

FA Module 6: Articulation of the income statement, balance sheet, and cash flow statement (overview)

(The attached PDF file has better formatting.)

Readings: chapter 6

- § 3: the cash flow statement: linkages and preparation (review)
- § 4: cash flow statement preparation, *excluding*
 - section 4.2 (common-size analysis of the statement of cash flows)

The final exam tests the articulation of the financial statements several ways. The most complete problems are the indirect method of forming the cash flow statement. Know well the articulation for

- net revenue, accounts receivable, cash from consumers, receivables turnover
- cost of goods sold, inventory, purchases from suppliers, and inventory turnover
- purchases from suppliers, accounts payable, cash paid to suppliers, and payables turnover

Similar relations hold for wage expense, interest expense, tax expense, and other operating expenses.

Some problems combine several entries. The gain or loss on sale of fixed assets combine the change of the gross values of fixed assets and of accumulated depreciation on the balance sheet, the depreciation expense and the gain or loss on sale from the income statement, and the investing cash flows.

Know whether to add or subtract the change in the balance sheet asset or liability of the income statement revenue or expense. The practice problems on the discussion forum explain the rules, and the textbook has examples for each entry. Adding a change instead of subtracting it (or vice versa) is a common cause of final exam errors. The articulation rules apply to all modules, especially for foreign currency translation, deferred tax assets and liabilities, and insurance contracts.

GAAP has similar relations for insurance premiums and claims:

- incurred losses = paid losses + Δ (claim reserves)
- earned premium = written premium – Δ (premium reserves)

Understand the general format of this formula:

- income statement debit = cash outflow – Δ (assets) + Δ (liabilities)
- income statement credit = cash inflow + Δ (assets) – Δ (liabilities)

IFRS 17 includes both cash inflows (premiums) and cash outflows (claims) in the fulfilment cash flows.

The final exam also tests free cash flow to the firm (both debt and equity) and free cash flow to equity. Be sure you understand when to use the tax adjustment.

Attached to this posting are two sections from an introductory financial accounting on-line textbook:

- 17.2 Cash Flows from Operating Activities: The Direct Method
- 17.3 Cash Flows from Operating Activities: The Indirect Method

The complete textbook is at <http://open.lib.umn.edu/financialaccounting/>

Working through the cash flow illustration in the attachments helps you master the concepts.

