FINANCIAL STATEMENTS

8

THE NAVIGATOR ✓

- Understand *Concepts for Review* ❑
- Read *Feature Story* ❑
- Scan *Study Objectives* ❑
- Read *Preview* ❑
- Read text and answer *Before You Go On* *p.* 239 ❑ *p.* 249 ❑ *p.* 262 ❑
- Work *Demonstration Problem* ❑
- Review *Summary of Study Objectives* ❑
- Complete *Assignments* ❑

CONCEPTS FOR REVIEW

Before studying this chapter, you should know or, if necessary, review:

a. The difference between the accrual basis and the cash basis of accounting. (Ch. 4, pp. 113–114)

b. The major items included in a corporation's balance sheet. (Ch. 5, pp. 161–166)

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FEATURE STORY

Cash Is King

Cash flow is important, and "Cash is king" is a phase used in almost all industries. For the most part, cash is the only difference between successful operations and closure. We all know that the income statement is important because it tells us how much money the operation has made. But, due to the accrual basis of accounting, we record sales when the transaction occurs, not when the cash is received. Thus, while an income statement may show a profit, if the sales made are still in the form of accounts receivables, there is no cash on hand to pay bills.

We also know that the balance sheet is important because it gives us, in a snapshot, the financial picture of our business. As with the income statement, it is done on an accrual basis. The balance sheet might show $200,000 in the cash account, but if there is also $400,000 in accounts payable, this is not a comfortable picture.

Therefore, you will want to use a statement of cash flows to give you an exact idea of where the money comes from, how it is spent, and, most important, how much cash you really have on hand for the business. But while the statement of cash flows is fundamental, it is also the most complex of the three statements. In November 1987, the Financial Accounting Standards Board (FASB) issued a new requirement—known as FASB 95—that all annual financial statements for fiscal years ending after July 15, 1988, must include the statement of cash flows as one of its components. This requirement has been viewed as one of the more important changes made in the accounting profession in recent years. As a result, the statement of cash flows and the topic of cash flow itself has become very important.

The cash-flow crunch experienced by the hospitality industry in recent years due to overbuilding and a weak economy has hospitality managers placing extra importance on cash flow. Cash is not only a prerequisite for a successful hospitality business, but also a continued essential element for business survival. A few years ago, print advertising spoke to the importance of profits. Today, profits are still important, but eye-catching phrases that contain the word *cash* are more prominent in stating the health of a business.

Source: A. L. DeFranco & R. S. Schmidgall, "Cash Flow Practices and Procedures in the Club Industry," *Bottomline*, 11 (8) (1996/1997), 16–20.

STUDY OBJECTIVES

After studying this chapter, you should be able to

1. Distinguish between multiple-step and single-step income statements.
2. Explain the computation and importance of gross profit.
3. Distinguish between departmental and consolidated income statements.
4. Indicate the primary purpose of the statement of cash flows.
5. Distinguish among operating, investing, and financing activities.
6. Prepare a statement of cash flows using the indirect method.
7. Prepare a statement of cash flows using the direct method.

PREVIEW OF CHAPTER 8

As you know by now, the three financial statements, income statement, balance sheet, and statement of cash flow, are all very important to each and every hospitality manager. Why would one want to use a multiple-step income statement when a single-step one is available? How many departmental statements are there in a hotel or a theme park? Can we just use departmental statements or the consolidated one but not both? How can a hotel company spend $400 million buying another property when it has just reported a loss of $10 million? Where does the money come from? Answers to these and similar questions can be found in this chapter, which presents the three financial statements.

The content and organization of Chapter 8 are as follows.

FINANCIAL STATEMENTS

The Income Statement
- Multiple-Step Income Statement
- Single-Step Income Statement
- Departmental Income Statement
- Consolidated Income Statement
- Classified Balance Sheet

The Statement of Cash Flows: Purpose and Format
- Purpose
- Meaning of "cash flows"
- Classifications
- Significant noncash activities
- Format
- Usefulness
- Preparation
- Indirect and Direct methods

Section 1: Indirect Method
- Determining net increase/decrease in cash
- Determining net cash provided/used by operating activities
- Determining net cash provided/used by investing and financing activities

Section 2: Direct Method
- Determining net increase/decrease in cash
- Determining net cash provided/used by operating activities
- Determining net cash provided/used by investing and financing activities

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THE INCOME STATEMENT

STUDY OBJECTIVE 1

Distinguish between a multiple-step and a single-step income statement.

Two forms of the income statement are widely used by merchandisers. Also, merchandisers use the classified balance sheet, introduced in Chapter 5. The use of these financial statements by merchandisers is explained below.

MULTIPLE-STEP INCOME STATEMENT

The **multiple-step income statement** is so named because it shows the steps in determining net income (or net loss). It shows two main steps: (1) Cost of goods sold is subtracted from net sales, to determine gross profit. (2) Operating expenses are deducted from gross profit, to determine net income. These steps relate to the company's principal operating activities. A multiple-step statement also distinguishes between *operating* and *nonoperating activities*. This distinction provides users with more information about a company's income performance. The statement also highlights intermediate components of income and shows subgroupings of expenses.

Income Statement Presentation of Sales

The multiple-step income statement begins by presenting sales revenue. As contra revenue accounts, sales returns and allowances, and sales discounts are deducted from sales to arrive at **net sales**. The sales revenues section for Sellers T-Shirts, using assumed data, is as follows.

Illustration 8-1

Computation of net sales

SELLERS T-SHIRTS
Income Statement (partial)

Sales revenues		
Sales		$480,000
Less: Sales returns and allowances	$12,000	
Sales discounts	8,000	20,000
Net sales		**$460,000**

This presentation discloses the key aspects of the company's principal revenue-producing activities.

Gross Profit

STUDY OBJECTIVE 2

Explain the computation and importance of gross profit.

From the previous chapter, you learned that cost of goods sold is deducted from sales revenue to determine **gross profit**. Net sales revenue are used for this computation. On the basis of the sales data presented in Illustration 8-1 (net sales of $460,000) and the cost of goods sold under the perpetual inventory system (assume $316,000), the gross profit for Sellers T-Shirts is $144,000, computed as follows:

Illustration 8-2

Computation of gross profit

Net sales	$460,000
Cost of goods sold	316,000
Gross profit	**$144,000**

A company's gross profit may also be expressed as a percentage. This is done by dividing the amount of gross profit by net sales. For Sellers T-Shirts the **gross profit rate** is 31.3 percent, computed as shown in Illustration 8-3.

Illustration 8-3

Gross profit rate formula and computation

Gross Profit	÷	Net Sales	=	Gross Profit Rate
$144,000	÷	$460,000	=	31.3%

The gross profit rate is generally considered to be more useful than the gross profit amount. The rate expresses a more meaningful (qualitative) relationship between net sales and gross profit. For example, a gross profit of $1,000,000 may be impressive. But, if it is the result of a gross profit rate of only 7 percent, it is not so impressive. The gross profit rate tells how many cents of each sales dollar go to gross profit.

Gross profit represents the **merchandising profit** of a company. It is not a measure of the overall profitability, because operating expenses have not been deducted. But the amount and trend of gross profit is closely watched by management and other interested parties. They compare current gross profit with amounts reported in past periods. They also compare the company's gross profit rate with rates of competitors and with industry averages. Such comparisons provide information about the effectiveness of a company's purchasing function and the soundness of its pricing policies.

Operating Expenses and Net Income

Operating expenses are the third component in measuring net income for a merchandiser. As indicated earlier, these expenses are similar in merchandising and service enterprises. At Sellers T-Shirts, operating expenses were $114,000. The firm's net income is determined by subtracting operating expenses from gross profit. Thus, net income is $30,000, as shown in Illustration 8-4.

Illustration 8-4

Operating expenses in computing net income

Gross profit	$144,000
Operating expenses	**114,000**
Net income	$ 30,000

The net income amount is the "bottom line" of a company's income statement.

Nonoperating Activities

Nonoperating activities consist of (1) revenues and expenses from auxiliary operations and (2) gains and losses that are unrelated to the company's operations. The results of nonoperating activities are shown in two sections: **Other revenues and gains** and **Other expenses and losses**. For a merchandiser, these sections will typically include the items shown in Illustration 8-5.

Illustration 8-5

Items reported in nonoperating sections

Nonoperating Activities

Other revenues and gains	Other expenses and losses
Interest revenue from notes receivable and marketable securities	Interest expense on notes and loans payable
Dividend revenue from investments in capital stock	Casualty losses from recurring causes such as vandalism and accidents
Rent revenue from subleasing a portion of the store	Loss from the sale or abandonment of property, plant, and equipment
Gain from the sale of property, plant, and equipment	Loss from strikes by employees and suppliers

The nonoperating activities are reported in the income statement immediately after the company's primary operating activities. These sections are shown in Illustration 8-6, using assumed data for Sellers T-Shirts.

Illustration 8-6

Multiple-step income statement—nonoperating sections and subgroupings of operating expenses

SELLERS T-SHIRTS
Income Statement
For the Year Ended December 31, 2004

Calculation of gross profit	**Sales revenues**		
	Sales		$480,000
	Less: Sales returns and allowances	$12,000	
	Sales discounts	8,000	20,000
	Net sales		460,000
	Cost of goods sold		316,000
	Gross profit		144,000
Calculation of income from operations	**Operating expenses**		
	Selling expenses		
	Store salaries expense	45,000	
	Advertising expense	16,000	
	Depreciation expense—store equipment	8,000	
	Freight-out	7,000	
	Total selling expenses	76,000	
	Administrative expenses		
	Salaries expense	19,000	
	Utilities expense	17,000	
	Insurance expense	2,000	
	Total administrative expenses	38,000	
	Total operating expenses		114,000
	Income from operations		30,000
Results of nonoperating activities	**Other revenues and gains**		
	Interest revenue	3,000	
	Gain on sale of equipment	600	
		3,600	
	Other expenses and losses		
	Interest expense	1,800	
	Casualty loss from vandalism	200	
		2,000	
			1,600
	Net income		$ 31,600

When the two nonoperating sections are included, the label **Income from operations** (or Operating income) precedes them. It clearly identifies the results of the company's normal operations. Income from operations is determined by subtracting cost of goods sold and operating expenses from net sales.

In the nonoperating activities sections, items are generally reported at the net amount. Thus, if a company received a $2,500 insurance settlement on vandalism losses of $2,700, the loss is reported at $200. Note, too, that the results of the two nonoperating sections are netted. The difference is added to or subtracted from income from operations to determine net income. It is not uncommon for companies to combine these two nonoperating sections into a single "Other revenues and expenses" section.

HELPFUL HINT

Operating income relates to the sale of primary goods in the ordinary course of business.

Subgrouping of Operating Expenses

In larger companies, operating expenses are often subdivided into selling expenses and administrative expenses, as illustrated in Illustration 8-6. **Selling expenses** are those associated with making sales. They include expenses for sales promotion as well as expenses of completing the sale, such as delivery and shipping. **Administrative expenses** (sometimes called general expenses) relate to general operating activities such as personnel management, accounting, and security.

When subgroupings are made, some expenses may have to be prorated (e.g., 70% to selling and 30% to administrative expenses). For example, if a store building is used for both selling and general functions, building expenses such as depreciation, utilities, and property taxes will need to be allocated.

Any reasonable classification of expenses that serves to inform those who use the statement is satisfactory. The tendency in statements prepared for management's internal use is to present in considerable detail expense data grouped along lines of responsibility.

ETHICS NOTE

At the end of a celebratory lunch the employees of a sales department each gave the manager $10, and he paid the bill with his charge card. During the next week you notice that the manager reported the full amount of the lunch bill on his expense report (and requested reimbursement). When this question was posed to the CEO of Intel, he suggested that an appropriate action would be to report the problem anonymously to the internal audit staff for investigation. What would you do? Does it make a difference if the company is large or small?

SINGLE-STEP INCOME STATEMENT

Another income statement format is the **single-step income statement**. The statement is so named because only one step, subtracting total expenses from total revenues, is required in determining net income (or net loss).

In a single-step statement, all data are classified under two categories: (1) revenues and (2) expenses. The Revenues category includes both operating revenues and other revenues and gains. The Expenses category includes cost of goods sold, operating expenses, and other expenses and losses. A condensed single-step statement for Sellers T-Shirts is shown in Illustration 8-7.

Illustration 8-7

Single-step income statement

SELLERS T-SHIRTS
Income Statement
For the Year Ended December 31, 2004

Revenues		
Net sales		$460,000
Interest revenue		3,000
Gain on sale of equipment		600
Total revenues		463,600
Expenses		
Cost of goods sold	$316,000	
Selling expenses	76,000	
Administrative expenses	38,000	
Interest expense	1,800	
Casualty loss from vandalism	200	
Total expenses		432,000
Net income		$ 31,600

There are two primary reasons for using the single-step format: (1) A company does not realize any type of profit or income until total revenues exceed total expenses, so it makes sense to divide the statement into these two categories. (2) The format is simpler and easier to read than the multiple-step format. But for homework problems, the single-step format should be used only when it is specifically requested.

DEPARTMENTAL INCOME STATEMENT

Imagine working in a theme park with different types of rides. While little kids might want to go on the bumper cars and trains, teenagers might prefer the roller coasters, others might want to take the monorail to view the entire park. Of course, these are not the only services a theme park offers. As guests, you will also visit the souvenir stores, have a snack at one of the food stands, or sit down for dinner at one of the theme restaurants.

STUDY OBJECTIVE 3

Distinguish between departmental and consolidated income statements.

In a hotel, a similar picture of a variety of options is depicted. Although the guests all stay in the guest rooms, some might want to have their meals in the hotel restaurant or order room service, while others might have their meals away from the hotel facilities. There are also services such as those at a business center, fax, and Internet access that will be used by some but not all.

So, how can a hotel or a theme park decide which service is making the property the most money? Are all these services, or departments, needed? Are there departments that are money losers but are necessary for the operation of the entire property?

This is the reason why *departmental income statements* are needed. In Chapter 2, you learned the various departments of a hotel and how they all work together to provide a total experience for the guests. Each of these departments has its own departmental income statement. Although each department provides a different service, each departmental income statement has the same format. For revenue-generating departments such as rooms and food and beverage, you will have revenues and expenses, very similar to the multiple-step and the single-step income statements discussed earlier. The statements for departments such as engineering, accounting, and security show only expenses as they do not generate any revenues. For a theme park, the departments will be rides instead of rooms or arcade games instead of a business center. Illustration 8-8 presents an example of a department income statement.

Illustration 8-8

Departmental Income Statement

DEPARTMENTAL INCOME STATEMENT
ROOMS DEPARTMENT
For the Month Ending April 30, 2004

Revenues	
Gross sales	$650,000
Less: Allowances	10,500
Net Sales	639,500
Expenses	
Salaries and wages	95,240
Benefits	28,500
Linen	12,340
Guests supplies	4,800
Guests transportation	1,060
Long distance calls	367
Total Expenses	(142,307)
Departmental Income	$497,193

CONSOLIDATED INCOME STATEMENT

Once all departmental income statements are put together, added, and summarized, the company now has a **consolidated income statement**. Its format is similar to the single-step and multiple-step income statements, but rather being headed as Rooms Department, it is named for the business, (i.e., Belleview Hotel). A sample consolidated income statement is presented in Illustration 8-9.

Illustration 8-9

Consolidated Income Statement

CONSOLIDATED INCOME STATEMENT SAVOY RESORT For the Month Ending June 30, 2004	
Revenues	
Rooms	$ 854,300
Food and beverage	1,788,560
Telecommunications	38,992
Garage and valet	85,000
Salon and spa	50,000
Total Departmental Income	$2,816,852
Expenses	
Rooms	$ 196,489
Food and beverage	1,466,619
Telecommunications	15,597
Garage and valet	22,100
Salon and spa	16,500
Administrative and general	208,447
Human resources	126,758
Information systems	92,956
Security	30,985
Marketing	64,788
Property operations and maintenance	67,604
Utilities	112,674
Occupation costs	45,000
Interest expense	3,680
Depreciation and amortization	42,253
Total Expenses	($2,512,451)
Gross Income	304,401
Less: Income tax	(103,496)
Net Income	$ 200,905

HELPFUL HINT
Merchandise inventory is a current asset because it is expected to be sold within one year or the operating cycle, whichever is longer.

CLASSIFIED BALANCE SHEET

In the balance sheet, merchandise inventory is reported as a current asset immediately below accounts receivable. Recall from Chapter 5 that items are listed under current assets in their order of liquidity. Merchandise inventory is less liquid than accounts receivable because the goods must first be sold and then collection must be made from the customer. Illustration 8-10 presents the assets section of a classified balance sheet for Sellers T-Shirts and also that of Fame Restaurant. Sellers, as was used in our illustrations, sells merchandise to hospitality companies. In the case of a restaurant, it also sells gifts and sundries to its customers. Therefore, you may also see "gift shop and sundries," which represents the merchandise.

Illustration 8-10

Assets section of a classified balance sheet (partial)

SELLERS T-SHIRTS Balance Sheet (partial) December 31, 2004		
Assets		
Current assets		
Cash		$ 9,500
Accounts receivable		16,100
Merchandise inventory		**40,000**
Prepaid insurance		1,800
Total current assets		67,400
Property, plant, and equipment		
Store equipment	$80,000	
Less: Accumulated depreciation—store equipment	24,000	56,000
Total assets		$123,400

HELPFUL HINT
The $40,000 is the cost of the inventory on hand, not its expected selling price.

FAME RESTAURANT Balance Sheet (partial) December 31, 2004		
Current Assets		
Cash—Petty		$ 500
Cash—Bank		200,000
Accounts Receivables	$25,000	
Less: Allowance of Doubtful Accounts	1,000	
Net Accounts Receivables		24,000
Inventories—Food		40,000
Inventories—Beverage		15,800
Gift Shop and Sundries		2,590
Supplies		4,587
Prepaid Expenses		34,877
Total Current Assets		$322,354

THE STATEMENT OF CASH FLOWS: PURPOSE AND FORMAT

STUDY OBJECTIVE 4

Indicate the primary purpose of the statement of cash flows.

The three basic financial statements we've studied so far present only fragmentary information about a company's cash flows (cash receipts and cash payments). For example, **comparative balance sheets** show the increase in property, plant, and equipment during the year. But they do not show how the additions were financed or paid for. The **income statement** shows net income. But it does not indicate the amount of cash generated by operating activities Similarly, the **retained earnings statement** shows cash dividends declared but not the cash dividends paid during the year. None of these statements presents a detailed summary of the net change in cash as a result of operating, investing, and financing activities during the period.

PURPOSE OF THE STATEMENT OF CASH FLOWS

The primary purpose of the statement of cash flows is to provide information about an entity's cash receipts and cash payments during a period. A secondary objective is to provide information about its operating, investing, and financing activities.[1] The **statement of cash flows** reports the cash receipts, cash payments, and net change in cash resulting from operating, investing, and financing activities during a period. It does so in a format that reconciles the beginning and ending cash balances.

Reporting the causes of changes in cash helps investors, creditors, and other interested parties understand what is happening to a company's most liquid resource—its cash. A statement of cash flows helps us understand what is happening. It provides answers to the following simple, but important, questions about an enterprise:

1. Where did the cash come from during the period?
2. What was the cash used for during the period?
3. What was the change in the cash balance during the period?

MEANING OF CASH FLOWS

The statement of cash flows is generally prepared using **cash and cash equivalents** as its basis. *Cash equivalents* are short-term, highly liquid investments that have two characteristics:

1. They are readily convertible to known amounts of cash.
2. They are so near their maturity that their market value is relatively insensitive to changes in interest rates.

Generally, only investments with original maturities of three months or less qualify under this definition. Examples of cash equivalents are Treasury bills, commercial paper (short-term corporate notes), and money market funds. All typically are purchased with cash that is in excess of immediate needs.

Note that since cash and cash equivalents are viewed as the same, transfers between cash and cash equivalents are not treated as cash receipts and cash payments. That is, such transfers are not reported in the statement of cash flows. The term *cash* when used in this chapter includes cash and cash equivalents.

CLASSIFICATION OF CASH FLOWS

STUDY OBJECTIVE 5

Distinguish among operating, investing, and financing activities.

The statement of cash flows classifies cash receipts and cash payments as operating, investing, and financing activities, as follows:

1. **Operating activities** include the cash effects of transactions that create revenues and expenses. They thus enter into the determination of net income.
2. **Investing activities** include (a) acquiring and disposing of investments and productive long-lived assets, and (b) lending money and collecting the loans.
3. **Financing activities** include (a) obtaining cash from issuing debt and repaying the amounts borrowed, and (b) obtaining cash from stockholders and providing them with a return on their investment.

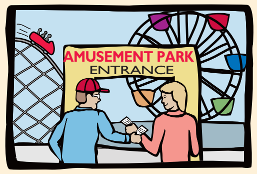
The category of operating activities is the most important because it shows the cash provided by company operations. This source of cash is generally considered to be the best measure of a company's ability to generate sufficient cash to continue as a going concern.

Illustration 8-11 below lists typical cash receipts and cash payments within each of the three classifications. *Study the list carefully.* It will prove very useful in solving homework exercises and problems.

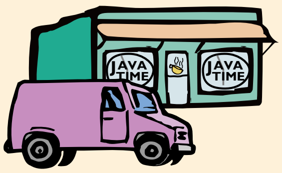
[1] "Statement of Cash Flows," *Statement of Financial Accounting Standards No. 95* (Stamford, Conn.: FASB, 1987).

Illustration 8-11

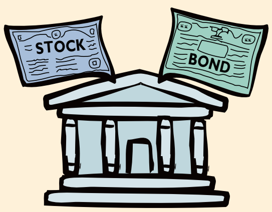
Typical receipts and payments classified by business activity and shown in the statement of cash flows



Operating activities



Investing activities



Financing activities

Types of Cash Inflows and Outflows

Operating activities

Cash inflows:
- From sale of goods or services.
- From returns on loans (interest received) and on equity securities (dividends received)

Cash outflows:
- To suppliers for inventory.
- To employees for services.
- To government for taxes.
- To lenders for interest.
- To others for expenses.

Investing activities

Cash inflows:
- From sale of property, plant, and equipment.
- From sale of debt or equity securities of other entities.
- From collection of principal on loans to other entities.

Cash outflows:
- To purchase property, plant, and equipment.
- To purchase debt or equity securities of other entities.
- To make loans to other entities.

Financing activities

Cash inflows:
- From sale of equity securities (company's own stock).
- From issuance of debt (bonds and notes).

Cash outflows:
- To stockholders as dividends.
- To redeem long-term debt or reacquire capital stock.

HELPFUL HINT
Operating activities generally relate to changes in current assets and current liabilities. Investing activities generally relate to changes in noncurrent assets. Financing activities relate to changes in long-term liabilities and stockholders' equity accounts.

As you can see, some cash flows related to investing or financing activities are classified as operating activities. For example, receipts of investment revenue (interest and dividends) are classified as operating activities. So are payments of interest to lenders. Why are these considered operating activities? **Because these items are reported in the income statement, where results of operations are shown.**

Note the following general guidelines: (1) Operating activities involve income determination (income statement) items. (2) Investing activities involve cash flows resulting from changes in investments and long-term asset items. (3) Financing activities involve cash flows resulting from changes in long-term liability and stockholders' equity items.

SIGNIFICANT NONCASH ACTIVITIES

Not all of a company's significant activities involve cash. Examples of significant noncash activities include the following:

- Issuance of common stock to purchase assets
- Conversion of bonds into common stock
- Issuance of debt to purchase assets
- Exchanges of plant assets

Significant financing and investing activities that do not affect cash are not reported in the body of the statement of cash flows. However, these activities are reported in either a *separate schedule* at the bottom of the statement of cash flows or in a *separate note or supplementary schedule* to the financial statements.

The reporting of these noncash activities in a separate schedule satisfies the **full disclosure principle**. In solving homework assignments you should present significant noncash investing and financing activities in a separate schedule at the bottom of the statement of cash flows. (See lower section of Illustration 8-12 for an example.)

HELPFUL HINT
Do not include noncash investing and financing activities in the body of the statement of cash flows. Report this information in a separate schedule.

ACCOUNTING IN ACTION *Business Insight*

Net income is not the same as net cash provided by operating activities. The differences are illustrated by the following results from recent annual reports for the same fiscal year (all data are in millions of dollars).

Company	Net Income (Loss)	Net Cash from Operations
Morton's Restaurant Group Inc. Fiscal year 2001	$ 989,000	$ 4,160,000
Darden Restaurants, Inc. Fiscal year 2002	$237,788,000	$508,142,000
Brinker International Inc. Fiscal year 2002	$152,713,000	$390,033,000
Starwood Hotels & Resorts Worldwide, Inc. Fiscal year 2001	$145,000,000	$761,000,000
Hilton Hotels Corp. Fiscal year 2001	$166,000,000	$585,000,000
Marriott International Inc. Fiscal year 2001	$236,000,000	$400,000,000
Choice Hotels International Inc. Fiscal year 2001	$ 14,327,000	$101,712,000

SOURCE: FISonline database.

Note the disparity among the companies that engaged in both the foodservice and hotel industries.

FORMAT OF THE STATEMENT OF CASH FLOWS

The general format of the statement of cash flows is the three activities discussed previously—operating, investing, and financing—plus the significant noncash investing and financing activities. A widely used form of the statement of cash flows is shown in Illustration 8-12.

Illustration 8-12

Format of statement of cash flows

COMPANY NAME
Statement of Cash Flows
Period Covered

Cash flows from operating activities		
(List of individual items)	XX	
Net cash provided (used) by operating activities		XXX
Cash flows from investing activities		
(List of individual inflows and outflows)	XX	
Net cash provided (used) by investing activities		XXX
Cash flows from financing activities		
(List of individual inflows and outflows)	XX	
Net cash provided (used) by financing activities		XXX
Net increase (decrease) in cash		XXX
Cash at beginning of period		XXX
Cash at end of period		XXX
Noncash investing and financing activities		
(List of individual noncash transactions)		XXX

As illustrated, the cash flows from operating activities section always appears first. It is followed by the investing activities and the financing activities sections.

Note also that **the individual inflows and outflows from investing and financing activities are reported separately**. Thus, cash outflow for the purchase of property, plant, and equipment is reported separately from the cash inflow from the sale of property, plant, and equipment. Similarly, the cash inflow from the issuance of debt securities is reported separately from the cash outflow for the retirement of debt. If a company did not report the inflows and outflows separately, it would obscure the investing and financing activities of the enterprise. This would make it more difficult to assess future cash flows.

The reported operating, investing, and financing activities result in either net cash *provided or used* by each activity. The amounts of net cash provided or used by each activity then are totaled. The result is the net increase (decrease) in cash for the period. This amount is then added to or subtracted from the beginning-of-period cash balance. This gives the end-of-period cash balance. Finally, any significant noncash investing and financing activities are reported in a separate schedule, usually at the bottom of the statement.

USEFULNESS OF THE STATEMENT OF CASH FLOWS

The information in a statement of cash flows should help investors, creditors, and others assess the following aspects of the firm's financial position.

1. **The entity's ability to generate future cash flows.** By examining relationships between items in the statement of cash flows, investors and others can make predictions of the amounts, timing, and uncertainty of future cash flows better than they can from accrual basis data.
2. **The entity's ability to pay dividends and meet obligations.** If a company does not have adequate cash, employees cannot be paid, debts settled, or dividends paid. Employees, creditors, and stockholders should be particularly interested in this statement, because it alone shows the flows of cash in a business.
3. **The reasons for the difference between net income and net cash provided (used) by operating activities.** Net income provides information on the success or failure of a business enterprise. However, some are critical of accrual basis net income because it requires many estimates. As a result, the reliability of the number is often challenged. Such is not the case with cash. Many readers of the statement of cash flows want to know the reasons for the difference between net income and net cash provided by operating activities. Then they can assess for themselves the reliability of the income number.
4. **The cash investing and financing transactions during the period.** By examining a company's investing and financing transactions, a financial statement reader can better understand why assets and liabilities changed during the period.

   In summary, the information in the statement of cash flows is useful in answering the following questions:

- How did cash increase when there was a net loss for the period?
- How were the proceeds of the bond issue used?
- How was the expansion in the plant and equipment financed?
- Why were dividends not increased?
- How was the retirement of debt accomplished?
- How much money was borrowed during the year?
- Is cash flow greater or less than net income?

ETHICS NOTE

Many investors believe that "Cash is cash and everything else is accounting." That is, they feel that cash flow is less susceptible to management manipulation than traditional accounting measures such as net income. Though we would discourage reliance on cash flows to the exclusion of accrual accounting, comparing cash from operations to net income can reveal important information about the "quality" of reported net income. Such a comparison can reveal the extent to which net income provides a good measure of actual performance.

HELPFUL HINT

Income from operations and cash flow from operating activities are different. Income from operations is based on accrual accounting: cash flow from operating activities is prepared on a cash basis.

PREPARING THE STATEMENT OF CASH FLOWS

The statement of cash flows is prepared differently from the three other basic financial statements. First, it is not prepared from an adjusted trial balance. The statement requires detailed information concerning the changes in account balances that occurred between two periods of time. An adjusted trial balance will not provide the necessary data. Second, the statement of cash flows deals with cash receipts and payments. As a result, **the accrual concept is not used in the preparation of a statement of cash flows**.

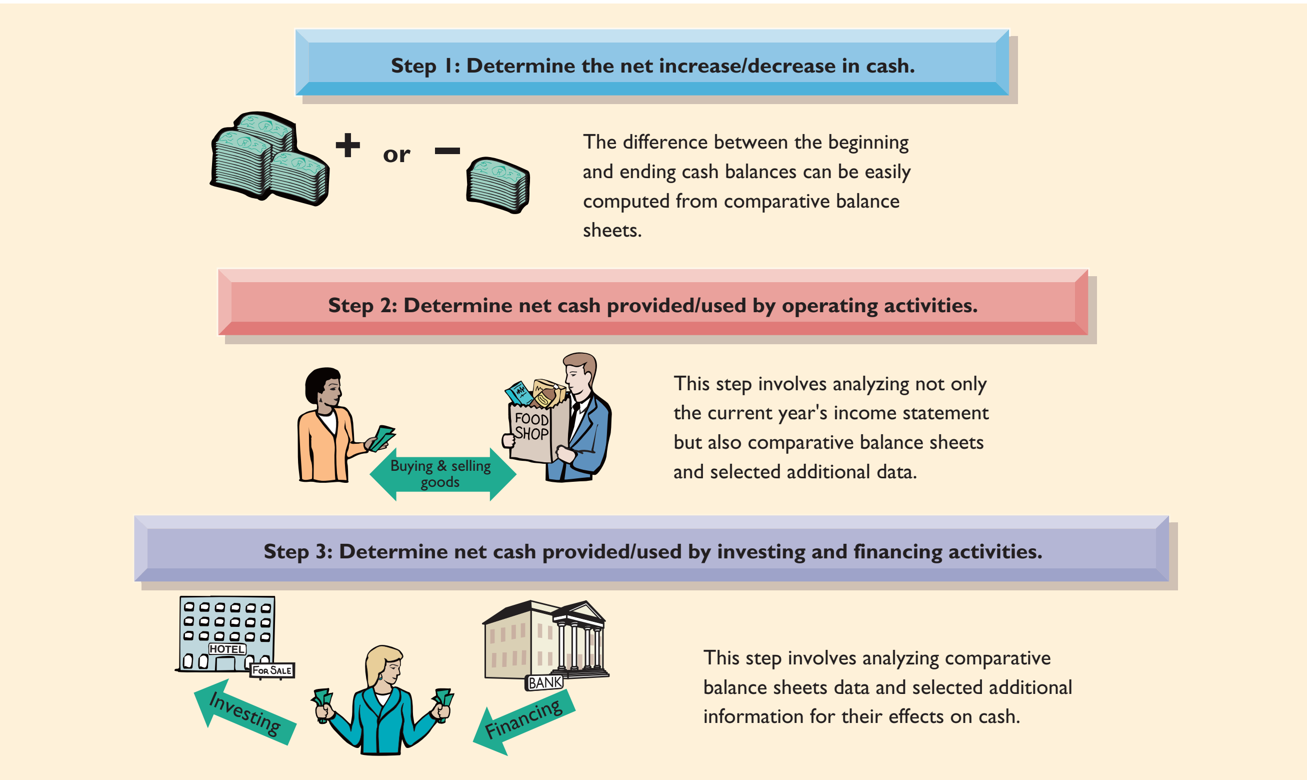
The information to prepare this statement usually comes from three sources:

1. **Comparative balance sheets.** Information in the comparative balance sheets indicates the amount of the changes in assets, liabilities, and stockholders' equities from the beginning to the end of the period.
2. **Current income statement.** Information in this statement helps determine the amount of cash provided or used by operations during the period.
3. **Additional information.** Such information includes transaction data that are needed to determine how cash was provided or used during the period.

Preparing the statement of cash flows from these data sources involves three major steps, explained in Illustration 8-13.

Illustration 8-13

Three major steps in preparing the statement of cash flows



INDIRECT AND DIRECT METHODS

In order to perform step 2, the operating activities section must be converted from an accrual basis to a cash basis. This conversion may be done by either of two methods: (1) the indirect method or (2) the direct method. Both methods arrive at the same total amount for "Net cash provided by operating activities." They differ in disclosing the items that comprise the total amount.

The indirect method is used extensively in practice. Companies (98.8%) favor the indirect method for two reasons: (1) It is easier to prepare, and (2) it focuses on the differences between net income and net cash flow from operating activities.

A minority of companies favor the direct method. This method shows operating cash receipts and payments, and so it is more consistent with the objective of a statement of cash flows. The FASB has expressed a preference for the direct method, but allows the use of either method. When the direct method is used, the net cash flow from operating activities as computed using the indirect method must also be reported in a separate schedule.

BEFORE YOU GO ON...

REVIEW IT

1. What is the primary purpose of a statement of cash flows?
2. What are the major classifications of cash flows on the statement of cash flows?
3. Why is the statement of cash flows useful? What key information does it convey?
4. What are the three major steps in preparing a statement of cash flows?

DO IT

During its first week of existence, Plano Submarine Sandwiches had the following transactions.

1. Issued 100,000 shares of $5 par value common stock for $800,000 cash.
2. Borrowed $200,000 from State Bank, signing a 5-year note bearing 8 percent interest.
3. Purchased two delivery trucks for $170,000 cash.
4. Paid employees $12,000 for salaries and wages.
5. Collected $20,000 cash for services provided.

Classify each of these transactions by type of cash flow activity.

ACTION PLAN

- Identify the three types of activities used to report all cash inflows and outflows.
- Report as operating activities the cash effects of transactions that create revenues and expenses and enter into the determination of net income.
- Report as investing activities transactions that (a) acquire and dispose of investments and productive long-lived assets, and (b) lend money and collect loans.
- Report as financing activities transactions that (a) obtain cash from issuing debt and repay the amounts borrowed, and (b) obtain cash from stockholders and pay them dividends.

SOLUTION

1. Financing activity
2. Financing activity
3. Investing activity
4. Operating activity
5. Operating activity

Related exercise material: 8-3, 8-8, and 8-10.

THE NAVIGATOR

INTERNATIONAL NOTE

International accounting requirements are quite similar in most respects with regard to the cash flow statement. Some interesting exceptions: In Japan, operating and investing activities are combined. In Australia, the direct method is mandatory. In Spain, the indirect method is mandatory. Also, in a number of European and Scandinavian countries a cash flow statement is not required at all, although in practice most publicly traded firms provide one.

On the following pages, in two separate sections, we describe the two cash flow methods. Section 1 illustrates the indirect method. Section 2 illustrates the direct method. These sections are independent of each other. *Only one or the other needs to be covered in order to understand and prepare the statement of cash flows.*

SECTION 1: INDIRECT METHOD FOR STATEMENT OF CASH FLOWS

STUDY OBJECTIVE 6

Prepare a statement of cash flows using the indirect method.

To explain and illustrate the indirect method, we will use the transactions of the Airport Shuttle Services Company for two years, 2004 and 2005, to prepare annual statements of cash flows. We will show basic transactions in the first year, with additional transactions added in the second year.

FIRST YEAR OF OPERATIONS—2004

Airport Shuttle Services Company started on January 1, 2004. At that time it issued 50,000 shares of $1.00 par value common stock for $50,000 cash. The company rented its office space and furniture and performed consulting services throughout the first year. The comparative balance sheets at the beginning and end of 2004, showing changes in each account, appear in Illustration 8-14. The income statement and additional information for Airport Shuttle Services Company are shown in Illustration 8-15.

Illustration 8-14

Comparative balance sheets, 2004, with increases and decreases

HELPFUL HINT

Although each of the balance sheet items increased, their individual effects are not the same. Some of these increases are cash inflows, and some are cash outflows.

AIRPORT SHUTTLE SERVICES COMPANY
Comparative Balance Sheets

Assets	Dec. 31, 2004	Jan. 1, 2004	Change Increase/Decrease
Cash	$34,000	$–0–	$34,000 Increase
Accounts receivable	30,000	–0–	30,000 Increase
Equipment	10,000	–0–	10,000 Increase
Total	$74,000	$–0–	
Liabilities and Stockholders' Equity			
Accounts payable	$ 4,000	$–0–	$ 4,000 Increase
Common stock	50,000	–0–	50,000 Increase
Retained earnings	20,000	–0–	20,000 Increase
Total	$74,000	$–0–	

Illustration 8-15

Income statement and additional information, 2004

AIRPORT SHUTTLE SERVICES COMPANY
Income Statement
For the Year Ended December 31, 2004

Revenues	$85,000
Operating expenses	40,000
Income before income taxes	45,000
Income tax expense	10,000
Net income	$35,000

Additional information:
1. A dividend of $15,000 was declared and paid during the year.
2. The equipment was purchased at the end of 2004. No depreciation was taken in 2004.

Step 1: Determine the Net Increase/Decrease in Cash

To prepare a statement of cash flows, the first step is to **determine the net increase or decrease in cash**. This is a simple computation. For example, Airport Shuttle Services Company had no cash on hand at the beginning of 2004. It had $34,000 on hand at the end of 2004. Thus, the change in cash for 2004 was an increase of $34,000.

HELPFUL HINT
You may wish to insert immediately into the statement of cash flows the beginning and ending cash balances and the increase/decrease in cash necessitated by these balances. The net increase/decrease is the target amount. The net cash flows from the three classes of activity must equal the target amount.

Step 2: Determine Net Cash Provided/Used by Operating Activities

To determine net cash provided by operating activities under the indirect method, **net income is adjusted for items that did not affect cash**. A useful starting point is to understand *why* net income must be converted. Under generally accepted accounting principles, most companies use the accrual basis of accounting. As you have learned, this basis requires that revenue be recorded when earned and that expenses be recorded when incurred. Earned revenues may include credit sales that have not been collected in cash. Expenses incurred may not have been paid in cash. Thus, under the accrual basis of accounting, net income is not the same as net cash provided by operating activities. Therefore, under the indirect method, net income must be adjusted to convert certain items to the cash basis.

The **indirect method** (or reconciliation method) starts with net income and converts it to net cash provided by operating activities. In other words, **the indirect method adjusts net income for items that affected reported net income but did not affect cash**. Illustration 8-16 shows this adjustment. That is, noncash charges in the income statement are added back to net income. Likewise, noncash credits are deducted. The result is net cash provided by operating activities.

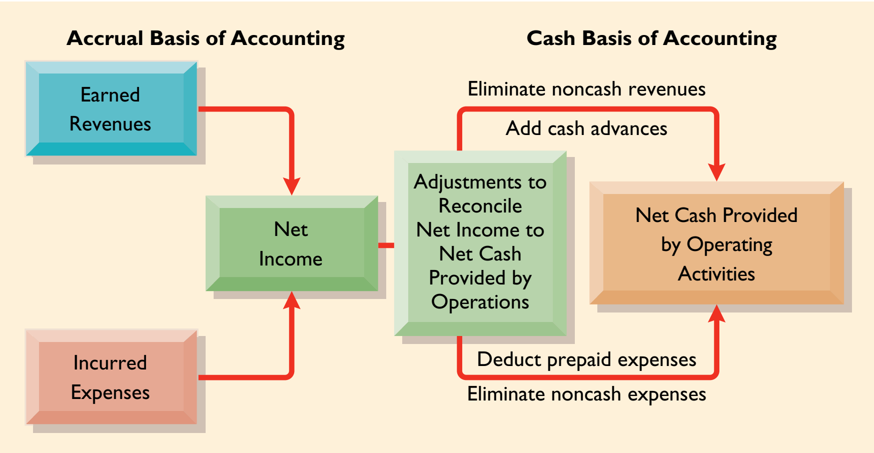


Illustration 8-16
Net income versus net cash provided by operating activities

A useful starting point in identifying the adjustments to net income is the current asset and current liability accounts other than cash. Those accounts—receivables, payables, prepayments, and inventories—should be analyzed for their effects on cash.

INCREASE IN ACCOUNTS RECEIVABLE. When accounts receivable increase during the year, revenues on an accrual basis are higher than revenues on a cash basis. In other words, operations of the period led to revenues, *but not all of these revenues resulted in an increase in cash*. Some of the revenues resulted in an increase in accounts receivable.

Illustration 8-17 shows that Airport Shuttle Services Company had $85,000 in revenues, but it collected only $55,000 in cash. To convert net income to net cash provided by operating activities, the increase of $30,000 in accounts receivable must be deducted from net income.

Illustration 8-17

Analysis of accounts receivable

Accounts Receivable

1/1/04	Balance	–0–	**Receipts from customers**	**55,000**
	Revenues	**85,000**		
12/31/04	Balance	30,000		

INCREASE IN ACCOUNTS PAYABLE. In the first year, operating expenses incurred on account were credited to Accounts Payable. When accounts payable increase during the year, operating expenses on an accrual basis are higher than they are on a cash basis. For Airport Shuttle Services, operating expenses reported in the income statement were $40,000. But, since Accounts Payable increased $4,000, only $36,000 ($40,000 − $4,000) of the expenses were paid in cash. To adjust net income to net cash provided by operating activities, the increase of $4,000 in accounts payable must be added to net income. A T-account analysis indicates that payments to creditors are less than operating expenses.

Illustration 8-18

Analysis of accounts payable

Accounts Payable

Payments to creditors	**36,000**	1/1/04	Balance	–0–
			Operating expenses	**40,000**
		12/31/04	Balance	4,000

For Airport Shuttle Services, the changes in accounts receivable and accounts payable were the only changes in current asset and current liability accounts. This means that any other revenues or expenses reported in the income statement were received or paid in cash. Thus, the income tax expense of $10,000 was paid in cash, and no adjustment of net income is necessary.

The operating activities section of the statement of cash flows for Airport Shuttle Services Company is shown in Illustration 8-19.

Illustration 8-19

Presentation of net cash provided by operating activities, 2004—indirect method

AIRPORT SHUTTLE SERVICES COMPANY
Statement of Cash Flows—Indirect Method (partial)
For the Year Ended December 31, 2004

Cash flows from operating activities		
Net income		$35,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Increase in accounts receivable	$(30,000)	
Increase in accounts payable	4,000	(26,000)
Net cash provided by operating activities		**$ 9,000**

Step 3: Determine Net Cash Provided/Used by Investing and Financing Activities

The third and final step in preparing the statement of cash flows begins with a study of the balance sheet. We look at it to determine changes in noncurrent accounts. The change in each noncurrent account is then analyzed to determine the effect, if any, the change had on cash.

In Airport Shuttle Services Company, the three noncurrent accounts are Equipment, Common Stock, and Retained Earnings. All three have increased during the year. What caused these increases? No transaction data are given in the balance sheet for the increases in Equipment of $10,000 and Common Stock of $50,000. In solving your homework, you should assume that any unexplained differences in noncurrent accounts involve *cash*. Thus, the increase in Equipment is assumed to be a purchase of equipment for $10,000 cash. This purchase of equipment is reported as a cash outflow in the investing activities section of the statement of cash flows. The increase in Common Stock is assumed to result from the issuance of common stock for $50,000 cash. The issuance of common stock is reported as an inflow of cash in the financing activities section.

What caused the net increase of $20,000 in the Retained Earnings account? First, net income increased retained earnings by $35,000. Second, the additional information provided below the income statement in Illustration 8-15 indicates that a cash dividend of $15,000 was declared and paid.

This analysis can also be made directly from the Retained Earnings account in the ledger of Airport Shuttle Services Company, as shown in Illustration 8-20.

Illustration 8-20

Analysis of retained earnings

Retained Earnings					
12/31/04	**Cash dividend**	**15,000**	1/1/04	Balance	–0–
			12/31/04	**Net income**	**35,000**
			12/31/04	Balance	20,000

The $20,000 increase in Retained Earnings in 2004 is a *net* change. When a net change in a noncurrent balance sheet account has occurred during the year, it generally is necessary to report the individual items that cause the net change. Therefore, the $35,000 increase due to net income is reported in the operating activities section. The cash dividend paid is reported in the financing activities section.

Statement of Cash Flows—2004

We now can prepare the statement of cash flows. The statement starts with the operating activities, followed by the investing activities, and then the financing activities. The 2004 statement of cash flows for Airport Shuttle Services is shown in Illustration 8-21.

Airport Shuttle Services' statement of cash flows for 2004 shows the following: Operating activities *provided* $9,000 cash. Investing activities *used* $10,000 cash. Financing activities *provided* $35,000 cash. The increase in cash of $34,000 reported in the statement of cash flows agrees with the increase of $34,000 shown as the change in the cash account in the comparative balance sheets.

Illustration 8-21

Statement of cash flows, 2004—indirect method

AIRPORT SHUTTLE SERVICES COMPANY Statement of Cash Flows—Indirect Method For the Year Ended December 31, 2004		
Cash flows from operating activities		
Net income		$35,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Increase in accounts receivable	$(30,000)	
Increase in accounts payable	4,000	(26,000)
Net cash provided by operating activities		9,000
Cash flows from investing activities		
Purchase of equipment	(10,000)	
Net cash used by investing activities		(10,000)
Cash flows from financing activities		
Issuance of common stock	50,000	
Payment of cash dividends	(15,000)	
Net cash provided by financing activities		35,000
Net increase in cash		34,000
Cash at beginning of period		–0–
Cash at end of period		$34,000

SECOND YEAR OF OPERATIONS—2005

Illustrations 8-22 and 8-23 present information related to the second year of operations for Airport Shuttle Services Company.

Illustration 8-22

Comparative balance sheets, 2005, with increases and decreases

AIRPORT SHUTTLE SERVICES COMPANY
Comparative Balance Sheets
December 31

Assets	2005	2004	Change Increase/Decrease
Cash	$ 56,000	$34,000	$ 22,000 Increase
Accounts receivable	20,000	30,000	10,000 Decrease
Prepaid expenses	4,000	–0–	4,000 Increase
Land	130,000	–0–	130,000 Increase
Building	160,000	–0–	160,000 Increase
Accumulated depreciation—building	(11,000)	–0–	11,000 Increase
Equipment	27,000	10,000	17,000 Increase
Accumulated depreciation—equipment	(3,000)	–0–	3,000 Increase
Total	$383,000	$74,000	
Liabilities and Stockholders' Equity			
Accounts payable	$ 59,000	$ 4,000	$ 55,000 Increase
Bonds payable	130,000	–0–	130,000 Increase
Common stock	50,000	50,000	–0–
Retained earnings	144,000	20,000	124,000 Increase
Total	$383,000	$74,000	

Illustration 8-23

Income statement and additional information, 2003

AIRPORT SHUTTLE SERVICES COMPANY
Income Statement
For the Year Ended December 31, 2005

Revenues		$507,000
Operating expenses (excluding depreciation)	$261,000	
Depreciation expense	15,000	
Loss on sale of equipment	3,000	279,000
Income from operations		228,000
Income tax expense		89,000
Net income		$139,000

Additional information:

1. In 2005, the company declared and paid a $15,000 cash dividend.
2. The company obtained land through the issuance of $130,000 of long-term bonds.
3. A building costing $160,000 was purchased for cash. Equipment costing $25,000 was also purchased for cash.
4. During 2005, the company sold equipment with a book value of $7,000 (cost $8,000, less accumulated depreciation $1,000) for $4,000 cash.

Step 1: Determine the Net Increase/Decrease in Cash

To prepare a statement of cash flows from this information, the first step is to determine the net increase or decrease in cash. As indicated from the information presented, cash increased $22,000 ($56,000 − $34,000).

Step 2: Determine Net Cash Provided/Used by Operating Activities

As in step 2 in 2004, net income on an accrual basis must be adjusted to arrive at net cash provided/used by operating activities. Explanations for the adjustments to net income for Airport Shuttle Services in 2005 follow.

DECREASE IN ACCOUNTS RECEIVABLE. Accounts receivable decreases during the period because cash receipts are higher than revenues reported on the accrual basis. To adjust net income to net cash provided by operating activities, the decrease of $10,000 in accounts receivable must be added to net income.

INCREASE IN PREPAID EXPENSES. Prepaid expenses increase during a period because cash paid for expenses is higher than expenses reported on the accrual basis. Cash payments have been made in the current period, but expenses (as charges to the income statement) have been deferred to future periods. To adjust net income to net cash provided by operating activities, the $4,000 increase in prepaid expenses must be deducted from net income. An increase in prepaid expenses results in a decrease in cash during the period.

INCREASE IN ACCOUNTS PAYABLE. Like the increase in 2004, the 2005 increase of $55,000 in accounts payable must be added to net income to convert to net cash provided by operating activities.

HELPFUL HINT

Decrease in accounts receivable indicates that cash collections were greater than sales.
Increase in accounts receivable indicates that sales were greater than cash collections.
Increase in prepaid expenses indicates that the amount paid for the prepayments exceeded the amount that was recorded as an expense.
Decrease in prepaid expenses indicates that the amount recorded as an expense exceeded the amount of cash paid for the prepayments.
Increase in accounts payable indicates that expenses incurred exceed the cash paid for expenses that period.

DEPRECIATION EXPENSE. During 2005, the company reported depreciation expense of $15,000. Of this amount, $11,000 related to the building and $4,000 to the equipment. These two amounts were determined by analyzing the accumulated depreciation accounts in the balance sheets.

- **Increase in Accumulated Depreciation—Building.** The Accumulated Depreciation—Building account increased $11,000. This change represents the depreciation expense on the building for the year. **Depreciation expense is a noncash charge. So it is added back to net income** in order to arrive at net cash provided by operating activities.
- **Increase in Accumulated Depreciation—Equipment.** The Accumulated Depreciation—Equipment account increased $3,000. But this change does not represent depreciation expense for the year. The additional information at the bottom of the income statement indicates why not: This account was decreased (debited $1,000) as a result of the sale of some equipment. Thus depreciation expense for 2005 was $4,000 ($3,000 + $1,000). That amount is added to net income to determine net cash provided by operating activities. The T-account in Illustration 8-24 provides information about the changes that occurred in this account in 2005.

Illustration 8-24

Analysis of accumulated depreciation—equipment

Accumulated Depreciation—Equipment				
Accumulated depreciation on equipment sold	1,000	1/1/05	Balance	–0–
			Depreciation expense	**4,000**
		12/31/05	Balance	3,000

Depreciation expense on the building ($11,000) plus depreciation expense on the equipment ($4,000) equals the depreciation expense of $15,000 reported in the income statement.

Other charges to expense that do not require the use of cash, such as the amortization of intangible assets and depletion expense, are treated in the same way as depreciation. Depreciation and similar noncash charges are frequently listed in the statement of cash flows as the first adjustments to net income.

LOSS ON SALE OF EQUIPMENT. In the income statement, Airport Shuttle Services Company reported a $3,000 loss on the sale of equipment (book value $7,000, less cash proceeds $4,000). The loss reduced net income but *did not reduce cash*. So the loss is *added to net income* in determining net cash provided by operating activities.[2]

As a result of the previous adjustments, net cash provided by operating activities is $218,000, as computed in Illustration 8-25.

[2]If a gain on sale occurs, a different situation results. To allow a gain to flow through to net cash provided by operating activities would be double-counting the gain—once in net income and again in the investing activities section as part of the cash proceeds from sale. As a result, a gain is deducted from net income in reporting net cash provided by operating activities.

Illustration 8-25

Presentation of net cash provided by operating activities, 2005—indirect method

AIRPORT SHUTTLE SERVICES COMPANY Statement of Cash Flows—Indirect Method (partial) For the Year Ended December 31, 2005		
Cash flows from operating activities		
Net income		$139,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	$15,000	
Loss on sale of equipment	3,000	
Decrease in accounts receivable	10,000	
Increase in prepaid expenses	(4,000)	
Increase in accounts payable	55,000	79,000
Net cash provided by operating activities		**$218,000**

Step 3: Determine Net Cash Provided/Used by Investing and Financing Activities

The next step involves analyzing the remaining changes in balance sheet accounts to determine net cash provided (used) by investing and financing activities.

INCREASE IN LAND. As indicated from the change in the Land account and the additional information, land of $130,000 was purchased through the issuance of long-term bonds. The issuance of bonds payable for land has no effect on cash. But it is a significant noncash investing and financing activity that merits disclosure in a separate schedule.

INCREASE IN BUILDING. As the additional data indicate, an office building was acquired for $160,000 cash. This is a cash outflow reported in the investing section.

INCREASE IN EQUIPMENT. The Equipment account increased $17,000. The additional information explains that this was a net increase that resulted from two transactions: (1) a purchase of equipment of $25,000 and (2) the sale for $4,000 of equipment costing $8,000. These transactions are classified as investing activities. Each transaction should be reported separately. Thus the purchase of equipment should be reported as an outflow of cash for $25,000. The sale should be reported as an inflow of cash for $4,000. The T-account below shows the reasons for the change in this account during the year.

Illustration 8-26

Analysis of equipment

Equipment				
1/1/05	Balance	10,000	Cost of equipment sold	8,000
	Purchase of equipment	**25,000**		
12/31/05	Balance	27,000		

The following entry shows the details of the equipment sale transaction.

Cash	4,000	
Accumulated Depreciation	1,000	
Loss on Sale of Equipment	3,000	
Equipment		8,000

A	=	L	+	SE
+4,000				−3,000
+1,000				
−8,000				

HELPFUL HINT
When stocks or bonds are issued for cash, the actual proceeds will appear in the statement of cash flows as a financing inflow (rather than the par value of the stocks or face value of bonds).

INCREASE IN BONDS PAYABLE. The Bonds Payable account increased $130,000. As indicated in the additional information, land was acquired from the issuance of these bonds. This noncash transaction is reported in a separate schedule at the bottom of the statement.

HELPFUL HINT
It is the **payment** of dividends, not the declaration, that appears in the cash flow statement.

INCREASE IN RETAINED EARNINGS. Retained earnings increased $124,000 during the year. This increase can be explained by two factors: (1) Net income of $139,000 increased retained earnings. (2) Dividends of $15,000 decreased retained earnings. Net income is adjusted to net cash provided by operating activities in the operating activities section. **Payment of the dividends is a cash outflow that is reported as a financing activity**.

Statement of Cash Flows—2005

Combining the previous items, we obtain a statement of cash flows for 2005 for Airport Shuttle Services Company as presented in Illustration 8-27.

Illustration 8-27
Statement of cash flows, 2005—indirect method

AIRPORT SHUTTLE SERVICES COMPANY
Statement of Cash Flows—Indirect Method
For the Year Ended December 31, 2005

Cash flows from operating activities		
Net income		$139,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	$ 15,000	
Loss on sale of equipment	3,000	
Decrease in accounts receivable	10,000	
Increase in prepaid expenses	(4,000)	
Increase in accounts payable	55,000	79,000
Net cash provided by operating activities		218,000
Cash flows from investing activities		
Purchase of building	(160,000)	
Purchase of equipment	(25,000)	
Sale of equipment	4,000	
Net cash used by investing activities		(181,000)
Cash flows from financing activities		
Payment of cash dividends	(15,000)	
Net cash used by financing activities		(15,000)
Net increase in cash		22,000
Cash at beginning of period		34,000
Cash at end of period		$ 56,000
Noncash investing and financing activities		
Issuance of bonds payable to purchase land		$130,000

HELPFUL HINT
Note that in the investing and financing activities sections, positive numbers indicate cash inflows (receipts), and negative numbers indicate cash outflows (payments).

Summary of Conversion to Net Cash Provided by Operating Activities—Indirect Method

As shown in the previous illustrations, the statement of cash flows prepared by the indirect method starts with net income. It then adds (or deducts) items not affecting cash, to arrive at net cash provided by operating activities. The additions and deductions consist of (1) changes in specific current assets and current liabilities and (2) noncash charges reported in the income statement. A summary of the adjustments for current assets and current liabilities is provided in Illustration 8-28.

Illustration 8-28

Adjustments for current assets and current liabilities

	Adjustments to Convert Net Income to Net Cash Provided by Operating Activities	
Current Assets and Current Liabilities	**Add to Net Income a(n):**	**Deduct from Net Income a(n):**
Accounts receivable	Decrease	Increase
Inventory	Decrease	Increase
Prepaid expenses	Decrease	Increase
Accounts payable	Increase	Decrease
Accrued expenses payable	Increase	Decrease

HELPFUL HINT

1. An increase in a current asset is deducted from net income.
2. A decrease in a current asset is added to net income.
3. An increase in a current liability is added to net income.
4. A decrease in a current liability is deducted from net income.

Adjustments for the noncash charges reported in the income statement are made as shown in Illustration 8-29.

Illustration 8-29

Adjustments for noncash charges

Noncash Charges	Adjustments to Convert Net Income to Net Cash Provided by Operating Activities
Depreciation expense	Add
Patent amortization expense	Add
Depletion expense	Add
Loss on sale of asset	Add

BEFORE YOU GO ON...

REVIEW IT

1. What is the format of the operating activities section of the statement of cash flows using the indirect method?
2. Where is depreciation expense shown on a statement of cash flows using the indirect method?
3. Where are significant noncash investing and financing activities shown in a statement of cash flows? Give some examples.

DO IT

Presented below is information related to Reynolds Gourmet Foods Company. Use it to prepare a statement of cash flows using the indirect method.

REYNOLDS GOURMET FOODS COMPANY
Comparative Balance Sheets
December 31

Assets	**2005**	**2004**	**Change Increase/Decrease**
Cash	$ 54,000	$ 37,000	$ 17,000 Increase
Accounts receivable	68,000	26,000	42,000 Increase
Inventories	54,000	–0–	54,000 Increase
Prepaid expenses	4,000	6,000	2,000 Decrease
Land	45,000	70,000	25,000 Decrease
Buildings	200,000	200,000	–0–
Accumulated depreciation—buildings	(21,000)	(11,000)	10,000 Increase
Equipment	193,000	68,000	125,000 Increase
Accumulated depreciation—equipment	(28,000)	(10,000)	18,000 Increase
Totals	$569,000	$386,000	
Liabilities and Stockholders' Equity			
Accounts payable	$ 23,000	$ 40,000	$ 17,000 Decrease
Accrued expenses payable	10,000	–0–	10,000 Increase
Bonds payable	110,000	150,000	40,000 Decrease
Common stock ($1 par)	220,000	60,000	160,000 Increase
Retained earnings	206,000	136,000	70,000 Increase
Totals	$569,000	$386,000	

REYNOLDS GOURMET FOODS COMPANY
Income Statement
For the Year Ended December 31, 2005

Revenues		$890,000
Cost of goods sold	$465,000	
Operating expenses	221,000	
Interest expense	12,000	
Loss on sale of equipment	2,000	700,000
Income from operations		190,000
Income tax expense		65,000
Net income		$125,000

Additional information:

1. Operating expenses include depreciation expense of $33,000 and charges from prepaid expenses of $2,000.
2. Land was sold at its book value for cash.
3. Cash dividends of $55,000 were declared and paid in 2005.
4. Interest expense of $12,000 was paid in cash.
5. Equipment with a cost of $166,000 was purchased for cash. Equipment with a cost of $41,000 and a book value of $36,000 was sold for $34,000 cash.
6. Bonds of $10,000 were redeemed at their book value for cash. Bonds of $30,000 were converted into common stock.
7. Common stock ($1 par) of $130,000 was issued for cash.
8. Accounts payable pertain to merchandise suppliers.

ACTION PLAN

- Determine the net increase/decrease in cash.
- Determine net cash provided/used by operating activities by adjusting net income for items that did not affect cash.
- Determine net cash provided/used by investing activities.
- Determine net cash provided/used by financing activities.

SOLUTION

REYNOLDS GOURMENT FOODS COMPANY Statement of Cash Flows—Indirect Method For the Year Ended December 31, 2005		
Cash flows from operating activities		
Net income		$125,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation expense	$ 33,000	
Increase in accounts receivable	(42,000)	
Increase in inventories	(54,000)	
Decrease in prepaid expenses	2,000	
Decrease in accounts payable	(17,000)	
Increase in accrued expenses payable	10,000	
Loss on sale of equipment	2,000	(66,000)
Net cash provided by operating activities		59,000
Cash flows from investing activities		
Sale of land	25,000	
Sale of equipment	34,000	
Purchase of equipment	(166,000)	
Net cash used by investing activities		(107,000)
Cash flows from financing activities		
Redemption of bonds	(10,000)	
Sale of common stock	130,000	
Payment of dividends	(55,000)	
Net cash provided by financing activities		65,000
Net increase in cash		17,000
Cash at beginning of period		37,000
Cash at end of period		$ 54,000
Noncash investing and financing activities		
Conversion of bonds into common stock		$ 30,000

HELPFUL HINT

1. Determine net cash provided/used by operating activities, recognizing that operating activities generally relate to changes in current assets and current liabilities.
2. Determine net cash provided/used by investing activities, recognizing that investing activities generally relate to changes in noncurrent assets.
3. Determine net cash provided/used by financing activities, recognizing that financing activities generally relate to changes in long-term liabilities and stockholders' equity accounts.

Related exercise material: 8-2 and 8-9.

THE NAVIGATOR

SECTION 2: DIRECT METHOD FOR STATEMENT OF CASH FLOWS

STUDY OBJECTIVE 7

Prepare a statement of cash flows using the direct method.

To explain and illustrate the direct method, we will use the transactions of Juarez Motel for two years, 2004 and 2005, to prepare annual statements of cash flows. We will show basic transactions in the first year, with additional transactions added in the second year.

FIRST YEAR OF OPERATIONS—2004

Juarez Motel began business on January 1, 2004. At that time it issued 300,000 shares of $1 par value common stock for $300,000 cash. The company rented office and sales space along with equipment. The comparative balance sheets at the beginning and end of 2004, showing changes in each account, appear in Illustration 8-30. The income statement and additional information for Juarez Motel are shown in Illustration 8-31.

Illustration 8-30

Comparative balance sheet, 2002, with increases and decreases

JUAREZ MOTEL Comparative Balance Sheet			
Assets	**Dec. 31, 2004**	**Jan. 1, 2004**	**Change Increase/Decrease**
Cash	$159,000	$–0–	$159,000 Increase
Accounts receivable	15,000	–0–	15,000 Increase
Inventory	160,000	–0–	160,000 Increase
Prepaid expenses	8,000	–0–	8,000 Increase
Land	80,000	–0–	80,000 Increase
Total	$422,000	$–0–	
Liabilities and Stockholders' Equity			
Accounts payable	$ 60,000	$–0–	$ 60,000 Increase
Accrued expenses payable	20,000	–0–	20,000 Increase
Common stock	300,000	–0–	300,000 Increase
Retained earnings	42,000	–0–	42,000 Increase
Total	$422,000	$–0–	

Illustration 8-31

Income statement and additional information, 2004

JUAREZ MOTEL Income Statement For the Year Ended December 31, 2004	
Revenues	$780,000
Cost of goods sold	450,000
Gross profit	330,000
Operating expenses	170,000
Income before income taxes	160,000
Income tax expense	48,000
Net income	$112,000

Additional information:

1. Dividends of $70,000 were declared and paid in cash.
2. The accounts payable increase resulted from the purchase of merchandise.

The three steps cited on page 238 for preparing the statement of cash flows are used in the direct method.

Step 1: Determine the Net Increase/Decrease in Cash

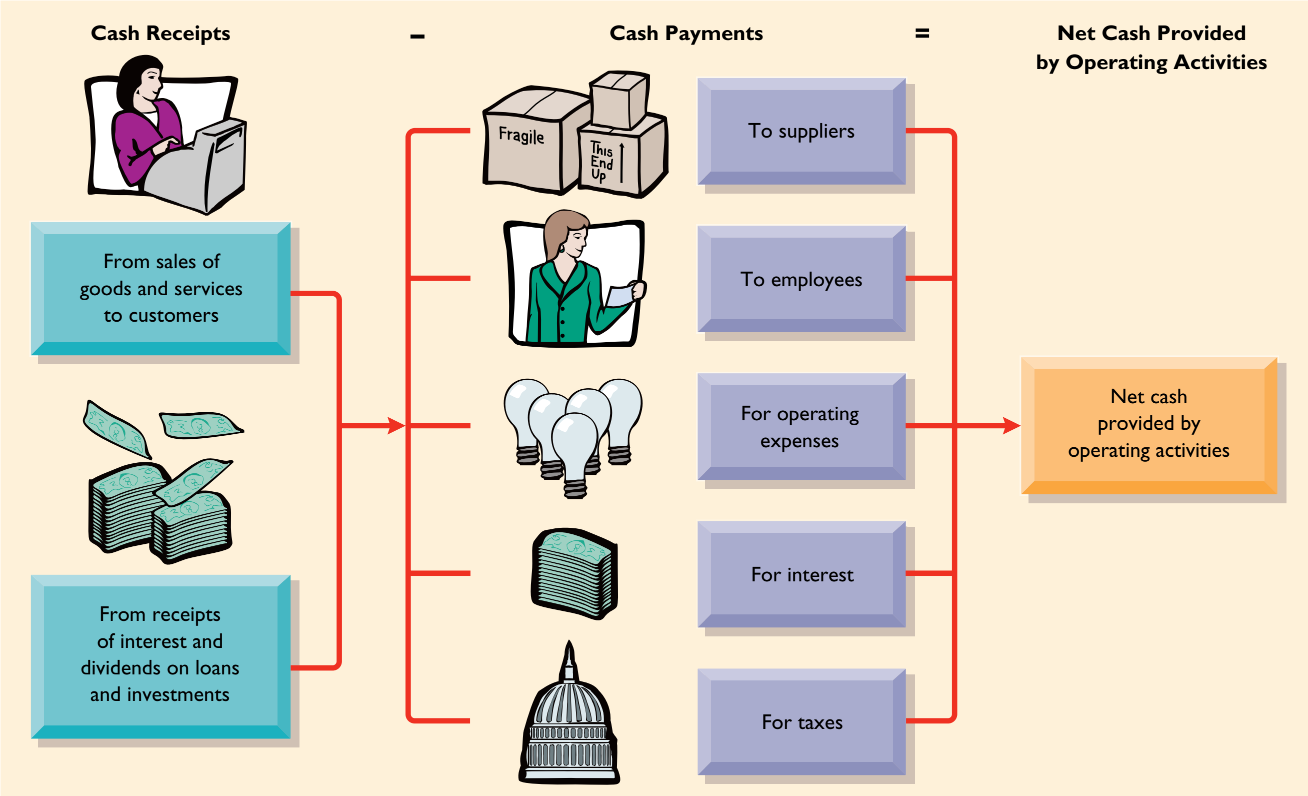
The comparative balance sheets for Juarez Motel show a zero cash balance at January 1, 2004, and a cash balance of $159,000 at December 31, 2004. Thus, the change in cash for 2004 was a net increase of $159,000.

Step 2: Determine Net Cash Provided/Used by Operating Activities

Under the **direct method**, net cash provided by operating activities is computed by *adjusting each item in the income statement* from the accrual basis to the cash basis. To simplify and condense the operating activities section, **only major classes of operating cash receipts and cash payments are reported**. For these major classes, the difference between cash receipts and cash payments is the net cash provided by operating activities. These relationships are as shown in Illustration 8-32.

Illustration 8-32

Major classes of cash receipts and payments



An efficient way to apply the direct method is to analyze the items reported in the income statement in the order in which they are listed. Cash receipts and cash payments related to these revenues and expenses are then determined. The direct method adjustments for Juarez Motel in 2004 to determine net cash provided by operating activities are presented on the following pages.

CASH RECEIPTS FROM CUSTOMERS. The income statement for Juarez Motel reported revenues from customers of $780,000. How much of that was cash receipts? To answer that, it is necessary to consider the change in accounts receivable during the year. When accounts receivable increase during the year, revenues on an accrual basis are higher than cash receipts from customers. Operations led to revenues, but not all of these revenues resulted in cash receipts. To determine the amount of cash receipts, the increase in accounts receivable is deducted from sales revenues. On the other hand, there may be a decrease in accounts receivable. That would occur if cash receipts from customers exceeded sales revenues. In that case, the decrease in accounts receivable is added to sales revenues.

For Juarez Motel, accounts receivable increased $15,000. Thus, cash receipts from customers were $765,000, computed as follows.

Illustration 8-33

Computation of cash receipts from customers

Revenues from sales	$780,000
Deduct: Increase in accounts receivable	15,000
Cash receipts from customers	**$765,000**

Cash receipts from customers may also be determined from an analysis of the Accounts Receivable account, as shown in Illustration 8-34.

Illustration 8-34

Analysis of accounts receivable

Accounts Receivable

1/1/04	Balance	–0–	**Receipts from customers**	**765,000**
	Revenues from sales	780,000		
12/31/04	Balance	15,000		

HELPFUL HINT
The T-account shows that revenue less increase in receivables equals cash receipts.

The relationships among cash receipts from customers, revenues from sales, and changes in accounts receivable are shown in Illustration 8-35.

Illustration 8-35

Formula to compute cash receipts from customers—direct method

Cash receipts from customers = Revenues from sales { + Decrease in accounts receivable or – Increase in accounts receivable }

CASH PAYMENTS TO SUPPLIERS. Juarez Motel reported cost of goods sold of $450,000 on its income statement. How much of that was cash payments to suppliers? To answer that, it is first necessary to find purchases for the year. To find purchases, cost of goods sold is adjusted for the change in inventory. When inventory increases during the year, purchases for the year have exceeded cost of goods sold. As a result, to determine the amount of purchases, the increase in inventory is added to cost of goods sold.

In 2004, Juarez's inventory increased $160,000. Purchases are computed as shown in Illustration 8-36.

Illustration 8-36

Computation of purchases

Cost of goods sold	$450,000
Add: Increase in inventory	160,000
Purchases	**$610,000**

After purchases are computed, cash payments to suppliers can be determined. This is done by adjusting purchases for the change in accounts payable. When accounts payable increase during the year, purchases on an accrual basis are higher than they are on a cash basis. As a result, to determine cash payments to suppliers, an increase in accounts payable is deducted from purchases. On the other hand, there may be a decrease in accounts payable. That would occur if cash payments to suppliers exceed purchases. In that case, the decrease in accounts payable is added to purchases.

For Juarez Motel, cash payments to suppliers were $550,000, shown in Illustration 8-37.

Illustration 8-37

Computation of cash payments to suppliers

Purchases	$610,000
Deduct: Increase in accounts payable	60,000
Cash payments to suppliers	**$ 550,000**

Cash payments to suppliers may also be determined from an analysis of the Accounts Payable account as shown in Illustration 8-38.

Illustration 8-38

Analysis of accounts payable

Accounts Payable

Payments to suppliers	550,000	1/1/04	Balance	–0–
			Purchases	610,000
		12/31/04	Balance	60,000

HELPFUL HINT
The T-account shows that purchases less increase in accounts payable equals payments to suppliers.

The relationships among cash payments to suppliers, cost of goods sold, changes in inventory, and changes in accounts payable are shown in the following formula.

Illustration 8-39

Formula to compute cash payments to suppliers—direct method

Cash payments to suppliers = Cost of goods sold { + Increase in inventory or – Decrease in inventory } { + Decrease in accounts payable or – Increase in accounts payable }

CASH PAYMENTS FOR OPERATING EXPENSES. Operating expenses of $170,000 were reported on Juarez's income statement. How much of that amount was cash paid for operating expenses? To answer that, we need to adjust this amount for any changes in prepaid expenses and accrued expenses payable. For example, when prepaid expenses increased $8,000 during the year, cash paid for operating expenses was $8,000 higher than operating expenses reported on the income statement. To convert operating expenses to cash payments for operating expenses, the increase must be added to operating expenses. On the other hand, if prepaid expenses decrease during the year, the decrease must be deducted from operating expenses.

Operating expenses must also be adjusted for changes in accrued expenses payable. When accrued expenses payable increase during the year, operating expenses on an accrual basis are higher than they are on a cash basis. As a result, to determine cash payments for operating expenses, an increase in accrued expenses payable is deducted from operating expenses. On the other hand, a decrease in accrued expenses payable is added to operating expenses because cash payments exceed operating expenses.

Juarez Motel's cash payments for operating expenses were $158,000, computed as shown in Illustration 8-40.

HELPFUL HINT
Decrease in accounts receivable indicates that cash collections were greater than sales.
Increase in accounts receivable indicates that sales were greater than cash collections.
Increase in prepaid expenses indicates that the amount paid for the prepayments exceeded the amount that was recorded as an expense.
Decrease in prepaid expenses indicates that the amount recorded as an expense exceeded the amount of cash paid for the prepayments.
Increase in accrued expenses payable indicates that expenses incurred exceed the cash paid for expenses that period.

Illustration 8-40

Computation of cash payments for operating expenses

Operating expenses	$170,000
Add: Increase in prepaid expenses	8,000
Deduct: Increase in accrued expenses payable	(20,000)
Cash payments for operating expenses	**$158,000**

The relationships among cash payments for operating expenses, changes in prepaid expenses, and changes in accrued expenses payable are shown in Illustration 8-41.

Illustration 8-41

Formula to compute cash payments for operating expenses—direct method

Cash payments for operating expenses = Operating expenses { + Increase in prepaid expense or − Decrease in prepaid expense } { + Decrease in accrued expenses payable or − Increase in accrued expenses payable }

CASH PAYMENTS FOR INCOME TAXES. The income statement for Juarez Motel shows income tax expense of $48,000. This amount equals the cash paid. The comparative balance sheets indicated no income taxes payable at either the beginning or end of the year.

All of the revenues and expenses in the 2004 income statement have now been adjusted to a cash basis. The operating activities section of the statement of cash flows is shown in Illustration 8-42.

Illustration 8-42

Operating activities section—direct method

JUAREZ MOTEL
Statement of Cash Flows—Direct Method (partial)
For the Year Ended December 31, 2004

Cash flows from operating activities		
Cash receipts from customers		$765,000
Cash payments:		
To suppliers	$550,000	
For operating expenses	158,000	
For income taxes	48,000	756,000
Net cash provided by operating activities		**$ 9,000**

Step 3: Determine Net Cash Provided/Used by Investing and Financing Activities

Preparing the investing and financing activities sections of the statement of cash flows begins by determining the changes in noncurrent accounts reported in the comparative balance sheets. The change in each account is then analyzed to determine the effect, if any, the change had on cash.

HELPFUL HINT
This is the same procedure used under the indirect method. The investing and financing activities are measured and reported the same under both methods.

INCREASE IN LAND. No additional information is given for the increase in land. In such case, you should assume that the increase affected cash. In solving homework problems, you should assume that any unexplained differences in noncurrent accounts involve cash. The purchase of land is an investing activity. Thus, an outflow of cash of $80,000 for the purchase of land should be reported in the investing activities section.

INCREASE IN COMMON STOCK. As indicated earlier, 300,000 shares of $1 par value stock were sold for $300,000 cash. The issuance of common stock is a financing activity. Thus, a cash inflow of $300,000 from the issuance of common stock is reported in the financing activities section.

INCREASE IN RETAINED EARNINGS. What caused the net increase of $42,000 in the Retained Earnings account? First, net income increased retained earnings by $112,000. Second, the additional information section indicates that a cash dividend of $70,000 was declared and paid. The adjustment of revenues and expenses to arrive at net cash provided by operations was done in step 2 above. The cash dividend paid is reported as an outflow of cash in the financing activities section.

This analysis can also be made directly from the Retained Earnings account in the ledger of Juarez Motel as shown in Illustration 8-43.

HELPFUL HINT
It is the *payment* of dividends, not the declaration, that appears on the cash flow statement.

Illustration 8-43
Analysis of retained earnings

Retained Earnings

12/31/04	**Cash dividend**	**70,000**	1/1/04	Balance	–0–
			12/31/04	**Net income**	**112,000**
			12/31/04	Balance	42,000

The $42,000 increase in Retained Earnings in 2004 is a net change. When a net change in a noncurrent balance sheet account has occurred during the year, it generally is necessary to report the individual items that cause the net change.

Statement of Cash Flows—2004

We can now prepare the statement of cash flows. The operating activities section is reported first, followed by the investing and financing activities sections. The statement of cash flows for Juarez Motel for 2004 is shown in Illustration 8-44.

Illustration 8-44
Statement of cash flows, 2004—direct method

JUAREZ MOTEL
Statement of Cash Flows—Direct Method
For the Year Ended December 31, 2004

Cash flows from operating activities		
Cash receipts from customers		$765,000
Cash payments:		
To suppliers	$550,000	
For operating expenses	158,000	
For income taxes	48,000	756,000
Net cash provided by operating activities		9,000
Cash flows from investing activities		
Purchase of land	(80,000)	
Net cash used by investing activities		(80,000)
Cash flows from financing activities		
Issuance of common stock	300,000	
Payment of cash dividend	(70,000)	
Net cash provided by financing activities		230,000
Net increase in cash		159,000
Cash at beginning of period		–0–
Cash at end of period		$159,000

HELPFUL HINT
Note that in the investing and financing activities sections, positive numbers indicate cash inflows (receipts), and negative numbers indicate cash outflows (payments).

The statement of cash flows shows the following: Operating activities *provided* $9,000 of the net increase in cash. Investing activities *used* $80,000 of cash. Financing activities *provided* $230,000 of cash. The $159,000 net increase in cash for the year agrees with the increase in cash of $159,000 reported in the comparative balance sheets.

SECOND YEAR OF OPERATIONS—2005

Illustrations 8-45 and 8-46 present information related to the second year of operations for Juarez Motel.

Illustration 8-45

Comparative balance sheets, 2005, with increases and decreases

JUAREZ MOTEL
Comparative Balance Sheets
December 31

Assets	2005	2004	Change Increase/Decrease
Cash	$191,000	$159,000	$ 32,000 Increase
Accounts receivable	12,000	15,000	3,000 Decrease
Inventory	130,000	160,000	30,000 Decrease
Prepaid expenses	6,000	8,000	2,000 Decrease
Land	180,000	80,000	100,000 Increase
Equipment	160,000	–0–	160,000 Increase
Accumulated depreciation—equipment	(16,000)	–0–	16,000 Increase
Total	$663,000	$422,000	
Liabilities and Stockholders' Equity			
Accounts payable	$ 52,000	$ 60,000	$ 8,000 Decrease
Accrued expenses payable	15,000	20,000	5,000 Decrease
Income taxes payable	12,000	–0–	12,000 Increase
Bonds payable	90,000	–0–	90,000 Increase
Common stock	400,000	300,000	100,000 Increase
Retained earnings	94,000	42,000	52,000 Increase
Total	$663,000	$422,000	

Illustration 8-46

Income statement and additional information, 2005

JUAREZ MOTEL
Income Statement
For the Year Ended December 31, 2005

Revenues		$975,000
Cost of goods sold	$660,000	
Operating expenses (excluding depreciation)	176,000	
Depreciation expense	18,000	
Loss on sale of store equipment	1,000	855,000
Income before income taxes		120,000
Income tax expense		36,000
Net income		$ 84,000

Additional information:

1. In 2005, the company declared and paid a $32,000 cash dividend.
2. Bonds were issued at face value for $90,000 in cash.
3. Equipment costing $180,000 was purchased for cash.
4. Equipment costing $20,000 was sold for $17,000 cash when the book value of the equipment was $18,000.
5. Common stock of $100,000 was issued to acquire land.

Step 1: Determine the Net Increase/Decrease in Cash

The comparative balance sheets show a beginning cash balance of $159,000 and an ending cash balance of $191,000. Thus, there was a net increase in cash in 2005 of $32,000.

Step 2: Determine Net Cash Provided/Used by Operating Activities

CASH RECEIPTS FROM CUSTOMERS. Revenues from sales were $975,000. Since accounts receivable decreased $3,000, cash receipts from customers were greater than sales revenues. Cash receipts from customers were $978,000, computed as shown in Illustration 8-47.

Revenues from sales	$975,000
Add: Decrease in accounts receivable	3,000
Cash receipts from customers	**$978,000**

Illustration 8-47

Computation of cash receipts from customers

CASH PAYMENTS TO SUPPLIERS. The conversion of cost of goods sold to purchases and purchases to cash payments to suppliers is similar to the computations made in 2004. For 2005, purchases are computed using cost of goods sold of $660,000 from the income statement and the decrease in inventory of $30,000 from the comparative balance sheets. Purchases are then adjusted by the decrease in accounts payable of $8,000. Cash payments to suppliers were $638,000, computed as shown in Illustration 8-48.

Cost of goods sold	$660,000
Deduct: Decrease in inventory	30,000
Purchases	630,000
Add: Decrease in accounts payable	8,000
Cash payments to suppliers	**$638,000**

Illustration 8-48

Computation of cash payments to suppliers

CASH PAYMENTS FOR OPERATING EXPENSES. Operating expenses (exclusive of depreciation expense) for 2005 were reported at $176,000. This amount is then adjusted for changes in prepaid expenses and accrued expenses payable to determine cash payments for operating expenses.

As shown in the comparative balance sheets, prepaid expenses decreased $2,000 during the year. This means that $2,000 was allocated to operating expenses (thereby increasing operating expenses), but cash payments did not increase by that $2,000. To determine cash payments for operating expenses, the decrease in prepaid expenses is deducted from operating expenses.

Accrued operating expenses decreased $5,000 during the period. As a result, cash payments were higher by $5,000 than the amount reported for operating expenses. The decrease in accrued expenses payable is added to operating expenses. Cash payments for operating expenses were $179,000, computed in Illustration 8-49.

Illustration 8-49

Computation of cash payments for operating expenses

Operating expenses, exclusive of depreciation	$176,000
Deduct: Decrease in prepaid expenses	(2,000)
Add: Decrease in accrued expenses payable	5,000
Cash payments for operating expenses	**$179,000**

DEPRECIATION EXPENSE AND LOSS ON SALE OF EQUIPMENT. Operating expenses are shown exclusive of depreciation. Depreciation expense in 2005 was $18,000. Depreciation expense is not shown on a statement of cash flows because it is a noncash charge. If the amount for operating expenses includes depreciation expense, operating expenses must be reduced by the amount of depreciation to determine cash payments for operating expenses.

The loss on sale of equipment of $1,000 is also a noncash charge. The loss on sale of equipment reduces net income, but it does not reduce cash. Thus, the loss on sale of equipment is not reported on a statement of cash flows.

Other charges to expense that do not require the use of cash, such as the amortization of intangible assets and depletion expense, are treated in the same manner as depreciation.

CASH PAYMENTS FOR INCOME TAXES. Income tax expense reported on the income statement was $36,000. Income taxes payable, however, increased $12,000. This increase means that $12,000 of the income taxes have not been paid. As a result, income taxes paid were less than income taxes reported in the income statement. Cash payments for income taxes were, therefore, $24,000 as shown in Illustration 8-50.

Illustration 8-50

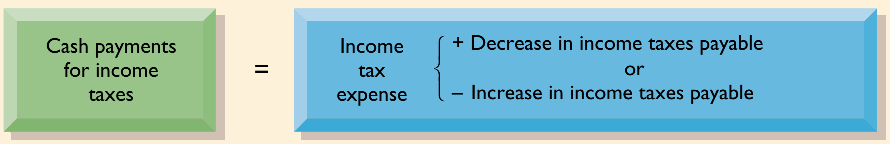
Computation of cash payments for income taxes

Income tax expense	$36,000
Deduct: Increase in income taxes payable	12,000
Cash payments for income taxes	**$24,000**

The relationships among cash payments for income taxes, income tax expense, and changes in income taxes payable are shown in Illustration 8-51.

Illustration 8-51

Formula to compute cash payments for income taxes—direct method



Step 3: Determine Net Cash Provided/Used by Investing and Financing Activities

INCREASE IN LAND. Land increased $100,000. The additional information section indicates that common stock was issued to purchase the land. The issuance of common stock for land has no effect on cash. **But it is a significant noncash investing and financing transaction**. This transaction requires disclosure in a separate schedule at the bottom of the statement of cash flows.

INCREASE IN EQUIPMENT. The comparative balance sheets show that equipment increased $160,000 in 2005. The additional information in Illustration 8-46 indicates that the increase resulted from two investing transactions: (1) Equipment costing $180,000 was purchased for cash. And (2) equipment costing $20,000 was sold for $17,000 cash when its book value was $18,000. The relevant data for the statement of cash flows is the cash paid for the purchase and the cash proceeds from the sale. For Juarez Motel, the investing activities section will show the following: The $180,000 purchase of equipment as an outflow of cash, and the $17,000 sale of equipment also as an inflow of cash. **The two amounts should not be netted**. **Both individual outflows and inflows of cash should be shown.**

The analysis of the changes in equipment should include the related Accumulated Depreciation account. These two accounts for Juarez Motel are shown in Illustration 8-52.

Illustration 8-52

Analysis of equipment and related accumulated depreciation

Equipment

1/1/05	Balance	–0–		Cost of equipment sold	20,000
	Cash purchase	**180,000**			
12/31/05	Balance	160,000			

Accumulated Depreciation—Equipment

	Sale of equipment	2,000	1/1/05	Balance	–0–
				Depreciation expense	18,000
			12/31/05	Balance	16,000

INCREASE IN BONDS PAYABLE. Bonds Payable increased $90,000. The additional information in Illustration 8-46 indicated that bonds with a face value of $90,000 were issued for $90,000 cash. The issuance of bonds is a financing activity. For Juarez Motel, there is an inflow of cash of $90,000 from the issuance of bonds.

INCREASE IN COMMON STOCK. The Common Stock account increased $100,000. The additional information indicated that land was acquired from the issuance of common stock. **This transaction is a significant noncash investing and financing transaction** that should be reported separately at the bottom of the statement.

INCREASE IN RETAINED EARNINGS. The $52,000 net increase in Retained Earnings resulted from net income of $84,000 and the declaration and payment of a cash dividend of $32,000. **Net income is not reported in the statement of cash flows under the direct method.** Cash dividends paid of $32,000 are reported in the financing activities section as an outflow of cash.

Statement of Cash Flows—2005

The statement of cash flows for Juarez Motel is shown in Illustration 8-53.

Illustration 8-53

Statement of cash flows, 2005—direct method

JUAREZ MOTEL
Statement of Cash Flows—Direct Method
For the Year Ended December 31, 2005

Cash flows from operating activities		
Cash receipts from customers		$978,000
Cash payments:		
To suppliers	$638,000	
For operating expenses	179,000	
For income taxes	24,000	841,000
Net cash provided by operating activities		137,000
Cash flows from investing activities		
Purchase of equipment	(180,000)	
Sale of equipment	17,000	
Net cash used by investing activities		(163,000)
Cash flows from financing activities		
Issuance of bonds payable	90,000	
Payment of cash dividends	(32,000)	
Net cash provided by financing activities		58,000
Net increase in cash		32,000
Cash at beginning of period		159,000
Cash at end of period		$191,000
Noncash investing and financing activities		
Issuance of common stock to purchase land		$100,000

BEFORE YOU GO ON...

REVIEW IT

1. What is the format of the operating activities section of the statement of cash flows using the direct method?
2. Where is depreciation expense shown on a statement of cash flows using the direct method?
3. Where are significant noncash investing and financing activities shown on a statement of cash flows? Give some examples.

DO IT

Presented below is information related to Reynolds Gourmet Foods Company. Use it to prepare a statement of cash flows using the direct method.

REYNOLDS GOURMET FOODS COMPANY
Comparative Balance Sheets
December 31

Assets	2005	2004	Change Increase/Decrease
Cash	$ 54,000	$ 37,000	$ 17,000 Increase
Accounts receivable	68,000	26,000	42,000 Increase
Inventories	54,000	–0–	54,000 Increase
Prepaid expenses	4,000	6,000	2,000 Decrease
Land	45,000	70,000	25,000 Decrease
Buildings	200,000	200,000	–0–
Accumulated depreciation—buildings	(21,000)	(11,000)	10,000 Increase
Equipment	193,000	68,000	125,000 Increase
Accumulated depreciation—equipment	(28,000)	(10,000)	18,000 Increase
Totals	$569,000	$386,000	
Liabilities and Stockholders' Equity			
Accounts payable	$ 23,000	$ 40,000	$ 17,000 Decrease
Accrued expenses payable	10,000	–0–	10,000 Increase
Bonds payable	110,000	150,000	40,000 Decrease
Common stock ($1 par)	220,000	60,000	160,000 Increase
Retained earnings	206,000	136,000	70,000 Increase
Totals	$569,000	$386,000	

REYNOLDS GOURMET FOODS COMPANY
Income Statement
For the Year Ended December 31, 2005

Revenues		$890,000
Cost of goods sold	$465,000	
Operating expenses	221,000	
Interest expense	12,000	
Loss on sale of equipment	2,000	700,000
Income from operations		190,000
Income tax expense		65,000
Net income		$125,000

Additional information:

1. Operating expenses include depreciation expense of $33,000 and charges from prepaid expenses of $2,000.
2. Land was sold at its book value for cash.
3. Cash dividends of $55,000 were declared and paid in 2005.
4. Interest expense of $12,000 was paid in cash.
5. Equipment with a cost of $166,000 was purchased for cash. Equipment with a cost of $41,000 and a book value of $36,000 was sold for $34,000 cash.
6. Bonds of $10,000 were redeemed at their book value for cash. Bonds of $30,000 were converted into common stock.
7. Common stock ($1 par) of $130,000 was issued for cash.
8. Accounts payable pertain to merchandise suppliers.

ACTION PLAN

- Determine the net increase/decrease in cash.
- Determine net cash provided/used by operating activities by adjusting each item in the income statement from the accrual basis to the cash basis.
- Determine net cash provided/used by investing activities.
- Determine net cash provided/used by financing activities.

HELPFUL HINT

1. Determine net cash provided/used by operating activities, recognizing that each item in the income statement must be adjusted to the cash basis.
2. Determine net cash provided/used by investing activities, recognizing that investing activities generally relate to changes in noncurrent assets.
3. Determine net cash provided/used by financing activities, recognizing that financing activities generally relate to changes in long-term liabilities and stockholders' equity accounts.

SOLUTION

REYNOLDS GOURMET FOODS COMPANY
Statement of Cash Flows—Direct Method
For the Year Ended December 31, 2005

Cash flows from operating activities		
Cash receipts from customers		$848,000[a]
Cash payments:		
To suppliers	$536,000[b]	
For operating expenses	176,000[c]	
For interest expense	12,000	
For income taxes	65,000	789,000
Net cash provided by operating activities		59,000
Cash flows from investing activities		
Sale of land	25,000	
Sale of equipment	34,000	
Purchase of equipment	(166,000)	
Net cash used by investing activities		(107,000)
Cash flows from financing activities		
Redemption of bonds	(10,000)	
Sale of common stock	130,000	
Payment of dividends	(55,000)	
Net cash provided by financing activities		65,000
Net increase in cash		17,000
Cash at beginning of period		37,000
Cash at end of period		$ 54,000
Noncash investing and financing activities		
Conversion of bonds into common stock		$ 30,000

Computations:

[a]$848,000 = $890,000 − $42,000
[b]$536,000 = $465,000 + $54,000 + $17,000
[c]$176,000 = $221,000 − $33,000 − $2,000 − $10,000

Technically, an additional schedule reconciling net income to net cash provided by operating activities should be presented as part of the statement of cash flows when using the direct method.

Related exercise material: 8-4 and 8-11.

THE NAVIGATOR

DEMONSTRATION PROBLEM 1

The income statement for the year ended December 31, 2004, for Tuscany Bay Resort contains the following condensed information.

TUSCANY BAY RESORT
Income Statement

Revenues		$6,583,000
Operating expenses (excluding depreciation)	$4,920,000	
Depreciation expense	880,000	5,800,000
Income before income taxes		783,000
Income tax expense		353,000
Net income		$ 430,000

Included in operating expenses is a $24,000 loss resulting from the sale of guest room furniture for $270,000 cash. Guest room furniture was purchased at a cost of $750,000.

The following balances are reported on Tuscany Bay's comparative balance sheets at December 31.

TUSCANY BAY RESORT
Comparative Balance Sheets (partial)

	2004	2003
Cash	$672,000	$130,000
Accounts receivable	775,000	610,000
Inventories	834,000	867,000
Accounts payable	521,000	501,000

Income tax expense of $353,000 represents the amount paid in 2004. Dividends declared and paid in 2004 totaled $200,000.

Instructions

(a) Prepare the statement of cash flows using the indirect method.

OR

(b) Prepare the statement of cash flows using the direct method.

SOLUTION TO DEMONSTRATION PROBLEM

(a)

TUSCANY BAY RESORT
Statement of Cash Flows—Indirect Method
For the Year Ended December 31, 2004

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

ACTION PLAN

- Apply the same data to the preparation of a statement of cash flows under both the indirect and direct methods.
- Note the similarities of the two methods: Both methods report the same information in the investing and financing sections.
- Note the differences between the two methods: The cash flows from operating activities sections report different information (but the amount of net cash provided by operating activities is the same for both methods).

(b)

TUSCANY BAY RESORT
Statement of Cash Flows—Direct Method
For the Year Ended December 31, 2004

Cash flows from operating activities		
Cash receipts from customers		$6,418,000*
Cash payments:		
For operating expenses	$4,843,000**	
For income taxes	353,000	5,196,000
Net cash provided by operating activities		1,222,000
Cash flows from investing activities		
Sale of guest room furniture	270,000	
Purchase of guest room furniture	(750,000)	
Net cash used by investing activities		(480,000)
Cash flows from financing activities		
Payment of cash dividends		(200,000)
Net increase in cash		542,000
Cash at beginning of period		130,000
Cash at end of period		$ 672,000

Direct Method Computations:

* Computation of cash receipts from customers:	
Revenues per the income statement	$6,583,000
Less increase in accounts receivable	165,000
Cash receipts from customers	$6,418,000

** Computation of cash payments for operating expenses:	
Operating expenses per the income statement	$4,920,000
Deduct loss from sale of guest room furniture	(24,000)
Deduct decrease in inventories	(33,000)
Deduct increase in accounts payable	(20,000)
Cash payments for operating expenses	$4,843,000

THE NAVIGATOR

DEMONSTRATION PROBLEM 2

The adjusted trial balance columns of the work sheet for the year ended December 31, 2004, for Tournament Souvenir and Pro Shop are as follows.

Debit		Credit	
Cash	14,500	Accumulated Depreciation	18,000
Accounts Receivable	11,100	Notes Payable	25,000
Merchandise Inventory	29,000	Accounts Payable	10,600
Prepaid Insurance	2,500	Common Stock	50,000
Store Equipment	95,000	Retained Earnings	31,000
Dividends	12,000	Sales	536,800
Sales Returns and Allowances	6,700	Interest Revenue	2,500
Sales Discounts	5,000		673,900
Cost of Goods Sold	363,400		
Freight-out	7,600		
Advertising Expense	12,000		
Store Salaries Expense	56,000		
Utilities Expense	18,000		
Rent Expense	24,000		
Depreciation Expense	9,000		
Insurance Expense	4,500		
Interest Expense	3,600		
	673,900		

Instructions
Prepare an income statement assuming Tournament Souvenir and Pro Shop does not use subgroupings for operating expenses.

SOLUTION TO DEMONSTRATION PROBLEM

TOURNAMENT SOUVENIR AND PRO SHOP
Income Statement
For the Year Ended December 31, 2004

Sales revenues		
Sales		$536,800
Less: Sales returns and allowances	$6,700	
Sales discounts	5,000	11,700
Net sales		525,100
Cost of goods sold		363,400
Gross profit		161,700
Operating expenses		
Store salaries expense	56,000	
Rent expense	24,000	
Utilities expense	18,000	
Advertising expense	12,000	
Depreciation expense	9,000	
Freight-out	7,600	
Insurance expense	4,500	
Total operating expenses		131,100
Income from operations		30,600
Other revenues and gains		
Interest revenue	2,500	
Other expenses and losses		
Interest expense	3,600	1,100
Net income		$ 29,500

ACTION PLAN

- Remember that the key components of the income statement are net sales, cost of goods sold, gross profit, total operating expenses, and net income (loss). Report these components in the right-hand column of the income statement.
- Put nonoperating items after income from operations.

THE NAVIGATOR

SUMMARY OF STUDY OBJECTIVES

1. *Distinguish between multiple-step and single-step income statements.* A multiple-step income statement shows numerous steps in determining net income, including nonoperating activities sections. In a single-step income statement, all data are classified under two categories (revenues or expenses) and net income is determined in one step.

2. *Explain the computation and importance of gross profits.* Gross profit is computed by subtracting cost of goods sold from net sales. Gross profit represents the merchandising profit of a company. The amount and trend of gross profit are closely watched by management and other interested parties.

3. *Distinguish between departmental and consolidated income statements.* A consolidated income statement is a summary statement of all the departmental income statements of a property.

4. *Indicate the primary purpose of the statement of cash flows.* The primary purpose of the statement of cash flows is to provide information about the cash receipts and cash payments during a period. A secondary objective is to provide information about the operating, investing, and financing activities during the period.

5. *Distinguish among operating, investing, and financing activities.* Operating activities include the cash effects of transactions that enter into the determination of net income. Investing activities involve cash flows resulting from changes in investments and long-term asset items. Financing activities involve cash flows resulting from changes in long-term liability and stockholders' equity items.

6. *Prepare a statement of cash flows using the indirect method.* The preparation of a statement of cash flows involves three major steps: (1) Determine the net increase or decrease in cash. (2) Determine net cash provided (used) by operating activities. (3) Determine net cash flows provided (used) by investing and financing activities. Under the indirect method, accrual basis net income is adjusted to net cash provided by operating activities.

7. *Prepare a statement of cash flows using the direct method.* The preparation of the statement of cash flows involves three major steps: (1) Determine the net increase or decrease in cash. (2) Determine net cash provided (used) by operating activities. (3) Determine net cash flows provided (used) by investing and financing activities. To determine net cash provided by operating activities, the direct method reports cash receipts less cash payments.

THE NAVIGATOR

GLOSSARY

Administrative expenses Expenses relating to general operating activities such as personnel management, accounting, and store security (p. 230).

Consolidated income statement A combined income statement of all departmental income statements of an entity (p. 231)

Direct method A method of determining the net cash provided by operating activities by adjusting each item in the income statement from the accrual basis to the cash basis (p. 252).

Financing activities Cash flow activities that include (a) obtaining cash from issuing debt and repaying the amounts borrowed and (b) obtaining cash from stockholders and providing them with a return on their investment (p. 234).

Income from operations Income from a company's principal operating activity; determined by subtracting cost of goods sold and operating expenses from net sales (p. 228).

Indirect method A method of preparing a statement of cash flows in which net income is adjusted for items that did not affect cash, to determine net cash provided by operating activities (p. 241).

Investing activities Cash flow activities that include (a) acquiring and disposing of investments and productive long-lived assets and (b) lending money and collecting on those loans (p. 234).

Multiple-step income statement An income statement that shows numerous steps in determining net income (or net loss) (p. 226).

Net sales Sales less sales returns and allowances and sales discounts (p. 227).

Operating activities Cash flow activities that include the cash effects of transactions that create revenues and expenses and thus enter into the determination of net income (p. 234).

Other expenses and losses A nonoperating activities section of the income statement that shows expenses from auxiliary operations and losses unrelated to the company's operations (p. 228).

Other revenues and gains A nonoperating activities section of the income statement that shows revenues from auxiliary operations and gains unrelated to the company's operations (p. 228).

Selling expenses Expenses associated with making sales (p. 229).

Single-step income statement An income statement that shows only one step in determining net income (or net loss) (p. 230).

Statement of cash flows A financial statement that provides information about the cash receipts and cash payments of an entity during a period, classified as operating, investing, and financing activities, in a format that reconciles the beginning and ending cash balances (p. 234).

EXERCISES

Contrast presentation in multiple-step and single-step income statements. (SO 1)

8-1 Explain where each of the following items would appear on (1) a multiple-step income statement, and on (2) a single-step income statement: **(a)** gain on sale of equipment, **(b)** casualty loss from vandalism, and **(c)** cost of goods sold.

Compute cash provided by operating activities—indirect method. (SO 6)

8-2 Titanic Candy reported net income of $2.5 million in 2004. Depreciation for the year was $260,000, accounts receivable decreased $350,000, and accounts payable decreased $310,000. Compute net cash provided by operating activities using the indirect approach.

Classify items by activities. (SO 5)

8-3 Classify the following items as an operating, investing, or financing activity. Assume all items involve cash unless there is information to the contrary.

(a) Purchase of equipment.
(b) Sale of building.
(c) Redemption of bonds.
(d) Depreciation.
(e) Payment of dividends.
(f) Issuance of capital stock.

Compute receipts from customers using direct method. (SO 7)

8-4 Kate's Uniforms Co. has accounts receivable of $14,000 at January 1, 2004, and $24,000 at December 31, 2004. Sales revenues for 2004 were $470,000. What is the amount of cash receipts from customers in 2004?

Determine cash received in sale of equipment. (SO 6, 7)

8-5 The T-accounts for Equipment and the related Accumulated Depreciation for Stone Kitchen Equipment Company at the end of 2004 are as follows.

Equipment

Beg. bal.	80,000	Disposals	22,000
Acquisitions	41,600		
End. bal.	99,600		

Accumulated Depreciation

Disposals	5,500	Beg. bal.	44,500
		Depr.	12,000
		End. bal.	51,000

Stone Kitchen Equipment Company's income statement reported a loss on the sale of equipment of $4,900. What amount was reported on the statement of cash flows as "cash flow from sale of equipment"?

8-6 The following T-account is a summary of the cash account of Amy's Candied Apples.

Identify financing activity transactions. (SO 5)

Cash (Summary Form)

Balance, 1/1/04	8,000		
Receipts from customers	364,000	Payments for goods	200,000
Dividends on stock investments	6,000	Payments for operating expenses	140,000
Proceeds from sale of equipment	36,000	Interest paid	10,000
Proceeds from issuance of bonds		Taxes paid	8,000
payable	200,000	Dividends paid	45,000
Balance, 12/31/04	211,000		

8-7 Presented below is financial information for two different companies.

Compute missing amounts. (SO 1)

	Amoruso Company	Tamburri Company
Sales	$90,000	(d)
Sales returns	(a)	$ 5,000
Net sales	83,000	95,000
Cost of goods sold	56,000	(e)
Gross profit	(b)	38,000
Operating expenses	15,000	(f)
Net income	(c)	15,000

Instructions

Determine the missing amounts.

8-8 Britney Hotels Corporation had the following transactions during 2004.

Classify transactions by type of activity. (SO 5)

1. Issued $50,000 par value common stock for cash.
2. Collected $16,000 of accounts receivable.
3. Declared and paid a cash dividend of $25,000.
4. Sold a long-term investment with a cost of $15,000 for $15,000 cash.
5. Issued $200,000 par value common stock upon conversion of bonds having a face value of $200,000.
6. Paid $18,000 on accounts payable.
7. Purchased a machine for $30,000, giving a long-term note in exchange.

Instructions

Analyze the transactions above and indicate whether each transaction resulted in a cash flow from **(a)** operating activities, **(b)** investing activities, **(c)** financing activities, or **(d)** noncash investing and financing activities.

8-9 The current sections of Depeche Ice balance sheets at December 31, 2003 and 2004, are presented below.

Prepare the operating activities section—indirect method. (SO 6)

DEPECHE ICE
Comparative Balance Sheets (partial)
December 31

	2004	2003
Current assets		
Cash	$105,000	$ 99,000
Accounts receivable	110,000	89,000
Inventory	171,000	186,000
Prepaid expenses	27,000	32,000
Total current assets	$413,000	$406,000
Current liabilities		
Accrued expenses payable	$ 15,000	$ 5,000
Accounts payable	$ 85,000	$ 92,000
Total current liabilities	$100,000	$ 97,000

Depeche Ice's net income for 2004 was $163,000. Depreciation expense was $30,000.

Instructions

Prepare the net cash provided by operating activities section of Depeche Ice's statement of cash flows for the year ended December 31, 2004, using the indirect method.

Classify transactions by type of activity.
(SO 5)

8-10 An analysis of comparative balance sheets, the current year's income statement, and the general ledger accounts of Winfrey Movies uncovered the following items. Assume all items involve cash unless there is information to the contrary.

1. Issuance of capital stock.
2. Amortization of patent.
3. Issuance of bonds for land.
4. Payment of interest on notes payable.
5. Conversion of bonds into common stock.
6. Sale of land at a loss.
7. Receipt of dividends on investment in stock.
8. Purchase of land.
9. Payment of dividends.
10. Sale of building at book value.
11. Exchange of land for patent.
12. Depreciation.
13. Redemption of bonds.
14. Receipt of interest on notes receivable.

Instructions

Indicate how the above items should be classified in the statement of cash flows using the following four major classifications: operating activity (indirect method), investing activity, financing activity, and significant noncash investing and financing activity.

Compute cash flow from operating activities—direct method.
(SO 5, 7)

8-11 The 2004 accounting records of Ryder Beer Co. reveal the following transactions and events.

Payment of interest	$ 6,000	Collection of accounts receivable	$180,000
Cash sales	38,000	Payment of salaries and wages	65,000
Receipt of dividend revenue	14,000	Depreciation expense	18,000
Payment of income taxes	15,000	Proceeds from sale of aircraft	812,000
Net income	38,000	Purchase of equipment for cash	22,000
Payment of accounts payable		Loss on sale of aircraft	3,000
for merchandise	90,000	Payment of dividends	14,000
Payment for land	74,000	Payment of operating expenses	20,000

Instructions

Prepare the cash flows from operating activities section using the direct method. (Not all of the above items will be used.)

Prepare the operating activities section—indirect method.
(SO 3)

8-12 The income statement of Rebecca Sherrick Company is shown below.

REBECCA SHERRICK COMPANY
Income Statement
For the Year Ended December 31, 2004

Sales		$7,100,000
Cost of goods sold		
Beginning inventory	$1,700,000	
Purchases	5,430,000	
Goods available for sale	7,130,000	
Ending inventory	1,920,000	
Cost of goods sold		5,210,000
Gross profit		1,890,000
Operating expenses		
Selling expenses	380,000	
Administrative expense	525,000	
Depreciation expense	75,000	
Amortization expense	30,000	1,010,000
Net income		$ 880,000

Additional information:

1. Accounts receivable increased $490,000 during the year.
2. Prepaid expenses increased $170,000 during the year.

3. Accounts payable to merchandise suppliers increased $40,000 during the year.
4. Accrued expenses payable decreased $180,000 during the year.

Instructions

Prepare the operating activities section of the statement of cash flows for the year ended December 31, 2004, for Rebecca Sherrick Company using the indirect method.

EXPLORING THE WEB

8-13 ***Purpose:*** Learn about the SEC.

Address: **www.sec.gov/index.html**

Steps

1. From the SEC homepage, choose **About the SEC**.

Instructions

Answer the following questions.

(a) How many enforcement actions does the SEC take each year against securities law violators? What are typical infractions?

(b) After the Depression, Congress passed the Securities Acts of 1933 and 1934 to improve investor confidence in the markets. What two commonsense notions are these laws based on?

(c) Who was the president of the United States at the time of the creation of the SEC? Who was the first SEC chairperson?

ETHICS CASE

8-14 Puebla Corporation is a medium-sized hotel corporation. It has ten stockholders, who have been paid a total of $1 million in cash dividends for eight consecutive years. The policy of the board of directors requires that in order for this dividend to be declared, net cash provided by operating activities as reported in Puebla's current year's statement of cash flows must be in excess of $1 million. President and CEO Phil Monat's job is secure so long as he produces annual operating cash flows to support the usual dividend.

At the end of the current year, controller Rick Rodgers presents President Monat with some disappointing news: The net cash provided by operating activities is calculated, by the indirect method, to be only $970,000. The president says to Rick, "We must get that amount above $1 million. Isn't there some way to increase operating cash flow by another $30,000?" Rick answers, "These figures were prepared by my assistant. I'll go back to my office and see what I can do." The president replies, "I know you won't let me down, Rick."

Upon close scrutiny of the statement of cash flows, Rick concludes that he can get the operating cash flows above $1 million by reclassifying a $60,000, two-year note payable listed in the financing activities section as "Proceeds from bank loan—$60,000." He will report the note instead as "Increase in payables—$60,000" and treat it as an adjustment of net income in the operating activities section. He returns to the president saying, "You can tell the Board to declare their usual dividend. Our net cash flow provided by operating activities is $1,030,000." "Good man, Rick! I knew I could count on you," exults the president.

Instructions

(a) Who are the stakeholders in this situation?

(b) Was there anything unethical about the president's actions? Was there anything unethical about the controller's actions?

(c) Are the board members or anyone else likely to discover the misclassification?

Remember to go back to the Navigator box on the chapter-opening page and check off your completed work.