

CHAPTER 23

Statement of Cash Flows

ASSIGNMENT CLASSIFICATION TABLE

Topics	Questions	Brief Exercises	Exercises	Problems	Cases
1. Format, objectives purpose, and source of statement.	1, 2, 7, 8, 12				1, 2, 5, 6
2. Classifying investing, financing, and operating activities.	3, 4, 5, 6, 16, 17, 19	1, 2, 3, 6, 7, 8, 12	1, 2, 10		1, 3, 4, 5
3. Direct vs. indirect methods of preparing operating activities.	9, 20	4, 5, 9, 10, 11	3, 4		5
4. Statement of cash flows—direct method.	11, 13, 14	8	3, 5, 7, 9, 12, 14, 15	3, 4, 6	
5. Statement of cash flows—indirect method.	10, 13, 15	8	4, 6, 8, 11, 13, 16, 17, 18, 20	1, 2, 4, 5, 6, 7, 8, 9	2
6. Preparing schedule of noncash investing and financing activities.	18			5, 7, 8, 9	5
7. Work sheet adjustments.	21	13	21		
8. Preparing balance sheet from cash flow data.			19		

ASSIGNMENT CHARACTERISTICS TABLE

Item	Description	Level of Difficulty	Time (minutes)
E23-1	Classification of transactions.	Simple	10-15
E23-2	Statement presentation—indirect method.	Moderate	20-30
E23-3	Operating activities section—indirect method.	Simple	15-25
E23-4	Operating activities section—direct method.	Simple	20-30
E23-5	Operating activities section—direct method.	Simple	20-30
E23-6	Operating activities section—indirect method.	Simple	15-20
E23-7	Operating activities section—direct method.	Simple	15-20
E23-8	Schedule of net cash flow from operating activities—indirect method.	Moderate	20-30
E23-9	SCF, direct method analysis.	Moderate	20-30
E23-10	Classification of transactions.	Moderate	25-35
E23-11	SCF, indirect method.	Moderate	30-35
E23-12	SCF, direct method.	Moderate	20-30
E23-13	SCF, direct method.	Moderate	30-40
E23-14	SCF, indirect method.	Moderate	30-40
E23-15	SCF, indirect method.	Moderate	25-35
E23-16	Cash provided by operating, investing, and financing activities.	Moderate	20-25
E23-17	SCF, indirect method and balance sheet.	Moderate	30-40
E23-18	Partial SCF, indirect method.	Moderate	25-30
E23-19	Work sheet analysis of selected accounts.	Moderate	20-25
E23-20	Work sheet analysis of selected transactions.	Moderate	20-25
E23-21	Work sheet preparation.	Moderate	45-55
P23-1	SCF, indirect method.	Moderate	40-45
P23-2	SCF, indirect method.	Moderate	50-60
P23-3	SCF, direct method.	Complex	50-60
P23-4	SCF, direct method.	Moderate	45-60
P23-5	SCF, indirect method.	Complex	50-65
P23-6	SCF, indirect method, and net cash flow from operating activities, direct method.	Moderate	40-50
P23-7	SCF, direct and indirect methods from comparative financial statements.	Moderate	30-40
P23-8	SCF—direct and indirect methods.	Moderate	30-40
P23-9	Statement of cash flows, indirect method, and related questions.	Moderate	30-40
C23-1	Analysis of improper SCF.	Moderate	30-35
C23-2	SCF theory and analysis of improper SCF.	Moderate	30-35
C23-3	SCF theory and analysis of transactions.	Moderate	30-35
C23-4	Analysis of transactions' effect on SCF.	Moderate	20-30
C23-5	Purpose and elements of SCF.	Complex	30-40
C23-6	Cash flow reporting, ethics.	Moderate	20-30

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 flows 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. Identify special problems in preparing a statement of cash flows.
 9. Explain the use of a work sheet in preparing a statement of cash flows.
 - *10. Contrast the direct and indirect methods of calculating net cash flow from operating activities.
 - *11. Prepare a statement of cash flows.
 - *12. Identify special problems in preparing a statement of cash flows.
- *This material is covered in an Appendix to the chapter.

CHAPTER REVIEW

1. Corporate investors and potential investors seek information about the financial position, results of operations, and cash flow. Prior to the issuance of *FASB No. 95, "Statement of Cash Flows,"* investors were limited to the information about cash flows that they could extract from the balance sheet, income statement, and statement of changes in financial position. The information in these statements was based on accrual accounting and an analysis of working capital which was somewhat removed from the underlying cash flows of the enterprise. With the required presentation of the statement of cash flows, financial statement users were provided with information about the major sources and uses of cash during the fiscal period. Chapter 23 describes the significance of the statement of cash flows and all aspects of its preparation. Numerous examples are included which assist in an understanding of how the statement is prepared and presented.

Purpose of the Statement of Cash Flows

2. (S.O. 1) The information in a statement of cash flows should help investors, creditors, and others to assess: (1) the entity's ability to generate future cash flows; (2) the entity's ability to pay dividends and meet obligations; (3) the reasons for the difference between net income and net cash flow from operating activities; and (4) the cash and noncash investing and financing transactions during the period.

Classification of Cash Flows

3. (S.O. 2) The statement of cash flows classifies cash receipts and cash payments by **operating, investing, and financing** activities. **Operating activities** include all transactions and events that are not investing and financing activities. Operating activities include cash effects of **transactions that enter into the determination of net income**, such as cash receipts from the sales of goods and services and cash payments to suppliers and employees for acquisitions of inventory and expenses. **Investing activities** include (a) making and collecting loans and (b) acquiring and disposing of investments and productive long-lived assets. **Financing activities** involve liability and owners' equity items and include (a) obtaining cash from creditors and repaying the amounts borrowed and (b) obtaining capital from owners and providing them with a return on, and return of, their investment.
4. The typical cash receipts and cash payments of a business entity classified according to operating, investing, and financing activities are shown below.

Operating Activities

Cash inflows

From sale 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.

Investing Activities

Cash inflows

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

Cash outflows

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

Financing Activities

Cash inflows

- From sale of equity securities.
- From issuance of debt (bonds and notes).

Cash outflows

- To shareholders as dividends.
- To redeem long-term debt or reacquire capital stock.

It should be noted that **(1)** operating activities involve income determination items, **(2)** investing activities involve cash flows generally resulting from changes in long-term asset items, and **(3)** financing activities involve cash flows generally resulting from changes in long-term liability and stockholders' equity items.

5. Some cash flows relating to investing or financing activities are classified as operating activities. For example, receipts of investment income (interest and dividends) and payments of interest to lenders are classified as operating activities. Conversely, some cash flows relating to operating activities are classified as investing or financing activities. For example, the cash received from the sale of property, plant, and equipment at a gain, although reported in the income statement, is classified as an investing activity, and the effect of the related gain would not be included in net cash flow from operating activities. Likewise a gain or loss on the payment of debt would generally be part of the cash outflow related to the repayment of the amount borrowed and, therefore, is a financing activity.

Steps in Preparation

6. The information used to prepare the statement of cash flows generally comes from three major sources: (a) **comparative balance sheets**, (b) **the current income statement**, and (c) **selected transaction data**. Actual preparation of the statement of cash flows involves three steps:
 - (1) **Determine the change in cash.** This procedure is straightforward because the difference between the beginning and ending cash balance can be easily computed from an examination of the comparative balance sheets.
 - (2) **Determine the net cash flow from operating activities.** This procedure is complex; it involves analyzing not only the current year's income statement but also comparative balance sheets as well as selected transaction data.
 - (3) **Determine cash flows from investing and financing activities.** All other changes in the balance sheet accounts must be analyzed to determine their effect on cash.
7. (S.O. 3) To compute net cash flows from operating activities it is necessary to report revenues and expenses on a cash basis. This is done by eliminating the effects of income statement transactions that did not result in a corresponding increase or decrease in cash. The conversion of accrual-based net income to net cash flow from operating activities may be done through either the **direct method** or the **indirect method**.

Direct and Indirect Methods

8. (S.O. 4) Under the **direct method** (also called the income statement method) cash revenues and expenses are determined. The difference between these two amounts represents net cash flows from operating activities. In essence, the direct method results in the presentation of a cash basis income statement. Under the **indirect method** (also called the reconciliation method), computation of net cash flows from operating activities begins with net income. This accrual based amount is then converted to net cash provided by operating activities by adding back noncash expenses and charges and deducting noncash revenues. For example, an increase in accounts receivable during the year means that sales for the year increased receivables without a corresponding increase in cash. Thus, the increase in accounts receivable must be deducted from net income to arrive at cash provided by operations. Similarly, if an entry was made at the end of the year for accrued wages, the wages expense would increase without a corresponding decrease in cash. Thus, the increase in accrued wages would have to be added back to net income to arrive at cash provided by operations.
9. While *FASB Statement No. 95* encourages the use of the direct method when preparing the statement of cash flows, use of the indirect method is also permitted. However, if the direct method is used the FASB requires that a reconciliation of net income to net cash flow from operating activities shall be provided in a separate schedule. Therefore, under either method, the indirect (reconciliation) approach must be presented. The textbook includes **three comprehensive illustrations** which provide a detailed explanation of the preparation and presentation of the statement of cash flows. Each illustration should be studied prior to attempting the assigned problem material.
10. Both the direct method and the indirect method have distinct advantages which should be considered when deciding on the method to be used in presenting the statement of cash flows. The principal advantage of the direct method is that it shows operating cash receipts and payments. Supporters contend that this is useful in estimating future cash flows and in assessing an entity's ability to **(a)** generate sufficient cash flow from operations for the payment of debt, **(b)** reinvest in its operations, and **(c)** make distributions to owners. Proponents of the indirect method cite the fact that it focuses on the difference between net income and net cash flow from operations as its principal advantage. Also, supporters of the indirect method contend that users are more familiar with the method and it is less costly to present the statement of cash flows using this method.

Direct Method Disclosures

11. (S.O. 7) Minimum disclosure requirements for companies which use the direct method include the following:

Receipts

- a. Cash collected from customers.
- b. Interest and dividends received.
- c. Other operating cash receipts, if any.

Payments

- a. Cash paid to suppliers and employees for goods and services.
- b. Interest paid.
- c. Income taxes paid.

- d. Other operating cash payments, if any.

Use of the indirect method requires separate disclosure of changes in inventory, receivables, and payables relating to operating activities. Such disclosures are required for the purpose of aiding users in approximating the direct method.

Indirect Method Disclosures

12. The schedule shown below presents the common types of adjustments that are made to net income to arrive at net cash flow provided by operating activities under the indirect method.

Additions to Net Income

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.
Decrease in receivables.
Decrease in inventories.
Decrease in prepaid expenses.
Increase in accounts payable.
Increase in accrued liabilities.

Deductions from Net Income

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 expenses.
Decrease in accounts payable.
Decrease in accrued liabilities.

Special Problems

13. (S.O. 8) Nine items, described as special problems related to preparing the statement of cash flows, are presented in the text material. These items relate to various aspects of the statement of cash flows and should be understood for accurate preparation of the statement.
- (a) **Adjustments similar to depreciation**—depreciation expense is added back to net income to arrive at net cash provided by operating activities. Likewise, amortization of intangible assets and amortization of deferred costs are also added back to net income.
- (b) **Accounts receivable (net)**—an increase in the Allowance for Doubtful Accounts should be added back to net income to arrive at net cash provided by operating activities. This is due to the fact that the increase in the allowance results in a charge to bad debts expense (a noncash expense).
- (c) **Other working capital changes**—some changes in working capital, although they affect cash, do not affect net income. Generally, these are investing or financing activities of a current nature such as the purchase of short-term investments (trading and available-for-sale securities).

- (d) **Net losses**—If an enterprise reports a net loss instead of net income, the net loss must be adjusted for those items that do not result in a cash inflow or outflow. As a result of such adjustments, the net loss may turn out to be a positive cash flow from operating activities.
- (e) **Gains**—because a gain on the sale of plant assets is reported in the statement of cash flows as part of the cash proceeds from the sale of the assets under investing activities, the gain is deducted from net income to avoid double counting.
- (f) **Stock options**—compensation expense is recorded during the period(s) in which an employee performs the service if a company has a stock option plan. This expense is recorded by debiting compensation expense and crediting a stockholders' equity account. Thus, net income has to be increased by the amount of compensation expense in computing net cash provided by operating activities.
- (g) **Postretirement benefit costs**—the difference between the pension expense recorded during the period and the amount of cash funded for the pension plan must be an adjustment to net income in arriving at net cash provided by operating activities.
- (h) **Extraordinary items**—cash flows from extraordinary transactions and other events whose effects are included in net income, but which are not related to operations, should be reported as either investing or financing activities.
- (i) **Significant noncash transactions**—significant noncash investing and financing activities (such as purchasing an asset by assuming long-term debt), if material in amount, should be disclosed in a separate schedule or narrative disclosure. These items are not to be incorporated in the statement of cash flows.

Worksheet and T-Account Approach

14. (S.O. 9) Near the end of Chapter 23, a **comprehensive illustration** of the statement of cash flows is presented. This illustration includes an explanation of how a work sheet can be used in preparing the statement.

LECTURE OUTLINE

The material in this chapter can be covered in three class sessions. Students often have difficulty in adjusting transactions recorded on an accrual basis to a cash basis income statement. **Illustration 23-7** provides a numerical example of calculating net cash flow from operating activities under both the indirect and direct methods.

A. Purposes and Uses of Statement of Cash Flows.

1. Purposes of the statement.
 - a. To provide information about the cash receipts and cash payments of an entity during a period. Important information for financial statement users because many feel that accrual accounting does not present true picture.
 - b. To summarize the operating, investing, and financing activities of the business.
2. Uses of the statement.
 - a. Assessing the entity's ability to generate positive future cash flows.
 - b. Assessing the entity's ability to pay dividends and meet obligations.
 - c. Reconciling the difference between net income and net cash flow from operating activities.
 - d. Assessing the cash and noncash investing and financing transactions during the period.

B. Classification of Cash Flows and Format of Statement of Cash Flows.

TEACHING TIP

Illustration 23-1 identifies the major classifications of cash flows and lists some typical cash receipts and payments under each classification.

1. **Operating activities:** transactions related to the calculation of net income.
2. **Investing activities:** transactions related to long-term assets.
3. **Financing activities:** transactions related to liabilities and stockholders' equity.
4. Format of the statement.

TEACHING TIP

Illustration 23-2 provides a skeleton format of a statement of cash flows (indirect method).

C. Preparation of the Statement of Cash Flows.

1. Sources of information.
 - a. Comparative balance sheets.

- b. Current income statement.
 - c. Selected transaction data.
2. Steps.
- a. Determine the change in cash and cash equivalents.
 - b. Determine the net cash flow from operating activities.
 - c. Determine cash flows from investing and financing activities.

D. Indirect Method to Determining Net Cash Flow from Operating Activities.

- 1. Start with net income and make adjustments for items which affect net income but do not affect cash.

TEACHING TIP

Illustration 23-3 provides a listing of typical additions and deductions from net income to arrive at net cash flow from operating activities using the indirect method.

- 2. Make adjustments for changes in working capital accounts that affect income.
- 3. Make adjustments for gains and losses.

E. Direct Method.

- 1. Schedule of changes from accrual to cash basis income statement.

TEACHING TIP

Illustration 23-4 provides a schedule of changes from the accrual to the cash basis income statement when using the direct method.

- 2. Cash flows from operating activities.

TEACHING TIP

Illustration 23-5 provides a partial statement of cash flows displaying net cash flow from operating activities using the direct method. The illustration is based on the same data used in **Illustration 23-4**.

- 3. Direct method must also provide a separate schedule showing the reconciliation of net income to net cash provided by operating activities.

F. Direct vs. Indirect Controversy

- 1. Direct method has the advantage of showing operating cash receipts and payments.

2. Indirect method has the advantage of reconciling net income with net cash flow from operating activities.
3. Although the FASB prefers the direct method, it permits the use of the indirect method.

TEACHING TIP

Illustration 23-6 presents the different formats of the operating activities section for the direct method and the indirect method. Even though the FASB has stated its preference for the direct method, an overwhelming majority of companies use the indirect method. Discuss with students why companies prefer using the indirect method.

4. Users of the direct method are required, at a minimum, to report separately:
 - a. Cash receipts
 - (1) Cash collected from customers.
 - (2) Interest and dividends received.
 - (3) Other operating cash receipts, if any.
 - b. Cash payments
 - (1) Cash paid to employees and suppliers of goods or services.
 - (2) Interest paid.
 - (3) Income taxes paid.
 - (4) Other operating cash payments, if any.
 5. Indirect method users are required to disclose separately:
 - (1) Changes in inventory, receivables, and payables to reconcile net income to net cash flow from operating activities.
 - (2) Interest paid.
 - (3) Income taxes paid.
- G. Special Problems in Preparing a Statement of Cash Flows.
1. Adjustments similar to depreciation. Amortization of intangible assets, deferred costs, bond discount or premium, and changes in deferred income taxes.
 - a. Also, changes related to an investment accounted for under the equity method.
 2. Accounts receivable.
 - a. Indirect method. Increase/decrease in the Allowance for Doubtful Accounts should be added/deducted from net income or, just compare the change in accounts receivable on a net basis.

- b. Direct method. Do not net the accounts receivable. If accounts have been written off an additional adjustment is necessary.
3. Other working capital changes.
- a. Items that affect cash, but not net income:
 - (1) Purchase of short-term available-for-sale securities.
 - (2) Short-term nontrade notes payable.
 - (3) Cash dividends payable.
4. Net losses. After adjustments, may result in either a positive or a negative net cash flow from operating activities.
5. Gains. Deducted from net income.
6. Stock options. Added to net income in the amount of compensation expense from stock options.
7. Pensions. Adjust net income for the difference between cash paid and expense reported.
8. Extraordinary gains/losses. Deducted/added from/to net income at gross amount.
- a. Classify as either an investing or financing activity.
 - b. Shown at gross amount, not net of tax.
 - c. FASB requires that all income taxes be classified as operating cash outflows.
9. Significant noncash transactions. Excluded from body of the statement of cash flows.
- a. If material in amount, may be disclosed in a narrative or schedule at the bottom of the statement, or
 - b. As a separate note or schedule to the financial statements.

TEACHING TIP

Illustration 23-7 provides a numerical example that contrasts the calculation of cash flow from operating activities using the indirect and direct methods. As an aid to understanding the schedule of changes from the accrual basis to the cash basis income statement under the direct method, mock journal entries are developed that indicate the cash effects of changes in related balance sheet and income statement accounts.

H. Use of a Work Sheet

- 1. Basic format. Explain each part of the work sheet.
 - a. In the balance sheet accounts section, debit balance accounts are listed separately from credit balance accounts.

- b. In the statement of cash flows effects sections, cash inflows are entered as debits and outflows as credits.
- c. Reconciling items are not entered in any journal or account.

TEACHING TIP

Illustration 23-8 provides the format of a work sheet for the preparation of the statement of cash flows using the indirect method.

- 2. Analyzing and entering transactions.
- 3. The bottom portion of the work sheet provides the information necessary to prepare the statement of cash flows.

ILLUSTRATION 23-1 OPERATING, INVESTING, AND FINANCING ACTIVITIES

COMPONENTS OF THE STATEMENT OF CASH FLOWS

CASH FLOWS FROM OPERATING ACTIVITIES

- + Sales and Service Revenue Received
- Cost of Sales Paid
- Selling Expenses Paid
- Administrative Expenses Paid
- Income and Other Taxes Paid
- + Interest Revenue Received (from OTHER companies)
- + Dividend Revenue Received (from OTHER companies)
- + Other Revenues Received
- Interest Expense Paid (on OWN company notes and bonds)
- Other Expenses Paid

CASH FLOWS FROM INVESTING ACTIVITIES

- +/- Plant and Equipment Sale and Acquisition
 - +/- Notes Receivable Collection from and Issuance to Customers
 - +/- Stock and Bond Sale and Acquisition
(Investments in OTHER companies)
- (gain or loss affects operating activities; cash flows appear here)*

CASH FLOWS FROM FINANCING ACTIVITIES

- +/- Stock and Bond Issuance and Retirement (for OWN company securities)
- +/- Notes Payable to Vendors and Banks Issuance and Retirement
- Dividends Paid (of OWN company to its owners)

NOTE: Only difficult pair to remember—Key is the originating statement:

Interest Expense is an Income Statement item → Operating Flow
Dividends Declared is a Retained Earnings item → Financing Flow

ILLUSTRATION 23-2
FORMAT OF STATEMENT OF CASH FLOWS (Indirect Method)

Company Name	
STATEMENT OF CASH FLOWS (Indirect Method)	
Period Covered	
Cash Flows from operating activities	xxx
Net income	
Adjustments to reconcile net income to net cash provided by operating activities:	
(List of individual items)	<u>xx</u>
Net cash flow provided (used) by operating activities	xxx
Cash flows from investing activities	
(List of individual inflows and outflows)	<u>xx</u>
Net cash provided (used) by investing activities	xxx
Cash flows from financing activities	
(List of individual inflows and outflows)	<u>xx</u>
Net cash provided (used) by financing activities	<u>xxx</u>
Net increase (decrease) in cash	xxx
Cash at beginning of period	<u>xxx</u>
Cash at end of period	<u>xxx</u>

**ILLUSTRATION 23-3
INDIRECT METHOD: ADDITIONS AND DEDUCTIONS
TO AND FROM NET INCOME**

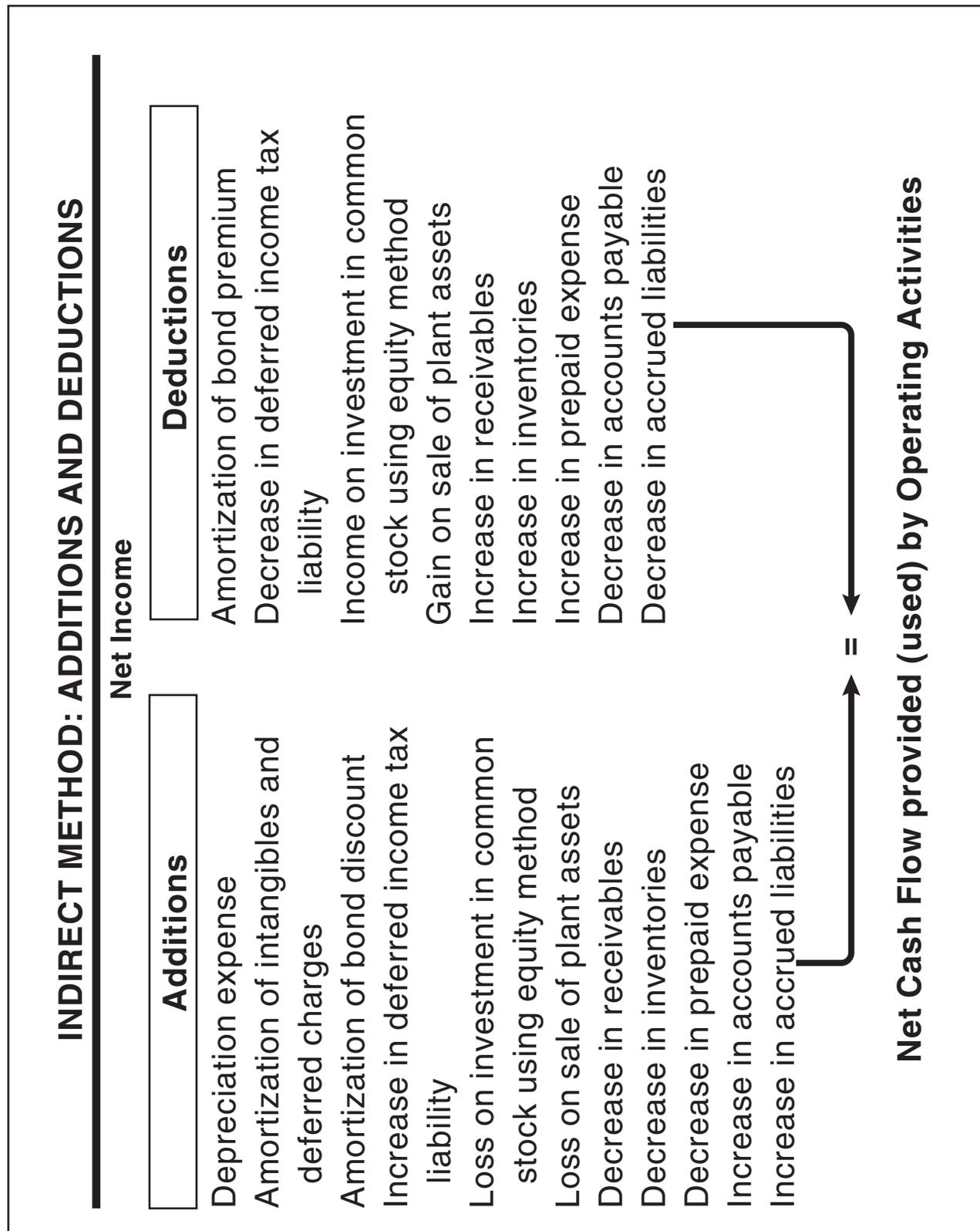


ILLUSTRATION 23-4
SCHEDULE OF CHANGES FROM THE ACCRUAL
TO THE CASH BASIS INCOME STATEMENT

Farmer Company			
SCHEDULE OF CHANGES FROM THE ACCRUAL TO THE CASH BASIS INCOME STATEMENT (Direct Method)			
Accrual Basis	Adjustment	Add (Subtract)	Cash Basis
Sales	\$232,000	+ Decrease in receivables \$8,000	\$240,000
Cost of goods sold	94,000	- Decrease in inventories (2,000)	
Selling and administrative expenses	70,000	+ Decrease in accounts payable 12,000	104,000
		- Depreciation expense (4,000)	
Income tax expense	12,000	+ Increase in prepaid expenses 1,000	67,000
Total expenses	<u>176,000</u>	- Increase in taxes payable (5,000)	<u>7,000</u>
Net income	<u>\$ 56,000</u>	Net cash provided by operating activities	<u>178,000</u> <u>\$ 62,000</u>

**ILLUSTRATION 23-5
CASH FLOWS FROM OPERATING ACTIVITIES—
DIRECT APPROACH**

**Farmer Company
STATEMENT OF CASH FLOWS (PARTIAL)
(Direct Method)**

Cash flows from operating activities	\$240,000
Cash received from customers	
Cash paid to suppliers	\$(104,000)
Selling and administrative expenses paid	(67,000)
Taxes paid	<u>(7,000)</u>
Cash disbursed for operating activities	<u>(178,000)</u>
Net cash provided by operating activities	<u>\$ 62,000</u>

**ILLUSTRATION 23-6
DIRECT VS INDIRECT CONTROVERSY**

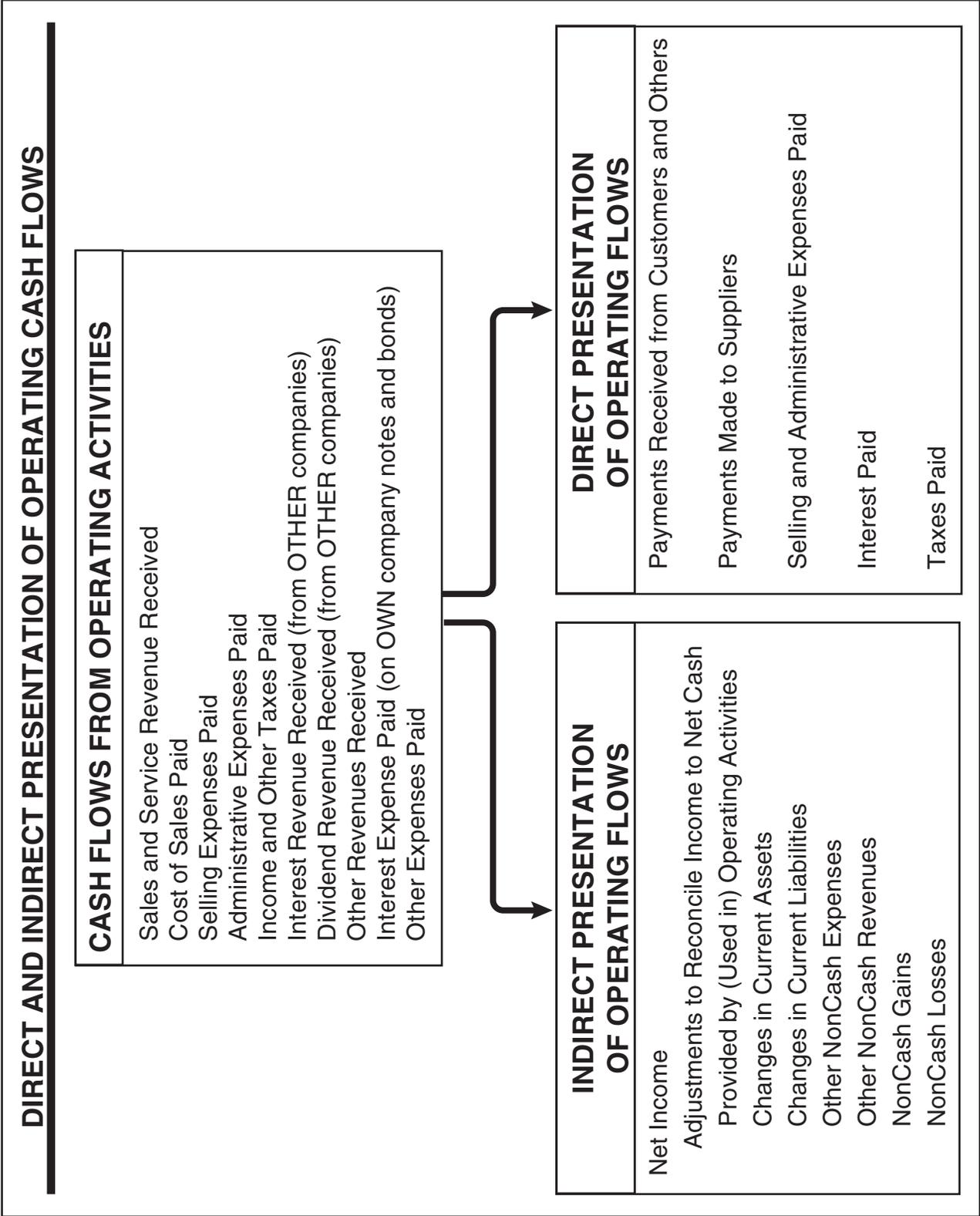


ILLUSTRATION 23-7 CALCULATION OF CASH FLOWS FROM OPERATING ACTIVITIES

DATA—The financial statements of the company are as follows:

THE ROBINSON COMPANY COMPARATIVE BALANCE SHEETS DECEMBER 31,

ASSETS	2004	2003	Increase (Decrease)
Cash	\$130,000	\$ 40,000	\$90,000
Accounts receivable	69,000	60,000	9,000
Inventory	80,000	100,000	(20,000)
Prepaid Insurance	6,000	4,000	2,000
Land	120,000	200,000	(80,000)
Building	500,000	400,000	100,000
Accumulated depreciation	(105,000)	(100,000)	(5,000)
Total Assets	<u>\$800,000</u>	<u>\$704,000</u>	<u>\$96,000</u>
LIABILITIES & OWNERS' EQUITY			
Accounts payable	\$ 20,000	\$ 25,000	\$ (5,000)
Income	22,600	20,000	2,600
Notes payable, long-term	40,000	50,000	(10,000)
Bonds payable	120,000	100,000	20,000
Common stock	450,000	400,000	50,000
Paid-in capital	60,000	50,000	10,000
Retained earnings	87,400	59,000	28,400
Total Liabilities & Owners' Equity	<u>\$800,000</u>	<u>\$704,000</u>	<u>\$96,000</u>

THE ROBINSON COMPANY INCOME STATEMENT For the Year Ended December 31, 2004

Sales Revenue		\$200,000
Expenses		
Cost of goods sold	\$ 80,000	
Salary expense	39,000	
Depreciation expense	5,000	
Interest expense	3,000	
Insurance expense	1,000	
Loss on sale of land	10,000	
Income tax expense	18,600	
Total expenses		<u>156,600</u>
Net income		<u>\$ 43,400</u>

ILLUSTRATION 23-7 (continued)

Other information:

1. Land which originally cost \$100,000 was sold for \$90,000.
2. Building was purchased for cash.
3. Bonds were issued at par value in exchange for land.
4. Common stock with a par value of \$50,000 was issued for \$60,000.
5. Dividends of \$15,000 were declared and paid during the year.

Calculation of cash flow from operating activities (indirect method)

<u>Operating—Net Income</u>	<u>43,400</u>	
Retained Earnings		43,400
Accounts Receivable	9,000	
<u>Operating—Increase in Accounts Receivable</u>		<u>9,000</u>
<u>Operating—Decrease in Inventory</u>	<u>20,000</u>	
Inventory		20,000
Prepaid Insurance	2,000	
<u>Operating—Increase in Prepaid Insurance</u>		<u>2,000</u>
Accounts Payable	5,000	
<u>Operating—Decrease in Accounts Payable</u>		<u>5,000</u>
<u>Operating—Increase in Income Taxes Payable</u>	<u>2,600</u>	
Income Taxes Payable		2,600
<u>Operating—Depreciation Expense</u>	<u>5,000</u>	
Accumulated Depreciation		5,000
Investing—proceeds from sale of land	90,000	
<u>Operating—Loss on Sale of Land</u>	<u>10,000</u>	
Land		100,000

ILLUSTRATION 23-7 (continued)

THE ROBINSON COMPANY STATEMENT OF CASH FLOWS (PARTIAL) (Indirect Method)

Cash flows from operating activities		
Net income		\$43,400
Adjustments to reconcile net income to net cash provided by operating activities:		
Increase in accounts receivable	\$(9,000)	
Decrease in inventory	20,000	
Increase in prepaid expenses	(2,000)	
Decrease in accounts payable	(5,000)	
Increase in income taxes payable	2,600	
Depreciation expense	5,000	
Loss on sale of land	<u>10,000</u>	<u>21,600</u>
Net cash provided by operating activities		<u>\$65,000</u>

Calculation of cash flows from operating activities (direct method)

THE ROBINSON COMPANY SCHEDULE OF CHANGES FROM THE ACCRUAL TO THE CASH BASIS INCOME STATEMENT

Accrual Basis	Adjustment	Add (subtract)	Cash Basis
Sales revenue	\$200,000	– Increase in accts. rec. \$(9,000)	<u>\$191,000</u>
Cost of goods sold	80,000	– Decrease in inventory (20,000) + Decrease in accts. pay. 5,000	65,000
Salary expense	39,000	—	
Depreciation expense	5,000	– Depreciation expense (5,000)	
Interest expense	3,000	—	
Insurance expense	1,000	+ Increase in prepaid ins. 2,000	3,000
Loss on sale of land	10,000	– Loss on sale of land (10,000)	
Income tax expense	<u>18,600</u>	– Increase in taxes pay. (2,600)	<u>16,000</u>
Total expenses	<u>156,600</u>		<u>126,000</u>
Net income	<u>\$43,400</u>		<u>\$65,000</u>

ILLUSTRATION 23-7 (continued)

As an aid in understanding the adjustments from the accrual to the cash basis, students may be more familiar with mock journal entries.

Accounts Receivable	9,000	
<u>Cash Received from Customers</u>	<u>191,000</u>	
Sales		200,000
Cost of goods sold	80,000	
Accounts Payable	5,000	
Inventory		20,000
<u>Cash Paid to Suppliers</u>		<u>65,000</u>
Salary Expense	39,000	
<u>Cash Paid to Employees</u>		<u>39,000</u>
Depreciation Expense	5,000	
Accumulated Depreciation		5,000
Interest Expense	3,000	
<u>Cash Paid for Interest</u>		<u>3,000</u>
Insurance Expense	1,000	
Prepaid Insurance	2,000	
<u>Cash Paid for Insurance</u>		<u>3,000</u>
Investing—proceeds for sale of land	90,000	
Loss on sale of land	10,000	
Land		100,000
Income Tax Expense	18,600	
Income Taxes Payable		2,600
<u>Cash Paid for Taxes</u>		<u>16,000</u>

THE ROBINSON COMPANY
STATEMENT OF CASH FLOWS (PARTIAL) (Indirect Method)

Cash flows from operating activities		
Cash received from customers		\$191,000
Cash paid to suppliers	\$(65,000)	
Cash paid to employees	(39,000)	
Cash paid for interest	(3,000)	
Cash paid for insurance	(3,000)	
Cash paid taxes	<u>(16,000)</u>	
Cash disbursed for operating activities		<u>(126,000)</u>
Net cash provided by operating activities		<u>\$65,000</u>

ILLUSTRATION 23-8
FORMAT OF WORK SHEET FOR PREPARATION OF THE
STATEMENT OF CASH FLOWS—INDIRECT METHOD

Company Name				
WORK SHEET FOR PREPARATION OF STATEMENT OF CASH FLOWS				
Period Covered				
<u>Balance Sheet Accounts</u>	Balances End of Last year	<u>Reconciling Items</u>		Balances End of Current year
		<u>Debits</u>	<u>Credits</u>	
Debit balance accounts	_____			_____
Total debits	=====			=====
Credit balance accounts	_____			_____
Total credits	=====			=====
<u>Statement of Cash Flow Effects</u>				
Operating activities				
Net income				
Adjustments				
Investing activities				
Receipts and payments				
Financing activities				
Receipts and payments				
Totals		_____	_____	
Increase (decrease) in cash		_____	_____	
Totals		=====	=====	