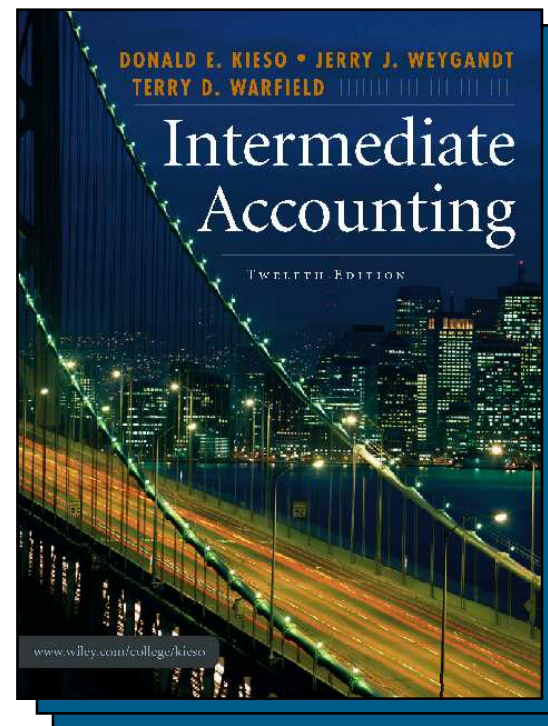


Cash Flow Reporting

Chapter 23

Intermediate Accounting
12th Edition
Kieso, Weygandt, and Warfield



Learning Objectives

1. Describe the purpose of the statement of cash flows.
2. Identify the major classifications of cash flows.
3. Differentiate between net income and net cash flows from operating activities.
4. Contrast the direct and indirect methods of calculating net cash flow from operating activities.
5. Determine net cash flows from investing and financing activities.
6. Prepare a statement of cash flows.
7. Identify sources of information for a statement of cash flows.
8. Discuss special problems in preparing a statement of cash flows.
9. Explain the use of a worksheet in preparing a statement of cash flows.

Statement of Cash Flows

Preparation of the Statement

- Usefulness
- Classification of cash flows
- Format of statement
- Steps in preparation
- Examples
- Sources of information
- Indirect vs. direct method

Special Problems in Statement Preparation

- Adjustments similar to depreciation
- Accounts receivable (net)
- Other working capital changes
- Net losses
- Gains
- Stock options
- Postretirement benefit costs
- Extraordinary items
- Significant noncash transactions

Use of a Worksheet

- Preparation of worksheet
- Analysis of transactions
- Preparation of final statement

Section 1 - Preparation of the Statement of Cash Flows

Primary purpose:

To provide information about a company's cash receipts and cash payments during a period.

Secondary objective:

To provide cash-basis information about the company's operating, investing, and financing activities.

Usefulness of the Statement of Cash Flows

Provides information to help assess:

1. Entity's ability to generate future cash flows.
2. Entity's ability to pay dividends and obligations.
3. Reasons for difference between net income and net cash flow from operating activities.
4. Cash and noncash investing and financing transactions.

Classification of Cash Flows

Operating Activities

Income
Statement
Items

Investing Activities

Generally
Long-Term
Asset Items

Financing Activities

Generally
Long-Term
Liability
and
Equity Items

The term "Cash" =
Cash and cash equivalents.

Classification of Cash Flows

Cash and Cash Equivalent

Text Footnote 3

3 The basis recommended by the FASB for the statement of cash flows is actually "cash and cash equivalents." **Cash equivalents** are 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. Generally, only investments with original maturities of three months or less qualify under this definition. Examples of cash equivalents are Treasury bills, commercial paper, and money market funds purchased with cash that is in excess of immediate needs.

Classification of Cash Flows

Classification of Typical Inflows and Outflows

Operating

Cash inflows

From sales of goods or services.

From returns on loans (interest) and on equity securities (dividends).

Cash outflows

To suppliers for inventory.

To employees for services.

To government for taxes.

To lenders for interest.

To others for expenses.

Illustration 23-1

**Income
Statement
Items**

Classification of Cash Flows

Classification of Typical Inflows and Outflows

Investing

Cash inflows

From sale of property, plant, and equipment.

From sale of debt or equity securities of other entities.

From collection of principal on loans to other entities.

Cash outflows

To purchase property, plant, and equipment.

To purchase debt or equity securities of other entities.

To make loans to other entities.

Illustration 23-1

Generally
Long-Term
Asset Items

Classification of Cash Flows

Classification of Typical Inflows and Outflows

Financing

Cash inflows

From sale of equity securities.

From issuance of debt (bonds and notes).

Cash outflows

To stockholders as dividends.

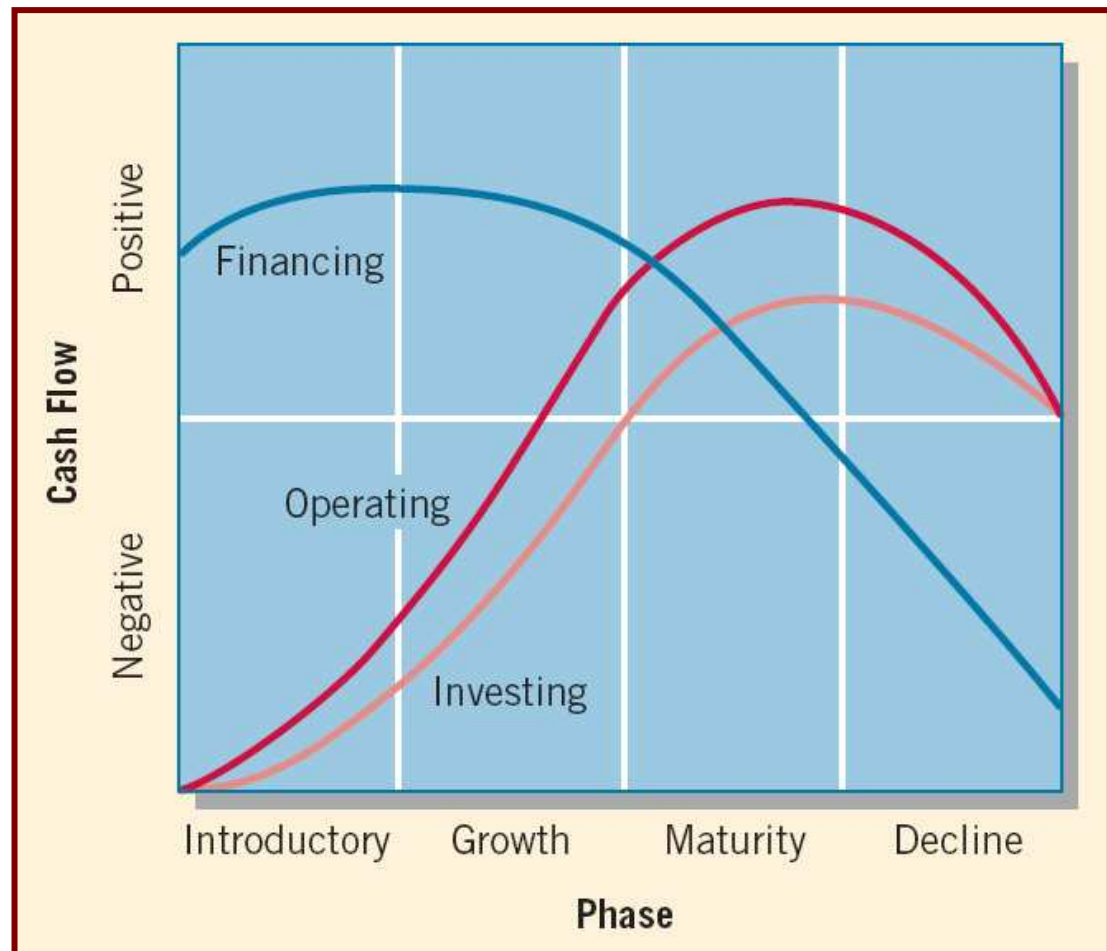
To redeem long-term debt or reacquire capital stock.

Illustration 23-1

Generally
Long-Term
Liability and
Equity Items

Classification of Cash Flows

Typical Company Product Life Cycle



Format of the Statement of Cash Flows

Order of Presentation:

1. Operating activities.
2. Investing activities.
3. Financing activities.

Direct Method

Indirect Method

Report inflows and outflows from investing and financing activities separately.

Steps in Preparation

Three Sources of Information:

1. Comparative balance sheets
2. Current income statement
3. Selected transaction data

Three Major Steps:

- Step 1.* Determine change in cash.
- Step 2.* Determine net cash flow from operating activities.
- Step 3.* Determine net cash flows from investing and financing activities.

Step 2: Determine Net Cash Flow from Operating Activities

A company must determine revenues and expenses on a **cash basis**.

Eliminate the effects of income statement transactions that do not result in an increase or decrease in cash.

Convert net income to net cash flow from operating activities through either a **direct** method or an **indirect** method.

Example - Operating Section

Indirect Method

Adjusts net income for items not affecting cash.

Illustration 23-8

Net income		\$34,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Increase in accounts receivable	\$(36,000)	
Increase in accounts payable	<u>5,000</u>	<u>(31,000)</u>
Net cash provided by operating activities		<u><u>\$ 3,000</u></u>

Common adjustments to Net Income (Loss):

- Depreciation and amortization expense.
- Gain or loss on disposition of long-term assets.
- Change in current assets and current liabilities.

E23-6 (Operating Activities—Indirect Method)

Krauss Company's financial statements for the year ended December 31, 2007, contained the following condensed information.

	2007	2006	Change
Revenues from fees	\$ 840,000		
Operating expenses	624,000		
Depreciation expense	60,000		
Loss on sale of equipment	26,000		
Income before income tax	130,000		
Income tax	40,000		
Net income	<u>\$ 90,000</u>		
Accounts receivable	\$ 37,000	\$ 54,000	\$ (17,000)
Accounts payable	41,000	31,000	10,000
Income taxes payable	4,000	8,500	(4,500)

E23-6 (Operating Activities—Indirect Method)

Prepare the operating activities section of the statement of cash flows using the indirect method (Step 2).

Cash flows from operating activities	
Net income	\$ 90,000
Adjustment to reconcile net income to net cash provided by operating activities:	
Depreciation expense	60,000
Loss on sale of equipment	26,000
Decrease in accounts receivable	17,000
Increase in accounts payable	10,000
Decrease in income taxes payable	(4,500)
Net cash provided by operating activities	<u>198,500</u>

Example - Operating Section

Direct Method

Deducts operating cash disbursements from operating cash receipts.

Illustration 23-6

Cash collected from revenues	\$89,000
Cash payments for expenses	<u>80,000</u>
Income before income taxes	9,000
Cash payments for income taxes	<u>6,000</u>
Net cash provided by operating activities	<u><u>\$ 3,000</u></u>

"Net cash provided by operating activities" is the equivalent of cash basis net income.

E23-5 (Operating Activities—Direct Method)

Krauss Company's financial statements for the year ended December 31, 2007, contained the following condensed information.

	2007	2006	Change
Revenues from fees	\$ 840,000		
Operating expenses	624,000		
Depreciation expense	60,000		
Loss on sale of equipment	26,000		
Income before income tax	130,000		
Income tax	40,000		
Net income	\$ 90,000		
Accounts receivable	\$ 37,000	\$ 54,000	\$ (17,000)
Accounts payable	41,000	31,000	10,000
Income taxes payable	4,000	8,500	(4,500)

Assume accounts payable relates to operating expenses.

E23-5 (Operating Activities—Direct Method)

Prepare the operating activities section of the statement of cash flows using the Direct method (**Step 2**).

Illustration 23-22

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

Computation of cash receipts from customers:

Revenue from fees	\$ 840,000
Add: Decrease in accounts receivable	17,000
Cash receipts from customers	<u><u>\$ 857,000</u></u>

E23-5 (Operating Activities—Direct Method)

Prepare the operating activities section of the statement of cash flows using the Direct method (Step 2).

Alternate computation of cash receipts from customers:

Accounts receivable, balance 2006	\$ 54,000
Add: Revenue from fees	840,000
Deduct: Cash receipts from customers	<u>(857,000)</u>
Accounts receivable, balance 2007	<u><u>\$ 37,000</u></u>

E23-5 (Operating Activities—Direct Method)

Prepare the operating activities section of the statement of cash flows using the Direct method (Step 2).

Computation of cash payments for operating expenses:

Operating expenses	\$ 624,000
Deduct: Increase in accounts payable	(10,000)
Cash payments for operating expenses	<u><u>\$ 614,000</u></u>

or

Accounts payable, balance 2006	\$ 31,000
Add: Operating expenses	624,000
Deduct: Cash payments for operating expenses	<u>(614,000)</u>
Accounts payable, balance 2007	<u><u>\$ 41,000</u></u>

E23-5 (Operating Activities—Direct Method)

Prepare the operating activities section of the statement of cash flows using the Direct method (Step 2).

Computation of cash payments for income taxes:

Income tax expense	\$ 40,000
Add: Decrease in income tax payable	4,500
Cash payments for income taxes	<u><u>\$ 44,500</u></u>

or

Income tax payable, balance 2006	\$ 8,500
Add: Income tax expense	40,000
Deduct: Cash payments for income taxes	<u>(44,500)</u>
Income tax payable, balance 2007	<u><u>\$ 4,000</u></u>

E23-5 (Operating Activities—Direct Method)

Prepare the operating activities section of the statement of cash flows using the Direct method (**Step 2**).

Cash flows from operating activities

Cash receipts from customers	\$ 857,000
Cash paid for operating expenses	(614,000)
Cash paid for income taxes	<u>(44,500)</u>
Net cash provided by operating activities	<u><u>198,500</u></u>

Step 3: Determine Net Cash Flow from Investing and Financing Activities

E23-2 (a) Plant assets that had cost \$20,000 6 years before and were being depreciated on a straight-line basis over 10 years with no estimated scrap value were sold for \$5,300.

Plant assets (cost)	\$ 20,000
Accumulated depreciation ($[\$20,000 / 10] \times 6$)	12,000
Book value at date of sale	<hr/> 8,000
Sale proceeds	(5,300)
Loss on sale	<hr/> <hr/> \$ 2,700

E23-2 (a)

Statement of Cash Flows	
O	Cash flow from operating activities
	Net income \$
	Adjustment to reconcile net income to cash:
	Loss on sale 2,700
	Cash from operations
I	Cash flow from investing activities
	Proceeds from sale of plant asset 5,400
	Cash from investing activities
F	Cash flow from financing activities
	Cash from financing activities
	Net Change in Cash \$

E23-2 (b)

E23-2 (b) During the year, 10,000 shares of common stock with a stated value of \$10 a share were issued for \$43 a share.

Shares sold	10,000
Market value per share	\$ 43
Value of shares	<u>\$430,000</u>

E23-2 (b)

Statement of Cash Flows

Cash flow from operating activities

Net income \$

Adjustment to reconcile net income to cash:

Cash from operations

Cash flow from investing activities

Cash from investing activities

Cash flow from financing activities

Sale of common stock 430,000

Cash from financing activities

Net Change in Cash \$

O

I

F

E23-2 (d)

E23-2 (d) The company sustained a net loss for the year of \$50,000. Depreciation amounted to \$22,000, and a gain of \$9,000 was realized on the sale of land for \$39,000 cash.

E23-2 (d)

Statement of Cash Flows

Cash flow from operating activities

Net loss	\$ (50,000)
Adjustment to reconcile net income to cash:	
Depreciation expense	22,000
Gain on sale	(9,000)

Cash from operations

Cash flow from investing activities

Sale of land	39,000
Cash from investing activities	

Cash flow from financing activities

Cash from financing activities

Net Change in Cash

\$

O

I

F

E23-2 (h)

E23-2 (h) During the year, treasury stock costing \$47,000 was purchased.

E23-2 (h)

Statement of Cash Flows

Cash flow from operating activities

Net income (loss)

Adjustment to reconcile net income to cash:

Cash from operations

Cash flow from investing activities

Cash from investing activities

Cash flow from financing activities

Purchase of company stock

Cash from financing activities

Net Change in Cash

(47,000)

\$

O

I

F

Statement of Cash Flows (a,b,d,h)

O

Statement of Cash Flows

Cash flow from operating activities

Net income (loss)	\$ (50,000)
Adjustment to reconcile net income to cash:	
Depreciation expense	22,000
Loss on sale	2,700
Gain on sale	(9,000)
Cash from operations	<u>(34,300)</u>

I

Cash flow from investing activities

Sale of plant assets	5,400
Sale of land	39,000
Cash from investing activities	<u>44,400</u>

F

Cash flow from financing activities

Sale of common stock	430,000
Purchase of company stock	(47,000)
Cash from financing activities	<u>383,000</u>
Net Change in Cash	<u>\$ 393,100</u>

Sources of Information for the Statement of Cash Flows

1. Comparative balance sheets.
2. An analysis of the Retained Earnings.
3. Writedowns, amortization charges, and similar "book" entries, such as depreciation, because they have no effect on cash.

Net Cash Flow from Operating Activities— Indirect Versus Direct Method

Net Income

Additions

Depreciation expense
Amortization of intangibles and
deferred charges
Amortization of bond discount
Increase in deferred income tax
liability
Loss on investment in common
stock using equity method
Loss on sale of plant assets
Loss on impairment of assets
Decrease in receivables
Decrease in inventories
Decrease in prepaid expense
Increase in accounts payable
Increase in accrued liabilities

Deductions

Amortization of bond premium
Decrease in deferred income
tax liability
Income on investment in common stock
using equity method
Gain on sale of plant assets
Increase in receivables
Increase in inventories
Increase in prepaid expense
Decrease in accounts payable
Decrease in accrued liabilities

Indirect Method

Net Cash Flow from Operating Activities— Indirect Versus Direct Method

Under the **Direct Method**, companies adjust each item in the income statement from the accrual basis to the cash basis.

Example line items found in the operating section:

- Cash receipts from customers (see E23-5)
- Cash payments to suppliers (see E23-4 to follow)
- Cash payments for operating expenses (see E23-5)
- Cash payments for income taxes (see E23-5)

BE23-4 (Direct Method)

BE 23-4 Azure Corporation's financial statements for 2008, contained the following condensed information (some facts added).

	2008	2007	Change
Sales	\$ 200,000		
Cost of goods sold	120,000		
Operating expenses	29,000		
Depreciation expense	21,000		
Net income	\$ 30,000		
Inventory	\$ 65,000	\$ 54,000	\$ 11,000
Accounts payable	44,000	31,000	13,000

Calculate "Cash Payments to Suppliers."

BE23-4 (Direct Method)

Illustration 23-23

$$\begin{array}{rcl}
 \text{Cash payments} & = & \text{Cost of} \\
 \text{to suppliers} & & \text{goods sold} \left\{ \begin{array}{l} + \text{ Increase in inventory} \\ \text{or} \\ - \text{ Decrease in inventory} \end{array} \right. \left\{ \begin{array}{l} + \text{ Decrease in} \\ \text{accounts payable} \\ \text{or} \\ - \text{ Increase in} \\ \text{accounts payable} \end{array} \right.
 \end{array}$$

Computation of cash payments to suppliers:

Cost of goods sold	\$ 120,000
Add: Increase in inventory	11,000
Purchases	<u>131,000</u>
Deduct: Increase in accounts payable	(13,000)
Deduct: Cash payments to suppliers	<u><u>\$ 118,000</u></u>

BE23-4 (Direct Method)

Alternate Computation of cash payments to suppliers:

Inventory, balance 2007	\$ 54,000
Add: Purchases	131,000
Deduct: Cost of good sold	(120,000)
Inventory, balance 2008	<u>\$ 65,000</u>

and

Accounts payable, balance 2007	\$ 31,000
Add: Purchases	131,000
Deduct: Cash payments to suppliers	(118,000)
Accounts payable, balance 2008	<u>\$ 44,000</u>

Direct Versus Indirect Controversy

In Favor of the Direct Method

- Shows operating cash receipts and payments.
- Information about cash receipts and payments is more revealing of a company's ability
 1. to generate sufficient cash from operating activities to pay its debts,
 2. to reinvest in its operations, and
 3. to make distributions to its owners.

Direct Versus Indirect Controversy

In Favor of the Indirect Method

- Focuses on the differences between net income and net cash flow from operating activities.
- Provides link between the statement of cash flows and the income statement and balance sheet.

Special Rules Applying to Indirect Methods

- Disclose Interest paid.
- Disclose Income taxes paid.

Special Problems in Statement Preparation

1. Adjustments similar to depreciation

- Amortization of limited-life intangible assets.
- Amortization of deferred costs.
- Amortization of bond discount or premium.
- Changes in deferred income taxes.
- Change related to an investment when recording income or loss under the equity method.

Special Problems in Statement Preparation

2. Accounts receivable, net
3. Other working capital changes
4. Net losses
5. Gains
6. Stock options
7. Postretirement benefits
8. Extraordinary items
9. Significant noncash transactions

Use of a Worksheet

A worksheet involves the following steps.

Step 1. Enter the balance sheet accounts and their beginning and ending balances in the balance sheet accounts section.

Step 2. Enter the data that explain the changes in the balance sheet accounts and their effects on the statement of cash flows in the reconciling columns of the worksheet.

Step 3. Enter the increase or decrease in cash on the cash line and at the bottom of the worksheet. This entry should enable the totals of the reconciling columns to be in agreement.

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