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Careers in Accounting

A Manager's Perspective

Don Lehman
Principal Accountant
The Coca-Cola Company

After working for three and a half years as a "Big Six" auditor, I moved to The Coca-Cola Company in the corporate finance division, working primarily on the company's external financial reporting. I was project manager for the financial section of the company's Annual Report to Share Owners for two years, and I also coordinated with the field divisions and the external auditors to implement two of the recently issued accounting standards.

As part of my responsibilities, I work with people from every part of the Company—Marketing, Operations, Legal, Human Resources, etc. I am often a financial division "representative" on committees or task forces. I have found that many of the non-financial people I work with in these situations have a relatively broad knowledge of finance and some knowledge of basic accounting. Many of these people came from accounting backgrounds, and others have sought additional training or education. This working knowledge of accounting is extremely important in getting team assignments completed quickly, because the team members can focus immediately on a solution with the best possible financial impact.

Almost every decision made here, as at most companies, is based on its eventual impact on the company's financial results, so a solid background in accounting and finance is an advantage for persons in non-financial roles who are trying to understand how their actions will be evaluated. The fundamental concepts that define assets, equity, and expenses are crucial to making informed management decisions at every level of every business. While learning all the accounting rules for employee benefits and equity-method investees is not necessary for every student, a good understanding of accounting principles is an essential building-block for your career.

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11

Analysis Using the Statement of Cash Flows

The income statement, statement of retained earnings, and the balance sheet provide useful data for management accountants. The fourth required financial statement, the statement of cash flows, also provides valuable information for decision making by helping to answer relevant questions. Such questions include: How much cash was generated by the company's operations? How much cash is available for investment purposes? Should the company change its cash management policies to allow for more flexibility? How much was spent for new plant and equipment, and where did the company get the cash for the expenditures?

In this chapter, you will learn about the statement of cash flows, which answers these questions. The statement of cash flows is another major required financial statement; it shows important information not shown directly in the other financial statements.

Learning Objectives

After studying this chapter, you should be able to:

1. Explain the purposes and uses of the statement of cash flows.
2. Describe the content of the statement of cash flows and where certain items would appear on the statement.
3. Describe how to calculate cash flows from operating activities under both the direct and indirect methods.
4. Prepare a statement of cash flows, under both the direct and indirect methods, showing cash flows from operating activities, investing activities, and financing activities.

(*continued*)

Purposes of the Statement of Cash Flows

In November 1987, the Financial Accounting Standards Board issued *Statement of Financial Accounting Standards No. 95,* "Statement of Cash Flows."[1] The *Statement* became effective for annual financial statements for fiscal years ending after July 15, 1988 and requires companies to include the statement of cash flows in their published financial statements. From a decision making perspective, the statement of cash flows is valuable because it shows clearly the sources and uses of cash during a period.

The main purpose of the statement of cash flows is to report on the cash receipts and cash disbursements of an entity during an accounting period. Broadly defined, *cash* includes both cash and cash equivalents, such as short-term investments in Treasury bills, commercial paper, and money market funds. Another purpose of

[1] FASB, Statement of Financial Accounting Standards No. 95, "Statement of Cash Flows" (Stamford, Conn., 1987). Copyright by the Financial Accounting Standards Board, High Ridge Park, Stamford, Connecticut 06905. U.S.A. Quoted (or excerpted) with permission. Copies of the complete document are available from the FASB.

Objectives

5. Analyze a statement of cash flows of a real company.

6. Analyze and use the financial results—cash flow per share of common stock, cash flow margin, and cash flow liquidity ratios.

7. Use a working paper to prepare a statement of cash flows (appendix).

this statement is to report on the entity's operating, investing, and financing activities for the period. As shown in Illustration 11.1, the statement of cash flows reports the effects on cash during a period of a company's operating, investing, and financing activities. Firms show the effects of significant investing and financing activities that do not affect cash in a schedule separate from the statement of cash flows.

Uses of the Statement of Cash Flows

The **statement of cash flows** summarizes the effects on cash of the operating, investing, and financing activities of a company during an accounting period; it reports on past management decisions on such matters as issuance of capital stock or the sale of long-term bonds. This information is available only in bits and pieces from the other financial statements. Since cash flows are vital to a company's financial health, the statement of cash flows provides useful information to management, investors, creditors, and other interested parties and helps them assess the sustainability of the company's cash management and operating strategies.

Management Uses

Objective 1
Explain the purposes and uses of the statement of cash flows.

The statement of cash flows presents the effects on cash of all significant operating, investing, and financing activities. By reviewing the statement, management can see the effects of its past major policy decisions in quantitative form. The statement may show a flow of cash from operating activities large enough to finance all projected capital needs internally rather than having to incur long-term debt or issue additional stock. Alternatively, if the company has been experiencing cash shortages, management can use the statement to determine why such shortages are occurring. Using the statement of cash flows, management may also recommend to the board of directors a reduction in dividends to conserve cash.

Investor and Creditor Uses

The information in a statement of cash flows assists users in assessing the following:

1. Enterprise's ability to generate positive future net cash flows.
2. Enterprise's ability to meet its obligations.
3. Enterprise's ability to pay dividends.
4. Enterprise's need for external financing.
5. Reasons for differences between net income and associated cash receipts and payments.
6. Effects on an enterprise's financial position of both its cash and noncash investing and financing transactions during the period (disclosed in a separate schedule).

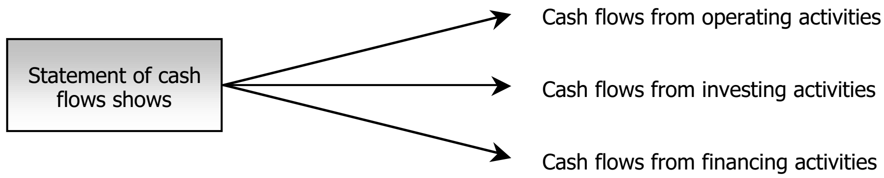
Information in the Statement of Cash Flows

Objective 2
Describe the content of the statement of cash flows and where certain items would appear on the statement.

The statement of cash flows classifies cash receipts and disbursements as operating, investing, and financing cash flows. Both inflows and outflows are included within each category. Look at Illustration 11.2 to see how activities can be classified to prepare a statement of cash flows. Knowing how the statement is prepared helps the managemnet accountant to more effectively interpret the data.

Operating activities generally include the cash effects (inflows and outflows) of transactions and other events that enter into the determination of net income. *Cash inflows* from operating activities affect items that appear on the income statement and include: (1) cash receipts from sales of goods or services; (2) interest received from making loans; (3) dividends received from investments in equity securities; (4) cash received from the sale of trading securities; and (5) other cash receipts that do not arise from transactions defined as investing or financing activities, such as amounts received to settle lawsuits, proceeds of certain insurance settlements, and cash refunds from suppliers.

Illustration 11.1 Statement of Cash Flows–Basic Content



Investing and financing activities that do not affect cash are shown in a separate schedule.

Illustration 11.2 Rules for Classifying Activities in the Statement of Cash Flows

Operating activities Cash effect of transactions and other events that enter into the determination of net income

Cash inflows from:	Cash outflows for:
Sales of goods or services	Merchandise inventory
Interest	Salaries and wages
Dividends	Interest
Sale of trading securities	Purchase of trading securities
Other sources not related to investing or financing activities (e.g., insurance settlements)	Other expenses
	Other items not related to investing or financing activities (e.g., contributions to charities)

Investing activities Transactions involving the acquisition or disposal of noncurrent assets

Cash inflows from:	Cash outflows for:
Sale of property, plant, and equipment	Purchase of property, plant, and equipment
Sale of available-for-sale and held-to-maturity securities	Purchase of available-for-sale and held-to-maturity securities
Collection of loans	Making of loans

Financing activities Transactions with creditors and owners

Cash inflows from:	Cash outflows for:
Issuing capital stock	Purchase of treasury stock
Issuing debt (bonds, mortgages, notes, and other short- or long-term borrowing of cash)	Payment of debt (principal only)
	Cash dividends

Cash outflows for operating activities affect items that appear on the income statement and include payments: (1) to acquire inventory; (2) to other suppliers and employees for other goods or services; (3) to lenders and other creditors for interest; (4) for purchases of trading securities; and (5) all other cash payments that do not arise from transactions defined as investing or financing activities, such as taxes and payments to settle lawsuits, cash contributions to charities, and cash refunds to customers.

Investing activities generally include transactions involving the acquisition or disposal of noncurrent assets. Thus, *cash inflows* from investing activities include cash received from: (1) the sale of property, plant, and equipment; (2) the sale of available-for-sale and held-to-maturity securities; and (3) the collection of long-term loans made to others. *Cash outflows* for investing activities include cash paid: (1) to purchase property, plant, and equipment; (2) to purchase available-for-sale and held-to-maturity securities; and (3) to make long-term loans to others.

Note to the Student
Cash flows from operating activities consist of items from the income statement converted to a cash basis. Cash flows from investing activities are the cash inflows and outflows resulting from the acquisition and disposal of noncurrent assets. Cash flows from financing activities are generally the cash inflows and outflows resulting from the noncurrent liabilities and equity sections of the balance sheet.

Financing activities generally include the cash effects (inflows and outflows) of transactions and other events involving creditors and owners. *Cash inflows* from financing activities include cash received from issuing capital stock and bonds, mortgages, and notes, and from other short- or long-term borrowing. *Cash outflows* for financing activities include payments of cash dividends or other distributions to owners (including cash paid to purchase treasury stock) and repayments of amounts borrowed. Payment of interest is not included because interest expense appears on the income statement and is, therefore, included in operating activities. Cash payments to settle accounts payable, wages payable, and income taxes payable are not financing activities. These payments are included in the operating activities section.

Reinforcing Problem
E11–1 Report specific items on statement of cash flows.

A Separate Schedule for Significant Noncash Investing and Financing Activities

Information about all material investing and financing activities of an enterprise that do not result in cash receipts or disbursements during the period appear in a separate schedule, rather than in the statement of cash flows. The disclosure may be in narrative form. For instance, assume a company issued a mortgage note to acquire land and buildings. A separate schedule might appear as follows:

Schedule of noncash financing and investing activities:	
Mortgage note issued to acquire land and buildings	$35,000

An Accounting Perspective

Business Insight In a supplemental schedule of noncash investing and financing activities, Johnson & Johnson reported one item as follows:

Treasury stock issued for employee compensation and stock option plans, net of cash proceeds	$252 million

The company included the cash proceeds amount from the exercise of stock options ($149 million) in the cash flows from financing activities section of the statement of cash flows.

Cash Flows from Operating Activities

Objective 3
Describe how to calculate cash flows from operating activities under both the direct and indirect methods.

Cash flows from operating activities show the net amount of cash received or disbursed during a given period for items that normally appear on the income statement. You can calculate these cash flows using either the direct or indirect method. The **direct method** deducts from cash sales only those operating expenses that *consumed cash.* This method converts each item on the income statement *directly* to a cash basis. Alternatively, the **indirect (addback) method** starts with accrual basis net income and indirectly adjusts net income for items that affected reported net income but did not involve cash.

Note to the Student
The FASB encourages the use of the direct method but permits use of the indirect method. However, only a few companies use the direct method.

The *Statement of Financial Accounting Standards No. 95* encourages use of the direct method but permits use of the indirect method. Whenever given a choice between the indirect and direct methods in similar situations, accountants choose the indirect method almost exclusively. The American Institute of Certified Public Accountants reports that approximately 98% of all companies choose the indirect method of cash flows.

The direct method converts each item on the income statement to a cash basis. For instance, assume that sales are stated at $100,000 on an accrual basis. If accounts receivable increased by $5,000, cash collections from customers would be $95,000, calculated as $100,000 – $5,000. The direct method also converts all remaining items on the income statement to a cash basis, as we will illustrate later.

The indirect method adjusts net income (rather than adjusting individual items in the income statement) for (1) changes in current assets (other than cash) and current liabilities, and (2) items that were included in net income but did not affect cash.

The most common example of an operating expense that does not affect cash is depreciation expense. The journal entry to record depreciation debits an expense account and credits an accumulated depreciation account. This transaction has no effect on cash and, therefore, should not be included when measuring cash from operations. Because accountants deduct depreciation in computing net income, net income understates cash from operations. Under the indirect method, since net income is a starting point in measuring cash flows from operating activities, depreciation expense must be added back to net income.

Note to the Student
Even though the indirect method is widely used in practice, studying the direct method is still worthwhile. For example, the insurance industry requires the use of the direct method for statutory reporting and *GASB Statement No. 9* implies a preference for the direct method over the indirect method in reports for governmental entities.

Consider the following example. Company A had net income for the year of $20,000 after deducting depreciation of $10,000, yielding $30,000 of positive cash flows. Thus, Company A had $30,000 of positive cash flows from operating activities. Company B had a net loss for the year of $4,000 after deducting $10,000 of depreciation. Although Company B experienced a loss, it had $6,000 of positive cash flows from operating activities, as shown here:

	Company A	**Company B**
Net income (loss)	$20,000	$(4,000)
Add depreciation expense (which did not require use of cash)	10,000	10,000
Positive cash flows from operating activities	$30,000	$ 6,000

Company B's loss would have had to exceed $10,000 to generate negative cash flows from operating activities.

Companies add other expenses and losses back to net income because they do not actually use company cash; they call these addbacks **noncash charges or expenses.** Besides depreciation, the items added back include amounts of depletion that were expensed, amortization of intangible assets such as patents and goodwill, amortization of discount on bonds payable, and losses from disposals of noncurrent assets.

Business Insight PSINet, Inc., an Internet-access provider, said it would have a positive cash flow from operations for the first time in early 1997. The company was the first to provide unlimited access to the Internet to consumers at a flat rate of $19.95 per month. However, it was costing about $22 per month per customer to provide the service. The company decided to abandon this market and sell only to the more profitable corporate market. Corporate clients at that time could be charged about $200 per month for dial-up access.

Source: "PSINet Sees Positive Cash Flow in '97; Likely Financial Boost Lifts Shares 24%," *The Wall Street Journal,* Friday, December 27, 1996, p. B11.

An Accounting Perspective

To illustrate the addback of losses from disposals of noncurrent assets, assume that Quick Company sold a piece of equipment for $6,000. The equipment had cost $10,000 and had accumulated depreciation of $3,000. The journal entry to record the sale is:

Cash	6,000	
Accumulated Depreciation	3,000	
Loss on Sale of Equipment	1,000	
Equipment		10,000
To record disposal of equipment at a loss.		

Quick would show the $6,000 inflow from the sale of the equipment as a cash inflow from investing activities on its statement of cash flows. Although Quick deducted the loss of $1,000 in calculating net income, it recognized the total $6,000 effect on cash (which reflects the $1,000 loss) as resulting from an investing activity. Thus, Quick must add the loss back to net income in converting net income to cash flows from operating activities to avoid double-counting the loss.

Certain revenues and gains included in arriving at net income do not provide cash; these items are **noncash credits or revenues.** Quick should deduct these revenues and gains from net income to compute cash flows from operating activities. Such items include gains from disposals of noncurrent assets, income from investments carried under the equity method, and amortization of premiums on bonds payable.

To illustrate why we deduct the gain on the disposal of a noncurrent asset from net income, assume that Quick sold the equipment just mentioned for $9,000. The journal entry to record the sale is:

Cash	9,000	
Accumulated Depreciation	3,000	
Equipment		10,000
Gain on Sale of Equipment		2,000
To record disposal of equipment at a gain.		

Quick shows the $9,000 inflow from the sale of the equipment on its statement of cash flows as a cash inflow from investing activities. Thus, it has already recognized the total $9,000 effect on cash (including the $2,000 gain) as resulting from an investing activity. Since the $2,000 gain is also included in calculating net income, Quick must deduct the gain in converting net income to cash flows from operating activities to avoid double-counting the gain.

Steps in Preparing Statement of Cash Flows

Objective 4
Prepare a statement of cash flows, under both the direct and indirect methods, showing cash flows from operating activities, investing activities, and financing activities.

Accountants follow specific procedures when preparing a statement of cash flows. We show these procedures using the financial statements and additional data for Welby Company in Illustration 11.3.

After determining the change in cash, the first step in preparing the statement of cash flows is to calculate the cash flows from operating activities, using either the direct or indirect method. The second step is to analyze all of the noncurrent accounts and additional data for changes resulting from investing and financing activities. The third step is to arrange the information gathered in steps 1 and 2 into the proper format for the statement of cash flows.

Step 1: Determining Cash Flows from Operating Activities—Direct Method

The direct method converts the income statement from the accrual basis to the cash basis. Accountants must consider changes in balance sheet accounts that are related to items on the income statement. The accounts involved are all current assets or current liabilities. The following schedule shows which balance sheet accounts are related to the items on Welby's income statement:

Income Statement Items	Related Balance Sheet Items	Cash Flows from Operating Activities
Sales	Accounts Receivable	Cash received from customers
Cost of goods sold	Accounts Payable and Merchandise Inventory	Cash paid for merchandise
Operating expenses and taxes	Accrued Liabilities and Prepaid Expenses	Cash paid for operating expenses

For other income statement items, the relationship is often obvious. For instance, salaries payable relates to salaries expense, federal income tax payable relates to federal income tax expense, prepaid rent relates to rent expense, and so on.

The table below shows how income statement items are affected by balance sheet accounts:

Illustration 11.3 Financial Statements and Other Data

WELBY COMPANY
Comparative Balance Sheet
December 31, 2007 and 2006

	2007	2006	Increase/ (Decrease)
Assets			
Cash	$ 21,000	$ 10,000	$11,000
Accounts receivable, net	30,000	20,000	10,000
Merchandise inventory	26,000	30,000	(4,000)
Equipment	70,000	50,000	20,000
Accumulated depreciation—Equipment	(10,000)	(5,000)	(5,000)
Total assets	$137,000	$105,000	$32,000
Liabilities and Stockholders' Equity			
Accounts payable	$ 9,000	$ 15,000	$(6,000)
Accrued liabilities payable	2,000	—0—	2,000
Common stock ($10 par value)	90,000	60,000	30,000
Retained earnings	36,000	30,000	6,000
Total liabilities and stockholders' equity	$137,000	$105,000	$32,000

WELBY COMPANY
Income Statement
For the Year Ended December 31, 2007

Sales		$140,000
Cost of goods sold		100,000
Gross margin		$ 40,000
Operating expenses		
(other than depreciation)	$25,000	
Depreciation expense	5,000	30,000
Net income		$ 10,000

Additional data

1. Equipment purchased for cash during 2007 amounted to $20,000.
2. Common stock with a par value of $30,000 was issued at par for cash.
3. Cash dividends declared and paid in 2007 totaled $4,000.

Accrual Basis			**Cash Basis (Cash Flows from Operating Activities)**
Sales	+ Decrease or – Increase in Accounts Receivable	=	Cash received from customers
Cost of goods sold	+ Increase or – Decrease in Merchandise Inventory *and* + Decrease or – Increase in Accounts Payable	=	Cash paid for merchandise
Operating expenses	+ Decrease or – Increase in related accrued liability *And* + Increase or – Decrease in related prepaid expense	=	Cash paid for operating expense

Noncash operating expenses (such as depreciation expense and amortization expense), revenues, gains, and losses are reduced to zero in the cash basis income statement.

Note to the Student
T-accounts could be used for the conversion from the accrual basis to the cash basis.

Reinforcing Problems
E11–2 Calculate the amount of cash paid for merchandise.
E11–3 Show effects of conversion from accrual to cash basis income.

As a general rule, an increase in a current asset (other than cash) decreases cash inflow or increases cash outflow. Thus, when accounts receivable increases, sales revenue on a cash basis decreases (some customers who bought merchandise have not yet paid for it). When inventory increases, cost of goods sold on a cash basis increases (increasing cash outflow). When a prepaid expense increases, the related operating expense on a cash basis increases. (For example, a company not only paid for insurance expense but also paid cash to increase prepaid insurance.) The effect on cash flows is just the opposite for decreases in these other current assets.

An increase in a current liability increases cash inflow or decreases cash outflow. Thus, when accounts payable increases, cost of goods sold on a cash basis decreases (instead of paying cash, the purchase was made on credit). When an accrued liability (such as salaries payable) increases, the related operating expense (salaries expense) on a cash basis decreases. (For example, the company incurred more salaries than it paid.) Decreases in current liabilities have just the opposite effect on cash flows.

Welby Company had no prepaid expenses. The current assets and current liabilities affecting the income statement items changed as follows:

	Increase	**Decrease**
Accounts receivable	$10,000	
Merchandise inventory		$4,000
Accounts payable		6,000
Accrued liabilities payable	2,000	

Thus, Welby converted its income statement to a cash basis as shown in Illustration 11.4.

Illustration 11.4 Working Paper to Convert Income Statement from Accrual Basis to Cash Basis

WELBY COMPANY
Working Paper to Convert Income Statement from Accrual Basis to Cash Basis
For the Year Ended December 31, 2007

	Accrual Basis		**Add**	**Deduct**	**Cash Basis (Cash Flows from Operating Activities)**	
Sales		$140,000		$10,000*		$130,000
Cost of goods sold	$100,000		$6,000†	4,000‡	$102,000	
Operating expenses	25,000			2,000§	23,000	
Depreciation expense	5,000			5,000	—0—	
		$130,000				125,000
Net income		$ 10,000				$ 5,000

* Increase in Accounts Receivable.
† Decrease in Accounts Payable.
‡ Decrease in Merchandise Inventory.
§ Increase in Accrued Liabilities Payable.

Alternate Step 1: Determining Cash Flows from Operating Activities—Indirect Method

The indirect method makes certain adjustments to convert net income to cash flows from operating activities. Welby must analyze the effects of changes in current accounts (other than cash) on cash. The firm should also take into account noncash items such as depreciation that affected net income but not cash. Welby had only one such item—depreciation expense of $5,000. Applying these adjustments to Welby's financial statements and other data in Illustration 11.3 yields the following schedule:

Cash flow from operating activities:		
Net income	$ 10,000	
Adjustments to reconcile net income to net cash provided by operating activities:		
Increase in accounts receivable	(10,000)	
Decrease in merchandise inventory	4,000	
Decrease in accounts payable	(6,000)	
Increase in accrued liabilities payable	2,000	
Depreciation expense	5,000	
Net cash provided by operating activities		$5,000

Real-World Example
For the year ending December 31, 2000, using the indirect method, General Electric Company reported net cash provided by operating activities of $22,690,000,000.

Notice that both the direct and indirect methods result in $5,000 net cash provided by operating activities.

You can use the following table to make the adjustments to net income for the changes in current assets and current liabilities:

For changes in these current assets and current liabilities:	Make these adjustments to convert accrual basis net income to cash basis net income:	
	Add	**Deduct**
Accounts Receivable	Decrease	Increase
Merchandise Inventory	Decrease	Increase
Prepaid expenses	Decrease	Increase
Accounts Payable	Increase	Decrease
Accrued liabilities payable	Increase	Decrease

Note that you would handle all changes in current asset accounts in a similar manner. All changes in current liability accounts require the opposite treatment of the current asset changes. Use this table in making these adjustments:

For Changes in—	Add the Changes to Net Income	Deduct the Changes from Net Income
Current assets	Decreases	Increases
Current liabilities	Increases	Decreases

In applying the rules in this table, add a decrease in a current asset to net income, and deduct an increase in a current asset from net income. For current liabilities, add increases to net income, and deduct decreases from net income.

Under the indirect method, the amount of cash flows from operating activities is calculated as follows:

Accrual basis net income

+ or – Changes in noncash current asset and current liability accounts

+ Expenses and losses not affecting cash

– Revenues and gains not affecting cash

= Cash flows from operating activities

Reinforcing Problems
E11–4 Compute cash flows from operating activities.
E11–5 Compute cash flows from operating activities.

Step 2: Analyzing the Noncurrent Accounts and Additional Data

After analyzing the changes in current accounts for their effect on cash, we examine the noncurrent accounts and additional data. Remember that a change in a noncurrent account usually comes about because cash is received or disbursed.

In the Welby example, we must analyze four noncurrent accounts: Retained Earnings, Equipment, Accumulated Depreciation—Equipment, and Common Stock.

1. The analysis of the noncurrent accounts can begin with any of the noncurrent accounts; we begin by reviewing the Retained Earnings account. Retained Earnings is the account to which net income or loss for the period was closed. The $6,000 increase in this account consists of $10,000 of net income less $4,000 of dividends paid.

Retained Earnings

		Beg. bal.	30,000
Dividends	4,000	Net income	10,000
		End. bal.	36,000

The net income amount is in the income statement. We enter both net income and dividends on the statement of cash flows in Illustration 11.5, Part B. The $10,000 net income is the starting figure in determining cash flows from operating activities. Thus, we enter the net income of $10,000 on the statement in the cash flows from operating activities section. The dividends are shown as a deduction in the cash flow from financing activities section.

2. The Equipment account increased by $20,000. The dividends are shown as a deduction in the cash flow from financing activities section. The additional data indicate that $20,000 of equipment was purchased during the period. A purchase of equipment is a deduction in the cash flows from investing activities section.

Reinforcing Problem
E11–6 Indicate treatment of a dividend.

3. The $5,000 increase in the Accumulated Depreciation—Equipment account equals the amount of depreciation expense in the income statement for the period. As shown earlier, because depreciation does not affect cash, under the indirect (addback) method we add it back to net income on the statement of cash flows to convert accrual net income to a cash basis.

4. The $30,000 increase in common stock resulted from the issuance of stock at par value, as disclosed in the additional data (item 2) in Illustration 11.3. An issuance of stock in the statement of cash flows is a positive amount in the cash flows from financing activities section.

Step 3: Arranging Information in the Statement of Cash Flows

After we have analyzed the noncurrent accounts, we can prepare the statement of cash flows from the information generated. Part A of Illustration 11.5 presents the statement of cash flows for Welby using the direct method. Part B shows the statement of cash flows for Welby using the indirect method. The appendix to this chapter shows how a working paper can be used to assist in preparing a statement of cash flows for the Welby Company under the indirect method. However, we believe you will gain a greater conceptual understanding by not using a working paper.

The statement of cash flows has three major sections: cash flows from operating activities, cash flows from investing activities, and cash flows from financing activities. The format in the operating activities section differs for the direct and indirect methods. The direct method adjusts each item in the income statement to a cash basis. The indirect method makes these same adjustments but to net income rather than to each item in the income statement. Both methods eliminate not only the effects of noncash items, such as depreciation, but also gains and losses on sales of plant assets.

Reinforcing Problems
BDC11–1 Prepare a statement of cash flows using the indirect method and answer owner's questions.
BDC11–2 Prepare a schedule showing cash flows from operating activities under the indirect method and decide whether certain goals can be met.

The only item in the cash flows from investing activities section is the cash outflow of $20,000 for the purchase of equipment. In a more complex situation, other items could be included in this category.

Two items are under the cash flows from financing activities section: The issuance of common stock resulted in a cash inflow of $30,000 and the payment of dividends resulted in a cash outflow of $4,000.

The last line of the statement is the $11,000 increase in cash for the year. Other examples could result in a decrease in cash for the year.

If the direct method is used, the reconciliation of net income to net cash flows from operating activities (the indirect method) must be shown in a separate schedule. However, if the indirect method is used and the reconciliation is shown in the statement of cash flows, no such separate schedule is required. Possibly this is one of the reasons why so many companies use the indirect method.

However, if the indirect method is used, the amount of interest and income taxes paid must be provided in related disclosures, usually immediately below the

Illustration 11.5 Statement of Cash Flows-Welby Company

A. Direct Method

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

Cash flows from operating activities:		
Cash received from customers	$130,000	
Cash paid for merchandise	(102,000)	
Cash paid for operating expenses	(23,000)	
Net cash provided by operating activities		$ 5,000
Cash flows from investing activities:		
Purchase of equipment		(20,000)
Cash flows from financing activities:		
Proceeds from issuing common stock	$ 30,000	
Paid cash dividends	(4,000)	
Net cash provided by financing activities		26,000
Net increase (decrease) in cash		$11,000

This portion differs between the two versions

This portion is the same in both versions

B. Direct Method

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

Cash flows from operating activities:		
Net income	$ 10,000	
Adjustments to reconcile net income to net cash Provided by operating activities:		
Increase in accounts receivable	(10,000)	
Decrease in merchandise inventory	4,000	
Decrease in accounts payable	(6,000)	
Increase in accrued liabilities payable	2,000	
Depreciation expense	5,000	
Net cash provided by operating activities		$ 5,000
Cash flows from investing activities:		
Purchase of equipment		(20,000)
Cash flows from financing activities:		
Proceeds from issuing common stock	$ 30,000	
Paid cash dividends	(4,000)	
Net cash provided by financing activities		26,000
Net increase (decrease) in cash		$11,000

statement of cash flows. For instance, if Welby Company had paid interest of $200 and income taxes of $8,000, these facts would be reported as follows:

Supplemental cash flow information:	
Interest paid	$ 200
Income taxes paid	8,000

Analysis of the Statement of Cash Flows

Objective 5
Analyze a statement of cash flows of a real company.

Management accountants and business students will benefit throughout their careers from knowing how to analyze a statement of cash flows. We will use the consolidated statement of cash flows from Synotech, Inc. to illustrate the analysis. This company will be used in the next chapter to illustrate the complete analysis and interpretation of all the financial statements. The example is adapted from a real U.S.A. company's recent annual report.

Synotech's Consolidated Statement of Cash Flows

Illustration 11.6 shows the consolidated statements of cash flows for the years 2007, 2006, and 2005 for Synotech, Inc. We also include portions of Management's Discussion and Analysis of the 2007 statement of cash flows. We will then discuss the statement further, explaining various items and illustrating how the information might be used for decision making.

Management's Discussion and Analysis

Liquidity and Capital Resources

Net cash provided by operations increased 13% to $1,101.0 in 2007 compared with $972.3 in 2006 and $995.3 in 2005. The increase in cash generated by operating activities in 2007 reflects the Company's improved profitability and working capital management. Cash generated from operations was used to fund capital spending, reduce debt levels and increase dividends.

During 2007, long-term debt decreased from $3,634.8 to $3,476.6. The Company continued to focus on enhancing its debt portfolio, resulting in the refinancing of a substantial portion of commercial paper and other short-term borrowings to longer term instruments. In 2007, the Company entered into a $595.6 loan agreement and obtained a $487.2 term loan with foreign commercial banks.

As of December 31, 2007, $410.3 of domestic and foreign commercial paper was outstanding. These borrowings carry a Standard & Poor's rating of A1. The commercial paper as well as other short-term borrowings are classified as long-term debt at December 31, 2007, as it is the Company's intent and ability to refinance such obligations on a long-term basis. The Company has additional sources of liquidity available in the form of lines of credit maintained with various banks. At December 31, 2007, such unused lines of credit amounted to $2,142.8.

Note to the student
Large lines of credit have allowed many companies to reduce the amount of liquid assets (including cash) held. This reduction has allowed companies to use their "excess" cash more profitably by investing in additional plant and equipment or longer-term, high-yield, projects.

The ratio of net debt to total capitalization (defined as the ratio of the book values of debt less cash and marketable securities ["net debt"] to net debt plus equity) decreased to 58% during 2007 from 64% in 2006. The decrease is primarily the result of higher Company earnings in 2007 as well as effective working capital management and lower acquisitions than in prior years. The ratio of market debt to market capitalization (defined as above using fair market values) decreased to 17% during 2007 from 23% in 2006. The Company primarily uses market value analyses to evaluate its optimal capitalization.

Capital expenditures were 5.2% of net sales in both 2007 and 2006 and were 5.3% of net sales in 2005. Capital spending continues to be focused primarily on projects that yield high aftertax returns, thereby reducing the Company's cost structure. Capital expenditures for 2008 are expected to continue at the current rate of approximately 5% of net sales.

Other investing activities in 2007, 2006 and 2005 included strategic acquisitions and equity investments worldwide. The aggregate purchase price of all 2007, 2006 and 2005 acquisitions was $46.2, $1,586.3 and $179.8, respectively.

During 2005, the Company repurchased a significant amount of common shares in the open market and private transactions to provide for employee benefit plans and to maintain its targeted capital structure. Aggregate repurchases for the year approximated 6.9 million shares with a total purchase price of $493.3.

Illustration 11.6 Consolidated Statements of Cash flows for Synotech, Inc. - Indirect Method

($ Millions)	2007	2006	2005
Operating Activities			
Net income	$ 762.0	$ 206.4	$ 696.2
Adjustments to reconcile net income to net cash provided by operations:			
Restructured operations, net	(126.7)	509.9	(46.9)
Depreciation and amortization	379.6	360.4	282.2
Deferred income taxes and other, net	(27.6)	(75.5)	77.6
Cash effects of changes in:			
Receivables	(18.5)	(52.9)	(60.1)
Inventories	(1.4)	(31.3)	(53.4)
Other current assets	–0–	(50.9)	(9.4)
Payables and accruals	133.6	106.2	109.1
Net cash provided by operations	$ 1,101.0	$ 972.3	$ 995.3
Investing Activities			
Capital expenditures	$ (550.8)	$ (518.2)	$ (481.0)
Payment for acquisitions, net of cash acquired	(71.2)	(1,560.5)	(175.7)
Sale of marketable securities and other investments	31.6	7.4	70.1
Other, net	(14.4)	(20.6)	37.3
Net cash used for investing activities	$ (604.8)	$ (2,091.9)	$ (549.3)
Financing Activities			
Principal payments on debt	$ (1,397.5)	$ (20.5)	$ (106.0)
Proceeds from issuance of debt, net	1,292.9	1,464.0	379.7
Proceeds from outside investors	10.3	36.6	18.2
Dividends paid	(355.5)	(331.8)	(296.3)
Purchase of common stock	(32.9)	(10.8)	(429.5)
Proceeds from exercise of stock options and other, net	36.8	33.9	22.2
Net cash (used for) provided by financing activities	$ (445.9)	$ 1,171.4	$ (411.7)
Effect of exchange rate changes on cash and cash equivalents	$ (2.8)	$ (5.2)	$ (3.3)
Net increase in cash and cash equivalents	$ 47.5	$ 46.6	$ 31.0
Cash and cash equivalents at beginning of year	250.5	203.9	172.9
Cash and cash equivalents at end of year	$ 298.0	$ 250.5	$ 203.9
Supplemental Cash Flow Information			
Income taxes paid	$ 304.4	$ 351.0	$ 313.3
Interest paid	274.9	274.3	116.3
Non-cash consideration in payment for acquisitions	–0–	58.7	9.6
Principal payments on ESOP debt, guaranteed by the Company	(6.0)	(5.3)	(4.8)

Dividend payments were $355.5 in 2007, up from $331.8 in 2006 and $296.3 in 2005.

Internally generated cash flows appear to be adequate to support currently planned business operations, acquisitions and capital expenditures. Significant acquisitions would require external financing.

The Company is a party to various superfund and other environmental matters and is contingently liable with respect to lawsuits, taxes and other matters arising out of the normal course of business. Management proactively reviews and manages its exposure to, and the impact of, environmental matters. While it is possible that the Company's cash flows and results of operations in particular quarterly or annual periods could be affected by the one-time impacts of the resolution of such contingencies, it is the opinion of management that the ultimate disposition of these matters, to the extent not previously provided for, will not have a material impact on the Company's financial condition or ongoing cash flows and results of operations.

Explanation of Items in Synotech's Consolidated Statements of Cash Flows

Refer to Illustration 11.6. First we will discuss the items in the operating activities section of the statement of cash flows, then we will discuss investing activities and financing activities.

Operating Activities The company used the indirect method of calculating net cash provided by operations. Various adjustments were made to convert accrual based net income to cash basis net income.

The "restructured operations, net" item resulted from the fact that many companies restructured their operations by closing plants and significantly reducing their work forces. Some companies recognized a net loss from restructuring and others recognized a net gain. Apparently, the company recognized a net gain in 2007 because it deducted the item from net income on the statement of cash flows. The actual cash flows from restructuring will occur in a later period.

"Depreciation and amortization" includes depreciation on plant assets and amortization of intangible assets. Depreciation and amortization are noncash charges against revenues and must be added back to net income.

The "deferred income taxes and other, net" item deduction from net income results primarily from the fact that income tax expense on the income statement was lower than the actual income taxes paid in 2007. This phenomenon occurs because of using a different method for tax and accounting purposes for such items as depreciation.

Receivables and inventories increased (causing cash to decrease), while other current assets remained about the same. Payables and accruals increased (causing cash to increase). These changes are net of any amounts related to acquisitions, dispositions, or amounts that are included elsewhere, such as in "restructured operations, net." The changes described may differ from the amounts derived from only analyzing the balance sheets for the last two years because of certain technical "adjustments" that are beyond the scope of this text.

Note to the student
In general, it is desirable to see a healthy amount of a company's cash inflows provided by operating activities. This cash is generated by the company's core business and is expected to be more sustainable in future years than cash provided by financing or investing activities. (For instance, a hotel selling room space is a core business activity.)

Note to the student
Cash provided or used in financing and investing activities does not result from core business activities. However, such activities can have a significant one-time impact on cash. (For instance a hotel may sell a truck or issue more capital stock, but these are not core business activities.)

Investing Activities "Capital expenditures" include the purchase of plant assets, such as new machinery and equipment, to modernize production facilities. Companies normally select those capital expenditures with the highest rate of return. For instance, if funds are limited (and they normally are) and two capital investments (a machine and a mainframe computer) are being considered, one yielding a 20% return and the other yielding a 25% return, the company will normally select the one with the 25% return.

"Payment for acquisitions, net of cash acquired" shows the amount spent in acquiring other companies and segments of other companies, net of the amount of cash held by those companies and obtained as a part of the acquisition.

The company sold "marketable securities and other investments." These securities normally consist of stocks, bonds, and other instruments of other companies. For fiscal years beginning after December 15, 1993, marketable securities must be identified as trading securities, available-for-sale securities, or held-to-maturity securities. These held-to-maturity securities are debt securities (such as bonds of other companies) that the company has purchased and has both the intent and ability to hold to maturity. As mentioned earlier, the proceeds from sales and purchases of trading securities must be shown as cash flows from operating activities, and the proceeds from sales and purchases of available-for-sale and held-to-maturity securities must be shown as cash flows from investing activities.

Financing Activities The company paid off some old debt ($1,397.5 million) and incurred new debt ($1,292.9 million). Recently many companies are substituting new debt with a low interest rate for old debt with a high interest rate, just as homeowners refinance their homes to lower their interest rate.

The "proceeds from outside investors" resulted from the other participants in the formation of certain businesses in which the company holds more than a 50% share.

"Dividends paid" is an item that should be familiar to you. Dividends paid increased each year for the period 2005 through 2007.

The company bought back some of its own stock (treasury stock). Companies often buy back their own shares because they (1) need the shares to issue to employees or officers under stock option plans, (2) want to bolster the market price of the stock, or (3) hope to later sell the stock at a substantially higher price.

"Proceeds from exercise of stock options and other, net" represents the proceeds received from employees and officers who exercised their stock options. Stock options are usually granted to employees to encourage them to work efficiently to increase profitability, which should increase the market price of the stock. Stock options made available to officers are for the same purpose or to attract or retain a talented executive. Normally, an option gives the recipient the right to buy a certain number of shares at a stated price within a given timeframe. For instance, the president of a company may be granted an option to buy 10,000 shares at $40 per share any time after two years from that date and before six years from that date. Assume that the current market price is $38. If the market price of the stock rises to $80 at some time during the option period, the president could buy the shares at $40 and then hold them or sell them at the higher market price. Executives of companies have become multimillionaires by exercising their stock options. The employees and executives of Synotech, Inc., paid the company between $22.2 million and $36.8 million per year to exercise their stock options during the three-year period. The company resissued some of its treasury stock as a result of the exercise of the stock options.

Note to the student
Mangement is highly interested in how stockholders will evaluate the statement of cash flows since stockholders are the owners of the corporation and can influence its future direction by voting in (or out) the Board of Directors.

Use of the Cash Flow Information for Decision Making

We will discuss some examples of the ways that the information in the statement of cash flows can be used by management, stockholders, and creditors to make decisions. While the focus of the text is on management's perspective, management has a direct interest in how external users (creditors, stockholders) will assess the information as those parties can have a direct influence on the ability of the company to do business.

Reinforcing Problems
P11–3A Analyze Dynatex, Inc.'s statement of cash flows.
P11–4A Analyze Gillette Company's 2000 statement of cash flows.

Management Management accountants and management are the first to see the information contained in the statement of cash flows. You have already read portions of "Management's Discussion and Analysis" concerning the information contained in that statement. Management concluded that the amount of internally generated cash flows (net cash provided by operations) appears adequate to support currently planned business operations, acquisitions, and capital expenditures. Thus, unless the company engages in a significant acquisition it will not have to sell more stock or borrow more funds in the foreseeable future. Also, the company apparently replaced some of its high interest rate debt ($1,397.5 million) with lower interest rate debt ($1,292.9 million). Many companies were doing this same thing in the early 2000s to take advantage of the low interest rates available.

Stockholders Stockholders can see that dividend payments ($355.5 million) are comfortably covered by net cash provided by operations ($1,101.0 million). Stockholders are undoubtedly pleased that the per share dividend rate has increased each year during 2005 through 2007. The company continues to invest in its future by making capital expenditures ($550.8 million) to modernize its productive facilities. The repurchase of its own stock ($32.9 million) decreases the number of shares outstanding, although some of the stock will undoubtedly be reissued in the future as employees and executives exercise their stock options. Any net reduction in the number of shares outstanding will tend to increase earnings per share and help to increase the market price per share in the future. Also, the company may decide to increase dividends per share in the

A Broader Perspective

Johnson & Johnson

JOHNSON & JOHNSON AND SUBSIDIARIES
Consolidated Statements of Cash Flows
For the Years Ended June 30, 2000, 1999, and 1998
($ millions)

	2000	1999	1998
Cash flows from operating activities			
Net earnings	$ 4,800	$ 4,167	$ 3,003
Adjustments to reconcile net earnings to cash flows:			
Depreciation and amortization of property and intangibles	1,515	1,444	1,285
Purchased in-process research and development	54	—	298
Increase in deferred taxes	(167)	(7)	(297)
Accounts receivable reserves	33	11	24
Changes in assets and liabilities, net of effects from acquisition of businesses:			
Increase in accounts receivable	(451)	(671)	(163)
Decrease (increase) in inventories	125	(333)	(100)
Increase in accounts payable and accrued liabilities	57	242	646
Decrease in other current and non-current assets	143	457	142
Increase in other current and non-current liabilities	454	450	153
Net cash flows from operating activities	$ 6,563	$ 5,760	$ 4,991
Cash flows from investing activities			
Additions to property, plant and equipment	$ (1,646)	$ (1,728)	$ (1,545)
Proceeds from the disposal of assets	161	35	108
Acquisition of businesses, net of cash acquired	(68)	(271)	(3,818)
Purchases of investments	(5,383)	(3,538)	(1,005)
Sales of investments	4,670	2,817	400
Other	(102)	(257)	(205)
Net cash used by investing activities	$ (2,368)	$ (2,942)	$ (6,065)
Cash flows from financing activities			
Dividends to shareowners	$ (1,724)	$ (1,479)	$(1,305)
Repurchase of common stock	(973)	(840)	(930
Proceeds from short-term debt	814	3,208	2,424
Retirement from short-term debt	(1,485)	(4,063)	(226)
Proceeds from long-term debt	4	793	535
Retirement from long-term debt	(28)	(176)	(471)
Proceeds from the exercise of stock options	292	180	178
Net cash (used by) provided by financing activities	$ (3,100)	$ (2,377)	$ 205
Effect of exchange rate changes on cash and cash equivalents	(47)	(72)	24
Increase (decrease) in cash and cash equivalents	1,048	369	(845)
Cash and cash equivalents, beginning of year	2,363	1,994	2,839
Cash and cash equivalents, end of year	$ 3,411	$ 2,363	$ 1,994

future. These favorable factors might induce present stockholders to retain their stock or even increase their holdings. Potential stockholders might also be attracted to the stock and thus give the company the ability to generate future cash flows through the sale of stock.

Creditors An encouraging factor is the increasing amount of net cash provided by operations in 2007. Also comforting to creditors is the information in Management's Discussion and Analysis that the company has access to $2,142.8 million in lines of credit.

The preceding discussions are merely examples of how the information contained in the statement of cash flows might be analyzed to make decisions. The next section describes three ratios that can provide further analyses of cash flows.

Analyzing and Using the Financial Results—Cash Flow per Share of Common Stock, Cash Flow Margin, and Cash Flow Liquidity Ratios

Objective 6
Analyze and use the financial results—cash flow per share of common stock, cash flow margin, and cash flow liquidity ratios.

The information in the statement of cash flows provides a basis for analyzing financial results. However, further analysis is possible through the use of three ratios relating to cash flow: the cash flow per share of common stock, cash flow margin, and cash flow liquidity ratios. The ratios shown below are results for Synotech, Inc. and recent results for other companies. All dollar amounts are rounded to the nearest million.

The **cash flow per share of common stock ratio** is equal to the net cash provided by operations divided by the average number of shares of common stock outstanding. This ratio indicates the company's ability to pay dividends and liabilities. The higher the ratio, the greater the ability to pay. The cash flow per share of common stock ratios for the companies were:

Company	Net Cash Provided by Operating Activities (millions)	Average Shares of Common Stock Outstanding* (millions)	Cash Flow per Share
Synotech, Inc.	$1,101	147	$7.49
J. C. Penney, Inc.	1,598	262	6.10
The Walt Disney Company	6,434	2,092	3.08
General Electric Company	22,690	9,893	2.29

*To determine the average number of shares, add the beginning and ending numbers outstanding and divide by two.

The **cash flow margin ratio** is equal to net cash provided by operating activities divided by net sales. This ratio is a measure of a company's ability to turn sales revenue into cash. The higher the ratio, the better. The cash flow margin ratios for the companies were:

Company	Net Cash Provided By Operating Activities (millions)	Net Sales (millions)	Cash Flow Margin
Synotech, Inc.	$ 1,101	10,499	10.49%
J. C. Penney, Inc.	1,598	31,846	5.02%
The Walt Disney Company	6,434	25,402	25.33%
General Electric Company	22,690	128,051	17.72%

The **cash flow liquidity ratio** is equal to the total of cash, marketable securities, and net cash provided by operating activities divided by current liabilities. This ratio is a test of a company's short-term, debt-paying ability. The higher the ratio, the better. The cash flow liquidity ratios for the companies were:

Company	Cash, Marketable Securities, and Net Cash Provided by Operating Activities (millions)	Current Liabilities (millions)	Cash Flow Liquidity Ratio
Synotech, Inc.	$1,470	$2,285	.64 times
J. C. Penney, Inc.	2,542	4,235	.60 times
The Walt Disney Company	7,276	8,402	.87 times
General Electric Company	35,913	156,116	.23 times

On the first of these measures, Synotech, Inc., seems to be in the strongest position, although all of the companies are financially sound. On the second measure, Walt Disney and General Electric have the highest cash flow margin ratios. On the third measure, Walt Disney seems to be in the strongest position. However, a more valid comparison on each of these measures would be made if each of these companies was compared with other companies in its industry. Dun & Bradstreet's Industry Norms and Key Business Ratios can be used for this purpose. (This source could also be used for comparisons of ratios in the next chapter.) A complete analysis using the techniques described in the next chapter would provide additional information about the strengths and weaknesses of each of these companies.

Understanding the Learning Objectives

Objective 1
Explain the purposes and uses of the statement of cash flows.

- The statement of cash flows summarizes the effects on cash of the operating, financing, and investing activities of a company during an accounting period.
- Management can see the effects of its past major policy decisions in quantitative form.
- Investors and creditors can assess the entity's ability to generate positive future net cash flows, to meet its obligations, and to pay dividends, and can assess the need for external financing.

Objective 2
Describe the content of the statement of cash flows and where certain items would appear on the statement.

- Operating activities generally include the cash effects (inflows and outflows) of transactions and other events that enter into the determination of net income. The cash flows from operating activities can be measured in two ways. The direct method deducts from cash sales only those operating expenses that consumed cash. The indirect method starts with net income and adjusts net income for items that affected reported net income but did not involve cash.
- Investing activities generally include transactions involving the acquisition or disposal of noncurrent assets.
- Financing activities generally include the cash effects (inflows and outflows) of transactions and other events involving creditors and owners.

Objective 3
Describe how to calculate cash flows from operating activities under both the direct and indirect methods.

- The direct method deducts from cash sales only those operating expenses that consumed cash. The FASB recommends use of the direct method.
- The indirect method starts with accrual basis net income and indirectly adjusts net income for items that affected reported net income but did not involve cash. A large majority of companies use the indirect method.

Objective 4
Prepare a statement of cash flows, under both the direct and indirect methods, showing cash flows from operating activities, investing activities, and financing activities.

- The first step is to determine the cash flows from operating activities. Either the direct or indirect method may be used.
- The second step is to analyze all the noncurrent accounts for changes in cash resulting from investing and financing activities.
- The third step is to arrange the information gathered in steps 1 and 2 into the format required for the statement of cash flows.

Objective 5
Analyze a statement of cash flows of a real company.

- Business students will benefit throughout their careers from knowing how to analyze a statement of cash flows.
- "Management's Discussion and Analysis" in the annual report provides part of the analysis.

- Inspection of the statement of cash flows together with "Management's Discussion and Analysis" will provide the most insight as to the cash flow situation.
- The cash flow per share of common stock ratio tests a company's ability to pay dividends and liabilities and is equal to net cash provided by operating activities divided by the average number of shares of common stock outstanding.
- The cash flow margin ratio measures a company's ability to turn sales revenue into cash and is equal to net cash provided by operating activities divided by net sales.
- The cash flow liquidity ratio tests a company's short-term, debt-paying ability and is equal to the total of cash, marketable securities, and net cash provided by operating activities divided by current liabilities.
- A work sheet can be used to assist in preparing a statement of cash flows.
- A company's comparative balance sheets, income statement, and additional data are used to prepare the work sheet.
- The work sheet technique makes the recording of the effects of transactions on cash flows almost a mechanical process.

Objective 6
Analyze and use the financial results—cash flow per share of common stock, cash flow margin, and cash flow liquidity ratios.

Objective 7
Use a working paper to prepare a statement of cash flows (Appendix).

Use of a Working Paper to Prepare a Statement of Cash Flows

APPENDIX

This appendix shows how a work sheet could be used to assist in preparing a statement of cash flows. We use the comparative balance sheets, income statement, and additional data for the Welby Company, shown on page 325**,** as the basis for this example.

Look at the working paper in Illustration 11.7 for Welby Company, which we use to analyze the transactions and prepare the statement of cash flows. While discussing the steps in preparing the working paper, we describe the items and trace their effects in the entries.

Objective 7
Use a working paper to prepare a statement of cash flows.

1. Enter the beginning account balances of all balance sheet accounts in the first column and the ending account balances in the fourth column. Notice that the debit items precede the credit items.
2. Total the debits and credits in the first and fourth columns to make sure that debits equal credits in each column.
3. Write "Cash Flows from Operating Activities" immediately below the total of the credit items. Skip sufficient lines for recording adjustments to convert accrual net income to cash flows from operating activities. Then write "Cash Flows from Investing Activities" and allow enough space for those items. Finally, write "Cash Flows from Financing Activities" and allow enough space for those items.
4. Enter entries for analyzing transactions in the second and third columns. The entries serve two functions: (*a*) they explain the change in each account; and (*b*) they classify the changes into operating, investing, and financing activities. We discuss these entries individually in the next section.
5. Total the debits and credits in the second and third columns; they should be equal. You will have one pair of totals for the balance sheet items and another pair for the bottom portion of the working paper. We use the bottom portion of the working paper to prepare the statement of cash flows.

Completing the Working Paper

To complete the working paper in Illustration 11.7, we must analyze the change in each noncash balance sheet account. The focus of this working paper is on cash, and every change in cash means a change in a noncash balance sheet account. After we have made the proper entries to analyze all changes in noncash balance sheet accounts, the working paper shows all activities affecting cash flows. The following explanations are keyed to the entry numbers on the working paper:

Entry 0 In comparing the beginning and ending cash balances, we determine the change in the Cash account during the year is an $11,000 increase. An entry on the working paper debits Cash for $11,000 and credits Increase in Cash for Year near the bottom of the schedule. This *0* entry does not explain the change in cash but is the "target" of the analysis. The entry sets out the change in cash that the statement seeks to explain. No further attention need be paid to cash in completing the working paper.

We now direct our attention toward changes in other balance sheet accounts. These accounts can be dealt with in any order; first, we record the net income for the period and analyze the current assets (other than cash) and the current liabilities. Second, we analyze the changes in the noncurrent accounts.

Entry 1 The income statement shows a net income for 2007 of $10,000. Entry *1* records the $10,000 as the starting point in measuring cash flows from operating activities and credits Retained Earnings as a partial explanation of the change in that account.

The next task is to analyze changes in current accounts other than Cash. The current accounts of Welby Company are closely related to operations, and their changes are included in converting net income to cash flows from operating activities.

Entry 2 We deduct the $10,000 increase in accounts receivable from net income when converting it to cash flows from operating activities. If accounts receivable increased, sales to customers exceeded cash received from customers. To convert net income to a cash basis, we must deduct the $10,000.

The working paper technique makes the recording of these effects almost mechanical. By debiting Accounts Receivable for $10,000, we increase it from $20,000 to $30,000. If Accounts Receivable is debited, we must credit an item that can be entitled "Increase in Accounts Receivable." We deduct the increase from net income in converting it to cash flows from operating activities.

Entry 3 is virtually a duplicate of entry *2,* except it involves merchandise inventory rather than receivables and is a decrease rather than an increase.

Entry 4 records the effect of a decrease in accounts payable on net income in converting it to cash flows from operating activities.

Entry 5 records the effect of an increase in accrued liabilities payable in converting net income to cash flows from operating activities.

Next, we analyze the changes in the noncurrent balance sheet accounts.

Entry 6 We add the $5,000 depreciation back to net income and credit the respective accumulated depreciation account. You can find the depreciation expense (1) on the income statement, or (2) by solving for the credit needed to balance the accumulated depreciation account on the balance sheet.

Illustration 11.7 Working Paper for Statement of Cash Flows

WELBY COMPANY
Working Paper for Statement of Cash Flows
For the Year Ending December 31, 2007

	Account Balances 12/31/06	Analysis of Transactions for 2007 Debit	Analysis of Transactions for 2007 Credit	Account Balances 12/31/07
Debits				
Cash	10,000	(0) 11,000		21,000
Accounts Receivable, Net	20,000	(2) 10,000		30,000
Merchandise Inventory	30,000		(3) 4,000	26,000
Equipment	50,000	(7) 20,000		70,000
Totals	110,000			147,000
Credits				
Accumulated Depreciation—Equipment	5,000		(6) 5,000	10,000
Accounts Payable	15,000	(4) 6,000		9,000
Accrued Liabilities Payable	—0—		(5) 2,000	2,000
Common Stock ($10 par value)	60,000		(8) 30,000	90,000
Retained Earnings	30,000	(9) 4,000	(1) 10,000	36,000
Totals	110,000	51,000	51,000	147,000
Cash Flows from Operating Activities				
Net Income		(1) 10,000		
Increase in Accounts Receivable			(2) 10,000	
Decrease in Merchandise Inventory		(3) 4,000		
Decrease in Accounts Payable			(4) 6,000	
Increase in Accrued Liabilities Payable		(5) 2,000		
Depreciation Expense		(6) 5,000		
Cash Flows from Investing Activities:				
Purchase of Equipment			(7) 20,000	
Cash Flows from Financing Activities:				
Proceeds from Issuing Common Stock		(8) 30,000		
Payment of Cash Dividends			(9) 4,000	
Increase in Cash for Year			(0) 11,000	
		51,000	51,000	

Accumulated Depreciation—Equipment

	Beg. bal.	5,000
	(6)	5,000
	End. bal.	10,000

Entry 7 We debit the Equipment account and credit "Purchase of Equipment" in the investing activities section for the $20,000 cash spent to acquire new plant assets (equipment).

Entry 8 We show the $30,000 cash received from sale of common stock as a financing activity. The entry also explains the change in the Common Stock account. If stock had been sold for more than its stated value of $50 per share, we would record the excess in a separate Paid-In Capital in Excess of Stated Value account. However, we would report the total amount of cash received from the issuance of common stock as a single figure on the statement of cash flows. Only this total amount received is significant to creditors and other users of the financial statements trying to judge the solvency of the company.

Entry 9 We debit Retained Earnings and credit Payment of Cash Dividends for the $4,000 dividends declared and paid. The entry also completes the following explanation of the change in Retained Earnings. Notice that on the statement of cash flows, the dividends must be paid to be included as a cash outflow from financing activities.

Retained Earnings

		Beg. bal.	30,000
(9)	4,000	(1)	10,000
		End. bal.	36,000

Preparing the Statement of Cash Flows

Using the data in the lower section of the working paper, we would prepare the statement of cash flows under the indirect method shown in Illustration 11.5 (Part B) on page 329.

Demonstration Problem

The following comparative balance sheets are for Dells Corporation as of June 30, 2007, and June 30, 2006. Also provided is the statement of income and retained earnings for the year ended June 30, 2007, with additional data.

DELLS COMPANY
Comparative Balance Sheet
June 30, 2007 and 2006

	2007	2006	Increase (Decrease)
Assets			
Current assets:			
Cash	$ 30,000	$ 80,000	$ (50,000)
Accounts receivable, net	160,000	100,000	60,000
Merchandise inventory	100,000	70,000	30,000
Prepaid rent	20,000	10,000	10,000
Total current assets	$310,000	$260,000	$ 50,000
Property, plant, and equipment:			
Equipment	$400,000	$200,000	$200,000
Accumulated depreciation—equipment	(60,000)	(50,000)	(10,000)
Total property, plant, and equipment	$340,000	$150,000	$190,000
Total assets	$650,000	$410,000	$240,000

Liabilities and Stockholders' Equity			
Current liabilities:			
Accounts payable	$ 50,000	$ 40,000	$ 10,000
Notes payable—bank	—0—	50,000	(50,000)
Salaries payable	10,000	20,000	(10,000)
Federal income taxes payable	30,000	20,000	10,000
Total current liabilities	$ 90,000	$130,000	$ (40,000)
Stockholders' equity:			
Common stock, $10 par	$300,000	$100,000	$200,000
Paid-in capital in excess of par	50,000	—0—	50,000
Retained earnings	210,000	180,000	30,000
Total stockholders' equity	$560,000	$280,000	$280,000
Total liabilities and stockholders' equity	$650,000	$410,000	$240,000

DELLS CORPORATION
Statement of Income and Retained Earnings
For the Year Ended June 30, 2007

Sales		$1,000,000
Cost of goods sold	$600,000	
Salaries and wages expense	200,000	
Rent expense	40,000	
Depreciation expense	20,000	
Interest expense	3,000	
Loss on sale of equipment	7,000	870,000
Income before federal income taxes		$ 130,000
Deduct: Federal income taxes		60,000
Net income		$ 70,000
Retained earnings, July 1, 2006		180,000
		$ 250,000
Deduct: Dividends		40,000
Retained earnings, June 30, 2007		$ 210,000

Additional data

1. Equipment with a cost of $20,000, on which $10,000 of depreciation had been recorded, was sold for $3,000 cash. Additional equipment was purchased for $220,000.
2. Stock was issued for $250,000 cash.
3. The $50,000 bank note was paid.

Required

Using the data given for Dells Corporation:

a. Prepare a statement of cash flows—indirect method.
b. Prepare a working paper to convert net income from an accrual basis to a cash basis. Then prepare a partial statement of cash flows—direct method, showing only the cash flows from operating activities section.

Solution to Demonstration Problem

a.

DELLS COMPANY
Statement of Cash Flows
For the Year Ended June 30, 2007

Cash flows from operating activities:		
Net income	$ 70,000	
Adjustments to reconcile net income to net cash provided by operating activities:		
Increase in accounts receivable	(60,000)	
Increase in merchandise inventory	(30,000)	
Increase in prepaid rent	(10,000)	
Increase in accounts payable	10,000	
Decrease in salaries payable	(10,000)	
Increase in federal income taxes payable	10,000	
Loss on sale of equipment	7,000	
Depreciation expense	20,000	
Net cash provided by operating activities		$7,000
Cash flows from investing activities:		
Proceeds from sale of equipment	$ 3,000	
Purchase of equipment	(220,000)	
Net cash used by investing activities		(217,000)
Cash flows from financing activities:		
Proceeds from issuing common stock	$250,000	
Repayment of bank note	(50,000)	
Dividends paid	(40,000)	
Net cash provided by financing activities		160,000
Net increase (decrease) in cash		$(50,000)

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b.

DELLS CORPORATION
Working Paper to Convert Income Statement
from Accrual Basis to Cash Basis
For the Year Ended June 30, 2007

	Accrual Basis		Add	Deduct	Cash Basis (Cash Flows from Operating Activities)	
Sales		$1,000,00		$60,000[a]		$940,000
Cost of goods sold	$600,000		$30,00[b]	10,000[c]	$620,000	
Salaries and wages expense	200,000		10,000[d]		210,000	
Rent expense	40,000		10,000[e]		50,000	
Depreciation expense	20,000			20,000	—0—	
Interest expense	3,000				3,000	
Loss on sale of equipment	7,000			7,000	—0—	
Federal income taxes	60,000			10,000[f]	50,000	
		930,000				933,000
Net income		$ 70,000				$ 7,000

[a]Increase in Accounts Receivable.
[b]Increase in Merchandise Inventory.
[c]Increase in Accounts Payable.
[d]Decrease in Salaries Payable.
[e]Increase in Prepaid Rent.
[f]Increase in Federal Income Taxes Payable.

DELLS CORPORATION
Partial Statement of Cash Flows—Direct Method
For the Year Ended June 30, 2007

Cash flows from operating activities:		
Cash received from customers	$ 940,000	
Cash paid for merchandise	(620,000)	
Salaries and wages paid	(210,000)	
Rent paid	(50,000)	
Interest paid	(3,000)	
Federal income taxes paid	(50,000)	
Net cash provided by operating activities		$ 7,000

New Terms

Cash flow liquidity ratio Cash and marketable securities plus net cash provided by operating activities divided by current liabilities. *335*

Cash flow margin ratio Net cash provided by operating activities divided by net sales. *335*

Cash flow per share of common stock ratio Net cash provided by operating activities divided by the average number of shares of common stock outstanding. *335*

Cash flows from operating activities The net amount of cash received or disbursed during a given period on items that normally appear on the income statement. *322*

Direct method Deducts from cash sales only those operating expenses that consumed cash. *322*

Financing activities Generally include the cash effects of transactions and other events involving creditors and owners. Cash payments made to settle current liabilities such as accounts payable, wages payable, and income taxes payable are not financing activities. These payments are operating activities. *322*

Indirect method A method of determining cash flows from operating activities that starts with net income and indirectly adjusts net income for items that do not involve cash. Also called the **addback** method. *322*

Investing activities Generally include transactions involving the acquisition or disposal of noncurrent assets. Examples include cash received or paid from the sale or purchase of property, plant, and equipment; available-for-sale and held-to-maturity securities; and loans made to others. *321*

Noncash charges or expenses Expenses and losses that are added back to net income because they do not actually use cash of the company. The items added back include amounts of depreciation on plant assets, depletion that was expensed, amortization of intangible assets such as patents and goodwill, amortization of discount on bonds payable, and losses from disposals of noncurrent assets. *323*

Noncash credits or revenues Revenues and gains included in arriving at net income that do not provide cash; examples include gains from disposals of noncurrent assets, income from investments carried under the equity method, and amortization of premium on bonds payable. *324*
Operating activities Generally include the cash effects of transactions and other events that enter into the determination of net income. *320*
Statement of cash flows A statement that summarizes the effects on cash of the operating, investing, and financing activities of a company during an accounting period. Both inflows and outflows are included in each category. The statement of cash flows must be prepared each time an income statement is prepared. *320*

Self-Test

True-False

Indicate whether each of the following statements is true or false.

1. The requirement for a statement of cash flows was preceded by the requirement for the statement of changes in financial position.
2. The statement of cash flows is one of the major financial statements.
3. Investing activities are transactions with creditors and owners.
4. The direct method of calculating cash flows from operations is encouraged by the FASB and is the predominant method used.
5. Issuance of capital stock and the subsequent reacquisition of some of those shares would both be financing activities.

Multiple-Choice

Select the best answer for each of the following questions.

1. Which of the following statements is true?
- **a.** The direct method of calculating cash flows from operations starts with net income and adjusts for noncash revenues and expenses and changes in current assets and current liabilities.
- **b.** The indirect method of calculating cash flows from operations adjusts each item in the income statement to a cash basis.
- **c.** The descriptions in *(a)* and *(b)* should be reversed.
- **d.** The direct method is easier to use than the indirect method.

2. Investing activities include all of the following except:
- **a.** Payment of debt.
- **b.** Collection of loans.
- **c.** Making of loans.
- **d.** Sale of available-for-sale and held-to-maturity securities.

3. If sales on an accrual basis are $500,000 and accounts receivable increased by $30,000, the cash received from customers would be:
- **a.** $500,000.
- **b.** $470,000.
- **c.** $530,000.
- **d.** Cannot be determined.

4. Assume cost of goods sold on an accrual basis is $300,000, accounts payable increased by $20,000, and inventory increased by $50,000. Cash paid for merchandise is:
- **a.** $370,000.
- **b.** $230,000.
- **c.** $270,000.
- **d.** $330,000.

5. Assume net income was $200,000, depreciation expense was $10,000, accounts receivable increased by $15,000, and accounts payable increased by $5,000. The amount of cash flows from operating activities is:
- **a.** $200,000.
- **b.** $180,000.
- **c.** $210,000.
- **d.** $190,000.

Now turn to page 362 to check your answers.

Questions

1. What are the purposes of the statement of cash flows?
2. What are some of the uses of the statement of cash flows?
3. What information is contained in the statement of cash flows?
4. Which activities are generally included in operating activities?
5. Which activities are included in investing activities?
6. Which activities are included in financing activities?
7. Where should significant investing and financing activities that do not involve cash flows be reported?
8. Explain the difference between the direct and indirect methods for computing cash flows from operating activities.
9. What are noncash expenses? How are they treated in computing cash flows from operating activities?
10. Describe the treatment of a gain on the sale of equipment in preparing a statement of cash flows under the indirect method.
11. Depreciation is sometimes referred to as a source of cash. Is it a source of cash? Explain.
12. Why is it unlikely that cash flows from operating activities will be equal to net income for the same period?
13. If the net income for a given period is $25,000, does this mean there is an increase in cash of the same amount? Why or why not?
14. Why might a company have positive cash flows from operating activities even though operating at a net loss?
15. Indicate the type of activity each of the following transactions represents (operating, investing, or financing) and whether it is an inflow or an outflow.
    - **a.** Sold goods.
    - **b.** Purchased building.
    - **c.** Issued capital stock.
    - **d.** Received cash dividends.
    - **e.** Paid cash dividends.
    - **f.** Purchased treasury stock.
    - **g.** Sold available-for-sale securities.
    - **h.** Made a loan.
    - **i.** Paid interest on loan.
    - **j.** Paid bond principal.
    - **k.** Received proceeds of insurance settlement.
    - **l.** Made contribution to charity.
16. Refer to "A Broader Perspective" on page 334. Answer the following questions:
    - **a.** What was the major investing activity in 2000?
    - **b.** Was there a net negative or positive cash flow from investing activities?
    - **c.** Was the positive cash flow from operating activities large enough to pay the cash dividends?
17. **Real World Question**
    Refer to The Limited in the Annual Report Appendix. Does it use the direct method or indirect method of reporting cash flows from operating activities?

Exercises

Exercise 11–1
Report specific items on statement of cash flows (L.O. 2, 4)

Indicate how the following data should be reported in a statement of cash flows. A company paid $500,000 cash for land. A building was acquired for $2,500,000 by assuming a mortgage on the building.

Exercise 11–2
Calculate the amount of cash paid for merchandise (L.O. 3)

Cost of goods sold in the income statement for the year ended 2007 was $260,000. The balances in Merchandise Inventory and Accounts Payable were:

	January 1, 2007	December 31, 2007
Merchandise Inventory	$160,000	$180,000
Accounts Payable	44,000	36,000

Calculate the amount of cash paid for merchandise for 2007.

Exercise 11–3 Show effects of conversion from accrual to cash basis income (L.O. 3)

Fill in the following chart, showing how increases and decreases in these accounts affect the conversion of accrual basis income to cash basis income:

	Add	Deduct
Accounts Receivable		
Merchandise Inventory		
Prepaid Expenses		
Accounts Payable		
Accrued Liabilities Payable		

Exercise 11–4 Compute cash flows from operating activities (L.O. 3)

The income statement of a company shows net income of $200,000; merchandise inventory on January 1 was $76,500 and on December 31 was $94,500; accounts payable for merchandise purchases were $57,000 on January 1 and $68,000 on December 31. Compute the cash flows from operating activities under the indirect method.

Exercise 11–5 Compute cash flows from operating activities (L.O. 3)

The operating expenses and taxes (including $80,000 of depreciation) of a company for a given year were $600,000. Net income was $350,000. Prepaid insurance decreased from $18,000 to $14,000 during the year, while wages payable increased from $22,000 to $36,000 during the year. Compute the cash flows from operating activities under the indirect method.

Exercise 11–6 Indicate treatment of a dividend (L.O. 2, 4)

Dividends payable increased by $20,000 during a year in which total dividends declared were $120,000. What amount appears for dividends paid in the statement of cash flows?

Exercise 11–7 Compute cash used to purchase plant assets (L.O. 2, 4)

Following are balance sheet data for Quality Merchandise, Inc.:

	December 31	
	2008	**2007**
Cash	$ 47,000	$ 26,000
Accounts receivable, net	141,000	134,000
Merchandise inventory	83,000	102,000
Prepaid expenses	9,000	11,000
Plant assets (net of accumulated depreciation)	235,000	230,000
Accounts payable	122,000	127,000
Accrued liabilities payable	40,000	41,000
Capital stock	300,000	300,000
Retained earnings	53,000	35,000

Assume that the depreciation recorded in 2008 was $15,000. Compute the cash spent to purchase plant assets, assuming no assets were sold or scrapped in 2008.

Exercise 11–8 Prepare statement of cash flows (L.O. 4)

Use the data in Exercise 11–7. Assume the net income for 2008 was $24,000, depreciation was $15,000, and dividends declared and paid were $6,000. The company paid interest of $2,000 and income taxes of $14,000. Prepare a statement of cash flows—indirect method. Also prepare any necessary supplemental schedule(s).

Exercise 11–9 Report specific items on statement of cash flows (L.O. 2, 4)

The following data are from a company's Automobile and the Accumulated Depreciation—Automobile accounts:

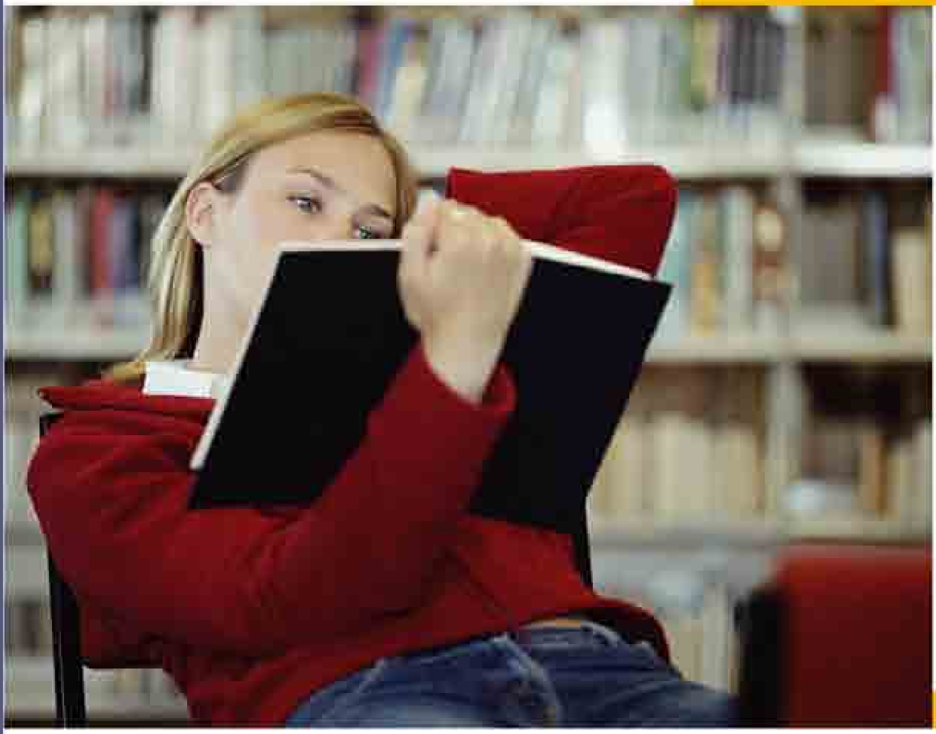
Automobile

Date		Debit	Credit	Balance
Jan. 1	Balance brought forward			16,000
July 1	Traded for new auto		16,000	–0–
	New auto	31,000		31,000

Accumulated Depreciation—Automobile

Date		Debit	Credit	Balance
Jan. 1	Balance brought forward			12,000
July 1	One-half year's depreciation		2,000	14,000
	Auto traded	14,000		–0–
Dec. 31	One-half year's depreciation		4,000	4,000

GMAC Bank



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* Undergraduate and graduate borrowers may borrow annually up to the lesser of the cost of attendance or $30,000 ($40,000 for certain schools where it has been determined that the annual cost of attendance exceeds $30,000). Borrowers in the Continuing Education loan program may borrow annually up to $30,000.

** Undergraduate students may choose to defer repayment until six months after graduation or ceasing to be enrolled at least half time in school. Interest only and immediate repayment options also available.

*** A 0.25% interest rate reduction is available for borrowers who elect to have monthly principal and interest payments transferred electronically from a savings or checking account. The interest rate reduction will begin when automatic principal and interest payments start, and will remain in effect as long as automatic payments continue without interruption. This reduced interest rate will return to contract rate if automatic payments are cancelled, rejected or returned for any reason. Upon request, borrowers are also entitled to an additional 0.25% interest rate reduction if (1) the first 36 payments of principal and interest are paid on time, and (2) at any time prior to the 36th on time payment, the borrower who receives the monthly bill elects to have monthly principal and interest payments transferred electronically from a savings or checking account, and continues to make such automatic payments through the 36th payment. This reduced interest rate will not be returned to contract rate if, after receiving the benefit, the borrower discontinues automatic electronic payment. The lender and servicer reserve the right to modify or discontinue borrower benefit programs (other than the co-signer release benefit) at any time without notice.

GMAC Bank Member FDIC

The old auto was traded for a new one, with the difference in values paid in cash. The income statement for the year shows a loss on the exchange of autos of $1,200.

Indicate the dollar amounts, the descriptions of these amounts, and their exact locations in a statement of cash flows—indirect method.

Problems

Problem 11–1
Prepare working paper to convert income statement to cash basis; prepare cash flows from operating activities under both methods (L.O. 2, 3)

The income statement and other data of Dunbar Carpet Outlet, Inc., follow:

DUNBAR CARPET OUTLET, INC.
Income Statement
For the Year Ended December 31, 2007

Sales		$920,000
Cost of goods sold		380,000
Gross margin		$540,000
Operating expenses (other than depreciation)	$140,000	
Depreciation expense	40,000	180,000
Net income		$360,000

Changes in current assets (other than cash) and current liabilities during the year were:

	Increase	Decrease
Accounts receivable		$20,000
Merchandise inventory	$16,000	
Prepaid insurance	8,000	
Accounts payable	28,000	
Accrued liabilities payable	4,000	

Depreciation was the only noncash item affecting net income.

Required

a. Prepare a working paper to calculate cash flows from operating activities under the *direct method.*

b. Prepare the cash flows from operating activities section of the statement of cash flows under the *direct method.*

c. Prove that the same cash flows amount will be obtained under the indirect method by preparing the cash flows from operating activities section of the statement of cash flows under the *indirect method.* You need not prepare a working paper.

Problem 11–2
Prepare statement of cash flows under the indirect method (L.O. 4)

The following comparative balance sheets and other data are for Cellular Telephone Sales, Inc.:

CELLULAR TELEPHONE SALES, INC.
Comparative Balance Sheets
December 31, 2008 and 2007

	2008	2007
Assets		
Cash	$ 76,105	$51,000
Accounts receivable, net	26,075	24,250
Merchandise inventory	30,000	35,000
Supplies on hand	1,750	2,550
Prepaid expenses	1,400	1,200
Land	180,000	142,500
Equipment	270,000	300,000
Accumulated depreciation—equipment	(75,000)	(67,500)
Total assets	$510,330	$489,000
Liabilities and Stockholders' Equity		
Accounts payable	$ 45,330	$ 76,300
Salaries payable	4,000	2,000
Accrued liabilities payable	2,000	8,250
Long-term note payable	150,000	150,000
Common stock ($5 par)	185,000	165,000
Paid-in capital in excess of par	32,500	—0—
Retained earnings	91,500	87,450
Total liabilities and stockholders' equity	$510,330	$489,000

Additional data

1. Land was bought for $37,500 cash. The company intends to build a building on the land. Currently the company leases a building for its operations.
2. Equipment costing $50,000 with accumulated depreciation of $30,000 was sold for $23,500 (a gain of $3,500), and equipment costing $20,000 was purchased for cash.
3. Depreciation expense for the year was $37,500.
4. Common stock was issued for $52,500 cash.
5. Dividends declared and paid in 2008 totaled $32,950.
6. Net income was $37,000.
7. The company paid interest of $3,000 and income taxes of $17,000.

Required

Prepare a statement of cash flows under the indirect method. Also prepare any necessary supplemental schedule(s).

Problem 11–3
Analyze Computer Associates International's statement of cash flows (L.O. 5, 6)

Computer Associates International, Inc., is leading business software company. The company was founded in 1977 with four employees and has grown to 18,200 employees and about 4.2 billion in revenues.

The company's statements of cash flows for the years 1999 through 2001 follow. Then the relevant portion of Management's Discussion and Analysis of the statement of cash flows is provided.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended March 31,		
Operating Activities:	**2001**	**2000**	**1999**
	(In Millions)		
Net (loss) income	**$ (591)**	$ 696	$ 626
Adjustments to reconcile net (loss) income to net cash provided by operating activities:			
Depreciation and amortization	**1,110**	594	325
Provision for deferred income taxes (benefit)	**(350)**	412	107
Charge for purchased research and development	**—**	795	—
Compensation (gain) expense related to stock pension plans	**(146)**	30	778
Decrease (increase) in noncurrent installment accounts receivable, net	**956**	(1,039)	(422)
Decrease (increase) in deferred maintenance revenue	**(3)**	113	43
Foreign currency transaction loss—before taxes	**14**	5	11
Charge for investment write-off	**—**	50	—
Gain on sale of property and equipment	**—**	(5)	(14)
Changes in other operating assets and liabilities, net of effects of acquisitions:			
Decrease (increase) in trade and installment receivables	**418**	83	(169)
Other changes in operating assets and liabilities	**(25)**	(168)	(18)
Net Cash Provided by Operating Activities	**$ 1,383**	$ 1,566	$ 1,267
Investing Activities:			
Acquisitions, primarily purchased software, marketing rights and intangibles, net of cash acquired	**$ (174)**	$ (3,049)	$ (610)
Settlements of purchase accounting liabilities	**(367)**	(429)	(57)
Purchases of property and equipment	**(89)**	(198)	(222)
Proceeds from sale of property and equipment	**5**	12	38
Disposition of businesses	**158**	—	—
Purchases of marketable securities	**(48)**	(95)	(2,703)
Sales of marketable securities	**40**	189	2,639
Increase in capitalized development costs and other	**(49)**	(36)	(29)
Net cash Used in Investing Activities	**$ (524)**	$ (3,606)	$ (944)
Financing Activities:			
Dividends	**$ (47)**	$ (43)	$ (44)
Purchases of treasury stock	**(449)**	—	(1,090)
Proceeds from borrowings	**1,049**	3,672	2,141
Repayment of borrowings	**(1,981)**	(776)	(1,216)
Exercise of common stock options and other	**50**	96	38
Net Cash Provided By (Used In) Financing Activities	**$ (1,378)**	$ 2,949	$ (171)

(Decrease) Increase In Cash And Cash Equivalents Before Effect of Exchange Rate Changes on Cash	**$ (519)**	$ 909	$ 152
Effect of exchange rate changes on cash	**(25)**	(1)	(4)
(Decrease) Increase in Cash and Cash Equivalents	**$ (544)**	$ 908	$ 148
Cash and Cash Equivalents—Beginning of Year	**1,307**	399	251
Cash and Cash Equivalents—End of Year	**$ 763**	$ 1,307	$ 399

Management's Discussion and Analysis

Liquidity and Capital Resources

Cash, cash equivalents and marketable securities totaled $850 million at March 31, 2001, a decrease of $537 million from the March 31, 2000 balance of $1,387 million. During fiscal year 2001, the Company used cash on hand to repay over $900 million in debt and repurchase approximately $450 million in treasury stock. Cash generated from operations for fiscal year 2001 was $1,383 million, a decrease of $183 million from the prior year's cash from operations of $1,566 million. Cash from operations was unfavorably impacted this current fiscal year due to higher costs associated with increased headcount and other expenses related to the Sterling acquisition.

The Company's bank credit facilities consist of a $1 billion four-year revolving credit facility, a $2 billion four-year term loan, and a 75 million British Pound Sterling denominated 364-day term loan. During the year, the Company repaid all outstanding amounts under both its $1.3 billion 364-day and four-year revolving credit agreements. As a reflection of its continued reduced need for bank borrowings, emphasis on debt reduction, and overall expected ability to generate cash from operations, the Company did not renew its $1.3 billion 364-day revolving credit facility when it expired in May 2001.

As of March 31, 2001, $2 billion remained outstanding under the four-year term loan and approximately U.S. $124 million was outstanding under the pound sterling term loan at various interest rates. There are no drawings under the Company's $1 billion four-year revolving credit facility. The interest rates on such debt are determined based on a ratings grid, which applies a margin to the prevailing London InterBank Offered Rate ("LIBOR"). In addition, the Company established a $1 billion U.S. Commercial Paper ("CP") program in the first quarter of this year to refinance some of its debt at more attractive interest levels. As of March 31, 2001, $340 million was outstanding under the CP program.

The Company also utilizes other financial markets in order to maintain its broad sources of liquidity. In fiscal 1999, $1.75 billion of unsecured Senior Notes were issued in a transaction governed by Rule 144A of the Securities Act of 1933. Amounts borrowed, rates and maturities for each issue were $575 million at 6.25% due April 15, 2003, $825 million at 6.375% due April 15, 2005 and $350 million at 6.5% due April 15, 2008. As of March 31, 2001, $192 million was outstanding under the Company's 6.77% Senior Notes. These Notes call for annual repayment of $64 million each April until final maturity in 2003.

Unsecured and uncommitted multicurrency lines of credit are available to meet any short-term working capital needs for subsidiaries operating outside the U.S. These lines total U.S. $56 million, of which U.S. $14 million was drawn as of March 31, 2001.

Debt ratings for the Company's senior unsecured notes and its bank credit facilities are BBB+ and Baa1 from Standard & Poor's and Moody's Investor Services, respectively. The Company's Commercial Paper program is rated A-2 from Standard & Poor's and P-2 from Moody's. Peak borrowings under all debt facilities during fiscal year 2001 totaled approximately $5.4 billion with a weighted-average interest rate of 7.2%.

As of March 31, 2001, the cumulative number of shares purchased under the Company's various open market Common Stock repurchase programs, including almost 16 million shares purchased in the current fiscal year, was 166 million. The remaining number of shares authorized for repurchase is approximately 34 million.

Capital resource requirements as of March 31, 2001 consisted of lease obligations for office space, computer equipment, mortgage or loan obligations and amounts due as a result of product and company acquisitions. It is expected that existing cash, cash equivalents, marketable securities, the availability of borrowings under credit lines and cash provided from operations will be sufficient to meet ongoing cash requirements.

The Company expects its long-standing history of providing extended payment terms to customers to continue under the new business model and thus does not expect a change to its future cash flow, since customers are expected to continue to finance their purchases over the contract period.

Required

a. Explain how the company could have a net loss in 2001 and yet have a positive net cash provided by operating activities.
b. What was the reason given by management for repaying all outstanding amounts under revolving credit agreements?
c. What is the interest rate on borrowings?
d. What information would normally appear immediately below the statement of cash flows that seems to be missing?
e. Does the amount of cash provided by operating activities seem large enough to continue the present dividend payments?
f. Given the following data, calculate the cash flow per share of common stock ratio, the cash flow margin ratio, and cash flow liquidity ratio.

	(in millions)
Average number of shares of common stock outstanding	583
Net sales	4,198
Cash and marketable securities	850
Current liabilities	2,286

Problem 11–4
Analyze Baxter Company's statement of cash flows
(L.O. 5, 6)

Mechan Company develops, manufactures, markets, installs and supports a wide range of standards-based LAN and WAN connectivity hardware and software products. The company's statements of cash flow for the years 2005–2007 follow. Then the relevant portion of Management's Discussion and Analysis of the statement of cash flows is provided.

CONSOLIDATED STATEMENTS OF CASH FLOWS
Years Ended February 29, 2007, and February 28, 2006 and 2005
(in thousands)

	2007	2006	2005
Cash flows from operating activities:			
Net income	**$ 164,418**	$ 161,974	$ 119,218
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	**32,061**	26,832	17,335
Provision for losses on accounts receivable	**356**	72	1,734
Loss on disposals of property, plant and equipment	**93**	174	113
Deferred taxes	**(38,766)**	(4,434)	(6,151)
Changes in assets and liabilities:			
Accounts receivables	**(55,101)**	(27,698)	(17,707)
Inventories	**(50,483)**	(23,080)	(8,758)
Prepaid expenses and other assets	**(18,844)**	(3,123)	1,211
Accounts payable and accrued expenses	**62,908**	11,336	22,003
Income taxes payable	**3,705**	10,476	(3,924)
Net cash provided by operating activities	**$ 100,347**	$ 152,529	$ 125,074
Cash flows from investing activities:			
Capital expenditures	**$ (65,035)**	$ (63,091)	$ (39,399)
Purchase of available-for-sale securities	**(79,427)**	(71,598)	(30,097)
Purchase of held-to-maturity securities	**(205,852)**	(282,712)	(258,517)
Maturities of marketable securities	**208,922**	323,682	197,406
Net cash used in investing activities	**$(141,392)**	$ (93,719)	$(130,607)
Cash flows from financing activities:			
Repayment of notes receivable from stockholders	**$ 174**	$ 131	$ 66
Repurchase of common stock	**(1,173)**	(13,070)	—
Tax benefit of options exercised	**7,215**	5,712	6,980
Common stock issued to employee stock purchase plan	**3,323**	2,287	1,637
Proceeds from stock option exercise	**16,021**	4,887	7,185
Net cash provided by (used for) financing activities	**$ 25,560**	$ (53)	$ 15,868
Effect of exchange rate changes on cash	**$ 166**	$ 712	$ 161
Net increase (decrease) in cash and cash equivalents	**$ (15,319)**	$ 59,469	$ 10,469
Cash and cash equivalents, beginning of year	**114,032**	54,563	44,067
Cash and cash equivalents, end of year	**$ 98,713**	$ 114,032	$ 54,563
Cash paid during the year for:			
Income taxes	**$ 105,233**	$ 68,420	$ 67,263

Management's Discussion and Analysis

Net cash provided by operating activities was $100.3 million in fiscal 2007, compared to $152.5 million in fiscal 2006 and $125.1 million in fiscal 2005.

Capital investment for fiscal 2007 of $65.0 million included $9.8 million for building costs of which $3.4 was for the purchase of an engineering building, $21.4 million for engineering computer and computer related software and equipment, $5.5 million for manufacturing and related equipment and $19.0 million for expanding global sales operations. During fiscal 2006, capital expenditures of $63.1 million included approximately $8.2 million for building costs related to expanding manufacturing and distribution capacities and enlarging worldwide sales operations, $12.5 million for manufacturing and manufacturing support equipment and $15.0 million for engineering computer and computer related equipment. Another $15.0 million was spent in support of expanded global sales activities. During fiscal 2005, capital expenditures of $39.4 million included $3.9 million on buildings, $10.1 million on engineering equipment, $7.8 million on manufacturing capacity expansions and $2.0 million to equip new sales offices.

Cash, cash equivalents and marketable securities increased during fiscal 2007 to $407.0 million, from $345.9 million in the prior fiscal year. State and local municipal bonds of approximately $264.2 million, maturing in approximately 1.5 years, were being held by the Company at February 29, 2007.

At February 29, 2007, the Company did not have any short or long term borrowing or any significant financial commitments outstanding, other than those required in the normal course of business.

In the opinion of management, internally generated funds from operations and existing cash, cash equivalents and marketable securities will be adequate to support the Company's working capital and capital expenditures requirements for both short and long term needs.

Required ➲

a. Which method did the company use in arriving at net cash flows from operating activities?

b. Did current assets other than cash increase or decrease during the year ended February 29, 2007?

c. Did current liabilities increase or decrease during the year ended February 29, 2007?

d. What were the main investing activities during this three-year period?

e. What was the main source of cash from financing activities during the three-year period?

f. Did the company pay any interest expense during the year ended February 19, 2007?

g. Given the following data, calculate the cash flow per share of common stock ratio, the cash flow margin ratio, and the cash flow liquidity ratio. How do these ratios compare with the ratios shown for other companies in the chapter?

	(in thousands)
Average number of shares of common stock outstanding	71,839
Net sales	$1,069,715
Cash and marketable securities	253,540
Current liabilities	164,352

Problem 11–5
Prepare working paper and statement of cash flows under the indirect method (Appendix) (L.O. 7)

The following comparative balance sheets and other data are for Dayton Tent & Awning Sales, Inc.:

DAYTON TENT & AWNING SALES, INC.
Comparative Balance Sheets
June 30, 2008 and 2007

	2008	2007
Assets		
Cash	$ 441,800	$ 332,600
Accounts receivable, net	750,750	432,900
Merchandise inventory	819,000	850,200
Prepaid insurance	3,900	5,850
Land	312,000	351,000
Buildings	2,184,000	1,209,000
Machinery and tools	858,000	468,000
Accumulated depreciation—machinery and tools	(809,250)	(510,900)
Total assets	$ 4,560,200	$ 3,138,650
Liabilities and Stockholders' Equity		
Accounts payable	$ 226,750	$ 275,500
Accrued liabilities payable	185,800	111,700
Bank loans (due in 2006)	56,550	66,300
Mortgage bonds payable	382,200	185,250
Common stock—$100 par	1,755,000	585,000
Paid-in capital in excess of par	58,500	—0—
Retained earnings	1,895,400	1,914,900
Total liabilities and stockholders' equity	$ 4,560,200	$ 3,138,650

Additional data

1. Net income for the year was $128,000.
2. Depreciation for the year was $356,850.
3. There was a gain of $7,800 on the sale of land. The land was sold for $46,800.
4. The additional mortgage bonds were issued at face value as partial payment for a building valued at $975,000. The amount of cash paid was $778,050.
5. Machinery and tools were purchased for $448,500 cash.
6. Fully depreciated machinery with a cost of $58,500 was scrapped and written off.
7. Additional common stock was issued at $105 per share. The total proceeds were $1,228,500.
8. Dividends declared and paid were $147,500.
9. A payment was made on the bank loan, $9,750.
10. The company paid interest of $9,000 and income taxes of $75,000.

Required

a. Prepare a working paper for a statement of cash flows.
b. Prepare a statement of cash flows under the indirect method. Also prepare any necessary supplemental schedule(s).

Alternate Problems

Problem 11–1A
Prepare working paper to convert income statement to cash basis; prepare cash flows from operating activities under both methods (L.O. 2, 3)

The following income statement and other data are for Kennesaw Auto Glass Specialists, Inc.:

KENNESAW AUTO GLASS SPECIALISTS, INC.
Income Statement
For the Year Ended December 31, 2007

Sales		$450,000
Cost of goods sold		125,000
Gross margin		$325,000
Operating expenses (other than depreciation)	$60,000	
Depreciation expense	20,000	80,000
Net income		$245,000

Changes in current assets (other than cash) and current liabilities during the year were:

	Increase	Decrease
Accounts receivable	$15,000	
Merchandise inventory		$25,000
Prepaid insurance	8,000	
Accounts payable		15,000
Accrued liabilities payable	4,000	

Depreciation was the only noncash item affecting net income.

Required

a. Prepare a working paper to calculate cash flows from operating activities under the *direct method.*

b. Prepare the cash flows from operating activities section of the statement of cash flows under the *direct method.*

c. Prove that the same cash flows amount is obtained under the indirect method by preparing the cash flows from operating activities section of the statement of cash flows under the *indirect method.* You need not prepare a working paper.

Problem 11–2A
Prepare statement of cash flows under the indirect method (L.O. 4)

The following information relates to Dunwoody Nursery & Garden Center, Inc. The company leases a building adjacent to its land.

DUNWOODY NURSERY & GARDEN CENTER, INC.
Comparative Balance Sheets
December 31, 2008 and 2007

	2008	2007
Assets		
Cash	$ 44,500	$ 52,000
Accounts receivable, net	59,000	60,000
Merchandise inventory	175,000	120,000
Equipment	412,500	315,000
Accumulated depreciation—equipment	(120,000)	(105,000)
Land	75,000	15,000
Total assets	$646,000	$457,000
Liabilities and Stockholders' Equity		
Accounts payable	$ 43,750	$40,750
Accrued liabilities payable	2,250	3,750
Capital stock—common—$10 par	375,000	300,000
Paid-in capital in excess of par	150,000	75,000
Retained earnings	75,000	37,500
Total liabilities and stockholders' equity	$646,000	$457,000

Additional data

1. Net income was $97,500 for the year.
2. Fully depreciated equipment costing $15,000 was sold for $3,750 (a gain of $3,750), and equipment costing $112,500 was purchased for cash.
3. Depreciation expense for the year was $30,000.
4. Land was purchased, $60,000.
5. An additional 7,500 shares of common stock were issued for cash at $20 per share (total proceeds, $150,000).
6. Cash dividends of $60,000 were declared and paid.

Required

The company paid interest of $6,000 and income taxes of $65,000. Prepare a statement of cash flows under the indirect method. Also prepare any necessary supplemental schedule(s).

Problem 11–3A
Analyze Dynatex, Inc.'s statement of cash flows (L.O. 5, 6)

Drexler, Inc., is an independent service organization that markets and services electronic credit card authorization and payment systems to small retail, wholesale, and professional businesses located throughout the United States. Prior to installing the company's electronic system, most of these businesses have used manual, paper-based systems to process credit card transactions or have not accepted credit cards at all. As the use of credit cards has significantly expanded, electronic processing has proven more convenient by accelerating customer purchases, lowering processing expenses, and reducing losses from fraudulent cards.

The company's account portfolio has grown through the purchase of account portfolios as well as through the internal development of accounts using telemarketing and field sales. With approximately 90,000 accounts at July 31, 2007, the company is one of the largest independent service organizations in the country.

The company's statements of cash flows for the years 2005–2007 follow. Then the relevant portion of Management's Discussion and Analysis of the statement of cash flows is provided.

Consolidated Statement of Cash Flows

	Year Ended July 31,		
	2005	**2006**	**2007**
Cash flows from operating activities:			
Net cash received from merchants	$ 19,657,687	$ 34,353,326	$ 67,313,124
Cash paid to vendors and employees	(14,758,040)	(28,467,472)	(49,128,150)
Interest received	22,262	310,136	1,672,714
Interest paid	(268,586)	(198,485)	(505,856)
Income taxes paid	(994,969)	(1,600,405)	(5,630,881)
Net cash provided by operating activities	$ 3,658,354	$ 4,397,100	$ 13,720,951
Cash flows from investing activities:			
Purchase of merchant portfolios	$ (8,415,055)	$(24,576,426)	$(31,787,725)
Purchase of property and equipment	(1,465,984)	(1,917,395)	(1,777,955)
Net cash used in investing activities	$ (9,881,039)	$(26,493,821)	$(33,565,680)
Cash flows from financing activities:			
Proceeds from issuance of long-term debt	$ 7,650,000	$ 16,450,000	$ 305,000
Payments on long-term debt	(1,163,170)	(12,828,503)	(16,545,500)
Proceeds from issuance of common stock	—	17,098,894	140,963,115
Payments to repurchase treasury stock	(45,000)	(32,500)	(12,000)
Proceeds from minority shareholder contribution	—	—	120,000
Net cash provided by financing activities	$ 6,441,830	$ 20,687,891	$124,830,615
Net increase (decrease) in cash and cash equivalents	$ 219,145	$ (1,408,830)	$104,985,886)
Cash and cash equivalents at beginning of year	1,664,830	1,883,975	475,145
Cash and cash equivalents at end of year	$ 1,883,975	$ 475,145	$105,461,031

Supplemental schedule of noncash activities:

In connection with the purchase of merchant portfolios in fiscal years 2005 and 2006, the Company issued promissory notes totaling $5,061,804 and $80,500, respectively.

The company recognized a tax benefit of $318,517 for the year ended July 31, 2007 for the excess of the fair market value at the exercise date over that at the award date for stock options exercised.

In connection with the purchase of merchant portfolio in March 2005, the Company issued 312,500 shares of common stock.

In connection with an agreement between the Company and a processing back entered into simultaneously with the purchase of a merchant portfolio in March 2005, the Company issued warrants to purchase 120,000 shares of common stock.

Reconciliation of net income to net cash provided by operating activities:			
Net income	$ 2,592,444	$3,640,155	$ 8,625,376
Martin Howe fiscal year conversion	—	—	(356,914)
Adjustments:			
Depreciation and amortization expense	1,648,023	3,517,852	7,509,630
Provision for merchant losses	484,993	483,245	654,705
Stock award compensation and other	239,659	241,477	120,395
Deferred income taxes	(453,658)	35,982	(761,705)
Changes in assets and liabilities:			
Accounts receivable	(1,562,961)	(1,459,799)	(2,125,510)
Inventory	(50,235)	(157,087)	(186,289)
Other assets	(1,716,464)	(1,895,097)	(501,353)
Accounts payable	1,557,611	44,106	587,784
Accrued liabilities	975,065	(223,411)	210,064
Deferred revenues	(56,123)	169,677	(55,232)
Net cash provided by operating activities	$ 3,658,354	$ 4,397,100	$ 13,720,951

Management's Discussion and Analysis

Capital Expenditures and Investing Activities

Capital expenditures were approximately $1.8 million for fiscal year 2007 as compared to $1.9 million for fiscal year 2006 and $1.5 million for fiscal year 2005. The increase in capital expenditures was primarily the result of additional expenditures related to the Company's management information system, the purchase of additional credit card terminals, the Company's relocation of its office facilities and the purchase of peripheral equipment for lease to merchants. In addition to the increase in capital expenditures, the Company used $8.4 million, $24.6 million and $31.8 million for the purchase of merchant portfolios in fiscal years 2005, 2006 and 2007, respectively. The Company purchased five merchant portfolios in fiscal 2005, nine merchant portfolios in fiscal year 2006 and five in fiscal year 2007.

Financing Activities

The significant increase in cash provided by financing activities for fiscal year 2006 resulted from the consummation of the Company's initial public offering in August 2005. Cash provided by financing activities for fiscal year 2006 was $20.7 million which reflects the net proceeds of the initial public offering after retirement of the Company's outstanding indebtedness. Additionally, the Company issued $15.3 million of long-term debt in connection with three of the nine merchant portfolios purchased in fiscal year 2006.

The cash provided by financing activities for fiscal 2007 reflects the Company's consummation of its second and third public offerings in October 2006 and April 2007, respectively. Net cash provided by financing activities was $124.8 million in fiscal 2007 which reflects the net proceeds from the offerings after retirement of the Company's outstanding bank indebtedness.

Future Capital Needs

Management believes that significant expenditures for the purchase of additional merchant portfolios may be required for the Company to sustain its growth in the future. Management expects to fund such purchases primarily through cash generated from operations and additional bank borrowings. Management believes the combination of these sources will be sufficient to meet the Company's anticipated liquidity needs and its growth plans through fiscal year 2008. The Company, however, may pursue additional expansion opportunities, including purchases of additional merchant portfolios, which may require additional capital, and the Company may incur, from time to time, additional short-term and long-term indebtedness or issue, in public or private transactions, equity or debt securities, the availability and terms of which will depend upon then prevailing market and other conditions.

The Company's revolving credit facility was amended and restated during fiscal year 2006 to increase the line of credit to $17.5 million. The Company repaid all outstanding debt related to this credit facility with the proceeds from its second public offering during fiscal year 2007. The amended agreement expires November 1, 2007 with all amounts then outstanding under the agreement due on November 1, 2007, unless the agreement is extended or the outstanding amounts have been converted to a term loan requiring equal monthly payments for 48 months.

Borrowings under the amended revolving credit facility are used to finance purchases of merchant portfolios and equipment and for working capital purposes. Borrowings are secured by substantially all the Company's assets and life insurance policies on the lives of two of the Company's executive officers.

Required ➲

a. Which method is the company using to determine net cash provided by operating activities?

b. Why does the company show the indirect method below the statement of cash flows?

c. What is the trend of net cash provided by operating activities over the three years?

d. How has the company increased its merchant portfolios?

e. What items of property and equipment were acquired during the three-year period?

f. What was the major source of the huge increase in cash and cash equivalents over the three-year period? How were the proceeds used?

g. How does the company expect to finance future expenditures to acquire additional merchant portfolios?

h. How are amounts secured that are borrowed under the line of credit?

i. Given the following data, calculate the cash flow per share of common stock ratio, the cash flow margin ratio, and the cash flow liquidity ratio. (Round the net cash provided from operating activities to the nearest thousand before you calculate the ratios.) How do the ratios compare with the ones for companies illustrated in the chapter?

	(in thousands)
Average number of shares of common stock outstanding	28,539
Net sales	$149,840
Cash and marketable securities	105,461
Current liabilities	6,862

Problem 11–4A
Analyze Gillette Company's 2000 statement of cash flows (L.O. 5, 6)

Founded in 1901, The Gillette Company is the world leader in male grooming products, a category that includes blades and razors, shaving preparations and electric shavers. Gillette also holds the number one position worldwide in selected female grooming products, such as wet shaving products and hair epilation devices. The Company is the world's top seller of writing instruments and correction products, toothbrushes and oral care appliances. In addition, the Company is the world leader in alkaline batteries.

Gillette manufacturing operations are conducted at 38 facilities in 19 countries, and products are distributed through wholesalers, retailers, and agents in over 200 countries and territories.

The company's statements of cash flows for the years 1998–2000 follow. Then the relevant portion of Management's Discussion and Analysis of the statement of cash flows is provided.

Consolidated Statement of Cash Flows (Millions of dollars)

Years Ended December 31, 2000, 1999, and 1998	2000	1999	1998
Operating Activities			
Income from continuing operations	$ 821	$ 1,248	$ 1,073
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision of restructuring and asset impairment	572	—	440
Depreciation and amortization	535	464	421
Other	5	(7)	(46)
Changes in assets and liabilities, excluding effects from acquisition and divestitures:			
Accounts receivable	(100)	(48)	(442)
Inventories	149	(140)	(62)
Accounts payable and accrued liabilities	(45)	65	72
Other working capital items	(136)	97	(104)
Other noncurrent assets and liabilities	(197)	(252)	(142)
Funding German pension plans	—	—	(252)
Net cash provided by operating activities	$ 1,604	$ 1,427	$ 958
Investing Activities			
Additions to property, plant and equipment	$ (793)	$ (889)	$ (952)
Disposals of property, plant and equipment	41	124	65
Acquisition of businesses, less cash acquired	—	—	(91)
Sale of businesses	539	—	200
Other	(1)	2	5
Net cash used in investing activities	$ (214)	$ (763)	$ (773)

Financing Activities			
Purchase of treasury stock	$ (944)	$(2,021)	$(1,066)
Proceeds from sale of put options	23	72	56
Proceeds from exercise of stock options and purchase plans	36	149	126
Proceeds from long-term debt	494	1,105	500
Repayment of long-term debt	(365)	—	(12)
Increase (decrease) in loans payable	(385)	484	708
Dividends paid	(671)	(626)	(552)
Settlements of debt-related derivative contracts	279	42	9
Net cash used in financing activities	$ 1,533)	$ (795)	$ (231)
Effect of Exchange Rate Changes on Cash	$ (5)	$ (2)	$ (2)
Net Cash Provided by Discontinued Operations	130	111	45
Decrease in Cash and Cash Equivalents	$ (18)	$ (22)	$ (3)
Cash and Cash Equivalents at Beginning of Year	80	102	105
Cash and Cash Equivalents at End of Year	$ 62	$ 80	$ 102
Supplemental disclosure of cash paid for:			
Interest	$ 243	$ 126	$ 120
Income taxes	$ 480	$ 457	$ 473
Noncash investing and financing activities:			
Acquisition of businesses			
Fair value of assets acquired	$ —	$ —	$ 100
Cash paid	—	—	91
Liabilities assumed	$ —	$ —	$ 9

Management's Discussion and Analysis*

Financial Condition

The Company's financial condition continued to be strong in 2000. Net debt (total debt net of associated swaps, less cash and cash equivalents) decreased $82 million during 2000, despite additional spending under the Company's share repurchase program, due to improved cash flow from operations, proceeds from the sale of the Stationery Products business and the favorable exchange impact on foreign currency debt. Net debt at December 31, 2000, amounted to $4.45 billion, compared with $4.53 billion and $3.18 billion at December 31, 1999 and 1998, respectively. The market value of Gillette equity was $38 billion at the end of 2000, compared with $43 billion at the end of 1999. The Company's book equity position amounted to $1.92 billion at the end of 2000, compared with $3.06 billion at the end of 1999 and $4.54 billion at the end of 1998. The decreases in book equity in 2000 and 1999 were due primarily to the Gillette share repurchase program, as well as to the effect of foreign currency translation.

Net cash provided by operating activities in 2000 was $1.60 billion, compared with $1.43 billion in 1999 and $.96 billion in 1998. The current ratio of the Company was .86 for 2000, compared with ratios of 1.39 for 1999 and 1.40 for 1998. The decrease in the 2000 current ratio was primarily attributable to the Company's reclassification of all commercial paper borrowings to short-term debt, due to the Company's credit facility agreements expiring within 2001. Capital spending in 2000 amounted to $793 million, compared with $889 million in 1999 and $952 million in 1998. Spending in all three years reflected substantial investments in the blade and razor, Duracell and Braun Products segments.

In 2000, the Company sold the Stationery Products business for $528 million. In 1998, the Company made acquisitions in the Duracell Products segment for $100 million and sold the Jafra business for $200 million.

Share repurchase funding in 2000, net of proceeds received from the sale of put options on Company stock, amounted to $921 million, compared with $1,949 million in 1999 and $1,010 million in 1998.

Strong cash inflows from operations, proceeds from the sale of the Stationery Products business and alternate financing sources enabled the Company to reduce its $2.0 billion revolving credit facility in 2000 to $1.4 billion, expiring October 2001, and its $1.1 billion credit facility, expiring December 2001, to $550 million in January 2001. Both facilities are used by the Company to complement its commercial paper program.

In order to increase flexibility in sourcing short-term borrowing, the Company launched a $1 billion Euro commercial paper program in 2000. At year-end 2000, there was $586 million outstanding under this program and $1.45 billion outstanding under the U.S. program, compared with $2.41 billion at the end of 1999 and $1.66 billion at the end of 1998.

During 2000, the Company issued Euro-denominated notes for $228 million, due December 2002, and entered into a $264 million Euro-denominated debt obligation, with redemption rights in December 2001. During 1999, the Company issued Euro-denominated notes for $343 million, due February 2004, and entered into a

$325 million Euro-denominated debt obligation, with redemption rights in March 2002, and a $437 million Euro-denominated debt obligation, with redemption rights in January 2003. The net proceeds were used to refinance existing short-term debt associated with the Company's share repurchase program.

During 2000, both Standard & Poor's and Moody's maintained the Company's current credit ratings. Standard & Poor's rates the Company's long-term debt at AA, while Moody's rating is Aa3. The commercial paper rating is A1+ by Standard & Poor's and P1 by Moody's.

Gillette will continue to have capital available for growth through both internally generated funds and significant credit resources. The Company has substantial unused lines of credit and access to worldwide financial market sources for funds.

*Source: The Gillette Company's 2000 annual report, p. 22.

Required

a. Does the company use the direct or indirect method of calculating net cash provided by operating activities?
b. Determine whether each of the current assets (other than cash) and current liabilities increased or decreased during 2000.
c. How is the company expanding its asset base?
d. How much greater is the total market value of the company's outstanding shares of common stock than the book equity (stockholders; equity)?
e. What is the likelihood that the company will be able to pay at least the current level of dividends in the future?
f. Do you expect to see purchases of treasury stock increase or decrease in the future?
g. Given the following data, calculate the cash flow per share of common stock ratio, the cash flow margin ratio, and the cash flow liquidity ratio. (Round the net cash provided by operating activities to the nearest million before you calculate the ratios.) How do the ratios compare with the ones for companies illustrated in the chapter?

	(in millions)
Average number of shares of common stock outstanding	1,059
Net sales	9,295
Cash and marketable securities	62
Current liabilities	5,471

Problem 11–5A
Prepare working paper and statement of cash flows under the indirect method (Appendix) (L.O. 7)

The following information is from the accounting records of Wescott Office Supplies, Inc., for the fiscal years 2008 and 2007:

	2008	2007
Assets		
Cash	$ 66,250	$ 61,000
Accounts receivable, net	84,000	42,000
Merchandise inventory	42,000	48,250
Prepaid expenses	7,875	12,125
Land	94,500	78,750
Buildings	199,500	147,000
Accumulated depreciation—buildings	(31,500)	(26,250)
Equipment	257,250	210,000
Accumulated depreciation—equipment	(78,750)	(63,000)
Total assets	$641,125	$509,875
Liabilities and Stockholders' Equity		
Accounts payable	$ 73,500	$ 47,250
Accrued liabilities payable	50,500	55,750
Five-year note payable	52,500	—0—
Capital stock—$50 par	420,000	367,500
Retained earnings		39,375
Total liabilities and stockholders' equity	$641,125	$509,875

Additional data

1. Net income for year ended June 30, 2008, was $56,250.
2. Additional land was acquired for cash, $15,750.
3. No equipment or building retirements occurred during the year.
4. Equipment was purchased for cash, $47,250.
5. The five-year note for $52,500 was issued to pay for a building erected on land leased by the company.
6. Stock was issued at par for cash, $52,500.
7. Dividends declared and paid were $51,000.
8. The company paid interest of $10,000 and income taxes of $40,000.

Required

- **a.** Prepare a working paper for a statement of cash flows.
- **b.** Prepare a statement of cash flows under the indirect method. Also prepare any necessary supplemental schedule(s).

Beyond the Numbers—Critical Thinking

Business Decision Case 11–1
Prepare a statement of cash flows using the indirect method and answer president's questions
(L.O. 1, 2, 4)

National Sports, Inc., is a sports equipment sales company. During 2008, the company replaced $18,000 of its fully depreciated equipment with new equipment costing $23,000. Although a midyear dividend of $5,000 was paid, the company found it necessary to borrow $5,000 from its bank on a two-year note. Further borrowing may be needed since the Cash account is dangerously low at year-end.

Following are the income statement and "cash flow statement," as the company's accountant calls it, for 2008.

NATIONAL SPORTS, INC.
Income Statement
For the Year Ended December 31, 2008

Sales		$195,000
Cost of goods sold	$140,000	
Operating expense and taxes	49,700	189,700
Net income		$ 5,300

NATIONAL SPORTS, INC.
Cash Flow Statement
For the Year Ended December 31, 2008

Cash received:		
From operations:		
Net income		$ 5,300
Depreciation		5,000
Total cash from operations		$10,300
Note issued to back		5,000
Mortgage note issued		16,000
Total funds provided		$31,300
Cash paid:		
New equipment	$23,000	
Dividends	5,000	28,000
Increase in cash		$ 3,300

The company's president is very concerned about what he sees in these statements and how it relates to what he knows has actually happened. He turns to you for help. Specifically, he wants to know why the cash flow statement shows an increase in cash of $3,300 when he knows the cash balance decreased from $15,000 to $500 during the year. Also, why is depreciation shown as providing cash?

You believe you can answer the president's questions after receiving the following condensed balance sheet data:

NATIONAL SPORTS, INC.
Comparative Balance Sheets
December 31, 2008, and 2007

	December 31	
	2008	**2007**
Assets		
Current assets:		
Cash	$ 500	$ 15,000
Accounts receivable, net	17,800	13,200
Merchandise inventory	28,500	17,500
Prepaid expenses	700	300
Total current assets	$ 47,500	$ 46,000
Property, plant, and equipment:		
Equipment	$ 40,000	$ 35,000
Accumulated depreciation—equipment	(11,000)	(24,000)
Total property, plant, and equipment	$ 29,000	$ 11,000
Total assets	$ 76,500	$ 57,000
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 8,700	$ 10,000
Accrued liabilities payable	600	1,100
Total current liabilities	$ 9,300	$ 11,100
Long-term liabilities:		
Notes payable	5,000	—0—
Mortgage note payable	16,000	—0—
Total liabilities	$ 30,300	$ 11,100
Stockholders' equity:		
Common stock	$ 40,000	$ 40,000
Retained earnings	6,200	5,900
Total stockholders' equity	$ 46,200	$ 45,900
Total liabilities and stockholders' equity	$ 76,500	$ 57,000

Required

Prepare a correct statement of cash flows using the indirect method that shows why National Sports, Inc., is having such a difficult time keeping sufficient cash on hand. Also, answer the president's questions. The company paid interest of $400 and income taxes of $3,000.

Business Decision Case 11–2
Prepare a schedule showing cash flows from operating activities under the indirect method and decide whether certain goals can be met (L.O. 4)

Following are comparative balance sheets for Hardiplank Siding, Inc.:

HARDIPLANK SIDING, INC.
Comparative Balance Sheets
December 31, 2008, and 2007

	2008	**2007**
Assets		
Cash	$ 80,000	$ 57,500
Accounts receivable, net	60,000	45,000
Merchandise inventory	90,000	52,500
Land	67,500	60,000
Buildings	90,000	90,000
Accumulated depreciation—buildings	(30,000)	(27,000)
Equipment	285,000	225,000
Accumulated depreciation—equipment	(52,500)	(48,000)
Goodwill	120,000	150,000
Total assets	$710,000	$605,000
Liabilities and Stockholders' Equity		
Accounts payable	$ 95,000	$ 65,000
Accrued liabilities payable	30,000	22,500
Capital stock	315,000	300,000
Paid-in capital—stock dividends	75,000	67,500
Paid-in capital—land donations	15,000	—0—
Retained earnings	180,000	150,000
Total liabilities and stockholders' equity	$710,000	$605,000

An analysis of the Retained Earnings account for the year reveals the following:

Balance, January 1, 2008			$150,000
Add:	Net income for the year		107,500
			$257,500
Less:	Cash dividends	$55,000	
	Stock dividends	22,500	77,500
Balance, December 31, 2008			$180,000

Additional data

a. Equipment with a cost of $30,000 on which $27,000 of depreciation had been accumulated was sold during the year at a loss of $1,500. Included in net income is a gain on the sale of land of $9,000.

b. The president of the company has set two goals for 2009: (1) increase cash by $40,000 and (2) increase cash dividends by $35,000. The company's activities in 2009 are expected to be quite similar to those of 2008, and no new fixed assets will be acquired.

Required

Prepare a schedule showing cash flows from operating activities under the indirect method for 2008. Can the company meet its president's goals for 2009? Explain.

Annual Report Analysis 11–3
Decide whether The Limited can maintain its current dividend (real world problem) (L.O. 1)

Refer to the Annual Report Appendix. Evaluate the ease with which The Limited will be able to maintain its dividend payments in the future at 2000 amounts. (Hint: Compare current dividend amount with net cash provided by operating activities.)

Annual Report Analysis 11–4
Analyze a company's statement of cash flows and answer questions (L.O. 5)

Refer to "A Broader Perspective" on page 334 and answer the following questions:

a. Over the last three years from which major activities (operations, investing, financing) has Johnson & Johnson received net cash inflows and on which major activities have they spent the funds?

b. What relationship do you see between "Depreciation and amortization of property and intangibles" and "Additions of property, plant, and equipment"?

c. What were the two major sources of cash outflows to stockholders and which was larger?

d. By how much did the investments in marketable securities grow or shrink over the three-year period?

e. By how much did long-term debt grow or shrink over the three-year period?

f. If you were a stockholder, would you feel uncertain or confident that this company will be able to pay future dividends at the same rate as in the past?

g. For what reason or reasons might the company be buying back its own stock?

h. For the latest year, did the current assets (other than cash) and current liabilities go up or down?

i. From the information that is available, does it appear that the company is performing well or poorly?

Group Project 11–5
Write a paper on a specific topic

In groups of two or three students write a two-page, double-spaced paper on one of the following topics:

Which Is Better, the Direct or Indirect Method (of calculating net cash provided by operating activities)?

Analysis of the Johnson & Johnson Cash Flow Statement (shown in "A Broader Perspective" in this chapter)

Analysis of Cash Flow Statement for The Limited (shown in the Annual Report Appendix)

Your analysis should be convincing and have no spelling or grammatical errors. Your paper should be neat and the result of several drafts. The paper should have a cover page with the title and the authors' names. Use a word processing program if possible.

Group Project 11–6
Perform library project on aspects of *Statement of Financial Accounting Standards No. 95*

In a group of one or two other students, go to the library and locate *Statement of Financial Accounting Standards No. 95,* "Statement of Cash Flows," published by the Financial Accounting Standards Board. Write a report to your instructor answering the following questions:

1. Why did the Board settle on cash flows instead of working capital flows?
2. Why did the Board strongly recommend use of the direct method?
3. Why did some members of the Board dissent from the final statement?

Group Project 11–7
Perform library project on aspects of *Statement of Financial Accounting Standards No. 95*

In a group of one or two other students, go to the library and locate *Statement of Financial Accounting Standards No. 95,* "Statement of Cash Flows," published by the Financial Accounting Standards Board. Write a report to your instructor covering the following points:

1. Describe the controversy over how to treat interest and dividends received.
2. What is the Board's position on reporting cash flow per share? Why did they take that position?
3. What is the Board's position on noncash transactions? Why did they take that position?

Using the Internet—A View of the Real World

Internet Project 11–8
Analyze statement of cash flows

Visit the following website for the Eastman Kodak Company:

http://www.kodak.com

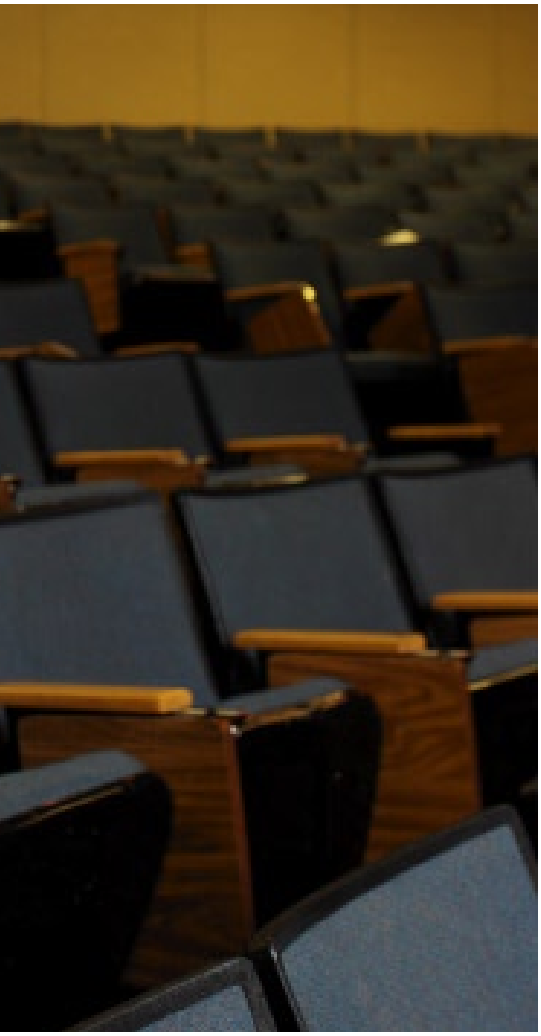
By following the instructions on the screen, locate the latest statement of cash flows and then print it. Analyze the statement and write a report to your instructor summarizing your analysis.

Internet Project 11–9
Analyze statement of cash flows

Visit the following website for Verizon:

http://www.verizon.com

By following the information on the screen, locate the latest statement of cash flows and then print it. Analyze the statement and then write a report to your instructor summarizing your analysis.



Answers to Self-Test

True-False

1. **True.** Before July 1988, the statement of changes in financial position was required. This statement emphasized changes in working capital rather than changes in cash.
2. **True.** The statement of cash flows must be published every time an income statement is published.
3. **False.** Investing activities are transactions involving the acquisition or disposal of noncurrent assets. Transactions with creditors and owners are financing activities.
4. **False.** While the direct method is the method encouraged by the FASB, it is not the predominant method in use. In a recent study, only about 3% of the companies surveyed used the direct method.
5. **True.** Both of these transactions are with owners and, therefore, would be financing activities.

Multiple-Choice

1. **c.** The descriptions in (*a*) and (*b*) would be correct if they were reversed. The indirect method is easier to use, and this characteristic is probably the main reason why it is used by most companies.
2. **a.** Payment of debt is a financing activity because it is a transaction with creditors. All of the others are investing activities because they are transactions involving the acquisition or disposal of noncurrent assets.
3. **b.** Sales of $500,000 minus the increase in accounts receivable of $30,000 = $470,000.
4. **d.** Cost of goods sold of $300,000, less the increase in accounts payable of $20,000, plus the increase in inventory of $50,000 = $330,000.
5. **a.** Net income of $200,000, plus depreciation of $10,000, less the increase in accounts receivable of $15,000, plus the increase in accounts payable of $5,000 = $200,000.