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, 8, 12	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	6, 7	3, 5, 7, 9, 12, 13	3, 4, 5	
5. Statement of cash flows—indirect method.	10, 13, 15, 16	10, 11	4, 6, 8, 11, 14, 15, 16, 17, 18	1, 2, 4, 5, 6, 7, 8	2
6. Preparing schedule of non-cash investing and financing activities.	18	12		6, 7, 8	5
7. Worksheet adjustments.	21	13	19, 20, 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	5, 6
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	5, 6, 7
5. Determine net cash flow 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
7. Identify sources of information for a statement of cash flows.			1, 2, 4, 7, 8
8. Discuss special problems in preparing a statement of cash flows.	12	10, 18	1, 2, 4, 5, 6, 7, 8
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—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 statement of financial position.	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, and net cash flow from operating activities, direct method.	Moderate	40–50
P23-6	SCF—direct and indirect methods from comparative financial statements.	Moderate	30–40
P23-7	SCF—direct and indirect methods.	Moderate	30–40
P23-8	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 provide 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 statement of financial position items; investing activities affect assets while financing activities affect liabilities and equity.

3. Investing activities generally involve non-current 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 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 ordinary shares, 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 ordinary shares, 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 statements of financial position and selected transaction data.

(3) Determine cash flows from investing and financing activities. All other changes in statement of financial position accounts are analyzed to determine their effect on cash.

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

7. Comparative statements of financial position, a current income statement, and certain transaction data all provide information necessary for preparation of the statement of cash flows. Comparative statements of financial position 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 non-cash items included in net income. Examples of adjustments include depreciation and other non-cash 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 $3,820,000. 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	300,000	320,000
Net cash provided by operating activities		$3,820,000

11.

Accrual basis sales	£100,000
Less: Increase in accounts receivable	30,000
	70,000
Less: Writeoff of accounts receivable	2,000
Cash sales	£ 68,000

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 ordinary shares.

13.

Declared dividends	$260,000
Add: Dividends payable (beginning of year)	85,000
	345,000
Deduct: Dividends payable (end of year)	90,000
Cash paid in dividends during the year	$255,000

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	€124,000	
Amortization of patent	40,000	
Loss on sale of plant assets	21,000	185,000
Net cash provided by operating activities		€505,000

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 [($18,000 ÷ 10) x $3^1/_2$] – $4,000		$ 2,300
Cash flows from investing activities		
Sale of plant assets		$ 4,000

(b) Cash flows from financing activities

Issuance of ordinary shares		$410,000

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

<u>Note to instructor</u>: 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 non-trading equity investments	(9,000)	
Cash flows from investing activities		
Sale of non-trading equity investments		$ 38,000

17. (a) Operating activity.
(b) Financing activity.
(c) Investing activity.
(d) Operating activity.
(e) Non-cash investing and financing activities in the notes.
(f) Financing activity.
(g) Operating activity.
(h) Financing activity.
(i) Non-cash investing and financing activities in the notes.
(j) Financing activity.
(k) Investing activity.
(l) Operating activity.

18. Examples of non-cash transactions are: (1) issuance of shares for non-cash assets, (2) issuance of shares to liquidate debt, (3) issuance of bonds or notes for non-cash assets, and (4) non-cash exchanges of property, plant, and equipment, and (5) refinancing of long-term debt.

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	$ (120,000)
Cash flows from financing activities	
Redemption of bonds payable	$(1,880,000)

20. Arguments for the indirect or reconciliation method are:

(a) By providing a reconciliation between net income and cash provided by operations, the differences are highlighted.

(b) 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.

(c) 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.

22. As in U.S. GAAP, the statement of cash flows is a required statement for IFRS. In addition, the content and presentation of an IFRS statement of cash flows is similar to one used for U.S. GAAP. However, the disclosure requirements related to the statement of cash flows are more extensive under U.S. GAAP.

Other similarities include: (1) Companies preparing financial statements under IFRS must prepare a statement of cash flows as an integral part; (2) Both IFRS and U.S. GAAP require that the statement of cash flows should have three major sections—operating, investing and financing—along with changes in cash and cash equivalents; (3) Similar to U.S. GAAP, the cash flow statement can be prepared using either the indirect or direct method under IFRS. In both U.S. and international settings, companies choose for the most part to use the indirect method for reporting net cash flows from operating activities.

Notable differences are (1) IFRS encourages companies to disclose the aggregate amount of cash flows that are attributable to the increase in operating capacity separately from those cash flows that are required to maintain operating capacity; (2) The definition of cash equivalents used in IFRS is similar to that used in U.S. GAAP. A major difference is that in certain situations bank overdrafts are considered part of cash and cash equivalents under IFRS (which is not the case in U.S. GAAP). Under U.S. GAAP, bank overdrafts are classified as financing activities; (3) IFRS requires that non-cash investing and financing activities be excluded from the statement of cash flows. Instead, these non-cash activities should be reported elsewhere. This requirement is interpreted to mean that non-cash investing and financing activities should be disclosed in the notes to the financial statements instead of in the financial statements. Under U.S. GAAP, companies may present this information in the cash flow statement. IFRS allows interest paid and received to be classified as either operating or investing activities. U.S. GAAP classifies interest paid and received as an operating activity.

23. The following table relates to the classification of interest, dividends, and taxes and indicates relative degree of choice inherent under IFRS. As some note, this increased degree of choice can lead to expanded disclosure under IFRS.

Item	U.S. GAAP	IFRS
Interest paid	Operating	Operating or financing
Interest received	Operating	Operating or investing
Dividends paid	Financing	Operating or financing
Dividends received	Operating	Operating or investing
Taxes paid	Operating	Operating—unless specific identification with financing or investing

25. Presently, the FASB and the IASB are involved in a joint project on the presentation and organization of information in the financial statements. The FASB favors presentation of operating cash flows using the direct method only. However, the majority of IASB members express a preference for not requiring use of the direct method of reporting operating cash flows. So the two Boards will have to resolve their differences in this area in order to issue a converged standard for the statement of cash flows. U.S. GAAP rules related to cash flow reporting are less flexible than IFRS, but this is not a major concern.

SOLUTIONS TO BRIEF EXERCISES

BRIEF EXERCISE 23-1

Cash flows from investing activities	
Sale of land	$ 180,000
Purchase of equipment	(415,000)
Purchase of equity investments	(59,000)
Net cash used by investing activities	$(294,000)

BRIEF EXERCISE 23-2

Cash flows from financing activities	
Issuance of ordinary shares	€ 250,000
Issuance of bonds payable	510,000
Payment of dividends	(350,000)
Purchase of treasury shares	(46,000)
Net cash provided by financing activities	€ 364,000

BRIEF EXERCISE 23-3

(a)	P-I	(g)	P-F	(m)	N
(b)	A	(h)	D	(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 – €12,000)		**€188,000**
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		**€ 41,000**

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	**(12,000)**	
Increase in inventory	**(11,000)**	**11,000**
Net cash provided by operating activities		**€41,000**

BRIEF EXERCISE 23-6

Sales	**$420,000**
Add: Decrease in accounts receivable	
($72,000 – $54,000)	**18,000**
Cash receipts from customers	**$438,000**

BRIEF EXERCISE 23-7

Cost of goods sold	**€500,000**
Add: Increase in inventory (€113,000 – €95,000)	**18,000**
Purchases	**518,000**
Deduct: Increase in accounts payable	
(€69,000 – €61,000)	**8,000**
Cash payments to suppliers	**€510,000**

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, 1/1/10	333,000
Cash, 12/31/10	£486,000

BRIEF EXERCISE 23-9

(a) Cash flows from operating activities

Cash received from customers	$90,000
Cash paid for expenses ($60,000 – $1,840)	58,160
Net cash provided by operating activities	$31,840

(b) Cash flows from operating activities

Net income	$40,000
Increase in net accounts receivable ($26,960[a] – $18,800[b])	(8,160)
Net cash provided by operating activities	$31,840

[a]($29,000 – $2,040) [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	12,300	
Increase in accounts receivable	(11,000)	
Increase in inventory	(7,400)	10,900
Net cash provided by operating activities		$60,900

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	81,000	
Increase in accounts receivable	(8,100)	72,900
Net cash provided by operating activities		$ 2,900

BRIEF EXERCISE 23-12

(a)

Land	40,000	
Share Capital—Ordinary		10,000
Share Premium—Ordinary		30,000

(b) No effect

(c) Non-cash Investing and Financing Activities

Purchase of land through issuance of ordinary shares	$40,000

This is presented in the notes to the financial statements.

BRIEF EXERCISE 23-13

(a)	Operating—Net Income	317,000,000	
	Retained Earnings		317,000,000
(b)	Retained Earnings	120,000,000	
	Financing—Cash Dividends		120,000,000
(c)	Equipment	114,000,000	
	Investing—Purchase of Equipment		114,000,000
(d)	Investing—Sale of Equipment	10,000,000	
	Accumulated Depreciation—Equipment	32,000,000	
	Equipment		40,000,000
	Operating—Gain on Sale of Equipment		2,000,000*

*¥10,000,000 – (¥40,000,000 – ¥32,000,000)

SOLUTIONS TO EXERCISES

EXERCISE 23-1 (10–15 minutes)

(a) Operating—add to net income.
(b) Financing activity.
(c) Investing activity.
(d) Operating—add to net income.
(e) Non-cash investing and financing activity (presented in the notes).
(f) Financing activity.
(g) Operating—add to net income.
(h) Financing activity.
(i) Non-cash investing and financing activity (presented in the notes).
(j) Financing activity.
(k) Operating—deduct from net income.
(l) Investing activity.

EXERCISE 23-2 (20–30 minutes)

(a)

Plant assets (cost)	€25,000
Accumulated depreciation ([€25,000 ÷ 10] X 6)	15,000
Book value at date of sale	10,000
Sale proceeds	(5,300)
Loss on sale	€ 4,700

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 ordinary shares	€330,000

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 certificate of deposit 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 ordinary shares for an investment in Plumlee is reported as a "non-cash investing and financing activity." It can be shown in a note as follows:

Non-cash investing and financing activities	
Purchase of investment by issuance of ordinary shares	€900,000

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

(i) The unrealized holding gain on a debt investment not held for collection increases net income but not net cash provided by operating activities. As a result the unrealized holding gain is shown as a deduction from net income to compute cash flows from operating activities.

EXERCISE 23-3 (15–25 minutes)

RODRIQUEZ COMPANY
Partial Statement of Cash Flows
For the Year Ended December 31, 2010

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	310,000	
Decrease in inventory	300,000	
Increase in prepaid expenses.......................	(170,000)	
Decrease in accounts payable	(275,000)	
Decrease in accrued expenses payable	(120,000)	105,000
Net cash provided by operating activities....		$1,155,000

EXERCISE 23-4 (20–30 minutes)

RODRIQUEZ COMPANY
Partial Statement of Cash Flows
For the Year Ended December 31, 2010

Cash flows from operating activities				
Cash receipts from customers			$7,210,000	(a)
Cash payments				
To suppliers	$4,675,000	(b)		
For operating expenses	1,380,000	(c)	6,055,000	
Net cash provided by operating activities			$1,155,000	

Computations:

(a) Cash receipts from customers

Sales	$6,900,000
Add: Decrease in accounts receivable	310,000
Cash receipts from customers	$7,210,000

(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	120,000	290,000
Cash payments for operating expenses		$1,380,000

*$450,000 + ($700,000 – $60,000)

EXERCISE 23-5 (20–30 minutes)

NORMAN COMPANY
Partial Statement of Cash Flows
For the Year Ended December 31, 2010

Cash flows from operating activities				
Cash receipts from customers			€862,000	(a)
Cash payments				
For operating expenses	€609,000	(b)		
For income taxes	44,500	(c)	653,500	
Net cash provided by operating activities			€208,500	

(a) Computation of cash receipts from customers:

Revenue from fees	€840,000
Add: Decrease in accounts receivable (€59,000 – €37,000)	22,000
Cash receipts from customers	€862,000

(b) Computation of cash payments:

Operating expenses per income statement	€624,000
Deduct: Increase in accounts payable (€46,000 – €31,000)	15,000
Cash payments for operating expenses	€609,000

(c) Computation for income tax:

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)

NORMAN COMPANY
Partial Statement of Cash Flows
For the Year Ended December 31, 2010

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	22,000	
Increase in accounts payable	15,000	
Decrease in income taxes payable	(4,500)	118,500
Net cash provided by operating activities		€208,500

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 – $39,000)	71,000
Net cash provided by operating activities	$ 58,000

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

Cost of goods sold	$310,000
Plus: Increase in inventory	21,000
Decrease in accounts payable	17,000
Cash payments to suppliers	$348,000

(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		
Net income		**$145,000**
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	**$39,000**	
Gain on sale of investment [($200 – $165) X 100]	**(3,500)**	
Decrease in accounts receivable	**12,000**	
Income from equity method investment ($27,000 X .30)	**(8,100)**	
Dividends from equity investment ($2,000 X .30)	**600**	**40,000**
Net cash provided by operating activities		**$185,000**

Other comments:

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

No. 2 is shown as a cash inflow from investing activities of $20,000 and the gain of $3,500 is deducted from net income in the operating activities section.

No. 3 is a non-cash 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 non-cash investing and financing activity (presented in the notes to the financial statements).

No. 6 is an increase in the investment account related to net income which does not increase cash flow. The net income amount must be deducted from net cash flow from operating activities.

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 – $3,800)]		6,800
	Cash collected from customers		$532,000
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 – $17,000)		8,000
	Cash payments to suppliers		$226,000
3.	Interest expense		$ 4,300
	Deduct: Decrease in unamortized bond discount		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 income taxes ($5,300 – $4,600)		700
	Cash paid for income taxes		$ 27,800
5.	Selling expenses		$141,500
	Deduct: Depreciation ($3,000* X 1/3)	1,000	
	Bad debts expense	5,000	6,000
	Cash paid for selling expenses		$135,500

*($16,500 – $13,500)

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		
12/31/09	247,000	45,000	Equipment sold
Equipment from exchange of B/P	25,000		
Payments for purchase of PP&E	?		
12/31/10	277,000		

Payments = $277,000 + $45,000 – $247,000 – $25,000
= $50,000

IFRS 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 in the notes as a non-cash investing and financing activity.

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

	Accumulated Depreciation		
		167,000	12/31/09
		38,000	Depreciation expense
Equipment sold	?		
		178,000	12/31/10

Accumulated depreciation on equipment sold = $167,000 + $38,000 – $178,000 = $27,000

The entry to reflect the sale of equipment is:

Cash (proceeds from sale of equipment)			
($45,000 + $14,500 – $27,000)	32,500		
Accumulated Depreciation	27,000		
Property, Plant, and Equipment		45,000	(given)
Gain on Sale of Equipment		14,500	(given)

EXERCISE 23-10 (Continued)

The proceeds from the sale of equipment of $32,500 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	12/31/09
Dividends declared	?	31,000	Net income
		104,000	12/31/10

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

Dividends Payable

		5,000	12/31/09
		18,000	Dividends declared
Cash dividends paid	?		
		8,000	12/31/10

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

Financing activities include all cash flows involving liabilities and 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	12/31/09
		25,000	Issuance of B/P for PP&E
Redemption of B/P	?		
		49,000	12/31/10

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 + $25,000 – $49,000
= $22,000

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

EXERCISE 23-11 (30–35 minutes)

FAIRCHILD COMPANY
Statement of Cash Flows
For the Year Ended December 31, 2010
(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	400	
Increase in receivables	(450)	
Decrease in accrued liabilities	(50)	150
Net cash provided by operating activities		960
Cash flows from investing activities		
Sale of held for collection investments [(€1,470 – €1,300) + €80]	250	
Purchase of plant assets [(€1,900 – €1,700) – €70]	(130)	
Net cash provided by investing activities		120
Cash flows from financing activities		
Issuance of ordinary shares [(€1,900 – €1,700) – €70]	130	
Retirement of bonds payable	(250)	
Payment of cash dividends	(260)	
Net cash used by financing activities		(380)
Net increase in cash		700
Cash, January 1, 2010		1,100
Cash, December 31, 2010		€1,800
<u>Non-cash investing and financing activities</u>*		
Issuance of ordinary shares for plant assets		€ 70

*This information is presented in the notes.

EXERCISE 23-12 (20–30 minutes)

FAIRCHILD COMPANY
Statement of Cash Flows
For the Year Ended December 31, 2010
(Direct Method)

Cash flows from operating activities		
Cash collections from customers		€6,450[a]
Less: Cash paid for merchandise	€4,000[b]	
Cash paid for selling/administrative expenses	950[c]	
Cash paid for income taxes	540	5,490
Net cash provided by operating activities		960
Cash flows from investing activities		
Sale of held-for-collection investments [(€1,470 – €1,300) + €80]	250	
Purchase of plant assets [(€1,900 – €1,700) – €70]	(130)	
Net cash provided by investing activities		120
Cash flows from financing activities		
Issuance of ordinary shares [(€1,900 – €1,700) – €70]	130	
Retirement of bonds payable	(250)	
Payment of cash dividends	(260)	
Net cash used by financing activities		(380)
Net increase in cash		700
Cash, January 1, 2010		1,100
Cash, December 31, 2010		€1,800
Non-cash investing and financing activities		
Issuance of ordinary shares for plant assets		€ 70[d]

[a]€6,900 – (€1,750 – €1,300)
[b]€4,700 – (€1,900 – €1,600) – (€1,200 – €800)
[c](€930 – €30) + (€250 – €200)
[d]This information is presented in the notes to the financial statements.

EXERCISE 23-13 (30–40 minutes)

ANDREWS INC.
Statement of Cash Flows
For the Year Ended December 31, 2010

Cash flows from operating activities		
Less: Cash received from customers		€325,150[a]
Cash paid to suppliers	€151,000[b]	
Cash paid for operating expenses	82,000[c]	
Cash paid for interest	11,400	
Cash paid for income taxes	8,750[d]	253,150
Net cash provided by operating activities		72,000
Cash flows from investing activities		
Sale of equipment [€30,000 – (€30,000 X .7)] + €2,000	11,000	
Purchase of equipment [€154,000 – (€130,000 – €30,000)]	(54,000)	
Purchase of non-trading investments	(17,000)	
Net cash used by investing activities		(60,000)
Cash flows from financing activities		
Principal payment on short-term loan	(2,000)	
Principal payment on long-term loan	(7,000)	
Dividend payments	(6,000)	
Net cash used by financing activities		(15,000)
Net decrease in cash		(3,000)
Cash, January 1, 2010		9,000
Cash, December 31, 2010		€ 6,000

[a]Sales	€338,150
Increase in accounts receivable	(13,000)
Cash received from customers	€325,150

[b]Cost of goods sold	€175,000
Increase in accounts payable	(4,000)
Decrease in inventories	(20,000)
Cash paid to suppliers	€151,000

EXERCISE 23-13 (Continued)

[c]Operating expenses	€120,000
Increase in prepaid rent	1,000
Depreciation expense	
€35,000 – [€25,000 – (€30,000 X .70)]	(31,000)
Amortization of copyright	(4,000)
Increase in wages payable	(4,000)
Cash paid for operating expenses	€ 82,000

[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)

ANDREWS INC.
Statement of Cash Flows
For the Year Ended December 31, 2010

Cash flows from operating activities		
Net income		€27,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	€31,000*	
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	4,000	
Increase in prepaid rent	(1,000)	
Increase in accounts receivable	(13,000)	
Decrease in income taxes payable	(2,000)	45,000
Net cash provided by operating activities		72,000
Cash flows from investing activities		
Sale of equipment [(€30,000 X 30%) + €2,000]	11,000	
Purchase of equipment		
[€154,000 – (€130,000 – €30,000)]	(54,000)	
Purchase of non-trading investments	(17,000)	
Net cash used by investing activities		(60,000)

*€35,000 – [€25,000 – (€30,000 X 70%)]

EXERCISE 23-14 (Continued)

Cash flows from financing activities		
Principal payment on short-term loan	(2,000)	
Principal payment on long-term loan....................	(7,000)	
Dividend payments	(6,000)	
Net cash used by financing activities		(15,000)
Net decrease in cash		(3,000)
Cash, January 1, 2010		9,000
Cash, December 31, 2010..		€ 6,000

<u>Note to instructor</u>: Supplemental disclosures of cash flow information is a follows:

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

EXERCISE 23-15 (25–35 minutes)

MORGANSTERN COMPANY
Statement of Cash Flows
For the Year Ended December 31, 2010

Cash flows from operating activities		
Net income		$ 46,000*
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	$ 28,000	
Loss on sale of investments	9,000	
Loss on sale of plant assets [($60,000 X .20) – $8,000]	4,000	
Increase in current assets other than cash....	(27,000)	
Increase in current liabilities	18,000	32,000
Net cash provided by operating activities..........		78,000
Cash flows from investing activities		
Sale of plant assets	8,000	
Sale of held-for-collection investments	34,000	
Purchase of plant assets.....................................	(180,000)**	
Net cash used by investing activities..................		(138,000)

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		5,000
Cash balance, January 1, 2010		10,000
Cash balance, December 31, 2010		$15,000

*Net income $59,000 – $9,000 – $4,000 = $46,000

**Supporting computation (purchase of plant assets)

Plant assets, December 31, 2009	$215,000
Less: Plant assets sold	60,000
	155,000
Plant assets, December 31, 2010	335,000
Plant assets purchased during 2010	$180,000

EXERCISE 23-16 (30–40 minutes)

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

Net income ($8,000 + $9,000) – $5,000		$12,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	$17,000*	
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)	10,000
Net cash provided by operating activities		$22,000

*$18,000 – [$8,000 – ($13,000 – $6,000)]

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 – $13,000)]	(28,000)
Net cash used by investing activities	$(25,000)

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

Cash dividends paid	$ (9,000)
Payment of notes payable	(23,000)
Issuance of bonds payable	30,000
Net cash used by financing activities	$ (2,000)

EXERCISE 23-17 (30–40 minutes)

(a)

OCHOA INC.
Statement of Cash Flows
For the Year Ended December 31, 2010

Cash flows from operating activities		
Net income		$30,250
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		41,750
Cash flows from investing activities		
Purchase of land	(11,000)	
Sale of non-trading equity investments	12,875	
Net cash provided by investing activities		1,875
Cash flows from financing activities		
Payment of dividends	(9,375)	
Retirement of bonds payable	(20,000)	
Issuance of ordinary shares	10,000	
Net cash used by financing activities		(19,375)

EXERCISE 23-17 (Continued)

Net increase in cash	24,250
Cash, January 1, 2010	8,500
Cash, December 31, 2010	$32,750

Non-cash investing and financing activities*

Issuance of bonds for land	$22,500

*This information is presented in the notes to the financial statements.

(b)

OCHOA INC.
Statement of Financial Position
December 31, 2010

Assets		Equities	
Investments	$ 9,125[a]	Share capital—ordinary	$ 85,000
Land	73,500*	Retained earnings	45,375**
Plant assets (net)	54,000	Long-term notes payable	25,500
Current assets other than cash	29,000	Bonds payable	27,500***
Cash	32,750	Current liabilities	15,000
	$198,375		$198,375

[a]$20,000 – ($12,875 – $ 2,000)
*$40,000 + $11,000 + $22,500
**$24,500 + $30,250 – $ 9,375
***$25,000 – $20,000 + $22,500

EXERCISE 23-18 (25–30 minutes)

POPOVICH COMPANY
Statement of Cash Flows (partial)
For the Year Ended December 31, 2010

Cash flows from operating activities		
Net income		€ 50,000
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		72,600

EXERCISE 23-18 (Continued)

Cash flows from investing activities		
Purchase of machinery	(62,000)	
Sale of machinery		
[(€66,000 – €25,200) – €5,800]	35,000	
Major repairs on machinery	(21,000)	
Cost of machinery constructed	(48,000)	
Net cash used by investing activities		(96,000)
Cash flows from financing activities		
Payment of cash dividends		(15,000)
Decrease in cash		(38,400)
Cash, January 1, 2010		xxx
Cash, December 31, 2010		€ xxx

EXERCISE 23-19 (20–25 minutes)

Retained Earnings	15,000	
Financing—Cash Dividends		15,000
Operating—Net Income	50,000	
Retained Earnings		50,000
Operating—Depreciation Expense	16,800	
Accumulated Depreciation—Machinery		16,800
Machinery	131,000	
Investing—Major Repairs to Machinery		21,000
Investing—Purchase of Machinery		62,000
Investing—Construction of Machinery		48,000
Operating—Loss on Sale of Equipment	5,800	
Accumulated Depreciation—Machinery	25,200	
Investing—Sale of Machinery	35,000	
Machinery		66,000

EXERCISE 23-20 (20–25 minutes)

1.	Bonds Payable	300,000	
	Share Capital—Ordinary		300,000
	(Non-cash financing activity)		
2.	Operating—Net income	360,000	
	Retained Earnings		360,000
3.	Operating—Depreciation Expense	90,000	
	Accumulated Depreciation—Building		90,000
4.	Accumulated Depreciation—Office Equipment	30,000	
	Office Equipment	5,000	
	Operating—Gain on Disposal of Plant Assets		1,000
	Investing—Purchase of Office Equipment		34,000
5.	Retained Earnings	123,000	
	Cash Dividend Payable		123,000

EXERCISE 23-21 (45–55 minutes)

LOWENSTEIN CORPORATION
Worksheet for Preparation of Statement of Cash Flows
For the Year Ended December 31, 2010

Debits	Balance at 12/31/09		2010 Reconciling Items Debit		2010 Reconciling Items Credit	Balance at 12/31/10
Cash	$ 24,000			(17)	$ 7,500	$ 16,500
Equity 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	57,000	(5)	24,500			81,500
Land	50,000					50,000
Buildings	78,500	(10)	46,500			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 (trade)	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
Share capital—ordinary	102,000			(15)	38,000	140,000
Share premium—ordinary	4,000			(15)	6,000	10,000
Retained earnings	51,500	(9)	10,000	(1)	31,900	73,400
Total credits	$361,000					$452,200

EXERCISE 23-21 (Continued)

Statement of Cash Flows Effects

Operating activities				
Net income	(1)	31,900		
Depreciation	(13)	12,000		
Dec. in accounts receivable (net)	(3)	1,800		
Inc. in prepaid expenses			(4)	1,700
Inc. in inventories			(5)	24,500
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 non-trading equity investments			(2)	6,000
Purchase of building			(10)	46,500
Purchase of equipment			(11)	7,000
Purchase of patents			(12)	15,000
Financing activities				
Payment of cash dividends			(9)	10,000
Issuance of mortgage payable	(14)	19,600		
Sale of ordinary shares	(15)	44,000		
Retirement of bonds			(16)	12,500
Totals		246,300		253,800
Decrease in cash	(17)	7,500		
Totals		$253,800		$253,800

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 non-cash investing and financing activities. The student is required to prepare the statement using the indirect method.

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 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 23-6 (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 23-7 (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 23-8 (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

SULLIVAN CORP.
Statement of Cash Flows
For the Year Ended December 31, 2010

Cash flows from operating activities			
Net income			$370,000
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	$147,000	(a)	
Gain on sale of equipment	(2,000)	(b)	
Equity in earnings of Myers Co.	(35,000)	(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)		55,000
Net cash provided by operating activities			425,000
Cash flows from investing activities:			
Proceeds from sale of equipment	40,000		
Loan to TLC Co.	(300,000)		
Principal payment of loan receivable	50,000		
Net cash used by investing activities			(210,000)
Cash flows from financing activities:			
Dividends paid	(100,000)		
Net cash used by financing activities			(100,000)
Net increase in cash			115,000
Cash, January 1, 2010			700,000
Cash, December 31, 2010			$815,000

PROBLEM 23-1 (Continued)

Separate schedule presented in the notes:

Non-cash investing and financing activities:

Issuance of lease liability for finance lease		$400,000*

Explanation of Amounts

(a) Depreciation

Net increase in accumulated depreciation for the year ended December 31, 2010		$125,000
Accumulated depreciation on equipment sold:		
Cost	$60,000	
Carrying value	38,000	22,000
Depreciation for 2010		$147,000

(b) Gain on sale of equipment

Proceeds	$ 40,000
Carrying value	(38,000)
Gain	$ 2,000

(c) Equity in earnings of Myers Co.

Myers's net income for 2010	$140,000
Sullivan's ownership..................................	X 25%
Undistributed earnings of Myers Co. ...	$ 35,000

PROBLEM 23-2

HINCKLEY CORPORATION
Statement of Cash Flows
For the Year Ended December 31, 2010

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	$ 4,100 (b)	
Gain from flood damage	(8,250)*	
Depreciation expense	1,900 (c)	
Patent amortization	1,250	
Gain on sale of investments	(1,700)	
Increase in accounts receivable (net)	(3,750)**	
Increase in inventory	(3,000)	
Increase in accounts payable	2,000	(7,450)
Net cash provided by operating activities		7,300
Cash flows from investing activities		
Sale of investments	4,700	
Sale of equipment	2,500	
Purchase of equipment	(20,000) (d)	
Proceeds from flood damage to building	32,000	
Net cash provided by investing activities		19,200
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		20,500
Cash, January 1, 2010		13,000
Cash, December 31, 2010		$33,500

*[$32,000 – ($29,750 – $6,000)]
**($12,250 – $3,000) – ($10,000 – $4,500)

PROBLEM 23-2 (Continued)

Supplemental disclosures of cash flow information:

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

Non-cash investing and financing activities*

Retired note payable by issuing ordinary shares	**$10,000**
Purchased equipment by issuing note payable	**16,000**
	$26,000

***Presented in the notes to the financial statements.**

Supporting Computations:

(a)	**Ending retained earnings**	**$20,750**
	Beginning retained earnings	**(6,000)**
	Net income	**$14,750**
(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**
(d)	**Beginning equipment balance**	**$20,000**
	Cost of equipment sold	**(11,000)**
	Remaining balance	**9,000**
	Purchase of equipment with note	**16,000**
	Adjusted balance	**25,000**
	Ending equipment balance	**(45,000)**
	Purchased with cash	**$20,000**

PROBLEM 23-3

MORTONSON COMPANY
Statement of Cash Flows
For the Year Ended December 31, 2010
($000 Omitted)

Cash flows from operating activities		
Cash receipts from customers		$3,520 (a)
Cash payments:		
Payments for merchandise	$1,270 (b)	
Salaries and benefits	725	
Heat, light, and power	75	
Property taxes	19	
Interest	30	
Miscellaneous	10	
Income taxes	808 (c)	2,937
Net cash provided by operating activities		583
Cash flows from investing activities		
Sale of non-trading equity investments	40	
Purchase of buildings and equipment	(310)	
Purchase of land	(80)	
Net cash used by investing activities		(350)
Increase in cash		233
Cash, January 1, 2010		100
Cash, December 31, 2010		$ 333

(a)	Sales	$3,800
	Deduct ending accounts receivable	780
		3,020
	Add beginning accounts receivable	500
	Cash receipts (collections from customers)	$3,520

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	330
	Cash purchases (payments for merchandise)	$1,270

(c)	Income taxes	$818
	Deduct ending income taxes payable	40
		778
	Add beginning income taxes payable	30
	Income taxes paid	$ 808

PROBLEM 23-4

MICHAELS COMPANY
Statement of Cash Flows
For the Year Ended December 31, 2010
(Direct Method)

Cash flows from operating activities		
Cash receipts:		
Cash received from customers	$1,152,450[a]	
Dividends received	2,400	$1,154,850
Cash payments:		
Cash paid to suppliers	765,000[b]	
Cash paid for operating expenses	226,350[c]	
Taxes paid	38,400[d]	
Interest paid	57,300[e]	1,087,050
Net cash provided by operating activities		67,800
Cash flows from investing activities		
Sale of short-term investments ($8,000 + $4,000)	12,000	
Sale of land ($175,000 – $125,000) + $8,000	58,000	
Purchase of equipment	(125,000)	
Net cash used by investing activities		(55,000)
Cash flows from financing activities		
Proceeds from issuance of ordinary shares	27,500	
Principal payment on long-term debt	(10,000)	
Dividends paid	(24,300)	
Net cash used by financing activities		(6,800)
Net increase in cash		6,000
Cash, January 1, 2010		4,000
Cash, December 31, 2010		$ 10,000

[a]Sales Revenue	$1,160,000
Increase in Accounts Receivable	(7,550)
Cash received from customers	$1,152,450

[b]Cost of Goods Sold	$ 748,000
Increase in Inventory	7,000
Decrease in Accounts Payable	10,000
Cash paid to suppliers	$ 765,000

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

PROBLEM 23-5

(a) Net Cash Flow from Operating Activities

Cash received from customers		$524,850[1]
Cash payments:		
Cash payments to suppliers	$375,750[2]	
Cash payments for operating expenses	105,675[3]	481,425
Net cash provided by operating activities		$ 43,425

[1]$540,000 – $10,500 – $4,650* = $524,850

[2]$380,000 + $6,000 – $10,250 = $375,750

[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)

MARCUS INC.
Statement of Cash Flows
For the Year Ended December 31, 2010

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)	(9,750)*	
Increase in inventory	(6,000)	
Increase in accounts payable	10,250	
Increase in accrued payables	750	925
Net cash provided by operating activities		43,425

PROBLEM 23-5 (Continued)

Cash flows from investing activities		
Purchase of equity investments		
$22,250 – ($38,500 – $25,000)	**(8,750)**	
Purchase of machinery		
$30,000 – ($18,750 – $3,750)	**(15,000)**	
Addition to buildings	**(11,250)**	
Sale of investments	**28,750**	
Sale of machinery	**2,200**	
Net cash used by investing activities		**(4,050)**
Cash flows from financing activities		
Reduction in long-term note payable	**(10,000)**	
Cash dividends paid	**(21,125)**	
Net cash used by financing activities		**(31,125)**
Net increase in cash		**8,250**
Cash, January 1, 2010		**33,750**
Cash, December 31, 2010		**$42,000**

***($70,500 – $2,250) – ($60,000 – $1,500)**

PROBLEM 23-6

(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 IFRS; however, the IASB 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 non-cash items included in net income, thereby providing a useful link between the statement of cash flows and the income statement and statement of financial position.**

(b) **The Statement of Cash Flows for Chapman Company, for the year ended May 31, 2010, using the direct method, is presented below.**

CHAPMAN COMPANY
Statement of Cash Flows
For the Year Ended May 31, 2010

Cash flows from operating activities		
Cash received from customers		$1,238,250
Cash payments:		
To suppliers	$684,000	
To employees	276,850	
For other expenses	10,150	
For interest	73,000	
For income taxes	43,000	1,087,000
Net cash provided by operating activities		151,250
Cash flows from investing activities		
Purchase of plant assets		(28,000)
Cash flows from financing activities		
Cash received from ordinary shares issue	$ 20,000	
Cash paid		
For dividends	(105,000)	
To retire bonds payable	(30,000)	
Net cash used by financing activities		(115,000)
Net increase in cash		8,250
Cash, June 1, 2009		20,000
Cash, May 31, 2010		$ 28,250

PROBLEM 23-6 (Continued)

Note 1: **Non-cash investing and financing activities:**
Issuance of ordinary shares for plant assets $70,000.

Supporting Calculations:

Collections from customers	
Sales	$1,255,250
Less: Increase in accounts receivable	17,000
Cash collected from customers	$1,238,250
Cash paid to suppliers	
Cost of merchandise sold	$ 722,000
Less: Decrease in merchandise inventory	30,000
Increase in accounts payable	8,000
Cash paid to suppliers	$ 684,000
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 23-6 (Continued)

(c) **The calculation of the cash flow from operating activities for Chapman Company, for the year ended May 31, 2010, using the indirect method, is presented below.**

CHAPMAN COMPANY
Statement of Cash Flows
For the Year Ended May 31, 2010

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	30,000	
Increase in accounts payable	8,000	
Increase in interest payable	2,000	
Increase in accounts receivable	(17,000)	
Increase in prepaid expenses	(2,000)	
Decrease in salaries payable	(24,750)	21,250
Net cash provided by operating activities		$151,250

PROBLEM 23-7

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

Cash receipts from customers			$925,000	(1)
Cash payments:				
Cash payments to suppliers	$608,000	(2)		
Cash payments for operating expenses	226,000	(3)		
Cash payments for income taxes	43,000	(4)	877,000	
Net cash provided by operating activities			$ 48,000	

(1) (Sales) less (Increase in Accounts Receivables)
$950,000 – $25,000 = $925,000

(2) (Cost of Goods Sold) plus (Increase in Inventory) less (Increase in Accounts Payable)
$600,000 + $14,000 – $6,000 = $608,000

(3) (Operating Expenses) less (Depreciation Expense) less (Bad Debt Expense)
$250,000 – $22,000* – $2,000 = $226,000

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

*$21,000 – [$14,000 – ($10,000 X .60)]	=	$13,000	Equipment depreciation
$37,000 – $28,000	=	9,000	Building depreciation
		$22,000	

PROBLEM 23-7 (Continued)

(b)

SHARPE COMPANY
Statement of Cash Flows
For the Year Ended December 31, 2010

Cash flows from operating activities		
Net income		$67,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	$22,000	
Gain on sale of equity investments	(15,000)	
Loss on sale of equipment	3,000	
Increase in accounts receivable (net)	(23,000)	
Increase in inventory	(14,000)	
Increase in accounts payable	6,000	
Increase in income taxes payable	2,000	(19,000)
Net cash provided by operating activities		48,000
Cash flows from investing activities		
Purchase of equity investments [$55,000 – ($85,000 – $35,000)]	(5,000)	
Purchase of equipment [$70,000 – ($48,000 – $10,000)]	(32,000)	
Sale of equity investments ($35,000 + $15,000)	50,000	
Sale of equipment [$10,000 – ($10,000 X 60%)] – $3,000	1,000	
Net cash provided by investing activities		14,000
Cash flows from financing activities		
Payment of long-term notes payable	(8,000)	
Cash dividends paid [($95,000 + $67,000) – $92,000]	(70,000)	
Issuance of ordinary shares	35,000*	
Net cash used by financing activities		(43,000)
Net increase in cash		19,000
Cash, January 1, 2010		51,000
Cash, December 31, 2010		$70,000

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

<u>Non-cash investing and financing activities</u>*

Issuance of ordinary shares for land	$15,000

*Presented in the notes to the financial statements.

PROBLEM 23-8

(a)

DINGEL CORPORATION
Statement of Cash Flows
For the Year Ended December 31, 2010

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	$ 5,200[(b)]	
Gain from flood damage	(13,250)*	
Depreciation expense	800[(c)]	
Copyright amortization	250	
Gain on sale of equity investment	(1,500)	
Increase in accounts receivable (net)	(3,750)	
Increase in inventory	(2,000)	
Increase in accounts payable	1,000	(13,250)
Net cash flow provided by operating activities		2,500
Cash flows from investing activities		
Sale of equity investments	4,500	
Sale of equipment	2,500	
Purchase of equipment (cash)	(15,000)	
Proceeds from flood damage to building	37,000	
Net cash provided by investing activities		29,000
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		25,500
Cash, January 1, 2010		13,000
Cash, December 31, 2010		$38,500

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

Supplemental disclosures of cash flow information:

Cash paid during the year for:

Interest	$2,000
Income taxes	$5,000

PROBLEM 23-8 (Continued)

Non-cash investing and financing activities:*

Retired note payable by issuing ordinary shares	$ 5,000
Purchased equipment by issuing note payable	16,000
	$21,000

*Presented in the notes to the financial statements.

Supporting Computations:

(a)	Ending retained earnings	$20,750
	Beginning retained earnings	(5,000)
	Net income	$15,750
(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

(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 uses 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 non-cash 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 company 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 company.

(b) The following are weaknesses in form and format of Maloney Corporation's Statement of Sources and uses 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.

   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 share 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. Non-cash investing and financing activities, if significant, should be shown in a note to the financial statements.

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

(c) 1. (i) The $25,000 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 $25,000 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. Share dividends or share splits need not be disclosed in the statement because these transactions do not significantly affect financial position.

4. The issuance of the 16,000 ordinary shares in exchange for the preference shares should be shown as a non-cash 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 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.

CA 23-1 (Continued)

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 Pacific Clothing Store did not have a superb first year, having suffered an €11,000 net loss. Lenny 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 non-cash investing and financing activities in a separate schedule. Lenny is wrong, however, about the actual increase in cash—€109,000 is the correct increase in cash.

(b)

PACIFIC CLOTHING STORE
Statement of Cash Flows
For the Year Ended January 31, 2010

Cash flows from operating activities		
Net loss		€ (11,000)*
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	€ 80,000	
Gain from sale of investment	(25,000)	55,000
Net cash provided by operating activities		44,000
Cash flows from investing activities		
Sale of debt investment	120,000	
Purchase of fixtures and equipment	(330,000)	
Purchase of investment	(95,000)	
Net cash used by investing activities		(305,000)
Cash flows from financing activities		
Sale of ordinary shares	380,000	
Purchase of treasury shares	(10,000)	
Net cash provided by financing activities		370,000
Net increase in cash		€109,000
Supplemental disclosure of cash flow information:		
Cash paid for interest		€ 3,000

CA 23-2 (Continued)

Significant non-cash investing and financing activities (presented in the notes).

Issuance of note for truck		€ 30,000

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

Sales of merchandise		€382,000
Interest revenue		8,000
Gain on sale of investment (€120,000 – €95,000)		25,000
Total revenues		415,000
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		€ (11,000)

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 $810,000 of income reported in 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 net income 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 $6,000 gain realized on the sale of the machine is deducted from net income to arrive at net cash provided by operating activities. The proceeds of $36,000 ($30,000 + $6,000) are shown as a cash inflow from investing activities.

5. In this case, no cash flow resulted from the lightning damage. The net loss (a non-cash 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 ordinary shares and the $425,000 issuance of the mortgage note, neither of which affects cash, should be reported as non-cash financing and investing activities (reported in the notes).

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

CA 23-4

	Where to Present	How to Present
1.	Investing and operating	Cash provided by sale of fixed assets, R4,750 as an investing activity. In addition, the loss of R2,250 [(R20,000 x $3^1/_2$) ÷ 10] – R4,750 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 R15,000 is added back to net income.
3.	Financing	Cash provided by the issuance of ordinary shares for R16,000.
4.	Operating	The net loss of R2,100 is presented as loss from operations, and depreciation of R2,000 and amortization of R400 are added back to the loss from operations. Net cash provided by operating activities is R300.
5.	Not reported in statement.	
6.	Investing and operating	Cash provided by the sale of the investment, R10,600 as an investing activity. The loss of R1,400 is added back to net income.
7.	Financing and operating	The retirement is reported as cash used by financing activities of R24,240. Additionally, the gain (of R1,760 = R26,000 – R24,240) 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 shares, and from sales of various productive fixed assets. Cash outflows for investing activities include payments for shares 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 share or its own debt. Cash outflows for financing activities include payments to shareholders and debtholders for dividends or retirement of its own shares and bonds (i.e., treasury shares).

(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 non-cash items from net income.

(d) Non-cash investing and financing transactions are to be reported in the related disclosures, either in a narrative form or summarized within a separate supplementary schedule. Examples of non-cash transactions are the conversion of debt to equity, acquiring assets by assuming directly related liabilities, and exchanging non-cash assets or liabilities for other non-cash assets or liabilities. For transactions that are part cash and part non-cash, 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 Brockman creates a short-term cash flow at the longer-term expense of the company’s operations and financial position. Barbara’s idea creates the deceiving illusion that the company is successfully generating positive cash flows.

(b) Barbara Brockman 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 Brockman 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.

FINANCIAL REPORTING PROBLEM

(a) M&S uses the indirect method to compute and report net cash provided by operating activities. The amounts of net cash provided by operating activities for 2007 and 2008 are £1,292.5 million and £1,069.8 million, respectively. The two items most responsible for the decrease in cash provided by operating activities in 2008 are the increase in operating profit and the increase in depreciation and amortization.

(b) The most significant item in the investing activities section is the £958.4 million that M&S spent on "property, plant and equipment." The most significant item in the financing activities section is the £631.7 million that M&S received from issuing medium term notes.

(c) M&S does not report deferred income taxes on its statement of cash flows. It does report income tax expense as an add back to net income in the operating activities section.

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

COMPARATIVE ANALYSIS CASE

(a) Both Cadbury and Nestlé use the indirect method of computing and reporting net cash provided by operating activities.

(In millions)	Cadbury	Nestlé
Net cash provided by operating activities	£469	CHF10,763

(b) The most significant investing activities items in 2008:

Cadbury
Purchase of property, plant, and equipment and software — **£500 million**

Nestlé
Disposal of businesses — **CHF10,999 million**

The most significant financing activities items in 2008:

Cadbury
Proceeds of new borrowings — **£4,382 million**

Nestlé
Purchase of treasury shares — **CHF8,696 million**

(c) Cadbury has decreased net cash provided by operating activities from 2007 to 2008 by £343 million or 42.2%. Nestlé has decreased net cash provided by operating activities by CHF2,676 million or 19.9%. Both companies have favorable trends in the generation of internal funds (profits) from operations.

(d) Both Cadbury and Nestlé report depreciation and amortization in the operating activities section:

Cadbury, £244 million
Nestlé, CHF3,249 million

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

COMPARATIVE ANALYSIS CASE (Continued)

(e)

		Cadbury	Nestlé
1.	Current cash debt coverage	$\frac{£469}{\frac{(£3,388 + £4,614)}{2}} = .12:1$	$\frac{CHF10,763}{\frac{(CHF33,223 + CHF43,326)}{2}} = .28:1$
2.	Cash debt coverage	$\frac{£469}{\frac{(£5,361 + £7,165)}{2}} = .07:1$	$\frac{CHF10,763}{\frac{(CHF51,299 + CHF60,585)}{2}} = .19:1$

(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. Nestlé's ratio of CHF.28 of cash flow from operations for every CHF of current debt was approximately 133% higher (.28 vs. .12) than Cadbury's £.12 of cash flow from operations per pound of current debt and indicates Nestlé was significantly more liquid in 2008 than Cadbury.**

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 Nestlé's cash debt coverage ratio was approximately 171% larger (.19 vs. .07) than Cadbury's, its ability to repay liabilities with cash flow from operations was substantially greater than Cadbury's in 2008.

FINANCIAL STATEMENT ANALYSIS CASE

(a) Telefónica uses the direct method to prepare the operating cash flow section of its statement of cash flows. Telefónica reports cash received from customers and cash paid to suppliers and employees, which are only reported under the direct method.

(b) Adjustments that would explain the difference between net income and operating cash flow include non-cash expenses (depreciation and amortization), gains and losses on disposal of non-current assets, and increases (decreases) in current assets and current liabilities. Depreciation (amortization) expense, losses on disposal of non-current assets, and increases (decreases) in current assets (liabilities) would all decrease. Telefónica's net income, but would have no affect on its operating cash flow.

(c) Telefónica reports interest received (paid), taxes paid, and dividends received as operating activities. It shows under investing activities interest paid on cash surpluses, and dividends paid as a financing activity. IFRS allows interest and dividends paid to be classified as either operating or financing, and allows interest and dividends received to be reported as either operating or investing.

INTERNATIONAL REPORTING CASE

VERMONT TEDDY BEAR CO.

(a) **Vermont's statement of cash flows has the same 3 categories (operating, investing, and financing) as an IFRS statement does. IFRS does allow some flexibility regarding the classification of interest and dividends paid and received. However it appears that there are no significant differences between Vermont's statement and IFRS requirements.**

(b) **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.**

(c) **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

INTERNATIONAL REPORTING CASE (Continued)

All of these ratios are very low. This is not surprising, however, for a company like the Vermont Teddy Bear Company that is still in a growth stage. When a company is in growth 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.

ACCOUNTING, ANALYSIS, AND PRINCIPLES

ACCOUNTING

LASKOWSKI COMPANY
Statement of Cash Flows—Indirect Method
For the Year Ended December 31, 2011

Cash flows from operating activities		
Net income		€ 430,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	€ 880,000	
Loss on sale of machinery	24,000	
Increase in accounts receivable	(165,000)	
Decrease in inventories	33,000	
Increase in accounts payable	20,000	792,000
Net cash provided by operating activities		1,222,000
Cash flows from investing activities		
Sale of machinery	270,000	
Purchase of machinery	(750,000)	
Net cash used by investing activities		(480,000)
Cash flows from financing activities		
Payment of cash dividends		(200,000)
Net increase in cash		542,000
Cash at beginning of period		130,000
Cash at end of period		€ 672,000

ANALYSIS

Laskowski's free cash flow is:

Net cash provided by operating activities	€1,222,000
Less purchase of machinery	750,000
Less dividends	200,000
Free cash flow	€ 272,000

Laskowski's free cash flow for the current year (€272,000) is less than the amount needed for expansion next year (€500,000). Thus, assuming operations at roughly the same level in future periods, Laskowski's free cash flow will not be sufficient to fund the expansion plan. The company might explore reducing the dividend or securing additional funds for the expansion through a borrowing.

According to IAS 7, "Information about the cash flows of an entity is useful in providing users of financial statements with a basis to assess the ability of the entity to generate cash and cash equivalents and the needs of the entity to utilise those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an entity to generate cash and cash equivalents and the timing and certainty of their generation. The objective of this Standard is to require the provision of information about the historical changes in cash and cash equivalents of an entity by means of a statement of cash flows which classifies cash flows during the period from operating, investing and financing activities."

PROFESSIONAL RESEARCH

(a) According to IAS 7, "Information about the cash flows of an entity is useful in providing users of financial statements with a basis to assess the ability of the entity to generate cash and cash equivalents and the needs of the entity to utilise those cash flows. The economic decisions that are taken by users require an evaluation of the ability of an entity to generate cash and cash equivalents and the timing and certainty of their generation. The objective of this Standard is to require the provision of information about the historical changes in cash and cash equivalents of an entity by means of a statement of cash flows which classifies cash flows during the period from operating, investing and financing activities."

IAS 7 does not mention anything about working capital.

(b) According to paragraph 10, "The statement of cash flows shall report cash flows during the period classified by operating, investing and financing activities." Further, paragraph 11 states "An entity presents its cash flows from operating, investing and financing activities in a manner which is most appropriate to its business. Classification by activity provides information that allows users to assess the impact of those activities on the financial position of the entity and the amount of its cash and cash equivalents. This information may also be used to evaluate the relationships among those activities."

(c) According to paragraph 14, "Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity. Therefore, they generally result from the transactions and other events that enter into the determination of profit or loss. Examples of cash flows from operating activities are:

(a) cash receipts from the sale of goods and the rendering of services;
(b) cash receipts from royalties, fees, commissions and other revenue;
(c) cash payments to suppliers for goods and services;
(d) cash payments to and on behalf of employees;

PROFESSIONAL RESEARCH (Continued)

(e) cash receipts and cash payments of an insurance entity for premiums and claims, annuities and other policy benefits;

(f) cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; and

(g) cash receipts and payments from contracts held for dealing or trading purposes."

PROFESSIONAL SIMULATION

Financial Statements

ELLWOOD HOUSE, INC.
Statement of Cash Flows
For the Year Ended December 31, 2011

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 equity 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 ordinary shares (g)	20,000	
Net cash used by financing activities		(9,000)
Net increase (decrease) in cash		56,050
Cash, January 1, 2011		10,000
Cash, December 31, 2011		$66,050
Non-cash investing and financing activities*		
Issuance of bonds for equipment		$32,000

*Presented in the notes to the financial statements.

PROFESSIONAL SIMULATION (Continued)

Explanation

Dear Mr. Brauer:

Enclosed is your statement of cash flows for the year ending December 31, 2011. I would like to take this opportunity to explain the changes which occurred in your business as a result of cash activities during 2011. (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 2011—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 investing activities during 2011, 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 non-current liability and equity items on the statement of financial position. 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 ordinary shares (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, 2011 to December 31, 2011.

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,