CHAPTER 23

Statement of Cash Flows

ASSIGNMENT CLASSIFICATION TABLE (BY TOPIC)

Topics	Questions	Brief Exercises	Exercises	Problems	Concepts for Analysis
1. Format, objectives purpose, and source of statement.	1, 2, 7, 8, 12				1, 2, 5, 6
2. Classifying investing, financing, and operating activities.	3, 4, 5, 6, 16, 17, 19	1, 2, 3, 6, 7, 8, 12, 16	1, 2, 10		1, 3, 4, 5
3. Direct vs. indirect methods of preparing operating activities.	9, 20	4, 5, 9, 10, 11	3, 4		5
4. Statement of cash flows —direct method.	11, 13, 14	8	3, 5, 7, 9, 12, 13	3, 4, 6	
5. Statement of cash flows —indirect method.	10, 13, 15, 16	8	4, 6, 8, 11, 14, 15, 16, 17, 18, 20	1, 2, 4, 5, 6, 7, 8, 9	2
6. Preparing schedule of noncash investing and financing activities.	18	12		5, 7, 8, 9	5
7. Worksheet adjustments.	21	13	19, 21		

ASSIGNMENT CLASSIFICATION TABLE (BY LEARNING OBJECTIVE)

Learning Objectives	Brief Exercises	Exercises	Problems
1. Describe the purpose of the statement of cash flows.			
2. Identify the major classifications of cash flows.	3	1, 2, 10, 16	
3. Differentiate between net income and net cash flows from operating activities.	4, 5, 9, 10, 11	2, 3, 4, 5, 6, 7, 8, 16	6, 7
4. Contrast the direct and indirect methods of calculating net cash flow from operating activities.	4, 5, 6, 7, 9	3, 4, 5, 6, 7, 8	6, 7
5. Determine net cash flows from investing and financing activities.	1, 2	16	
6. Prepare a statement of cash flows.	8	9, 11, 12, 13, 14, 15, 17, 18	1, 2, 3, 4, 5, 6, 7, 8, 9
7. Identify sources of information for a statement of cash flows.			1, 2, 4, 5, 8, 9
8. Discuss special problems in preparing a statement of cash flows.	12	10, 18	1, 2, 4, 5, 6, 7, 8, 9
9. Explain the use of a worksheet in preparing a statement of cash flows.	13	19, 20, 21	

ASSIGNMENT CHARACTERISTICS TABLE

Item	Description	Level of Difficulty	Time (minutes)
E23-1	Classification of transactions.	Simple	10–15
E23-2	Statement presentation of transactions—indirect method.	Moderate	20–30
E23-3	Preparation of operating activities section—indirect method, periodic inventory.	Simple	15–25
E23-4	Preparation of operating activities section—direct method.	Simple	20–30
E23-5	Preparation of operating activities section—direct method.	Simple	20–30
E23-6	Preparation of operating activities section—indirect method.	Simple	15–20
E23-7	Computation of operating activities section—direct method.	Simple	15–20
E23-8	Schedule of net cash flow from operating activities—indirect method.	Moderate	20–30
E23-9	SCF—direct method.	Moderate	20–30
E23-10	Classification of transactions.	Moderate	25–35
E23-11	SCF—indirect method.	Moderate	30–35
E23-12	SCF—direct method.	Moderate	20–30
E23-13	SCF—direct method.	Moderate	30–40
E23-14	SCF—indirect method.	Moderate	30–40
E23-15	SCF—indirect method.	Moderate	25–35
E23-16	Cash provided by operating, investing, and financing activities.	Moderate	30–40
E23-17	SCF—indirect method and balance sheet.	Moderate	30–40
E23-18	Partial SCF—indirect method.	Moderate	25–30
E23-19	Worksheet analysis of selected accounts.	Moderate	20–25
E23-20	Worksheet analysis of selected transactions.	Moderate	20–25
E23-21	Worksheet preparation.	Moderate	45–55
P23-1	SCF—indirect method.	Moderate	40–45
P23-2	SCF—indirect method.	Moderate	50–60
P23-3	SCF—direct method.	Complex	50–60
P23-4	SCF—direct method.	Moderate	45–60
P23-5	SCF—indirect method.	Complex	50–65
P23-6	SCF—indirect method, and net cash flow from operating activities, direct method.	Moderate	40–50
P23-7	SCF—direct and indirect methods from comparative financial statements.	Moderate	30–40
P23-8	SCF—direct and indirect methods.	Moderate	30–40
P23-9	Indirect SCF.	Moderate	30–40
CA23-1	Analysis of improper SCF.	Moderate	30–35
CA23-2	SCF theory and analysis of improper SCF.	Moderate	30–35
CA23-3	SCF theory and analysis of transactions.	Moderate	30–35
CA23-4	Analysis of transactions' effect on SCF.	Moderate	20–30
CA23-5	Purpose and elements of SCF.	Complex	30–40
CA23-6	Cash flow reporting, ethics.	Moderate	20–30

ANSWERS TO QUESTIONS

1. The main purpose of the statement of cash flows is to show the change in cash of a company from one period to the next. The statement of cash flows provides information about a company's operating, financing, and investing activities. More precisely, it provides information about the company's cash inflows and outflows for the period.

2. Some uses of this statement are:
   Assessing future cash flows: Income data when augmented with current cash flow data provides a better basis for assessing future cash flows.
   Assessing quality of income: Some believe that cash flow information is more reliable than income information because income involves a number of assumptions, estimates and valuations.
   Assessing operating capability: Whether an enterprise is able to maintain its operating capability, provide for future growth, and distribute dividends to the owners depends on whether adequate cash is being or will be generated.
   Assessing financial flexibility and liquidity: Cash flow data indicate whether a company should be able to survive adverse operating problems and whether a company might have difficulty in meeting obligations as they become due, paying dividends, or meeting other recurring costs.
   Providing information on financing and investing activities: Cash flows are classified by their effect on balance sheet items; investing activities affect assets while financing activities affect liabilities and stockholders' equity.

3. Investing activities involve noncurrent assets and include (1) lending money and collecting on those loans and (2) acquiring and disposing of investments and productive long-lived assets. Financing activities, on the other hand, involve liability and owners' equity items and include (1) obtaining cash from creditors and repaying the amounts borrowed and (2) obtaining capital from owners and providing them with a return on their investment. Operating activities include all transactions and events that are not investing and financing activities. Operating activities involve the cash effects of transactions that enter into the determination of net income.

4. Examples of sources of cash in a statement of cash flows include cash from operating activities, issuance of debt, issuance of capital stock, sale of investments, and the sale of property, plant, and equipment. Examples of uses of cash include cash used in operating activities, payment of cash dividends, redemption of debt, purchase of investments, redemption of capital stock, and the purchase of property, plant, and equipment.

5. Preparing the statement of cash flows involves three major steps:
   1. Determine the change in cash. This is simply the difference between the beginning and ending cash balances.
   2. Determine the net cash flow from operating activities. This involves analyzing the current year's income statement, comparative balance sheets and selected transaction data.
   3. Determine cash flows from investing and financing activities. All other changes in balance sheet accounts are analyzed to determine their effect on cash.

6. Purchase of land—investing;
   Payment of dividends—financing;
   Cash sales—operating;
   Purchase of treasury stock—financing.

7. Comparative balance sheets, a current income statement, and certain transaction data all provide information necessary for preparation of the statement of cash flows. Comparative balance sheets indicate how assets, liabilities, and equities have changed during the period. A current income statement provides information about the amount of cash provided from operating activities. Certain transactions provide additional detailed information needed to determine whether cash was provided or used during the period.

8. It is necessary to convert accrual-based net income to a cash basis because net income includes items that do not provide or use cash. An example would be an increase in accounts receivable. If accounts receivable increased during the period, revenues reported on the accrual basis would be higher than the actual cash revenues received. Thus, accrual basis net income must be adjusted to reflect the net cash flow from operating activities.

9. Net cash flow from operating activities under the **direct method** is the difference between cash revenues and cash expenses. The direct method adjusts the revenues and expenses directly to reflect the cash basis. This results in cash net income, which is equal to "net cash flow from operating activities."

   The **indirect method** involves adjusting accrual net income. This is done by starting with accrual net income and adding or subtracting noncash items included in net income. Examples of adjustments include depreciation and other noncash expenses and changes in the balances of current asset and current liability accounts from one period to the next.

10. Net cash flow from operating activities is $3,870,000. Using the indirect method, the solution is:

Net income		$3,500,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	$ 520,000	
Accounts receivable increase	(500,000)	
Accounts payable increase	350,000	370,000
Net cash provided by operating activities		$3,870,000

11.

Accrual basis sales	$100,000
Less: Increase in accounts receivable	30,000
	70,000
Less: Writeoff of accounts receivable	4,000
Cash sales	$ 66,000

12. A number of factors could have caused an increase in cash despite the net loss. These are: (1) high cash revenues relative to low cash expenses, (2) sales of property, plant, and equipment, (3) sales of investments, and (4) issuance of debt or capital stock.

13.

Declared dividends	$260,000
Add: Dividends payable (beginning of year)	85,000
	345,000
Deduct: Dividends payable (end of year)	70,000
Cash paid in dividends during the year	$275,000

14. To determine cash payments to suppliers, it is first necessary to find purchases for the year. To find purchases, cost of goods sold is adjusted for the change in inventory (increased when inventory increases or decreased when inventory decreases). After purchases are computed, cash payments to suppliers are determined by adjusting purchases for the change in accounts payable. An increase (decrease) in accounts payable is deducted from (added to) purchases to determine cash payments to suppliers.

15. Cash flows from operating activities

Net income		$320,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	$114,000	
Amortization of patent	40,000	
Loss on sale of plant assets	21,000	175,000
Net cash provided by operating activities		$495,000

16. (a)

Cash flows from operating activities		
Net income		XXXX
Adjustments to reconcile net income to net cash provided by operating activities:		
Loss on sale of plant assets [($20,000 ÷ 10) x $3^{1}/_{2}$] – $4,000		$3,000
Cash flows from investing activities		
Sale of plant assets		$4,000

(b)

Cash flows from financing activities	
Issuance of common stock	$410,000

(c) No effect on cash; not shown in the statement of cash flows or in any related schedules or notes.

Note to instructor: The change in net accounts receivable is an adjustment to net income under the indirect method.

(d)

Cash flows from operating activities		
Net loss		$(50,000)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation expense	$22,000	
Gain on sale of available-for-sale securities	(9,000)	
Cash flows from investing activities		
Sale of available-for-sale securities		$ 38,000

17. (a) Investing activity.
(b) Financing activity.
(c) Investing activity.
(d) Operating activity.
(e) Significant noncash investing and financing activities.
(f) Financing activity.
(g) Operating activity.
(h) Financing activity.
(i) Significant noncash investing and financing activities.
(j) Financing activity.
(k) Operating activity.
(l) Operating activity.

18. Examples of noncash transactions are: (1) issuance of stock for assets, (2) issuance of stock to liquidate debt, (3) issuance of bonds or notes for assets, and (4) noncash exchanges of property, plant, and equipment.

19.

Cash flows from operating activities	
Net income	XXXX
Adjustments to reconcile net income to net cash provided by operating activities:	
Gain on redemption of bonds payable	$ (220,000)
Cash flows from financing activities	
Redemption of bonds payable	$(1,780,000)

20. Arguments for the indirect or reconciliation method are:
(1) By providing a reconciliation between net income and cash provided by operations, the differences are highlighted.
(2) The direct method is nothing more than a cash basis income statement which will confuse and create uncertainty for financial statement users who are familiar with the accrual-based income statements.
(3) There is some question as to whether the direct method is cost/benefit-justified as this method would probably lead to additional preparation cost because the financial records are not maintained on a cash basis.

21. A worksheet is desirable because it allows the orderly accumulation and classification of data that will appear on the statement of cash flows. It is an optional but efficient device that aids in the preparation of the statement of cash flows.

SOLUTIONS TO BRIEF EXERCISES

BRIEF EXERCISE 23-1

Cash flow from investing activities	
Sale of land	$ 130,000
Purchase of equipment	(415,000)
Purchase of available-for-sale securities	(59,000)
Net cash used by investing activities	$(344,000)

BRIEF EXERCISE 23-2

Cash flow from financing activities	
Issuance of common stock	$250,000
Issuance of bonds payable	510,000
Payment of dividends	(300,000)
Purchase of treasury stock	(46,000)
Net cash provided by financing activities	$414,000

BRIEF EXERCISE 23-3

(a)	D	(g)	P-F	(m)	N
(b)	A	(h)	P-I	(n)	D
(c)	R-F	(i)	P-I	(o)	R-F
(d)	A	(j)	A	(p)	P-F
(e)	R-I	(k)	D	(q)	R-I, A
(f)	R-I, D	(l)	R-F	(r)	P-F

BRIEF EXERCISE 23-4

Cash flows from operating activities		
Cash received from customers		
($200,000 – $17,000)		**$183,000**
Cash payments		
To suppliers		
($120,000 + $11,000 – $13,000)	**$118,000**	
For operating expenses		
($50,000 – $21,000)	**29,000**	**147,000**
Net cash provided by operating activities		**$ 36,000**

BRIEF EXERCISE 23-5

Cash flows from operating activities		
Net income		**$30,000**
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	**$21,000**	
Increase in accounts payable	**13,000**	
Increase in accounts receivable	**(17,000)**	
Increase in inventory	**(11,000)**	**6,000**
Net cash provided by operating activities		**$36,000**

BRIEF EXERCISE 23-6

Sales	**$420,000**
Add: Decrease in accounts receivable	**13,000**
Cash receipts from customers	**$433,000**

BRIEF EXERCISE 23-7

Cost of goods sold	**$500,000**
Add: Increase in inventory	**23,000**
Purchases	**523,000**
Deduct: Increase in accounts payable	**8,000**
Cash payments to suppliers	**$515,000**

BRIEF EXERCISE 23-8

Net cash provided by operating activities	$531,000
Net cash used by investing activities	(963,000)
Net cash provided by financing activities	585,000
Net increase in cash	153,000
Cash, 1/1/08	333,000
Cash, 12/31/08	$486,000

BRIEF EXERCISE 23-9

(a) Cash flows from operating activities

Cash received from customers	$90,000
Cash paid for expenses ($60,000 – $1,540)	58,460
Net cash provided by operating activities	$31,540

(b) Cash flows from operating activities

Net income	$40,000
Increase in net accounts receivable ($27,260[a] – $18,800[b])	(8,460)
Net cash provided by operating activities	$31,540

[a]($29,000 – $1,740) [b]($20,000 – $1,200)

BRIEF EXERCISE 23-10

Cash flows from operating activities		
Net income		$50,000
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation expense	17,000	
Increase in accounts payable	9,300	
Increase in accounts receivable	(11,000)	
Increase in inventory	(7,400)	7,900
Net cash provided by operating activities		$57,900

BRIEF EXERCISE 23-11

Cash flows from operating activities		
Net loss		($70,000)
Adjustments to reconcile net income (loss) to net cash provided by operating activities		
Depreciation expense	84,000	
Increase in accounts receivable	(8,100)	75,900
Net cash provided by operating activities		$ 5,900

BRIEF EXERCISE 23-12

(a)	Land	50,000	
	Common Stock		10,000
	Paid-in Capital in Excess of Par		40,000

(b) No effect

(c) Noncash Investing and Financing Activities
Purchase of land through issuance of common stock $50,000

BRIEF EXERCISE 23-13

(a)	Operating—Net Income	317,000	
	Retained Earnings		317,000
(b)	Retained Earnings	120,000	
	Financing—Cash Dividends		120,000
(c)	Equipment	114,000	
	Investing—Purchase of Equipment		114,000
(d)	Investing—Sale of Equipment	13,000	
	Accumulated Depreciation—Equipment	32,000	
	Equipment		40,000
	Operating—Gain on Sale of Equipment		5,000

SOLUTIONS TO EXERCISES

EXERCISE 23-1 (10–15 minutes)

(a) Investing activity.
(b) Financing activity.
(c) Investing activity.
(d) Operating—add to net income.
(e) Significant noncash investing and financing activity.
(f) Financing activity.
(g) Operating—add to net income.
(h) Financing activity.
(i) Significant noncash investing and financing activity.
(j) Financing activity.
(k) Operating—deduct from net income.
(l) Operating—add to net income.

EXERCISE 23-2 (20–30 minutes)

(a)

Plant assets (cost)	$20,000
Accumulated depreciation ([$20,000 ÷ 10] X 6)	12,000
Book value at date of sale	8,000
Sale proceeds	(5,300)
Loss on sale	$ 2,700

The loss on sale of plant assets is reported in the operating activities section of the statement of cash flows. It is added to net income to arrive at net cash provided by operating activities.

The sale proceeds of $5,300 are reported in the investing activities section of the statement of cash flows as follows:

Sale of plant assets	$5,300

(b) Shown in the financing activities section of a statement of cash flows as follows:

Sale of common stock	$430,000

EXERCISE 23-2 (Continued)

(c) The writeoff of the uncollectible accounts receivable of $27,000 is not reported on the statement of cash flows. The writeoff reduces the Allowance for Doubtful Accounts balance and the Accounts Receivable balance. It does not affect cash flows.

Note to instructor: The change in net accounts receivable is sometimes used to compute an adjustment to net income under the indirect method.

(d) The net loss of $50,000 should be reported in the operating activities section of the statement of cash flows. Depreciation of $22,000 is reported in the operating activities section of the statement of cash flows. The gain on sale of land also appears in the operating activities section of the statement of cash flows. The proceeds from the sale of land of $39,000 are reported in the investing activities section of the statement of cash flows. These four items might be reported as follows:

Cash flows from operating activities		
Net loss		$(50,000)
Adjustments to reconcile net income to net cash used in operating activities*:		
Depreciation	22,000	
Gain on sale of land	(9,000)	

*Either net cash used or provided depending upon other adjustments. Given only the adjustments in (d), the "net cash used" should be employed.

Cash flows from investing activities	
Sale of land	$39,000

(e) The purchase of the U.S. Treasury bill is not reported in the statement of cash flows. This instrument is considered a cash equivalent and therefore cash and cash equivalents have not changed as a result of this transaction.

(f) Patent amortization of $20,000 is reported in the operating activities section of the statement of cash flows. It is added to net income in arriving at net cash provided by operating activities.

EXERCISE 23-2 (Continued)

(g) The exchange of common stock for an investment in Tabasco is reported as a "noncash investing and financing activity." It is shown as follows:

Noncash investing and financing activities	
Purchase of investment by issuance of common stock	$900,000

(h) The purchase of treasury stock is reported as a cash payment in the financing activities section of the statement of cash flows.

EXERCISE 23-3 (15–25 minutes)

Vince Gill Company
Partial Statement of Cash Flows
For the Year Ended December 31, 2008

Cash flows from operating activities		
Net income		$1,050,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	$ 60,000	
Decrease in accounts receivable	360,000	
Decrease in inventory	300,000	
Increase in prepaid expenses	(170,000)	
Decrease in accounts payable	(275,000)	
Decrease in accrued expenses payable	(100,000)	175,000
Net cash provided by operating activities		$1,225,000

EXERCISE 23-4 (20–30 minutes)

Vince Gill Company
Partial Statement of Cash Flows
For the Year Ended December 31, 2008

Cash flows from operating activities			
Cash receipts from customers		$7,260,000	(a)
Cash payments			
To suppliers	$4,675,000 (b)		
For operating expenses	1,360,000 (c)	6,035,000	
Net cash provided by operating activities		$1,225,000	

Computations:

(a) Cash receipts from customers

Sales	$6,900,000
Add: Decrease in accounts receivable	360,000
Cash receipts from customers	$7,260,000

(b) Cash payments to suppliers

Cost of goods sold	$4,700,000
Deduct: Decrease in inventories	300,000
Purchases	4,400,000
Add: Decrease in accounts payable	275,000
Cash payments to suppliers	$4,675,000

(c) Cash payments for operating expenses

Operating expenses, exclusive of depreciation		$1,090,000*
Add: Increase in prepaid expenses	$170,000	
Decrease in accrued expenses payable	100,000	270,000
Cash payments for operating expenses		$1,360,000

*$450,000 + ($700,000 – $60,000)

EXERCISE 23-5 (20–30 minutes)

Krauss Company
Partial Statement of Cash Flows
For the Year Ended December 31, 2007

Cash flows from operating activities				
Cash receipts from customers			$857,000	(a)
Cash payments				
For operating expenses	$614,000	(b)		
For income taxes	44,500	(c)	658,500	
Net cash provided by operating activities			$198,500	

(a) Computation of cash receipts from customers:

Revenue from fees	$840,000
Add: Decrease in accounts receivable ($54,000 – $37,000)	17,000
Cash receipts from customers	$857,000

(b) Computation of cash payments:

Operating expenses per income statement	$624,000
Deduct: Increase in accounts payable ($41,000 – $31,000)	10,000
Cash payments for operating expenses	$614,000

(c)

Income tax expense per income statement	$ 40,000
Add: Decrease in income taxes payable ($8,500 – $4,000)	4,500
Cash payments for income taxes	$ 44,500

EXERCISE 23-6 (15–20 minutes)

KRAUSS COMPANY
Partial Statement of Cash Flows
For the Year Ended December 31, 2007

Cash flows from operating activities		
Net income		$90,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	$60,000	
Loss on sale of equipment	26,000	
Decrease in accounts receivable	17,000	
Increase in accounts payable	10,000	
Decrease in income taxes payable	(4,500)	108,500
Net cash provided by operating activities		$198,500

EXERCISE 23-7 (15–20 minutes)

Situation A: Cash flows from operating activities

Cash receipts from customers ($200,000 – $71,000)	$129,000
Cash payments for operating expenses ($110,000 – $29,000)	81,000
Net cash provided by operating activities	$ 48,000

Situation B: (a) Computation of cash payments to suppliers

Cost of goods sold	$310,000
Plus: Increase in inventory	26,000
Decrease in accounts payable	17,000
Cash payments to suppliers	$353,000

(b) Computation of cash payments for operating expenses

Operating expenses	$230,000
Deduct: Decrease in prepaid expenses	8,000
Increase in accrued expenses payable	11,000
Cash payments for operating expenses	$211,000

EXERCISE 23-8 (20–30 minutes)

Cash flows from operating activities		**$145,000**
Net income		
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	**$39,000**	
Gain on sale of investment [($200 – $145) X 100]	**(5,500)**	
Decrease in accounts receivable	**12,000**	
Income from equity method investment ($27,000 X .40)	**(10,800)**	
Dividends from equity investment ($2,0000 X .40)	**800**	**35,500**
Net cash provided by operating activities		**$180,500**

Other comments:

No. 1 is shown as a cash inflow from the issuance of treasury stock and cash outflow for the purchase of treasury stock, both financing activities.

No. 2 is shown as a cash inflow from investing activities of $20,000 and the gain of $5,500 is deducted from net income in the operating activities section.

No. 3 is a noncash expense (Bad Debt Expense) in the income statement. Bad debt expense is not handled separately when using the indirect method. It is part of the change in net accounts receivable.

No. 4 is a significant noncash investing and financing activity.

No. 7 (dividends received) is added to net income. Another alternative is to net the Company's pro-rata share of the dividend against the income from equity method investment amount reported in the cash flows from operating activities.

No. 8 is not shown on a statement of cash flows.

EXERCISE 23-9 (20–30 minutes)

1\.

Sales		**$538,800**
Deduct: Increase in accounts receivable, net of write-offs [$33,000 – ($30,000 – $4,800)]		**7,800**
Cash collected from customers		**$531,000**

2\.

Cost of goods sold		**$250,000**
Deduct: Decrease in inventory ($47,000 – $31,000)		**16,000**
Purchases		**234,000**
Deduct: Increase in accounts payable ($25,000 – $15,500)		**9,500**
Cash payments to suppliers		**$224,500**

3\.

Interest expense		**$4,300**
Deduct: Decrease in unamortized bond discount ($5,000 – $4,500)		**500**
Cash paid for interest		**$3,800**

4\.

Income tax expense		**$20,400**
Add: Decrease in income taxes payable ($29,100 – $21,000)		**8,100**
Deduct: Increase in deferred tax liability ($5,300 – $4,600)		**700**
Cash paid for income taxes		**$27,800**

5\.

Selling expenses		**$141,500**
Deduct: Depreciation ($1,500* X 1/3)	**500**	
Bad debts expense	**5,000**	**5,500**
Cash paid for selling expenses		**$136,000**

***($16,500 – $15,000)**

EXERCISE 23-10 (25–35 minutes)

1. **The solution can be determined through use of a T-account for property, plant, and equipment.**

Property, plant & equipment

12/31/07	247,000	45,000	Equipment sold
Equipment from exchange of B/P	20,000		
Payments for purchase of PP&E	?		
12/31/08	277,000		

Payments = $277,000 + $45,000 – $247,000 – $20,000
= $55,000

SFAS 95 states that investing activities include the acquisition and disposition of long-term productive assets. Accordingly, the purchase of property, plant, and equipment is an investing activity. Note that the acquisition of property, plant, and equipment in exchange for bonds payable would be disclosed as a noncash investing and financing activity.

2. **The solution can be determined through use of a T-account for accumulated depreciation.**

Accumulated depreciation

		167,000	12/31/07
		33,000	Depreciation expense
Equipment sold	?		
		178,000	12/31/08

Accumulated depreciation on equipment sold = $167,000 + $33,000 – $178,000 = $22,000

The entry to reflect the sale of equipment is:

Cash (proceeds from sale of equipment)			
($45,000 + $14,500 – $22,000)	37,500		
Accumulated depreciation	22,000		
Property, plant, and equipment		45,000	(given)
Gain on sale of equipment		14,500	

EXERCISE 23-10 (Continued)

The proceeds from the sale of equipment of $37,500 are considered an investing activity. Investing activities include the acquisition and disposition of long-term productive assets.

3. The cash dividends paid can be determined by analyzing T-accounts for retained earnings and dividends payable.

Retained earnings

		91,000	12/31/07
Dividends declared	?	31,000	Net income
		104,000	12/31/08

Dividends declared = $91,000 + $31,000 – $104,000
= $18,000

Dividends payable

		5,000	12/31/07
		18,000	Dividends declared
Cash dividends paid	?		
		8,000	12/31/08

Cash dividends paid = $5,000 + $18,000 – $8,000
= $15,000

Financing activities include all cash flows involving liabilities and stockholders' equity other than operating items. Payment of cash dividends is thus a financing activity.

4. The redemption of bonds payable amount is determined by setting up a T-account.

Bonds payable

		46,000	12/31/07
		20,000	Issuance of B/P for PP&E
Redemption of B/P	?		
		49,000	12/31/08

The problem states that there was no amortization of bond premium or discount; thus, the redemption of bonds payable is the only change not accounted for.

EXERCISE 23-10 (Continued)

Redemption of bonds payable = \$46,000 + \$20,000 – \$49,000
= \$17,000

Financing activities include all cash flows involving liabilities and stockholders' equity other than operating items. Therefore, redemption of bonds payable is considered a financing activity.

EXERCISE 23-11 (30–35 minutes)

Pat Metheny Company
STATEMENT OF CASH FLOWS
For the Year Ended December 31, 2008
(Indirect Method)

Cash flows from operating activities		
Net income		$ 810
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense ($1,200 – $1,170)	$ 30	
Gain on sale of investments	(80)	
Decrease in inventory	300	
Increase in accounts payable	300	
Increase in receivables	(450)	
Decrease in accrued liabilities	(50)	50
Net cash provided by operating activities		860
Cash flows from investing activities		
Sale of held-to-maturity investments [($1,420 – $1,300) + $80]	200	
Purchase of plant assets [($1,900 – $1,700) – $70]	(130)	
Net cash provided by investing activities		70
Cash flows from financing activities		
Issuance of capital stock [($1,900 – $1,700) – $70]	130	
Retirement of bonds payable	(150)	
Payment of cash dividends	(260)	
Net cash used by financing activities		(280)
Net increase in cash		650
Cash, January 1, 2008		1,150
Cash, December 31, 2008		$1,800
Noncash investing and financing activities		
Issuance of common stock for plant assets		$ 70

EXERCISE 23-12 (20–30 minutes)

Pat Metheny Company
STATEMENT OF CASH FLOWS
For the Year Ended December 31, 2008
(Direct Method)

Cash flows from operating activities		
Cash collections from customers		$6,450*
Less: Cash paid for merchandise	$4,100**	
Cash paid for selling/administrative expenses	950***	
Cash paid for income taxes	540	5,590
Net cash provided by operating activities		860
Cash flows from investing activities		
Sale of held-to-maturity investments [($1,420 – $1,300) + $80]	200	
Purchase of plant assets [($1,900 – $1,700) – $70]	(130)	
Net cash provided by investing activities		70
Cash flows from financing activities		
Issuance of capital stock [($1,900 – $1,700) – $70]	130	
Retirement of bonds payable	(150)	
Payment of cash dividends	(260)	
Net cash used by financing activities		(280)
Net increase in cash		650
Cash, January 1, 2008		1,150
Cash, December 31, 2008		$1,800
Noncash investing and financing activities		
Issuance of common stock for plant assets		$ 70

*$1,300 + $6,900 – $1,750
**$1,600 + $4,700 – $1,900 + $900 – $1,200
***$250 + ($930 – $30) – $200

EXERCISE 23-13 (30–40 minutes)

Brecker Inc.
STATEMENT OF CASH FLOWS
For the Year Ended December 31, 2008

Cash flows from operating activities		
Less: Cash received from customers		$327,150[a]
Cash paid to suppliers	$149,000[b]	
Cash paid for operating expenses	89,000[c]	
Cash paid for interest	11,400	
Cash paid for income taxes	8,750[d]	258,150
Net cash provided by operating activities		$ 69,000
Cash flows from investing activities		
Sale of equipment [($20,000 X 30%) + $2,000]	8,000	
Purchase of equipment	(44,000)	
Purchase of available-for-sale investments	(17,000)	
Net cash used by investing activities		(53,000)
Cash flows from financing activities		
Principal payment on short-term loan	(2,000)	
Principal payment on long-term loan	(9,000)	
Dividend payments	(6,000)	
Net cash used by financing activities		(17,000)
Net decrease in cash		(1,000)
Cash, January 1, 2008		7,000
Cash, December 31, 2008		$ 6,000

[a]Sales	$338,150
– Increase in accounts receivable	(11,000)
Cash received from customers	$327,150

[b]Cost of goods sold	$175,000
– Increase in accounts payable	(6,000)
– Decrease in inventories	(20,000)
Cash paid to suppliers	$149,000

EXERCISE 23-13 (Continued)

[c]Operating expenses	$120,000
+ Increase in prepaid rent	1,000
– Depreciation expense	(24,000)
$35,000 – [$25,000 – ($20,000 X .70)]	
– Amortization of copyright	(4,000)
– Increase in wages payable	(4,000)
Cash paid for operating expenses	$ 89,000

[d]Income tax expense	$6,750
+ Decrease in income taxes payable	2,000
Cash paid for income taxes	$8,750

EXERCISE 23-14 (30–40 minutes)

Brecker Inc.
STATEMENT OF CASH FLOWS
For the Year Ended December 31, 2008

Cash flows from operating activities		
Net income		$27,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	$24,000*	
Amortization of copyright	4,000	
Gain on sale of equipment	(2,000)	
Decrease in inventories	20,000	
Increase in wages payable	4,000	
Increase in accounts payable	6,000	
Increase in prepaid rent	(1,000)	
Increase in accounts receivable	(11,000)	
Decrease in income taxes payable	(2,000)	42,000
Net cash provided by operating activities		69,000
Cash flows from investing activities		
Sale of equipment [($20,000 X 30%) + $2,000]	8,000	
Purchase of equipment	(44,000)	
Purchase of available-for-sale investments	(17,000)	
Net cash used by investing activities		(53,000)

EXERCISE 23-14 (Continued)

Cash flows from financing activities		
Principal payment on short-term loan	(2,000)	
Principal payment on long-term loan	(9,000)	
Dividend payments	(6,000)	
Net cash used by financing activities		(17,000)
Net decrease in cash		(1,000)
Cash, January 1, 2008		7,000
Cash, December 31, 2008		$ 6,000

Supplemental disclosures of cash flow information:

Cash paid during the year for:	
Interest	$11,400
Income taxes	$ 8,750

*$35,000 – [$25,000 – ($20,000 X 70%)]

EXERCISE 23-15 (25–35 minutes)

Antonio Brasileiro Company
STATEMENT OF CASH FLOWS
For the Year Ended December 31, 2008

Cash flows from operating activities		
Net income		$ 46,000*
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	$ 20,000	
Loss on sale of investments	9,000	
Loss on sale of plant assets	2,000	
Increase in current assets other than cash	(25,000)	
Increase in current liabilities	18,000	24,000
Net cash provided by operating activities		70,000
Cash flows from investing activities		
Sale of plant assets	8,000	
Sale of held-to-maturity investments	34,000	
Purchase of plant assets	(170,000)**	
Net cash used by investing activities		(128,000)

EXERCISE 23-15 (Continued)

Cash flows from financing activities		
Issuance of bonds payable	75,000	
Payment of dividends	(10,000)	
Net cash provided by financing activities		65,000
Net increase in cash		7,000
Cash balance, January 1, 2008		8,000
Cash balance, December 31, 2008		$15,000

*Net income $57,000 – $9,000 – $2,000 = $46,000

**Supporting computation
(purchase of plant assets)

Plant assets, December 31, 2007	$215,000
Less: Plant assets sold	(50,000)
	165,000
Plant assets, December 31, 2008	335,000
Plant assets purchased during 2008	$170,000

EXERCISE 23-16 (30–40 minutes)

(a) Computation of net cash provided by operating activities:

Net income ($8,000 + $10,000) – $5,000		$13,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	$14,000*	
Loss on sale of equipment ($6,000 – $3,000)	3,000	
Increase in accounts receivable ($45,000 – $55,000)	(10,000)	
Increase in merchandise inventory ($45,000 – $65,000)	(20,000)	
Decrease in prepaid expenses ($25,000 – $15,000)	10,000	
Increase in accounts payable ($65,000 – $52,000)	13,000	
Decrease in accrued expenses ($15,000 – $18,000)	(3,000)	7,000
Net cash provided by operating activities		$20,000

*[$18,000 + ($10,000 – $6,000)] – $8,000

EXERCISE 23-16 (Continued)

(b) Computation of net cash provided (used) by investing activities:

Sale of equipment	$ 3,000
Purchase of equipment	
[$90,000 – ($75,000 – $10,000)]	(25,000)
Net cash used by investing activities	$(22,000)

(c) Computation of net cash provided (used) by financing activities:

Cash dividends paid	$(10,000)
Payment of notes payable	(23,000)
Issuance of bonds payable	30,000
Net cash used by financing activities	$ (3,000)

EXERCISE 23-17 (30–40 minutes)

(a)

Jobim Inc.
STATEMENT OF CASH FLOWS
For the Year Ended December 31, 2008

Cash flows from operating activities		
Net income		$35,250
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	$13,500	
Gain on sale of investment	(2,000)	11,500
Net cash provided by operating activities		46,750
Cash flows from investing activities		
Purchase of land	(9,000)	
Sale of available-for-sale investments	12,875	
Net cash provided by investing activities		3,875
Cash flows from financing activities		
Payment of dividends	(9,375)	
Retirement of bonds payable	(15,000)	
Issuance of capital stock	10,000	
Net cash used by financing activities		(14,375)

EXERCISE 23-17 (Continued)

Net increase in cash	36,250
Cash, January 1, 2008	8,500
Cash, December 31, 2008	$44,750

Noncash investing and financing activities

Issuance of bonds for land	$22,500

(b)

Jobim Inc.
BALANCE SHEET
December 31, 2008

Assets		Equities	
Cash	$ 44,750	Current liabilities	$ 15,000
Current assets other than cash	29,000	Long-term notes payable	25,500
Investments	9,125[a]	Bonds payable	32,500**
Plant assets (net)	54,000	Capital stock	85,000
Land	71,500*	Retained earnings	50,375***
	$208,375		$208,375

[a] $20,000 – ($12,875 – $2,000)
*$40,000 + $9,000 + $22,500
**$25,000 – $15,000 + $22,500
***$24,500 + $35,250 – $9,375

EXERCISE 23-18 (25–30 minutes)

Anita Baker Company
Statement of Cash Flows (partial)
For the Year Ended December 31, 2008

Cash flows from operating activities		
Net income		$ 40,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	$16,800	
Loss on sale of equipment	5,800	22,600
Net cash provided by operating activities		62,600

EXERCISE 23-18 (Continued)

Cash flows from investing activities		
Purchase of machinery	**(62,000)**	
Sale of machinery		
[($56,000 – $25,200) – $5,800]	**25,000**	
Extraordinary repairs on machinery	**(21,000)**	
Cost of machinery constructed	**(48,000)**	
Net cash used by investing activities		**(106,000)**
Cash flows from financing activities		
Payment of cash dividends		**(15,000)**
Decrease in cash		**(58,400)**
Cash, January 1, 2008		**xxx**
Cash, December 31, 2008		**$ xxx**

EXERCISE 23-19 (20–25 minutes)

Retained Earnings	**15,000**	
Financing—Cash Dividends		**15,000**
Operating—Net Income	**40,000**	
Retained Earnings		**40,000**
Operating—Depreciation Expense	**16,800**	
Accumulated Depreciation—Machinery		**16,800**
Machinery	**110,000**	
Investing—Purchase of Machinery		**62,000**
Investing—Construction of Machinery		**48,000**
Accumulated Depreciation—Machinery	**21,000**	
Investing—Extraordinary Repairs to Machinery		**21,000**
Operating—Loss on Sale of Equipment	**5,800**	
Accumulated Depreciation—Machinery	**25,200**	
Investing—Sale of Machinery	**25,000**	
Machinery		**56,000**

EXERCISE 23-20 (20–25 minutes)

		Debit	Credit
1.	Bonds Payable	300,000	
	Common Stock		300,000
	(Noncash financing activity)		
2.	Operating—Net income	410,000	
	Retained Earnings		410,000
3.	Operating—Depreciation Expense	90,000	
	Accumulated Depreciation—Building		90,000
4.	Accumulated Depreciation—Office Equipment	30,000	
	Office Equipment	10,000	
	Operating—Gain on Disposal of Plant Assets		6,000
	Investing—Purchase of Office Equipment		34,000
5.	Retained Earnings	123,000	
	Cash Dividend Payable		123,000

EXERCISE 23-21 (45–55 minutes)

Stevie Wonder Corporation
WORKSHEET FOR PREPARATION OF STATEMENT OF CASH FLOWS
For the Year Ended December 31, 2008

Debits	Balance at 12/31/07		2008 Reconciling Items Debit		2008 Reconciling Items Credit	Balance at 12/31/08
Cash	$ 21,000			(17)	$ 4,500	$ 16,500
Short-term investments	19,000	(2)	$ 6,000			25,000
Accounts receivable	45,000			(3)	2,000	43,000
Prepaid expenses	2,500	(4)	1,700			4,200
Inventories	65,000	(5)	16,500			81,500
Land	50,000					50,000
Buildings	73,500	(10)	51,500			125,000
Equipment	46,000	(11)	7,000			53,000
Delivery equipment	39,000					39,000
Patents		(12)	15,000			15,000
Total debits	$361,000					$452,200
Credits						
Accounts payable	$ 16,000			(6)	$10,000	$ 26,000
Short-term notes payable	6,000	(7)	$ 2,000			4,000
Accrued payables	4,600	(8)	1,600			3,000
Allowance for doubtful accounts	2,000	(3)	200			1,800
Accum. depr.—bldg.	23,000			(13)	7,000	30,000
Accum. depr.—equip.	15,500			(13)	3,500	19,000
Accum. depr.—del. equip.	20,500			(13)	1,500	22,000
Mortgage payable	53,400			(14)	19,600	73,000
Bonds payable	62,500	(16)	12,500			50,000
Capital stock	102,000			(15)	38,000	140,000
Addtl. paid-in capital	4,000			(15)	6,000	10,000
Retained earnings	51,500	(9)	15,000	(1)	36,900	73,400
Total credits	$361,000					$452,200

EXERCISE 23-21 (Continued)

Statement of Cash Flows Effects

Operating activities				
Net income	(1)	36,900		
Depreciation	(13)	12,000		
Dec. in accounts receivable (net)	(3)	1,800		
Inc. in prepaid expenses			(4)	1,700
Inc. in inventories			(5)	16,500
Inc. in accounts payable	(6)	10,000		
Dec. in notes payable			(7)	2,000
Dec. in accrued payables			(8)	1,600
Investing activities				
Purchase of available-for-sale investments			(2)	6,000
Purchase of building			(10)	51,500
Purchase of equipment			(11)	7,000
Purchase of patents			(12)	15,000
Financing activities				
Payment of cash dividends			(9)	15,000
Issuance of mortgage payable	(14)	19,600		
Sale of stock	(15)	44,000		
Retirement of bonds			(16)	12,500
Totals		253,300		257,800
Decrease in cash	(17)	4,500		
Totals		$257,800		$257,800

TIME AND PURPOSE OF PROBLEMS

Problem 23-1 (Time 40–45 minutes)
Purpose—to develop an understanding of the procedures involved in the preparation of a statement of cash flows. The student is required to prepare the statement using the indirect method.

Problem 23-2 (Time 50–60 minutes)
Purpose—to develop an understanding of the procedures involved in the preparation of a statement of cash flows, including a schedule of noncash investing and financing activities. The student is required to prepare the statement using the indirect method, and consider the proper treatment of an extraordinary item.

Problem 23-3 (Time 50–60 minutes)
Purpose—to develop an understanding of the procedures involved in the preparation of a statement of cash flows. The student is required to prepare the statement using the direct method.

Problem 23-4 (Time 45–60 minutes)
Purpose—to develop an understanding of the procedures involved in the preparation of a statement of cash flows. The student is required to prepare the statement using the direct method, including a reconciliation schedule.

Problem 23-5 (Time 50–65 minutes)
Purpose—to develop an understanding of the procedures involved in the preparation of a statement of cash flows, including the treatment accorded unusual and extraordinary items. The student is required to prepare the statement using the indirect method, and include any supporting schedules or computations.

Problem 23-6 (Time 40–50 minutes)
Purpose—to develop an understanding of the procedures involved in the preparation of a statement of cash flows. The student is required to prepare the statement using the indirect method. The student also must calculate the net cash flow from operating activities using the direct method.

Problem 23-7 (Time 30–40 minutes)
Purpose—Using comparative financial statement data, the student is required to prepare the statement of cash flows, using the direct method. The student must also prepare the operating activities section of the statement of cash flows using the indirect method.

Problem 23-8 (Time 30–40 minutes)
Purpose—to develop an understanding of both the direct and indirect method. The student is first asked to compute net cash provided by operating activities under the direct method. In addition a statement of cash flows using the indirect method must be computed.

Problem 23-9 (Time 30–40 minutes)
Purpose—to develop an understanding of the indirect method. In the second part, the student is asked to determine how operating, investing and financing sections of the statement of cash flows will change under various situations.

SOLUTIONS TO PROBLEMS

PROBLEM 23-1

Blue Man Corp.
STATEMENT OF CASH FLOWS
For the Year Ended December 31, 2008

Cash flows from operating activities			
Net income			$370,000
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	$150,000	(a)	
Gain on sale of equipment	(5,000)	(b)	
Equity in earnings of Blige Co.	(30,000)	(c)	
Decrease in accounts receivable	40,000		
Increase in inventories	(135,000)		
Increase in accounts payable	60,000		
Decrease in income taxes payable	(20,000)		60,000
Net cash provided by operating activities			430,000
Cash flows from investing activities:			
Proceeds from sale of equipment	40,000		
Loan to TLC Co.	(300,000)		
Principal payment of loan receivable	37,500		
Net cash used by investing activities			(222,500)
Cash flows from financing activities:			
Dividends paid	(100,000)		
Net cash used by financing activities			(100,000)
Net increase in cash			107,500
Cash, January 1, 2008			700,000
Cash, December 31, 2008			$807,500

PROBLEM 23-1 (Continued)

Schedule at bottom of statement of cash flows:

Noncash investing and financing activities:		
Issuance of lease obligation for capital lease		$400,000

Explanation of Amounts

(a) Depreciation		
Net increase in accumulated depreciation for the year ended December 31, 2008		$125,000
Accumulated depreciation on equipment sold:		
Cost	$60,000	
Carrying value	35,000	25,000
Depreciation for 2008		$150,000
(b) Gain on sale of equipment		
Proceeds		$ 40,000
Carrying value		(35,000)
Gain		$ 5,000
(c) Equity in earnings of Blige Co.		
Blige's net income for 2008		$120,000
Blue Man's ownership		25%
Undistributed earnings of Blige Co.		$ 30,000

PROBLEM 23-2

Shenandoah Corporation
STATEMENT OF CASH FLOWS
For the Year Ended December 31, 2008

Cash flows from operating activities		
Net income		$14,750 (a)
Adjustments to reconcile net income to net cash provided by operating activities:		
Loss on sale of equipment	$ 5,200 (b)	
Gain from flood damage	(8,250)*	
Depreciation expense	800 (c)	
Patent amortization	1,250	
Gain on sale of investments	(3,700)	
Increase in accounts receivable (net)	(3,750)	
Increase in inventory	(3,000)	
Increase in accounts payable	2,000	(9,450)
Net cash provided by operating activities		5,300
Cash flows from investing activities		
Sale of investments	6,700	
Sale of equipment	2,500	
Purchase of equipment	(15,000)	
Proceeds from flood damage to building	32,000	
Net cash provided by investing activities		26,200
Cash flows from financing activities		
Payment of dividends	(5,000)	
Payment of short-term note payable	(1,000)	
Net cash used by financing activities		(6,000)
Increase in cash		25,500
Cash, January 1, 2008		13,000
Cash, December 31, 2008		$38,500

*($30,000 + $2,000) – ($29,750 – $6,000)

PROBLEM 23-2 (Continued)

Supplemental disclosures of cash flow information:

Cash paid during the year for:		
Interest	**$2,000**	
Income taxes:	**$6,500**	

Noncash investing and financing activities

Retired note payable by issuing common stock	**$10,000**
Purchased equipment by issuing note payable	**16,000**
	$26,000

Supporting Computations:

(a)	**Ending retained earnings**	**$20,750**
	Beginning retained earnings	**(6,000)**
	Net income	**$14,750**

(b)	**Cost**	**$11,000**
	Accumulated depreciation (30% X $11,000)	**(3,300)**
	Book value	**$ 7,700**
	Proceeds from sale	**(2,500)**
	Loss on sale	**$ 5,200**

(c)	**Accumulated depreciation on equipment sold**	**$3,300**
	Decrease in accumulated depreciation	**(2,500)**
	Depreciation expense	**$ 800**

PROBLEM 23-3

Mardi Gras Company
STATEMENT OF CASH FLOWS
For the Year Ended December 31, 2008
($000 omitted)

Cash flows from operating activities		
Cash receipts from customers		$3,560 (a)
Payments for merchandise	$1,280 (b)	
Salaries and benefits	725	
Heat, light, and power	75	
Property taxes	19	
Interest	30	
Miscellaneous	10	
Income taxes	798 (c)	2,937
Net cash provided by operating activities		623
Cash flows from investing activities		
Sale of available-for-sale investments	50	
Purchase of buildings and equipment	(310)	
Purchase of land	(80)	
Net cash used by investing activities		(340)
Increase in cash		283
Cash, January 1, 2008		100
Cash, December 31, 2008		$ 383

(a)	Sales	$3,800
	Deduct ending accounts receivable	(740)
		3,060
	Add beginning accounts receivable	500
	Cash receipts (collections from customers)	$3,560

PROBLEM 23-3 (Continued)

(b)

Cost of goods sold	$1,200
Add ending inventory	720
Goods available for sale	1,920
Deduct beginning inventory	(560)
Purchases	1,360
Deduct ending accounts payable	(420)
	940
Add beginning accounts payable	340
Cash purchases (payments for merchandise)	$1,280

(c)

Income taxes	$818
Deduct ending income taxes payable	(40)
	778
Add beginning income taxes payable	20
Income taxes paid	$798

PROBLEM 23-4

Cleveland Company
STATEMENT OF CASH FLOWS
For the Year Ended December 31, 2007
(Direct Method)

Cash flows from operating activities		
Cash received from customers	$1,155,450[a]	
Dividends received	2,400	
Cash paid to suppliers	(760,000)[b]	
Cash paid for operating expenses	(226,350)[c]	
Taxes paid	(38,400)[d]	
Interest paid	(57,300)[e]	
Net cash provided by operating activities		$75,800
Cash flows from investing activities		
Sale of available-for-sale investments	14,000	
Sale of land	58,000	
Purchase of equipment	(125,000)	
Net cash used by investing activities		(53,000)
Cash flows from financing activities		
Proceeds from issuance of common stock	22,500	
Principal payment on long-term debt	(10,000)	
Dividends paid	(24,300)	
Net cash used by financing activities		(11,800)
Net increase in cash		11,000
Cash, January 1, 2007		4,000
Cash, December 31, 2007		$15,000

[a]Sales Revenue	$1,160,000
– Increase in Accounts Receivable	(4,550)
Cash received from customers	$1,155,450

[b]Cost of Goods Sold	$748,000
+ Increase in Inventory	7,000
+ Decrease in Accounts Payable	5,000
Cash paid to suppliers	$760,000

PROBLEM 23-4 (Continued)

[c]Operating Expenses	$276,400	
– Depreciation/Amortization Expense	(40,500)	
– Decrease in Prepaid Rent	(9,000)	
+ Increase in Prepaid Insurance	1,200	
+ Increase in Office Supplies	250	
– Increase in Wages Payable	(2,000)	
Cash paid for Operating Expenses	$226,350	
[d]Income Tax Expense	$39,400	
– Increase in Income Taxes Payable	(1,000)	
Taxes paid	$38,400	
[e]Interest Expense	$51,750	
+ Decrease in Bond Premium	5,550	
Interest paid	$57,300	

Reconciliation of Net Income to Net Cash Provided by Operating Activities:

Net income		$58,850
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation/amortization expense	$40,500	
Decrease in prepaid rent	9,000	
Increase in taxes payable	1,000	
Increase in wages payable	2,000	
Increase in accounts receivable	(4,550)	
Increase in inventory	(7,000)	
Increase in prepaid insurance	(1,200)	
Increase in office supplies	(250)	
Decrease in accounts payable	(5,000)	
Gain on sale of land	(8,000)	
Gain on sale of short-term investments	(4,000)	
Amortization of bond premium	(5,550)	
Total adjustments		16,950
Net cash provided by operating activities		$75,800

PROBLEM 23-5

Texas Hold Em Corporation
STATEMENT OF CASH FLOWS
For the Year Ended December 31, 2008
(Indirect Method)

Cash flows from operating activities			
Net income			$115,000*
Adjustments to reconcile net income to net cash provided by operating activities:			
Loss on sale of machinery	$ 4,200	(4)	
Gain on retirement of bonds	(425)	(5)	
Depreciation of machinery	48,200	(4)	
Depreciation of building	31,200	(8)	
Amortization of patents	10,000	(3)	
Amortization of copyright	10,000		
Amortization of bond discount	87	(6)	
Amortization of bond premium	(75)	(5)	
Equity in earnings of subsidiary	(10,500)	(7)	
Increase in accounts receivable (net)	(131,124)		
Increase in inventory	(131,700)		
Increase in prepaid expenses	(4,000)		
Increase in taxes payable	10,650		
Increase in accounts payable	19,280		(144,207)
Net cash used by operating activities			(29,207)
Cash flows from investing activities			
Sale of machinery	7,000	(4)	
Investment in subsidiary	(100,000)	(7)	
Addition to buildings	(127,300)		
Extraordinary repairs to building	(7,200)	(8)	
Purchase of machinery	(33,400)	(4)	
Purchase of patent	(15,000)	(3)	
Increase in cash surrender value of life insurance	(504)		
Net cash used by investing activities			(276,404)

PROBLEM 23-5 (Continued)

Cash flows from financing activities		
Redemption of bonds	(101,900) (5)	
Sale of bonds less expense of sale	120,411 (6)	
Sale of stock	257,000	
Net cash provided by financing activities		275,511
Decrease in cash		(30,100)
Cash, January 1, 2008		298,000
Cash, December 31, 2008		$267,900

*Net income per retained earnings statement ($25,000 + $90,000) $115,000

Supplemental disclosures of cash flow information:

Cash paid during the year for:

Interest	$10,500
Income taxes	$34,000

<u>Noncash investing and financing activities</u>

Reduction in stated value of stock to eliminate deficit	$425,000

Comments on Numbered Items

(1) Write-off of deficit has no effect on cash. Analysis of the capital stock account shows the following:

Balance 12/31/07	$1,453,200
Restatement of stated value of stock	425,000
Balance 4/1/08	1,028,200
(2) Sale of 29,600 shares 11/1/08 for $257,000 with stated value of $5 per share	148,000
Balance 12/31/08	$1,176,200

PROBLEM 23-5 (Continued)

(3) A patent was purchased for $15,000 cash. The account activity is analyzed as follows:

Balance 12/31/07	$64,000
Purchase	15,000
Total	79,000
Balance 12/31/08	(69,000)
Amortization charged against income which did not use cash	$10,000

(4) Analysis of the Machinery account shows the following:

Balance 12/31/07	$190,000
Disposition of machinery	(16,400)
Total	173,600
Balance 12/31/08	(207,000)
Additions requiring cash	$ (33,400)

Loss on sale:		
($16,400 – $5,200) – $7,000	$4,200	
Cash received from disposition	$7,000	
Analysis of accumulated depreciation—machinery:		
Balance 12/31/07 of Accumulated Depreciation		$130,000
Amount on asset sold		(5,200)
Balance		124,800
Balance 12/31/08		(173,000)
Depreciation charged against income which did not use cash		$ (48,200)

PROBLEM 23-5 (Continued)

(5) Funds to redeem bonds (net of taxes) [($100,000 X 1.02) – $100]		$101,900
Face value of bonds		$100,000
Unamortized premium 12/31/07	$2,400	
Amortization to 3/31/08 not requiring cash ($6,000 ÷ 20) x 1/4	75	
Balance at date of redemption		2,325
Book value of bonds		$102,325
Gain on redemption ($102,325 – $101,900)		$(425)

(6) Face amount of bonds issued		$125,000
Discount on $125,000 of bonds sold	$3,750	
Expense of issuance	839	
Total		(4,589)
Proceeds of issue		$120,411
Amortization for nine months, which did not require cash	(87)*	
Change in discount account	$4,502	

*($4,589/477 months) X 9 months = $87

(7) Purchase of stock requiring cash		$100,000
70% of subsidiary's income for year ($15,000), which did not provide cash but was credited to income		10,500
Balance 12/31/08		$110,500

(8) Analysis of accumulated depreciation—building		
Balance of accumulated depreciation 12/31/07		$400,000
Charge for major repairs which used cash		(7,200)
		392,800
Balance 12/31/08		(424,000)
Depreciation charged against income which did not require cash		($ 31,200)

PROBLEM 23-5 (Continued)

Comments on Other Items
(not required)

Increase in cash surrender value of insurance required cash	**$ 504**
Increase in Buildings required cash	**127,300**
Decrease in Copyright was a noncash charge against income	**10,000**
Dividends declared did not require cash	**70,000**

Accrued interest on retired bonds and issuance does not affect the statement of cash flows. These items are already recorded in income.

PROBLEM 23-6

(a) **Net Cash Flow from Operating Activities**

Cash received from customers		$527,850[1]
Cash payments to suppliers	$380,750[2]	
Cash payments for operating expenses	105,675[3]	(486,425)
Net cash provided by operating activities		$ 41,425

[1]$540,000 – $7,500 – $4,650* = $527,850

[2]$380,000 + $6,000 – $5,250 = $380,750

[3]$120,450 – $8,625 – $750** – $5,400 = $105,675

*Writeoff of accounts receivable. ($1,500 + $5,400 – $2,250)
**Increase in accrued payables

(b)

Secada Inc.
STATEMENT OF CASH FLOWS
For the Year Ended December 31, 2008

Cash flows from operating activities		
Net income		$42,500
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	$ 8,625	
Gain on sale of investments	(3,750)	
Loss on sale of machinery	800	
Increase in accounts receivable (net)	(6,750)*	
Increase in inventory	(6,000)	
Increase in accounts payable	5,250	
Increase in accrued payables	750	(1,075)
Net cash provided by operating activities		41,425

PROBLEM 23-6 (Continued)

Cash flows from investing activities		
Purchase of investments		
$22,250 – ($38,500 – $20,000)	**(3,750)**	
Purchase of machinery		
$30,000 – ($18,750 – $3,750)	**(15,000)**	
Addition to buildings	**(11,250)**	
Sale of investments	**23,750**	
Sale of machinery	**2,200**	
Net cash used by investing activities		**(4,050)**
Cash flows from financing activities		
Reduction in long-term note payable	**(5,000)**	
Cash dividends paid	**(21,125)**	
Net cash used by financing activities		**(26,125)**
Net increase in cash		**11,250**
Cash, January 1, 2008		**33,750**
Cash, December 31, 2008		**$45,000**

***($67,500 – $2,250) – ($60,000 – $1,500)**

PROBLEM 23-7

(a) Both the direct method and the indirect method for reporting cash flows from operating activities are acceptable in preparing a statement of cash flows according to SFAS No. 95; however, the FASB encourages the use of the direct method. Under the direct method, the statement of cash flows reports the major classes of cash receipts and cash disbursements, and discloses more information; this may be the statement's principal advantage. Under the indirect method, net income on the accrual basis is adjusted to the cash basis by adding or deducting noncash items included in net income, thereby providing a useful link between the statement of cash flows and the income statement and balance sheet.

(b) The Statement of Cash Flows for George Winston Company, for the year ended May 31, 2008, using the direct method, is presented below.

George Winston Company
STATEMENT OF CASH FLOWS
For the Year Ended May 31, 2008

Cash flows from operating activities		
Cash received from customers		$1,233,250
Cash paid		
To suppliers	$674,000	
To employees	276,850	
For other expenses	10,150	
For interest	73,000	
For income taxes	43,000	1,077,000
Net cash provided by operating activities		156,250
Cash flows from investing activities		
Purchase of plant assets		(48,000)
Cash flows from financing activities		
Cash received from common stock issue	$ 40,000	
Cash paid		
For dividends	(105,000)	
To retire bonds payable	(30,000)	
Net cash used by financing activities		(95,000)
Net increase in cash		13,250
Cash, June 1, 2007		20,000
Cash, May 31, 2008		$ 33,250

PROBLEM 23-7 (Continued)

Note 1: Noncash investing and financing activities:
Issuance of common stock for plant assets $50,000.

Supporting Calculations:

Collections from customers	
Sales	$1,255,250
Less: Increase in accounts receivable	22,000
Cash collected from customers	$1,233,250
Cash paid to suppliers	
Cost of merchandise sold	$722,000
Less: Decrease in merchandise inventory	40,000
Increase in accounts payable	8,000
Cash paid to suppliers	$674,000
Cash paid to employees	
Salary expense	$252,100
Add: Decrease in salaries payable	24,750
Cash paid to employees	$276,850
Cash paid for other expenses	
Other expenses	$ 8,150
Add: Increase in prepaid expenses	2,000
Cash paid for other expenses	$10,150
Cash paid for interest	
Interest expense	$75,000
Less: Increase in interest payable	2,000
Cash paid for interest	$73,000
Cash paid for income taxes:	
Income tax expense (given)	$43,000

PROBLEM 23-7 (Continued)

(c) The calculation of the cash flow from operating activities for George Winston Company, for the year ended May 31, 2008, using the indirect method, is presented below.

George Winston Company
STATEMENT OF CASH FLOWS
For the Year Ended May 31, 2008

Cash flows from operating activities		
Net income		$130,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	$25,000	
Decrease in merchandise inventory	40,000	
Increase in accounts payable	8,000	
Increase in interest payable	2,000	
Increase in accounts receivable	(22,000)	
Increase in prepaid expenses	(2,000)	
Decrease in salaries payable	(24,750)	26,250
Net cash provided by operating activities		$156,250

PROBLEM 23-8

(a) **Net Cash Provided by Operating Activities**

Cash receipts from customers		$935,000 (1)
Cash payments to suppliers	$604,000 (2)	
Cash payments for operating expenses	228,000 (3)	
Cash payments for income taxes	43,000 (4)	875,000
Net cash provided by operating activities		$ 60,000

(1) (Sales) less (Increase in Receivables)
$950,000 – $15,000 = $935,000

(2) (Cost of Goods Sold) plus (Increase in Inventory) less (Increase in Accounts Payable)
$600,000 + $14,000 – $10,000 = $604,000

(3) (Operating Expenses) less (Depreciation Expense) less (Bad Debt Expense)
$250,000 – $20,000* – $2,000 = $228,000

(4) (Income Taxes) less (Increase in Income Taxes Payable)
$45,000 – $2,000 = $43,000

*$21,000 – [$14,000 – ($10,000 X .40)]	= $11,000	Equipment depreciation
$37,000 – $28,000	= 9,000	Building depreciation
	$20,000	

PROBLEM 23-8 (Continued)

(b) Jensen Company

STATEMENT OF CASH FLOWS

For the Year Ended December 31, 2007

Cash flows from operating activities		
Net income		$67,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	$20,000	
Gain on sale of investments	(15,000)	
Loss on sale of equipment	3,000	
Increase in receivable (net)	(13,000)	
Increase in inventory	(14,000)	
Increase in accounts payable	10,000	
Increase in income taxes payable	2,000	(7,000)
Net cash provided by operating activities		60,000
Cash flows from investing activities		
Purchase of investments [$55,000 – ($85,000 – $35,000)]	(5,000)	
Purchase of equipment [$70,000 – ($48,000 – $10,000)]	(32,000)	
Sale of investments ($35,000 + $15,000)	50,000	
Sale of equipment [$10,000 – ($10,000 X 40%)] – $3,000	3,000	
Net cash provided by investing activities		16,000
Cash flows from financing activities		
Payment of long-term notes payable	(8,000)	
Cash dividends paid [($95,000 + $67,000) – $88,000]	(74,000)	
Issuance of common stock	35,000*	
Net cash used by financing activities		(47,000)
Net increase in cash		29,000
Cash, January 1, 2007		51,000
Cash, December 31, 2007		$80,000
<u>Noncash investing and financing activities</u>		
Issuance of common stock for land		$15,000

*$50,000 ($310,000 – $260,000) – ($40,000 – $25,000)
$310,000 – $260,000 = $50,000; $50,000 – ($40,000 – $25,000) = $35,000

PROBLEM 23-9

(a)

Seneca Corporation
STATEMENT OF CASH FLOWS
For the Year Ended December 31, 2007

Cash flows from operating activities		
Net income		$15,750[a]
Adjustments to reconcile net income to net cash provided by operating activities:		
Loss on sale of equipment	$ 4,100[b]	
Gain from flood damage	(13,250)*	
Depreciation expense	1,900[c]	
Copyright amortization	250	
Gain on sale of investment	(2,500)	
Increase in accounts receivable (net)	(3,750)	
Increase in inventory	(2,000)	
Increase in accounts payable	1,000	(14,250)
Net cash flow provided by operating activities		1,500
Cash flows from investing activities		
Sale of investments	5,500	
Sale of equipment	2,500	
Purchase of equipment (cash)	(10,000)	
Proceeds from flood damage to building	37,000	
Net cash provided by investing activities		35,000
Cash flows from financing activities		
Payment of dividends	(5,000)	
Payment of short-term note payable	(1,000)	
Net cash used by financing activities		(6,000)
Increase in cash		30,500
Cash, January 1, 2007		13,000
Cash, December 31, 2007		$43,500

Supplemental disclosures of cash flow information:

Cash paid during the year for:

Interest	$2,000
Income taxes	$5,000

*[($33,000 + $4,000) – ($29,750 – $6,000)]

PROBLEM 23-9 (Continued)

Noncash investing and financing activities:

Retired note payable by issuing common stock	$ 5,000
Purchased equipment by issuing note payable	16,000
	$21,000

Supporting Computations:

(a)	Ending retained earnings	$20,750
	Beginning retained earnings	(5,000)
	Net income	$15,750
(b)	Cost	$11,000
	Accumulated depreciation (40% X $11,000)	(4,400)
	Book value	$ 6,600
	Proceeds from sale	(2,500)
	Loss on sale	$ 4,100
(c)	Accumulated depreciation on equipment sold	$4,400
	Decrease in accumulated depreciation	(2,500)
	Depreciation expense	$1,900

(b) (1) For a severely financially troubled firm:

Operating: Probably a small cash inflow or a cash outflow.
Investing: Probably a cash inflow as assets are sold to provide needed cash.
Financing: Probably a cash inflow from debt financing (borrowing funds) as a source of cash at high interest cost.

(2) For a recently formed firm which is experiencing rapid growth:

Operating: Probably a cash inflow.
Investing: Probably a large cash outflow as the firm expands.
Financing: Probably a large cash inflow to finance expansion.

TIME AND PURPOSE OF CONCEPTS FOR ANALYSIS

CA 23-1 (Time 30–35 minutes)
Purpose—to develop an understanding of the proper composition and presentation of the statement of cash flows. The student is required to analyze a statement of sources and application of cash and indicate the proper treatment of various transactions.

CA 23-2 (Time 30–35 minutes)
Purpose—to illustrate the proper form of the statement of cash flows. The student is required to prepare the statement using the indirect method, and to discuss the rationale behind the statement.

CA 23-3 (Time 30–35 minutes)
Purpose—to help a student identify whether a transaction creates a cash inflow or a cash outflow. The student is required to indicate whether a cash inflow or a cash outflow results from the transaction. The student must also discuss the proper disclosure of the transaction.

CA 23-4 (Time 20–30 minutes)
Purpose—to help the student identify the sections of the statement of cash flows. The student is required to indicate whether a transaction belongs in the investing, financing, or operating section of the statement.

CA 23-5 (Time 30–40 minutes)
Purpose—to identify and explain reasons and purposes for preparing a statement of cash flows, to identify the categories of activities reported in the statement of cash flows, to identify and describe the two methods of reporting cash flows from operations, and to describe the presentation of noncash transactions.

CA 23-6 (Time 20–30 minutes)
Purpose—provides the student the opportunity to examine the effects of a securitization on the statement of cash flows, including ethical dimensions.

SOLUTIONS TO CONCEPTS FOR ANALYSIS

CA 23-1

(a) The main purpose of the statement of cash flows is to show the change in cash from one period to the next. Another objective of a statement of the type shown is to summarize the financing and investing activities of the entity, including the extent to which the enterprise has generated cash or near cash assets from operations during the period. Another objective is to complete the disclosure of changes in financial position during the period. The information shown in such a statement is useful to a variety of users of financial statements in making economic decisions regarding the enterprise.

(b) The following are weaknesses in form and format of Abriendo Corporation's Statement of Sources and Application of Cash:

1. The title of the statement should be Statement of Cash Flows.
2. The statement should add back to (or deduct from) net income certain items that did not use (or provide) cash during the period. The resulting total should be described as net cash provided by operating activities. Cash flows from extraordinary items, if any, should be presented with appropriate modifications in terminology as investing or financing activities.

   The only apparent adjustments in this situation are the amounts to be added back to net income for the depreciation and depletion expense, for any wage or salary expense related to the employee stock option plans, and for changes in current assets and liabilities.

3. The format used should separate the cash flows into investing, financing, and operating activities. Noncash investing and financing activities, if significant, should be shown in a separate schedule or note.

4. Individual items should not be grouped together, as was the case for the $14,000 item.

(c) 1. (i) The $22,000 option plan wage and salary expense should be included in the statement as an amount added back to net income, an expense not requiring the outlay of cash during the period.
   (ii) Since the statement balances and no reference is made to the $22,000 payroll expense, it appears the expense was not recorded or that there is an offsetting error elsewhere in the statement.

2. The expenditures for plant-asset acquisitions should not be reported net of the proceeds from plant-asset retirements. Both the outlay for acquisitions and the proceeds from retirements should be reported as investing activities. The details provide useful information about changes in financial position during the period.

3. Stock dividends or stock splits need not be disclosed in the statement because these transactions do not significantly affect financial position.

4. The issuance of the 16,000 shares of common stock in exchange for the preferred stock should be shown as a noncash financing activity. Since these transactions significantly change the corporation's capital structure, they should be disclosed.

5. The presentation of the combined total of depreciation and depletion is probably acceptable. The general rule is that related items should be shown separately in proximity when the result contributes information useful to the user of the statement, but immaterial items may be

CA 23-1 (Continued)

combined. In this situation, it is likely that no additional relevant information would be added by showing depletion as a separate item. The total should be added back to net income in the computation of the net cash flow from operating activities.

6. The details of changes in long-term debt should be shown separately. Payments should not be netted against increases in long-term borrowings. The long-term borrowing of $620,000 should be shown as cash provided and the retirement of $441,000 of debt should be shown as use of cash from financing activities.

CA 23-2

(a) From the information given, it appears that from an operating standpoint Tropical Clothing Store did not have a superb first year, having suffered a $21,000 net loss. Flaco is correct; the statement of cash flows is not prepared in correct form. The sources and uses format is not an acceptable form. The correct form classifies cash flows from three activities—operating, investing, and financing; and it also presents significant noncash investing and financing activities in a separate schedule. Flaco is wrong, however, about the actual increase in cash—$109,000 is the correct increase in cash.

(b)

Tropical Clothing Store
STATEMENT OF CASH FLOWS
For the Year Ended January 31, 2008

Cash flows from operating activities		
Net loss		$ (21,000)*
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	$ 80,000	
Gain from sale of investment	(35,000)	45,000
Net cash provided by operating activities		24,000
Cash flows from investing activities		
Sale of investment	120,000	
Purchase of fixtures and equipment	(340,000)	
Purchase of investment	(85,000)	
Net cash used by investing activities		(305,000)
Cash flows from financing activities		
Sale of capital stock	400,000	
Purchase of treasury stock	(10,000)	
Net cash provided by financing activities		390,000
Net increase in cash		$109,000
Supplemental disclosure of cash flow information:		
Cash paid for interest		$3,000

CA 23-2 (Continued)

Significant noncash investing and financing activities

Issuance of note for truck		$30,000

***Computation of net income (loss)**

Sales of merchandise		$362,000
Interest revenue		8,000
Gain on sale of investment ($120,000 – $85,000)		35,000
Total revenues		405,000
Merchandise purchases	$253,000	
Operating expenses ($170,000 – $80,000)	90,000	
Depreciation	80,000	
Interest expense	3,000	
Total expenses		(426,000)
Net loss		$ (21,000)

CA 23-3

1. The earnings are treated as a source of cash and should be reported as part of the net cash provided by operating activities in the statement of cash flows. There should be $910,000 of income before extraordinary items because extraordinary items should be separated from operating activities.

2. The $315,000 depreciation expense is neither a source nor a use of cash. Because depreciation is an expense, it was deducted in the computation of net income. Accordingly, the $315,000 must be added back to income before extraordinary items in the operating activities section because it was deducted in determining earnings, but it was not a use of cash.

3. The writeoff of uncollectible accounts receivable against the allowance account has no effect on cash because the net accounts receivable remain unchanged. An adjustment to income is only necessary if the net receivable amount increases or decreases. Because the net receivable amount is the same before and after the writeoff, an adjustment to income would not be made.

   The $51,000 of bad debt expense does not affect cash would be added back to income because it affects the amount of net accounts receivable. The recording of bad debt expense reduces the net receivable because the allowance account increases. Although bad debt expense is not usually treated as a separate item to be added back to income from operations, it is accounted for by analyzing the accounts receivable at the net amount and then making the necessary adjustment to income based on the change in the net amount of receivables.

4. The $9,000 gain realized on the sale of the machine is an ordinary gain, not an extraordinary gain, for accounting purposes. This $9,000 gain must be deducted from net income to arrive at net cash provided by operating activities. The proceeds of $39,000 are shown as a cash inflow from investing activities.

5. Generally, extraordinary items are investing or financing activities and the cash inflow or outflow resulting from such events should be reported in the investing or financing activities section of the statement of cash flows. In this case, no cash flow resulted from the lightning damage. The net loss (a noncash event) must be added back to net income (under the indirect method) as one of the adjustments to reconcile net income to net cash flow provided by operating activities.

CA 23-3 (Continued)

6. The $75,000 use of cash should be reported as a cash outflow from investing activities. The $200,000 issuance of common stock and the $425,000 issuance of the mortgage note, neither of which affects cash, should be reported as noncash financing and investing activities.

7. This conversion is not a source or use of cash, but it is a significant noncash financing activity and should be reported in a separate schedule or note.

CA 23-4

	Where to Present	How to Present
1.	Investing and operating	Cash provided by sale of fixed assets, $5,250 as an investing activity. In addition, the loss of $1,750 [($20,000 x $3^1/_2$) ÷ 10] – $5,250 on the sale would be added back to net income.
2.	Operating	The impairment reduced earnings from operations but did not use cash. The amount of $15,000 is added back to net income.
3.	Financing	Cash provided by the issuance of capital stock of $17,000.
4.	Operating	The net loss of $2,100 is presented as loss from operations, and depreciation of $2,000 and amortization of $400 are added back to the loss from operations. Cash provided by operating activities is $300.
5.	Not reported in statement.	
6.	Investing and operating	Cash provided by the sale of the investment, $10,600 as an investing activity. The loss of $1,400 is added back to net income.
7.	Financing and operating	The retirement is reported as cash used by financing activities of $24,720. Additionally, the gain (of $1,280 = $26,000 – $24,720) is deducted from net income in the operating activities section.

CA 23-5

(a) The primary purpose of the Statement of Cash Flows is to provide information concerning the cash receipts and cash payments of a company during a period. The information contained in the Statement of Cash Flows, together with related disclosures in other financial statements, may help investors and creditors
   1. assess the company's ability to generate future net cash inflows.
   2. assess the company's ability to meet its obligations, e.g., pay dividends and meet needs for external financing.
   3. analyze the differences between net income and the associated cash receipts and payments.

(b) The Statement of Cash Flows classifies cash inflows and outflows as those resulting from operating activities, investing activities, and financing activities.

Cash inflows from operating activities include receipts from the sale of goods and services, receipts from returns on loans and equity securities (interest and dividends), and all other receipts that do not arise from transactions defined as financing and investing activities. Cash outflows for operating activities include payments to buy goods for manufacture and resale, payments to employees for services, tax payments, payments to creditors for interest, and all other payments that do not arise from transactions defined as financing and investing activities.

CA 23-5 (Continued)

Cash inflows from investing activities include receipts from collections or sales of debt instruments of other companies, from the sale of the investments in those stocks, and from sales of various productive fixed assets. Cash outflows for investing activities include payments for stocks of other companies, purchase of productive fixed assets, and debt instruments of other companies.

Cash inflows from financing activities include proceeds from the company issuing its own stock or its own debt. Cash outflows for financing activities include payments to shareholders and debtholders for dividends or retirement of its own stocks and bonds (i.e., treasury stock).

(c) Cash flows from operating activities may be presented using the direct method or the indirect method. Under the direct method, the major classes of operating cash receipts and cash payments are shown separately. The indirect method involves adjusting net income to net cash flow from operating activities by removing the effects of deferrals of past cash receipts and payments, accruals of future cash receipts and payments, and noncash items from net income.

(d) Noncash investing and financing transactions are to be reported in the related disclosures, either in a narrative form or summarized within a schedule. Examples of noncash transactions are the conversion of debt to equity, acquiring assets by assuming directly related liabilities, and exchanging noncash assets or liabilities for other noncash assets or liabilities. For transactions that are part cash and part noncash, only the cash portion should be reported in the Statement of Cash Flows.

CA 23-6

(a) It is true that selling current assets, such as receivables and notes to factors, will generate cash flows for the company, but this practice does not cure the systemic cash problems for the organization. In short, it may be a bad business practice to liquidate assets, incurring expenses and losses, in order to "window dress" the cash flow statement.

The ethical implications are that Durocher creates a short-term cash flow at the longer-term expense of the company's operations and financial position. Laraine's idea creates the deceiving illusion that the company is successfully generating positive cash flows.

(b) Laraine Durocher should be told that if she executes her plan, the company may not survive. While the factoring of receivables and the liquidation of inventory will indeed generate cash, the actual amount of cash the company receives will be less than the carrying value of the receivables and the raw materials. In addition, the company would still have the future expenditure of replenishing its raw materials inventories, at a cost higher than the sales price.

As chief accountant for Durocher Guitar, it is your responsibility to work with the company's chief financial officer to devise a coherent strategy for improving the company's cash flow problems. One strategy may be to downsize the organization by selling excess property, plant, and equipment to repay long-term debt. In addition, Durocher Guitar may be a good candidate for a quasi-reorganization.

FINANCIAL REPORTING PROBLEM

(a) P&G uses the indirect method to compute and report net cash provided by operating activities. The amounts of net cash provided by operating activities for 2002, 2003, and 2004 are $7,742 million, $8,700 million, and $9,362 million, respectively. The two items most responsible for the increase in cash provided by operating activities in 2004 are the increase in net earnings ($6,481 – $5,186) and deferred income taxes ($415 – $63).

(b) The most significant item in the investing activities section is the $7,476 million that P&G spent on "acquisitions." The most significant item in the financing activities section is the $4,911 million that P&G received from proceeds from short term debt.

(c) Deferred taxes are reported in the operating activities section of P&G's statement of cash flows. The $415 million is reported as an add back to net income because it is a noncash charge in the income statement.

(d) Depreciation and amortization is reported in the operating activities section of P&G's statement of cash flows as an add back to net income because it is a noncash charge in the income statement.

FINANCIAL STATEMENT ANALYSIS CASE

VERMONT TEDDY BEAR CO.

(a) Even though prior year income exceeded the current year income by \$821,432 (\$838,955 – \$17,523), the current year cash flow from operations exceeded prior year's cash flow from operations by \$937,437 (\$236,480 – \$700,957). This apparent paradox can be explained by evaluating the components of cash from operating activities. Significant contributors to the positive cash flow figure in the current year were (1) the depreciation and amortization add-back of \$316,416 versus \$181,348 in the prior year, and (2) accounts payable increase of \$2,017,059 in the current year versus a decline of \$284,567 in the prior year. An increase in accounts payable causes an increase in cash from operations; thus, the majority of the increase in cash is explained by the company's dramatic increase in accounts payable. An investor or creditor would want to investigate this increase to ensure that the company is not delinquent on its payments. However, it should be noted that inventories did increase by \$1,599,014.

(b) Liquidity: current cash debt coverage ratio (net cash provided by operating activities ÷ average current liabilities)

\$236,480 ÷ ((\$4,055,465 + \$1,995,600) ÷ 2) = .078:1

Solvency: cash debt coverage ratio (net cash provided by operating activities ÷ average total liabilities)

\$236,480 ÷ ((\$4,620,085 + \$2,184,386) ÷ 2) = .070:1

Profitability: cash return on sales ratio (net cash provided by operating activities ÷ net sales)

\$236,480 ÷ \$20,560,566 = .012:1

All of these ratios are very low. This is not surprising, however, for a company like the Vermont Teddy Bear Company that is in the early stages of its life. When a company is in the introductory phase of its main product, it will not typically generate significant cash flow from operations. However, because of the precarious nature of companies in this stage of their lives, the company's cash position should be monitored closely to ensure that it does not slide into a distress financial state due to cash shortages.

COMPARATIVE ANALYSIS CASE

(a) Both Coca-Cola and PepsiCo use the indirect method of computing and reporting net cash provided by operating activities in 2002–2004.

(In millions)	Coca-Cola	PepsiCo
Net cash provided by operating activities	$5,968	$5,054

(b) The most significant investing activities items in 2004:

Coca-Cola
Purchases of property plant, and equipment — $755 million

PepsiCo
Capital spending — $1,387 million

The most significant financing activities items in 2004:

Coca-Cola
Issuance of debt — $3,030 million

PepsiCo
Share repurchases—common — $3,028 million

(c) The Coca-Cola Company has increased net cash provided by operating activities from 2002 to 2004 by $1,226 million or 25.9%. PepsiCo, Inc. has increased net cash provided by operating activities by $427 million or 9.2%. Both companies have favorable trends in the generation of internal funds from operations.

(d) Both Coca-Cola and PepsiCo report depreciation and amortization in the operating activities section:

Coca-Cola, $893 million
PepsiCo, $1,264 million

Depreciation and amortization is reported in the operating activities section because it is a noncash charge in the income statement.

COMPARATIVE ANALYSIS CASE (Continued)

(e)

		Coca-Cola	PepsiCo
1.	Current cash debt coverage	$\dfrac{\$5{,}968}{\frac{(\$10{,}971 + \$7{,}886)}{2}} = .63:1$	$\dfrac{\$5{,}054}{\frac{(\$6{,}752 + \$6{,}415)}{2}} = .77:1$
2.	Cash debt coverage	$\dfrac{\$5{,}968}{\frac{(\$15{,}392 + \$13{,}252)}{2}} = .42:1$	$\dfrac{\$5{,}054}{\frac{(\$14{,}464 + \$13{,}453)}{2}} = .36:1$

(f) The current cash debt coverage ratio uses cash generated from operations during the period and provides a better representation of liquidity on an average day. PepsiCo's ratio of $.77 of cash flow from operations for every dollar of current debt was approximately 22% higher (.77 vs. .63) than Coca-Cola's $.63 of cash flow from operations per dollar of current debt and indicates PepsiCo was more liquid in 2004 than Coca-Cola.

The cash debt coverage ratio shows a company's ability to repay its liabilities from cash generated from operating activities without having to liquidate the assets employed in its operations. Since Coca-Cola's cash debt coverage ratio was approximately 17% larger (.42 vs. .36) than PepsiCo's, its ability to repay liabilities with cash flow from operations was greater than PepsiCo's in 2004.

RESEARCH CASE

(a) The complications concern how Tyco accounts for the purchase of customer contracts for security alarms. Tyco treats the payments for the contracts, amounting to over $830 million in 2001, as acquisitions. However, cash paid for an acquisition does not get counted against Tyco's preferred measure of cash flow—free cash flow. Furthermore, when Tyco collects on the contracts, the payments are counted as increases in its free cash flow. So Tyco counts the inflows but excludes the outflows for contracts, which makes its free cash flow look good.

(b) Free cash flow is a measure of cash flow defined as cash generated by operations, minus dividends and capital expenditures (introduced in Chapter 5). It is a measure of operating cash flow after adjusting for cash expenditures that are considered fairly non-discretionary or unavoidable. Tyco and many other companies like to focus on this measure . . . its chief financial officer has told . . . "investors to forget reported earnings" and instead focus on cash-flow generation as a percentage of net income, to "show that our quality of earnings is good."

As discussed in (a), Tyco manipulates free cash flow by keeping payments to acquire contracts out of free cash flow, but records the monthly fees as an addition to free cash flow. If Tyco had acquired the customer directly, rather than through an acquisition, its free cash flow would have been negative. Tyco gets a similar boost to free cash flow by counting the connection fee as an inflow to free cash flow but the payment to get the contract is left out.

(c) There is no GAAP for free cash flow. This is a "pro-forma" measure that different companies measure different ways. For example, some companies do not deduct dividends from their free cash flow measure, arguing that the dividends can be avoided. As with other pro forma reporting, the lack of standards makes it difficult to compare measures such as free cash flow across companies.

(d) If Tyco had acquired its customers through in-house marketing efforts, different accounting rules would have applied—and, as a result, the company would have shown much lower upfront earnings

and free cash flow from the new customers. According to Professor Mulford, "Tyco is effectively buying earnings and operating cash flow with the contract purchases." The practice is risky because, Tyco may not be able to sustain the earnings and cash flows; if Tyco stopped the purchases tomorrow, its operating cash flow would drop off immediately.

INTERNATIONAL REPORTING CASE

(a) Similarities include:

1. Major classifications—the statement is divided into sources and uses of funds.
2. There is a sub-total for funds provided by operations with similar adjustments for items such as depreciation and amortization.
3. The statement concludes with a reconciliation from beginning of the year to end of the year funds balances.

(b) Differences include:

1. Statement Title—Statement of Changes in Financial Position.
2. The statement shows the change in funds rather than cash flows. Funds are defined as working capital.
3. The funds statement does not use sub-categories for investing and financing activities. That is, investing and financing activities are mixed together as sources and applications of funds.
4. The statement is stated in Brazilian reals rather than dollars.

Note that prior to SFAS No. 95, U.S. companies prepared a statement similar to this, rather than a statement of cash flows. International Accounting Standards call for a statement of cash flows.

PROFESSIONAL RESEARCH: FINANCIAL ACCOUNTING AND REPORTING

Search Strings: "concept of funds;" "information provided in a statement of cash flows;" "Cash inflows for operating activities;" "Cash outflows for operating activities"

(a) FAS 95 Summary: This Statement establishes standards for cash flow reporting. It supersedes APB Opinion No. 19, Reporting Changes in Financial Position, and requires a statement of cash flows as part of a full set of financial statements for all business enterprises in place of a statement of changes in financial position. Prior to FAS 95's requirement of a statement of cash flows, APB 19 required companies to provide a funds statement based on either cash or working capital.

FAS 95, Appendix B, Par. 50: To achieve those objectives requires that the statement focus on flows of cash rather than flows of working capital. An overwhelming majority of respondents agreed with that focus. Many made negative comments on the usefulness of working capital as a concept of funds, generally questioning its relevance since positive working capital does not necessarily indicate liquidity nor does negative working capital necessarily indicate illiquidity.

(b) Par. 51: Cash is the most useful concept of funds because decisions of investors, creditors, and others focus on assessments of future cash flows. However, enterprises commonly invest cash in excess of immediate needs in short-term, highly liquid investments, and whether cash is on hand, on deposit, or invested in a short-term financial instrument that is readily convertible to a known amount of cash is largely irrelevant to users' assessments of liquidity and future cash flows. The Board therefore decided that a statement of cash flows should focus on the aggregate of cash and cash equivalents.

(c) FAS 95, Par. 5: The information provided in a statement of cash flows, if used with related disclosures and information in the other financial statements, should help investors, creditors, and others to (a) assess the enterprise's ability to generate positive future net cash flows; (b) assess the enterprise's ability to meet its obligations, its ability to pay dividends, and its needs for external financing; (c) assess the reasons for differences between net income and associated cash receipts and payments; and (d) assess the effects on an enterprise's financial position of both its cash and noncash investing and financing transactions during the period.

(d) FAS 95, Par. 22: Cash inflows from operating activities are:

a. Cash receipts from sales of goods or services, including receipts from collection or sale of accounts and both short- and long-term notes receivables from customers arising from those sales.

b. Cash receipts from returns on loans, other debt instruments of other entities, and equity securities—interest and dividends.

c. All other cash receipts that do not stem from transactions defined as investing or financing activities, such as amounts received to settle lawsuits; proceeds of insurance settlements except for those that are directly related to investing or financing activities, such as from destruction of a building; and refunds from suppliers.

FAS 95, Par. 23: Cash outflows for operating activities are:

a. Cash payments to acquire materials for manufacture or goods for resale, including principal payments on accounts and both short- and long-term notes payable to suppliers for those materials or goods.

b. Cash payments to other suppliers and employees for other goods or services.

c. Cash payments to governments for taxes, duties, fines, and other fees or penalties.

d. Cash payments to lenders and other creditors for interest.

All other cash payments that do not stem from transactions defined as investing or financing activities, such as payments to settle lawsuits, cash contributions to charities, and cash refunds to customers.

PROFESSIONAL SIMULATION

Financial Statements

Ellwood House, Inc.
STATEMENT OF CASH FLOWS
For the Year Ended December 31, 2007

Cash flows from operating activities		
Net income		$42,000
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation expense (a)	$13,550	
Gain on sale of investment (b)	(500)	13,050
Net cash provided by operating activities		$55,050
Cash flows from investing activities		
Purchase of land (c)	(5,500)	
Sale of investments (d)	15,500	
Net cash provided by investing activities		10,000
Cash flows from financing activities		
Payment of dividends (e)	(19,000)	
Retirement of bonds payable (f)	(10,000)	
Issuance of capital stock (g)	20,000	
Net cash used by financing activities		(9,000)
Net increase (decrease) in cash		56,050
Cash, January 1, 2007		10,000
Cash, December 31, 2007		$66,050
Noncash investing and financing activities		
Issuance of bonds for equipment		$32,000

PROFESSIONAL SIMULATION (Continued)

Explanation

Dear Mr. Brauer:

Enclosed is your statement of cash flows for the year ending December 31, 2007. I would like to take this opportunity to explain the changes which occurred in your business as a result of cash activities during 2007. (Please refer to the attached statement of cash flows.)

The first category shows the net cash flow which resulted from all of your operating activities. Operating activities are those engaged in for the routine conduct of business, involving most of the transactions used to determine net income. The cash inflow from operations which affects this category is net income. However, this figure must be adjusted, first for depreciation (item a)—because this expense did not involve a cash outlay in 2007—and second for the $500 gain on the sale of your investment portfolio (item b). The gain must be subtracted from this section because it was included in net income, but it is not the result of an operating activity—it is an investing activity.

The second category, cash flows from investing activities, results from the acquisition/disposal of long-term assets including the purchase of another entity's debt or equity securities. Your purchase of land (item c) as well as the sale of your investment portfolio (item d) represent your investment activities during 2007, the purchase being a $5,500 outflow and the sale being a $15,500 inflow.

Cash flows arising from the issuance and retirement of debt and equity securities are properly classified as "Cash flows from financing activities." These inflows and outflows generally include the long-term liability and stockholders' equity items on the balance sheet. Examples of your financing activities resulting in cash flows are the payment of dividends (item e), the retirement of your bonds payable (item f), and your issuance of capital stock (item g). Note that, although $32,000 worth of bonds were issued for the purchase of heavy equipment, the transaction has no effect on the change in cash from January 1, 2007 to December 31, 2007.

I hope this information helps you to better understand the enclosed statement of cash flows. If I can further assist you, please let me know.

Sincerely,