Statement of Cash Flows: Reporting and Analysis

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Course Description

A statement of cash flows is required as part of a full set of financial statements. It must be prepared in conformity with generally accepted accounting principles (GAAP). The statement is not required if the financial statements are prepared on a basis of accounting other than GAAP. The statement must be included in both annual and interim financial statements. This course discusses the requirements of ASC 230, *Statement of Cash Flows* (ASC 230-10-45-18 and 45-27). ASC 958-205, *Not-for-Profit Entities: Presentation of Financial Statements*, requires the statement of cash flows for not-for-profit entities.

Field of Study	Accounting
Level of Knowledge	Basic to Intermediate
Prerequisite	Basic Accounting
Advanced Preparation	None

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Statement of Cash Flows:

Reporting and Analysis

Learning Objectives:

After completing this section, you should be able to:

1. Recognize the use of and the objectives for a statement of cash flows.
2. Identify between operating, investing, and financing activities, and how different cash variables will affect the statement of cash flows.
3. Identify differences for preparation of the statement of cash flows using the direct method vs. the indirect method.
4. Understand and calculate how changes and transactions in asset and debt accounts affect the cash flows of a company.
5. Recognize some IFRS differences in reporting the statement of cash flows.

A statement of cash flows is required as part of a full set of financial statements. It must be prepared in conformity with GAAP. Its primary purpose is to provide information about cash receipts and payments by reporting the cash effects of an enterprise's operating, investing, and financing activities. The statement must be included in both annual and interim financial statements.

This course discusses the requirements of ASC 230, *Statement of Cash Flows* (ASC 230-10-45-18 and 45-27). ASC 958-205, *Not-for-Profit Entities: Presentation of Financial Statements*, requires the statement of cash flows for not-for-profit entities. A statement of cash flows is to be presented in general-purpose external financial statements by all business enterprises and not-for-profit organizations.

The statement presents the net effect of cash flows on the company's *cash.* It includes a reconciliation of beginning and ending cash. The total amount of cash at the beginning and end of year presented in the statement of cash flows should match the totals presented in the balance sheet. The statement presents cash flows from operating, investing, and financing activities. Separate disclosure must be made for noncash investing and financing transactions. Generally, these disclosures are presented in narrative form in a separate schedule appended at the bottom of the Statement of Cash Flows. They also may be disclosed in a note to the financial statements or in a supplementary schedule.

The statement of cash flows shows the sources and uses of cash, which is a basis for cash flow analysis for managers. The statement aids you in answering vital questions like "where was money obtained?" and "where was money put and for what purpose?" If sued with information in the other financial statements, the statement of cash flows should help users to assess the entity's ability to generate positive future net cash flows (liquidity), its ability t meet obligations (solvency) and pay dividends, the need for external financing, the reasons for differences between income and cash receipt sand payments, and the cash and noncash aspects of the investing and financing activities.

The statement of cash flows provides many benefits to the preparers and users of the statement, such as the following:

- Enables the assessment of the amounts, timing, and uncertainty surrounding future cash flows.
- Furnishes a reconciliation between net income and cash flow from operations.
- Provides the net effects of operating transactions on profit and cash flow.
- Indicates the impact on the company's financial status of its investing and financing transactions.
- Shows the company's ability to obtain financing.
- Provides important information about the entity's cash receipts and cash payments for the period.
- Shows the company's ability to generate recurring cash earnings.
- Evaluates the company's ability to pay debt when due.
- Allows for the evaluation of the company's ability to pay its expenses and conduct normal operations.
- Shows the entity's ability to pay dividends.
- Provides the reasons for the change in cash and cash equivalents for the period.

It is prohibited to present cash flow per share because doing so will give the false impression that such a statistic is as important as earnings per share. Reporting a per-share amount might improperly imply that cash flow is an alternative to net income as a performance measure. Further, the term *funds* should not be used, because it is ambiguous and easily misinterpreted.

Cash and Cash Equivalents

Cash consists of currency and coin on hand, as well as deposits not restricted by the bank, that is, checking and generally savings accounts. Although banks could restrict the withdrawal of savings account funds, they generally do not. Cash also includes negotiable items such as cashier's checks, personal checks, certified checks, and money orders. In addition, it includes other accounts having demand deposit characteristics and allowing for customer deposit or withdrawal at will without penalty, such as unrestricted certificates of deposit. However, cash does not consist of items such as postage stamps (office supplies), post-dated checks (receivables), restricted certificates of deposit (short-term investments), and travel advances (prepaid expenses), which are sometimes misclassified as cash. GAAP defines *cash equivalents* as short-term, highly liquid investments that are both readily convertible to known amounts of cash and so near their maturity that they present insignificant risk of changes in value because of changes in interest rates. Moreover, cash equivalents ordinarily include only investments with original maturities to the holder of 3 months or less.

Securities and Exchange Commission Regulation S-X, Rule 5-02(1), provides that amounts held in bank accounts that are unavailable for immediate withdrawal (e.g., compensating balances) should be considered as cash for the purposes of preparing the statement of cash flows. Any restrictions on withdrawal should be disclosed.

Reconciliation of Net Income to Cash Flow from Operations

A reconciliation of net income to cash flow from operations is required whether the direct method or indirect method is used. The reconciliation presents the various adjustments required to net income. Under the direct method, the operating section presents gross cash receipts and gross cash payments from operating activities, with a reconciliation of net income to cash flow from operations in a separate schedule accompanying the statement of cash flows. The cash flow from operations derived in this separate schedule must agree with the cash flow from operations in the operating section of the statement of cash flows.

Under the indirect method, gross cash receipts and gross cash payments from operating activities are not presented. Instead, only the reconciliation of net income to cash flow from operations may be presented either in the body of the operating section or in a separate schedule. If presented in a separate schedule, the net cash flow from operating activities is presented as a single line item in the operating section. The reconciling adjustments to derive cash flow from operations include adding back noncash expenses to and deducting noncash revenues from net income. Examples of these adjustments include adding back depreciation and depletion expense, adding back pension expense arising from a deferred pension liability, adding back bad debts, adding back accrued warranty expense, adding back tax expense arising from a deferred tax liability, adding back the loss on a fixed asset, adding back compensation expense arising from an employee stock option plan, deducting the amortization of deferred revenue, deducting the amortization of bond premium, subtracting tax expense arising from a deferred tax asset, subtracting the gain on the sale of a fixed asset, subtracting pension expense associated with a deferred pension asset, subtracting unrealized gains on trading securities, and subtracting income from investments under the equity method. **Note**: Treasury stock transactions involve cash flows that do not affect net income. However, the excess of acquisition cost over proceeds (assuming purchase and sale in the same period) should be subtracted from net income in the reconciliation.

Irrespective of whether the direct method or the indirect method is used, there must be separate disclosure of income taxes and interest paid during the year.

Exhibit 1 presents an illustrative reconciliation of net income to cash flow from operations. It shows the adjustment process for the various reconciling items.

Exhibit 1: Illustrative Reconciliation of Net Income to Cash Flow from Operations

Net income
Adjustments required to convert net income to the cash basis:
Add: noncash expenses (depreciation, depletion, amortization expense, loss on sale of fixed assets)
Less: noncash revenues (amortization of deferred revenue, amortization of bond premium, gain on sale of fixed assets)
Add (deduct) changes in current assets
    Add: decrease in current asset accounts
    Less: increase in current asset accounts
Add (deduct) changes in current liabilities
    Add: increase in current liability accounts
    Less: decrease in current liability accounts
Cash provided by operations

Note: A decrease in a current asset account results in an increase in cash flow. An example is a collection on accounts receivable. An increase in a current asset account results in a cash payment, such as the purchase of inventory. An increase in a current liability results in a cash receipt, such as the receipt of a short-term advance. A decrease in a current liability account results in a cash payment, such as a payment on an account payable.

EXAMPLE

XYZ Company reports net income of $50,000, depreciation expense of $4,000, amortization of patents of $500, amortization of deferred revenue of $3,000, loss of the sale of a fixed asset of $2,000, a decrease in accounts receivable of $8,000, a decrease in prepaid expenses of $1,000, a decrease in accounts payable of $6,000, and an increase in accrued liabilities of $4,000. Based on this information, a reconciliation of net income to cash flow from operations is prepared:

Reconciliation	
Net income	$50,000
Add: noncash expenses	
Depreciation expense	4,000
Amortization expense	500
Loss on sale of fixed asset	2,000
Less: noncash revenue	
Amortization of deferred revenue	(3,000)
Decrease in accounts receivable	8,000
Decrease in prepaid expenses	1,000
Decrease in accounts payable	(6,000)
Increase in accrued liabilities	4,000
Cash provided by operations	$60,500

The topic of reconciliation is discussed more fully in the following sections on the direct and indirect methods.

Review Questions

1. A financial statement includes all of the following items: operating activities, financial activities and investing activities. What financial statement is this?

   A. Statement of cash flows.

   B. Balance sheet.

   C. Income statement.

   D. Statement of retained earnings.

2. A corporation issues a balance sheet and income statement for the current year and comparative income statements for each of the 2 previous years. Under GAAP, a statement of cash flows

   A. Should be issued for the current year only.

   B. Should be issued for the current and the previous year only.

   C. Should be issued for all 3 years.

   D. May be issued at the company's option for any or all of the 3 years.

3. Which of the following should be reported in a statement of cash flows issued by Grady Company?

   A. Basic cash flows per share only.

   B. Diluted cash flows per share only.

   C. Both basic diluted cash flows per share.

   D. Cash flows per share should not be reported.

4. A statement of cash flows is intended to help users of financial statements

A. Evaluation a firm’s liquidity, solvency, and financial flexibility.

B. Evaluate a firm’s economic resources and obligations.

C. Determine a firm’s components of income from operations.

D. Determine whether insiders have sold or purchased the firm’s stock.

5. A financial statement includes all of the following items: net income, depreciation, operating activities, and financial activities. What financial statement is this?

A. Balance sheet.

B. Income statement.

C. Statement of cash flows.

D. Statement of shareholders’ equity.

Direct Method

The *direct method* is preferred by ASC 230-10-45-25, *Statement of Cash Flows: Overall*. Under this method, companies present cash flows from operating activities by major categories of gross receipts and gross payments and the resulting net amount. A company using the direct method should report separately operating cash receipts and operating cash payments. These cash flows from operations are discussed in the section of this course titled "Operating Activities."

Note: The only difference between the direct method and the indirect method is the presentation in the *operating activities* section of the statement of cash flows. The investing and financing sections are identical under both methods and are disclosed using the "direct method" presentation.

The direct method enables the user to comprehend better the relationship between the company's profit and its cash earnings. To this end, the FASB requires that an entity prepare, in addition to the direct method presentation of cash flows from operating activities, **a reconciliation of net income to net cash flows from operating activities.** This reconciliation is identical in form and content to the presentation of cash flows from operating activities using the indirect method (see indirect approach). It should be disclosed either in a separate schedule or at the bottom of the cash flows statement.

The direct method shows that the amount of net cash received or used in operating activities during the year equals the difference between the total amount of gross cash receipts and total gross cash payments applying to operating activities.

It is helpful to show how to convert income statement amounts for the direct method presentation from the accrual basis to cash basis. Three typical conversion formulas are:

1. Net sales + beginning accounts receivable - ending accounts receivable write-offs of accounts receivable = cash received from customers.

2. Cost of sales + ending inventory + beginning accounts payable - beginning inventory - ending accounts payable = cash paid to suppliers.

3. Operating expenses + ending prepaid expenses + beginning accrued expenses - beginning prepaid expenses - depreciation and amortization - ending accrued expenses payable - bad debt expense = cash paid for operating expenses.

EXAMPLE

A company's cost of sales for the year 2X12 was $300,000. During the year, the inventory increased by $60,000 and accounts payable to suppliers decreased by $50,000. The amount paid to suppliers to be reported in the statement of cash flows under the direct method is $410,000, computed as follows:

Cost of sales	$300,000
Add: increase in inventory	60,000
Add: decrease in accounts payable	50,000
Cash paid to suppliers	$410,000

Indirect (Reconciliation) Method

Although the direct method is preferred, the *indirect method* is used much more frequently by companies in financial reporting. In the indirect method, a company computes net cash flow from operating activities *indirectly* by adjusting an entity's net income or net loss to derive net cash flow from operations. Essentially, the presentation of net cash flow from operations is nothing more than a reconciliation of the entity's accrual income to net cash provided by operating activities. As previously noted, this reconciliation is also a required disclosure if a company chooses to use the direct approach. The indirect method emphasizes changes in most current asset and current liability accounts as they apply to operating activities. This was discussed in the reconciliation section of this course. **Caution:** Changes in current assets and current liabilities relating to investing or financing activities (e.g., short-term loans or short-term notes payable not involving sales of goods or services) should be presented as investing or financing activities, as applicable.

A reconciliation of ending retained earnings to net cash flow from operations is not disclosed on the statement of cash flows, regardless of whether a direct or an indirect presentation is made. A reconciliation of net income to net cash flow from operations is reported in a separate schedule if the direct method is used. This reconciliation may be reported within the statement or provided in a separate schedule if the indirect method is used.

The amounts paid for interest and income taxes must be disclosed either on the face of the statement of cash flows or in the notes. If explained in the footnotes, they may appear in the relevant footnote on long-term debt or income taxes or may be discussed in a separate footnote dealing with supplemental cash flow disclosures.

A disadvantage of the indirect method is possible user confusion as to where the cash was received or paid to. The indirect method shows only adjustments to accrual basis net income to cash flow from operations in the operating activities section.

An illustrative format of the statement of cash flows under the indirect method is presented in Exhibit 2.

Exhibit 2: Illustrative Indirect Method Presentation

Operating activities:
- Net income
- Adjustments
- Cash flow provided from operating activities

Investing activities:
- Cash received from investing activities
- Cash paid for investing activities
- Net cash flow provided (used) by investing activities

Financing activities:
- Cash received from financing activities
- Cash paid for financing activities
- Net cash flow provided (used) by financing activities

Net increase (decrease) in cash

Schedule of noncash investing and financing activities

EXAMPLE

Levine Company used the following data in the preparation of its 2005 statement of cash flows:

	December 31	*January 1*
Accounts receivable, net	$14,000	$11,100
Prepaid rent expense	4,100	6,200
Accounts payable	11,200	9,700

Levine's 2x12 net income is $75,000. In ascertaining the amount that Levine should include as net cash provided by operating activities in the statement of cash flows, the following rule should be adhered to when the indirect method is used: In converting net income to net cash flow from operating activities, the following additions and subtractions must be made: net income + decreases in current assets accounts (other than cash) - increases in current assets accounts (other than cash) + increases in current liability accounts - decreases in current liability accounts + noncash expenses (e.g., depreciation, bond discount amortization) - noncash revenues (e.g., gain on sale of plant assets, bond premium amortization).

COMPUTATION

Net income	$75,000
Add (subtract)	
Increase in net accounts receivable	

$14,000 - $11,100	(2,900)
Decrease in prepaid rent expense:	
$6,200 - $4,100	2,100
Increase in accounts payable:	
$11,200 - $9,700	1,500
Net cash provided by operating activities, 2x12	$75,700

Gross versus Net Cash Flows

In the investing and financing sections of the statement, gross cash inflows should be shown separately from gross cash outflows for similar items. Moreover, cash inflows and outflows ordinarily are not netted. They should be reported separately at *gross amounts*. (**Note:** There are a few exceptions in which netting is permitted, such as when the items involve fast turnover, are significant in amount, and have short maturities, such as transactions involving long-term investments, loans, and debts having a maturity of three months or less.) For example, in the investing section, the acquisition of a fixed asset would be a use of cash (say, $100,000), whereas the sale of a fixed asset (say, $60,000) would be a source of cash. Separate presentation of both the cash inflow and cash outflow aids reader comprehension and realism of the financial statements. The netting of the two (net cash outflow of $40,000) distorts what is really happening. In the financing section, the issuance of long-term debt (say, $80,000) would be a source of cash, but paying back the debt principal (say, $50,000) would be an application of cash. Both the cash inflows and cash outflows must be presented separately. A company is not allowed to present the net effect as a net source of cash of $30,000.

EXAMPLE

Carol Company reported net income of $150,000 for 2x12. The following changes occurred in several of the company's balance sheet accounts:

Equipment	$12,500 increase
Accumulated depreciation	$20,000 increase
Note payable	$15,000 increase

In addition, three pertinent activities took place:

1. Depreciation expense for the year was $26,000.

2. In December 2x12, Carol purchased equipment costing $25,000, with $10,000 down and the issuance of a 12% note payable of $15,000.

3. During 2x12, Carol sold equipment costing $12,500, with accumulated depreciation of $6,000 for a gain of $2,500.

What is the net cash used in investing activities that should be reported by Carol?

In general, the cash flows from investing activities of an enterprise include transactions involving long-term assets and include the acquisition and disposal of investments and long-lived assets and the extension and collection of loans. There- fore, in Carol Company's 2x12 statement of cash flows, the net cash used in investing activities should be computed in the following way:

Sale of equipment (cash inflow)	
($12,500 - $6,000 + $2,500)	$9,000
Acquisition of equipment (cash outflow)	(10,000)
Net cash used in investing activities, 2x12	$(1,000)

In Carol's 2x12 statement of cash flows, net cash flow provided by operating activities would be computed as follows:

Net income	$150,000
Add (subtract):	
Depreciation expense	26,000
Gain on sale of equipment	(2,500)
Net cash provided by operating activities	$173,500

EXAMPLE

During 2x12, Dran Inc. had the following transactions related to its financial operations:

☐ Proceeds from the sale of stock of treasury stock (carrying amount at cost, $21,500)	$25,000
☐ Carrying amount of convertible preferred stock in Dran Inc., converted in common shares	30,000
☐ Distribution in 2x12 of cash dividend declared in 2004 to preferred stockholders	15,500
☐ Payment for the early retirement of long-term bonds payable (carrying amount $185,000)	187,500

What is the net cash flow used in Dran's financing operations?

In general, the financing activities of an entity relate to liability and stockholder equity items and include obtaining cash from creditors and repaying these amounts and obtaining capital from owners and providing them in return with dividends as well returning their investments (reacquisition of capital stock).

In Dran's statement of cash flows for 2x12, therefore, the net cash flow used in its financing operations should be computed as follows:

Proceeds from the sale of treasury stock (cash inflow)	$25,000
Cash dividend distributed in 2x12 (cash outflow)	(15,500)
Payment for the early retirement of bonds payable	(187,500)
Net cash used in financing activities, 2x12	$(178,000)

Operating Activities

Operating activities apply to producing or selling merchandise or performing services. Under the direct method, items applying to the income statement are presented in the operating activities section.

Cash inflows from operating activities include:

- Cash receipts from sales or servicing, such as from customers, licensees, and lessees.
- Interest and dividend receipts.
- Proceeds received from an insurance policy.
- Refunds from suppliers.
- Sale of trading securities.
- Award received from a lawsuit.
- Other operating receipts.

Cash outflows from operating activities include:

- Cash paid to buy materials and merchandise purchases.
- Cash paid for services.
- Payment of general and administrative expenses.

- Employee salary payments.
- Payments to suppliers.
- Insurance payments.
- Advertising and promotion payments.
- Payment for lawsuit damages.
- Cash refunds such as to customers for inferior goods.
- Interest payments.
- Income tax payments.
- Cash purchase of trading securities.
- Payment of duties, fines, and penalties.
- Charitable contribution payments.
- Other operating cash payments.
- Amortization of acquisition date fair value adjustments under either the purchase or acquisition methods.

There may be further breakdowns of operating cash receipts and cash payments to improve financial reporting. For example, a producer may divide cash paid to vendors into payments to buy merchandise and payments for selling expenses.

ASC 230-10-45-17, provides that a cash payment to pay off an asset retirement obligation should be presented under operating activities.

Exhibit 3 illustrates the presentation of cash flows from operating activities using the direct method.

As stated before, with the direct method, the reconciliation of earnings to cash flow from operations is presented in a separate schedule.

Exhibit 3: Cash Flows from an Operating Activities Section Under the Direct Method

Cash inflows:	
Cash received from customers	$600,000
Dividend and interest receipts	100,000

Award received from a lawsuit	200,000	
Cash inflows from operating activities		$900,000
Cash outlays:		
Cash paid to vendors	$300,000	
Cash paid to employees	50,000	
Interest paid	20,000	
Income taxes paid	80,000	
Payment of insurance	30,000	
Advertising outlays	70,000	
Purchase of trading securities	150,000	
Cash outlays from operating activities		700,000
Net cash flow from operations		$200,000

Under the indirect method, as previously noted, the operating section presents only the reconciliation of net income to cash flow from operations based on adjustments for noncash revenue and noncash expense items as well as changes in current asset and current liability accounts affecting operating activities.

Investing Activities

Investing activities include making and collecting loans; purchasing and selling property, plant, and equipment; and buying or selling available-for-sale or held-to-maturity securities in other companies. **Note:** Trading securities are considered operating activities.

Cash inflows from investing activities include:

- Proceeds received from selling fixed assets.
- Selling available-for-sale or held-to-maturity securities in other companies.
- Collecting on loans made to debtors, principal portion.
- Insurance proceeds from property, plant and equipment damaged or destroyed.

Cash outlays for investing activities include:

- Acquiring fixed assets.
- Buying available-for-sale or held-to-maturity securities of other companies.
- Granting loans to borrowers.

- Cash purchases of businesses in a business combination.

Note: Cash flows for investing activities should include only advance payments, the down payment, or other payments at the date when fixed assets are bought, or shortly before or after. If there are principal payments on an installment loan at later dates, such payments are included in financing activities. Any noncash element of a transaction to buy a fixed asset, such as through debt incurrence, is disclosed in a supplementary schedule titled "Noncash Investment and Financing Activities." (Exhibit 4)

Exhibit 4:

Chiron

2003 Annual Report

Note 3-Supplemental Cash Flow Information

	2003	*2002*	*2001*
	(In thousands)		
Interest paid	$2,310	$876	$749
Income taxes paid	$70,240	$132,124	$134,827
Noncash investing and financing activities:			
Acquisitions:			
Cash acquired	$92,178	$18,208	-
Fair value of all other assets acquired	1,074,668	53,682	-
Liabilities assumed	(141,110)	(4,980)	-
Reduction of income taxes payable	-	1,739	-
Income taxes payable	(17,741)	-	-
Net deferred tax asset (liability)	(60,170)	8,425	-
Carrying value of original investment	-	(310)	-
Acquisition costs not yet paid as of December 31, 2003 and 2002	(40,930)	(707)	-
Total cash paid	$906,895	$76,057	$ -
Capital Lease:	$157,500	$ -	$ -
Exercise of common stock warrant	$ -	$ -	$18,513

Tip: If a company is bought or sold under the purchase method to account for a business combination, any cash paid or received is considered an investing activity. ASC 230 requires that a purchase of net assets be presented as one net outflow in the investing activities section. This type of transaction typically occurs when a company purchases the assets of another company. The fair market value of any assets acquired or liabilities incurred in such a transaction would be presented in the schedule of noncash investing and financing activities.

Financing Activities

Financing activities include issuing or repurchasing a company's own stock (common stock or preferred stock), paying cash dividends to stockholders, and issuing or paying back short-term or long-term debt.

Cash inflows from financing activities include:

- Funds received from issuing the company's own short-term or long-term debt (e.g., bonds payable, notes payable, or mortgage payable).
- Funds received from selling the company's own equity securities. (**Note:** This also includes the subsequent reissuance of treasury stock.)

Cash outflows for financing activities include:

- Purchase of treasury stock.
- Cash dividend payments. (**Note:** Dividends declared but unpaid and stock dividends are noncash transactions and are presented in a supplementary schedule titled "Noncash Investing and Financing Activities.")
- Retiring or paying off the principal on short-term or long-term debt. (This includes payments of principal on capital lease obligations.)
- Other principal payments to long-term creditors.
- Payment of debt issue costs.
- Subsidiary dividends paid to noncontrolling interest shareholders.

Caution: Gains or losses from the early extinguishment of debt are part of the cash flow related to the repayment of the amount borrowed as a financing activity. Such gains or losses are not an element of net cash flow from operating activities.

Multiclassification

If a cash receipt or cash payment relates to more than one classification (e.g., operating, investing, and financing), classification is based on the major activity involving the cash flow. For example, the acquisition and sale of machinery is usually deemed an investing outlay. Further, the purchase and sale of equipment used by the business or rented out typically is considered an investing activity. However, if the business intends to use or rent the equipment for a short time period and then sell it, this would be considered an operating activity.

Noncash Investing and Financing Activities

These noncash transactions are not to be incorporated in the statement of cash flows. They may be summarized in a separate schedule at the bottom of the statement or appear in a separate supplementary schedule to the financials. In addition, though a transaction having cash and noncash components should be discussed, only the cash aspect should be presented in the statement of cash flows. In other words, if a transaction is part cash and part noncash, the cash part is reported in the cash flow statement while the noncash portion is disclosed in narrative form or in a schedule of noncash activities. Examples of noncash investing and financing activities are buying property in exchange for a mortgage payable and/or common stock, purchasing an intangible asset with the issuance of preferred stock, converting long-term debt into common stock, converting preferred stock to common stock, converting long term notes receivable to held-to-maturity securities, conducting nonmonetary exchange of assets, and acquiring an asset though a capital lease. These should not be included in the statement of cash flows. The following are also noncash investing and financing activities: stock issue costs not paid in cash, third-party financing, stock dividends, and property dividends. An illustrative presentation follows:

NONCASH INVESTING AND FINANCING ACTIVITIES:	
Purchase of land by issuing a mortgage payable	\$100,000
Conversion of a bond payable to common stock	\$400,000

Special Items in the Income Statement

Extraordinary items, cumulative effect of a change in principle, and income from discontinued operations do not have to be broken out separately in the statement of cash flows. These items may be classified under operating, investing, or financing activities as appropriate. For example, an extraordinary loss due to a lawsuit would be presented under operating activities. An extraordinary gain on the early extinguishment of debt would be shown under financing activities. An extraordinary loss on equipment due to a fire would be presented as an investing activity.

Agency Arrangements

Some changes in certain current assets and liabilities do not affect net income or cash earnings. An example is a company that collects sales taxes from customers that it must remit to the government. This type of agency transaction is an operating activity and results in cash inflow and then cash outflow. Although the company does not receive any benefit for tax collection and remittance, it must still present the transaction in the operating section of the statement of cash flows.

Hedging Transactions

Cash inflow and outflow may relate to futures contracts, swap agreements, or option contracts designed to hedge specific transactions, such as the purchase or sale of goods. The cash flow arising from the hedge transaction should be classified in the same manner as the cash flow associated with the hedge item (e.g., inventory). Disclosure should be made of the company's accounting treatment for hedged events and transactions.

Foreign Currency Cash Flows

A company may have foreign operations and foreign currency translations. For accounting purposes in treating foreign currency cash flows, the exchange rate at the time of the cash flow should be used in reporting the currency equivalent. Alternatively, the weighted-average exchange rate may be used if there is an immaterial difference relative to using the actual currency exchange rate. The weighted-average exchange rate may be suitable for revenues and expenses. The effect of changes in the exchange rate on cash balances held in foreign currencies is presented as a separate item when reconciling the change in cash and cash equivalents for the year. Further, noncash exchange gains and losses presented in the income statement should be shown as a separate item when reconciling net income to cash flow from operations. Footnote disclosure should be made of the exchange rate to convert cash flows.

Review Questions

6. Which of the following should not be disclosed in an enterprise's statement of cash flows prepared using the indirect method?

A. Interest paid, net of amounts capitalized.

B. Income taxes paid.

C. Cash flow per share.

D. Dividends paid on preferred stock.

7. The primary purpose of a statement of cash flows is to provide relevant information about

A. Differences between net income and associated cash receipts and disbursements.

B. An enterprise's ability to generate future positive net cash flows.

C. The cash receipts and cash disbursements of an enterprise during a period.

D. An enterprise's ability to meet cash operating needs.

8. In a statement of cash flows, which of the following would increase reported cash flows from operating activities using the direct method? (Ignore income tax considerations.)

A. Dividends received from investments.

B. Gain on sale of equipment.

C. Gain on early retirement of bonds.

D. Change from straight-line to accelerated depreciation.

9. The following information is available from Sand Corp.'s accounting records for the year ended December 31, 2005: Cash received from customers = $870,000; Rent received = $10,000; Cash paid to

suppliers and employees = $510,000; Taxes paid =$110,000; Cash dividends paid= $30,000. Net cash flow provided by operations for 2005 was

A. $220,000

B. $230,000

C. $250,000

D. $260,000

10. In a statement of cash flows, interest payments to lenders and other creditors should be classified as cash outflows for

A. Operating activities.

B. Borrowing activities.

C. Lending activities.

D. Financing activities.

11. Fara Co. reported bonds payable of $47,000 at December 31, Year 1, and $50,000 at December 31, Year 2. During Year 2, Fara issued $20,000 of bonds payable in exchange for equipment. There was no amortization of bond premium or discount during the year. What amount should Fara report in its Year 2 statement of cash flows for redemption of bonds payable?

A. $3,000

B. $17,000

C. $20,000

D. $23,000

12. During 2X12, Beck Co. purchased equipment for cash of $47,000, and sold equipment with a $10,000 carrying value for a gain of $5,000. How should these transactions be reported in Beck's 2X12 statement of cash flows?

A. Cash outflow of $32,000.

B. Cash outflow of $42,000.

C. Cash inflow of $5,000 and cash outflow of $47,000.

D. Cash inflow of $15,000 and cash outflow of $47,000.

Comprehensive Examples

The Cash Flow Statement Using the Direct Method

Cherry Inc.
Balance Sheets
December 31

	2X12	*2X11*
ASSETS		
Current Assets		
Cash	$16,225	$28,125
Accounts receivable	56,400	60,800
Notes receivable—Lou Company	13,900	5,700
Interest receivable	725	400
Inventory	74,750	91,650
Total current assets	$162,000	$186,675
Property and Equipment		
Land	30,000	30,000
Building	160,000	160,000
Machinery	27,500	20,000
Fixtures	9,250	9,250
Autos	5,500	11,750
	$232,250	$231,000
Accumulated depreciation	97,975	92,500
	$134,325	$138,500
Other Assets		
Cash surrender value of insurance policy	11,475	9,675
Deferred costs	675	1,350
	12,150	11,025
TOTAL ASSETS	$308,475	$336,200
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities		
Notes payable	$20,000	$25,000
Current portion of serial bonds	36,000	33,750
Accounts payable	85,425	89,700
Accrued liabilities		
Wages	5,500	4,075
Interest	925	700
Payroll taxes	650	475

Income taxes	2,175	1125
Total current liabilities	$150,675	$154,825
Serial long-term debt, less current portion	90,250	121,250
TOTAL LIABILITIES	240,925	276,075
Stockholders' Equity		
Common Stock	10,000	10,000
Retained Earnings	57,550	50,125
TOTAL STOCKHOLDERS' EQUITY	$67,550	$60,125
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$308,475	$336,200

Cherry Inc. Statement of Income Year Ended December 31, 2X12

REVENUES	
Sales	$368,600
Gain on sale of auto	125
Interest income	1200
	$369,925
COST OF SALES	
Raw materials	157,600
Labor	16,450
Transportation-in	8,350
	$182,400
GROSS PROFIT	$187,525
SELLING AND ADMINISTRATIVE EXPENSES	
Administrator's salaries	44,800
Sales employees salaries	24,200
Office salaries	25,800
Payroll taxes	9,325
Rent expense	12,925
Office expenses	5,400
Life insurance of administrators	2,100
Fees to outside professionals	2,950
Telephone expenses	2,350
Utilities expenses	4,675
Maintenance expense	3,350
Insurance expense	7,150
Uncollectible accounts expense	10,000
Amortization expense	675
Depreciation expense	9,425
Miscellaneous taxes	1,600
Interest expense	7,325

	$174,050
Income before income taxes	$13,475
Income taxes	4,050
NET INCOME	$9,425
RETAINED EARNINGS—BEGINNING OF THE YEAR	50,125
DIVIDENDS PAID	(2,000)
RETAINED EARNINGS—END OF THE YEAR	$57,550

Additional Data for Cherry Inc.

- Lou Company repaid $1,800 of its $5,700 receivable during the year. At December 31, 2X12, the Lou Company borrowed an additional $10,000.
- Cherry Company purchased machinery in exchange for a $2,500 down payment and a $5,000 note. The first payment on the machinery note is due in 2X13.
- An auto with an original cost of $6,250 and accumulated depreciation of $4,000 was sold for $2,375.
- The notes payable indicated in the current liabilities section have original maturities of less than three months.

Statement of Cash Flows—Direct Method

CASH FLOWS FROM OPERATING ACTIVITIES		
Collections from customers	$363,000	(1)
Interest received	875	(2)
Cash paid to suppliers and employees	(316,600)	(3)
Interest paid	(7,100)	(4)
Income taxes paid	(3,000)	(5)
Net cash provided by operating activities	$37,175	
NET FLOWS FROM INVESTING ACTIVITIES		
Purchase of machinery	(2,500)	
Proceeds from sale of auto	2,375	
Loans made to Lou Company	(10,000)	
Collections of loans	1,800	
Net cash used by investing activities	(8,325)	
CASH FLOWS FROM FINANCING ACTIVITIES		
Short-term payment of debt	(5,000)	
Long-term payment of debt	(33,750)	
Dividends paid	(2,000)	
Net cash used by financing activities	(40,750)	
Net decrease in cash	(11,900)	

Cash at the beginning of year	28,125
Cash at end of year	$16,225

Supplemental Disclosures

Noncash investing and financing activities	
Purchase of $7,500 of machinery paid for in part with a $5,000 note	$5,000

Analysis of Captions in the Statement of Cash Flows—Direct Method

(1) Collections from customers Sales from the income statement	$368,600
Increase in accounts receivable	(5,600)
Total	$363,000
(2) Interest received	
Interest income	$1,200
Increase in interest receivable	(325)
Total	$875
(3) Cash paid to suppliers and employees	
Cost of sales	$182,400
Selling and administrative cost	174,050
Deduct for interest—separately disclosed	(7,325)
Deduct noncash expenditures	
Depreciation	(9,425)
Amortization	(675)
Increase in cash surrender value of insurance policy	1800
Uncollectible accounts expense	(10,000)
Decrease in inventory	(16,900)
Decrease in payables	4,275
Increase in compensation and payroll taxes	(1,600)
Total	$316,600
(4) Interest paid	
Interest expense on income statement	$7,325
Increase in interest payable	(225)
Total	$7,100
(5) Income taxes paid	
Income taxes per income statement	$4,050
Increase in income taxes payable	(1,050)
Total	$3,000

ASC 230-10-45-17 requires that if an enterprise uses the direct method to present cash flow from operating activities, it also must provide in a separate schedule the reconciliation of net income to net cash flow provided by operating activities. This reconciliation represents the identical form and content of the indirect method. The reconciliation shown next should be presented at the bottom of the statement of cash flows when the direct method is used or in a separate schedule.

Reconciliation

Net income	$9,425
Adjustment to reconcile net income to net cash provided by operating activities	
Depreciation	9,425
Amortization	675
Gain on sale of auto	(125)
Cash surrender value of insurance	(1,800)
Uncollectible accounts expense	10,000
Increase in accounts receivable	(5,600)
Increase in interest receivable	(325)
Decrease in inventories	16,900
Decrease in accounts payable	(4,275)
Increase in accrued liabilities	2,875
Net cash provided by operating activities	$37,175

ASC 230, *Statement of Cash Flows*

This example illustrates the direct and indirect methods of preparing the statement of cash flows.

The comparative balance sheet of CF Inc. is as follows:

CF Inc.
Comparative Balance Sheet
As of 12/31/2X12 and 12/31/2X11

	12/31/2X12	*12/31/2X11*
ASSETS		
Cash	268,120	10,000
Accounts receivable	20,000	17,000
Short-term investments	15,000	25,000
Inventory	85,000	75,000
Prepaid rent	5,000	17,000
Prepaid insurance	4,500	3,000
Office supplies	2,500	500
Land	100,000	250,000
Building	855,500	855,500

Less: Accumulated depreciation	(220,000)	(150,000)
Equipment	750,000	500,000
Less: Accumulated depreciation	(180,000)	(160,000)
Patent	30,000	50,000
Total assets	1,735,620	1,493,000
LIABILITIES AND EQUITY		
Accounts payable	350,000	400,000
Taxes payable	8,000	3,000
Wages payable	25,000	15,000
Short-term notes payable	75,000	75,000
Long-term notes payable	65,000	85,000
Bonds payable	500,000	500,000
Premium on bonds payable	80,000	90,000
Common stock	260,000	170,000
Paid-in-capital in excess of par	270,010	60,000
Retained earnings	102,610	95,000
Total liabilities and equity	1,735,620	1,493,000

The income statement of CF Inc. is as follows:

CF Inc.
Income Statement
For Year Ended 12/31/2X12

Sales revenue		1,350,000
Cost of goods sold		(800,000)
Gross margin		550,000
Operating expenses		
Selling expenses	(120,000)	
Administrative expenses	(195,000)	
Depreciation/amortization	(110,000)	
Total operating expenses		(425,000)
Income from operations		125,000
Other revenues and expenses		
Gain on sale of land	60,000	
Gain on sale of short-term investments	35,000	
Dividends revenue	6,600	
Interest expense	(80,000)	
Total other revenues and expenses		21,600

Income before taxes	146,600
Income taxes (30%)	(43,980)
Net income	102,620
Dividends—common stock	(95,000)
)Addition to retained earnings	7,620

The first step in preparing the statement of cash flows is to analyze the changes in the balance sheet accounts:

Change in:	
Cash	258,120
Accounts receivable	3,000
Short-term investments	(10,000)
Inventory	10,000
Prepaid rent	(12,000)
Prepaid insurance	1,500
Office supplies	2,000
Land	(150,000)
Building	-
Less: Accumulated depreciation	(70,000)
Equipment	250,000
Less: Accumulated depreciation	(20,000)
Patent	(20,000)
Accounts payable	(50,000)
Taxes payable	5,000
Wages payable	10,000
Short-term notes payable	-
Long-term notes payable	(20,000)
Bonds payable	-
Premium on bonds payable	(10,000)
Common stock	90,000
Paid-in-capital in excess of par	210,010
Retained earnings	7,620

The statement of cash flows using the *direct method* may now be prepared as follows:

CF Inc.

Statement of Cash Flows—Direct Method

For Year Ended 12/31/2X12

CASH FLOWS FROM OPERATING ACTIVITIES			
Cash received from customers	1,347,000		(1)
Dividends received	6,600		
Cash paid to suppliers	(860,000)		(2)
Cash paid for operating expenses	(296,500)		(3)
Taxes paid	(38,980)		(4)
Interest paid	(90,000)		(5)
Net cash from operating activities		68,120	
CASH FLOWS FROM INVESTING ACTIVITIES			
Sale of short-term investment	45,000		
Sale of land	210,000		
Purchase of equipment	(250,000)		
Net cash from investing activities		5,000	
CASH FLOWS FROM FINANCING ACTIVITIES			
Issuance of common stock	110,000		
Payment of principal on long-term debt	(20,000)		
Payment of dividends	95,000		
Net cash from financing activities		185,000	
Net change in cash		258,120	
Beginning cash balance		10,000	
Ending cash balance		268,120	

The supporting computations are as follows:

(1)	Sales revenue	1,350,000	
	- Increase in accounts receivable	(3,000)	
	Cash received from customers		1,347,000
(2)	Cost of goods sold	800,000	
	+ Increase in inventory	10,000	
	+ Decrease in accounts payable	50,000	
	Cash paid to suppliers		860,000
(3)	Operating expenses	425,000	
	- Depreciation/amortization expense	(110,000)	
	- Decrease in prepaid rent	(12,000)	
	+ Increase in prepaid insurance	1,500	
	+ Increase in office supplies	2,000	
	- Increase in wages payable	(10,000)	
	Cash paid for operating expenses		296,500
(4)	Income taxes (30%)	43,980	

	- Increase in tax payable	(5,000)	
	Taxes paid		38,980
(5)	Interest expense	80,000	
	+ Decrease in bond premium	10,000	
	Interest paid		90,000

Whenever the direct method is used, **ASC 230 requires reconciliation of net income to net cash from operating activities:**

Reconciliation

Net income		102,620
Adjustments		
+ Depreciation/amortization expense	110,000	
- Amortization of bond premium	(10,000)	
- Gain on sale of land	(60,000)	
- Gain on sale of investment	(35,000)	
- Increase in accounts receivable	(3,000)	
- Increase in inventory	(10,000)	
+ Decrease in prepaid rent	12,000	
- Increase prepaid insurance	(1,500)	
- Increase in office supplies	(2,000)	
- Decrease in accounts payable	(50,000)	
+ Increase in taxes payable	5,000	
+ Increase in wages payable	10,000	
Total adjustments		(34,500)
Net cash from operating activities		68,120

Alternatively, the statement of cash flows using the *indirect method* may be prepared as follows:

CF Inc.
Statement of Cash Flows—Indirect
Method For Year Ended 12/31/2X12

CASH FLOWS FROM OPERATING ACTIVITIES		
Net income		102,620
Adjustments		
+ Depreciation/amortization expense	110,000	
- Amortization of bond premium	(10,000)	
- Gain on sale of land	(60,000)	

- Gain on sale of investment	(35,000)	
- Increase in accounts receivable	(3,000)	
- Increase in inventory	(10,000)	
+ Decrease in prepaid rent	12,000	
- Increase prepaid insurance	(1,500)	
- Increase in office supplies	(2,000)	
- Decrease in accounts payable	(50,000)	
+ Increase in taxes payable	5,000	
+ Increase in wages payable	10,000	
Total adjustments		(34,500)
Net cash from operating activities		68,120
CASH FLOWS FROM INVESTING ACTIVITIES		
Sale of short-term investment	45,000	
Sale of land	210,000	
Purchase of equipment	(250,000)	
Net cash from investing activities		5,000
CASH FLOWS FROM FINANCING ACTIVITIES		
Issuance of common stock	110,000	
Payment of principal on long-term debt	(20,000)	
Payment of dividends	95,000	
Net cash from financing activities		185,000
Net change in cash		258,120
Beginning cash balance		10,000
Ending cash balance		268,120

As per ASC 230-10-45-18, cash inflows and cash outflows for transactions in securities, and other assets bought only for *resale* and carried at market value in a *trading account* of banks, dealers, and brokers must be classified in the operating section of the statement of cash flows. A similar treatment is afforded for loans acquired for resale and carried at market value. They are also presented in the operating section of the statement.

Exception: Securities, other assets, or loans bought solely for investment purposes are presented in the investing section.

A statement of cash flows need not be prepared for a defined pension plan that is reporting under ASC 715-30, *Compensation—Retirement Benefits: Defined Benefit Plans—Pension*.

A statement of cash flows is not required for investment companies or for a common collective investment trust fund provided that the following conditions are satisfied:

- The entity prepared a statement of changes in net assets.

- The investments held are very liquid and expressed at market value.
- The entity's debt position is either minimal or none.

According to ASC 230-10-45-27, financial institutions may present net cash inflows and outflows for collections of loans, principal, deposit repayments, withdrawal of deposits, deposits with other financial institutions (e.g., credit unions, banks, savings institutions), time deposits, and client loans.

ASC 230-10-45-27 permits an entity that satisfies certain criteria to classify the cash flow arising from a hedging transaction in the same section of the cash flow statement as the hedged item (e.g., investing activity, financing activity). Appropriate disclosure should also be made of the accounting policy.

Cash Flow Analysis

Cash is king. Although net income provides a long-term measure of a company's success or failure, cash is its lifeblood. Without cash, a company will not survive. For small and newly developing companies, cash flow is the single most important element for survival. Even medium and large companies must control cash flow.

Along with financial statement (ratio) analysis, cash flow analysis is a valuable tool. The cash flow statement provides information on how your company generated and used cash, that is, why cash flow increased or decreased. An analysis of the statement is helpful in appraising past performance, projecting the company's future direction, forecasting liquidity trends, and evaluating your company's ability to satisfy its debts at maturity. Because the statement lists the specific sources and uses of cash during the period, it can be used to answer the following:

- How was the expansion in plant and equipment financed?
- What use was made of net income?
- Where did you obtain funds?
- How much required capital is generated internally?
- Is the dividend policy in balance with its operating policy?
- How much debt was paid off?
- How much was received from the issuance of stock?
- How much debt financing was taken out?

The *cash flow per share* equals net cash flow divided by the number of shares. A high ratio is desirable because it indicates a liquid position, that is, that the company has ample cash on hand .

Operating Section

An analysis of the operating section of the statement of cash flows determines the adequacy of cash flow from operating activities. For example, an operating cash outlay for refunds given to customers for deficient goods indicates a quality problem with the merchandise, while payments of penalties, fines, and lawsuit damages reveal poor management practices that result in nonbeneficial expenditures.

Creditors examine the cash flow statement carefully because they are concerned about being paid. They begin their examination by finding *net cash provided by operating activities*. A high amount indicates that a company is able to generate sufficient cash from operations to pay its bills without further borrowing. Conversely, a low or negative amount of net cash provided by operating activities indicates that a company may have to borrow or issue equity securities to acquire sufficient cash to pay its bills. Consequently, creditors look for answers to the following questions in the company's cash flow statements.

- How successful is the company in generating net cash provided by operating activities?
- What are the trends in net cash flow provided by operating activities over time?
- What are the major reasons for the positive or negative net cash provided by operating activities?

You should recognize that companies can fail even though they report net income. The difference between net income and net cash provided by operating activities can be substantial. Companies such as W. T. Grant Company and Prime Motor Inn**,** for example, reported high net income numbers but negative net cash provided by operating activities. Eventually both companies filed for bankruptcy. **You can go broke (bankrupt) while making a profit!**

In addition, substantial increases in receivables and/or inventory can explain the difference between positive net income and negative net cash provided by operating activities. For example, in its first year of operations Robin Inc. reported a net income of $80,000. Its net cash provided by operating activities, however, was a negative $95,000, as shown in Exhibit 5.

Exhibit 5: Robin Inc.

Net Cash Flow from Operating Activities

Cash flows from operating activities		$ 80,000

Net income	$ (75,000)	
Adjustments to reconcile net income to net cash provided by operating activities:	(100,000)	
Increase in receivables		
Increase in inventories		(175,000)
Net cash provided by operating activities		$(95,000)

Robin could easily experience a "cash crunch" because it has its cash tied up in receivables and inventory. If Robin encounters problems in collecting receivables, or if inventory moves slowly or becomes obsolete, its creditors may have difficulty collecting on their loans.

Investing Section

An analysis of the investing section can identify investments in other companies. These investments may lead to an attempt to assume control of another company for purposes of diversification. The analysis may also indicate a change in future direction or a change in business philosophy. An increase in fixed assets indicates capital expansion and future growth. A contraction in business arising from the sale of fixed assets without adequate replacement is a negative sign.

Financing Section

An evaluation of the financing section reveals the company's ability to obtain financing in the money and capital markets as well as its ability to meet obligations. The financial mixture of bonds, long-term loans from banks, and equity instruments affects risk and the cost of financing. Debt financing carries greater risk because the company must generate adequate funds to pay the interest costs and to retire the obligation at maturity; thus, a very high percent of debt to equity is generally not advisable. The problem is acute if earnings and cash flow are declining. On the other hand, reducing long-term debt is desirable because it points to lowered risk.

The ability to obtain financing through the issuance of common stock at attractive terms (high stock price) indicates that the investing public is optimistic about the financial well-being of the business. The issuance of preferred stock may be a negative sign, since it may mean the company is having difficulty selling its common stock. Perhaps investors view the company as very risky and will invest only in preferred stock since preferred stock has a preference over common stock in the event of the company's liquidation. Evaluate the company's ability to pay dividends. Stockholders who rely on a fixed income, such as a retired couple, may be unhappy when dividends are cut or eliminated.

Example

X Company provides the following financial statements:

X Company
Comparative Balance Sheets
December 31
(in millions)

	2X12	*2X13*
ASSETS		
Cash	$47	$40
Accounts receivable	35	30
Prepaid expenses	2	4
Land	35	50
Building	80	100
Accumulated depreciation	(6)	(9)
Equipment	42	50
Accumulated depreciation	(7)	(11)
Total assets	$228	$254
LIABILITIES AND STOCKHOLDERS' EQUITY		
Accounts payable	$16	$20
Long-term notes payable	20	30
Common stock	100	100
Retained earnings	92	104
Total liabilities and stockholders' equity	$228	$254

X Company
Income Statement
For the Year Ended December 31, 2X13
(in millions)

Revenue		$300
Operating expenses (excluding depreciation)	$200	
Depreciation	7	207
Income from operations		$ 93
Income tax expense		32
Net income		$61

Additional information is as follows:

- Cash dividends paid totaled $49.
- The company issued long-term notes payable for cash.
- Land, building, and equipment were acquired for cash.

The statement of cash flows can now be prepared under the indirect method as follows:

X Company
Statement of Cash Flows
For the Year Ended December 31, 2X13
(in millions)

Cash flow from operating activities:		
Net income		$61
Add (deduct) items not affecting cash:		
Depreciation expense		$7
Decrease in accounts receivable		5
Increase in prepaid expenses		(2)
Increase in accounts payable	4	14
Net cash flow from operating activities	$75	
Cash flow from investing activities:		
Purchase of land	$(15)	
Purchase of building	(20)	
Purchase of equipment	(8)	(43)
Cash flow from financing activities:		
Issuance of long-term notes payable	$10	
Payment of cash dividends	(49)	(39)
Net decrease in cash		$(7)

A financial analysis of the statement of cash flows reveals that the profitability and operating cash flow of X Company improved. This indicates good earnings performance as well as the fact that earnings are backed up by cash. The decrease in accounts receivable may reveal better collection efforts. The increase in accounts payable is a sign that suppliers are confident in the company and willing to give interest-free financing. The acquisition of land, building, and equipment points to a growing business undertaking capital expansion. The issuance of long-term notes payable indicates that part of the financing of assets is through debt. Stockholders will be happy with the significant dividend payout of 80.3% (dividends divided by net income, or $49/$61). Overall, there was a decrease in cash of $7, but this should not cause alarm because of the company's profitability and the fact that the cash was used for capital expansion and dividend payments. The dividend payout should be reduced from its high level and the funds reinvested in the profitable business. Also, the curtailment of dividends by more than $7 would result in a positive net cash flow for the year. Cash flow is needed for immediate liquidity needs.

Example

Y Company presents the following statement of cash flows:

Cash flows from operating activities:

Net income		$134,000
Add (deduct) items not affecting cash		
Depreciation expense	$21,000	
Decrease in accounts receivable	10,000	
Increase in prepaid expenses	(6,000)	
Increase in accounts payable	35,000	60,000
Net cash flow from operating activities	$194,000	
Cash flows from investing activities:		
Purchase of land	$(70,000)	
Purchase of building	(200,000)	
Purchase of equipment	(68,000)	
Cash used by investing activities	(338,000)	
Cash flows from financing activities:		
Issuance of bonds	$150,000	
Payment of cash dividends	(18,000)	
Cash provided by financing activities		132,000
Net decrease in cash		$(12,000)

An analysis of the statement of cash flows reveals that the company is profitable. Also, cash flow from operating activities exceeds net income, which indicates good internal cash generation. The ratio of cash flow from operating activities to net income is a solid 1:45 ($194,000/$134,000). A high ratio is desirable because it shows that earnings are backed up by cash. The decline in accounts receivable could indicate better collection efforts. The increase in accounts payable shows that the company can obtain interest-free financing. The company is definitely in the process of expanding for future growth, as evidenced by the purchase of land, building, and equipment. The debt position of the company has increased, indicating greater risk. The dividend payout was 13.4% ($18,000/$134,000). Stockholders look positively on a firm that pays dividends. The decrease in cash flow for the year of $12,000 is a negative sign.

Financial Liquidity

Users of financial statements often assess liquidity by using the current cash debt coverage ratio. It indicates whether the company can pay off its current liabilities from its operations in a given year. The formula for this ratio is given below.

Current Cash Debt Coverage Ratio

= Net Cash Provided by Operating Activities/Average Current Liabilities

Example

Castle Corporation reports the following information:

Net cash provided by operating activities	$255,000
Average current liabilities	150,000
Average long-term liabilities	100,000
Dividends paid	60,000
Capital expenditures	110,000
Payments of debt	35,000

Current cash debt coverage ratio = Net Cash Provided by Operating Activities/Average Current Liabilities = $255,000/150,000 = 1.7

Financial Flexibility

The cash debt coverage ratio provides information on financial flexibility. It indicates a company's ability to repay its liabilities from net cash provided by operating activities, without having to liquidate the assets employed in its operations. Notice its similarity to the current cash debt coverage ratio. However, because it uses average total liabilities in place of average current liabilities, it takes a somewhat longer-range view.

Cash Debt Coverage Ratio

= Net Cash Provided by Operating Activities/Average Total Liabilities

For Castle, the *cash Debt Coverage Ratio* = Net Cash Provided by Operating Activities/Average Total Liabilities = $255,000/(150,000 + 100,000) = $255,000/250,000 = 1.02

The higher this ratio, the less likely the company will experience difficulty in meeting its obligations as they come due. It signals whether the company can pay its debts and survive if external sources of funds become limited or too expensive.

Free Cash Flow

A more sophisticated way to examine a company's financial flexibility is to develop a free cash flow analysis. Free cash flow (FCF) is the amount of discretionary cash flow a company has. It can use this cash flow to purchase additional investments, retire its debt, purchase treasury stock, or simply add to its liquidity. This is a valuable tool for evaluating the cash position of a business. The greater the free cash flow, the greater its options.

It is calculated as follows:

Cash flow from operations

Less: Cash used to purchase fixed assets

Less: Cash dividends

Free cash flow

In a free cash flow analysis, we first deduct capital spending, to indicate it is the least discretionary expenditure a company generally makes. (Without continued efforts to maintain and expand facilities, it is unlikely that a company can continue to maintain its competitive position.) We then deduct dividends. Although a company *can* cut its dividend, it usually will do so only in **a** *financial emergency***.** The amount resulting after these deductions is the company's free cash flow. Obviously, the greater the amount of free cash flow, the greater the company's amount of financial flexibility.

Questions that a free cash flow analysis answers are:

1. Is the company able to pay its dividends without resorting to external financing?
2. If business operations decline, will the company be able to maintain its needed capital investment?
3. What is the amount of discretionary cash flow that can be used for additional investment, retirement of debt, purchase of treasury stock, or addition to liquidity?

Below is a free cash flow analysis using the cash flow statement for Castle.

Net cash provided by operating activities	$255,000
Less: Capital expenditure	(111,000)

Dividends	(60,000)
Free cash flow	$ 85,000

This computation shows that Castle has a positive, and substantial, net cash provided by operating activities of $255,000. Castle's statement of cash flows reports that the company purchased equipment of $111,000. Castle has more than sufficient cash flow to meet its dividend payment and therefore has satisfactory financial flexibility.

IFRS Differences Affecting the Statement of Cash Flows

Both IFRS and U.S. GAAP require that the statement of cash flows should have three major sections—operating, investing, and financing—along with changes in cash and cash equivalents. One area where there can be substantive differences between IFRS and U.S. GAAP relates to the classification of interest, dividends, and taxes. The following table indicates the differences between the two approaches.

Classification Item	***IFRS* (IAS 7)***	***U.S. GAAP (ASC 230-10, FAS No.95)***
Interest paid (associate with interest expense)	Operating or financing	Operating
Dividends paid (not an income statement item)	Operating or financing	Financing
Interest received (associate with interest revenue)	Operating or investing	Operating
Dividends received (associate with dividend revenue)	Operating or investing	Operating
Taxes paid (associated with income tax expense)	Usually operating, but can be split among operating, investing, and financing depending on the nature of the transaction giving rise to	Operating

the tax payment

* 1. Reporting cash flow per share is not prohibited.

2. An entity must disclose the operating, investing, and financing cash flows of a discontinued operation.

3. A financial institution customarily classifies interest paid or received and dividends received as operating items.

Review Questions

13. In a statement of cash flows, which of the following items is reported as a cash outflow from financing activities: I. Payments to retire mortgage notes; II. Interest payments on mortgage notes; III. Dividend payments

A. I, II, and III.
B. II and III.
C. I only.
D. I and III.

14. Which of the following is NOT disclosed on the statement of cash flows when prepared under the direct method, either on the face of the statement or in a separate schedule?

A. The major classes of gross cash receipts and gross cash payments.

B. The amount of income taxes paid.

C. A reconciliation of net income to net cash flow from operations.

D. A reconciliation of ending retained earnings to net cash flow from operations.

15. Would the following be added back to net income when reporting operating activities' cash flows by the indirect method?

A. Both Excess of Treasury Stock Acquisition Cost over Sales Proceeds (Cost Method) AND Bond Discount Amortization
B. Neither Excess of Treasury Stock Acquisition Cost over Sales Proceeds (Cost Method) nor Bond Discount Amortization
C. Bond Discount Amortization, but not Both Excess of Treasury Stock Acquisition Cost over Sales Proceeds (Cost Method)
D. Excess of Treasury Stock Acquisition Cost over Sales Proceeds (Cost Method), but not Bond Discount Amortization

16. ASC 230 states that noncash investing and financing transactions should be:

A. Disclosed in a separate schedule

B. Presented within the statement of cash flows as an investing activity

C. Presented within the statement of cash flows on a net basis

D. Presented within the statement of cash flows as both an investing and financing activity

17. If a company purchases several net assets in a transaction accounted for using the purchase method, and the entire transaction is paid for by cash, how should the transaction be presented on the statement of cash flows?

A. In the operating activities section

B. As an outflow in the financing activities section

C. As one net outflow in the investing activities section

D. Disclosed

18. In general, the most important measure presented on the statement of cash flows is:

A. Cash from operating activities

B. Free cash flow

C. Investment income

D. Working capital

19**.** Purchases and sales of ________________ are presented in the operating activities section of the statement of cash flows.

A. Available-for-sale securities

B. Debt securities held to maturity

C. Non-securities

D. Trading securities

20. Which of the following should be presented in the investing activities section of the statement of cash flows?

A. Amounts received to settle lawsuits

B. Business interruption insurance proceeds

C. Insurance proceeds from inventory damaged or destroyed

D. Insurance proceeds from property, plant and equipment damaged or destroyed

Glossary

Cash equivalents. Short term, highly liquid investments that are both: (a) readily convertible to known amounts of cash and (b) so near their maturity that they present insignificant risk of changes in interest rates.

Direct method. Also called the income statement method, a method of presenting the statement of cash flows which reports cash receipts and cash disbursements from operating activities.

Financing activities. Activities that involve liability and stockholder's equity items and include (a) obtaining cash from creditors and repaying the amounts borrowed an (b) obtaining capital from owners and providing them with a return on , and a return of, their investment.

Indirect method. Also **c**alled the reconciliation method, a method of presenting the statement of cash flows that starts with net income and converts it to net cash provided by operating activities.

Investing activities. Activities that involve long-term assets and include (a) making and collecting loans and (b) acquiring and disposing of investments and productive long-lived assets.

Operating activities. The net cash effects of transactions that enter into the determination of net income, such as cash receipts from sales of goods and services and cash payments to suppliers and employees for acquisitions of inventory and expenses.

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Appendix:

Annual Report References

Note: Skim through this section for more annual report references

Marathon Oil 2008 Annual Report

22. Supplemental Cash Flow Information

(In millions)	*2008*	*2007*	*2006*
Net cash provided from operating activities from continuing operations included:			
Interest paid (net of amounts capitalized)	$ 92	$ 66	$ 96
Income taxes paid to taxing authorities	2,921	3,283	4,149
Income tax settlements paid to United States Steel	-	13	35
Commercial paper and revolving credit arrangements, net:			
Commercial paper-issuances	$46,706	$12,751	$1,321
-repayments	(46,706)	(12,751)	(1,321)
Credit agreements-borrowings	404		-
-repayments	(404)	-	-
Noncash investing and financing activities:			
Asset retirement costs capitalized, excluding acquisitions	$ 26	$ 8	$ 286
Debt payments assumed by United States Steel	14	21	24
Capital lease and sale-leaseback financing obligations	84	49	1
Bond obligation assumed for trusteed funds	-	1,000	-
Acquisitions:			
Debt and other liabilities assumed -		1,541	26
Common stock or securities exchangeable for common stock issued to seller	-	1,910	-
Noncash effect of deconsolidation of EGHoldings:			
Decrease in non-cash assets	$ -	$ 1,759	$ -
Equity method investment recorded	-	942	-
Decrease in liabilities	-	310	-
Elimination of minority interests	-	544	-

Anheuser-Busch 2007 Annual Report

9. Supplemental Cash Flow Information

Accounts payable include $120 million and $105 million of outstanding checks at December 31, 2007 and 2006, respectively. Supplemental cash flow information for the three years ended December 31 is presented in the following table (in millions).

	2007	*2006*	*2005*
Cash paid during the year			
Interest, net of interest capitalized	**$ 454.8**	$ 433.2	$ 436.0
Income taxes	**$ 936.6**	$ 920.2	$ 814.7
Excise taxes	**$2,298.9**	$2,252.3	$2,217.3
Change in working capital			
(Increase)/Decrease in current assets:			
Accounts receivable	**$ (85.0)**	$ (38.8)	$ 14.7
Inventories	**(28.6)**	(40.4)	35.8
Other current assets	**(17.4)**	(4.6)	6.9
Increase/(Decrease) in current liabilities:			
Accounts payable	**38.2**	176.8	54.7
Accrued salaries, wages and benefits	**31.5**	91.9	(40.5)
Accrued taxes	**(27.7)**	(22.8)	3.8
Accrued interest	**12.2**	0.5	(1.5)
Other current liabilities	**3.5**	17.1	(2.9)
Derivatives fair value adjustment	**(7.4)**	6.1	(9.8)
Working capital adjustment for acquisition/disposition	**(1.4)**	3.0	(10.9)
Impact of FIN 48 adoption	**58.6**	-	-
Net (increase)/decrease in working capital	$ **(23.5)**	$ 188.8	$ 50.3

General Electric 2005 Annual Report

Note 25. Supplemental Cash Flows Information

Changes in operating assets and liabilities are net of acquisitions and dispositions of principal businesses.

Amounts reported in the “Payments for principal businesses purchased” line in the Statement of Cash Flows is net of cash acquired and included debt assumed and immediately repaid in acquisitions.

Amounts reported in the “All other operating activities” line in the Statement of Cash Flows consists primarily of adjustments to current and noncurrent accruals and deferrals of costs and expenses, adjustments for gains and losses on assets, increases and decreases in assets held for sale and adjustments to assets.

Non-cash transactions include the following: in 2005, NBC Universal acquired IAC's 5.44% common interest in VUE for a total purchase price that included $115 million of non-cash consideration, representing the fair value of future services to be performed by NBC Universal (see note 16); in 2004, the issuance of GE common stock valued at $10,674 million in connection with the acquisition of Amersham and the issuance of NBC Universal shares valued at $5,845 million in connection with the combination of NBC and VUE; and in 2003, the acquisition of Osmonics, Inc. for GE common stock valued at $240 million.

December 31 (in millions)	*2005*	*2004*	*2003*
GE			
NET DISPOSITIONS (Purchases) OF GE SHARES FOR TREASURY			
Open market purchases under share repurchase program	$(5,024)	$(203)	$(340)
Other purchases	(1,844)	(1,689)	(837)
Dispositions	2,024	5,885	1,903
	$(4,844)	$(3,993)	$726

GECS			
ALL OTHER OPERATING ACTIVITIES			
Net change in assets held for sale	$2,192	$84	$1,168
Amortization of intangible assets	459	519	618
Realized gains on sale of investment securities	(381)	(204)	(205)
Other	(1,205)	(2,711)	(1,941)
	$1,065	$(2,312)	$(360)
NET INCREASE IN GECS FINANCING RECEIVABLES			
Increase in loans to customers	$(315,697)	$(342,357)	$(263,815)
Principal collections from customers—loans	267,728	305,846	238,518
Investment in equipment for financing leases	(23,728)	(22,649)	(22,518)
Principal collections from customers—financing leases	21,770	19,715	18,909
Net change in credit card receivables	(21,391)	(20,651)	(11,483)
Sales of financing receivables	54,144	44,816	36,009
	$(16,954)	$(15,280)	$(4,687)
ALL OTHER INVESTING ACTIVITIES			
Purchases of securities by insurance activities	$(9,264)	$(7,474)	$(7,942)
Dispositions and maturities of securities by insurance activities	10,892	9,305	9,509
Proceeds from principal business dispositions	209	472	3,337
Other	2,807	2,807	1,199

	$4,644	$6,083	$6,103
NEWLY ISSUED DEBT HAVING MATURITIES LONGER THAN 90 DAYS			
Short-term (91 to 365 days)	$4,675	$3,940	$3,661
Long-term (longer than one year)	60,176	53,641	55,661
Proceeds-nonrecourse, leveraged lease	203	562	791
	$65,054	$58,143	$60,113
REPAYMENTS AND OTHER REDUCTIONS OF DEBT HAVING MATURITIES LONGER THAN 90 DAYS			
Short-term (91 to 365 days)	$(38,132)	$(41,443)	$(38,756)
Long-term (longer than one year)	(10,746)	(3,443)	(3,664)
Proceeds-nonrecourse, leveraged lease	(831)	(652)	(782)
	(49,709)	(45,538)	(43,202)
ALL OTHER FINANCING ACTIVITIES			
Proceeds from sales of investment contracts	$15,743	$11,079	$766
Redemption of investment contracts	(16,934)	(14,476)	(480)
	$(1,191)	$(3,397)	$286

Anheuser Busch 2004 Annual Report

9. Supplemental Cash Flow Information

Accounts payable include $111 million of outstanding checks at both December 31, 2004 and 2003. Supplemental cash flows information for the three years ended December 31 is presented in the following table (in millions).

	2004	*2003*	*2002*
Cash paid during the year:			
Interest, net of interest capitalized	**$390.3**	$369.0	$343.0
Income taxes	**$962.3**	$952.2	$788.7
Excise taxes	**$2,229.1**	$2,169.4	$2,119.5
Noncash investing activity:			
Issuance of treasury stock related to wholesaler acquisition (1)	**$ -**	$72.6	$ -
Change in working capital:			
(Increase)/decrease in current assets:			
Accounts receivable	**$(26.7)**	$(39.0)	$(9.5)
Inventories	**(102.8)**	(23.9)	28.2
Other current assets	**(21.6)**	(60.5)	53.3
Increase/(decrease) in current liabilities:			
Accounts payable	**101.1**	107.1	41.6

Accrued salaries, wages and benefits	**2.5**	1.4	31.7
Accrued taxes	**(10.2)**	(17.9)	19.9
Other current liabilities	**18.4**	(21.1)	(42.0)
Derivatives fair value adjustment	**(91.3)**	77.2	17.7
Working capital adjustment for acquisition	**(51.0)**	9.3	-
Net (increase)/decrease in working capital	**$(181.6)**	$32.6	$140.9

Note 1: Recorded as a reduction in treasury stock for the company's average cost of the shares ($28.5) and an increase in capital in excess of par value for the remainder ($44.1).

Alcoa 2005 Annual Report

Cash payments for interest and income taxes follow:

	2005	*2004*	*2003*
Interest	$386	$318	$352
Income taxes	413	294	303

The details related to acquisitions follow.

	2005	*2004*	*2003*
Fair value of assets acquired	$373	$7	$275
Liabilities assumed	(102)	(5)	(80)
Minority interests	190	-	224
Stock issued	-	-	(410)
Cash paid	461	2	9
Less: cash acquired	-	-	-
Net cash paid	$461	$2	$9

Kerr-McGee 2002 Annual Report

2 Cash Flow Information

Net cash provided by operating activities reflects cash payments for income taxes and interest as follows:

(Millions of dollars)	***2002***	*2001*	*2000*
Income tax payments	**$89**	$434	$338
Less refunds received	**(268)**	(19)	(34)
Net income tax payments (refunds)	**$(179)**	$415	$304
Interest payments	**$258**	$189	$193

Noncash items affecting net income included in the reconciliation of net income to net cash provided by operating activities include the following:

(Millions of dollars)	***2002***	*2001*	*2000*

Litigation reserve provisions	**$72**	$ -	$7
Net periodic pension credit for qualified plan	**(48)**	(53)	(43)
Abandonment provisions—exploration and production	**38**	34	37
Increase (decrease) in fair value of embedded options in the DECS[1]	**34**	(205)	-
Increase (decrease) in fair value of trading securities[1]	**(61)**	7	-
All other[2]	**91**	70	44
Total	**$126**	$(147)	$45

Details of other changes in current assets and liabilities and other within the operating section of the Consolidated Statement of Cash Flows consist of the following:

(Millions of dollars)	***2002***	*2001*	*2000*
Environmental expenditures	**$(107)**	$(94)	$(117)
Cash abandonment expenditures-exploration and production	**(48)**	(29)	(9)
All other[2]	**(42)**	(50)	(9)
Total	**$(197)**	$(173)	$(135)

Information about noncash investing and financing activities not reflected in the Consolidated Statement of Cash Flows follows:

(Millions of dollars)	***2002***	*2001*	*2000*
Noncash investing activities			
Increase (decrease) in fair value of securities available for sale[1]	**$11**	$(34)	$280
Increase (decrease) in fair value of trading securities[1]	**61**	(188)	-
Investment in equity affiliate	**2**	-	-
Noncash financing activities			
Common stock issued in HS Resources acquisition	-	355	-
Debt assumed in HS Resources acquisition	-	506	-
Increase in the valuation of the DECS[1]	**8**	8	187
Increase (decrease) in fair value of embedded options in the DECS[1]	**34**	(205)	-
Dividends declared but not paid	-	3	4

[1] See Notes 1 and 18 for discussion of FAS 133 adoption.

[2] No other individual item is material to total cash flows from operations.

Chevron Texaco 2003 Annual Report

Note 4. Information Relating to the Consolidated Statement of Cash Flows

“Net decrease in operating working capital” is composed of the following:

	Year ended December 31		
	2003	*2002*	*2001*
(Increase) decrease in accounts and notes receivable	**$(265)**	$(1,135)	$2,472
Decrease (increase) in inventories	**115**	185	(294)
Decrease (increase) in prepaid expenses and other current assets	**261**	92	(211)
Increase (decrease) in accounts payable and accrued liabilities	**242**	1,845	(742)
(Decrease) increase in income and other taxes payable	**(191)**	138	(582)
Net decrease in operating working capital	**$162**	$1,125	$643
Net cash provided by operating activities includes the following cash payments for interest and income taxes:			
Interest paid on debt (net of capitalized interest)	**$467**	$533	$873
Income taxes paid	**$5,316**	$2,916	$5,465
Net (purchases) sales of marketable securities consist of the following gross amounts:			
Marketable securities purchased	**$(3,563)**	$(5,789)	$(2,848)
Marketable securities sold	**3,716**	5,998	2,665
Net sales (purchases) of marketable securities	**$153**	$209	$(183)

The 2003 “Net Cash Provided by Operating Activities” includes an $890 “Decrease in other deferred charges” and a decrease of the same amount in “Other” related to balance sheet reclassifications for certain pension-related assets and liabilities, in accordance with the requirements of FAS 87, “Employers' Accounting for Pensions.”

The major components of “Capital expenditures” and the reconciliation of this amount to the capital and exploratory expenditures, excluding equity in affiliates, presented in the Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) are detailed in the following table.

	Year ended December 31		
	2003	*2002*	*2001*
Additions to properties, plant and equipment[1]	**$4,953**	$6,262	$6,445
Additions to investments	**687**	1,138	2,902[2]
Current-year dry-hole expenditures	**132**	252	418
Payments for other liabilities and assets, net	**(147)**	(55)	(52)
Capital expenditures	**5,625**	7,597	9,713
Expensed exploration expenditures	**315**	303	393
Payments of long-term debt and other financing obligations, net	**286**[3]	2	210[3]
Capital and exploratory expenditures, excluding equity	**6,226**	7,902	10,316

affiliates			
Equity in affiliates' expenditures	**1,137**	1,353	1,712
Capital and exploratory expenditures, including equity affiliates	**$7,363**	$9,255	$12,028

[1] Net of noncash items of $1,183 in 2003, $195 in 2002 and $63 in 2001.

[2] Includes $1,500 for investment in Dynegy preferred stock.

[3] Deferred payments of $210 related to 1993 acquisition of an interest in the Tengizchevroil joint venture were made in 2003 and 2001.

Visteon 2003 Annual Report

15 Cash Flows

The reconciliation of net (loss) to cash flows provided by operating activities is as follows:

(in millions)	*2003*	*2002*	*2001*
Net (loss)	$(1,213)	$(352)	$(118)
Adjustment to reconcile net (loss) to cash flows from operating activities:			
Cumulative effect of change in accounting, net of tax	-	265	-
Depreciation and amortization	674	631	666
Asset impairment charges	436	-	-
Loss on divestitures	-	26	-
Earnings of affiliated companies in excess of dividends remitted	(20)	(28)	(12)
Benefit for deferred income taxes	(56)	(142)	(143)
Sale of receivables	5	10	-
Changes in assets and liabilities:			
Decrease (increase) in accounts receivable and other current assets	(39)	276	(197)
Decrease in inventory	143	85	86
Increase (decrease) in accounts payable, accrued and other liabilities	(13)	49	(185)
Increase in postretirement benefits other than pensions	376	258	256
Other	77	23	83
Cash flows provided by operating activities	$370	$1,101	$436

Cash paid for interest and income taxes was as follows:

(in millions)	2003	2002	2001
Interest	$94	$120	$131
Income taxes	75	80	44

Copart 2003 Annual Report

(15) Noncash Financing and Investing Activities

In fiscal 2002, the Company acquired $18,487,000 of intangible assets and $9,505,900 of tangible assets through the issuance of common stock in conjunction with the New Castle, Delaware; Savannah, Georgia; Tifton, Georgia; Haslet, Texas and Greencastle, Pennsylvania acquisitions and purchase of land at the Baton Rouge, Louisiana location. In fiscal 2002, the Company received 21,670 shares of common stock as payment for the exercise of 148,000 shares of common stock under the 1992 Stock Option Plan. The Company retired these shares upon receipt. In fiscal 2001, the Company acquired $774,600 of intangible assets and $88,100 of tangible assets through the issuance of common stock in conjunction with the Shreveport, Louisiana acquisition.

H. J. Heinz 2005 Annual Report

	2005	2004	2003
	(Dollars in thousands)		
Cash Paid During the Year for:			
Interest	$209,888	$169,671	$282,366
Income taxes	$381,443	$221,043	$155,843
Details of Acquisitions:			
Fair value of assets	$187,108	$126,082	$30,391
Liabilities*	48,179	13,235	11,489
Cash paid	138,929	112,847	18,902
Less cash acquired	12,380	-	5,348
Net cash paid for acquisitions	126,549	$112,847	$13,554
Non-cash activities:			
Net assets spun-off	$ -	$ -	$1,644,195

* Includes obligations to sellers of $5.5 million and $4.6 million in 2005 and 2004, respectively.

National Semiconductor 2005 Annual Report

Note 15. Supplemental Disclosure of Cash Flow Information and Noncash Investing and Financing Activities

(IN MILLIONS)	*2005*	*2004*	*2003*
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION			
Cash paid for:			
Interest	$1.4	$1.3	$1.5
Income taxes	$76.1	$15.4	$17.6
SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES			
Issuance of stock for employee benefit plans	$ -	$0.9	$0.8
Issuance of common stock to directors	$1.0	$0.4	$0.3
Issuance of common stock in connection with the final installment payment of the purchase price paid to DigitalQuake	$ -	$0.6	$ -
Unearned compensation relating to restricted stock issuance	$2.6	$3.1	$0.5
Restricted stock cancellation	$1.4	$1.4	$1.1
Change in unrealized gain on cash flow hedges	$ -	$0.2	$0.2
Change in unrealized gain on available-for-sale securities	$(0.3)	$(3.4)	$(34.9)
Minimum pension liability	$13.5	$(24.3)	$57.5
Effect of investee equity transactions	$ -	$ -	$4.7
Acquisition of software license under long-term contracts	$ -	$19.7	$16.4
Repurchase of common stock upon settlement of an advance repurchase contract	$30.0	$ -	$ -

Review Question Answers

1. A financial statement includes all of the following items: operating activities, financial activities and investing activities. What financial statement is this?

A. **Correct.** A statement of cash flows is a required financial statement. Its primary purpose is to provide information about cash receipts and payments by reporting the cash effects of an enterprise's operating, investing, and financing activities. Because the statement or a separate schedule reconciles net income and net operating cash flow, depreciation, a noncash expense, is included in the presentation.
B. Incorrect. The balance sheet does not include periodic net income or depreciation expense.
C. Incorrect. The income statement does not have captions for operating and financing activities.
D. Incorrect. Retained earnings does not include captions for operating and investing activities, depreciation, and net income.

2. A corporation issues a balance sheet and income statement for the current year and comparative income statements for each of the 2 previous years. Under GAAP, a statement of cash flows

A. Incorrect. A statement of cash flows must be provided for all 3 years.
B. Incorrect. A statement of cash flows must be provided for all 3 years.
C. **Correct.** When a business enterprise provides a set of financial statements that reports both financial position and results of operations, it must also present a statement of cash flows for each period for which the results of operations are provided.
D. Incorrect. The statement of cash flows is not optional in these circumstances.

3. Which of the following should be reported in a statement of cash flows issued by Grady Company?

A. Incorrect. Cash flows per share should not be reported. However, an entity with a simple capital structure must report basic EPS.
B. Incorrect. Cash flows per share should not be reported. However, an entity with a complex capital structure must report basic and diluted EPS.
C. Incorrect. Neither basic nor diluted cash flows per share should be reported.

D. **Correct.** ASC 230, *Statement of Cash Flows,* prohibits reporting of a cash flow-per-share amount. Reporting a per-share amount might improperly imply that cash flow is an alternative to net income as a performance measure.

4. A statement of cash flows is intended to help users of financial statements

A. **Correct.** The statement of cash flows shows the sources and uses of cash, which is a basis for cash flow analysis for managers. The statement aids you in answering vital questions like "where was money obtained?" and "where was money put and for what purpose?" If sued with information in the other financial statements, the statement of cash flows should help users to assess the entity's ability to generate positive future net cash flows (liquidity), its ability t meet obligations (solvency) and pay dividends, the need for external financing, the reasons for differences between income and cash receipt sand payments, and the cash and noncash aspects of the investing and financing activities.
B. Incorrect. The statement of cash flows deals with only one resource-cash.
C. Incorrect. The income statement shows the components of income from operations.
D. Incorrect. The identity of stock buyers and sellers is not shown.

5. A financial statement includes all of the following items: net income, depreciation, operating activities, and financial activities. What financial statement is this?

A. Incorrect. The balance sheet does not include periodic net income or depreciation expense.
B. Incorrect. The income statement does not have captions for operating and financing activities.
C. **Correct.** A statement of cash flows is a required financial statement. Its primary purpose is to provide information about cash receipts and payments by reporting the cash effects of an enterprise's operating, investing, and financing activities. Because the statement or a separate schedule reconciles net income and net operating cash flow, depreciation, a noncash expense, is included in the presentation.
D. Incorrect. Shareholders' equity does not include captions for operating and investing activities, depreciation, and net income.

Section 2

6. Which of the following should not be disclosed in an enterprise's statement of cash flows prepared using the indirect method?

A. Incorrect. Interest paid (net of amounts capitalized) is disclosed in the statement of cash flows.
B. Incorrect. Income taxes paid are disclosed in the statement of cash flows.
C. **Correct.** Cash flow per share is not presented in financial statements. Doing so might imply that cash flow is an alternative to net income as an indicator of performance.
D. Incorrect. Preferred dividends are disclosed in the statement of cash flows.

7. The primary purpose of a statement of cash flows is to provide relevant information about

A. Incorrect. Reconciling net income with cash flows is a secondary purpose.
B. Incorrect. Assessing the ability to generate cash flows is a secondary purpose.
C. **Correct.** The primary purpose is to provide information about the cash receipts and cash payments of a business enterprise during a period. This information helps investors, creditors, and other users to assess the enterprise's ability to generate net cash inflows, meet its obligations, pay dividends, and secure external financing. It also helps assess reasons for the differences between net income and net cash flow and the effects of cash and noncash financing and investing activities.
D. Incorrect. The ability to meet cash needs is a secondary purpose.

8. In a statement of cash flows, which of the following would increase reported cash flows from operating activities using the direct method? (Ignore income tax considerations.)

A. **Correct.** Operating activities are transactions and other events not classified as investing and financing activities. In general, the cash effects of operating activities (other than gains and losses) enter into the determination of income from continuing operations. Cash receipts from dividends on equity securities are operating activities.
B. Incorrect. The sale of equipment is an investing activity.
C. Incorrect. An early retirement of bonds is a financing activity.
D. Incorrect. A change in accounting principle is a noncash event.

9. The following information is available from Sand Corp.'s accounting records for the year ended December 31, 2005: Cash received from customers = $870,000; Rent received = $10,000; Cash paid to

suppliers and employees = $510,000; Taxes paid =$110,000; Cash dividends paid= $30,000. Net cash flow provided by operations for 2005 was

A. Incorrect. $220,000 includes the $30,000 dividend payment as an operating, not a financing, cash outflow and omits the rent received.
B. Incorrect. $230,000 includes the $30,000 dividend payment as an operating, not a financing, cash outflow.
C. Incorrect. $250,000 omits the rent received.
D. **Correct.** Payment of dividends is a financing activity. All other transactions listed are cash flows from operating activities. Accordingly, the net cash flow provided by operations is $260,000 ($870,000 + $10,000 - $510,000 - $110,000).

10. In a statement of cash flows, interest payments to lenders and other creditors should be classified as cash outflows for

A. **Correct.** Cash receipts from sales of goods and services, from interest on loans, and from dividends on equity securities are from operating activities. Cash payments to suppliers for inventory; to employees for services; to other suppliers for other goods and services; to governments for taxes, duties, fines, and fees; and to lenders for interest are also from operating activities.
B. Incorrect. Borrowing is not one of the three categories of cash flows.
C. Incorrect. Lending is not one of the three categories of cash flows.
D. Incorrect. Financing activities include issuance of stock, payment of distributions to owners, treasury stock transactions, issuance of debt, and repayment or other settlement of debt obligations, and receipt of resources donor restricted for long-term purposes.

11. Fara Co. reported bonds payable of $47,000 at December 31, Year 1, and $50,000 at December 31, Year 2. During Year 2, Fara issued $20,000 of bonds payable in exchange for equipment. There was no amortization of bond premium or discount during the year. What amount should Fara report in its Year 2 statement of cash flows for redemption of bonds payable?

A. Incorrect. $3,000 equals the increase in bonds payable.
B. **Correct.** Assuming no amortization of premium or discount, the net amount of bonds payable reported was affected solely by the issuance of bonds for equipment and the redemption of bonds. Given that $20,000 of bonds were issued and that the amount reported increased by only $3,000, $17,000 of bonds must have been redeemed. This amount should be reported in the statement of cash flows as a cash outflow from a financing activity.

C. Incorrect. $20,000 is the amount of bonds issued.
D. Incorrect. $23,000 is the sum of the bonds issued and the increase in bonds payable.

12. During 2X12, Beck Co. purchased equipment for cash of $47,000, and sold equipment with a $10,000 carrying value for a gain of $5,000. How should these transactions be reported in Beck's 2X12 statement of cash flows?

A. Incorrect. Cash inflows and outflows ordinarily are not netted.
B. Incorrect. An outflow of $42,000 assumes netting and a $5,000 inflow.
C. Incorrect. The cash inflow was $15,000. Beck received the $10,000 carrying value and a $5,000 gain.
D. **Correct.** Investing activities include making and collecting loans and acquiring and disposing of debt or equity instruments and property, plant, and equipment and other productive assets, that is, assets held for or used in the production of goods or services (other than the materials held in inventory). Thus, the cash effects of purchases and sales of equipment should be reported in the investing cash flows section of the statement of cash flows. Moreover, cash inflows and outflows ordinarily are not netted. They should be reported separately at *gross amounts*. Accordingly, Beck should report a cash inflow of $15,000 ($10,000 carrying value + $5,000 gain) for the sale of equipment and a $47,000 outflow for the purchase. In adjusting accrual-based net income to net operating cash flow, the $5,000 gain on the sale of equipment should be subtracted to prevent double counting.

Section 3

13. In a statement of cash flows, which of the following items is reported as a cash outflow from financing activities: I. Payments to retire mortgage notes; II. Interest payments on mortgage notes; III. Dividend payments

A. Incorrect. Interest payments are outflows from operating activities.
B. Incorrect. Interest payments are not outflows from financing activities.
C. Incorrect. Payments to retire mortgage notes are not the only outflows from financing activities.
D. **Correct.** Financing activities include the issuance of stock, the payment of dividends and other distributions to owners, treasury stock transactions, the issuance of debt, and the repayment or other settlement of debt obligations. Thus, the payment of the principal of a mortgage note and the payment of dividends are outflows from financing activities.

14. Which of the following is NOT disclosed on the statement of cash flows when prepared under the direct method, either on the face of the statement or in a separate schedule?

A. Incorrect. A statement of cash flows prepared using the direct method reports the major classes of gross cash receipts and payments and their arithmetic sum (net cash flow from operating activities).
B. Incorrect. Under the direct method, the operating section presents gross cash receipts and gross cash payments from operating activities, with a reconciliation of net income to cash flow from operations in a separate schedule accompanying the statement of cash flows.
C. Incorrect. The reconciliation of net income to net operating cash flow is provided in a separate schedule.
D. **Correct.** A reconciliation of ending retained earnings to net cash flow from operations is not disclosed on the statement of cash flows, regardless of whether a direct or an indirect presentation is made. A reconciliation of net income to net cash flow from operations is reported in a separate schedule if the direct method is used. This reconciliation may be reported within the statement or provided in a separate schedule if the indirect method is used.

15. Would the following be added back to net income when reporting operating activities' cash flows by the indirect method?

A. Incorrect. The excess of acquisition cost over proceeds (assuming purchase and sale in the same period) should be subtracted from net income in the reconciliation.
B. Incorrect. The bond discount amortization should be added to net income.
C. **Correct.** Bond discount amortization is a noncash component of interest expense. It is added in the reconciliation of net income to net operating cash flow. Treasury stock transactions involve cash flows that do not affect net income. However, the excess of acquisition cost over proceeds (assuming purchase and sale in the same period) should be subtracted from net income in the reconciliation.
D. Incorrect. The bond discount amortization should be added to net income and the excess of acquisition cost over proceeds (assuming purchase and sale in the same period) should be subtracted from net income in the reconciliation.

16. ASC 230 states that noncash investing and financing transactions should be:

A. **Correct.** ASC 230 states that these noncash transactions are not to be incorporated in the statement of cash flows. They may be summarized in a separate schedule at the bottom of the statement or appear in a separate supplementary schedule to the financials.
B. Incorrect. Presenting the noncash transaction as an investing activity would only identify one side of the two-sided transaction.
C. Incorrect. Presenting the noncash transactions on a net basis would result in the transactions netting out to zero, thereby not being included on the statement.
D. Incorrect. Mechanically, presenting the transaction as both an investing and financing activity would properly identify both sides of the transaction. However, ASC 230 specifically states a different reporting method for non-cash investing and financing activities.

17. If a company purchases several net assets in a transaction accounted for using the purchase method, and the entire transaction is paid for by cash, how should the transaction be presented on the statement of cash flows?

A. Incorrect. Purchases of assets are not presented in the operating activities section as such a transaction does not relate to cash flows involving the income statement.
B. Incorrect. Purchases of assets are not presented in financing activities. Instead, in general, debt and equity transactions are presented in financing activities.
C. **Correct.** ASC 230 requires that a purchase of net assets be presented as one net outflow in the investing activities section. This type of transaction typically occurs when a company purchases the assets of another company.
D. Incorrect. Non-cash investing and financing activities should be disclosed. When various net assets are purchased for cash, disclosure is not required as the entire transaction is funded by cash.

18. In general, the most important measure presented on the statement of cash flows is:

A. **Correct.** In general, the most important measure presented on the statement of cash flows is cash from operating activities. This is also where many companies find loopholes to manipulate the numbers to increase their cash from operating activities numbers.
B. Incorrect. Free cash flow is not a presented on the statement of cash flows. However, many analysts are using free cash flow to track cash flow and other financial measurements in relation to GAAP income.
C. Incorrect. Investment income is presented on the income statement but not on the statement of cash flows.
D. Incorrect. Although working capital is an important measure, it is not presented as an element on the statement of cash flows.

19. Purchases and sales of ________________ are presented in the operating activities section of the statement of cash flows.

A. Incorrect. All activity related to available-for-sale securities is presented in the investing activities section of the statement of cash flows.
B. Incorrect. All activity related to debt securities held to maturity is presented in the investing activities section of the statement of cash flows.
C. Incorrect. Purchases and sales of non-securities are presented in the investing activities section of the statement of cash flows.
D. **Correct.** Purchases and sales of trading securities are presented in the operating activities section of the statement of cash flows.

20. Which of the following should be presented in the investing activities section of the statement of cash flows?

A. Incorrect. ASC 230 defines cash inflows from operating activities to include amounts received to settle lawsuits.
B. Incorrect. Business interruption insurance proceeds are presented in operating activities.
C. Incorrect. Insurance proceeds from inventory damaged or destroyed is presented in operating activities.
D. **Correct.** Insurance proceeds from property, plant and equipment damaged or destroyed is presented in investing activities. ASC 230 defines cash inflows from operating activities to include "all other cash receipts that do not stem from transactions defined as investing or financing activities ... except for those that are directly related to investing or financing activities, such as from destruction of a building, and refunds from suppliers."