CHAPTER 14

The Statement of Cash Flows

KEY POINTS

The following key points are emphasized in this chapter:

- **The structure and format of the statement of cash flows.**
- **Cash flows from operating, investing, and financing activities.**
- **How the statement of cash flows complements the other financial statements and how it can be used by those interested in the financial condition of a company.**
- **Important investing and financing transactions that do not appear on the statement of cash flows and how they are reported.**
- **Economic consequences associated with the statement of cash flows.**
- **Preparing a statement of cash flows from the information contained in two balance sheets, an income statement, and a statement of shareholders' equity.**

MicroStrategy was a red-hot software company in the business-to-business Internet sector. Unlike many other Internet companies, MicroStrategy reported profits early and often. Then, the bottom fell out when news was released that MicroStrategy had been "cooking the books" by overstating revenues and profits. The stock price plunged and Zack's Research Report noted that, at the time, nine out of ten analysts had recently published "buy" or "strong buy" recommendations. Interestingly, well in advance of the stock price collapse, the company's cash flow from operations told a sobering story—negative $2.5 million instead of a profit of $9 million. Should the analysts have been looking at net cash from operations instead of net income? This chapter, which covers the statement of cash flows, answers that question, and discusses what cash flow is, how it should be used, and how earnings quality can be assessed by comparing net income to cash flow from operations.

Like U.S. GAAP, IFRS requires the presentation of a statement of cash flows, and the format of the statement is largely the same.

The statement of cash flows contains a summary of a company's transactions that involve the cash account over a period of time. It is designed to highlight the cash flows associated with three aspects of the company's economic activities: (1) operations, (2) investments, and (3) financing. The basic structure of the statement of cash flows is provided in Figure 14–1. The reported numbers were taken from the 2008 annual report of Southwest Airlines, currently one of the few companies in the airline industry generating consistent positive cash flows from operations.

FIGURE 14–1
Sample statement of cash flows

Southwest Airlines
Statement of Cash Flows
for the Year Ended December 31, 2008
(in millions)

	2008	2007	2006
Cash provided (used) by operating activities	$(1,521)	$2,845	$ 1,406
Cash provided (used) by investing activities	(978)	(1,529)	(1,495)
Cash provided (used) by financing activities	1,654	(493)	(801)
Increase (decrease) in cash	$ (845)	$ 823	$ (890)
Cash—beginning of year	2,213	1,390	2,280
Cash—end of year	$ 1,368	$2,213	$ 1,390

Recall that the statement of cash flows has already been presented and discussed. Chapter 1 introduced the statement and provided an example. Chapter 2 discussed the basic nature of the statement and related it to the income statement, balance sheet, and statement of shareholders' equity. Chapter 4 explained how a statement of cash flows can be prepared from the cash T-account, and Appendix 4A contained an exercise where a statement of cash flows was prepared from two balance sheets and an income statement. Chapter 5 described how it can be interpreted to assess solvency, and subsequent chapters covered the effects of a variety of transactions on the statement of cash flows. Thus, you have already been exposed to the fundamentals of the statement of cash flows. This chapter provides a more complete discussion of the nature of the statement, how it can be used, and how it is prepared.

The statement of cash flows was established as a standard of financial reporting in 1987 when the Financial Accounting Standards Board decided (in FASB *Statement No. 95, Statement of Cash Flows*) to modify the statement of changes in financial position, which had been required since 1971.

On its 2009 statement of cash flows, Starbucks Corporation reported net cash flows from operating activities of $1.4 billion. The same year, reported net income was only $391 million. Briefly explain how net cash flow from operating activities can be so much higher than net income.

THE DEFINITION OF CASH

Chapter 6 of this text defines cash for purposes of balance sheet disclosure and points out that it consists of coin, currency, and available funds on deposit at the bank. Negotiable instruments such as money orders, certified checks, cashier's checks, personal checks, and bank drafts are also considered cash. The total of these items as of the balance sheet date is the cash amount that appears on the balance sheet.

When preparing the statement of cash flows, companies commonly consider as cash the items already mentioned as well as certain **cash equivalents,** which include commercial paper and other debt investments with maturities of less than three months.[1] They do so because these items can be converted to cash immediately; for all intents and purposes, therefore, they are virtually the same as cash. In the remainder of this chapter, where we illustrate the statement of cash flows, we will also treat cash equivalents as cash.

Bristol-Myers Squibb considers securities with maturities of less than three months to be cash equivalents. Would such securities be included in the cash account and reported on the statement of cash flows or in the marketable securities account on the balance sheet? Why?

A GENERAL DESCRIPTION OF THE STATEMENT OF CASH FLOWS

Take a moment now and refer back to Chapter 2. It describes the statement of cash flows in terms of the other financial statements, explaining the change in the cash balance from one balance sheet date to the next. Figure 14–2 illustrates the statement of cash flows more completely. This statement is divided into three sections (operating activities, investing activities, and financing activities) and shows the cash inflow and outflow categories that normally comprise each section.

1. Commercial paper and short-term debt instruments were discussed in Chapter 10. Also, some corporations, like McDonnell Douglas, Eli Lilly, and Walt Disney, also include short-term investments, such as marketable securities, in the definition of cash for purposes of the statement of cash flows. Such a practice is acceptable under generally accepted accounting principles because marketable securities, by definition, are highly liquid.

FIGURE 14–2
Standard statement of cash flows

XYZ Corporation
Statement of Cash Flows
for the Year Ended December 31, 2011

Operating activities:		
Cash received from customers	$ 7,000	
Cash paid for operations (to suppliers, employees, and others)	(5,200)	
Cash provided (used) by other operating items	(870)	
Net cash provided (used) by operating activities		$ 930
Investing activities:		
Cash outflows for the purchase of noncurrent assets	$(3,000)	
Cash inflows from sale of noncurrent assets	400	
Net cash provided (used) by investing activities		(2,600)
Financing activities:		
Cash inflows from borrowings	$ 3,000	
Cash inflows from stock issuances	2,000	
Cash outflows for debt retirements	(1,460)	
Cash outflows for treasury stock purchases	(1,550)	
Cash outflows for dividend payments	(200)	
Net cash provided (used) by financing activities		1,790
Net increase (decrease) in cash and cash equivalents		$ 120
Cash and cash equivalents at the beginning of the year		100
Cash and cash equivalents at the end of the year		$ 220

Cash Provided (Used) by Operating Activities

Cash provided (used) by **operating activities** includes those cash inflows and outflows associated directly with the acquisition and sale of the company's inventories and services. This category includes the cash receipts from sales and accounts receivable as well as cash payments for the purchase of inventories, payments on accounts payable, selling and administrative activities, and interest and taxes. Under generally accepted accounting principles (both U.S. GAAP and IFRS), there are two acceptable ways to present the operating section of the statement of cash flows: the direct method and the indirect method.

THE DIRECT METHOD

The statement of cash flows illustrated in Figure 14–2 was prepared using the **direct method.** It is so called because the computation of cash provided (used) by operating activities ($930) consists of cash inflows and outflows that can be traced *directly* to the cash T-account. For example, the $7,000 collected from customers, the $5,200 paid for operations, and the $870 used for other operating items all represent aggregate totals of entries initially recorded in the journal and posted to the cash account in the ledger.

THE INDIRECT METHOD

Another method of computing and disclosing cash provided (used) by operating activities that is acceptable under GAAP is called the **indirect method.** Under this method, cash provided (used) by operating activities is computed *indirectly* by beginning with the net income figure, which appears on the income statement, and adjusting it for the

differences between cash flows and accruals. The indirect method of computing cash from operating activities is illustrated in Figure 14–3. An example of how to prepare the operating section of the statement of cash flows under the indirect method is contained in Appendix 4A.

FIGURE 14–3
Cash from operating activities: Indirect method

Operating activities:	
Net income	**$1,085**
Noncash charges to noncurrent accounts:	
Depreciation, amortization, and other noncash charges on noncurrent items	**$ 400**
Book losses	**50**
Book gains	**(450)**
Changes in current accounts other than cash:	
Net decreases (increases) in current assets	**105**
Net increases (decreases) in current liabilities	**(260)**
Net cash provided (used) by operating activities	**$ 930**

In general, items added back to net income in the computation of cash provided (used) by operating activities (e.g., depreciation, amortization, book losses, and decreases in current assets) decrease net income on the income statement but involve no cash outflows. Items subtracted from net income in this computation (e.g., book gains, decreases in current liabilities) increase net income on the income statement but involve no cash inflows. Note also that these adjustments are separated into two categories: (1) noncash charges to the noncurrent accounts and (2) changes in current accounts. The first category includes depreciation and amortization charges as well as book gains and losses recognized on the transfer of long-term assets and liabilities. The second category includes the changes during the period in the current asset and current liability accounts other than cash, marketable securities, and dividends payable.[2]

A depreciation charge of $538 million is included on the 2009 statement of cash flows for Biomet, a medical technology company. Does the company use the direct or indirect method of presenting the statement of cash flows? Why would an income statement expense like depreciation appear on the statement of cash flows?

THE FASB'S POSITION

Both the direct and the indirect methods result in the same dollar amount ($930) for cash provided (used) by operating activities; in that respect, they simply represent two different forms of presentation. In fact, when the FASB made the statement of cash flows a requirement, it allowed either the direct or the indirect method. If the direct method is chosen, however, the FASB requires that it be accompanied by a schedule of the adjustments that reconcile net income to cash provided (used) by operating activities. This schedule can appear either in the footnotes to the financial statements or on the face of the statement itself. Also, generally accepted accounting principles require that under either method cash amounts paid for taxes and interest must be separately disclosed.

2. Changes in marketable securities and dividends payable are reflected in the investing and financing sections, respectively.

Since the adjustments on this schedule are the same as those disclosed under the indirect method, the direct method (including the accompanying schedule) discloses more about the changes in the cash account than the indirect method. To encourage increased disclosure and what the FASB believes to be a more straightforward presentation, it has recommended that companies use the direct method. However, the vast majority of major U.S. companies choose not to follow this recommendation; they use the indirect method probably because it requires fewer disclosures.[3]

World Sources Online once reported that the principal advantage of the direct method is that it shows operating cash receipts and payments, while the principal advantage of the indirect method is that it focuses on the differences between net income and net cash from operations. Explain how each advantage could be useful to an analyst.

Cash Provided by Investing Activities

Cash provided (used) by **investing activities** includes the cash inflows and outflows associated with the purchase and sale of a company's noncurrent assets.[4] This section includes the cash effects from purchases and sales of long-term investments, long-lived assets, and intangible assets. The statement of cash flows in Figure 14–2, for example, shows that $3,000 was used to purchase such items, and $400 was collected from selling noncurrent assets. These cash inflows and outflows all can be traced to entries in the cash account in the company's ledger.

Cash Provided (Used) by Financing Activities

Cash provided (used) by **financing activities** includes cash inflows and outflows associated with a company's two sources of outside capital: liabilities and contributed capital. This category primarily includes the cash inflows associated with borrowings and equity issuances as well as the cash outflows related to debt repayments, treasury stock purchases, and dividend payments. The statement of cash flows in Figure 14–2 shows that the company borrowed $3,000, raised $2,000 by issuing stock, made principal payments on debt in the amount of $1,460, used $1,550 to purchase treasury stock, and paid cash dividends of $200. These cash flows also can be traced to the cash account in the company's ledger.

Note also that cash interest payments are not included in this section, even though they represent a cost of financing. Instead, such payments are included in the operating section of the statement of cash flows. This practice has been questioned because it confuses the distinction between financing and operating activities. Figure 14–4 provides an example of a recently published statement of cash flows prepared under the indirect form of presentation. It was taken from the April 25, 2009, annual report of La-Z-Boy, a well-known furniture manufacturer.

3. *Accounting Trends and Techniques* (2009) reports that, of the 500 major U.S. companies surveyed, only five used the direct form of presentation. The remaining 495 used the indirect form.

4. Investing activities can include the purchase and/or sale of securities listed as short-term, but sometimes these investments are included as cash equivalents, and in many cases they are not material.

FIGURE 14–4 La-Z-Boy statement of cash flows

La-Z-Boy Incorporated
Consolidated Statement of Cash Flows

(Amounts in thousands)	Fiscal Year Ended 4/25/2009	4/26/2008	4/28/2007
Cash flows from operating activities			
Net income (loss)	$(121,347)	$(13,537)	$ 4,139
Adjustments to reconcile net income (loss) to cash provided by operating activities			
(Gain) loss on sale of assets	(2,813)	270	(14,147)
Write-down of investments	5,140	—	—
Write-down of intangibles	47,677	8,426	—
Write-down of long-lived assets	7,503	—	—
Write-down of assets from businesses held for sale (net of tax)	—	2,159	14,936
(Gain) loss on sale of discontinued operations (net of tax)	—	3,696	(935)
Restructuring	12,460	8,135	11,033
Provision for doubtful accounts	25,254	8,550	3,790
Depreciation and amortization	23,479	24,696	27,204
Stock-based compensation expense	3,819	4,527	3,959
Change in receivables	27,223	20,956	5,064
Change in inventories	36,995	23,471	4,486
Change in payables	(14,544)	(10,394)	(11,607)
Change in other assets and liabilities	(37,961)	(25,689)	1,701
Change in deferred taxes	38,803	(6,027)	(16,390)
Total adjustments	173,035	62,776	29,094
Net cash provided by operating activities	51,688	49,239	33,233
Cash flows from investing activities			
Proceeds from disposals of assets	9,060	8,761	46,974
Proceeds from sale of discontinued operations	—	4,169	42,659
Capital expenditures	(15,625)	(27,386)	(25,811)
Purchases of investments	(11,330)	(34,562)	(18,165)
Proceeds from sales of investments	34,675	35,580	17,342
Change in restricted cash	(18,207)	160	(116)
Change in other long-term assets	(581)	(705)	(955)
Net cash provided by (used for) investing activities	(2,008)	(13,983)	61,928
Cash flows from financing activities			
Proceeds from debt	50,794	93,861	91,787
Payments on debt	(92,139)	(144,790)	(128,483)
Stock issued/(canceled) for stock and employee benefit plans	—	(269)	1,340
Repurchases of common stock	—	—	(6,947)
Dividends paid	(5,177)	(20,746)	(24,886)
Net cash used for financing activities	(46,522)	(71,944)	(67,189)
Effect of exchange rate changes on cash and equivalents	(901)	109	(456)
Change in cash and equivalents	2,257	(36,579)	27,516
Cash acquired from consolidation of VIEs	631	—	—
Cash and equivalents at beginning of period	14,476	51,055	23,539
Cash and equivalents at end of period	$ 17,364	$ 14,476	$ 51,055

The accompanying Notes to Consolidated Financial Statements are an integral part of these statements.

Google, Inc. reported the following cash flows over the three-year period 2007–2009 (dollars in millions).

	2009	2008	2007
Operating cash flows	$9,316	$7,853	$5,775
Investing cash flows	(8,019)	(5,319)	(3,682)
Financing cash flows	233	88	403

Discuss Google's cash management over the three-year period.

HOW THE STATEMENT OF CASH FLOWS CAN BE USED

The statement of cash flows is used primarily to assess performance in two basic areas: (1) a company's ability to generate cash and (2) the effectiveness of a company's cash management. The ability to generate cash is determined by the strength of the company's operating activities as well as its **financial flexibility,** which reflects the company's capacity to borrow, issue equity, and sell nonoperating assets (e.g., investments). During 2009, for example, the drugstore chain Walgreens generated $4.1 billion through its operating activities, which was sufficient to finance $2.8 billion of additional investments, repurchase $279 million of its own stock, pay a $446 million dividend, and maintain its cash balance. On the other hand, the national retailer Saks needed to raise over $156 million in financing to fund its investments of $123 million because cash from operations was a negative $1.5 million.

Effective cash management requires that two competing objectives be balanced. On one hand, cash must be available to meet debts as they come due. That is, **solvency** must be maintained. On the other hand, cash must be invested in productive assets that provide returns. Sources of cash include the sale of inventories and services, borrowings, equity issuances, and the selling of long-term assets. Uses of cash include purchasing and manufacturing inventories, covering selling and administrative costs, making debt interest and principal payments, purchasing long-term assets, purchasing treasury stock, and paying dividends. Effective cash management involves managing these cash sources and uses in a way that provides a high return without bearing too great a risk of insolvency.

Review Figure 14–4 and comment on La-Z-Boy's cash management over the three-year period covering fiscal years 2007, 2008, and 2009.

Analyzing the Statement of Cash Flows

Questions like the following can be answered by referring to the statement of cash flows: Is the company's cash balance increasing or decreasing? What portion of the company's cash is generated through operations, the sale of investments, or the issuance of debt and equity securities? What portions of the company's cash payments go toward supporting operations, capital investments, repayments of debt, purchasing treasury stock, and dividends? In Chapter 5, we discussed cash flow analysis. There we distinguished between operating performance, financial flexibility, and liquidity, and

illustrated how the statement of cash flows can be used to identify cash flow profiles of companies. You may wish to review this material now.

The Importance of Cash from Operating Activities

The amount of cash generated through operating activities is especially important to financial statement users because the successful sale of a company's services or inventories is a prerequisite for a successful business. Also, while cash flows from investing and financing activities tend to vary from one year to the next, operating activities, by definition, are normal and expected to recur. Consequently, positive net cash flows from operations, especially across several periods of time, can indicate financial strength.

It is generally desirable to finance asset purchases and debt payments with cash generated from operations. Companies able to follow such a strategy consistently tend to have higher credit ratings and are generally viewed as financially more stable than those unable to do so. DuPont, for example, one of the ten largest companies in the world with an AAA credit rating, commented in an annual report:

Cash provided by operations was sufficient to finance the company's capital expenditures, repurchase 1,968,000 shares of the company's common stock, reduce borrowings, and pay dividends.

The management of AT&T, a leader in the communications industry, stated:

Strong cash flow from operations permitted us to continue efforts toward increased financial flexibility. We redeemed $830 million of preferred stock and retired $147 million of long-term debt. Our external financing was limited to $343 million. Consequently, for the second consecutive year, we have reduced our utilization of external sources of financing.

In 2008, Swiss chocolate company Nestlé, which uses IFRS, reported net income of 19 billion Swiss francs (CHF) and cash from operations of only 10.8 billion CHF. The prior year the company reported net income of 11.4 billion CHF, and a higher cash from operations of 13.4 billion CHF. Provide reasonable explanations for how the relationship between net income and cash from operations could be so different from one year to the next for a single company.

The items that explain the difference between net income and net cash from operating activities also can be used to assess the quality of reported earnings in a given year. Examine the operating section of La-Z-Boy's 2009 statement of cash flows (Figure 14–4), for example, and note that net cash provided by operating activities exceeds net income by over $173 million. One of the major reasons for this difference is the numerous asset write-downs.

A review of La-Z-Boy's income statement would reveal that net income was reduced by the $60.3 million due to asset write-downs (excluding the restructuring charge), and the disclosure on the statement of cash flows (added back to net income) indicates that the write-downs had no cash impact. That is, net income was reduced by the change, but cash flow was unaffected. Consequently, an analyst might discount the effect of the write-down on net income, concluding that the change represented a one-time effect that signaled little about La-Z-Boy's financial performance in 2009.

Business Credit, a trade journal for analysts, states that financial analysis can be plagued by GAP ("games accountants play") in deriving the earnings number—the so-called sins of accrual accounting. The effect of these actions is to either increase current profits or hide them for a later date. It is important for analysts to understand the effects of these games on cash flows. Explain how understanding these cash flows effects can be useful to analysts.

The Importance of Significant Noncash Transactions

The statement of cash flows includes only those transactions that directly affect cash or cash equivalents. Many important transactions, however, neither increase nor decrease cash and, as a result, are excluded from the face of the statement. For example, the purchase of a long-lived asset in exchange for a long-term note payable can be a significant capital transaction, yet as illustrated by the journal entry below, it has no effect on the cash account.

Equipment (+A)	**20,000**	
Notes Payable (+L)		**20,000**
Purchased equipment financed with a long-term note		

Similarly, the acquisition of land in exchange for a note payable, the acquisition of a subsidiary by issuing stock, the payment of a debt with common stock, and the declaration of a dividend are capital transactions that are not found on the statement of cash flows.

These kinds of capital transactions can be very important to a company's financial condition, and the FASB requires in its standard on cash flows that they be described clearly in the footnotes to the financial statements. It is important that such information be accessible to readers who are interested in examining the financing and investing activities of a company. For example, when MCI acquired Satellite Business Systems (SBS) and selected other assets from IBM, MCI issued common stock and signed a note payable. No cash was exchanged in the transaction, and accordingly, neither the acquired assets nor the increases in the common stock and notes payable accounts appeared on MCI's statement of cash flows. However, the transaction was important enough to warrant disclosure, and MCI reported it directly below the statement of cash flows in the following manner:

Acquisition of SBS (in millions):	
Common stock issued to acquire SBS	*$ 376*
Communications systems acquired	*(428)*
Other assets acquired	*(52)*
Current obligations assumed	*104*
Cash outflow to acquire SBS	*$ 0*

THE STATEMENT OF CASH FLOWS: ECONOMIC CONSEQUENCES

The economic consequences associated with the statement of cash flows result primarily from investors, creditors, and other interested parties using it to assess the investment potential and creditworthiness of companies and the equity and debt securities that they issue. *Forbes* magazine reported: "a number of stock advisers are basing their

work in part on cash flow . . . an investor who ignores cash flow in picking stocks is being deprived of one of the most valuable tools in an arsenal." Furthermore, many writers have claimed that had investors relied more heavily on cash flow numbers, instead of working capital and the current ratio, famous bankruptcies, like W. T. Grant, Penn Central, Sambo's Restaurants, AM International, and Wickes, might have been foreseen earlier. As one survey found: "The evidence could not be clearer. Investors use the statement of cash flows more, and the income statements less, than previously."[5]

The increasing importance of cash flow information to investors and creditors creates incentives for management to **window dress** the statement of cash flows. Such incentives can be troublesome because in the short run it is relatively easy for management to present a favorable cash position. Delaying payments on short-term payables, for example, can significantly boost the amount of cash provided (used) by operating activities. Selling investments, even if it is not in the shareholders' long-term interests, can increase cash inflows from investing activities, while delaying debt payments and dividends can inflate cash from financing activities.

In 2009, Kyocern, a Japanese electronics manufacturer that uses IFRS, reduced its accounts payable balance by over $784 million. Net cash from operations that year was $988 million. What could Kyocern have done to report an even higher net cash from operations?

Those who use the statement of cash flows must be careful not to place too much importance on the cash flows of a particular period, which can be manipulated. However, such manipulation is much less effective when statements are viewed across several periods because payments that are delayed in one period must normally be paid in the next. For this reason, the FASB requires that cash flow statements from at least the previous three years be disclosed.

From management's standpoint, it is also important to realize that decisions designed to manipulate the disclosures on the statement of cash flows can be counterproductive. While such decisions may improve the appearance of a company's cash position in the current period, they can (1) represent poor business decisions, (2) make the cash position of the company look worse in the future, (3) reduce the credibility of the company and its financial reports in the eyes of investors, creditors, and other interested parties, and (4) if fraudulent, can expose management to future lawsuits. In addition, such manipulations may simply be unethical.

A *Wall Street Journal* article titled "Analysts Increasingly Favor Using Cash Flow over Reported Earnings in Stock Valuations" describes how some analysts are losing faith in the earnings number, choosing instead to rely on various measures of cash flows in the assessments of a company's future performance. They claim that cash flow across time is less variable, less subject to manipulation, and easier to predict. Briefly discuss how cash flow from operations might be easier to predict than net income.

5. Marc J. Epstein and Moses L. Paun, "How Useful Is the Statement of Cash Flows?" *Management Accounting,* July 1992, p. 52.

DERIVING CASH FLOW FROM ACCRUAL FINANCIAL STATEMENTS

In Chapter 4 of this text, we prepared a simple statement of cash flows by focusing on the cash effects of the individual transactions of the period. That is, we prepared the statement from the entries to the cash T-account. This section demonstrates how the statement of cash flows can be prepared when the analysis of individual transactions is either impractical or, in some cases, impossible. We show that the statement can be prepared primarily from the information contained in two balance sheets, the intervening income statement, and the statement of shareholders' equity. This method is followed by most companies, and the resulting statement of cash flows is the same as that prepared from analyzing the entries to the cash T-account. In most cases, however, the method we illustrate here is far more practical. Figure 14–5 contains the December 31, 2011 and 2012, balance sheets of ABC Enterprises and the related income statement and statement of shareholders' equity. Additional information is disclosed in the section that appears below the statements.

In the sections that follow, we prepare a statement of cash flows under both the direct and indirect methods from the information contained in Figure 14–5. Cash provided (used) by operating activities is derived first, followed by the cash provided

FIGURE 14–5
The financial statements of ABC Enterprises

ABC Enterprises, Inc.
Balance Sheets
for December 31, 2011 and 2012

	2012	2011
ASSETS		
Cash	$ 5,900	$ 8,000
Accounts receivable	23,200	12,000
Less: Allowance for doubtful accounts	(1,300)	(1,000)
Inventory	4,000	3,000
Prepaid insurance	1,000	2,000
Land	30,000	20,000
Machinery	6,000	8,000
Less: Accumulated depreciation	(2,500)	(2,000)
Building	30,000	—
Less: Accumulated depreciation	(1,500)	—
Patent	6,000	8,000
Total assets	$100,800	$58,000
LIABILITIES AND SHAREHOLDERS' EQUITY		
Accounts payable	$ 9,000	$12,000
Accrued payables	3,000	1,500
Income taxes payable	200	500
Payments in advance	—	3,000
Dividends payable	3,000	1,000
Notes payable	24,000	25,000
Less: Discount on notes payable	(1,800)	(2,000)
Common stock	42,000	10,000
Additional paid-in capital	19,300	2,000
Retained earnings	2,100	6,000
Less: Treasury stock	—	(1,000)
Total liabilities and shareholders' equity	$100,800	$58,000

FIGURE 14–5
(Concluded)

ABC Enterprises, Inc.
Income statement
for December 31, 2012

Sales		$ 32,000
Fees earned		3,000
Cost of goods sold		(11,000)
Gross profit		$ 24,000
Operating expenses:		
Miscellaneous expenses	$11,000	
Insurance expense	1,000	
Bad debt expense	1,100	
Depreciation expense (machinery)	1,000	
Depreciation expense (building)	1,500	
Amortization of patent	2,000	17,600
Net operating income		$ 6,400
Nonoperating revenues and expenses:		
Loss on sale of machinery	$ 100	
Interest expense	2,000	2,100
Net income from continuing operations before taxes		$ 4,300
Less: Income tax expense		1,200
Net income		$ 3,100

ABC Enterprises, Inc.
Statement of Shareholders' Equity
for the Year Ended December 31, 2012

	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock	Total
Beginning balance	$10,000	$ 2,000	$6,000	$(1,000)	$17,000
Stock issuance for building	20,000	10,000			30,000
Stock issuance for cash	10,000	5,000			15,000
Net income			3,100		3,100
Dividends					
Cash			(3,000)		(3,000)
Stock	2,000	2,000	(4,000)		
Treasury stock reissuance		300		1,000	1,300
Ending balance	$42,000	$19,300	$2,100	0	$63,400

Additional information:
1. Two thousand shares of common stock ($10 par; $15 fair market value) were issued for a building early in 2012.
2. A 5 percent stock dividend on 4,000 outstanding shares was distributed late in 2012 when the fair market value of the $10 par value stock was $20 per share.
3. Treasury stock that was originally purchased for $1,000 was reissued for $1,300.

(used) by investing activities, and cash provided (used) by financing activities. In the figures that appear throughout these sections, italics are used to indicate dollar amounts taken directly from the information in Figure 14–5.

Cash Provided (Used) by Operating Activities

This section analyzes the cash flows associated with each income statement account: sales and bad debt expense, fees earned, cost of goods sold, miscellaneous expenses, insurance expense, depreciation of machinery and of building, amortization of patent, loss on sale of machinery, interest expense, and income tax expense.

SALES AND BAD DEBT EXPENSE

The cash inflow from sales can be determined by analyzing the changes in accounts receivable and allowance for doubtful accounts. Refer to the T-accounts and related journal entries in Figure 14–6.

FIGURE 14–6 Determining cash inflow from sales

Sales		Accounts Receivable		Allowance for Doubtful Accounts		Bad Debt Expense	
	(1) *32,000*	*12,000*			*1,000*	(2) 1,100	
		(1) 32,000	(3) 800	(3) 800	(2) 1,100		
			(4) 20,000				
		23,200			*1,300*		

Effect on Accounts:

Transactions	Accounts	Debit (Net)	Credit (Net)
(1)	Accounts Receivable	32,000	
	Sales		32,000
(2)	Bad Debt Expense	1,100	
	Allowance for Doubtful Accounts		1,100
(3)	Allowance for Doubtful Accounts	800	
	Accounts Receivable		800
(4)	Cash	20,000	
	Accounts Receivable		20,000

Cash collections from sales: $20,000

The beginning and ending balances in accounts receivable and the allowance for doubtful accounts appear on the balance sheets in Figure 14–5. We assume that all sales were made on account, and therefore, $32,000 (see income statement) was debited to accounts receivable during the year.[6] The $1,100 bad debt expense (see income

6. In this illustration we assume that all sales were made on account. Similarly, when analyzing future accounts (e.g., fees earned, inventory purchases, miscellaneous expenses), we make similar assumptions. These assumptions simplify the analysis, but they are not necessary. Any of a number of reasonable assumptions could be made, leading to the exact same result.

statement) was credited to allowance for doubtful accounts at year-end, which (when the beginning and ending balances in the allowance account are considered) implies that uncollectibles in the amount of $800 must have been written off and credited to accounts receivable. Therefore, an additional credit of $20,000 to accounts receivable must have been entered during the year. The corresponding debit represents cash receipts on outstanding accounts during the year.

FEES EARNED

The cash inflow related to fees earned can be determined by analyzing the change in the payments in advance account. Refer to Figure 14–7.

FIGURE 14–7
Determining cash inflow from fees earned

Fees Earned			Payments in Advance		
	(1)	*3,000*			*3,000*
			(1)	3,000	
					0

Effect on Accounts:

Transactions	Accounts	Debit (Net)	Credit (Net)
(1)	Payments in Advance	3,000	
	Fees Earned		3,000

Cash collections from fees earned: $0

The beginning ($3,000) and ending ($0) balances in the payments in advance account appear on the balance sheets in Figure 14–5. The recognition of $3,000 in fees earned (see income statement) involved a $3,000 debit to payments in advance. This entry accounts for the entire change in the payments in advance account, indicating that no cash inflow was associated with fees earned.

COST OF GOODS SOLD

The cash outflow associated with cost of goods sold can be determined by analyzing the changes in the inventory and accounts payable accounts. Refer to Figure 14–8.

The beginning and ending balances in inventory and accounts payable appear on the balance sheets in Figure 14–5. The $11,000 debit to cost of goods sold (see income statement) was credited to inventory, which (when the beginning and ending balances in the inventory account are considered) implies that inventory purchases of $12,000 must have been made during the year. Assuming that all inventory purchases were made on account, $12,000 must have been credited to accounts payable. Considering the beginning and ending balances in accounts payable, an additional debit of $15,000 must have been recognized during the year. The corresponding credit represents cash payments of $15,000 on accounts payable during the year.

MISCELLANEOUS EXPENSES

The cash outflow related to miscellaneous expenses can be determined by analyzing the change in the accrued payables account. Refer to Figure 14–9.

The beginning ($1,500) and ending ($3,000) balances in accrued payables appear on the balance sheets in Figure 14–5. Assuming that all miscellaneous expenses were

FIGURE 14–8
Determining cash outflow from inventory purchases

Cost of Goods Sold		Inventory		Accounts Payable	
(1) *11,000*		*3,000*			*12,000*
			(1) 11,000		(2) 12,000
		(2) 12,000		(3) 15,000	
		4,000			*9,000*

Effect on Accounts:

Transactions	Accounts	Debit (Net)	Credit (Net)
(1)	Cost of Goods Sold	11,000	
	Inventory		11,000
(2)	Inventory	12,000	
	Accounts Payable		12,000
(3)	Accounts Payable	15,000	
	Cash		15,000

Cash paid to suppliers: $15,000

FIGURE 14–9
Determining cash outflow from miscellaneous expenses

Miscellaneous Expenses		Accrued Payables	
(1) *11,000*			*1,500*
			(1) 11,000
		(2) 9,500	
			3,000

Effect on Accounts:

Transactions	Accounts	Debit (Net)	Credit (Net)
(1)	Miscellaneous Expenses	11,000	
	Accrued Payables		11,000
(2)	Accrued Payables	9,500	
	Cash		9,500

Cash paid for miscellaneous expenses: $9,500

accrued, the debit of $11,000 to miscellaneous expenses (see income statement) must have involved an $11,000 credit to accrued payables. Considering the beginning and ending balances in accrued payables, a $9,500 debit must have been entered in the account. The corresponding credit represents cash payments on accrued payables.

INSURANCE EXPENSE

The cash outflow related to insurance expense can be determined by analyzing the change in the prepaid insurance account. Refer to Figure 14–10.

The beginning ($2,000) and ending ($1,000) balances in prepaid insurance appear on the balance sheets in Figure 14–5. The debit of $1,000 to insurance expense (see income statement) involved a $1,000 credit to prepaid insurance. This entry accounts for the entire change in the prepaid insurance account, indicating that no cash was paid for insurance during the year.

FIGURE 14–10
Determining cash outflow related to insurance expense

Insurance Expense			Prepaid Insurance		
(1)	*1,000*		*2,000*		
				(1)	1,000
			1,000		

Effect on Accounts:

Transactions	Accounts	Debit (Net)	Credit (Net)
(1)	Insurance Expense	1,000	
	Prepaid Insurance		1,000

Cash paid for insurance: $0

DEPRECIATION OF MACHINERY, DEPRECIATION OF BUILDING, AMORTIZATION OF PATENT, AND LOSS ON SALE OF MACHINERY

There are no operating cash effects associated with depreciation, amortization, or book gains and losses.

INTEREST EXPENSE

The cash outflow related to interest expense can be determined by analyzing the change in the discount on notes payable account. Refer to Figure 14–11.

FIGURE 14–11
Determining cash outflow related to interest expense

Interest Expense			Discount on Notes Payable		
(1)	*2,000*		*2,000*		
				(1)	200
			1,800		

Effect on Accounts:

Transactions	Accounts	Debit (Net)	Credit (Net)
(1)	Interest Expense	2,000	
	Discount on Notes Payable		200
	Cash		1,800

Cash paid for interest: $1,800

The beginning ($2,000) and ending ($1,800) balances in the discount on notes payable account appear on the balance sheets in Figure 14–5. The $200 difference between the beginning and ending balances indicates that the discount was amortized in the amount of $200 during the year. Discounts are amortized into interest expense, as illustrated in Figure 14–11. Thus, $1,800 cash must have been paid for interest during the year.

INCOME TAX EXPENSE

The cash outflow related to income tax expense can be determined by analyzing the changes in the income tax payable account. Refer to Figure 14–12.

The beginning ($500) and ending ($200) balances in the income tax payable account appear on the balance sheets in Figure 14–5. The debit of $1,200 to income tax expense (see income statement), assuming that income taxes were accrued, involved a $1,200 credit to income tax payable. Considering the beginning and ending balances in

FIGURE 14–12
Determining cash outflow related to income taxes

Income Tax Expense		Income Tax Payable	
(1) *1,200*			*500*
		(1) 1,200	
		(2) 1,500	
			200

Effect on Accounts:

Transactions	Accounts	Debit (Net)	Credit (Net)
(1)	Income Tax Expense	1,200	
	Income Tax Payable		1,200
(2)	Income Tax Payable	1,500	
	Cash		1,500

Cash paid for income taxes: $1,500

income tax payable, $1,500 must have been debited to the account during the year. The corresponding credit represents cash payments for income taxes.

Cash Provided (Used) by Investing Activities

In this section, we determine the cash inflows and outflows associated with investing activities by analyzing changes in the long-lived asset accounts. Specifically, we analyze the $10,000 increase in the land account and the $2,000 decrease in the machinery account. The building was acquired in exchange for stock and involved no cash exchange, while the $2,000 decrease in the patent account reflects amortization, which also involved no cash receipt or payment.

PURCHASE OF LAND

The $10,000 increase in the land account (see Figure 14–5) indicates that land was acquired during the period. Since there is no indication that noncash assets were exchanged for the land or a liability was credited, we assume that the land was purchased for a $10,000 cash payment. Refer to Figure 14–13.

SALE OF MACHINERY

The cash inflow from the sale of machinery can be determined by using the available information to reconstruct the journal entry that recorded the transaction. Refer to Figure 14–14.

FIGURE 14–13
Determining cash outflow for land purchases

Land	
20,000	
(1) 10,000	
30,000	

Effect on Accounts:

Transactions	Accounts	Debit (Net)	Credit (Net)
(1)	Land	10,000	
	Cash		10,000

Cash payment for land: $10,000

FIGURE 14–14 Determining cash inflow from sale of machinery

Machinery			Accumulated Depreciation			Loss on Sale of Machinery			Depreciation Expense		
8,000					*2,000*	(2)	*100*		(1)	*1,000*	
	(2)	2,000		(1)	1,000						
			(2)	500							
6,000					*2,500*						

Effect on Accounts:

Transactions	Accounts	Debit (Net)	Credit (Net)
(1)	Depreciation Expense	1,000	
	Accumulated Depreciation		1,000
(2)	Cash	1,400	
	Accumulated Depreciation	500	
	Loss on Sale of Machinery	100	
	Machinery		2,000

Cash receipt for sale of machinery: $1,400

The beginning and ending balances in the machinery and accumulated depreciation accounts can be found on the balance sheets in Figure 14–5. Depreciation expense of $1,000 on the machinery (see income statement) was recognized during the period; accordingly, $1,000 must have been credited to accumulated depreciation. The accumulated depreciation account, therefore, must have been debited for $500 when the machine was sold. Given the $100 loss on the sale (see income statement), the $2,000 reduction in the machinery account, and the $500 debit to accumulated depreciation, the journal entry to record the sale can be reconstructed and the amount of cash received ($1,400) can be determined.

Cash Provided (Used) by Financing Activities

In this section, we determine the cash inflows and outflows associated with financing activities by analyzing changes in the long-term liability and shareholders' equity accounts. Specifically, we analyze the $1,000 decrease in the notes payable account, the increase in the common stock and additional paid-in capital accounts, the issuance of treasury stock for $1,300, and the declaration of a $3,000 cash dividend.

PRINCIPAL PAYMENT ON NOTES PAYABLE

We have no indication that the $1,000 decrease in the notes payable account (see Figure 14–5) was due to anything other than the payment of cash. Refer to Figure 14–15.

ISSUANCE OF COMMON STOCK AND TREASURY STOCK

The cash inflows from the issuance of common stock and treasury stock can be determined by analyzing the changes in the common stock, additional paid-in capital, and

FIGURE 14–15
Determining cash outflow from payments on notes

Notes Payable			
			25,000
(1)	1,000		
			24,000

Effect on Accounts:

Transactions	Accounts	Debit (Net)	Credit (Net)
(1)	Notes Payable	1,000	
	Cash		1,000

Cash payment of notes payable: $1,000

treasury stock accounts. Note that the statement of shareholders' equity and the "additional information" section of Figure 14–5 indicate that a building was acquired for common stock, a stock dividend was distributed, and treasury stock was sold for $1,300. Refer to Figure 14–16.

FIGURE 14–16
Determining cash inflow from stock issuances

Building			Treasury Stock			Stock Dividend		
	0		*1,000*			(2)	*4,000*	
(1)	30,000			(3)	1,000			
	30,000		*0*					

Common Stock			Additional Paid-In Capital		
		10,000			*2,000*
	(1)	20,000		(1)	10,000
	(2)	2,000		(2)	2,000
				(3)	300
	(4)	10,000		(4)	5,000
		42,000			*19,300*

Effect on Accounts:

Transactions	Accounts	Debit (Net)	Credit (Net)
(1)	Building	30,000	
	Common Stock		20,000
	Additional Paid-In Capital		10,000
(2)	Stock Dividend	4,000	
	Common Stock		2,000
	Additional Paid-In Capital		2,000
(3)	Cash	1,300	
	Treasury Stock		1,000
	Additional Paid-In Capital		300
(4)	Cash	15,000	
	Common Stock		10,000
	Additional Paid-In Capital		5,000

Cash receipts from issuance of treasury stock: $1,300
Cash receipts from issuance of common stock: $15,000

The beginning and ending balances in common stock, additional paid-in capital, and treasury stock appear on the balance sheets and the statement of shareholders' equity in Figure 14–5. The purchase of the $30,000 building increased common stock and additional paid-in capital by $20,000 and $10,000, respectively. Common stock and additional paid-in capital each increased by $2,000 when the $4,000 stock dividend was distributed. Additional paid-in capital increased by $300 when the treasury stock was issued for $1,300 cash, which was greater than its $1,000 cost. The additional information that follows the financial statement in Figure 14–5 describes these three transactions. Given the ending balances in common stock and additional paid-in capital, there must have been a stock issuance for cash in the amount of $15,000 during the year.

CASH DIVIDENDS

The cash dividend payment can be determined by analyzing the changes in the dividends payable account. Refer to Figure 14–17.

The beginning ($1,000) and ending ($3,000) balances in the dividends payable account appear on the balance sheets in Figure 14–5. The declaration of the $3,000 cash dividend (see statement of shareholders' equity) created a $3,000 dividend payable liability. Therefore, $1,000 must have been debited to dividends payable during the year, which represents cash payments to the shareholders.

FIGURE 14–17
Determining cash outflow from dividend payments

Cash Dividends

(1)	*3,000*		

Dividends Payable

			1,000
(2)	1,000	(1)	3,000
			3,000

Effect on Accounts:

Transactions	Accounts	Debit (Net)	Credit (Net)
(1)	Cash Dividends	3,000	
	Dividends Payable		3,000
(2)	Dividends Payable	1,000	
	Cash		1,000

Cash payment for dividends: $1,000

THE COMPLETE STATEMENT OF CASH FLOWS

We have now derived the cash flows of the period and can prepare the statement of cash flows. The following sections cover the direct method and the indirect method.

The Direct Method

A statement of cash flows prepared under the direct method is provided in Figure 14–18. Note that the dollar amounts are identical to the cash flows derived in the previous section.

FIGURE 14–18
Statement of cash flows for ABC Enterprises: Direct method

ABC Enterprises, Inc.
Statement of Cash Flows
for the Year Ended December 31, 2012

Operating activities:		
Cash collections from sales and accounts receivable	$ 20,000	
Cash paid to suppliers	(15,000)	
Cash paid on miscellaneous expenses	(9,500)	
Cash paid for interest	(1,800)	
Cash paid for income taxes	(1,500)	
Net cash provided (used) by operating activities		$(7,800)
Investing activities:		
Purchase of land	$(10,000)	
Sale of machinery	1,400	
Net cash provided (used) by investing activities		(8,600)
Financing activities:		
Proceeds from issuing common stock	$ 15,000	
Proceeds from sale of treasury stock	1,300	
Cash dividends	(1,000)	
Principal payment on outstanding note payable	(1,000)	
Net cash provided (used) by financing activities		14,300
Net increase (decrease) in cash balance		$(2,100)
Beginning cash balance		8,000
Ending cash balance		$ 5,900

Note that cash outflows due to interest are disclosed in the operating section under U.S. GAAP. Under IFRS, firms can choose to disclose interest in the operating or financing sections.

The Indirect Method

The statement of cash flows under the indirect method is exactly the same as the direct method, except for the presentation of the operating section and the derivation of net cash provided (used) by operating activities. The operating section presented under the indirect method for ABC Enterprises, Inc. is illustrated in Figure 14–19. Note first that the dollar amount of net cash provided (used) by operating activities is the same (−$7,800) whether the direct or the indirect method is used. The difference is in the way in which the amount is computed. Under the indirect method, net cash provided by operating activities (−$7,800) is computed by adjusting net income ($3,100), which appears on the income statement, for the timing difference between operating accruals and cash flows. As indicated earlier in this chapter, these adjustments are classified into two categories: (1) noncash charges to noncurrent accounts (e.g., depreciation, amortization, and book gains and losses) and (2) changes in the current noncash accounts (e.g., accounts receivable, inventory, accounts payable, income tax and miscellaneous accruals, payments in advance, and prepaid insurance), except for short-term

FIGURE 14–19
Statement of cash flows: Indirect method

ABC Enterprises, Inc.
Statement of Cash Flows
for the Year Ended December 31, 2012

Operating activities:		
Net income	**$ 3,100**	
Noncash charges to noncurrent accounts:		
Depreciation of machinery	**1,000**	
Depreciation of building	**1,500**	
Amortization of patent	**2,000**	
Loss on sale of machinery	**100**	
Decrease in discount on notes payable	**200**	
Changes in current noncash accounts:		
Increase in net accounts receivable	**(10,900)**	
Increase in inventory	**(1,000)**	
Decrease in accounts payable	**(3,000)**	
Increase in accrued payables and taxes payable	**1,200**	
Decrease in payments in advance	**(3,000)**	
Decrease in prepaid insurance	**1,000**	
Net cash provided (used) by operating activities		**$(7,800)**

investments and dividends payable, which are reflected in the investing and financing sections, respectively.

The first category of adjustments, "noncash charges to noncurrent accounts," affected net income but did not affect cash flows. Depreciation and amortization charges, for example, simultaneously reduced the dollar amounts of long-lived assets and created expenses, which reduced net income. The entries to record depreciation and amortization, however, do not reduce cash. Consequently, when deriving cash flows from net income, as is done under the indirect method, depreciation and amortization charges are added back. Similarly, gains and losses on the disposal of long-lived assets do not affect operating cash flows. Note in Figure 14–19 that the loss on sale of machinery is added back in the computation of net cash provided (used) by operating activities. Such transactions often involve cash flows, but these cash flows are reflected in the investing—instead of the operating—section of the statement of cash flows. Other common examples, where changes in non-current assets affect net income—but not cash flow—include long-term investments accounted for under the equity method, deferred income taxes, and the amortization of discounts and premiums on long-term debt.

Kyocern, the Japanese electronics manufacturer which uses IFRS, reports the following four items in the operating section of its 2009 statement of cash flows (dollars in millions):

- Provision for doubtful accounts +$6.8
- Inventory write-downs +$88
- Gains on sales of property −$84
- Equity earnings −$65

Explain why.

FIGURE 14–20
Explaining current adjustments to net income in the calculation of net cash provided (used) by operating activities

	Current Assets	Current Liabilities
Increase	Subtract from Accrual Numbers	Add to Accrual Numbers
Decrease	Add to Accrual Numbers	Subtract from Accrual Numbers

One way to better understand the adjustments included in the second category, "changes in current noncash accounts," is to refer to Figure 14–20. Here, four possible combinations are illustrated. Increases (decreases) in current assets and decreases (increases) in current liabilities are subtracted from (added to) net income in the computation of net cash provided (used) by operating activities. The logic is fairly straightforward. Increases in accounts receivable, for example, must mean that revenues are being recognized faster than cash is being collected from customers—that is, net income, not backed by cash receipts, is being recorded. Accordingly, an increase in accounts receivable is subtracted from net income in the calculation of net cash provided (used) by operating activities. Similarly, growing current payables must mean that expenses are being recognized faster than cash is being paid. Net income must be adjusted upward, therefore, in the computation of net cash provided (used) by operating activities. Note how Figure 14–20 explains each of the adjustments under the heading "changes in current noncash accounts."

That same year, Kyocern adds the decrease in accounts receivable, and subtracts the decrease in short-term payables in the operating section. Why?

ANALYZING THE STATEMENT OF CASH FLOWS: AN APPLICATION

Now that the statement of cash flows has been prepared, we can use it to assess ABC Enterprises' cash management policies. ABC's cash position decreased (from $8,000 to $5,900) during 2012. For the most part, this decrease was caused by investing and operating activities, which required $8,600 and $7,800, respectively. Financing activities, which provided $14,300, almost made up for these cash deficits. While the exact sources and uses of cash in each of these three areas should be examined, the $7,800 cash deficit due to operating activities appears to be the most troublesome and definitely deserves special attention.

Summarizing the Cash Effects of Operating Transactions

ABC's income statement shows that net income for 2012 totaled $3,100. At the same time, the operations that produced net income reduced the cash balance by $7,800. Interestingly, these two measures produced significantly different numbers that are used to evaluate the same (operating) activities.

The statement of cash flows under the indirect method (Figure 14–19) explains the difference between net income and cash provided (used) by operations. Four items appear to be the most important: (1) the $10,900 buildup in net accounts receivable, (2) the $3,000 decrease in accounts payable, (3) the $3,000 decrease in payments in advance, and (4) the depreciation and amortization of the long-lived assets.

The net accounts receivable buildup increased net income but not cash. This could indicate aggressive revenue recognition policies. Coupled with the decrease in accounts payable, it indicates that ABC paid its suppliers more quickly than it received payments from its customers. Such a strategy can give rise to cash flow problems. The $3,000 decrease in payments in advance was reflected in revenues (and thus net income) but produced no cash. Presumably, the $3,000 was received some time before December 31, 2011. The depreciation and amortization of long-lived assets reduced net income by a total dollar amount of $4,500 ($1,000 + $1,500 + $2,000) but required no cash.

Keep in mind also that the management of ABC could have manipulated cash provided (used) by operating activities. For example, had management chosen to defer cash payment on accounts payable, cash provided (used) by operating activities would have been considerably higher. This particular decision would have had no effect on net income.

In the operating section of its 2008 statement of cash flows, McDonald's reported three items: depreciation and amortization (+$1.2 billion), provision for impairment charges (+$6 million), and gains on sales of investments (−$160 million). Explain why these items are added to or subtracted from net income in the computation of net cash provided by operations.

Summarizing the Cash Effect of Investing and Financing Transactions

ABC Enterprises relied heavily on stock issuances for its cash needs during 2012. The statement of cash flows shows that common stock was issued for cash in the amount of $15,000 and that the sale of treasury stock produced $1,300. Both issuances diluted ABC's outstanding stock. The sale of a piece of machinery produced $1,400.

The cash produced by the financing and investing sources was used primarily to cover the cash deficit from operating activities (−$7,800) and to purchase land ($10,000). Dividend and principal payments on outstanding loans amounted to $1,000 each.

Note that ABC Enterprises issued 2,000 shares of common stock, valued at $15 each, for a building (see Figure 14–5). While this transaction does not affect ABC's cash balance and does not appear on the statement of cash flows, it is nonetheless very important and should be reported in the footnotes to the financial statements. Apparently, ABC relied even more heavily on equity issuances and purchased more long-term assets than the statement of cash flows indicates.

During 2008, Safeguard Scientifics, Inc. reported a loss of $52 million, yet boosted its investments by over $14 million. Explain how the company must have financed these investments and indicate where one could find this information on the financial statements.

Two Additional Observations

Now that we have covered the nature, use, and preparation of the statement of cash flows, two additional observations might be helpful. First, the statement of cash flows provides very little new information over and above that provided by the balance sheet, income statement, and statement of shareholders' equity. After all, we just illustrated how the statement can be derived from these statements. Its significant value comes from the way in which it is organized and its focus on cash. It is the only statement that reports on the operating, investing, and financing activities of a business from a cash perspective, and many believe that cash management is a key to business success. Professor Loyd Heath, whose writings did much to motivate the development of the statement of cash flows, describes it as being "complementary to the income statement and balance sheet," and the project manager for the FASB once said that "cash flow is one of the best measures of corporate liquidity." A well-known article published in the *Wall Street Journal,* titled "Why Cash Is King in the Current Climate," noted that, during economic downturns, "companies with high amounts of cash relative to debt are likely to be coveted by investors as economic growth turns increasingly sluggish. Cash may be a new gauge of value in the stock market."

A second observation is that normally one cannot explain the adjustments in the operating section of the statement of cash flows (indirect method) of a major U.S. company by computing the changes in the current accounts on its balance sheet. For example, the 2008 statement of cash flows of SUPERVALU reported an accounts receivable decrease of about $68 million. The change computed from the 2007 and 2008 balance sheets, however, indicated a decrease of approximately $78 million. The difference can be explained by the consolidation process. When a company such as SUPERVALU acquires another company, the cash decrease is reflected in the investing section—not the operating section—of the statement of cash flows. When the accounts are consolidated at the end of the year, the current assets and liabilities of the acquired company are added to those of the parent. The result is an inconsistency. In the SUPERVALU case, the $78 million decrease in accounts receivable indicated on the balance sheet reflects revenues that are being recognized slower than cash is being collected, but it also reflects receivables that have been purchased in other companies. The inconsistency arises because the cash outflows associated with these purchases are reflected in the investing section, rather than the operating section, of the statement of cash flows.

During 2008, Motorola sold off businesses for $93 million, and purchased businesses for $282 million. Would you expect the change in receivables indicated on the statement of cash flows to be greater than or less than the change in receivables computed from the 2007 and 2008 balance sheets? Why?

INTERNATIONAL PERSPECTIVE: THE STATEMENT OF CASH FLOWS

The importance of debt capital to many foreign companies places a premium on cash flow information, which banks and other lenders use to assess solvency. As indicated earlier, international financial reporting standards (IFRS) require a statement of cash flows in the same format as required by U.S. GAAP.

Interpreting the statement of cash flows for a multinational company can be tricky. Multinational companies, based in the United States and elsewhere, conduct operations in a variety of countries, many of which use different currencies. A U.S. corporation, for

example, may sell goods or services to a customer in France, giving rise to a receivable expressed in euros. When the value of the euro changes relative to that of the U.S. dollar, the value of the receivable on the U.S. company's balance sheet must be restated, which, in turn, gives rise to a gain or loss reported on the income statement.

Foreign currency exchange gains and losses, however, involve no cash flow. Consequently, when the statement of cash flows is prepared under the indirect method, an adjustment must be made to net income. Partly because these adjustments are becoming more and more significant, accounting pronouncements now require that they be disclosed separately at the bottom of the statement, immediately before "net increase (decrease) in cash and cash equivalents."

Refer to Figure 14–4, the statement of cash flows of La-Z-Boy, and find the adjustment for foreign currency exchange rate changes. What are the dollar amounts? Are they negative or positive, and what do they indicate?

REVIEW PROBLEM

Figure 14–21 contains balance sheets (December 31, 2011 and 2012) for XYZ Enterprises and the intervening income statement. Following these statements are several selected pieces of information that more completely describe the activity of XYZ during 2012. The two forms of the statement of cash flows are contained in Figures 14–22 (direct method) and 14–23 (indirect method). We have included relevant calculations on the statements to explain how the numbers were derived. Examine each cash flow statement closely, and trace the calculations back to the original financial statements and information given in Figure 14–21.

FIGURE 14–21
Financial statements for XYZ Enterprises

XYZ Enterprises
Balance Sheets
for December 31, 2011 and 2012

	2012	2011
ASSETS		
Cash	$ 3,000	$ 2,500
Accounts receivable	4,500	4,000
Inventory	10,500	8,000
Prepaid rent	3,000	2,000
Fixed assets	40,000	35,000
Less: Accumulated depreciation	(12,000)	(10,000)
Patent	8,000	9,000
Total assets	$57,000	$ 50,500
LIABILITIES AND SHAREHOLDERS' EQUITY		
Accounts payable	$ 6,500	$ 3,000
Other current payables	7,000	10,000
Bonds payable	19,000	19,000
Plus: Premium on bonds payable	2,500	3,000
Common stock	15,000	10,000
Additional paid-in capital	4,000	3,000
Retained earnings	3,000	2,500
Total liabilities and shareholders' equity	$57,000	$ 50,500

XYZ Enterprises
Income Statement
for the Year Ended Dec. 31, 2012

Sales	$55,000
Less: Cost of goods sold	35,000
Gross profit	$20,000
Rent expense	(2,000)
Interest expense	(2,000)
Miscellaneous expense	(9,000)
Depreciation of fixed assets	(5,000)
Amortization of patent	(1,000)
Gain on sale of machinery	1,000
Net income	$ 2,000

FIGURE 14–22 Statement of cash flows for XYZ Enterprises: Direct method

XYZ Enterprises
Statement of Cash Flows
for the Year Ended December 31, 2012

OPERATING ACTIVITIES:

INCOME STATEMENT		ADJUSTMENT/EXPLANATION	OPERATING CASH FLOWS	
Sales	$55,000	(500) [increase in accounts receivable]	$54,500	
COGS	(35,000)	(2,500) [increase in inventory]		
		+3,500 [increase in accounts payable]	(34,000)	
Rent	(2,000)	(1,000) [increase in prepaid rent]	(3,000)	
Interest	(2,000)	(500) [decrease in premium]	(2,500)	
Misc.	(9,000)	(3,000) [decrease in other current payables]	(12,000)	
Depreciation	(5,000)	[no cash effect]	0	
Amortization	(1,000)	[no cash effect]	0	
Gain	1,000	[no cash effect]	0	
Net income	$ 2,000	Net cash from operations		$3,000
INVESTING ACTIVITIES:				
Sale of machinery		[see note below]	$ 3,000	
Purchase of machinery		[see note below]	(10,000)	
Net cash provided (used) by investing activities				(7,000)
FINANCING ACTIVITIES:				
Issue of common stock		[increase in common stock and APIC]	$ 6,000	
Cash dividends		[see change in retained earnings plus net income]	(1,500)	
Net cash provided (used) by financing activities				4,500
Increase (decrease) in cash balance				$ 500
Beginning cash balance				2,500
Ending cash balance				$3,000

(*Continued*)

NOTE:

	COST OF FIXED ASSETS		ACCUMULATED DEPRECIATION
Beginning balance	$35,000		$10,000
Plus: Increases (purchases)	10,000	(depreciation expense)	5,000
Less: Decreases (sales)	(5,000)	(sold machinery)	(3,000)
Ending balance	$40,000		$12,000

Cash (+A)	3,000	
Accumulated Depreciation (+A)	3,000	
Machinery (−A)		5,000
Gain on Sale of Machinery (Ga, +RE)		1,000

Additional information

1. Purchased $3,000 of prepaid rent.
2. Sold a piece of machinery (cost: $5,000; accumulated depreciation: $3,000) for $3,000 cash. Purchased additional machinery for $10,000 cash.
3. Paid annual interest of $2,500 on note payable.
4. Issued 500 shares of $10 par value common stock for $12 per share.

FIGURE 14–23
Statement of cash flows for XYZ Enterprises: Indirect method

XYZ Enterprises
Statement of Cash Flows
for the Year Ended December 31, 2012

OPERATING ACTIVITIES:		
Net income	$ 2,000	
Noncash charges to noncurrent accounts:		
Depreciation of fixed assets	5,000	
Amortization of patent	1,000	
Gain on sale of machinery	(1,000)	
Decreases in premium	(500)	
Changes in current accounts other than cash:		
Increase in accounts receivable	(500)	
Increase in inventory	(2,500)	
Increase in prepaid rent	(1,000)	
Decrease in other payables	(3,000)	
Increase in accounts payable	3,500	
Cash provided (used) by operating activities		$3,000
INVESTING ACTIVITIES:		
Sale of machinery	$ 3,000	
Purchase of machinery	(10,000)	
Cash provided (used) by investing activities		(7,000)
FINANCING ACTIVITIES:		
Issue of common stock	$ 6,000	
Cash dividends	(1,500)	
Net cash provided (used) by financing activities		4,500
Net increase (decrease) in cash balance		$ 500
Beginning cash balance		2,500
Ending cash balance		$3,000

SUMMARY OF KEY POINTS

- *The structure and format of the statement of cash flows.*

  The statement of cash flows explains the change in a company's cash account from one accounting period to the next. It is divided into three sections: (1) cash provided (used) by operating activities, (2) cash provided (used) by investing activities, and (3) cash provided (used) by financing activities. Each of these sections contains the cash inflows and outflows of the period that were associated with the indicated activity.

- *Cash flows from operating, investing, and financing activities.*

  Cash flows from operating activities include those cash inflows and outflows associated directly with the acquisition and sale of a company's inventories and services. Such activities include the cash receipts from sales and accounts receivable, as well as cash payments from the purchase of inventories, payments on accounts payable, selling and administrative expenses, and interest and taxes. The sale or purchase of inventory on account is an operating transaction that does not appear on the statement of cash flows.

  Cash flows from investing activities include the cash inflows and outflows associated with the purchase and sale of a company's noncurrent assets. Cash activities include the cash effects from the purchase and sale of long-term investments, long-lived assets, and intangible assets.

  Cash flows from financing activities include cash inflows and outflows associated with a company's two sources of outside capital: liabilities and contributed capital. Such activities include the cash inflows associated with borrowings and equity issuances as well as the cash outflows associated with debt repayment, treasury stock purchases, and dividends.

- *How the statement of cash flows complements the other financial statements and how it can be used by those interested in the financial condition of a company.*

  While the income statement provides a summary of a company's operating transactions on an accrual basis, and the balance sheet represents the accumulated accruals of the company's operating, investing, and financing transactions as of a particular point in time, neither statement indicates much about the cash effects of the company's operating, investing, and financing activities. The statement of cash flows is designed to fill this void by summarizing the cash effects of the company's operating, investing, and financing transactions.

  The statement of cash flows is used primarily to evaluate a company's ability to generate cash (i.e., financial flexibility) as well as the effectiveness of its cash management policies. Financial flexibility reflects a company's ability to generate cash through operations, borrowings, issuing equity, or selling noncurrent assets. Effective cash management involves investing cash to provide a high rate of return while maintaining enough cash to meet debts as they come due (i.e., solvency). The statement of cash flows is helpful to this evaluation in three interrelated ways: (1) it explains the change in the cash balance, (2) it summarizes the cash effects of operating transactions, and (3) it summarizes the cash effects of capital (investing and financing) transactions.

- *Important investing and financing transactions that do not appear on the statement of cash flows and how they are reported.*

  The statement of cash flows includes only those transactions that either increase or decrease the cash account. Many important operating and capital transactions do not affect the cash account and are therefore excluded from the statement. For example, the purchase of machinery in exchange for a long-term note payable, the acquisition of land or the payment of a debt with capital stock, and the declaration of a dividend are all capital transactions that have no effect on the cash account and are therefore excluded from the statement.

  The FASB requires that capital transactions that do not affect the cash account be described clearly in the footnotes to the financial statements. No special disclosures are required for operating transactions that do not affect the cash account, because the effects of such transactions can be inferred from the reconciliation of net income to net cash provided (used) by operating activities.

- *Economic consequences associated with the statement of cash flows.*

  The economic consequences associated with the statement of cash flows occur when investors, creditors, and other interested parties use it to assess the investment potential and creditworthiness of companies and the equity and debt securities they issue. The rising importance of cash flow information to report users creates incentives for managers to "window dress" the statement of cash flows. Such incentives can present problems, because in the short run, it is relatively easy for management to present a favorable cash position. Such manipulation is much less effective, however, when statements are viewed across several periods, because payments delayed in one period must normally be paid in the next. For this reason, the FASB requires that cash flow statements from at least the previous three years be disclosed in the financial report.

- *Preparing a statement of cash flows from the information contained in two balance sheets, an income statement, and a statement of shareholders' equity.*

  One can prepare the statement of cash flows, under either the direct or indirect method, by reconstructing the T-account for each balance sheet account, posting the transactions that are reflected on the income statement and statement of shareholders' equity, and deriving the related cash flows.

KEY TERMS

Note: Definitions for these terms are provided in the glossary at the end of this text.

Cash equivalents (p. 641)
Direct method (p. 642)
Financial flexibility (p. 646)
Financing activities (p. 644)
Indirect method (p. 642)
Investing activities (p. 644)
Operating activities (p. 642)
Solvency (p. 646)
Window dress (p. 649)

ETHICS in the Real World

MicroStrategy, a software maker in the business-to-business Internet industry, was introduced at the beginning of the chapter. Since it revised its earnings numbers downward, the company continued to report net losses for some time. Clearly, company management was under considerable pressure from shareholders, bankers, and the investment community to turn things around. While the company's cash flow situation appeared somewhat more promising, a closer look at the numbers indicates that net cash from operations was buoyed by huge increases in the company's accounts payable balance. It is possible, for example, that MicroStrategy intentionally delayed some payments to suppliers in an effort to put as positive a spin as possible on the company's cash flow position.

ETHICAL ISSUE Is it ethical for a company in weak financial condition to manage the timing of its cash receipts and payments to delay signaling that weakness to the public?

INTERNET RESEARCH EXERCISE

General Motors was once the largest and most dominant auto manufacturer in the world. In an unprecedented move, the U.S. government stepped in to salvage the business, funding over $19 billion to the company before it filed bankruptcy, and billions more afterward. At the time the federal government owned a majority of the company. GM statement of cash flows showed cash used by operating activities of $12.1 billion for the year ending 12/31/2008, coupled with

$1.7 billion used for investing activities for that year. Given the tumult in the financial markets in fall 2008 and GM's deteriorating condition, any cash from financing activities was not enough to keep the company afloat. You can view the 12/31/2008 10-K financial statement on www.gm.com/corporate/investor_information/. Review the statement of cash flows and look at the cash generated by the company and the many drains on that cash flow.

BRIEF EXERCISES

REAL DATA
BE14–1
The indirect presentation

The 2008 statement of cash flows for technology company Hewlett-Packard reported net earnings of $8.3 billion and net cash provided by operating activities of $14.6 billion. Depreciation and amortization totaled $3.4 billion. HP used the indirect form of presenting the statement of cash flows.

a. How is depreciation disclosed on the statement of cash flows? Why?
b. Why doesn't net earnings plus depreciation equal net cash provided by operating activities?
c. Provide an estimate of the net change in current assets and current liabilities for HP during 2008.

REAL DATA
BE14–2
Cash vs. accruals

Pier 1 Imports reported retail sales for fiscal 2008 of $1.3 billion. During the year, accounts receivable decreased from $24.2 million to $19.1 million.

Estimate the cash collected by Pier 1 from its customers during 2008.

REAL DATA
BE14–3
Inferring inventory transactions

Pier 1 Imports reported cost of sales of $957 million for fiscal 2008. Inventory decreased during the year from $412 million to $316 million, and accounts payable (related to inventory purchases) decreased from $106 million to $81 million.

a. Estimate the cost of inventories purchased during 2008.
b. Estimate the cash payments made to inventory suppliers during 2008.

REAL DATA
BE14–4
Interpreting the statement of cash flows

The following information was taken from the 2008 statements of cash flow for Agilent Technologies and Advanced Micro Devices (dollars in millions):

Company	Net Income/ (Loss)	Cash from Operating	Cash from Investing	Cash from Financing
Agilent	$ 693	$ 756	$(399)	$(774)
AMD	(3,098)	(692)	(27)	220

a. Compute the change in cash for both companies.
b. Describe the cash management profile for each company—that is, what is the source of each company's cash, and how is each company using it?
c. Discuss why cash from operating for AMD and Agilent is greater than profits. What does the cash from financing figure tell you about the companies' activities?

REAL DATA
BE14–5
Interpreting IFRS-based statements of cash flow across time

The statement of cash flow for Nestlé Group, a Swiss-based food conglomerate that publishes IFRS-based financial statements, contained the following numbers (in million Swiss francs—CHF).

	2008	2007
Profit	19,051	11,382
Operating cash flow	10,763	13,439
Cash flow from investing activities	4,699	(15,753)
Cash flow from financing activities	(16,884)	3,397

a. Explain how profit could be below operating cash flow in one year and above it the next.
b. Analyze Nestlé's cash management activities in 2007 and contrast them with 2008.

EXERCISES

E14–1
Classifying transactions

Classify each of the following transactions as an operating, investing, or financing activity, even those that would not appear explicitly on the statement of cash flows. Some transactions may be classified in more than one category.

1. Purchase of machinery for cash
2. Issuance of common stock for cash
3. Sale of inventory on account
4. Purchase of outstanding stock (treasury stock) for cash
5. Sale of land held as a long-term investment
6. Purchase of a building for cash and a mortgage payable
7. Cash payment for principal and interest on an outstanding debt
8. Cash payment on accounts payable
9. Payment of a cash dividend
10. Payment of wages to employees

E14–2
Operating, investing, or financing activity?

The following are several activities that Wallingford, Inc. engaged in during 2012:

1. Wrote off an open receivable as uncollected.
2. Purchased a piece of plant equipment.
3. Reacquired 5,000 shares of its common stock.
4. Sold a building in exchange for a five-year note.
5. Declared, but did not pay, a cash dividend.
6. Retired bonds payable by issuing common stock.
7. Collected on a long-term note receivable.
8. Issued a stock dividend.
9. Recorded depreciation on fixed assets. (Assume that the direct method is used.)
10. Paid interest on long-term debt.
11. Purchased inventory on account.
12. Collected open accounts receivable.
13. Exchanged a building for land.
14. Issued 75,000 shares of preferred stock.
15. Purchased a two-year fire insurance policy.

Assume that each of these transactions involved cash unless otherwise indicated. Indicate in which section of the statement of cash flows each transaction would be classified. Classify each transaction as one of the following:

a. An operating activity
b. An investing activity
c. A financing activity
d. Not included on the statement of cash flows

E14–3
Cash management policies across companies

Summaries of the 2012 statements of cash flows for five different companies follow. For each company compute the missing dollar amount, and briefly describe the company's cash management policy for 2012.

	Cash Provided (Used) by			Net Increase
Company	Operations	Investments	Financing	(Decrease)
AAA	$320	?	$(180)	$ (38)
BBB	219	$(450)	190	?
CCC	?	(414)	80	$(137)
DDD	120	(130)	?	420
EEE	?	(120)	(100)	70

REAL DATA

E14–4

Cash management across companies

Excerpts of statements of cash flows reported by Kraft Foods, Kellogg's, and General Mills, three companies in the food industry, are provided below (dollars in millions).

Company	Cash from Operations	Cash from Investments	Cash from Financing	Net Change in Cash
Kraft Foods	**$5,084**	**$?**	**$(2,988)**	**$857**
Kellogg's	**1,643**	**(370)**	**(1,194)**	**?**
General Mills	**?**	**(289)**	**(1,450)**	**89**

For each company compute the missing dollar amount, and briefly describe the company's cash management policy.

E14–5

Journalizing and classifying transactions

Presented below is a list of transactions entered into by Kaitland Manufacturing during 2012.

1. Recorded depreciation expense of $170,000.
2. Sold 10,000 shares of common stock ($10 par value) for $18 per share.
3. Purchased 5,000 shares of IBM for $75 per share.
4. Purchased a three-year insurance policy for $27,000.
5. Purchased a building with a fair market value of $200,000 in exchange for a twenty-five-year mortgage. The agreement called for a down payment of $40,000.

Assume that each transaction is independent. Indicate how each transaction affects the accounting equation and how the cash effect, if any, would be disclosed on the company's statement of cash flows. That is, provide

a. the dollar amount of the cash effect,
b. whether it increases or decreases cash, and
c. the section of the statement of cash flows in which it would appear.

E14–6

Converting accrual to cash numbers

The following are several account titles that could appear on an income statement:

1. Cost of Goods Sold
2. Insurance Expense
3. Sales Revenue
4. Rent Expense
5. Dividend Revenue
6. Wage Expense
7. Supplies Expense
8. Interest Expense
9. Rent Revenue
10. Depreciation Expense

Several possible balance sheet accounts follow.

A. Cash
B. Merchandise Inventory
C. Retained Earnings
D. Unearned Sales Revenue
E. Interest Payable
F. Dividends Receivable
G. Fixed Assets
H. Rent Payable
I. Accounts Payable
J. Accounts Receivable
K. Premium on Bonds Payable
L. Allowance for Doubtful Accounts
M. Deferred Income Taxes
N. Prepaid Rent
O. Wages Payable
P. Common Stock
Q. Supplies Inventory
R. Discount on Bonds Payable
S. Unearned Rent
T. Marketable Securities
U. Prepaid Interest
V. Bonds Payable
W. Accumulated Depreciation
X. Prepaid Insurance

a. Assume that you wish to compute the cash inflow or outflow associated with each income statement account. Match each income statement account with the related balance sheet account (or accounts) that you would analyze in this computation.
b. For Sales Revenue, Cost of Goods Sold, and Interest Expense indicate whether an increase in the related balance sheet accounts (identified in [a]) would be added to or deducted from the income statement item when computing the cash effect.

E14–7

Depreciation: A source of cash?

Your boss asks you to examine the following income statements of Hamilton Hardware and Watson Glass:

	Hamilton Hardware	Watson Glass
Sales	**$900,000**	**$900,000**
Cost of goods sold	**(400,000)**	**(400,000)**
Depreciation expense	**(50,000)**	**(100,000)**
Other expenses	**(200,000)**	**(200,000)**
Net income	**$250,000**	**$200,000**

In the notes to the financial statements, you notice that Hamilton Hardware uses the straight-line method of depreciation and that Watson Glass uses the double-declining-balance method.

a. Assume that the dollar amounts for sales, cost of goods sold, and other expenses reflect total cash collections from customers, total cash paid for inventory, and total cash paid for other expenses, respectively. Compute cash provided (used) by operating activities for each company, using each of the following:
   1. The direct method format
   2. The indirect method format

b. Why is the cash provided (used) by operations different from net income? Which of the two methods shows this more clearly?

c. Would you agree or disagree with the following statement? *Depreciation is an important source of cash for most companies.* Explain your answer.

E14–8

Preparing a statement of cash flows from original transactions

Tony began a small retailing operation on January 1, 2012. During 2012, the following transactions occurred:

1. Tony contributed $20,000 of his own money to the business.
2. $60,000 was borrowed from the bank.
3. Long-lived assets were purchased for $25,000 cash.
4. Inventory was purchased: $25,000 cash and $15,000 on account.
5. Inventory with a cost of $25,000 was sold for $80,000: $20,000 cash and $60,000 on account.
6. Cash payments included $18,000 for operating expenses, $5,000 for loan principal, and a $2,000 dividend.
7. $15,000 in expenses were accrued at the end of the year.

a. Prepare journal entries for each economic event.

b. Prepare a balance sheet as of the end of 2012 and an income statement and reconciliation of retained earnings for 2012 for Tony's business.

c. Prepare a cash T-account and a statement of cash flows using the direct method.

d. Prepare a statement of cash flows using the indirect method, but this time prepare it from the company's two balance sheets, the income statement, and the reconciliation of retained earnings. Tony's first balance sheet contains all zero balances.

E14–9

Preparing a statement of cash flows from the cash account in the ledger

Driftwood Shipbuilders entered into the following transactions during 2012:

1. Sold $6,000 of no-par common stock.
2. Purchased $6,000 of inventory on account.
3. Purchased new equipment for $5,000 in cash.
4. Collections on accounts receivable totaled $10,000.
5. Made payments of $5,000 to suppliers.
6. Declared and paid dividends of $2,000.
7. Paid rent of $6,000 for the last six months of 2011 and $6,000 for the first six months of 2012.
8. Made sales totaling $100,000: $35,000 on account and the remainder for cash.
9. Paid $40,000 in cash for miscellaneous expenses.
10. Sold investments with a cost of $20,000 for $25,000.

a. Prepare journal entries for each transaction.
b. Prepare a cash T-account and post all transactions affecting cash to the account. Assume a beginning cash balance of $25,000.
c. Prepare a statement of cash flows (direct method) from the cash T-account.

E14–10
Computing cash outflows from accrual information

The following year-end totals were taken from the records of Landau's Supply House. Compute the cash outflows associated with insurance and wages during 2012.

	2012	2011
Prepaid insurance	**$7,000**	**$4,200**
Wages payable	**6,000**	**0**
Insurance expense	**3,000**	**4,700**
Wage expense	**8,500**	**3,000**

E14–11
Reconstructing a transaction and its cash effect

The following information was taken from the records of Dylan's Toys:

	2012	2011
Machinery	**$ 45,000**	**$ 20,000**
Accumulated depreciation	**$(15,000)**	**$(10,000)**
Depreciation expense	**7,000**	**6,000**
Gain on sale of machinery	**2,000**	**500**

Machinery with a cost of $8,000 was sold during 2012.

a. How much machinery was purchased during 2012?
b. How much cash was collected on the sale of the machinery during 2012?
c. Provide the journal entry to record the sale of the machinery.

REAL DATA

E14–12
Compute cash flows from accrual numbers

Excerpts from the 2008 financial statements of SUPERVALU supermarkets are as follows (dollars in millions):

	2008	2007
Sales	**$44,564**	**$44,048**
Cost of sales	**34,451**	**33,943**
Accounts receivable	**887**	**965**
Inventory	**2,709**	**2,776**
Accounts payable	**2,441**	**2,579**

Compute estimates of cash receipts from customers and cash payments to suppliers. Assume that all sales are on account and that accounts payable includes only accounts with suppliers.

E14–13
Computing cash provided by operations from accrual information

Income statement and balance sheet excerpts of Shevlin and Liberty for the period ending December 31, 2012, follow. Compute cash provided (used) by operating activities for the period ending December 31, 2012. Use both the direct and indirect forms of presentation.

INCOME STATEMENT EXCERPTS		
Sales		**$48,000**
Cost of goods sold		**30,000**
Gross profit		**$18,000**
Wage expense	**$4,000**	
Advertising expense	**1,000**	
Depreciation expense	**2,000**	**7,000**
Net income		**$11,000**

BALANCE SHEET EXCERPTS	2012	2011
Accounts receivable	$4,000	$ 5,000
Deferred revenues	0	3,000
Inventory	9,000	11,000
Accounts payable	3,000	4,000
Wages payable	1,800	900
Prepaid advertising	3,000	1,200
Accumulated depreciation	5,000	3,000

E14–14

Preparing a statement of cash flows from information contained in the other financial statements

The following information was taken from the records of Grimes Pools. Prepare a statement of cash flows (direct method) for the period ending December 31, 2012. Assume that all transactions involve cash.

	2012	2011
Cash	$ 4,000	$ 6,000
Noncash operating assets	15,000	15,000
Nonoperating assets	20,000	28,000
Operating liabilities	2,000	8,000
Nonoperating liabilities	6,000	4,000
Contributed capital	26,000	30,000
Retained earnings	5,000	7,000
Revenues	35,000	
Expenses	34,000	
Dividends	3,000	

E14–15

Preparing a statement of cash flows from information contained in the other financial statements

The following information was taken from the records of Romora Supply House. Prepare a statement of cash flows (direct method) for the period ending December 31, 2012. Assume that all transactions involve cash.

	2012	2011
Cash	$12,000	$ 5,000
Noncash operating assets	18,000	23,000
Nonoperating assets	27,000	23,000
Operating liabilities	7,000	2,000
Nonoperating liabilities	6,000	8,000
Contributed capital	35,000	32,000
Retained earnings	9,000	9,000
Revenues	64,000	
Expenses	61,000	
Dividends	3,000	

E14–16

Computing net income from cash provided by operating activities

The operating cash flows and balance sheet excerpts of Schlee and Associates for the period ending December 31, 2012, follow. Compute net income for the period ending December 31, 2012.

OPERATING ACTIVITIES	
Cash inflows from sales	$ 65,000
Cash payments for inventories	$(40,000)
Cash payments for wages	(6,000)
Cash payments for advertising	(1,000)
Cash provided (used) by operating activities	$ 18,000

BALANCE SHEET EXCERPTS	2012	2011
Accounts receivable	$ 3,000	$ 9,000
Deferred revenues	4,000	1,000
Inventory	18,000	10,000
Accounts payable	7,000	3,000
Salaries payable	2,100	1,300
Prepaid advertising	5,000	8,000
Accumulated depreciation	8,000	5,000

E14–17

Preparing the operating section of the statement of cash flows: Direct and indirect methods

The following balance sheet and income statement data were taken from the records of L. L. Beeno for the year ended December 31, 2012:

	2012	2011
BALANCE SHEET		
Cash	$ 3,000	$ 2,800
Accounts receivable	5,600	4,500
Inventory	7,500	7,800
Prepaid insurance	600	900
Total current assets	$16,700	$16,000
Machinery (net)	29,000	26,000
Total	$45,700	$42,000
Accounts payable	$ 5,600	$ 7,300
Wages payable	4,500	3,400
Total current liabilities	$10,100	$10,700
Bonds payable (net)	14,000	14,800
Capital stock	5,000	5,000
Retained earnings	16,600	11,500
Total	$45,700	$42,000
INCOME STATEMENT		
Revenues	$47,000	
Cost of goods sold	25,000	
Gross profit	$22,000	
Wage expense	(6,200)	
Insurance expense	(4,200)	
Interest expense	(1,600)	
Depreciation expense	(3,300)	
Net income before taxes	$ 6,700	
Tax expense	1,200	
Net income	$ 5,500	

Prepare the operating section of the statement of cash flows, and present it under both the direct and indirect methods.

E14–18

Preparing the operating section of the statement of cash flows: Direct and indirect methods

The following balance sheet and income statement data were taken from the records of Martland Stores for the year ended December 31, 2012.

	2012	2011
BALANCE SHEET		
Cash	$ 6,000	$ 1,400
Accounts receivable	12,000	13,500
Inventory	4,500	9,800
Prepaid insurance	900	1,200
Total current assets	$23,400	$25,900
Machinery (net)	38,000	37,500
Total	$61,400	$63,400

	2012	2011
Accounts payable	$12,600	$13,100
Wages payable	9,500	7,400
Total current liabilities	$22,100	$20,500
Bonds payable (net)	17,000	17,000
Capital stock	15,000	15,000
Retained earnings	7,300	10,900
Total	$61,400	$63,400
INCOME STATEMENT		
Revenues	$96,000	
Cost of goods sold	64,000	
Gross profit	$32,000	
Wage expense	(18,600)	
Insurance expense	(9,200)	
Interest expense	(2,100)	
Depreciation expense	(5,700)	
Net loss	$ 3,600	

Prepare the operating section of the statement of cash flows, and present it under both the direct and indirect methods.

E14–19

Preparing the operating section of the statement of cash flows: Direct and indirect methods

The following balance sheet and income statement data were taken from the records of Mako Retail Supply for the year ended December 31, 2012.

	2012	2011
BALANCE SHEET		
Cash	$ 6,000	$ 5,400
Accounts receivable	11,200	9,000
Inventory	15,000	15,600
Prepaid rent	1,200	1,800
Total current assets	$ 33,400	$31,800
Equipment (net)	58,000	52,000
Total	$ 91,400	$83,800
Accounts payable	$ 11,200	$14,600
Wages payable	9,000	6,800
Interest payable	1,500	2,200
Unearned revenue	6,500	4,700
Total current liabilities	$ 28,200	$28,300
Bonds payable (net)	28,000	28,400
Capital stock	10,000	10,000
Retained earnings	25,200	17,100
Total	$ 91,400	$83,800
INCOME STATEMENT		
Revenues	$109,100	
Cost of goods sold	56,000	
Gross profit	$ 53,100	
Wage expense	(15,200)	
Rent expense	(9,000)	
Interest expense	(2,900)	
Depreciation expense	(6,200)	
Loss on sale of equipment	(4,200)	
Net income before taxes	$ 15,600	
Tax expense	4,400	
Net income	$ 11,200	

Prepare the operating section of the statement of cash flows, and present it under both the direct and indirect methods.

E14–20

Preparing the operating section of the statement of cash flows: Direct and indirect methods

The following balance sheet and income statement data were taken from the records of Steeler and Jones for the year ended December 31, 2012:

	2012	2011
BALANCE SHEET		
Cash	$ 6,400	$ 7,400
Accounts receivable	11,900	13,000
Inventory	14,100	15,600
Prepaid rent	1,300	900
Total current assets	$ 33,700	$ 36,900
Equipment (net)	52,000	66,000
Total	$ 85,700	$102,900
Accounts payable	$ 9,200	$ 14,600
Wages payable	4,500	6,800
Interest payable	1,500	1,300
Unearned revenue	6,500	8,700
Total current liabilities	$ 21,700	$ 31,400
Bonds payable (net)	16,500	24,300
Capital stock	20,000	25,000
Retained earnings	27,500	22,200
Total	$ 85,700	$102,900
INCOME STATEMENT		
Revenues	$ 87,400	
Cost of goods sold	46,700	
Gross profit	$ 40,700	
Wage expense	$(13,200)	
Rent expense	(11,000)	
Interest expense	(1,900)	
Depreciation expense	(5,700)	
Plus: Gain on sale of equipment	5,200	
Net income before taxes	$ 14,100	
Tax expense	4,800	
Net income	$ 9,300	

Prepare the operating section of the statement of cash flows, and present it under both the direct and indirect methods.

E14–21

Preparing the operating section of the statement of cash flows: Direct and indirect methods

The following balance sheet and income statement data were taken from the records of Harbaugh Auto Supply for the year ended December 31, 2012:

	2012	2011
BALANCE SHEET		
Cash	$ 10,100	$ 8,400
Accounts receivable	14,400	13,900
Inventory	21,600	18,700
Interest receivable	1,200	1,500
Prepaid rent	2,600	1,400
Total current assets	$ 49,900	$ 43,900
Investments	35,400	32,100
Equipment (net)	98,000	91,700
Total	$183,300	$167,700

	2012	2011
Accounts payable	$ 18,700	$ 21,300
Wages payable	9,800	11,200
Interest payable	2,300	1,700
Dividend payable	1,700	1,200
Taxes payable	3,100	4,300
Unearned revenue	12,300	15,100
Total current liabilities	$ 47,900	$ 54,800
Long-term notes payable (net)	68,300	62,800
Capital stock	42,000	42,000
Retained earnings	25,100	8,100
Total	$183,300	$167,700
INCOME STATEMENT		
Sales revenues		$ 47,500
Service revenue		35,200
Interest revenue		9,300
Cost of goods sold		(21,200)
Wage expense		(17,600)
Rent expense		(15,300)
Interest expense		(6,200)
Depreciation expense		(11,500)
Add: Gain on sale of investments		13,200
Net income before taxes		$ 33,400
Tax expense		9,100
Net income		$ 24,300

The company sells goods and provides services. All sales are made on account, and cash is received in advance on services with service revenues being recognized after services are performed.

Prepare the operating section of the statement of cash flows, and present it under both the direct and indirect methods.

E14–22

Preparing the operating section of the statement of cash flows: Direct and indirect methods

The following balance sheet and income statement data were taken from the records of Standard Center Manufacturing for the year ended December 31, 2012.

The company sells goods and provides services. All sales are made on account, and cash is received in advance on services with service revenues being recognized after services are performed.

Prepare the operating section of the statement of cash flows, and present it under both the direct and indirect methods.

	2012	2011
BALANCE SHEET		
Cash	$ 20,200	$ 22,800
Accounts receivable	28,800	34,800
Inventory	42,900	43,900
Interest receivable	4,100	6,300
Prepaid rent	3,900	1,200
Total current assets	$ 99,900	$109,000
Investments	18,200	23,500
Equipment (net)	43,900	62,500
Total	$162,000	$195,000

	2012	2011
Accounts payable	$ 12,500	$ 8,600
Wages payable	11,100	11,500
Interest payable	1,800	2,100
Dividend payable	900	1,700
Taxes payable	1,200	3,200
Unearned revenue	7,200	9,600
Total current liabilities	$ 34,700	$ 36,700
Long-term notes payable (net)	75,400	97,300
Capital stock	25,000	25,000
Retained earnings	26,900	36,000
Total	$162,000	$195,000

INCOME STATEMENT	
Sales revenues	$67,500
Service revenue	28,200
Interest revenue	7,300
Cost of goods sold	(19,500)
Wage expense	(28,400)
Rent expense	(21,500)
Interest expense	(7,200)
Depreciation expense	(4,300)
Loss on sale of investments	(17,900)
Net income before taxes	$ 4,200
Tax expense	1,400
Net income	$ 2,800

REAL DATA

E14–23

Working with an IFRS-based operating section of the statement of cash flows

The information below was taken from the IFRS-based 2008 financial statements published by Carrefour, a French retailer (in million euros).

Income before tax	2,214
Tax	624
Provision for amortization	1,946
Net gains on sales of assets	219
Provision for impairment	642
Net increase in working capital	964

From the information above, estimate net cash from operations.

PROBLEMS

P14–1

Placing transactions on the statement of cash flows

The following events occurred during 2012 for Frames Unlimited:

1. Purchased inventory for $60,000 in cash.
2. Recorded $40,000 in insurance expense for the portion of an insurance policy acquired in 2011 that expired during 2012.
3. Paid $40,000 for rental space that the company will not use until 2013.
4. Sold land with a cost of $80,000 for $94,000 cash.
5. Paid $90,000 on a long-term note. Included in the $90,000 is $15,000 in interest, $9,000 of which was accrued in 2011.
6. Recorded bad debt expense in the amount of $30,000 (allowance method).

7. Reissued 5,000 shares of treasury stock for $30 per share. The stock was acquired at $18 per share.
8. Declared and issued a stock dividend. Ten thousand shares of common stock ($10 par value) were issued with a fair market value of $25 per share at the time.
9. Issued $500,000 face value bonds for cash at a total discount of $25,000.
10. Purchased a building for $100,000 in cash, $50,000 in common stock, and a note with a present value of $217,000.
11. Recorded $35,000 in sales to customers on account.

Frames Unlimited is in the process of preparing a statement of cash flows under the direct method.

REQUIRED:

Use a chart like the one in this problem to indicate the following:

a. The section of the statement of cash flows in which each transaction should be listed. Use the following terms:
   (1) Operating—for operating activities
   (2) Investing—for investing activities
   (3) Financing—for financing activities
   (4) N/A—for items that would not be included on the statement of cash flows
b. Whether the transaction would involve an inflow or an outflow of cash.
c. The dollar amount, if appropriate, that the company would report on the statement of cash flows.

The first transaction is done for you as an example.

Transaction	Section	Inflow	Outflow	Amount
1.	**Operating**		**X**	**$60,000**

P14–2

Placing transactions on the statement of cash flows

Endnote Enterprises entered into the following transactions during 2012:

1. Sold merchandise for $52,000 in cash.
2. Purchased a parcel of land. The company paid $12,000 in cash and issued a $30,000 note payable for the remainder.
3. Purchased a three-year insurance policy for $30,000.
4. Purchased a building in exchange for a long-term note with a face value and present value of $115,000.
5. Collected $100,000 on a long-term note receivable. Included in the $100,000 is $6,000 in interest earned and accrued in the previous period and $4,000 in interest earned in the current period.
6. Collected from customers $45,000 that will not be earned until 2013.
7. Reacquired 5,000 shares of its common stock for $10 per share.
8. Declared and paid a cash dividend of $40,000.
9. Paid $25,000 for wages accrued in a prior year.
10. Retired $500,000 in bonds payable. The company gave the creditor $300,000 in cash and $200,000 in common stock.
11. Purchased $60,000 of inventory on account.
12. Wrote off an open account ($5,000) as uncollectible (allowance method).
13. Recorded $84,000 in depreciation expense for the year.

Endnote Enterprises is in the process of preparing its statement of cash flows under the direct method.

REQUIRED:

Use the chart format below and on the next page to indicate the following:

a. The section of the statement of cash flows in which each transaction would be listed. Use the following terms:
   (1) Operating—for operating activities
   (2) Investing—for investing activities
   (3) Financing—for financing activities
   (4) N/A—for items that would not be included on the statement of cash flows
b. Whether the transaction would involve an inflow or an outflow of cash.
c. The dollar amount, if appropriate, that the company would report on the statement of cash flows.

The first transaction is done for you as an example.

Transaction	Section	Inflow	Outflow	Amount
1.	**Operating**	**X**		**$52,000**

P14–3

Classifying transactions and their cash effects

MHT Enterprises entered into the following transactions during 2012:

1. Sold a piece of equipment with a book value of $8,000 for $1,200.
2. Purchased a parcel of land for $13,000.
3. Purchased a three-year insurance policy for $9,000.
4. Issued 1,000 shares of common stock at $7 per share.
5. Collected a short-term note, including interest, in the amount of $2,500.
6. Collected $3,000 from customers that will not be earned until 2013.
7. Purchased a building in exchange for a long-term note with a face value of $15,000 (the present value of the note is $12,000).
8. Declared and paid a cash dividend of $7,000.
9. Paid $5,000 in wages.
10. Converted an outstanding receivable into a short-term note receivable that matures in February 2013.
11. Purchased $4,500 of inventory on account.
12. Wrote off an account ($500) as uncollectible (allowance method).
13. Recorded $9,000 in depreciation expense for the year.

REQUIRED:

a. The controller of MHT Enterprises is trying to explain the change in the company's cash balance from January 1, 2012, to December 31, 2012. The controller has asked you to analyze each of the transactions. You are to indicate whether cash was provided, used, or not affected by each transaction. If the cash balance is affected by the transaction, indicate the dollar amount of the increase or decrease. Unless otherwise indicated, assume that all transactions involve cash.
b. Classify each transaction identified in (a) as affecting cash as one of the following:
   (1) An operating activity
   (2) An investing activity
   (3) A financing activity

P14–4

Comparing cash flow policies across companies in the Internet industry

Cash flows from three well-known Internet companies are provided below (dollars in millions):

Priceline:	**2009**	**2008**	**2007**
Operations	**$510**	**$316**	**$156**
Investing	**(501)**	**(152)**	**(221)**
Financing	**(169)**	**(169)**	**19**

Amazon.com:	2009	2008	2007
Operations	$3,293	$1,697	$1,405
Investing	(2,337)	(1,199)	42
Financing	(280)	(198)	50

eBay:	2009	2008	2007
Operations	$2,908	$2,882	$2,641
Investing	(1,149)	(2,057)	(693)
Financing	(946)	(1,674)	(694)

REQUIRED:

Describe the similarities and differences of the cash flow policies across the three companies.

P14–5

Classifying transactions and their cash effects

Several transactions entered into by Travis Retail during 2012 follow:

1. Received $50,000 for wine previously sold on account.
2. Paid $55,000 in wages.
3. Sold a building for $100,000. The building had cost $170,000, and the related accumulated depreciation at the time of sale was $55,000.
4. Declared and paid a cash dividend of $70,000.
5. Repurchased 10,000 shares of outstanding common stock at $50 per share.
6. Purchased a two-year, $100,000 fire and storm insurance policy on June 30.
7. Purchased some equipment in exchange for 1,000 shares of common stock. The stock was currently selling for $75 per share.
8. Purchased $500,000 in equity securities considered to be long-term.
9. Issued $200,000 face value bonds. The bonds were sold at 101.
10. Owed $30,000 in rent as of December 31.

REQUIRED:

Record each transaction on a chart like the following. Classify the sections of the statement of cash flows as a cash flow from operating, investing, or financing activities. Transaction (1) is done as an example.

Transaction	Effect on Cash	Section of Statement	Explanation
1.	+50,000	Operating	Operations is defined in terms of inventory activity.

P14–6

A company's cash management policy across time

Ruttman Enterprises began operations in early 2010. Summaries of the statement of cash flows for the years 2010, 2011, and 2012 follow:

	2012	2011	2010
Cash provided (used) by operating activities	$?	$(202)	$?
Cash provided (used) by investing activities	160	?	(500)
Cash provided (used) by financing activities	(150)	280	900
Increase (decrease) in cash	$?	$ (24)	$ 110
Cash balance at beginning of year	86	?	0
Cash balance at end of year	$ 176	$ 86	$?

REQUIRED:

a. Compute the missing dollar amounts.
b. Briefly comment on the company's cash management policy over the three-year period.

REAL DATA

P14–7

Cash management across time

The following information was taken from the 2008 annual report of Hewlett-Packard, a leading technology manufacturer (dollars in millions):

	2008	2007	2006
Cash provided (used) by operating activities	**$14,591**	**$?**	**$11,353**
Cash provided (used) by investing activities	**(13,711)**	**(9,123)**	**?**
Cash provided (used) by financing activities	**?**	**(5,590)**	**(6,077)**
Increase (decrease) in cash	**(1,140)**	**?**	**2,489**
Cash balance at beginning of year	**?**	**16,400**	**13,911**
Cash balance at end of year	**$10,153**	**$11,293**	**$?**

REQUIRED:

a. Compute the missing dollar amounts.
b. Comment on the company's cash management policies across the three-year period.

P14–8

Deriving the cash effects of investing transactions

Webb Industries reported the following information concerning the company's property, plant, and equipment in its 2012 financial report:

	2012	2011
Buildings	**$ 750,000**	**$820,000**
Accumulated depreciation	**(100,000)**	**(80,000)**
Equipment	**500,000**	**380,000**
Accumulated depreciation	**(75,000)**	**(85,000)**
Land	**250,000**	**250,000**
Depreciation expense—buildings	**40,000**	**25,000**
Depreciation expense—equipment	**15,000**	**12,000**

Listed here are four independent cases involving buildings, equipment, and land during 2012.

1. The company purchased a building for $60,000.
2. The company sold equipment in December 2012 that was purchased for $50,000. It recorded a gain of $5,000 on the sale.
3. The company sold a piece of land for $300,000 at a gain of $75,000.
4. The company acquired a building in exchange for land. The land had a book value of $150,000 and a market value of $600,000.

REQUIRED:

a. For each case, explain the change from 2011 to 2012 in the affected buildings, equipment, and land accounts. (For example, in case [1] explain the change in the building account, the related accumulated depreciation account, and the balance in the related depreciation expense account.)
b. For each case, compute the effect on the cash balance, and indicate the appropriate disclosure on the statement of cash flows.

P14–9

Deriving the cash generated from a common stock issuance

The shareholders' equity section of Mountvale Associates is as follows:

	2012	2011
Common stock ($1 par value)	**$128,000**	**$100,000**
Additional paid-in capital (C/S)	**95,000**	**12,000**
Retained earnings	**41,000**	**35,000**
Total shareholders' equity	**$264,000**	**$147,000**

The following selected transactions occurred during 2012:

1. 1/1/12: A 20 percent stock dividend was issued. The fair market value of the stock at the time was $3 per share.
2. 8/25/12: Land was purchased in exchange for 6,000 shares of common stock. The fair market value of the stock was $3 per share.
3. 12/31/12: Common stock was issued for cash.

REQUIRED:

How many shares of common stock did Mountvale issue on December 31, 2012, and how much cash did the issuance generate? Show all calculations clearly. (*Hint:* Calculate the number of shares of common stock issued for cash.)

P14–10

Converting cash flow numbers to accrual numbers and vice versa

Taylor Brothers began operations in 2011. The following selected information was extracted from its financial records:

	2012	2011
Sales returns	**$ 25,000**	**$ 20,000**
Cost of goods sold	**375,000**	**250,000**
Inventory	**110,000**	**130,000**
Accounts receivable	**150,000**	**95,000**
Insurance expense	**50,000**	**35,000**
Cash collected on sales	**500,000**	**350,000**
Accounts payable	**115,000**	**105,000**
Cash paid for insurance	**90,000**	**65,000**

REQUIRED:

a. Compute gross sales (accrual basis) for 2011 and 2012.
b. Calculate the amount of cash paid to suppliers during 2012 for inventory.
c. Compute the balance in the prepaid insurance account as of December 31, 2011, and December 31, 2012.

P14–11

Reconciling the income statement, the direct method, and the indirect method

Battery Builders, Inc. prepared statements of cash flows under both the direct and indirect methods. The operating sections of each statement under the two methods follow:

DIRECT METHOD

Collections from customers	**$26,000**
Payments to suppliers	**(13,000)**
Payments for operating expenses	**(10,000)**
Cash provided (used) by operating activities	**$ 3,000**

INDIRECT METHOD

Net income	**$9,000**
Depreciation	**3,000**
Gain on sale of equipment	**(2,000)**
Increase in inventory	**(3,000)**
Increase in accounts receivable	**(3,000)**
Increase in accounts payable	**1,000**
Decrease in accrued payables	**(2,000)**
Cash provided (used) by operating activities	**$3,000**

REQUIRED:

Prepare an income statement from the information provided.

P14–12

Manipulating dollar amounts on the statement of cash flows

Pendleton Enterprises began operations on January 1, 2010. Balance sheet and income statement information for 2010, 2011, and 2012 follow:

	2012	2011	2010
Cash	**$ 6,000**	**$ 9,000**	**$7,000**
Accounts receivable	**8,000**	**5,000**	**4,000**
Accounts payable	**5,000**	**3,000**	**2,000**
Revenues	**12,000**	**14,000**	**8,000**
Expenses	**14,000**	**9,000**	**6,000**

REQUIRED:

a. Prepare the operating sections of the statement of cash flows for 2010, 2011, and 2012 under the direct method.
b. Assume that the $4,000 of outstanding accounts receivable on December 31, 2010, was actually collected before the end of 2010 but that the accounts receivable balances for 2011 and 2012 are unchanged. Prepare the statements of cash flows under the direct method for all three years.
c. Ignore the assumption in (b), and assume alternatively that the company deferred an additional $3,000 on the payment of accounts payable as of December 31, 2010 (i.e., accounts payable equal $5,000, and cash equals $10,000 on December 31, 2010). The accounts receivable balances for 2011 and 2012 are unchanged. Prepare the operating section of the statements of cash flows for all three periods.
d. How can managers manipulate cash provided (used) by operations, and what usually happens in the subsequent period?

P14–13

Preparing the statement of cash flows from two balance sheets and an income statement

The 2011 and 2012 balance sheets and related income statement of Watson and Holmes Detective Agency follow:

	2012	2011
BALANCE SHEET		
ASSETS		
Cash	$10,000	$ 6,000
Accounts receivable	7,000	2,000
Less: Allowance for doubtful accounts	(1,000)	(500)
Inventory	8,000	10,000
Long-lived assets	12,000	11,000
Less: Accumulated depreciation	(4,000)	(2,000)
Total assets	$32,000	$26,500
LIABILITIES AND SHAREHOLDERS' EQUITY		
Accounts payable	$ 5,000	$ 6,000
Deferred revenues	1,000	2,000
Long-term note payable	10,000	10,000
Less: Discount on note payable	(800)	(1,000)
Common stock	12,000	6,000
Retained earnings	4,800	3,500
Total liabilities and shareholders' equity	$32,000	$26,500
INCOME STATEMENT		
Revenues	$42,000	
Cost of goods sold	(24,000)	
Depreciation expense	(2,000)	
Interest expense	(3,000)	
Bad debt expense	(2,000)	
Other expense	(9,000)	
Net income	$ 2,000	

REQUIRED:

Prepare a statement of cash flows under both the direct and indirect methods for 2012.

P14–14

Paying short-term debts: Effects on working capital, the current ratio, and the statement of cash flows

ISS Inc. began operations on January 1, 2012. It engaged in the following economic events during 2012:

1. Issued 6,000 shares of no-par common stock for $10 per share.
2. Purchased on account 20,000 units of inventory for $1 per unit.
3. Paid and capitalized $7,000 for rent covering 2012 and 2013.

4. Purchased furniture for $30,000, paying $20,000 in cash and signing a long-term note for the remaining balance.
5. Sold on account 8,800 units of inventory for $4 per unit.
6. Paid one-half of the outstanding accounts payable.
7. Received $12,000 from customers on open accounts.
8. Paid miscellaneous expenses of $10,000 for the year.
9. Depreciation recorded on the furniture totaled $5,000.
10. Accrued interest on the long-term note payable amounted to $1,000.
11. Declared dividends of $3,000 at year-end to be paid in January 2013.
12. Recorded entry for $3,000 of rent expired during 2012.

REQUIRED:

a. Prepare journal entries for these events.
b. Prepare an income statement, statement of shareholders' equity, balance sheet, and statement of cash flows (indirect method).
c. Compute working capital and the current ratio.
d. Assume that the company pays the outstanding accounts payable on the final day of 2012. Recompute working capital, the current ratio, and cash provided (used) by operating activities.

P14–15

Preparing the statement of cash flows and reconciling the operating section with the income statement

Sunshine Enterprises included the following statements in its 2012 financial report:

INCOME STATEMENT	2012
Marketing revenue	$1,000,000
Salary expense	(250,000)
Office supplies expense	(175,000)
Depreciation expense	(100,000)
Insurance expense	(60,000)
Rent expense	(120,000)
Net income	$ 295,000

BALANCE SHEET	2012	2011
Cash	$100,000	$ 120,000
Accounts receivable	150,000	105,000
Office supply inventory	75,000	85,000
Prepaid insurance	50,000	10,000
Office furniture	500,000	465,000
Less: Accumulated depreciation	(325,000)	$(225,000)
Total assets	$550,000	$ 560,000
Rent payable	$ 20,000	$ 8,000
Common stock ($10 par value)	100,000	100,000
Additional paid-in capital	125,000	125,000
Retained earnings	305,000	327,000
Total liabilities and shareholders' equity	$550,000	$ 560,000

REQUIRED:

a. Convert each of the accrual-basis income statement accounts to a cash basis. Would you classify this method as directly or indirectly computing cash provided (used) by operating activities?
b. Prepare a proof of results. That is, begin with net income and adjust net income to arrive at cash provided (used) by operating activities. Would you classify this method as directly or indirectly computing cash provided (used) by operating activities?
c. Refer to Figure 14–19, and use the same format to reconcile the income statement with operating cash flows.

P14–16

Preparing the statement of cash flows from two balance sheets and an income statement: Book losses and amortized discounts

The following information was taken from the financial records of Bower Manufacturing Industries:

INCOME STATEMENT	2012
Sales	$190,000
Cost of goods sold	(80,000)
Depreciation expense	(30,000)
Interest expense	(10,000)
Salary expense	(12,000)
Supplies expense	(7,000)
Loss on sale of marketable sec.	(4,000)
Loss on sale of fixed assets	(10,000)
Net income	$37,000

BALANCE SHEETS	2012	2011
Cash	$ 747,000	$ 593,000
Marketable securities	85,000	140,000
Accounts receivable	450,000	400,000
Supplies inventory	10,000	12,000
Inventory	150,000	175,000
Short-term notes receivable	100,000	50,000
Machinery and equipment	550,000	500,000
Less: Accumulated depreciation	(90,000)	(75,000)
Total assets	$2,002,000	$1,795,000
Accounts payable	$ 60,000	$ 95,000
Salaries payable	10,000	10,000
Bonds payable	500,000	500,000
Discount on bonds payable	(5,000)	(10,000)
Common stock ($10 par value)	200,000	100,000
Additional paid-in capital	900,000	800,000
Retained earnings	337,000	300,000
Total liabilities and shareholders' equity	$2,002,000	$1,795,000

The company purchased machinery in exchange for 10,000 shares of common stock. The stock was selling for $20 per share at that time. The short-term receivable was received from a customer in exchange for the sale of merchandise inventory.

REQUIRED:

Prepare a statement of cash flows for the year ended December 31, 2012, using both the direct and indirect methods.

P14–17

Preparing the statement of cash flows from two balance sheets and an income statement: Book gains and amortized premiums

The following information was taken from the 2012 financial records of Price Restaurant Supply Company:

INCOME STATEMENT	
Sales	$160,000
Cost of goods sold	(100,000)
Depreciation expense	(12,000)
Insurance expense	(10,000)
Interest expense	(11,000)
Gain on sale of plant equipment	10,000
Net income	$ 37,000

BALANCE SHEETS	2012	2011
Cash	$173,000	$120,000
Accounts receivable	60,000	65,000
Inventory	210,000	110,000
Prepaid insurance	14,000	24,000
Plant equipment	275,000	350,000
Less: Accumulated depreciation	(67,000)	(75,000)
Total assets	$665,000	$594,000
Accounts payable	$ 51,000	$ 50,000
Bonds payable	200,000	200,000
Premium on bonds payable	3,000	5,000
Common stock ($10 par value)	75,000	40,000
Additional paid-in capital	125,000	95,000
Retained earnings	211,000	204,000
Total liabilities and shareholders' equity	$665,000	$594,000

The company sold a piece of plant equipment for cash that had originally cost $100,000. The accumulated depreciation associated with the equipment at the time of sale was $20,000.

REQUIRED:

Prepare a statement of cash flows for the year ended December 31, 2012, using both the direct and indirect methods.

P14–18

Preparing the statement of cash flows and using it to set dividend policy

Lynch Engineering Firm provided the following income statement for 2012 in its annual financial report:

	2012		2011	
Sales		$5,967,000		$5,590,000
Salary expense	$2,025,000		$1,794,000	
Advertising expense	755,000		710,000	
Bad debt expense	275,000		260,000	
Administrative expenses	898,000		832,000	
Janitorial expense	132,000		120,000	
Supplies expense	281,000		299,000	
Depreciation expense	963,000	5,329,000	978,000	4,993,000
Net income		$ 638,000		$ 597,000

1. The company declared and paid a dividend of $550,000 in 2011 but did not declare any dividends in 2012.
2. 2011:
   (a) Thirty-five percent of the sales were on account.
   (b) The accounts receivable balance decreased by $2,980,000 from January 1 to December 31.
   (c) As of December 31, the company still owed $145,000 in wages and $67,000 on the supplies used during the year.
3. 2012:
   (a) Seventy-five percent of the sales were on account.
   (b) The accounts receivable balance increased by $1,671,750 from January 1 to December 31.
   (c) As of December 31, the company still owed $25,000 in wages and $50,000 in advertising.
   (d) On January 1, 2011, the company had a balance of $13,245 in cash.
4. The company had no write-offs or recoveries of accounts receivable during 2011 or 2012.

REQUIRED:

a. Prepare the operating section of the statement of cash flows for 2011 and 2012, using the direct method.
b. Assume that you are a member of the board of directors of the Lynch Engineering Firm. Several influential shareholders have called you and complained that the company generated more net income in 2012 than in 2011, yet chose not to declare a dividend in 2012. How would you explain the board's position on dividends in 2011 versus 2012?

P14–19

Preparing a complete set of financial statements from a set of original transactions

Mick's Photographic Equipment began operations on January 1, 2011. During 2011, the company entered into the following transactions:

1. Issued 50,000 shares of $15 par value common stock for $30 per share in exchange for cash. Also issued, for cash, 1,000 shares of 10 percent, $100 par value preferred stock for $102 per share.
2. Purchased $750,000 of fixed assets in exchange for cash.
3. Issued twenty bonds, each with a face value of $1,000, at 146 (annual coupon rate = 16 percent and annual yield rate = 10 percent). The bonds pay interest semiannually on December 31 and June 30.
4. Purchased land in exchange for 1,000 shares of $15 par value common stock. The shares were selling for $40 per share at the time.
5. Purchased $2,000,000 of inventory on account. $1,075,000 was subsequently paid during 2005.
6. Sold $2,050,000 of merchandise in exchange for cash. The related inventory had cost $875,000.
7. Purchased a two-year insurance policy for $80,000.
8. Purchased short-term marketable securities for $250,000.
9. Sold $880,000 of merchandise on account. The related inventory had a cost of $490,000. $500,000 of the sales made on account were collected during the year.
10. Paid $500,000 in miscellaneous expenses (rent, utilities, and wages).
11. Declared, but did not pay, a $100,000 dividend.
12. Made the first interest payment on the bonds on December 31.

Adjusting entries include:

a. The fixed assets were purchased on January 1 and had an estimated useful life and salvage value of five years and $50,000, respectively. The company uses the straight-line depreciation method.
b. The company used one-fourth of the insurance policy during 2011.
c. The market value of the marketable securities on December 31 was $225,000.
d. As of December 31, the company had incurred, but had not yet paid, $75,000 in miscellaneous expenses.
e. The company estimates that 8 percent of credit sales will prove uncollectible.
f. The market value of the inventory was $5,000 less than the cost.

REQUIRED:

a. Prepare journal entries for each of the original and adjusting transactions. Establish T-accounts for each account. Post the entries to the T-accounts.
b. Prepare the necessary closing entries. Post these entries.
c. Prepare the income statement and balance sheet for Mick's Photographic Equipment for the year ended December 31, 2011.
d. Prepare the statement of cash flows for Mick's Photographic Equipment for the year ended December 31, 2011, using both the direct and indirect methods.

ISSUES FOR DISCUSSION

REAL DATA
ID14–1
Using the cash flow statement to spot earnings quality problems

An article in *BusinessWeek* described how Bob Olstein, a successful stock analyst, predicts that the prices of stocks issued by firms that "engage in aggressive accounting practices" will go down, stating that other "investors have unrealistic expectations of the earnings potential." He cites Mattel as an example by noting that big changes in net receivables, inventories, and deferred income taxes, as well as foreign currency translation gains that produced no cash, accounted for most of Mattel's earnings growth. The company's debt also jumped "from $440 million to $630 million in about two years."

REQUIRED:

a. Explain how the statement of cash flows, especially if prepared under the indirect format, can be used to identify "quality of earnings" and "earnings persistence" problems.
b. Specifically describe how the information mentioned above about Mattel was used to indicate these kinds of problems.
c. Do you think that it is possible to identify over- and undervalued stocks by identifying firms that use aggressive accounting practices?

REAL DATA
ID14–2
Equity in unconsolidated affiliates

As of January 3, 2010, The Washington Post Company held significant, but not controlling, interest in Bowater Mercy Paper Company and other companies. These investments totaled $54.7 million on the company's 2009 balance sheet. In its 2009 annual report, The Washington Post Company included a statement of cash flows, presented in the indirect form, which covered the three-year period of 2009, 2008, and 2007. A line item was included in the operating section of that statement, titled "equity in losses of affiliates, net of distributions," and the dollar amounts for this item for 2009, 2008, and 2007 were $30.1 million, $9.1 million, and $(3.8) million, respectively.

REQUIRED:

a. Briefly describe the accounting methods used for unconsolidated affiliates, in which a company has a "significant influence." (For a review, see the equity method in Chapter 8.)
b. Explain why the dollar amounts were added to net income on the statement of cash flows.
c. What does the phrase "net of distributions" mean?
d. On the same statement of cash flows, The Washington Post Company reported another line item in the operating section, titled "net loss on sale or write-down of property, plant, and equipment," which included dollar amounts for 2009, 2008, and 2007 of $19.7 million, $4.5 million, and $3.1 million, respectively. Describe the transactions that led to these disclosures and explain why the three-dollar amounts are added to net income in the calculation of net cash flow from operating activities. Would these amounts appear on any of the other financial statements, and if so, which one?

REAL DATA
ID14–3
Accrual and cash flow accounting

Loan officer Han Blackford once commented that cash flow analysis has risen in importance due to a "trend over the past twenty years toward capitalizing and deferring more and more expenses. Although the practice may match revenues and expenses more closely, a laudable intent, it has also made it harder to find the available cash in a company—and easier for lenders to wind up with a loss." He further noted that recessions draw attention to the need for better warning signals of the sort cash flow analysis could provide.

REQUIRED:

a. Why would the process of capitalizing match revenues and expenses more closely, yet make it harder to find the cash available in a company?
b. Discuss the difference between earning power and solvency, why both are essential for a successful business, and how present-day financial accounting statements provide measures of each.
c. Explain why a wave of bankruptcies would draw attention to cash flow analysis.

REAL DATA
ID14–4
Analyzing the operating section of the statement of cash flows

SUPERVALU is one of the largest grocery chains in the United States. Its February 28, 2009, statement of cash flows included the following (dollars in thousands):

SUPERVALU INC. and Subsidiaries
Consolidated Statements of Cash Flows
(in millions)

	February 28, 2009 (53 weeks)	February 23, 2008 (52 weeks)	February 24, 2007 (52 weeks)
Cash flows from operating activities			
Net earnings (loss)	$(2,855)	$ 593	$ 452
Adjustments to reconcile net earnings (loss) to net cash provided by operating activities:			
Goodwill and intangible asset impairment charges	3,524	—	—
Asset impairment and other charges	169	14	26
Depreciation and amortization	1,057	1,017	879
LIFO charge	78	30	18
Gain on sale of assets	(9)	(23)	(15)
Deferred income taxes, net of effects from acquisition and dispositions of businesses	(118)	(74)	44
Stock-based compensation	44	52	42
Other	(25)	(15)	(6)
Changes in operating assets and liabilities, net of effects from acquisition and dispositions of businesses:			
Receivables	68	103	258
Inventories	(12)	(20)	28
Accounts payable and accrued liabilities	(216)	(278)	(683)
Income taxes and currently payable	(83)	319	(224)
Other	(88)	14	(18)
Net cash provided by operating activities	1,534	1,732	801
Cash flows from investing activities			
Proceeds from sale of assets	117	195	189
Purchases of property, plant and equipment	(1,186)	(1,191)	(837)
Business acquisitions, net of cash acquired	—	—	(2,402)
Release of restricted cash	—	14	238
Other	55	14	52
Net cash used investing activities	(1,014)	(968)	(2,760)
Cash flows from financing activities			
Proceeds from issuance of long-term debt	215	41	3,313
Payment of long-term debt and capital lease obligations	(581)	(692)	(1,490)
Proceeds from settlement of mandatory convertible securities	—	52	—
Dividends paid	(145)	(142)	(113)
Net proceeds from the sale of common stock under option plans and related tax benefits	11	153	252
Payment for purchase of treasury shares	(23)	(218)	(220)
Payment of Albertsons standalone drug business payables	—	—	(299)
Net cash (used in) provided by financing activities	(523)	(806)	1,443
Net decrease in cash and cash equivalents	(3)	(42)	(516)
Cash and cash equivalents at beginning of year	243	285	801
Cash and cash equivalents at end of year	$ 240	$ 243	$ 285

(*Continued*)

SUPPLEMENTAL CASH FLOW INFORMATION

The Company's non-cash activities were as follows:			
Capital lease asset additions and related obligations	**$ 26**	**$ 36**	**$ 73**
Purchase of property, plant and equipment included in Accounts payable	**$ 98**	**$ 154**	**$ 105**
Interest and income taxes paid:			
Interest paid (net of amount capitalized)	**$ 614**	**$ 743**	**$ 545**
Income taxes paid (net of refunds)	**$ 274**	**$ 107**	**$ 310**

See Notes to Consolidated Financial Statements.

REQUIRED:

a. Depreciation and amortization are added back to net earnings in the computation of net cash provided by operations. Does this mean that depreciation and amortization are sources of cash?
b. What is meant by "impairment charges"? What event would lead to such an expense? Why is it added back to net earnings?
c. Explain why the "gain on the sale" of assets is subtracted from net earnings, while "loss on sale" is added. Describe the entries that led to these disclosures.
d. Comment on the trends across time of the company's current accounts, especially inventory and receivables.
e. Comment on the quality of the company's earnings over the three-year period.

REAL DATA
ID14–5
Misunderstandings in the financial press

The financial press often uses the term *cash flow* to refer to a company's "net income + depreciation." In a well-known article in *Barron's* titled "No Substitutions, Please," Intel was criticized for relying heavily on a number the company called "cash earnings," computed by adding amortization of intangible assets to net earnings.

REQUIRED:

Do you believe that using cash flow measures like the ones described above are superior to using net cash from operations as disclosed in the operating section of the statement of cash flows? Explain.

REAL DATA
ID14–6
Analyzing the statement of cash flows

The operating section of the 2008 consolidated statement of cash flows for Imation Corporation, a global technology company, is excerpted below (dollars in millions):

	2008	2007	2006
Net income (loss)	**$(33.3)**	**$(50.4)**	**$ 76.4**
Adjustments:			
Depreciation	**25.9**	**28.6**	**29.1**
Amortization	**23.4**	**18.3**	**9.3**
Deferred income taxes	**0.2**	**(10.7)**	**9.7**
Asset impairments	**39.7**	**102.5**	**7.2**
Gain on sale of company	**—**	**—**	**(2.1)**
Stock-based compensation	**9.5**	**10.2**	**11.0**
Pension settlement/curtailment	**5.7**	**2.4**	**1.7**
Excess tax benefit—stock options	**—**	**—**	**(3.3)**
Other	**4.9**	**3.5**	**0.6**
Changes in operating accounts			
Accounts receivable	**129.0**	**(33.7)**	**(37.6)**
Inventory	**0.2**	**7.8**	**(49.3)**
Other assets	**(2.9)**	**(9.1)**	**1.5**
Accounts payable	**(61.5)**	**(8.7)**	**30.5**
Other liabilities	**(56.1)**	**26.8**	**12.8**
Net cash provided by operating activities	**$ 84.7**	**$ 87.5**	**$ 97.5**

REQUIRED:

a. Review the trends across time of depreciation. Does the company's growth strategy seem to involve investing in property, plant, and equipment? Explain.
b. Why is stock-based compensation added back to net income?
c. Has the inventory balance increased or decreased during the years shown? Explain.
d. Explain the cash flows associated with the asset impairments and the sale of a subsidiary company.

REAL DATA
ID14–7
Analyzing an IFRS-based statement of cash flows

The IFRS-based 2007 and 2008 statements of cash flows published by the Danone Group, a French food processor, are provided below. Briefly describe each of the line items, and comment on the company's cash management policies.

CONSOLIDATED STATEMENTS OF CASH FLOWS

		Year Ended December 31	
(In € millions)	Notes	2007	2008
Net income attributable to the Group		4,180	1,313
Net income attributable to minority interests		158	178
Net income from discontinued operations		(3,292)	(269)
Net income of equity-accounts affiliates		(87)	(62)
Depreciation and amortization		420	525
Dividends received from equity-accounted affiliates		30	29
Other flows with impact on cash	26	—	(113)
Other flows with no impact on cash	26	21	98
Cash flows provided by operating activities, excluding changes in net working capital		1,430	1,699
(Increase) decrease in inventories		(51)	3
(Increase) decrease in trade accounts receivable		(39)	(74)
Increase (decrease) in trade accounts payable		244	36
Changes in other working capital items		27	90
Net change in current working capital		181	55
Cash flows provided by (used in) operating activities		1,611	1,754
Capital expenditures		(726)	(706)
Purchase of businesses and other investments net of cash and cash equivalents acquired	26	(12,100)	(259)
Proceeds from the sale of businesses and other investments net of cash and cash equivalents disposed of	26	4,699	329
(Increase) decrease in long-term loans and other long-term assets		(142)	67
Changes in cash and cash equivalents of discontinued operations		171	—
Cash flows provided by (used in) investing activities		(8,098)	(569)
Increase in capital and additional paid-in capital		66	48
Purchases of treasury stock (net of disposals)		(439)	46
Dividends		(622)	(705)
Increase (decrease) in non-current financial liabilities		3,069	1,338
Increase (decrease) in current financial liabilities		2,614	(1,901)
(Increase) decrease in marketable securities		1,708	63
Cash flows provided by (used in) financing activities		6,396	(1,111)
Effect of exchange rate changes on cash and equivalents		(16)	(31)
Increase (decrease) in cash and cash equivalents		(107)	43
Cash and cash equivalents at beginning of period		655	548
Cash and cash equivalents at end of period		548	591
Supplemental disclosures			
Cash paid during the year:			
—net interests[(1)]		152	433
—income tax		369	221

(1) In 2007, net interests corresponded to interest expense on net debt ("interest") for € 252 million net interest income on net debt for € 100 million.

REAL DATA
ID14–8
Cash management profiles across time—A mature firm

The following information was taken from the 2008 annual report and statement of cash flows of Eli Lilly, a major pharmaceutical (dollars in millions):*

	2008	2007	2006
Net income (loss)	**$(2,072)**	**$2,953**	**$2,663**
Net cash from operations	**7,296**	**5,155**	**3,976**
Net cash from investing activities	**(7,269)**	**(4,328)**	**608**
Net cash from financing activities	**(2,346)**	**(845)**	**(4,579)**
Change in cash	**2,276**	**111**	**103**

*Change in the cash balance does not always equal the sum of cash from operations, investing, and financing due to adjustments for exchange rate changes.

REQUIRED:

a. Discuss the cash management profile of Lilly across the three-year period. Where did the company get its cash, and what did it do with it?
b. Explain how the cash management profile relates to the company's financial condition and performance over this time period.

REAL DATA
ID14–9
Cash management profile

Starbucks is a relatively young, fast-growing company that is a pioneer and leader in its industry. Excerpts from its 2009 statement of cash flows are as follows (dollars in millions):

	2009	2008	2007
Net income	**$ 391**	**$ 316**	**$ 673**
Net cash from operations	**1,389**	**1,259**	**1,331**
Net cash from investing activities	**(421)**	**(1,087)**	**(1,202)**
Net cash from financing activities	**(642)**	**(185)**	**(172)**
Change in cash	**330**	**(12)**	**(3)**

*Change in the cash balance does not always equal the sum of cash from operations, investing, and financing due to adjustments for exchange rate changes.

REQUIRED:

a. Discuss the cash management profile of Starbucks across the three-year period. Where did the company get its cash, and what did it do with it?
b. Explain how the cash management profile may be representative of a young, fast-growing company.
c. Comment on how this profile reflects the company's financial condition and performance.
d. What do you think Starbucks' future cash will look like? Will the company maintain the same profile or change to a new profile? Why?

REAL DATA
ID14–10
The SEC Form 10-K of NIKE

The 10-K of NIKE is reproduced in Appendix C.

REQUIRED:

Review the 10-K, and answer the following questions.

a. What are the major sources of cash for the company, and what is it doing with that cash?
b. Were there any significant transactions in 2007, 2008, or 2009 that did not affect cash but were reported on the statement of cash flows?
c. Why is the gain on divestitures a negative number?
d. Discuss NIKE's handling of its accounts receivable over the three years. How does it compare to sales growth, and what might the differences indicate?
e. Analyze NIKE's cash management policies across the three-year period (2007–2009).