KARVINA

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Statement of Retained Earnings

- ***The statement of retained earnings shows the relationship between a company's income statement and balance sheet from one reporting period to the next.***

- Specifically, it indicates that the company's earnings after tax (EAT) have been moved into the company's retained earnings account, as earnings after tax (EAT) must be set to zero at the start of each new reporting period.

- Earnings after tax (EAT) net of dividend is moved from the statement of retained earnings to the balance sheet.

Statement of Retained Earnings

- The statement of retained earnings is the staging point between the income statement and the balance sheet.

- It shows any deductions from the EAT (such as dividends paid to shareholders) to determine the net amount left over.

- This amount is left in the company and is accounted for by adding it to the retained earnings account on the balance sheet.

- The statement also shows the changes in the retained earnings account between the opening and closing periods identified on each balance sheet.

Statement of Retained Earnings

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- The first line of the statement shows the beginning retained earnings amount. Then come net income and dividends.

- The retained earnings ending balance is the final amount on the statement.

- The information provided by this statement indicates the reasons why retained earnings increased or decreased during the period.

- If there is a net loss, it is deducted with dividends in the retained earnings statement.

Statement of Stockholders´ Equity

- ***The statement of stockholders´ equity is a financial statement that summarizes the changes in stockholders´ equity over an interval of time.***

- Stockholders´ equity has two primary components - ***common stock*** and ***retained earnings.***

Stockholders´ Equity = Common Stock + Retained Earnings

Statement of Stockholders´ Equity

- Recall that common stock represents amounts invested by stockholders (the owners of the corporation) when they purchase shares of stock.

- ***Common stock*** is an *external source* of stockholders´ equity.

- **Retained earnings**, on the other hand, is an *internal source* of stockholders´ equity.

- Its balance represents *all net income minus all dividends* over the life of the company.

Retained Earnings = All net income – All dividends

Retained Earnings

- Think of retained earnings this way.
- A company that has net income has generated resources through its operations.
- Those resources can either be returned to owners for their personal use (dividend payments) or retained in the business for future use.
- From the company´s perspective, we need to account for the total net income retained in the business.
- That´s the balance of retained earnings.

Statement of Cash Flows

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- The statement of cash flows provides information on the cash receipts and payments for a specific period of time.

- The statement of cash flow reports:
  - the cash effects of a company´s operations during a period
  - its investing activities
  - its financing activities
  - the net increase or decrease in cash during the period
  - and the cash amount at the end of the period

Statement of Cash Flows

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- Reporting the sources, uses, and change in cash is useful because investors, creditors, and other want to know what is happening to a company´s most liquid resources.

- The statement of cash flows provides answer to the following simple but important questions.

  1. Where did cash come from during the period?
  2. What was cash used for during the period?
  3. What was the change in the cash balance during the period?

Statement of Cash Flows

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- A statement of cash flows provides a summary of ***cash inflows*** and ***cash outflows*** during the reporting period.
- ***A cash inflow*** simply means cash received by the company during the period.
- ***A cash outflow*** is cash paid by the company during the period.
- The difference between cash inflows and cash outflows is called net cash flows.

Statement of Cash Flows

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- The statement of cash flows is a financial statement that measures activities involving cash receipts and cash payments over an interval of time.

- We can classify all cash transactions into three categories that correspond to the three fundamental business activities – ***operating, investing, and financing*.**

- The three primary categories of cash flows are:

  1. Cash flows from ***operating activities***
  2. Cash flows from ***investing activities***
  3. Cash flows from ***financing activities***

Operating cash flows (operating activities)

- Operating cash flows include cash receipts and cash payments for transactions involving revenue and expense activities during the period.

- In other words, operating activities include the cash effects of the same activities that are reported in the income statement to calculate net income.

- For example, investors use the relationship between net income (revenues minus expenses) and operating cash flows (cash flows from revenue and expense activities) to forecast a company´s future profitability.

- Common examples of operating activities include the collection of cash from customers or the payment of cash for inventory, salaries, and rent.

Investing cash flows

- Investing cash flows generally include cash transactions for the purchase and sale of investments and long-term assets.

- Long-term assets are resources owned by a company that are thought to provide benefits for more than one year.

- Creditors compare operating cash flows and investing cash flows to assess a company´s ability to repay debt.

Financing cash flows

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- Financing cash flows include cash transactions with lenders, such as borrowing money and repaying debt, and with stockholders, such as issuing stock and paying dividends.

- Financing activities provide information to investors and creditors about the mix of external financing of the company.

Statement of Cash Flows

- The statement of cash flows can be an important source of information to investors and creditors.
- For example, investors use the relationship between net income (revenues minus expenses) and operating cash flows (cash flows from revenue and expense activities) to forecast a company´s future profitability.
- Creditors compare operating cash flows and investing cash flows to assess a company´s ability to repay debt.
- Financing activities provide information to investors and creditors about the mix of external financing of the company.

Statement of Cash Flows

- The total of the net cash flows from operating, investing, and financing activities equals the net change in cash during the period.

- The statement of cash flows reports separately the net cash flows from operating, investing, and financing activities.

- The sum of the net cash flows from those three activities equals the change in total cash for the period.

<u>Change in cash = Operating cash flows + Investing cash flows + Financing cash flows</u>

The Links Among Financial Statements

- The four financial statements are linked, because events that are reported in one financial statement often affect amounts reported in another.

- Many times, a single business transaction, such as receiving cash from a customer when providing services, will affect more than one of the financial statement.

- In practice, companies don´t report retained earnings in a separate statement from common stock, so that´s why we demonstrate the statement of stockholders´ equity.

The Links Among Financial Statements

- Providing services to a customer, for example, results in revenues recorded in the income statement, which are used to calculate net income.
- Net income, in turn, is reported in the calculation of retained earnings in the statement of stockholders´ equity.
- Then, the ending balance of retained earnings is reported in the balance sheet.
- Thus, any transaction that affects the income statement ultimately affects the balance sheet thought the balance of retained earning.
- The cash received from customers will be reported as part of the ending cash balance in the balance sheet and as part of operating cash flows in the statement of cash flows.

Noncash Activities

- Suppose a company borrows $200 000 in cash from a bank, issuing a long-term note payable for that amount.

- The company reports this transaction in a statement of cash flows as a *financing activity*.

- Suppose the company then uses that cash to purchase new equipment.

- The company reports this second transaction as an *investing activity*.

Noncash Activities

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- But what if, instead of two separate transactions, the company had a single transaction that involved acquiring $200 000 of new equipment by issuing a 200 000 long-term note payable to the seller?

- ***Since this single transaction does not affect cash, there are no investing or financing activities to report in the statement of cash flows.***

- However, undertaking a significant investing activity and a significant financing activity as two parts of a single transaction does not lessen the value or reporting these activities.

- For that reason, transactions that do not increase or decrease cash, but that result in significant investing and financing activities, are reported as ***noncash activities*** either directly after the cash flow statement or in a note to the financial statements.

Noncash Activities

- Examples of significant noncash investing and financing activities include

1. Purchase of long-term assets by issuing debt.
2. Purchase of long-term assets by issuing stock.
3. Conversion of bonds payable into common stock.
4. Exchange of long-term assets.

Operating Activities Format - Methods

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- We have two ways to determine and report cash flows from operating activities in a statement of cash flows

    1. the indirect method

    2. the direct method

Operating Activities Format – Indirect Method

- Using the indirect method, we begin with net income and then list adjustments to net income, in order to arrive at operating cash flows.

- The indirect method is more popular because it is generally easier and less costly to prepare.

- In fact, nearly all major companies in the United States (about 99 %) prepare the statement of cash flows using the indirect method.

Operating Activities Format – Direct Method

- Using the direct method, we adjust the items in the income statement to directly show the cash inflows and outflows from operations such as cash received from customers and cash paid for inventory, salaries, rent, interest, and taxes.

- If a company decides to use the direct method to report operating activities, it must also report the indirect method either along with the statement of cash flows or in a separate note to the financial statements.

Operating Activities Format - Methods

- ***The total net cash flows from operating activities are identical under both methods.***
- The methods differ only in the presentation format for operating activities.
- Investing, financing, and noncash activities are reported identically under both methods.

Thank you for your attention.