CHAPTER 14

Statement of Cash Flows

LEARNING OBJECTIVES

After you have mastered the material in this chapter, you will be able to:

1 Prepare the operating activities section of a statement of cash flows using the indirect method.

2 Prepare the operating activities section of a statement of cash flows using the direct method.

3 Prepare the investing activities section of a statement of cash flows.

4 Prepare the financing activities section of a statement of cash flows.

CHAPTER OPENING

To make informed investment and credit decisions, financial statement users need information to help them assess the amounts, timing, and uncertainty of a company's prospective cash flows. This chapter explains more about the items reported on the statement of cash flows and describes a more practical way to prepare the statement than analyzing every entry in the cash account. As previously shown, the statement of cash flows reports how a company obtained and spent cash during an accounting period. Sources of cash are ***cash inflows,*** and uses are ***cash outflows.*** Cash receipts (inflows) and payments (outflows) are reported as either operating activities, investing activities, or financing activities.

The Curious Accountant

Sirius XM Radio, Inc., was created by a merger between Sirius Radio and XM Radio, in July 2008. Sirius Radio was formed in 1990, and XM Radio began in 1992, although these companies did not generate any significant amounts of revenue in the early years of their existence. Even though their revenues grew steadily over the years, neither XM, Sirius, nor the combined company, Sirius XM Radio, has ever earned a profit. Its cumulative net losses totaled $9.7 billion by the end of 2008, with $5.5 billion of that coming in 2008 alone.

How could Sirius XM lose so much money and still be able to pay its bills? (Answer on page 643.)

AN OVERVIEW OF THE STATEMENT OF CASH FLOWS

The statement of cash flows provides information about cash coming into and going out of a business during an accounting period. Cash flows are classified into one of three categories: operating activities, investing activities, or financing activities. A separate section also displays any significant noncash investing and financing activities. Descriptions of these categories and how they are presented in the statement of cash flows follow.

Operating Activities

Routine cash inflows and outflows resulting from running (operating) a business are reported in the **operating activities** section of the statement of cash flows. Cash flows reported as operating activities include:

1. Cash receipts from revenues including interest and dividend revenue.
2. Cash payments for expenses including interest expense. Recall that dividend payments are not expenses. Dividend payments are reported in the financing activities section.

EXHIBIT 14.1

Operating Activities—Direct Method

Cash Flows from Operating Activities	
Cash receipts from customers	$400
Cash payments for expenses	(350)
Net cash flow from operating activities	$ 50

Under generally accepted accounting principles, the operating activities section of the statement of cash flows can be presented using either the *direct* or the *indirect* method. The **direct method** explicitly (*directly*) identifies the major *sources* and *uses* of cash. To illustrate, assume that during 2011 New South Company earns revenue on account of $500 and collects $400 cash from customers. Further assume the company incurs $390 of expenses on account and pays $350 cash to settle accounts payable. Exhibit 14.1 shows the operating activities section of the statement of cash flows using the *direct method.*

In contrast, the **indirect method** starts with net income as reported on the income statement followed by the adjustments necessary to convert the accrual-based net income figure to a cash-basis equivalent. To illustrate, begin with New South Company's income statement based on the above assumptions.

Revenues	$500
Expenses	(390)
Net income	$110

Converting the net income of $110 to the net cash flow from operating activities of $50 requires the following adjustments.

1. New South earned $500 of revenue but collected only $400 in cash. The remaining $100 will be collected in the next accounting period. This $100 *increase in accounts receivable* must be *subtracted* from net income to determine cash flow because it increased net income but did not increase cash.
2. New South incurred $390 of expense but paid only $350 in cash. The remaining $40 will be paid in the next accounting period. This $40 *increase in accounts payable* must be *added* back to net income to determine cash flow because it decreased net income but did not use cash.

EXHIBIT 14.2

Operating Activities—Indirect Method

Cash Flows from Operating Activities	
Net income	$110
Subtract: Increase in accounts receivable	(100)
Add: Increase in accounts payable	40
Net cash flow from operating activities	$ 50

Exhibit 14.2 shows the operating activities section of the statement of cash flows using the indirect method.

Compare the direct method presented in Exhibit 14.1 with the indirect method presented in Exhibit 14.2. Both methods report $50 of net cash flow from operating activities. They represent two different approaches to computing the same amount.

Because people typically find the direct method easier to understand, the Financial Accounting Standards Board (FASB) recommends it. Most companies, however, use the indirect method. Why? Back when the FASB adopted a requirement for companies to include a statement of cash flows in their annual reports, most companies used accounting systems that were compatible with the indirect method. It was therefore easier to prepare the new statement under the indirect method using existing systems than to create new record-keeping systems compatible with the direct method.

The FASB continues to advocate the direct method and a growing number of companies use it. Since the majority of companies continue to use the indirect method, however, financial statement users should understand both methods.

CHECK YOURSELF 14.1

Hammer, Inc., had a beginning balance of $22,400 in its Accounts Receivable account. During the accounting period, Hammer earned $234,700 of net income. The ending balance in the Accounts Receivable account was $18,200. Based on this information alone, determine the amount of cash flow from operating activities.

Answer

Account Title	Ending	Beginning	Change
Accounts receivable	$18,200	$22,400	$(4,200)

Applicable Rule	Cash Flow from Operating Activities	Amount
	Net income	$234,700
Rule 1	Add: Decrease in accounts receivable	4,200
	Cash flow from operating activities	$238,900

Investing Activities

For a business, long-term assets are investments. Cash flows related to acquiring or disposing of long-term assets are therefore reported in the **investing activities** section of the statement of cash flows. Cash flows reported as investing activities include:

1. Cash receipts (inflows) from selling property, plant, equipment, or marketable securities as well as collections from nonoperating credit instruments such as notes or mortgages receivable.
2. Cash payments (outflows) for purchasing property, plant, equipment, or marketable securities as well as nonoperating loans to borrowers.

Financing Activities

Cash flows related to borrowing (short- or long-term) and stockholders' equity are reported in the **financing activities** section of the statement of cash flows. Cash flows reported as financing activities include:

1. Cash receipts (inflows) from borrowing money and issuing stock.
2. Cash payments (outflows) to repay debt, purchase treasury stock, and pay dividends.

The classification of cash flows is based on the type of activity, not the type of account. For example, buying another company's common stock is an investing activity, but issuing a company's own common stock is a financing activity. Receiving dividends from a common stock investment is an operating activity, and paying dividends to a company's own stockholders is a financing activity. Similarly, loaning money is an investing activity, although borrowing it is a financing activity. Focus on the type of activity rather than the type of account when classifying cash flows as operating, investing, or financing activities.

Noncash Investing and Financing Activities

Companies sometimes undertake significant **noncash investing and financing activities** such as acquiring a long-term asset in exchange for common stock. Since these types of transactions do not involve exchanging cash they are not reported in the main body of the statement of cash flows. However, because the FASB requires that all material investing and financing activities be disclosed, whether or not they involve exchanging cash, companies must include with the statement of cash flows a separate schedule of any noncash investing and financing activities.

Reporting Format for the Statement of Cash Flows

Cash flow categories are reported in the following order: (1) operating activities; (2) investing activities; and (3) financing activities. In each category, the difference between the inflows and outflows is presented as a net cash inflow or outflow for the category. These net amounts are combined to determine the net change (increase or decrease) in the company's cash for the period. The net change in cash is combined with the beginning cash balance to determine the ending cash balance. The ending cash balance on the statement of cash flows is the same as the cash balance reported on the balance sheet. The schedule of noncash investing and financing activities is typically presented at the bottom of the statement of cash flows. Exhibit 14.3 outlines this format.

EXHIBIT 14.3 Format for Statement of Cash Flows

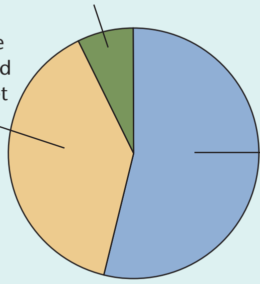
WESTERN COMPANY
Statement of Cash Flows
For the Year Ended December 31, 2011

Cash flows from operating activities	
Net increase (decrease) from operating activities	XXX
Cash flows from investing activities	
Net increase (decrease) from investing activities	XXX
Cash flows from financing activities	
Net increase (decrease) from financing activities	XXX
Net increase (decrease) in cash	XXX
Plus: Beginning cash balance	XXX
Ending cash balance	XXX
Schedule of Noncash Investing and Financing Activities	
List of significant noncash transactions	XXX

As indicated in Exhibit 14.4, most companies present the statement of cash flows as the last of the four primary financial statements. However, a sizable number of companies present it after the income statement and balance sheet but before the statement of changes in stockholders' equity. Some companies place the statement of cash flows first, before the other three statements.

EXHIBIT 14.4

Placement of Statement of Cash Flows Relative to Other Financial Statements



Data Source: AICPA, *Accounting Trends and Techniques.*

PREPARING A STATEMENT OF CASH FLOWS

Most of the data needed to construct a statement of cash flows can be obtained from two successive balance sheets and the intervening income statement. Certain information from the long-term asset records is also usually required. To illustrate, refer to the financial statements for New South Company presented in Exhibit 14.5. Notice that cash decreased from $400 at the end of 2011 to $300 at the end of 2012. The statement of cash flows explains what caused this $100 decrease.

EXHIBIT 14.5 Financial Statements for New South Company

NEW SOUTH COMPANY
Balance Sheets
As of December 31

	2012	2011
Current assets:		
Cash	$ 300	$ 400
Accounts receivable	1,000	1,200
Interest receivable	400	300
Inventory	8,900	8,200
Prepaid insurance	1,100	1,400
Total current assets	11,700	$11,500
Long-term assets		
Investment securities	5,100	3,500
Store fixtures	5,400	4,800
Accumulated depreciation	(900)	(1,200)
Land	8,200	6,000
Total long-term assets	17,800	13,100
Total assets	$29,500	$24,600
Current liabilities:		
Accounts payable—inventory purchases	$ 800	$ 1,100
Salaries payable	1,000	900
Other operating expenses payable	1,500	1,300
Interest payable	300	500
Unearned rent revenue	600	1,600
Total current liabilities	4,200	5,400

continued

EXHIBIT 14.5 *concluded*

NEW SOUTH COMPANY
Balance Sheets
As of December 31

	2012	2011
Long-term liabilities		
Mortgage payable	2,200	0
Bonds payable	1,000	4,000
Total long-term liabilities	3,200	4,000
Stockholders' equity		
Common stock	10,000	8,000
Retained earnings	12,700	7,200
Treasury stock	(600)	0
Total stockholders' equity	22,100	15,200
Total liabilities and stockholders' equity	$29,500	$24,600

NEW SOUTH COMPANY
Income Statement
For the Year Ended December 31, 2012

Sales revenue		$20,600
Cost of goods sold		(10,500)
Gross margin		10,100
Operating expenses		
Depreciation expense	$(1,000)	
Salaries expense	(2,700)	
Insurance expense	(1,300)	
Other operating expenses	(1,400)	
Total operating expenses		(6,400)
Income from sales business		3,700
Other income—rent revenue		2,400
Operating income		6,100
Nonoperating revenue and expense		
Interest revenue	700	
Interest expense	(400)	
Gain on sale of store fixtures	600	
Total nonoperating items		900
Net income		$ 7,000

Note 1: No investment securities were sold during 2012.
Note 2: During 2012, New South sold store fixtures that had originally cost $1,700. At the time of sale, accumulated depreciation on the fixtures was $1,300.
Note 3: Land was acquireds during 2012 by issuing a mortgage note payable. No land sales occurred during 2012.

PREPARING THE OPERATING ACTIVITIES SECTION OF A STATEMENT OF CASH FLOWS USING THE INDIRECT METHOD

LO 1

Prepare the operating activities section of a statement of cash flows using the indirect method.

Recall that the indirect approach begins with the amount of net income. Many aspects of accrual accounting, such as recognizing revenues and expenses on account, can cause differences between the amount of net income reported on a company's income statement and the amount of net cash flow it reports from operating activities. Most of the differences between revenue and expense recognition and cash flows are related to changes in the balances of the noncash current assets and current liabilities.

Answers to The Curious Accountant

First, it should be remembered that GAAP requires earnings and losses to be computed on an accrual basis. A company can have negative earnings and still have positive cash flows from operating activities. This was not the case at **Sirius XM Radio** (Sirius). From 2005 through 2008 the company's cash flows from operating activities totaled a negative $1 billion. Although this is much less than the $7.8 billion of cumulative net losses the company incurred during the same period, negative cash flows do not pay the bills.

In its early years of operations, Sirius, like many new companies, was able to stay in business because of the cash it raised through financing activities. In the most recent years, however, it has raised cash primarily through its investing activities, most notably, through the cash it received in 2008 as a part of the merger. Obviously, a company cannot operate indefinitely without generating cash from operating activities. Individuals and institutions who are willing to buy a company's stock or loan it cash in its early years will disappear if they do not believe the company will eventually begin earning profits and positive cash flows from operations. Exhibit 14.6 presents Sirius's statements of cash flows from 2005 through 2008.

EXHIBIT 14.6

SIRIUS XM RADIO INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
(dollar amounts in thousands)

	For the Years Ended December 31			
	2008	**2007**	**2006**	**2005**
Cash Flows from Operating Activities:				
Net loss	$(5,313,288)	$(565,252)	$(1,104,867)	$(862,997)
Adjustments to reconcile net loss to net cash used in operating activities:				
Depreciation and amortization	203,752	106,780	105,749	98,555
Impairment of goodwill	4,766,190	—	—	—
Noncash interest expense, net of amortization of premium	(6,311)	4,269	3,107	3,169
Provision for doubtful accounts	21,589	9,002	9,370	4,311
Noncash income (expense) from affiliate	—	—	—	3,192
Noncash loss from redemption of debt	98,203	—	—	712
Amortization of deferred income related to equity method investment	(1,156)	—	—	—
Loss on disposal of assets	4,879	(428)	1,661	1,028
Equity granted to third parties and employees	—	—	—	163,078
Impairment loss	—	—	10,917	—
Loss on investments, net	28,999	—	4,445	—
Shared-based payment expense	87,405	78,900	437,918	—
Deferred income taxes	2,476	2,435	2,065	2,311
Other noncash purchase price adjustments	(68,330)	—	—	—
Other	1,643	—	—	—

continued

EXHIBIT 14.6 *concluded*

SIRIUS XM RADIO INC. AND SUBSIDIARIES
Consolidated Statements of Cash Flows
(dollar amounts in thousands)

	For the Years Ended December 31			
	2008	**2007**	**2006**	**2005**
Changes in operating assets and liabilities, net of assets and liabilities acquired:				
Marketable securities	—	—	—	16
Accounts receivable	(32,121)	(28,881)	(1,871)	(28,440)
Inventory	8,291	4,965	(20,246)	(6,329)
Receivables from distributors	14,401	(13,179)	(20,312)	—
Related party assets	(22,249)	(1,241)	(1,189)	—
Prepaid expenses and other current assets	(19,953)	11,118	(42,132)	(29,129)
Other long-term assets	(5,490)	13,691	(18,377)	6,476
Accounts payable and accrued expenses	(65,481)	66,169	26,366	145,052
Accrued interest	23,081	(8,920)	1,239	17,813
Deferred revenue	55,778	169,905	181,003	210,947
Related party liabilities	34,646	—	—	—
Other long-term liabilities	30,249	1,901	3,452	(3,505)
Net cash used in operating activities	(152,797)	(148,766)	(421,702)	(273,740)
Cash Flows from Investing Activities:				
Additions to property and equipment	(130,551)	(65,264)	(92,674)	(49,888)
Sales of property and equipment	105	641	127	72
Purchases of restricted and other investments	(3,000)	(310)	(12,339)	(21,291)
Release of restricted investments	—	—	—	10,997
Acquisition of acquired entity cash	819,521	—	—	—
Merger related costs	(23,519)	(29,444)	—	—
Purchase of available-for-sale securities	—	—	(123,500)	(148,900)
Sale of restricted and other investments	65,869	40,191	255,715	31,850
Maturities of available-for-sale securities	—	—	—	5,085
Net cash provided by (used in) investing activities	728,425	(54,186)	27,329	(172,075)
Cash Flows from Financing Activities:				
Proceeds from exercise of warrants and stock options and from share borrow arrangement	471	4,097	25,787	18,543
Long-term borrowings, net of related costs	531,743	244,879	—	493,005
Redemption of debt	—	—	—	(57,609)
Payment of premiums on redemption of debt	(18,693)	—	—	—
Payments to minority interest holder	(1,479)	—	—	—
Repayment of long-term borrowings	(1,146,044)	(625)	—	—
Other	—	—	—	(8)
Net cash (used in) provided by financing activities	(634,002)	(248,351)	25,787	453,931
Net (decrease) increase in cash and cash equivalents	(58,374)	45,399	(368,586)	8,116
Cash and cash equivalents at beginning of period	438,820	393,421	762,007	753,891
Cash and cash equivalents at end of period	$ 380,446	$438,820	$393,421	$762,007

Indirect Method—Reconciliation Approach

The following section of this chapter examines the relationships between items reported on the income statement and the related assets and liabilities. Begin by reconciling the *noncash* current asset and current liability amounts shown on the balance sheets in Exhibit 14.5. *Do not include Cash in this analysis.* The amount of the change in the cash balance is the result of not only operating activities but also investing and financing activities.

Reconciliation of Accounts Receivable

Use the information in Exhibit 14.5 to prepare the following reconciliation of Accounts Receivable. The beginning and ending balances appear on the balance sheets. The *increase due to revenue recognized on account* is the sales revenue reported on the income statement.

Table 1 Reconciliation of Accounts Receivable

$200 Decrease

Beginning balance	$ 1,200
Increase due to revenue recognized on account	20,600
Decrease due to cash collections from customers	? = (20,800)
Ending balance	$ 1,000

To balance Accounts Receivable, the *decrease due to cash collections from customers* must be $20,800.[1]

The reconciliation shows that the $200 decrease in the accounts receivable balance occurred because *cash collections from customers* were $200 more than the amount of *revenue recognized on account* ($20,800 versus $20,600). Since the amount of cash collected is more than the amount of revenue recognized, we add $200 to the amount of net income to determine net cash flow from operating activities (Reference No. 1 in Exhibit 14.7).

Reconciliation of Interest Receivable

The beginning and ending balances appear on the balance sheets in Exhibit 14.5. The *increase due to interest revenue recognized on account* is the interest revenue reported on the income statement.

Table 2 Reconciliation of Interest Receivable

$100 Increase

Beginning balance	$300
Increase due to interest revenue recognized on account	700
Decrease due to cash collections of interest receivable	? = (600)
Ending balance	$400

To balance Interest Receivable, the *decrease due to cash collections of interest receivable* must be $600.

The reconciliation shows that the $100 increase in the interest receivable balance occurred because *cash collections of interest* were $100 less than the *interest revenue recognized on account* ($600 versus $700). Since the amount of cash collected is less than the amount of revenue recognized, we subtract the $100 from the amount of net income to determine net cash flow from operating activities (Reference No. 2 in Exhibit 14.7).

Reconciliation of Inventory and Accounts Payable

To simplify computing the amount of cash paid for inventory purchases, assume that all inventory purchases are made on account. The computation requires two steps. First, Inventory must be analyzed to determine the amount of inventory purchased. Second, Accounts Payable must be analyzed to determine the amount of cash paid to purchase inventory.

Use the financial statement information in Exhibit 14.5 to prepare the following Inventory reconciliation. The beginning and ending balances appear on the balance sheets. The *decrease due to recognizing cost of goods sold* is the cost of goods sold reported on the income statement.

[1] This text uses the simplifying assumption that all sales occur on account.

Table 3 Reconciliation of Inventory

$700 Increase	Beginning balance	$ 8,200	
	Increase due to inventory purchases	?	= 11,200
	Decrease due to recognizing cost of goods sold	(10,500)	
	Ending balance	$ 8,900	

To balance Inventory, the *increase due to inventory purchases* must be $11,200.

Assuming the inventory was purchased on account, the $11,200 of inventory purchases determined above equals the *increase due to inventory purchases* used in the reconciliation of Accounts Payable below. The beginning and ending balances appear on the balance sheets in Exhibit 14.5.

Table 4 Reconciliation of Accounts Payable*

$300 Decrease	Beginning balance	$ 1,100	
	Increase due to inventory purchases	11,200	
	Decrease due to cash settlements of accounts payable—inv.	?	= (11,500)
	Ending balance	$ 800	

*Assume that Accounts Payable is used for purchases of inventory only.

To balance Accounts Payable, the *decrease due to cash settlements of accounts payable—inventory* (cash paid to purchase inventory) must be $11,500.

Since the amount of *cash paid to purchase inventory* is $1,000 more than the amount of *cost of goods sold* recognized on the income statement ($11,500 versus $10,500), we subtract the $1,000 difference from the amount of net income to determine net cash flow from operating activities. In Exhibit 14.7 the $1,000 subtraction is divided between a $700 increase in inventory (Reference No. 3 in Exhibit 14.7) and a $300 decrease in accounts payable (Reference No. 4 in Exhibit 14.7).

Reconciliation of Prepaid Insurance

Use the financial statement information in Exhibit 14.5 to reconcile Prepaid Insurance. The beginning and ending balances appear on the balance sheets. The *decrease due to recognizing insurance expense* is the insurance expense reported on the income statement.

Table 5 Reconciliation of Prepaid Insurance

$300 Decrease	Beginning balance	$1,400	
	Increase due to the cash purchase of insurance	?	= 1,000
	Decrease due to recognizing insurance expense	(1,300)	
	Ending balance	$1,100	

To balance Prepaid Insurance, the amount of the *increase due to the cash purchase of insurance* must be $1,000.

The reconciliation shows that the $300 decrease in the prepaid insurance balance occurred because *cash paid to purchase insurance* was $300 less than the amount of *insurance expense recognized* ($1,000 versus $1,300). Since the amount of cash paid is less than the amount of expense recognized, we add $300 to the amount of net income to determine the net cash flow from operating activities (Reference No. 5 in Exhibit 14.7).

Reconciliation of Salaries Payable

Use the financial statement information in Exhibit 14.5 to reconcile Salaries Payable. The beginning and ending balance appear on the balance sheets. The *increase due to recognizing salary expense on account* is the salaries expense reported on the income statement.

Table 6 Reconciliation of Salaries Payable

$100 Increase	Beginning balance	$ 900
	Increase due to recognizing salary expense on account	2,700
	Decrease due to cash settlements of salaries payable	? = (2,600)
	Ending balance	$1,000

To balance Salaries Payable, the amount of the *decrease due to cash settlements of salaries payable* (cash paid for salaries expense) must be $2,600. The reconciliation shows that the $100 increase in the salaries payable balance occurred because the *cash paid for salary expense* is $100 less than the amount of *salary expense recognized on account* ($2,600 versus $2,700). Since the amount of cash paid is less than the amount of expense recognized, we add $100 to the amount of net income to determine the cash flow from operating activities (Reference No. 6 in Exhibit 14.7).

Reconciliation of Other Operating Expenses Payable

Use the financial statement information in Exhibit 14.5 to reconcile Other Operating Expenses Payable. The beginning and ending balances appear on the balance sheets. The *increase due to recognizing other operating expenses on account* is the other operating expenses amount reported on the income statement.

Table 7 Reconciliation of Other Operating Expenses Payable

$200 Increase	Beginning balance	$1,300
	Increase due to recognizing other operating expenses on account	1,400
	Decrease due to cash settlements of other operating expenses pay.	? = (1,200)
	Ending balance	$1,500

To balance Other Operating Expenses Payable, the amount of the *decrease due to cash settlements of other operating expenses payable* must be $1,200.

The reconciliation shows that the $200 increase in the other operating expenses payable balance occurred because the *cash paid for other operating expenses* was $200 less than the amount of *other operating expenses recognized on account* ($1,200 versus $1,400). Since the amount of cash paid is less than the amount of expense recognized, we add $200 to the amount of net income to determine the net cash flow from operating activities (Reference No. 7 in Exhibit 14.7).

Reconciliation of Interest Payable

Use the financial statement information in Exhibit 14.5 to reconcile Interest Payable. The beginning and ending balances appear on the balance sheets. The *increase due to recognizing interest expense on account* is the interest expense reported on the income statement.

Table 8 Reconciliation of Interest Payable

$200 Decrease	Beginning balance	$500
	Increase due to recognizing interest expense on account	400
	Decrease due to cash settlements of interest payable	? = (600)
	Ending balance	$300

To balance Interest Payable, the amount of the *decrease due to cash settlements of interest payable* (cash paid for interest expense) must be $600.

The reconciliation shows that the $200 decrease in the interest payable balance occurred because the amount of *cash paid for interest expense* is $200 more than the amount of *interest expense recognized on account* ($600 versus $400). Since the amount of cash paid is more than the amount of interest expense recognized, we subtract $200 from the amount of net income to determine the net cash flow from operating activities (Reference No. 8 in Exhibit 14.7).

Reconciliation of Unearned Rent Revenue

Use the financial statement information in Exhibit 14.5 to reconcile Unearned Rent Revenue. The beginning and ending balances appear on the balance sheets. The *decrease due to recognizing other income—rent revenue* is the other income—rent revenue reported on the income statement.

Table 9 Reconciliation of Unearned Rent Revenue

$1,000 Decrease

Beginning balance	$ 1,600	
Increase due to collecting cash in advance of providing rental services	?	= 1,400
Decrease due to recognizing other income—rent revenue	(2,400)	
Ending balance	$ 600	

To balance Unearned Rent Revenue, the amount of the *increase due to collecting cash in advance of providing rental services* must be $1,400.

The reconciliation shows that the $1,000 decrease in the unearned rent revenue balance occurred because the amount of *cash collected in advance of providing rental services* is $1,000 less than the amount of *rent revenue recognized* ($1,400 versus $2,400). Since the amount of cash collected is less than the amount of revenue recognized, we subtract $1,000 from the amount of net income to determine the net cash flow from operating activities (Reference No. 9 in Exhibit 14.7).

Noncash Expenses

The calculation of accrual-based net income frequently includes noncash expenses such as depreciation expense. Since noncash expenses are deducted in determining net income, they must be added back to the amount of net income when computing net cash flow from operating activities (Reference No. 10 in Exhibit 14.7).

Gains and Losses

When a company retires a long-term asset, the company may receive cash from the sale of the asset being retired. If the asset is sold for more than book value (cost − accumulated depreciation), the gain increases net income; if the asset is sold for less than book value, the loss decreases net income. In either case, the cash inflow is the total amount of cash collected from selling the asset, not the amount of the gain or loss, and this cash inflow is reported in the investing activities section of the statement of cash flows. Since gains increase net income and losses decrease net income, but neither represents the amount of cash received from an asset sale, gains must be subtracted from and losses added back to net income to determine net cash flow from operating activities (Reference No. 11 in Exhibit 14.7).

Indirect Method—Rule-Based Approach

The reconciliation process described in the previous section of this chapter leads to a set of rules that can be used to convert accrual-based revenues and expenses to their cash flow equivalents. These rules are summarized in Exhibit 14.8.

Although the rule-based approach offers less insight, it is easy to apply. To illustrate, return to the financial statement data in Exhibit 14.5. The *noncash* current assets

EXHIBIT 14.7

Cash Flows from Operating Activities—Indirect Method

Reference No.	Cash Flows from Operating Activities	
	Net income	$7,000
	Adjustments to reconcile net income to net cash flow from operating activities:	
1	Decrease in accounts receivable	200
2	Increase in interest receivable	(100)
3	Increase in inventory	(700)
4	Decrease in accounts payable for inventory purchases	(300)
5	Decrease in prepaid insurance	300
6	Increase in salaries payable	100
7	Increase in other operating expenses payable	200
8	Decrease in interest payable	(200)
9	Decrease in unearned rent revenue	(1,000)
10	Depreciation expense	1,000
11	Gain on sale of store fixtures	(600)
	Net cash flow from operating activities	$5,900

EXHIBIT 14.8

Cash Flows from Operating Activities—Indirect Method

	Net income	XXX
Rule 1	Add decreases and subtract increases in noncash current assets	XXX
Rule 2	Add increases and subtract decreases in noncash current liabilities	XXX
Rule 3	Add noncash expenses (e.g., depreciation)	XXX
Rule 4	Add losses and subtract gains	XXX
	Net cash flow from operating activities	XXX

and current liabilities reported on the balance sheets are summarized in Exhibit 14.9 for your convenience. The amount of the change in each balance is shown in the *Change* column.

Refer to the income statement to identify the amounts of net income, noncash expenses, gains, and losses. The income statement for New South Company in Exhibit 14.5 includes three relevant figures: net income of $7,000; depreciation expense of $1,000;

EXHIBIT 14.9

Noncash Current Assets and Current Liabilities

Account Title	2012	2011	Change
Accounts receivable	$1,000	$1,200	$ (200)
Interest receivable	400	300	100
Inventory	8,900	8,200	700
Prepaid insurance	1,100	1,400	(300)
Accounts payable—inventory purchases	800	1,100	(300)
Salaries payable	1,000	900	100
Other operating expenses payable	1,500	1,300	200
Interest payable	300	500	(200)
Unearned rent revenue	600	1,600	(1,000)

EXHIBIT 14.10 Cash Flows from Operating Activities—Indirect Method, Operating Activities

NEW SOUTH COMPANY
Statement of Cash Flows
For the Year Ended December 31, 2012

Applicable Rule	Cash Flows from Operating Activities	
	Net income	$7,000
	Adjustments to reconcile net income to net cash flow from operating activities:	
Rule 1	Decrease in accounts receivable	200
Rule 1	Increase in interest receivable	(100)
Rule 1	Increase in inventory	(700)
Rule 2	Decrease in accounts payable for inventory purchases	(300)
Rule 1	Decrease in prepaid insurance	300
Rule 2	Increase in salaries payable	100
Rule 2	Increase in other operating expenses payable	200
Rule 2	Decrease in interest payable	(200)
Rule 2	Decrease in unearned rent revenue	(1,000)
Rule 3	Depreciation expense	1,000
Rule 4	Gain on sale of store fixtures	(600)
	Net cash flow from operating activities	$5,900

and a $600 gain on sale of store fixtures. Applying the rules in Exhibit 14.8 produces the operating activities section of the statement of cash flows shown in Exhibit 14.10. The applicable rule for each item is referenced in the first column of the exhibit.

The operating activities section of the statements of cash flows shown in Exhibits 14.10 and 14.7 are identical. The rule-based approach is an alternative way to prepare this section when using the indirect method.

CHECK YOURSELF 14.2

Q Magazine, Inc., reported $369,000 of net income for the month. At the beginning of the month, its Unearned Revenue account had a balance of $78,000. At the end of the month, the account had a balance of $67,000. Based on this information alone, determine the amount of net cash flow from operating activities.

Answer

Account Title	Ending	Beginning	Change
Unearned revenue	$67,000	$78,000	$(11,000)

Applicable Rule	Cash Flows from Operating Activities	Amount
	Net income	$369,000
Rule 2	Deduct: Decrease in unearned revenue	(11,000)
	Net cash flow from operating activities	$358,000

CHECK YOURSELF 14.3

The following account balances were drawn from the accounting records of Loeb, Inc.

Account Title	Ending Balance	Beginning Balance
Prepaid rent	$3,000	$4,200
Interest payable	2,650	2,900

Loeb reported $7,400 of net income during the accounting period. Based on this information alone, determine the amount of net cash flow from operating activities.

Answer Based on Rule 1, the $1,200 decrease ($3,000 − $4,200) in Prepaid Rent (current asset) must be added to net income to determine the amount of net cash flow from operating activities. Rule 2 requires that the $250 decrease ($2,650 − $2,900) in interest Payable (current liability) must be deducted from net income. Accordingly, the cash flow from operating activities is $8,350 ($7,400 + $1,200 − $250). Note that paying interest is defined as an operating activity and should not be confused with dividend payments, which are classified as financing activities.

CHECK YOURSELF 14.4

Arley Company's income statement reported net income (all amounts are in millions) of $326 for the year. The income statement included depreciation expense of $45 and a net loss on the sale of long-term assets of $22. Based on this information alone, determine the net cash flow from operating activities.

Answer Based on Rule 3 and Rule 4, both the depreciation expense and the loss would have to be added to net income to determine net cash flow from operating activities. Net cash flow from operating activities would be $393 million ($326 + $45 + $22).

PREPARING THE OPERATING ACTIVITIES SECTION OF A STATEMENT OF CASH FLOWS USING THE DIRECT METHOD

LO 2

Prepare the operating activities section of a statement of cash flows using the direct method.

The reconciliation tables developed earlier to determine net cash flow from operating activities under the *indirect method* also disclose the information needed to present the amount of net cash flow from operating activities under the *direct method.* Remember that the amount of net cash flow from operating activities is the same whether it is presented using the indirect or the direct method.

The direct method shows the specific sources and uses of cash that are associated with operating activities. It does not show adjustments to net income. To illustrate, examine Exhibit 14.11. The information in the reference column identifies the reconciliation table from which the cash flow amounts were drawn. The page number indicates where the reconciliation table is located in this chapter.

Table 3 is not included above because it does not directly involve a cash flow. Also, noncash expenses, gains, and losses are not used in the determination of net cash flow from operating activities when using the direct method.

EXHIBIT 14.11

Cash Flows from Operating Activities—Direct Method

Reference	Cash Flows from Operating Activities	
Table 1, page 645	Inflow from customers	$ 20,800
Table 2, page 645	Inflow from interest revenue	600
Table 4, page 646	Outflow for inventory purchases	(11,500)
Table 5, page 646	Outflow to purchase insurance	(1,000)
Table 6, page 647	Outflow to pay salary expense	(2,600)
Table 7, page 647	Outflow for other operating expenses	(1,200)
Table 8, page 647	Outflow to pay interest expense	(600)
Table 9, page 648	Inflow from rent revenue	1,400
	Net cash flow from operating activities	$ 5,900

PREPARING THE INVESTING ACTIVITIES SECTION OF A STATEMENT OF CASH FLOWS

LO 3

Prepare the investing activities section of a statement of cash flows.

The direct and indirect methods discussed above pertain only to the presentation of operating activities. The *investing activities* section of the statement of cash flows is the same regardless of whether the direct or indirect method is used for operating activities. The information necessary to identify cash inflows and outflows from investing activities is obtained by reconciling changes in a company's long-term assets. In general:

- Increases in long-term asset balances suggest cash outflows to purchase assets.
- Decreases in long-term asset balances suggest cash inflows from selling assets.

It is usually necessary to analyze data from the long-term asset records to determine details about long-term asset purchases and sales. In the New South Company example, these details are presented as notes at the bottom of the balance sheets.

To illustrate, return to the financial statements in Exhibit 14.5. New South Company reports the following three long-term assets on its balance sheets. *It is not necessary to reconcile accumulated depreciation since it does not affect cash flow.*

Long-term Assets	2012	2011
Investment securities	$5,100	$3,500
Store fixtures	5,400	4,800
Land	8,200	6,000

For each long-term asset, reconcile the beginning and ending balances by identifying purchases and sales affecting it. Review the notes for additional relevant information. Begin with investment securities.

Reconciliation of Investment Securities

Reconciliation of Investment Securities		
Beginning balance in investment securities	$3,500	
Increase due to purchase of investment securities	?	= 1,600
Decrease due to sale of investment securities	0	
Ending balance in investment securities	$5,100	

Because Note 1 below the balance sheets indicates no investment securities were sold during 2012, the *decrease due to sale of investment securities* is zero. To balance Investment Securities, the *increase due to purchase of investment securities* must be \$1,600. In the absence of contrary information, assume New South used cash to purchase the investment securities. This cash outflow is reported in the investing activities section of the statement of cash flows in Exhibit 14.12.

Reconciliation of Store Fixtures

Reconciliation of Store Fixtures

Beginning balance in store fixtures	\$4,800	
Increase due to purchase of store fixtures	?	= 2,300
Decrease due to sale of store fixtures	(1,700)	
Ending balance in store fixtures	\$5,400	

Note 2 below the balance sheets indicates that the *decrease due to sale of store fixtures* is \$1,700. What is the cash flow from this sale? The book value of these fixtures was \$400 (\$1,700 cost − \$1,300 accumulated depreciation). Since the income statement reports a \$600 gain on the sale of store fixtures, the cash collected from the sale was more than the book value of the store fixtures. Compute the amount of cash collected from the sale of store fixtures as follows:

Cash inflow = book value + gain = \$400 + \$600 = \$1,000

The \$1,000 cash inflow from the sale of store fixtures is reported in the investing activities section of the statement of cash flows in Exhibit 14.12.

To balance Store Fixtures, the *increase due to purchase of store fixtures* must be \$2,300. In the absence of contrary information, assume New South used cash to purchase store fixtures. The cash outflow is reported in the investing activities section of the statement of cash flows in Exhibit 14.12.

Reconciliation of Land

Reconciliation of Land

Beginning balance in land	\$6,000	
Increase due to purchase of land	?	= 2,200
Decrease due to sale of land	0	
Ending balance in land	\$8,200	

Because Note 3 below the balance sheets indicates no land was sold during 2012, the *decrease due to sale of land* is zero. To balance Land, the *increase due to purchase of land* must be \$2,200. Since the land was acquired by issuing a mortgage note payable, New South did not use cash for the purchase. This type of transaction is reported in the *noncash investing and financing activities* section of the statement of cash flows, discussed in more detail later in the chapter. The cash inflows and outflows from investing activities are summarized in Exhibit 14.12.

EXHIBIT 14.12

Cash Flows from Investing Activities

Cash Flows from Investing Activities	
Cash outflow to purchase investment securities	$(1,600)
Cash inflow from the sale of store fixtures	1,000
Cash outflow to purchase store fixtures	(2,300)
Net cash outflow from investing activities	$(2,900)

CHECK YOURSELF 14.5

On January 1, 2011, Wyatt Company had an Equipment balance of $124,000. During 2011, Wyatt purchased equipment that cost $50,000. The balance in Equipment on December 31, 2011, was $90,000. The 2011 income statement included a $7,000 loss from the sale of equipment. On the date of sale, accumulated depreciation on the equipment sold was $49,000.

Required

a. Determine the cost of the equipment sold during 2011.

b. Determine the amount of cash flow from the sale of equipment that should be reported in the investing activities section of the 2011 statement of cash flows.

Solution

a.

Reconciliation of Equipment		
Beginning balance	$124,000	
Increase due to the purchase of equipment	50,000	
Decrease due to sale of equipment	?	= (84,000)
Ending balance	$ 90,000	

To balance Equipment, *decrease due to sale of equipment* must be $84,000.

b. The book value of the equipment sold was $35,000 ($84,000 − $49,000 accumulated depreciation). Since Wyatt recognized a loss on the equipment sale, the amount of cash collected from the sale was less than the book value of the equipment. The cash collected from the sale of the equipment was $28,000 ($35,000 book value − $7,000 loss on sale).

PREPARING THE FINANCING ACTIVITIES SECTION OF A STATEMENT OF CASH FLOWS

LO 4

Prepare the financing activities section of a statement of cash flows.

Because the differences between the direct and the indirect methods of presenting the statement of cash flows pertain only to operating activities, the *financing activities* section is the same under either approach. The information necessary to identify cash inflows and outflows from financing activities is obtained by reconciling changes in short-term notes payable, long-term liabilities, and stockholders' equity. In general:

- Increases in short-term notes payable or long-term debt balances suggest cash inflows occurred from issuing debt instruments (notes or bonds).
- Decreases in short-term notes payable or long-term debt balances suggest cash outflows occurred for payment of debt (notes or bonds).

- Increases in contributed capital (common stock, preferred stock, or paid-in capital) suggest cash inflows occurred from issuing equity instruments.
- Increases or decreases in treasury stock suggest cash outflows or inflows occurred to purchase or sell a company's own stock.
- Decreases in retained earnings from cash dividends suggest cash outflows occurred to pay dividends.

To illustrate, return to the financial statements of the New South Company in Exhibit 14.5. The following long-term liability and stockholders' equity balances are reported on the New South balance sheets.

Account Title	2012	2011
Mortgage payable	$ 2,200	$ 0
Bonds payable	1,000	4,000
Common stock	10,000	8,000
Retained earnings	12,700	7,200
Treasury stock	600	0

For each account, reconcile the beginning and ending balances by identifying the increases and decreases affecting it. Review the notes for additional relevant information. Begin with the mortgage payable liability.

Reconciliation of Mortgage Payable

Reconciliation of Mortgage Payable	
Beginning balance in mortgage payable	$ 0
Increase due to issuing mortgage payable	2,200
Decrease due to payment of mortgage payable	0
Ending balance in mortgage payable	$2,200

As previously discussed, Note 3 indicates a mortgage payable was issued to acquire land. The *increase due to issuing mortgage payable* is $2,200. Since New South received land, not cash, by issuing the mortgage, the transaction is reported in the noncash investing and financing activities section of the statement of cash flows.

Reconciliation of Bonds Payable

Bonds Payable		
Beginning balance in bonds payable	$4,000	
Increase due to issuing bonds payable	0	
Decrease due to payment of bonds payable	?	= (3,000)
Ending balance in bonds payable	$1,000	

Since there is no indication that New South issued bonds during 2012, assume the *increase due to issuing bonds payable* is zero. To balance Bonds Payable, the *decrease due to payment of bonds payable* must be $3,000. The cash outflow is reported in the financing activities section in Exhibit 14.13.

Reconciliation of Common Stock

Reconciliation of Common Stock		
Beginning balance in common stock	$ 8,000	
Increase due to issuing common stock	?	= 2,000
Ending balance in common stock	$10,000	

To balance Common Stock, the *increase due to issuing common stock* has to be $2,000. The cash inflow is reported in the financing activities section in Exhibit 14.13.

Reconciliation of Retained Earnings

Reconciliation of Retained Earnings		
Beginning balance in retained earnings	$ 7,200	
Increase due to net income	7,000	
Decrease due to of dividends	?	= (1,500)
Ending balance in retained earnings	$12,700	

The *increase due to net income* comes from the income statement. To balance Retained Earnings, the decrease due to of dividends must be $1,500. In the absence of information to the contrary, assume the decrease is due to the cash payment of dividends. The cash outflow for payment of dividends is reported in the financing activities section of the statement of cash flows in Exhibit 14.13.

Reconciliation of Treasury Stock

Reconciliation of Treasury Stock		
Beginning balance in treasury stock	$ 0	
Increase due to purchasing treasury stock	?	= 600
Decrease due to reissuing treasury stock	0	
Ending balance in treasury stock	$600	

Since there is no indication that New South reissued treasury stock during 2012, the *decrease due to reissuing treasury stock* is zero. To balance Treasury Stock, the increase due to purchasing treasury stock must be $600. The cash outflow is reported in the financing activities section in Exhibit 14.13.

Exhibits 14.14 and 14.15 illustrate the complete statement of cash flows for New South Company under the two alternative methods. Exhibit 14.14 presents operating activities using the indirect method. Exhibit 14.15 presents operating activities using the direct method. The investing and financing activities do not differ between methods. Under either method the combined effects of operating, investing, and financing activities result in a net decrease in cash of $100 for 2012. This $100 decrease is necessarily consistent with the difference between the December 31, 2012, and the December 31, 2011, cash balances shown in the balance sheets in Exhibit 14.5.

EXHIBIT 14.13

Cash Flows from Financing Activities

Cash Flows from Financing Activities	
Cash outflow to reduce bonds payable	$(3,000)
Cash inflow from issuing common stock	2,000
Cash outflow to pay dividends	(1,500)
Cash outflow to purchase treasury stock	(600)
Net cash outflow from financing activities	$(3,100)

EXHIBIT 14.14 Statement of Cash Flows—Indirect Method

NEW SOUTH COMPANY
Statement of Cash Flows
For the Year Ended December 31, 2012

Cash Flows from Operating Activities		
Net income	$ 7,000	
Adjustments to reconcile net income to net cash flow from operating activities:		
Decrease in accounts receivable	200	
Increase in interest receivable	(100)	
Increase in inventory	(700)	
Decrease in accounts payable for inventory purchases	(300)	
Decrease in prepaid insurance	300	
Increase in salaries payable	100	
Increase in other operating expenses payable	200	
Decrease in interest payable	(200)	
Decrease in unearned rent revenue	(1,000)	
Depreciation expense	1,000	
Gain on sale of store fixtures	(600)	
Net cash flow from operating activities		$5,900
Cash Flows from Investing Activities		
Cash outflow to purchase investment securities	(1,600)	
Cash inflow from the sale of store fixtures	1,000	
Cash outflow to purchase store fixtures	(2,300)	
Net cash outflow from investing activities		(2,900)
Cash Flows from Financing Activities		
Cash outflow to reduce bonds payable	(3,000)	
Cash inflow from issuing common stock	2,000	
Cash outflow to pay dividends	(1,500)	
Cash outflow to purchase treasury stock	(600)	
Net cash outflow from financing activities		(3,100)
Net decrease in cash		(100)
Plus: Beginning cash balance		400
Ending cash balance		$ 300
Schedule of Noncash Investing and Financing Activities		
Issue mortgage for land		$2,200

EXHIBIT 14.15 Statement of Cash Flows—Direct Method

NEW SOUTH COMPANY
Statement of Cash Flows
For the Year Ended December 31, 2012

Cash Flows from Operating Activities		
Inflow from customers	$ 20,800	
Inflow from interest revenue	600	
Outflow for inventory purchases	(11,500)	
Outflow to purchase insurance	(1,000)	
Outflow to pay salary expense	(2,600)	
Outflow for other operating expenses	(1,200)	
Outflow to pay interest expense	(600)	
Inflow from rent revenue	1,400	
Net cash flow from operating activities		$5,900

continued

EXHIBIT 14.15 *concluded*

NEW SOUTH COMPANY
Statement of Cash Flows
For the Year Ended December 31, 2012

Cash Flows from Investing Activities		
Cash outflow to purchase investment securities	(1,600)	
Cash inflow from the sale of store fixtures	1,000	
Cash outflow to purchase store fixtures	(2,300)	
Net cash outflow from investing activities		(2,900)
Cash Flows from Financing Activities		
Cash outflow to reduce bonds payable	(3,000)	
Cash inflow from issuing common stock	2,000	
Cash outflow to pay dividends	(1,500)	
Cash outflow to purchase treasury stock	(600)	
Net cash outflow from financing activities		(3,100)
Net decrease in cash		(100)
Plus: Beginning cash balance		400
Ending cash balance		$ 300
Schedule of Noncash Investing and Financing Activities		
Issue mortgage for land		$2,200

CHECK YOURSELF 14.6

On January 1, 2011, Sterling Company had a balance of $250,000 in Bonds Payable. During 2011, Sterling issued bonds with a $75,000 face value. The bonds were issued at face value. The balance in Bonds Payable on December 31, 2011, was $150,000.

Required

a. Determine the cash outflow for repayment of bond liabilities assuming the bonds were retired at face value.

b. Prepare the financing activities section of the 2011 statement of cash flows.

Solution

a.

Reconciliation of Bonds Payable

Beginning balance	$250,000
Increase due to issuing bonds payable	75,000
Decrease due to payment of bonds payable	? = (175,000)
Ending balance	$150,000

In order to balance Bonds Payable, the decrease due to payment of bonds payable must be $175,000. In the absence of information to the contrary, assume cash was used to pay the bond liabilities.

b.

Cash Flows from Financing Activities

Inflow from issuing bond liabilities	$ 75,000
Outflow for reduction of bond liabilities	(175,000)
Net cash outflow from financing activities	$(100,000)

PREPARING THE SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES

As mentioned earlier, companies may engage in significant noncash investing and financing activities. For example, New South Company acquired land by issuing a $2,200 mortgage note. Since these types of transactions do not involve exchanging cash, they are not reported in the main body of the statement of cash flows. However, the Financial Accounting Standards Board (FASB) requires disclosure of all material investing and financing activities whether or not they involve exchanging cash. Companies must therefore include with the statement of cash flows a separate schedule that reports noncash investing and financing activities. See the *Schedule of Noncash Investing and Financing Activities* at the bottom of Exhibits 14.14 and 14.15 for an example.

REALITY BYTES

How did **Dillard's, Inc.**, the department store chain, acquire $22 million of property, plant, and equipment in its 2006 fiscal year *without* spending any cash? Oddly enough, the answer can be found on its statement of cash flows.

The supplemental "noncash transactions" information included at the bottom of Dillard's statement of cash flows revealed that it acquired the assets by exchanging debt directly for assets. Capital lease transactions, a form of borrowing, were responsible for $19.5 million of these purchases. The remaining $2.5 million was purchased through "accrued capital transactions."

Had Dillard's borrowed $22 million from a bank and then used this cash to purchase $22 million of assets, it would have reported two separate cash events in the body of its statement of cash flows. A cash inflow would have been reported in the financing activities for the borrowing transaction, and a cash outflow would have been reported in the investing activities section for the purchase transaction. Acquiring large amounts of assets is considered important, even if there is no immediate exchange of cash, so generally accepted accounting principles require such events to be reported as a part of the statement of cash flows.

INTERPRETING THE STATEMENT OF CASH FLOWS

Why are financial analysts interested in the statement of cash flows? Understanding the cash flows of a business is essential because cash is used to pay the bills. A company, especially one experiencing rapid growth, can be short of cash in spite of earning substantial net income. To illustrate, assume you start a computer sales business. You borrow $2,000 and spend the money to purchase two computers for $1,000 each. You sell one of the computers on account for $1,500. If your loan required a payment at this time, you could not make it. Even though you have net income of $500 ($1,500 sales − $1,000 cost of goods sold), you have no cash until you collect the $1,500 account receivable. A business cannot survive without managing cash flow carefully. It is little wonder that financial analysts are keenly interested in cash flow.

Real-World Data

The statement of cash flows frequently provides a picture of business activity that would otherwise be lost in the complexities of accrual accounting. For example, **IBM Corporation**'s combined operating losses (before taxes) for 1991, 1992, and 1993 were more than $17.9 *billion.* During this same period, IBM reported "restructuring charges"

of more than $24 billion. Restructuring costs relate to reorganizing a company. They may include the costs of closing facilities and losses on asset disposals. Without the restructuring charges, IBM would have reported operating *profits* of about $6 billion (before taxes). Do restructuring charges signal positive or negative changes? Different financial analysts have different opinions about this issue. However, one aspect of IBM's performance during these years is easily understood. The company produced over $21 billion in positive cash flow from operating activities. It had no trouble paying its bills.

Investors consider cash flow information so important that they are willing to pay for it, even when the FASB discourages its use. The FASB *prohibits* companies from disclosing *cash flow per share* in audited financial statements. However, one prominent stock analysis service, ***Value Line Investment Survey***, sells this information to a significant customer base. Clearly, Value Line's customers value information about cash flows.

Exhibit 14.16 compares income from operations to cash flows from operating activities for six real-world companies for 2003 through 2005 and 2007 and 2008. These first three years were a time of economic expansion in the United States, but the economy had slowed and eventually entered into a recession in 2007 and 2008.

Several things are apparent from Exhibit 14.16. The cash flow from operating activities exceeds income from operations for all but four of the 30 comparisons, and three of these four are for one company, **Pulte Homes**. Cash flows often exceed income because depreciation, a noncash expense, is usually significant. Excluding Pulte Homes, which will be discussed separately, the most dramatic example of the differences between cash flow and income is **Alaska Air Group**, the company that owns **Alaska Airlines**. For the five years shown in Exhibit 14.16, its net income totals $71.8 million, but its cash flows from operations were $1.6 billion. The difference between cash flow from operating activities and operating income helps explain how

EXHIBIT 14.16

Operating Income versus Cash Flow from Operations (Amounts in $000)

	2008	2007	2005	2004	2003
Alaska Air Group					
Operating income	$ (135,900)	$ 125,000	$ 84,500	$ (15,300)	$ 13,500
Cash flow—operations	164,300	482,000	271,900	334,000	355,200
Boeing					
Operating income	2,654,000	4,058,000	2,562,000	1,820,000	718,000
Cash flow—operations	(401,000)	9,584,000	7,000,000	3,458,000	3,881,000
Johnson & Johnson					
Operating income	12,949,000	10,576,000	10,411,000	8,509,000	7,197,000
Cash flow—operations	14,972,000	15,249,000	11,877,000	11,131,000	10,595,000
McAfee					
Operating income	172,209	166,980	138,828	225,065	70,242
Cash flow—operations	308,322	393,415	419,457	358,913	156,304
McDonalds					
Operating income	4,313,200	2,335,000	2,602,200	2,278,500	1,508,200
Cash flow—operations	5,917,200	4,876,300	4,336,800	3,903,600	3,268,800
Pulte Homes, Inc.					
Operating income	(1,473,113)	(2,274,417)	1,436,888	998,008	617,322
Cash flow—operations	1,220,392	1,218,255	18,704	(698,280)	(301,848)

some companies can have significant losses over a few years and continue to stay in business and pay their bills.

The exhibit also shows that cash flow from operating activities can be more stable than operating income. Results for Alaska Air Group also demonstrate this clearly. For the five years presented, Alaska Air earned a profit in three years, but had a loss in two years. However, its operating cash flows were not only positive for all five years, but they were never lower than $164.3 million.

What could explain why Pulte Homes had *less* cash flow from operating activities than operating income in 2003, 2004, and 2005, but not in 2007 and 2008? In the early years, when the housing market was strong, Pulte was experiencing the kind of growth described earlier for your computer business. Its cash outflows were supporting growth in inventory. Pulte is one of the nation's largest new-home construction companies. Its growth rates, based on sales of new homes, were 25%, 31%, and 28% for 2003, 2004, and 2005, but sales declined by 35% and 33% in 2007 and 2008. Notice that in the years of declining sales, its cash flows from operating activities *exceeded* its net income.

Finally, why did **Boeing** have negative cash flow from operations in 2008 even though its revenue and operating income were also declining? It was because of a growth in inventory, but not due to revenue growth. This situation was significant enough that Boeing explained it in the footnotes of its 2008 annual report, as follows.

> *In 2008 inventory grew at a faster rate than customer advances. The 2008 increase in inventories was driven by continued spending on production materials, airplane engines, and supplier advances during the IAM strike, lower commercial airplane deliveries and the continued ramp-up of the 787 program. We expect to generate positive operating cash flows in 2009.*

The Pulte Homes situation highlights a potential weakness in the format of the statement of cash flows. Some accountants consider it misleading to classify all increases in long-term assets as *investing activities* and all changes in inventory as affecting cash flow from operating activities. They argue that the increase in inventory at Pulte that results from building more houses should be classified as an investing activity, just as the cost of a new building is. Although inventory is classified as a current asset and buildings are classified as long-term assets, in reality there is a certain level of inventory a company must permanently maintain to stay in business. The GAAP format of the statement of cash flows penalizes cash flow from operating activities for increases in inventory that are really a permanent investment in assets.

Conversely, the same critics might argue that some purchases of long-term assets are not actually *investments* but merely replacements of old, existing property, plant, and equipment. In other words, the *investing activities* section of the statement of cash flows makes no distinction between expenditures that expand the business and those that simply replace old equipment (sometimes called *capital maintenance* expenditures).

Users of the statement of cash flows must exercise the same care interpreting it as when they use the balance sheet or the income statement. Numbers alone are insufficient. Users must evaluate numbers based on knowledge of the particular business and industry they are analyzing.

Accounting information alone cannot guide a businessperson to a sound decision. Making good business decisions requires an understanding of the business in question, the environmental and economic factors affecting the operation of that business, and the accounting concepts on which the financial statements of that business are based.

A Look Back <<

This chapter examined in detail only one financial statement, the statement of cash flows. The chapter provided a more comprehensive discussion of how accrual accounting relates to cash-based accounting. Effective use of financial statements requires understanding not only accrual and cash-based accounting systems but also how they relate to each other. That relationship is why a statement of cash flows can begin with a reconciliation of net income, an accrual measurement, to net cash flow from operating activities, a cash measurement. Finally, this chapter explained how the conventions for classifying cash flows as operating, investing, or financing activities require analysis and understanding to make informed decisions with the financial information.

www.mhhe.com/edmonds2011

A step-by-step audio-narrated series of slides is provided on the text website at www.mhhe.com/edmonds2011.

SELF-STUDY REVIEW PROBLEM

The following financial statements pertain to Schlemmer Company.

Balance Sheets As of December 31		
	2012	**2011**
Cash	$48,400	$ 2,800
Accounts receivable	2,200	1,200
Inventory	5,600	6,000
Equipment	18,000	22,000
Accumulated depreciation—equip.	(13,650)	(17,400)
Land	17,200	10,400
Total assets	$77,750	$25,000
Accounts payable (inventory)	$ 5,200	$ 4,200
Long-term debt	5,600	6,400
Common stock	19,400	10,000
Retained earnings	47,550	4,400
Total liabilities and equity	$77,750	$25,000

Income Statement For the Year Ended December 31, 2012	
Sales revenue	$67,300
Cost of goods sold	(24,100)
Gross margin	43,200
Depreciation expense	(1,250)
Operating income	41,950
Gain on sale of equipment	2,900
Loss on disposal of land	(100)
Net income	$44,750

Additional Data

1. During 2012 equipment that had originally cost $11,000 was sold. Accumulated depreciation on this equipment was $5,000 at the time of sale.
2. Common stock was issued in exchange for land valued at $9,400 at the time of the exchange.

Required

Using the indirect method, prepare in good form a statement of cash flows for the year ended December 31, 2012.

Solution

SCHLEMMER COMPANY
Statement of Cash Flows
For the Year Ended December 31, 2012

Cash Flows from Operating Activities		
Net income	$44,750	
Add:		
Decrease in inventory (1)	400	
Increase in accounts payable (2)	1,000	
Depreciation expense (3)	1,250	
Loss on disposal of land (4)	100	
Subtract:		
Increase in accounts receivable (1)	(1,000)	
Gain on sale of equipment (4)	(2,900)	
Net cash inflow from operating activities		$43,600
Cash Flows from Investing Activities		
Cash inflow from the sale of equipment (5)	8,900	
Cash outflow for the purchase of equipment (5)	(7,000)	
Cash inflow from sale of land (6)	2,500	
Net cash outflow from investing activities		4,400
Cash Flows from Financing Activities		
Cash outflow to repay long-term debt (7)	(800)	
Cash outflow to pay dividends (8)	(1,600)	
Net cash outflow from financing activities		(2,400)
Net Increase in Cash		45,600
Plus: Beginning cash balance		2,800
Ending cash balance		$48,400
Schedule of Noncash Investing and Financing Activities		
Issue of common stock for land (9)		$ 9,400

(1) Add decreases and subtract increases in current asset account balances to net income.

(2) Add increases and subtract decreases in current liability account balances to net income.

(3) Add noncash expenses (depreciation) to net income.

(4) Add losses on the sale of noncurrent assets to net income and subtract gains on the sale of long-term assets from net income.

(5) Information regarding the Equipment account is summarized in the following table.

Equipment Account Information	
Beginning balance in equipment	$22,000
Purchases of equipment (cash outflows)	?
Sales of equipment (cash inflows)	(11,000)
Ending balance in equipment	$18,000

To balance the account, equipment costing $7,000 must have been purchased. In the absence of information to the contrary, we assume cash was used to make the purchase.

Note 1 to the financial statement shows that equipment sold had a book value of $6,000 ($11,000 cost − $5,000 accumulated depreciation). The amount of the cash inflow from this sale is computed as follows:

Cash inflow = book value + gain = $6,000 + $2,900 = $8,900

(6) The information regarding the Land account is as follows:

Land Account Information

Beginning balance in land	$10,400
Purchase of land (issue of common stock)	9,400
Sale of land (cash inflows)	?
Ending balance in land	$17,200

Note 2 indicates that land valued at $9,400 was acquired by issuing common stock. Since there was no cash flow associated with this purchase, the event is shown in the *noncash investing and financing activities* section of the statement of cash flows.

To balance the account, the cost (book value) of land sold had to be $2,600. Since the income statement shows a $100 loss on the sale of land, the cash collected from the sale is computed as follows:

Cash inflow = book value − less = $2,600 − $100 = $2,500

(7) The information regarding the Long-term Debt account is as follows:

Long-term Debt Information

Beginning balance in long-term debt	$6,400
Issue of long-term debt instruments (cash inflow)	0
Payment of long-term debt (cash outflow)	?
Ending balance in long-term debt	$5,600

There is no information in the financial statements that suggest that long-term debt was issued. Therefore, to balance the account, $800 of long-term debt had to be paid off, thereby resulting in a cash outflow.

(8) The information regarding the Retained Earnings account is as follows:

Retained Earnings Information

Beginning balance in retained earnings	$ 4,400
Net income	44,750
Dividends (cash outflow)	?
Ending balance in retained earnings	$47,550

To balance the account, $1,600 of dividends had to be paid, thereby resulting in a cash outflow.

(9) Note 2 states that common stock was issue to acquire land valued at $9,400. This is a non-cash investing and financing activity.

KEY TERMS

Cash inflows 636
Cash outflows 636
Direct method 638
Financing activities 639
Indirect method 638
Investing activities 639
Noncash investing and financing activities 640
Operating activities 638

QUESTIONS

1. What is the purpose of the statement of cash flows?
2. What are the three categories of cash flows reported on the cash flow statement? Discuss each and give an example of an inflow and an outflow for each category.
3. What are noncash investing and financing activities? Provide an example. How

are such transactions shown on the statement of cash flows?

4. Albring Company had a beginning balance in accounts receivable of $12,000 and an ending balance of $14,000. Net income amounted to $110,000. Based on this information alone, determine the amount of net cash flow from operating activities.
5. Forsyth Company had a beginning balance in utilities payable of $3,300 and an ending balance of $5,200. Net income amounted to $87,000. Based on this information alone, determine the amount of net cash flow from operating activities.
6. Clover Company had a beginning balance in unearned revenue of $4,300 and an ending balance of $3,200. Net income amounted to $54,000. Based on this information alone, determine the amount of net cash flow from operating activities.
7. Which of the following activities are financing activities?
   (a) Payment of accounts payable.
   (b) Payment of interest on bonds payable.
   (c) Sale of common stock.
   (d) Sale of preferred stock at a premium.
   (e) Payment of a cash dividend.
8. Does depreciation expense affect net cash flow? Explain.
9. If Best Company sold land that cost $4,200 at a $500 gain, how much cash did it collect from the sale of land?
10. If Best Company sold office equipment that originally cost $7,500 and had $7,200 of accumulated depreciation at a $100 loss, what was the selling price for the office equipment?
11. In which section of the statement of cash flows would the following transactions be reported?
    (a) The amount of the change in the balance of accounts receivable.
    (b) Cash purchase of investment securities.
    (c) Cash purchase of equipment.
    (d) Cash sale of merchandise.
    (e) Cash sale of common stock.
    (f) The amount of net income.
    (g) Cash proceeds from loan.
    (h) Cash payment on bonds payable.
    (i) Cash receipt from sale of old equipment.
    (j) The amount of the change in the balance of accounts payable.
12. What is the difference between preparing the statement of cash flows using the direct method and using the indirect method?
13. Which method (direct or indirect) of presenting the statement of cash flows is more intuitively logical? Why?
14. What is the major advantage of using the indirect method to present the statement of cash flows?
15. What is the advantage of using the direct method to present the statement of cash flows?
16. How would Best Company report the following transactions on the statement of cash flows?
    (a) Purchased new equipment for $46,000 cash.
    (b) Sold old equipment for $8,700 cash. The equipment had a book value of $4,900.
17. Can a company report negative net cash flows from operating activities for the year on the statement of cash flows but still have positive net income on the income statement? Explain.

MULTIPLE-CHOICE QUESTIONS

Multiple-choice questions are provided on the text website at www.mhhe.com/edmonds2011.

www.mhhe.com/edmonds2011

EXERCISES—SERIES A

All applicable Exercises in Series A are available with McGraw-Hill's *Connect Accounting*.

connect ACCOUNTING

Exercise 14-1A ***Use the indirect method to determine cash flows from operating activities*** **LO 1**

An accountant for Golden Enterprise Companies (GEC) computed the following information by making comparisons between GEC's 2011 and 2012 balance sheets. Further information was determined by examining the company's 2011 income statement.

1. The amount of an increase in the balance of the Accounts Receivable account.
2. The amount of a loss arising from the sale of land.
3. The amount of an increase in the balance of the Other Operating Expenses Payable account.
4. The amount of a decrease in the balance of the Bonds Payable account.
5. The amount of depreciation expense shown on the income statement.
6. The amount of cash dividends paid to the stockholders.
7. The amount of a decrease in the balance of an Unearned Revenue account.
8. The amount of an increase in the balance of an Inventory account.
9. The amount of an increase in the balance of a Land account.
10. The amount of a decrease in the balance of a Prepaid Rent account.
11. The amount of an increase in the balance of a Treasury Stock account.

Required

For each item described above indicate whether the amount should be added to or subtracted from the amount of net income when determining the amount of net cash flow from operating activities. If an item does not affect net cash flow from operating activities, identify it as being not affected.

LO 1

Exercise 14-2A *Use the indirect method to determine cash flows from operating activities*

Mendez Incorporated presents its statement of cash flows using the indirect method. The following accounts and corresponding balances were drawn from the company's 2012 and 2011 year-end balance sheets.

Account Title	2012	2011
Accounts receivable	$15,200	$16,500
Accounts payable	8,800	9,200

The 2012 income statement showed net income of $27,200.

Required

a. Prepare the operating activities section of the statement of cash flows.

b. Explain why the change in the balance in accounts receivable was added to or subtracted from the amount of net income when you completed Requirement *a*.

c. Explain why the change in the balance in accounts payable was added to or subtracted from the amount of net income when you completed Requirement *a*.

LO 1

Exercise 14-3A *Use the indirect method to determine cash flows from operating activities*

Chang Company presents its statement of cash flows using the indirect method. The following accounts and corresponding balances were drawn from Chang's 2012 and 2011 year-end balance sheets.

Account Title	2012	2011
Accounts receivable	$28,000	$32,000
Prepaid rent	1,800	1,500
Interest receivable	700	500
Accounts payable	8,500	9,800
Salaries payable	3,600	3,200
Unearned revenue	4,000	6,000

The income statement contained a $1,200 gain on the sale of equipment, a $900 loss on the sale of land, and $2,500 of depreciation expense. Net income for the period was $52,000.

Required

Prepare the operating activities section of the statement of cash flows.

Exercise 14-4A ***Use the direct method to determine cash flows from operating activities*** **LO 2**

The following accounts and corresponding balances were drawn from Widjaja Company's 2012 and 2011 year-end balance sheets.

Account Title	2012	2011
Unearned revenue	$6,500	$5,000
Prepaid rent	1,800	2,400

During the year, $68,000 of unearned revenue was recognized as having been earned. Rent expense for 2012 was $15,000.

Required

Based on this information alone, prepare the operating activities section of the statement of cash flows assuming the direct approach is used.

Exercise 14-5A ***Use the direct method to determine cash flows from operating activities*** **LO 2**

The following accounts and corresponding balances were drawn from Berry Company's 2012 and 2011 year-end balance sheets.

Account Title	2012	2011
Accounts receivable	$46,000	$42,000
Interest receivable	5,000	6,000
Other operating expenses payable	27,000	22,000
Salaries payable	12,000	15,000

The 2012 income statement is shown below:

Income Statement	
Sales	$680,000
Salary expense	(172,000)
Other operating expenses	(270,000)
Operating income	238,000
Nonoperating items: Interest revenue	24,000
Net income	$262,000

Required

a. Use the direct method to compute the amount of cash inflows from operating activities.

b. Use the direct method to compute the amount of cash outflows from operating activities.

Exercise 14-6A ***Direct versus indirect method of determining cash flows from operating activities*** **LO 1, 2**

Master Mechanics, Inc. (MMI), recognized $1,200 of sales revenue on account and collected $1,100 of cash from accounts receivable. Further, MMI recognized $700 of operating expenses on account and paid $500 cash as partial settlement of operating expenses payable.

Required

Based on this information alone:

a. Prepare the operating activities section of the statement of cash flows under the direct method.

b. Prepare the operating activities section of the statement of cash flows under the indirect method.

LO 1, 2

Exercise 14-7A ***The direct versus the indirect method of determining cash flows from operating activities***

The following accounts and corresponding balances were drawn from Larry Company's 2012 and 2011 year-end balance sheets.

Account Title	2012	2011
Accounts receivable	$78,000	$75,000
Prepaid rent	800	900
Utilities payable	1,500	1,200
Other operating expenses payable	34,000	33,000

The 2012 income statement is shown below:

Income Statement	
Sales	$272,000
Rent expense	(24,000)
Utilities expense	(36,400)
Other operating expenses	(168,000)
Net Income	$ 43,600

Required

a. Prepare the operating activities section of the statement of cash flows using the direct method.

b. Prepare the operating activities section of the statement of cash flows using the indirect method.

LO 3

Exercise 14-8A ***Determining cash flow from investing activities***

On January 1, 2011, Webber Company had a balance of $278,000 in its Land account. During 2011, Webber sold land that had cost $94,000 for $120,000 cash. The balance in the Land account on December 31, 2011, was $300,000.

Required

a. Determine the cash outflow for the purchase of land during 2011.

b. Prepare the investing activities section of the 2011 statement of cash flows.

LO 3

Exercise 14-9A ***Determining cash flows from investing activities***

On January 1, 2011, Duncan Company had a balance of $59,600 in its Delivery Equipment account. During 2011, Duncan purchased delivery equipment that cost $18,500. The balance in the Delivery Equipment account on December 31, 2011, was $60,000. The 2011 income statement reported a gain from the sale of equipment for $3,000. On the date of sale, accumulated depreciation on the equipment sold amounted to $10,000.

Required

a. Determine the cost of the equipment that was sold during 2011.

b. Determine the amount of cash flow from the sale of delivery equipment that should be shown in the investing activities section of the 2011 statement of cash flows.

LO 3

Exercise 14-10A ***Determining cash flows from investing activities***

The following accounts and corresponding balances were drawn from Winston Company's 2012 and 2011 year-end balance sheets.

Account Title	2012	2011
Investment securities	$102,000	$112,000
Machinery	520,000	425,000
Land	140,000	90,000

Other information drawn from the accounting records:

1. Winston incurred a $2,000 loss on the sale of investment securities during 2012.
2. Old machinery with a book value of $5,000 (cost of $25,000 minus accumulated depreciation of $20,000) was sold. The income statement showed a gain on the sale of machinery of $4,000.
3. Winston did not sell land during the year.

Required

a. Compute the amount of cash flow associated with the sale of investment securities.
b. Compute the amount of cash flow associated with the purchase of machinery.
c. Compute the amount of cash flow associated with the sale of machinery.
d. Compute the amount of cash flow associated with the purchase of land.
e. Prepare the investing activities section of the statement of cash flows.

Exercise 14-11A *Determining cash flows from financing activities* LO 4

On January 1, 2011, BGA Company had a balance of $500,000 in its Bonds Payable account. During 2011, BGA issued bonds with a $150,000 face value. There was no premium or discount associated with the bond issue. The balance in the Bonds Payable account on December 31, 2011, was $300,000.

Required

a. Determine the cash outflow for the repayment of bond liabilities assuming that the bonds were retired at face value.
b. Prepare the financing activities section of the 2011 statement of cash flows.

Exercise 14-12A *Determining cash flows from financing activities* LO 4

On January 1, 2011, Parker Company had a balance of $120,000 in its Common Stock account. During 2011, Parker paid $18,000 to purchase treasury stock. Treasury stock is accounted for using the cost method. The balance in the Common Stock account on December 31, 2011, was $130,000. Assume that the common stock is no par stock.

Required

a. Determine the cash inflow from the issue of common stock.
b. Prepare the financing activities section of the 2011 statement of cash flows.

Exercise 14-13A *Determining cash flows from financing activities* LO 4

The following accounts and corresponding balances were drawn from Berry Company's 2012 and 2011 year-end balance sheets.

Account Title	2012	2011
Bonds payable	$210,000	$300,000
Common stock	370,000	275,000

Other information drawn from the accounting records:

1. Dividends paid during the period amounted to $30,000.
2. There were no bond liabilities issued during the period.

Required

a. Compute the amount of cash flow associated with the repayment of bond liabilities.
b. Compute the amount of cash flow associated with the issue of common stock.
c. Prepare the financing activities section of the statement of cash flows.

PROBLEMS—SERIES A

connect ACCOUNTING

All applicable Problems in Series A are available with McGraw-Hill's *Connect Accounting.*

LO 1, 2

Problem 14-14A *The direct versus the indirect method to determine cash flow from operating activities*

eXcel

CHECK FIGURE
Net cash flow from operating activities: $28,700

Top Brands, Inc. (TBI), presents its statement of cash flows using the indirect method. The following accounts and corresponding balances were drawn from TBI's 2012 and 2011 year-end balance sheets.

Account Title	2012	2011
Accounts receivable	$24,000	$26,000
Merchandise inventory	56,000	52,000
Prepaid insurance	19,000	24,000
Accounts payable	23,000	20,000
Salaries payable	4,600	4,200
Unearned service revenue	1,000	2,700

The 2012 income statement is shown below:

Income Statement	
Sales	$ 603,000
Cost of goods sold	(383,000)
Gross margin	220,000
Service revenue	4,000
Insurance expense	(40,000)
Salaries expense	(160,000)
Depreciation expense	(6,000)
Operating income	18,000
Gain on sale of equipment	3,000
Net income	$ 21,000

Required

a. Prepare the operating activities section of the statement of cash flows using the direct method.

b. Prepare the operating activities section of the statement of cash flows using the indirect method.

LO 3

Problem 14-15A *Determining cash flows from investing activities*

eXcel

CHECK FIGURES
b. $5,000
c. $35,000

The following information was drawn from the year-end balance sheets of Desoto Company:

Account Title	2012	2011
Investment securities	$ 33,500	$ 30,000
Equipment	235,000	220,000
Buildings	845,000	962,000
Land	80,000	69,000

Additional information regarding transactions occurring during 2012:

1. Investment securities that had cost $5,600 were sold. The 2012 income statement contained a loss on the sale of investment securities of $600.
2. Equipment with a cost of $50,000 was purchased.

3. The income statement showed a gain on the sale of equipment of $6,000. On the date of sale, accumulated depreciation on the equipment sold amounted to $8,000.
4. A building that had originally cost $158,000 was demolished.
5. Land that had cost $25,000 was sold for $22,000.

Required

a. Determine the amount of cash flow for the purchase of investment securities during 2012.
b. Determine the amount of cash flow from the sale of investment securities during 2012.
c. Determine the cost of the equipment that was sold during 2012.
d. Determine the amount of cash flow from the sale of equipment during 2012.
e. Determine the amount of cash flow for the purchase of buildings during 2012.
f. Determine the amount of cash flow for the purchase of land during 2012.
g. Prepare the investing activities section of the 2012 statement of cash flows.

Problem 14-16A *Determining cash flows from financing activities*

LO 4

The following information was drawn from the year-end balance sheets of Pet Doors, Inc.:

CHECK FIGURES

c. $15,000

e. Net cash flow from financing activities: ($74,000) outflow

Account Title	2012	2011
Bonds payable	$800,000	$900,000
Common stock	197,000	140,000
Treasury stock	25,000	10,000
Retained earnings	80,000	69,000

Additional information regarding transactions occurring during 2012:

1. Pet Doors, Inc., issued $50,000 of bonds during 2012. The bonds were issued at face value. All bonds retired were retired at face value.
2. Common stock did not have a par value.
3. Pet Doors, Inc., uses the cost method to account for treasury stock.
4. The amount of net income shown on the 2012 income statement was $27,000.

Required

a. Determine the amount of cash flow for the retirement of bonds that should appear on the 2012 statement of cash flows.
b. Determine the amount of cash flow from the issue of common stock that should appear on the 2012 statement of cash flows.
c. Determine the amount of cash flow for the purchase of treasury stock that should appear on the 2012 statement of cash flows.
d. Determine the amount of cash flow for the payment of dividends that should appear on the 2012 statement of cash flows.
e. Prepare the financing activities section of the 2012 statement of cash flows.

Problem 14-17A *Preparing a statement of cash flows*

LO 1, 3, 4

The following information can be obtained by examining a company's balance sheet and income statement information.

a. Decreases in noncash current asset account balances.
b. Cash outflows to repay long-term debt.
c. Increases in noncash current asset account balances.
d. Cash outflows made to purchase long-term assets.
e. Decreases in current liability account balances.
f. Noncash expenses (depreciation).
g. Cash outflows to purchase treasury stock.
h. Gains recognized on the sale of long-term assets.

i. Cash outflows to pay dividends.
j. Cash inflows from the issue of common stock.
k. Cash inflows from the sale of long-term assets.
l. Increases in current liability account balances.
m. Cash inflows from the issue of long-term debt.
n. Losses incurred from the sale of long-term assets.

Required

Construct a table like the one shown below. For each item, indicate whether it would be used in the computation of net cash flows from operating, investing, or financing activities. Also, indicate whether the item would be added or subtracted when determining the net cash flow from operating, investing, or financing activities. Assume the indirect method is used to prepare the operating activities section of the statement of cash flows. The first item has been completed as an example.

Item	Type of Activity	Add or Subtract
a.	Operating	Add
b.		
c.		
d.		
e.		
f.		
g.		
h.		
i.		
j.		
k.		
l.		
m.		
n.		

LO 1, 3, 4

CHECK FIGURES
Net Cash Flow from Operating Activities: $18,750
Net Increase in Cash: $21,400

Problem 14-18A ***Using financial statements to prepare a statements of cash flows—Indirect method***

The comparative balance sheets and income statements for Pacific Company follow.

Balance Sheets As of December 31	2012	2011
Assets		
Cash	$24,200	$ 2,800
Accounts receivable	2,000	1,200
Inventory	6,400	6,000
Equipment	19,000	42,000
Accumulated depreciation—equipment	(9,000)	(17,400)
Land	18,400	10,400
Total assets	$61,000	$45,000
Liabilities and equity		
Accounts payable (inventory)	$ 2,600	$ 4,200
Long-term debt	2,800	6,400
Common stock	22,000	10,000
Retained earnings	33,600	24,400
Total liabilities and equity	$61,000	$45,000

Income Statement For the Year Ended December 31, 2012	
Sales revenue	$35,700
Cost of goods sold	(14,150)
Gross margin	21,550
Depreciation expense	(3,600)
Operating income	17,950
Gain on sale of equipment	500
Loss on disposal of land	(50)
Net income	$18,400

Additional Data

1. During 2012, the company sold equipment for $18,500; it had originally cost $30,000. Accumulated depreciation on this equipment was $12,000 at the time of the sale. Also, the company purchased equipment for $7,000 cash.
2. The company sold land that had cost $4,000. This land was sold for $3,950, resulting in the recognition of a $50 loss. Also, common stock was issued in exchange for title to land that was valued at $12,000 at the time of exchange.
3. Paid dividends of $9,200.

Required

Prepare a statement of cash flows using the indirect method.

Problem 14-19A *Using financial statements to prepare a statement of cash flows—Indirect method*

LO 1, 3, 4

eXcel

The comparative balance sheets and an income statement for Redwood Corporation follow.

CHECK FIGURES

Net cash flow from operating activities: $170,200

Net increase in cash: $28,200

Balance Sheets As of December 31	2012	2011
Assets		
Cash	$ 68,800	$ 40,600
Accounts receivable	30,000	22,000
Merchandise inventory	160,000	176,000
Prepaid rent	2,400	4,800
Equipment	256,000	288,000
Accumulated depreciation	(146,800)	(236,000)
Land	192,000	80,000
Total assets	$562,400	$375,400
Liabilities		
Accounts payable (inventory)	$ 67,000	$ 76,000
Salaries payable	28,000	24,000
Stockholders' equity		
Common stock, $25 par value	250,000	200,000
Retained earnings	217,400	75,400
Total liabilities and stockholders' equity	$562,400	$375,400

Income Statement For the Year Ended December 31, 2012	
Sales	$1,500,000
Cost of goods sold	(797,200)
Gross profit	702,800
Operating expenses	
Depreciation expense	(22,800)
Rent expense	(24,000)
Salaries expense	(256,000)
Other operating expenses	(258,000)
Net income	$ 142,000

Other Information

1. Purchased land for $112,000.
2. Purchased new equipment for $100,000.
3. Sold old equipment that cost $132,000 with accumulated depreciation of $112,000 for $20,000 cash.
4. Issued common stock for $50,000.

Required

Prepare the statement of cash flows for 2012 using the indirect method.

LO 2, 3, 4

Problem 14-20A *Using transaction data to prepare a statement of cash flows—Direct method*

CHECK FIGURE
Net Cash Flow from Operating Activities: $(110,775)

Store Company engaged in the following transactions during the 2011 accounting period. The beginning cash balance was $28,600 and ending cash balance was $6,025.

1. Sales on account were $250,000. The beginning Accounts Receivable balance was $87,000 and the ending balance was $83,000.
2. Salaries expense for the period was $56,000. The beginning Salaries Payable balance was $3,500 and the ending balance was $2,000.
3. Other operating expenses for the period were $125,000. The beginning Other Operating Expenses Payable balance was $4,500 and the ending balance was $8,500.
4. Recorded $19,500 of depreciation expense. The beginning and ending balances in the Accumulated Depreciation account were $14,000 and $33,500, respectively.
5. The Equipment account had beginning and ending balances of $210,000 and $240,000 respectively. There were no sales of equipment during the period.
6. The beginning and ending balances in the Notes Payable account were $50,000 and $150,000, respectively. There were no payoffs of notes during the period.
7. There was $6,000 of interest expense reported on the income statement. The beginning and ending balances in the Interest Payable account were $1,500 and $1,000, respectively.
8. The beginning and ending Merchandise Inventory account balances were $90,000 and $108,000, respectively. The company sold merchandise with a cost of $156,000 (cost of goods sold for the period was $156,000). The beginning and ending balances of Accounts Payable were $9,500 and $11,500, respectively.
9. The beginning and ending balances of Notes Receivable were $5,000 and $10,000, respectively. Notes receivable result from long-term loans made to employees. There were no collections from employees during the period.
10. The beginning and ending balances of the Common Stock account were $100,000 and $120,000, respectively. The increase was caused by the issue of common stock for cash.
11. Land had beginning and ending balances of $50,000 and $41,000, respectively. Land that cost $9,000 was sold for $12,200, resulting in a gain of $3,200.

12. The tax expense for the period was $7,700. The Taxes Payable account had a $950 beginning balance and an $875 ending balance.
13. The Investments account had beginning and ending balances of $25,000 and $29,000, respectively. The company purchased investments for $18,000 cash during the period, and investments that cost $14,000 were sold for $9,000, resulting in a $5,000 loss.

Required

a. Determine the amount of cash flow for each item and indicate whether the item should appear in the operating, investing, or financing activities section of a statement of cash flows. If an item does not affect the cash flow statement, make a statement indicating that the cash flow statement will not be affected. Assume Store Company uses the direct method for showing net cash flow from operating activities.
b. Prepare a statement of cash flows based on the information you developed in Requirement *a.*

Problem 14-21A *Using financial statements to prepare a statement of cash flows—Direct method*

LO 2, 3, 4

The following financial statements were drawn from the records of Raceway Sports:

CHECK FIGURES

Net Cash Flow from Operating Activities: $86,800

Net Increase in Cash: $95,400

Balance Sheets
As of December 31

	2012	2011
Assets		
Cash	$123,600	$ 28,200
Accounts receivable	57,000	66,000
Inventory	126,000	114,000
Notes receivable (long-term)	0	30,000
Equipment	147,000	255,000
Accumulated depreciation-equipment	(74,740)	(141,000)
Land	82,500	52,500
Total assets	$461,360	$404,700
Liabilities and equity		
Accounts payable (inventory)	$ 42,000	$ 48,600
Salaries payable	30,000	24,000
Utilities payable	600	1,200
Interest payable	0	1,800
Notes payable (long-term)	0	60,000
Common stock	300,000	240,000
Retained earnings	88,760	29,100
Total liabilities and equity	$461,360	$404,700

Income Statement
For the Year Ended December 31, 2012

Sales revenue	$580,000
Cost of goods sold	(288,000)
Gross margin	292,000
Operating expenses	
Salary expense	(184,000)
Depreciation expense	(17,740)
Utilities expense	(12,200)
Operating income	78,060
Nonoperating items	
Interest expense	(3,000)
Loss on the sale of equipment	(1,800)
Net income	$ 73,260

Additional Information

1. Sold equipment costing $108,000 with accumulated depreciation of $84,000 for $22,200 cash.
2. Paid a $13,600 cash dividend to owners.

Required

Analyze the data and prepare a statement of cash flows using the direct method.

EXERCISES—SERIES B

LO 1

Exercise 14-1B *Use the indirect method to determine cash flows from operating activities*

An accountant for Farve Enterprise Companies (FEC) computed the following information by making comparisons between FEC's 2012 and 2011 balance sheets. Further information was determined by examining the company's 2012 income statement.

1. The amount of cash dividends paid to the stockholders.
2. The amount of an increase in the balance of an Unearned Revenue account.
3. The amount of a decrease in the balance of an Inventory account.
4. The amount of a decrease in the balance of a Land account.
5. The amount of an increase in the balance of a Prepaid Rent account.
6. The amount of an increase in the balance of a Treasury Stock account.
7. The amount of a decrease in the balance of the Accounts Receivable account.
8. The amount of a gain arising from the sale of land.
9. The amount of an increase in the balance of the Salaries Payable account.
10. The amount of an increase in the balance of the Bonds Payable account.
11. The amount of depreciation expense shown on the income statement.

Required

For each item described above, indicate whether the amount should be added to or subtracted from the amount of net income when determining the amount of net cash flow from operating activities using the indirect method. If an item does not affect net cash flow from operating activities, identify it as being not affected.

LO 1

Exercise 14-2B *Use the indirect method to determine cash flows from operating activities*

Haughton Incorporated presents its statement of cash flows using the indirect method. The following accounts and corresponding balances were drawn from the company's 2012 and 2011 year-end balance sheets:

Account Title	2012	2011
Accounts receivable	$26,200	$21,400
Accounts payable	9,700	9,300

The 2012 income statement showed net income of $36,300.

Required

a. Prepare the operating activities section of the statement of cash flows.
b. Explain why the change in the balance in accounts receivable was added to or subtracted from the amount of net income when you completed Requirement *a.*
c. Explain why the change in the balance in accounts payable was added to or subtracted from the amount of net income when you completed Requirement *a.*

Exercise 14-3B *Use the indirect method to determine cash flows from operating activities* LO 1

Hong Company presents its statement of cash flows using the indirect method. The following accounts and corresponding balances were drawn from Hong's 2012 and 2011 year-end balance sheets:

Account Title	2012	2011
Accounts receivable	$46,000	$38,000
Prepaid rent	2,400	2,800
Interest receivable	900	1,000
Accounts payable	10,500	9,000
Salaries payable	4,200	4,800
Unearned revenue	5,000	4,500

The income statement contained a $500 loss on the sale of equipment, a $700 gain on the sale of land, and $3,200 of depreciation expense. Net income for the period was $47,000.

Required

Prepare the operating activities section of the statement of cash flows.

Exercise 14-4B *Use the direct method to determine cash flows from operating activities* LO 2

The following accounts and corresponding balances were drawn from Pizzazz Company's 2012 and 2011 year-end balance sheets:

Account Title	2012	2011
Unearned revenue	$5,000	$6,500
Prepaid rent	2,400	1,800

During the year, $72,000 of unearned revenue was recognized as having been earned. Rent expense for 2012 was $20,000.

Required

Based on this information alone, prepare the operating activities section of the statement of cash flows assuming the direct approach is used.

Exercise 14-5B *Use the direct method to determine cash flows from operating activities* LO 2

The following accounts and corresponding balances were drawn from Hughes Company's 2012 and 2011 year-end balance sheets:

Account Title	2012	2011
Accounts receivable	$56,000	$41,000
Interest receivable	6,000	5,000
Other operating expenses payable	22,000	28,000
Salaries payable	15,000	13,000

The 2012 income statement is shown below:

Income Statement	
Sales	$725,000
Salary expense	(180,000)
Other operating expenses	(310,000)
Operating income	235,000
Nonoperating items: Interest revenue	18,000
Net income	$253,000

Required

a. Use the direct method to compute the amount of cash inflows from operating activities.

b. Use the direct method to compute the amount of cash outflows from operating activities.

LO 1, 2

Exercise 14-6B *Direct versus indirect method of determining cash flows from operating activities*

Security Services, Inc. (SSI), recognized $2,400 of sales revenue on account and collected $1,900 of cash from accounts receivable. Further, SSI recognized $900 of operating expenses on account and paid $400 cash as partial settlement of accounts payable.

Required

Based on this information alone:

a. Prepare the operating activities section of the statement of cash flows under the direct method.

b. Prepare the operating activities section of the statement of cash flows under the indirect method.

LO 1, 2

Exercise 14-7B *The direct versus the indirect method of determining cash flows from operating activities*

The following accounts and corresponding balances were drawn from Littlejohn Company's 2012 and 2011 year-end balance sheets:

Account Title	2012	2011
Accounts receivable	$89,000	$92,000
Prepaid rent	1,100	1,500
Utilities payable	2,100	2,600
Other operating expenses payable	42,000	49,000

The 2012 income statement is shown below:

Income Statement	
Sales	$312,000
Rent expense	(36,000)
Utilities expense	(41,900)
Other operating expenses	(189,000)
Net income	$ 45,100

Required

a. Prepare the operating activities section of the statement of cash flows using the direct method.

b. Prepare the operating activities section of the statement of cash flows using the indirect method.

LO 3

Exercise 14-8B *Determining cash flow from investing activities*

On January 1, 2011, Oswalt Company had a balance of $156,000 in its Land account. During 2011, Oswalt sold land that had cost $66,000 for $98,000 cash. The balance in the Land account on December 31, 2011, was $220,000.

Required

a. Determine the cash outflow for the purchase of land during 2011.

b. Prepare the investing activities section of the 2011 statement of cash flows.

Exercise 14-9B *Determining cash flow from investing activities* LO 3

On January 1, 2011, Artex Company had a balance of $65,600 in its Office Equipment account. During 2011, Artex purchased office equipment that cost $21,600. The balance in the Office Equipment account on December 31, 2011, was $65,000. The 2011 income statement contained a gain from the sale of equipment for $5,000. On the date of sale, accumulated depreciation on the equipment sold amounted to $8,300.

Required

a. Determine the cost of the equipment that was sold during 2011.

b. Determine the amount of cash flow from the sale of office equipment that should be shown in the investing activities section of the 2011 statement of cash flows.

Exercise 14-10B *Determining cash flows from investing activities* LO 3

The following accounts and corresponding balances were drawn from Callon Company's 2012 and 2011 year-end balance sheets:

Account Title	2012	2011
Investment securities	$ 98,000	$106,000
Machinery	565,000	520,000
Land	90,000	140,000

Other information drawn from the accounting records:

1. Callon incurred a $4,000 loss on the sale of investment securities during 2012.
2. Old machinery with a book value of $7,000 (cost of $32,000 minus accumulated depreciation of $25,000) was sold. The income statement showed a gain on the sale of machinery of $5,500.
3. Callon incurred a loss of $2,500 on the sale of land in 2012.

Required

a. Compute the amount of cash flow associated with the sale of investment securities.

b. Compute the amount of cash flow associated with the purchase of machinery.

c. Compute the amount of cash flow associated with the sale of machinery.

d. Compute the amount of cash flow associated with the sale of land.

e. Prepare the investing activities section of the statement of cash flows.

Exercise 14-11B *Determining cash flows from financing activities* LO 4

On January 1, 2011, MMC Company had a balance of $700,000 in its Bonds Payable account. During 2011, MMC issued bonds with a $200,000 face value. There was no premium or discount associated with the bond issue. The balance in the Bonds Payable account on December 31, 2011, was $400,000.

Required

a. Determine the cash outflow for the repayment of bond liabilities assuming that the bonds were retired at face value.

b. Prepare the financing activities section of the 2011 statement of cash flows.

Exercise 14-12B *Determining cash flows from financing activities* LO 4

On January 1, 2011, Graves Company had a balance of $200,000 in its Common Stock account. During 2011, Graves paid $15,000 to purchase treasury stock. Treasury stock is accounted for using the cost method. The balance in the Common Stock account on December 31, 2011, was $240,000. Assume that the common stock is no par stock.

Required

a. Determine the cash inflow from the issue of common stock.

b. Prepare the financing activities section of the 2011 statement of cash flows.

LO 4

Exercise 14-13B *Determining cash flows from financing activities*

The following accounts and corresponding balances were drawn from Poole Company's 2012 and 2011 year-end balance sheets:

Account Title	2012	2011
Bonds payable	$300,000	$210,000
Common stock	550,000	450,000

Other information drawn from the accounting records:

1. Dividends paid during the period amounted to $40,000.
2. There were no bond liabilities repaid during the period.

Required

a. Compute the amount of cash flow associated with the issue of bond liabilities.
b. Compute the amount of cash flow associated with the issue of common stock.
c. Prepare the financing activities section of the statement of cash flows.

PROBLEMS—SERIES B

LO 1, 2

Problem 14-14B *The direct versus the indirect method to determine cash flows from operating activities*

The following accounts and corresponding balances were drawn from Bryan Sports, Inc.'s 2012 and 2011 year-end balance sheets:

Account Title	2012	2011
Accounts receivable	$36,000	$45,000
Merchandise inventory	65,000	62,000
Prepaid insurance	24,000	20,000
Accounts payable	20,000	25,000
Salaries payable	4,500	3,900
Unearned service revenue	9,500	8,600

The 2012 income statement is shown below:

Income Statement	
Sales	$651,500
Cost of goods sold	(402,000)
Gross margin	249,500
Service revenue	15,000
Insurance expense	(38,000)
Salaries expense	(175,000)
Depreciation expense	(8,000)
Operating income	43,500
Gain on sale of equipment	2,500
Net income	$ 46,000

Required

a. Prepare the operating activities section of the statement of cash flows using the direct method.
b. Prepare the operating activities section of the statement of cash flows using the indirect method.

Problem 14-15B *Determining cash flows from investing activities* LO 3

The following information was drawn from the year-end balance sheets of Madison Company:

Account Title	2012	2011
Investment securities	$ 46,500	$ 50,000
Equipment	275,000	260,000
Buildings	950,000	920,000
Land	110,000	90,000

Additional information regarding transactions occurring during 2012:

1. Investment securities that had cost $7,800 were sold. The 2012 income statement contained a loss on the sale of investment securities of $1,200.
2. Equipment with a cost of $75,000 was purchased.
3. The income statement showed a gain on the sale of equipment of $10,000. On the date of sale, accumulated depreciation on the equipment sold amounted to $52,000.
4. A building that had originally cost $70,000 was demolished.
5. Land that had cost $15,000 was sold for $20,000.

Required

a. Determine the amount of cash flow for the purchase of investment securities during 2012.
b. Determine the amount of cash flow from the sale of investment securities during 2012.
c. Determine the cost of the equipment that was sold during 2012.
d. Determine the amount of cash flow from the sale of equipment during 2012.
e. Determine the amount of cash flow for the purchase of buildings during 2012.
f. Determine the amount of cash flow for the purchase of land during 2012.
g. Prepare the investing activities section of the 2012 statement of cash flows.

Problem 14-16B *Determining cash flows from financing activities* LO 4

The following information was drawn from the year-end balance sheets of Sports Supply, Inc.:

Account Title	2012	2011
Bonds payable	$700,000	$800,000
Common stock	180,000	140,000
Treasury stock	40,000	25,000
Retained earnings	96,000	80,000

Additional information regarding transactions occurring during 2012:

1. Sports Supply, Inc., issued $70,000 of bonds during 2012. The bonds were issued at face value. All bonds retired were retired at face value.
2. Common stock did not have a par value.
3. Sports Supply, Inc., uses the cost method to account for treasury stock. Sports Supply, Inc., did not resell any treasury stock in 2012.
4. The amount of net income shown on the 2012 income statement was $36,000.

Required

a. Determine the amount of cash flow for the retirement of bonds that should appear on the 2012 statement of cash flows.
b. Determine the amount of cash flow from the issue of common stock that should appear on the 2012 statement of cash flows.

c. Determine the amount of cash flow for the purchase of treasury stock that should appear on the 2012 statement of cash flows.

d. Determine the amount of cash flow for the payment of dividends that should appear on the 2012 statement of cash flows.

e. Prepare the financing activities section of the 2012 statement of cash flows.

LO 1, 3, 4

Problem 14-17B *Preparing a statement of cash flows*

The following information can be obtained by examining a company's balance sheet and income statement information.

a. Gains recognized on the sale of noncurrent assets.
b. Cash outflows to pay dividends.
c. Cash inflows from the issue of common stock.
d. Cash inflows from the sale of noncurrent assets.
e. Increases in current liability account balances.
f. Cash inflows from the issue of noncurrent debt.
g. Losses incurred from the sale of noncurrent assets.
h. Decreases in noncash current asset account balances.
i. Cash outflows to repay noncurrent debt.
j. Increases in noncash current asset account balances.
k. Cash outflows made to purchase noncurrent assets.
l. Decreases in current liability account balances.
m. Noncash expenses (e.g., depreciation).
n. Cash outflows to purchase treasury stock.

Required

Construct a table like the one shown below. For each item, indicate whether it would be used in the computation of net cash flows from operating, investing, or financing activities. Also, indicate whether the item would be added or subtracted when determining the net cash flow from operating, investing, or financing activities. Assume the indirect method is used to prepare the operating activities section of the statement of cash flows. The first item has been completed as an example.

Item	Type of Activity	Add or Subtract
a.	Operating	Subtract
b.		
c.		
d.		
e.		
f.		
g.		
h.		
i.		
j.		
k.		
l.		
m.		
n.		

Problem 14-18B ***Using financial statements to prepare a statement of cash flows—Indirect method*** **LO 1, 3, 4**

The following financial statements were drawn from the records of Healthy Products Co.

Balance Sheets As of December 31	2012	2011
Assets		
Cash	$16,120	$ 1,940
Accounts receivable	2,400	2,000
Inventory	2,000	2,600
Equipment	13,700	17,100
Accumulated depreciation—equipment	(11,300)	(12,950)
Land	13,000	8,000
Total assets	$35,920	$18,690
Liabilities and stockholders' equity		
Accounts payable (inventory)	$ 3,600	$ 2,400
Long-term debt	3,200	4,000
Common stock	17,000	10,000
Retained earnings	12,120	2,290
Total liabilities and stockholders' equity	$35,920	$18,690

Income Statement For the Year Ended December 31, 2012	
Sales revenue	$17,480
Cost of goods sold	(6,200)
Gross margin	11,280
Depreciation expense	(1,750)
Operating income	9,530
Gain on sale of equipment	1,800
Loss on disposal of land	(600)
Net income	$10,730

Additional Data

1. During 2012, the company sold equipment for $6,800; it had originally cost $8,400. Accumulated depreciation on this equipment was $3,400 at the time of the sale. Also, the company purchased equipment for $5,000 cash.
2. The company sold land that had cost $2,000. This land was sold for $1,400, resulting in the recognition of a $600 loss. Also, common stock was issued in exchange for title to land that was valued at $7,000 at the time of exchange.
3. Paid dividends of $900.

Required

Prepare a statement of cash flows using the indirect method.

Problem 14-19B ***Using financial statements to prepare a statement of cash flows—Indirect method*** **LO 1, 3, 4**

The comparative balance sheets and an income statement for Lind Beauty Products, Inc., are shown on the next page.

Balance Sheets
As of December 31

	2012	2011
Assets		
Cash	$ 6,300	$ 48,400
Accounts receivable	10,200	7,260
Merchandise inventory	45,200	56,000
Prepaid rent	700	2,140
Equipment	140,000	144,000
Accumulated depreciation	(73,400)	(118,000)
Land	116,000	50,000
Total assets	$245,000	$189,800
Liabilities and equity		
Accounts payable (inventory)	$ 37,200	$ 40,000
Salaries payable	12,200	10,600
Stockholders' equity		
Common stock, $50 par value	150,000	120,000
Retained earnings	45,600	19,200
Total liabilities and equity	$245,000	$189,800

Income Statement
For the Year Ended December 31, 2012

Sales	$480,000
Cost of goods sold	(264,000)
Gross profit	216,000
Operating expenses	
Depreciation expense	(11,400)
Rent expense	(7,000)
Salaries expense	(95,200)
Other operating expenses	(76,000)
Net income	$ 26,400

Other Information

1. Purchased land for $66,000.
2. Purchased new equipment for $62,000.
3. Sold old equipment that cost $66,000 with accumulated depreciation of $56,000 for $10,000 cash.
4. Issued common stock for $30,000.

Required

Prepare the statement of cash flows for 2012 using the indirect method.

LO 2, 3, 4

Problem 14-20B *Using transaction data to prepare a statement of cash flows—Direct method*

Greenstein Company engaged in the following transactions during 2012. The beginning cash balance was $86,000 and ending cash balance was $123,100.

1. Sales on account were $548,000. The beginning Accounts Receivable balance was $128,000 and the ending balance was $90,000.
2. Salaries expense was $232,000. The beginning Salaries Payable balance was $16,000 and the ending balance was $8,000.
3. Other operating expenses were $236,000. The beginning Other Operating Expenses Payable balance was $16,000 and the ending balance was $10,000.
4. Recorded $30,000 of depreciation expense. The beginning and ending balances in the Accumulated Depreciation account were $12,000 and $42,000, respectively.

5. The Equipment account had beginning and ending balances of $44,000 and $56,000, respectively. There were no sales of equipment during the period.
6. The beginning and ending balances in the Notes Payable account were $44,000 and $36,000, respectively. There were no notes payable issued during the period.
7. There was $4,600 of interest expense reported on the income statement. The beginning and ending balances in the Interest Payable account were $8,400 and $7,500, respectively.
8. The beginning and ending Merchandise Inventory account balances were $22,000 and $29,400, respectively. The company sold merchandise with a cost of $83,600. The beginning and ending balances of Accounts Payable were $8,000 and $6,400, respectively.
9. The beginning and ending balances of Notes Receivable were $100,000 and $60,000, respectively. Notes receivable result from long-term loans made to creditors. There were no loans made to creditors during the period.
10. The beginning and ending balances of the Common Stock account were $120,000 and $160,000, respectively. The increase was caused by the issue of common stock for cash.
11. Land had beginning and ending balances of $24,000 and $14,000, respectively. Land that cost $10,000 was sold for $6,000, resulting in a loss of $4,000.
12. The tax expense for the period was $6,600. The Tax Payable account had a $2,400 beginning balance and a $2,200 ending balance.
13. The Investments account had beginning and ending balances of $20,000 and $60,000, respectively. The company purchased investments for $50,000 cash during the period, and investments that cost $10,000 were sold for $22,000, resulting in a $12,000 gain.

Required

a. Determine the amount of cash flow for each item and indicate whether the item should appear in the operating, investing, or financing activities section of a statement of cash flows. If an item does not affect the cash flow statement, make a statement indicating that the cash flow statement will not be affected. Assume Greenstein Company uses the direct method for showing net cash flow from operating activities.

b. Prepare a statement of cash flows based on the information you developed in Requirement *a.*

Problem 14-21B *Using financial statements to prepare a statement of cash flows—Direct method* LO 2, 3, 4

The following financial statements were drawn from the records of Norton Materials, Inc.

Balance Sheets
As of December 31

	2012	2011
Assets		
Cash	$ 94,300	$ 14,100
Accounts receivable	36,000	40,000
Inventory	72,000	64,000
Notes receivable (long-term)	0	16,000
Equipment	98,000	170,000
Accumulated depreciation—equipment	(47,800)	(94,000)
Land	46,000	30,000
Total assets	$298,500	$240,100
Liabilities and equity		
Accounts payable	$ 24,000	$ 26,400
Salaries payable	15,000	10,000
Utilities payable	800	1,400
Interest payable	0	1,000
Notes payable (long-term)	0	24,000
Common stock	150,000	110,000
Retained earnings	108,700	67,300
Total liabilities and equity	$298,500	$240,100

Income Statement For the Year Ended December 31, 2012	
Sales revenue	$300,000
Cost of goods sold	(144,000)
Gross margin	156,000
Operating expenses	
Salary expense	(88,000)
Depreciation expense	(9,800)
Utilities expense	(6,400)
Operating income	51,800
Nonoperating items	
Interest expense	(2,400)
Loss on sale of equipment	(800)
Net income	$ 48,600

Additional Information

1. Sold equipment costing $72,000 with accumulated depreciation of $56,000 for $15,200 cash.
2. Paid a $7,200 cash dividend to owners.

Required

Analyze the data and prepare a statement of cash flows using the direct method.

ANALYZE, THINK, COMMUNICATE

ATC 14-1 Real-World Case *Following the cash*

Vonage Holding Corporation provides telecommunication services using voice over Internet technology. It began operations in 2002 and has never made a profit. By the end of 2008 it had cumulative losses of $1 billion. Vonage's statements of cash flows for 2006, 2007, and 2008 follow.

VONAGE HOLDINGS CORP.
Statements of Cash Flows
(amounts in thousands)

	For the Years Ended		
	2008	2007	2006
Cash Flows from Operating Activities			
Net income (loss)	$ (64,576)	$(267,428)	$(338,573)
Depreciation and amortization and impairment charges	45,796	33,574	22,709
Amortization of intangibles	2,816	2,144	968
Loss on early extinguishment of notes	30,570	—	—
Beneficial conversion on interest in kind on convertible notes	108	42	32
Amortization of discount on debt	882	—	—
Accrued interest	3,014	846	4,002
Allowance for doubtful accounts	207	1,852	266
Allowance for obsolete inventory	1,519	2,799	1,441
Amortization of deferred financing costs	—	4,689	1,999
Amortization of debt-related costs	3,237	—	—

continued

	For the Years Ended		
	2008	2007	2006
Loss (gain) on disposal of fixed assets	12	283	320
Share-based expense	12,238	7,542	26,980
Other adjustments	—	—	(49)
Accounts receivable	2,028	(5,296)	(10,196)
Inventory	7,472	2,196	(10,133)
Prepaid expenses and other current assets	(282)	(6,185)	(6,218)
Deferred customer acquisition costs	13,322	(10,796)	(21,053)
Due from related parties	2	74	32
Other assets	(7,498)	(81)	(294)
Accounts payable	(22,029)	(2,966)	42,407
Accrued expenses	(12,738)	(77,770)	62,281
Deferred revenue	(10,124)	20,509	34,181
Other liability	(5,321)	23,046	—
Net cash flows from operating activities	655	(270,926)	(188,898)
Cash Flows from Investing Activities			
Capital expenditures	(11,386)	(20,386)	(45,336)
Purchase of intangible assets	(560)	(5,500)	(5,268)
Purchase of marketable securities	(21,375)	(236,875)	(639,707)
Maturities and sales of marketable securities	101,317	446,949	484,116
Acquisition and development of software assets	(26,530)	(21,346)	(4,060)
Decrease (increase) in restricted cash	(980)	(31,385)	(543)
Net cash flows from investing activities	40,486	131,457	(210,798)
Cash Flows from Financing Activities			
Principal payments on capital lease obligations	(1,036)	(1,020)	(826)
Principal payments on debt	(326)	—	—
Proceeds from issuance of debt	223,200	—	2,047
Discount on notes payable	(7,167)	—	—
Early extinguishment of notes	(253,460)	—	—
Debt-related costs	(26,799)	—	(283)
Proceeds from subscription receivable, net	9	279	169
Proceeds from common stock issuance, net	—	—	493,040
Purchase of treasury stock	—	—	(11,723)
Proceeds (payments) for directed-share program, net	62	169	(5,426)
Proceeds from exercise of stock options	47	817	431
Net cash flows from financing activities	(65,470)	245	477,429
Effect of exchange rate changes on cash	(1,079)	513	(29)
Net change in cash and cash equivalents	(25,408)	(138,711)	77,704
Cash and cash equivalents, beginning of period	71,542	210,253	132,549
Cash and cash equivalents, end of period	$ 46,134	$ 71,542	$ 210,253

Required

a. This chapter explained that many companies that report net losses on their earnings statements report positive cash flows from operating activities. How does Vonage's net income for each year compare to its cash flows from operating activities?

b. Based only on the information in the statements of cash flows, does Vonage appear to be improving its position in the telecommunications business? Explain.

c. In 2008 Vonage paid off over $250 million in debt. Where did it get the funds to repay this debt?

d. All things considered, based on the information in its statements of cash flows, did Vonage's cash position appear to be improving or deteriorating?

ATC 14-2 Group Assignment *Preparing a statement of cash flows*

The following financial statements and information are available for Blythe Industries Inc.

Balance Sheets
As of December 31

	2011	2012
Assets		
Cash	$120,600	$ 160,200
Accounts receivable	85,000	103,200
Inventory	171,800	186,400
Marketable securities (available for sale)	220,000	284,000
Equipment	490,000	650,000
Accumulated depreciation	(240,000)	(310,000)
Land	120,000	80,000
Total assets	$967,400	$1,153,800
Liabilities and equity		
Liabilities		
Accounts payable (inventory)	$ 66,200	$ 36,400
Notes payable—Long-term	250,000	230,000
Bonds payable	100,000	200,000
Total liabilities	416,200	466,400
Stockholders' equity		
Common stock, no par	200,000	240,000
Preferred stock, $50 par	100,000	110,000
Paid-in capital in excess of par—Preferred stock	26,800	34,400
Total paid-In capital	326,800	384,400
Retained earnings	264,400	333,000
Less: Treasury stock	(40,000)	(30,000)
Total stockholders' equity	551,200	687,400
Total liabilities and stockholders' equity	$967,400	$1,153,800

Income Statement
For the Year Ended December 31, 2012

Sales revenue		$1,050,000
Cost of goods sold		(766,500)
Gross profit		283,500
Operating expenses		
Supplies expense	$20,400	
Salaries expense	92,000	
Depreciation expense	90,000	
Total operating expenses		(202,400)
Operating income		81,100
Nonoperating items		
Interest expense		(16,000)
Gain from the sale of marketable securities		30,000
Gain from the sale of land and equipment		12,000
Net income		$ 107,100

Additional Information

1. Sold land that cost $40,000 for $44,000.
2. Sold equipment that cost $30,000 and had accumulated depreciation of $20,000 for $18,000.

3. Purchased new equipment for $190,000.
4. Sold marketable securities, classified as available-for-sale, that cost $40,000 for $70,000.
5. Purchased new marketable securities, classified as available-for-sale, for $104,000.
6. Paid $20,000 on the principal of the long-term note.
7. Paid off a $100,000 bond issue and issued new bonds for $200,000.
8. Sold 100 shares of treasury stock at its cost.
9. Issued some new common stock.
10. Issued some new $50 par preferred stock.
11. Paid dividends. (*Note:* The only transactions to affect retained earnings were net income and dividends.)

Required

Organize the class into three sections, and divide each section into groups of three to five students. Assign each section of groups an activity section of the statement of cash flows (operating activities, investing activities, or financing activities).

Group Task

Prepare your assigned portion of the statement of cash flows. Have a representative of your section put your activity section of the statement of cash flows on the board. As each section adds its information on the board, the full statement of cash flows will be presented.

Class Discussion

Have the class finish the statement of cash flows by computing the net change in cash. Also have the class answer the following questions:

a. What is the cost per share of the treasury stock?
b. What was the issue price per share of the preferred stock?
c. What was the book value of the equipment sold?

ATC 14-3 Business Applications Case *Identifying different presentation formats*

In *Statement of Financial Accounting Standards No. 95,* the Financial Accounting Standards Board (FASB) recommended but did not require that companies use the direct method. In Appendix B, Paragraphs 106–121, of the standard, the FASB discussed its reasons for this recommendation.

Required

Obtain a copy of *Standard No. 95* and read Appendix B Paragraphs 106–121. Write a brief response summarizing the issues that the FASB considered and its specific reaction to those issues. Your response should draw heavily on paragraphs 119–121.

ATC 14-4 Writing Assignment *Explaining discrepancies between cash flow and operating income*

The following selected information was drawn from the records of Fleming Company:

Assets	2011	2012
Accounts receivable	$ 400,000	$ 840,200
Merchandise inventory	720,000	1,480,000
Equipment	1,484,000	1,861,200
Accumulated depreciation	(312,000)	(402,400)

Fleming is experiencing cash flow problems. Despite the fact that it reported significant increases in operating income, operating activities produced a net cash outflow. Recent financial forecasts predict that Fleming will have insufficient cash to pay its current liabilities within three months.

Required

Write an explanation of Fleming's cash shortage. Include a recommendation to remedy the problem.

ATC 14-5 Ethical Dilemma *Would I lie to you, baby?*

Andy and Jean Crocket are involved in divorce proceedings. When discussing a property settlement, Andy told Jean that he should take over their investment in an apartment complex because she would be unable to absorb the loss that the apartments are generating. Jean was somewhat distrustful and asked Andy to support his contention. He produced the following income statement, which was supported by a CPA's unqualified opinion that the statement was prepared in accordance with generally accepted accounting principles.

CROCKET APARTMENTS
Income Statement
For the Year Ended December 31, 2011

Rent revenue		$580,000
Less: Expenses		
Depreciation expense	$280,000	
Interest expense	184,000	
Operating expense	88,000	
Management fees	56,000	
Total expenses		(608,000)
Net loss		$ (28,000)

All revenue is earned on account. Interest and operating expenses are incurred on account. Management fees are paid in cash. The following accounts and balances were drawn from the 2010 and 2011 year-end balance sheets.

Account Title	2010	2011
Rent receivable	$40,000	$44,000
Interest payable	12,000	18,000
Accounts payable (oper. exp.)	6,000	4,000

Jean is reluctant to give up the apartments but feels that she must do so because her present salary is only $40,000 per year. She says that if she takes the apartments, the $28,000 loss would absorb a significant portion of her salary, leaving her only $12,000 with which to support herself. She tells you that while the figures seem to support her husband's arguments, she believes that she is failing to see something. She knows that she and her husband collected a $20,000 distribution from the business on December 1, 2011. Also, $150,000 cash was paid in 2011 to reduce the principal balance on a mortgage that was taken out to finance the purchase of the apartments two years ago. Finally, $24,000 cash was paid during 2011 to purchase a computer system used in the business. She wonders, "If the apartments are losing money, where is my husband getting all the cash to make these payments?"

Required

a. Prepare a statement of cash flows for the 2011 accounting period.

b. Compare the cash flow statement prepared in Requirement *a* with the income statement and provide Jean Crocket with recommendations.

c. Comment on the value of an unqualified audit opinion when using financial statements for decision-making purposes.

ATC 14-6 Research Assignment *Analyzing cash flow information*

In 2008 **Time Warner, Inc.**, reported a net loss of $13.4 billion. This loss occurred predominantly because Time Warner took a charge for "asset impairments" of $24,309 million, ($24.3 billion). (These amounts do not include tax benefits.) Without these special charges, Time Warner's net income would have been a positive $10.9 billion. Using the company's 2008 Form 10-K, complete the requirements below. Be sure to use the Form 10-K for *Time Warner, Inc.,* not *Time Warner Cable, Inc.* The Form 10-K can be found on the company's website. It can also be obtained using the EDGAR system following the instructions in Appendix A.

Required

a. How much cash flow from operating activities did Time Warner generate?

b. Based on the statement of cash flows, how much cash did the company pay out as a result of the asset impairments?

c. How much cash did Time Warner spend on investing activities (net)?

d. How much cash did the company use the repay debt? Where did it get the cash to make these payments?