AICPA

Statement of Cash Flows: Preparation, Presentation, and Use

TOM KLAMMER

WILEY

STATEMENT OF CASH FLOWS: PREPARATION, PRESENTATION, AND USE

BY TOM KLAMMER, PH.D., CPA

Notice to Readers

Statement of Cash Flows: Preparation, Presentation, and Use is intended solely for use in continuing professional education and not as a reference. It does not represent an official position of the Association of International Certified Professional Accountants, and it is distributed with the understanding that the author and publisher are not rendering legal, accounting, or other professional services in the publication. This course is intended to be an overview of the topics discussed within, and the author has made every attempt to verify the completeness and accuracy of the information herein. However, neither the author nor publisher can guarantee the applicability of the information found herein. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

You can qualify to earn free CPE through our pilot testing program.
If interested, please visit aicpa.org at http://apps.aicpa.org/secure/CPESurvey.aspx.

Course Code: **746421**
CL4FCFS GS-0417-0A
Revised: **February 2017**

TABLE OF CONTENTS

Recent Developments

Users of this course material are encouraged to visit the AICPA website at www.aicpa.org/CPESupplements to access supplemental learning material reflecting recent developments that may be applicable to this course. The AICPA anticipates that supplemental materials will be made available on a quarterly basis. Also available on this site are links to the various "Standards Trackers" on the AICPA's Financial Reporting Center which include recent standard-setting activity in the areas of accounting and financial reporting, audit and attest, and compilation, review and preparation.

Chapter 1

STATEMENT OF CASH FLOWS SUMMARY OF PRESENTATION REQUIREMENTS

This chapter provides a brief summary of the major requirements relating to the statement of cash flows. You will work with these fundamental requirements and then prepare an illustrative statement of cash flows. This introduction to the reporting requirements sets the stage for a careful review of technical reporting and disclosure requirements and several problem areas. There are many areas where professional judgment influences cash flow reporting decisions.

Requirements for the statement of cash flows discussed throughout the course rely on the guidance in FASB *Accounting Standards Codification* (ASC) 230, *Statement of Cash Flows*.

LEARNING OBJECTIVES

After completing this chapter, you should be able to do the following:

- Recall the fundamental cash flow reporting requirements.
- Identify general financing, investing, and operating inflows and outflows as well as noncash transactions.
- Identify characteristics of the direct and indirect methods of presenting cash from operations.
- Estimate direct method operating cash inflows and outflows from given financial data.
- Recall how to prepare a statement of cash flows using both the direct and indirect method of presenting operating information.

What Is a Statement of Cash Flows?

The statement of cash flows is a classified listing of the cash inflows and outflows of a reporting entity during a period.

The statement of cash flows

- provides information on cash inflows and outflows during a period;
- provides users with a second flows statement, complementing the income statement;
- does not replace the income statement;
- provides information not available on other financial reports; and
- indirectly provides information on an entity's liquidity and financial flexibility.

The measurement of resource inflows and outflows is a critical part of the accounting process. There are two general flow statements prepared by accountants for external reporting purposes: the income statement and the statement of cash flows.

1. The *statement of comprehensive income*, or income statement, is the primary measure of the periodic performance of the entity.
2. The *statement of cash flows* is a presentation of the inflows and outflows (during a period) of an individual asset or liability, a group of assets or liabilities, and cash, or cash and cash equivalents. The focus of the statement is on cash inflows and outflows.

The reconciliation of the differences between these two flow statements (and also the statement of financial position) represents an issue of growing importance to standard-setting bodies.

KNOWLEDGE CHECK

1. The statement of cash flows provides

    a. A direct predictor of an entity's liquidity.
    b. Users with a third required flow statement.
    c. Information designed to replace income statement information.
    d. Information on cash inflows and outflows during a period.

Fundamentals of Cash Flow Presentation

Key Point

Cash flow reporting guidance has been in place for nearly thirty years, yet precisely what cash flow information entities should present and what level of detail should be provided remain arguable questions.

How individuals use the statement remains uncertain. This uncertainty leaves the purpose and function of the statement subject to dispute.

These and many other issues are addressed throughout this course as you examine the preparation, presentation, and use of cash flow information.

Examples throughout the text illustrate many of the possible presentation formats of a statement of cash flows. The presentation suggestions made in the text typically *emphasize the value of statements that are easy for users to understand.*

The skeletal statement on the next page is an example of a display and disclosure possibility that may make the statement of cash flows more usable.

Quick Exercise 1-1

Review the following skeletal statement for Example Company and list the major features of this statement.

Example Company Statement of Cash Flows for the Years Ending December 31

	20X2		20X1	
Cash Flows From Operating Activities				
Inflows				
Xxx	$ 300		$ 210	
Xxx	20	$ 320	40	$ 250
Outflows				
Xxx	160		130	
Xxx	90		70	
Xxx	10	$ 260	10	$ 210
Net flows provided by operating activities		60		40
Cash Flows From Investing Activities				
Inflows				
Xxx	70		100	
Xxx	200		110	
Xxx	10	280	30	240
Outflows				
Xxx	160		80	
Xxx	20	180	40	120
Net cash flows provided by investing activities		100		120
Cash Flows From Financing Activities				
Inflows				
Xxx	100		70	
Xxx	40	140	20	90
Outflows				
Xxx	140		160	
Xxx	60		40	
Xxx	10	210	10	210
Net cash flows used by financing activities		(70)		(120)
Net increase (decrease) in cash and cash equivalents		90		40
Beginning cash and cash equivalents		180		140
Ending cash and cash equivalents		$ 270		$ 180

Workspace

List the major features of the statement of cash flows.

Requirements

Reporting requirements for the statement of cash flows include the following:

1. Cash flow information should be presented whenever a statement of financial position and an income statement are presented.
2. The presentation order in the statement is operating, investing, and financing.
3. Both the indirect method, or reconciliation technique, and the direct method are currently acceptable. The indirect approach does not have inflows and outflows in the operating section.
4. The statement reconciles the change from beginning to ending cash and cash equivalents.[1]

[1] If a firm has restricted cash or restricted cash equivalents the reconciliation is to the change in cash, cash equivalents, and restricted cash or cash equivalents. Further discussion of restricted cash is provided in chapter 2. Because a large majority of firms do not have restricted cash we will us cash and cash equivalents in our discussion and in the example statements that are presented.

Cash Flow Reporting Guidance

The statement of cash flows is an essential part of an entity's financial report:

- An entity should present a statement of cash flows whenever a set of financial reports, which also include a statement of comprehensive income and a statement of financial position (balance sheet), are prepared using accounting principles generally accepted in the United States of America (U.S. GAAP).
- An entity should present comparative statements of cash flows.

The guidance in FASB ASC 230 specifies the general form and content of a statement of cash flows prepared under U.S. GAAP. The major statement requirements are summarized on the following pages.

Key Point

The statement of cash flows is a valuable source of information and we suggest it should be presented even if presentation is not required. Cash flow information can be particularly useful when statements are prepared primarily for internal use.

Quick Exercise 1-2

Take a moment and list some situations where cash flow information would be useful to you. Individual answers will vary.

1. Uses for an external user of the statement's information

2. Uses for an internal user of the statement's information

Cash and Cash Equivalents[2]

The statement of cash flows uses cash, or cash and cash equivalents, as the definition of funds.

- The statement should explain the change in cash and cash equivalents during the period.
- The total ending cash (or cash and cash equivalents) amount should directly tie to a similar line item shown on the statement of financial position.

When an entity chooses a pure definition of *cash* for the statement of cash flows, cash consists of traditional cash items, such as cash on hand and cash in demand deposit accounts. There are, by

[2] See discussion of restricted cash and disclosure requirements in chapter 2.

definition, no cash equivalents when an entity uses the pure cash approach. The pure cash approach is likely to become the required approach when there is a major revision of cash flow reporting guidance.

Currently, many entities use a broader definition that includes *cash equivalents* for the statement of cash flows. In general terms

- cash equivalents are short-term, highly liquid investments that are quickly convertible to known amounts of cash. There is essentially no credit risk; and
- cash equivalents have original maturities to the entity of three months or less. There is essentially no market (or interest) rate risk.

Examples of cash equivalents include short-term Treasury bills, commercial paper, and money market funds.

Following is an illustrative disclosure of the cash equivalent definition used by many companies.

CCE Company

Annual Report: December 31, 20X2

Notes to Consolidated Financial Statements

Cash Equivalents

All highly liquid investments with maturities of three months or less at the date of purchase are considered to be cash equivalents.

GROSS AND NET CASH FLOWS

Entities should report the total (gross) amount of investing and financing cash inflow and cash outflow amounts on the statement of cash flows. For example,

- present the cash received from the sale of investments separately from the cash paid for investments or
- present the cash received from the issuance of long-term bonds separately from the cash paid to retire long-term bonds.

The partial financing section of a statement of cash flows that follows illustrates the presentation of gross cash flow amounts.

Moo Moo Manufacturing
Partial Statements of Cash Flows
for the Years Ending June 30

	20X2	20X1	20X0
Cash Flows From Financing Activities			
Net increase (decrease) in short-term debt	$ 1,024	$ 571	$ 3,036
→ Increase in long-term debt	10,793	36,794	124,984
→ Decrease in long-term debt	(27,323)	(33,050)	(162,644)
→ Issuance of stock	20	27	1,684
→ Acquisition of stock for Treasury		(247)	
Net cash flows provided by (used for) financing activities	$ (15,486)	$ 4,095	$ (32,940)

Is Netting Allowed?

Yes – If turnover is quick, the amounts are large, and the maturities are short:

- The guidance in FASB ASC 230 simply specifies that the original maturity of the asset or liability to the entity must be three months or less before the entity may net. For example, a bank may net demand deposit liabilities.

An entity may choose to present total inflows and total outflows for any item that qualifies for netting. Net presentation is a choice, not a requirement.

KNOWLEDGE CHECK

2. The statement of cash flows defines *funds* as

   a. Cash and short-term receivables.
   b. Cash and short-term investments.
   c. Cash and cash equivalents.
   d. Working capital.

Classification

The statement of cash flows classifies cash flows into three major cash activity groups: *operating*, *investing*, and *financing*. There are inflows and outflows that affect each category. Reporting guidance clearly identifies the basic classes of items that are part of the investing and financing sections of the statement of cash flows.

OPERATING CASH FLOWS

The operating section reports the cash effects of most recurring transactions and other events that enter into the determination of net income. It is the default classification under existing guidance. *Operating inflows* and *operating outflows* include those activities not defined as investing or financing activities.

Cash Flows From Operating Activities	
Inflows	**Outflows**
Cash receipts from the sale of goods or services	Cash payments for trade goods purchased for resale or for use in manufacturing
Cash receipts from the collection or sale of operating receivables. These receivables arise from the sales of goods or services	Cash payments for notes to suppliers of trade goods
Cash interest received	Cash payments to other suppliers and to employees
Cash dividends received	Cash paid for taxes, fees, and fines
Other cash receipts not directly identified with financing or investing activities (such as lawsuit settlements or normal insurance settlements)	Interest paid to creditors
	Other cash payments not directly identified with financing or investing activities (such as lawsuit settlements, contributions, or certain asset retirement obligations)

Cash Flows from Investing Activities

Activities classified as *investing activities* on the statement of cash flows are those activities associated with investments in productive assets and investments in the debt or equity securities of other entities. Interest and dividends received are classified as operating.

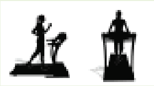
Cash Flows From Investing Activities	
Inflows	**Outflows**
Collections of principal amounts (such as the face value of a six-month note) on debt instruments issued by other entities	Cash amounts paid out to acquire the debt instruments of other entities (such as loans to suppliers, and acquisitions of mortgage notes)
Cash proceeds from the sale of equity investments, such as common or preferred stock (the total proceeds from the sale, not the original investment)	Cash payments made to buy an equity interest (such as common or preferred shares) in other entities
Cash received from the sale of productive assets	Disbursements made to purchase productive assets (such as property, plant, and equipment)

Cash Flows From Financing Activities

Most of the cash flows on the statement of cash flows are classified as *financing activities* between the entity and its providers of capital, both debt and equity.

Cash Flows From Financing Activities	
Inflows	**Outflows**
Cash proceeds from the sale of equity securities (such as common and preferred stock)	Cash disbursed to repay principal on long and short-term debt, (such as bonds, mortgages, and notes)
Cash receipts from borrowing (such as bonds, mortgages, and notes)	Cash paid to reacquire common and preferred equity instruments, whether retired or placed in the Treasury
Cash receipts from contributions and investment income donor restricted for endowments or buying, improving or constructing long-lived assets (also includes interest and dividends received on assets donor restricted for long-term purposes)	Dividends paid to common and preferred shareholders Debt issue costs, payments for prepayment or debt extinguishment, certain contingent liability payments made soon after an acquisition

Quick Exercise 1-3



Classify the following eight items as operating, investing, financing, or noncash:

1. Capital expenditures made for cash
2. Issuance of 10-year bond
3. Capital lease with no down payment
4. Loan to a supplier
5. Collection from customer
6. Interest paid
7. Dividend paid
8. Sale of stock held in another entity

Reporting Noncash Transactions

Only cash inflows and outflows are reported on the statement of cash flows. Investing and financing activities not resulting in cash inflows or outflows are reported on a separate schedule or in a narrative presentation. *This noncash information is not part of the statement of cash flows*.

The following transactions are examples of events that would be included in a separate schedule of noncash investing and financing transactions:

- Issuance of common stock in exchange for equipment
- Capital lease transactions
- Conversion of bonds to common stock

Technically, if there is a cash flow, the transaction belongs on the statement of cash flows. If there is not a cash flow, the transaction does not go on the statement of cash flows. Separate disclosure of major noncash transactions is necessary.

Presentation Issue: Reporting Noncash Transactions

The presentation may take many forms. FASB ASC 230 permits the use of either a separate schedule or a narrative.

ABC Corporation
Supplementary Statement of Cash Flows Information
for the Years Ending December 31

Supplemental Schedule of Noncash Investing and Financing Activities

	20X2	**20X1**
Equipment acquired under capital leases		$ 99,509
Stock issued to employee	$ 10,000	
Stock issued to employee profit-sharing plan		51,962
Noncash investing and financing activities	$ 10,000	$ 151,471

OPERATING SECTION PRESENTATION OPTIONS

Existing cash flow reporting guidance permits organizations to use either of two methods of presenting the operating section of the statement of cash flows.

- *Direct method* – This method shows both cash receipts and cash disbursements as line items in the operating section. The direct method is the approach standard-setting bodies recommend that an entity use.
- *Indirect method* – This method starts the operating section with net income. Items that do not require cash are added and those requiring additional cash are subtracted from net income to determine cash provided by operations.

Key Point

The total amount reported as cash flows from operating activities will be the same whether an organization uses the direct or uses the indirect method.

Simplified illustrations of both the direct and the indirect method of presenting the operating section of the statement of cash flows are provided on the following page.

In reviewing the examples that follow, note that

- the cash provided by operating activities is the same,
- identical investing and financing sections would follow the operating section,
- the direct method focuses on gross cash inflow and outflow amounts, and
- the indirect method specifies which items included in income did not use cash and which required the use of more cash.

Statement of Cash Flows
Direct Method
for the Year Ending December 31, 20X2

Cash Flows From Operating Activities		
Cash inflows		
Receipts from customers	$ 30,000	
Dividends received	3,000	$ 33,000
Cash outflows		
Paid to suppliers	15,000	
Paid for wages and administration	10,000	
Interest paid	4,000	
Taxes paid	2,000	31,000
Net cash flows from operating activities		$ 2,000

Statement of Cash Flows
Indirect Method
for the Year Ending December 31, 20X2

Cash Flows From Operating Activities	
Net income	$ 1,000
Additions needed to reconcile net income to net cash provided	
Depreciation and amortization	800
Increase in deferred income taxes	200
Decrease in accounts receivable	300
Subtractions needed to reconcile net income to net cash provided	
Decrease in interest payable	(100)
Increase in inventory	(200)
Cash flows provided by operating activities	$ 2,000

Direct Method

The direct method of reporting cash inflows and cash outflows in the operating section of the statement of cash flows is the approach recommended by the standard-setting bodies. Despite this, relatively few large public firms currently use the direct method in their statement of cash flows:

- When an entity uses the direct method it must also provide a reconciliation of net income to cash flows from operating activities. This indirect method presentation provides users with additional details about operating cash flows. This requirement has discouraged many firms from experimenting with direct method presentation.

Although the direct method is less familiar as a method of presentation, it may well become the required approach when the next major revision of cash flow reporting requirements are made.

Minimum Requirements if Direct Method Is Used

Operating cash inflow disclosures

- Cash collected from customers
- Interest and dividends received in cash
- Any other cash receipts related to operations

Operating cash outflow disclosures

- Cash paid for normal operating expenses, such as payments to employees and suppliers
- Interest paid in cash
- Income taxes paid
- Any other cash payments related to operations

These are minimum, but not maximum, cash inflow and outflow disclosure requirements. An entity may estimate the operating cash inflows and outflows if actual cash flow information is not available.

It is currently acceptable to lump most operating cash payments into a single outflow category. The existing guidance encourages entities to experiment with statements that provide additional disclosure details.

Indirect Method

Entities may present cash flows from operating activities using the indirect method. When this method is used, you must remove from net income the effects of all deferrals of cash receipts and payments and all accruals of cash receipts and payments.

Required Adjustments and Disclosures if Indirect Method Is Used

Required adjustments of net income include

- deferrals of operating cash receipts and payments, such as those for inventory and prepaid revenues;
- accruals of operating cash receipts and payments, such as those for receivables and payables; and
- adjustments for gains and losses where the cash flows are part of the investing or financing sections. Examples include depreciation, sale of capital assets, or debt extinguishment.

The cash provided by operating activities calculated by the indirect method will equal the amount an entity would report if it used the direct method:

- Adjustments are made for period-to-period changes in such items as accounts receivable and accounts payable after eliminating any change amounts that represent investing and financing activities.

When using the indirect method, separate disclosure of the amount of interest and income taxes paid is required.

KNOWLEDGE CHECK

3. Cash paid out to acquire the debt instruments of another entity is classified as

   a. Operating.
   b. Investing.
   c. Financing.
   d. Noncash.

4. FASB ASC 230, *Statement of Cash Flows*

   a. Allows firms to present operating cash flows based on a working capital definition of funds.
   b. Requires the indirect method of presenting cash from operations to be used.
   c. Requires the direct method of presenting cash from operations to be used.
   d. Permits either the direct or the indirect method to be used in presenting cash from operations.

Preparing a Statement of Cash Flows

The preparation of a statement of cash flows requires *analysis of account changes and the reasons for these changes*. Ideally, information on the actual cash inflows and outflows that affect a particular activity is available for transfer to the statement of cash flows.

An entity must present total inflow and outflow information for most financing and investing activities. The accounting system may provide these amounts directly or it may be necessary to analyze the accounts to get the necessary information. For example, it is relatively easy to determine the actual cash dividends paid during the year; the cash dividends received. The cash proceeds from the sale of investments are often readily available from external activity statements or transaction documents. It may be necessary to review the activities that affected a specific account or account group, such as long-term debt, to get cash flow information.

Illustration 1-1

Facts

The entity's bonds payable account increased by $30,000 during the year. The company issued $90,000 in new bonds, retired $40,000 in bonds during the year at a cost of $42,000, and transferred $20,000 to short-term bonds payable because they are due early next year.

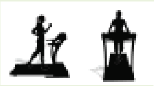
Statement Presentation Requirements

The statement of cash flows should show

1. the $90,000 inflow of cash from the sale of bonds in the financing section and
2. the $42,000 outflow of cash to retire the bonds in the financing section.

Any gain or loss on the extinguishment of debt is ignored under the direct approach in presenting operating information. This gain or loss amount is added to or subtracted from net income if the entity uses the indirect approach.

Quick Exercise 1-4



Answer each of the following questions.

1. Assume accrued interest payable increased by $15,000 during a period and the reported interest expense is $240,000. What is the cash outflow for interest during the period?

2. Assume that accrued wages increased $20,000 during the year and wage expense is $280,000. How much cash did the entity spend for wages during the year? How would this information be reported using the direct method? How would this information be reported using the indirect method?

3. An entity shows an increase of $20,000 in accounts receivable and sales of $300,000. There were no bad debts or write-offs during the year, but the entity bought another entity. The acquisition included $5,000 of accounts receivable. How much cash did the entity collect from its customers? Explain.

PREPARING THE OPERATING SECTION: DIRECT VERSUS INDIRECT METHODS

FASB has recommended that an entity use the direct method of presenting cash provided by operating activities in the statement of cash flows:

- An entity should use actual cash inflow and outflow information if it is available.
  - Certain information is almost certain to be available, such as dividends paid or interest received.
  - Other operating information may require an analysis of transactions during the period. For example, accounts payable may need to be analyzed in conjunction with cost of goods sold to determine how much cash was paid to suppliers.

Some accounting systems may not collect actual cash inflows and outflows. To make the direct method easy to use, the existing reporting guidance specifically permits entities to estimate (determine indirectly) major operating cash inflows and outflows. This approach is sometimes called the *indirect direct* method. To use this approach:

- Analyze the related income statement and balance sheet accounts to approximate cash inflows and outflows.
  - Assume that sales were $100,000 during the period. The accounts receivable balance (all of which relate to operating activities) increased from $5,000 to $10,000. You would estimate that the cash

collected from customers was $95,000. This is because the revenues include $5,000 of receivables that the entity has not yet collected.

- This analysis approach allows you to prepare an informative and cost effective statement of cash flows. Practically, the same type of analysis is completed for the indirect direct method as would be used for indirect method statement preparation.
  - In the indirect method you would subtract the $5,000 increase in receivables from net income when computing the cash provided by operating activities total.

KNOWLEDGE CHECK

5. Which activity will require a greater amount of analysis for you to determine the actual cash inflows and outflows?

   a. Cash dividends paid during the year.
   b. Interest income received.
   c. Long-term debt activities.
   d. All of the above will require the same amount of analysis.

Illustration of Direct and Indirect Methods

You can use the following income statement and change in balance sheet account information to prepare the operating section of a statement of cash flows using the direct method and indirect methods. Assume that the accrual and deferral accounts are operating activities and that all accounts payable relate to the purchase of inventory.

Income Statement
for the Year Ending December 31, 20X2

Revenue		$ 175,000
Cost of sales	$ 110,000	
Other expenses	45,000	
Depreciation	15,000	170,000
Net income		$ 5,000

Change in Selected Balance Sheet Accounts
During 20X1

Cash	+	$ 2,000
Accounts receivable	+	10,000
Inventories	–	7,000
Plant	+	20,000
Accumulated depreciation	+	15,000
Accounts payable	–	8,000
Common stock	+	13,000
Retained earnings	+	5,000

The entity sold common stock and purchased a plant asset during the year.

Solution Using the Direct Method

Statement of Cash Flows
for the Year Ending December 31, 20X2

Cash Flows From Operating Activities		
Inflows		
Cash from customers (1)		$ 165,000
Outflows		
Cash paid to suppliers (2)	$ 111,000	
Other expenses paid	45,000	156,000
Net cash from operating activities		9,000
Cash Flows Used in Investing Activities		
Purchase of plant		(20,000)
Cash Flows Provided by Financing Activities		
Sale of stock		13,000
Change in cash		$ 2,000
(1) Revenue		$ 175,000
Less increase in receivable		(10,000)
Cash from customers		$ 165,000
(2) Cost of sales		$ 110,000
Less decrease in inventory		(7,000)
Plus decrease in accounts payable		8,000
Cash paid to suppliers		$ 111,000

Solution Using the Indirect Method

Statement of Cash Flows
for the Year Ending December 31, 20X2

Cash Flows From Operating Activities	
Net income	$ 5,000
Adjustments to reconcile net income to net cash flows from operating activities	
Depreciation	15,000
(Increase) decrease in assets	
Accounts receivable	(10,000)
Inventories	7,000
(Decrease) increase in liabilities	
Accounts payable	(8,000)
Net cash provided by operating activities	$ 9,000
Cash Flows Used in Investing Activities	
Purchase of plant	(20,000)
Cash Flows Provided by Financing Activities	
Sale of stock	13,000
Change in cash	$ 2,000

Comprehensive Exercise

Comprehensive Exercise 1-1

Use the following income statement and balance sheet for Shake-A-Little Company to prepare its statement of cash flows using both the direct and indirect methods for the operating section.

During the year, the company sold a machine for $7,000. The machine had originally cost $20,000 and was half depreciated. The company also repaid bonds payable of $100,000 during the year. Assume that all accruals and deferrals relate to operations. Make any additional assumptions that are needed to complete the statement.

Income Statement
for the Year Ending December 31, 20X2

Sales	$ 600,000	
Interest income	20,000	$ 620,000
Cost of goods sold	360,000	
Salaries	150,000	
Depreciation	30,000	
Advertising	32,000	
Loss on sale of asset	3,000	
Interest expense	15,000	590,000
		30,000
Taxes		10,000
Net income		$ 20,000

Balance Sheet
December 31

	20X2	20X1
Assets		
Cash	$ 8,000	$ 2,000
Accounts receivable	23,000	20,000
Inventory	35,000	40,000
Long-term investments	200,000	200,000
Plant, property and equipment, net	300,000	280,000
	$ 566,000	$ 542,000
Liabilities and Equity		
Accounts payable	$ 13,000	$ 12,000
Unearned interest income	6,000	5,000
Accrued advertising	10,000	8,000
Accrued interest	5,000	3,000
Salaries payable	2,000	4,000
Bonds payable-20X3	130,000	100,000
Common stock	140,000	130,000
Retained earnings	260,000	280,000
	$ 566,000	$ 542,000

Workspace

Direct Method

Indirect Method

Appendix A

SUPPLEMENTAL PROBLEMS

This appendix provides supplemental practice exercises that will help refine your understanding of the fundamentals of cash flow reporting.

SUPPLEMENTAL PROBLEM 1-1

The Skip Company income statement and comparative balance sheet are presented as follows. Assume all accruals and deferrals relate solely to operating activities.

Skip Company
Income for Year

Revenues	$ 150,000	
Gain on sale of asset	3,000	
Cost of sales	$ 50,000	
Salaries	30,000	
Depreciation	9,000	
Insurance	4,000	93,000
Net income		$ 60,000

Skip Company
Changes in Selected Accounts

Cash	+	$ 62,000
Accounts receivable	+	20,000
Unearned revenue	+	10,000
Accrued wages	+	4,000
Prepaid insurance	+	3,000
Inventory	+	2,000
Accounts payable	+	8,000
Additional Information		
Long-term asset acquisition		$13,000
Sale of productive asset		11,000
Retirement of long-term debt		9,000
Payment of dividends		2,000
Issuance of long-term debt		12,000

Required

Use the financial statements to prepare both a direct and the indirect method statement of cash flows that meet the requirements of FASB ASC 230, *Statement of Cash Flows*.

SUPPLEMENTAL PROBLEM 1-2

Prepare a direct method and an indirect method statement of cash flows using the information provided as follows. Assume only normal transactions occurred during the period and all accruals and deferrals are related to operating transactions.

The following information is taken from the accounting worksheet for X-Ray Corporation:

Account Balances

	12/31/20X2	12/31/20X1
Cash	$ 24,000	$ 30,000
Accounts receivable	27,000	25,000
Inventories	50,000	45,000
Equipment	62,000	58,000
Land	12,000	
Accumulated depreciation	(32,000)	(30,000)
Accounts payable	(21,000)	(21,000)
Common stock	(100,000)	(100,000)
Retained earnings	(17,000)	(7,000)
Appropriation of retained earnings	(5,000)	
Sales	(100,000)	
Cost of goods sold	50,000	
Selling and administrative expense	20,000	
Depreciation	5,000	
Net income	25,000	

Additional Information

- A fully depreciated piece of equipment was discarded during the year.
- A cash dividend of $10,000 was paid and an appropriation of $5,000 was made against retained earnings.

SUPPLEMENTAL PROBLEM 1-3

Use the balance sheet and income statement information presented as follows, along with the additional information on the following page, to prepare a statement of cash flows using the direct method and a reconciliation of net income to cash from operations for EXX Company.

EXX Company
Balance Sheet
December 31

	20X2	20X1
Assets		
Cash	$ 50,000	$ 45,000
Accounts receivable	150,000	200,000
Inventory	280,000	390,000
Prepaid advertising expense	20,000	10,000
Land	200,000	100,000
Building and equipment	380,000	250,000
Accumulated depreciation	(100,000)	(120,000)
Marketable securities, noncurrent	70,000	50,000
	$ 1,050,000	$ 925,000
Liabilities and Equity		
Accounts payable	$ 400,000	$ 300,000
Taxes payable		50,000
Bonds payable, net	100,000	75,000
Common stock	150,000	100,000
Retained earnings	400,000	400,000
	$ 1,050,000	$ 925,000

EXX Company
Income Statement
for the Year Ending December 31, 20X2

Sales		$ 1,000,000
Cost of sales	$ 500,000	
Depreciation	40,000	
General expense	300,000	
Interest expense	25,000	
Loss on sale of equipment	15,000	
Tax expense	70,000	950,000
Net income		$ 50,000

Additional Information

- Land was purchased with equal amounts of common stock and cash.
- Equipment costing $80,000 that was three-quarters depreciated was sold.
- Advertising expense is part of general expenses.
- Interest expense includes discount amortization of $5,000.
- Bonds payable of $50,000 were retired during the year.
- Marketable securities costing $30,000 were sold for no gain or loss during the year.

Chapter 2

Cash Equivalents and Gross Versus Net Presentation: Issues and Examples

Business activities are complex and take on many forms. Exactly how and where to present cash flow information related to these activities in financial statements remains controversial. In this chapter the focus is on two preparation and presentation issues that can be troublesome. These two issues are as follows:

1. What qualifies as a cash equivalent?
2. When is net rather than gross presentation of cash inflows and outflows acceptable?

Learning Objectives

After completing this chapter, you should be able to do the following:

- Recall the purpose for presenting cash flow information and the statement of cash flows.
- Identify factors in determining what constitutes cash and cash equivalents.
- Indicate how cash equivalent disclosures may be presented.
- Recognize why total (gross) inflows and outflows should be shown in the investing and operating sections of the statement of cash flows.
- Identify when investing and financing cash flows can be reported net.

Statement of Cash Flows: Preparation, Presentation, and Use
By Tom Klammer

Presentation Fundamentals

Purpose of the Statement of Cash Flows

The primary purpose of the statement of cash flows is to *provide information about the cash receipts and cash payments* of the entity during the reporting period.

- This objective focuses attention on the cash inflows and outflows that took place during an accounting period.
- The statement is a presentation of cash inflows and outflows. Significant transactions not affecting cash are reported in a separate schedule.
- For consistency, an entity should present cash receipt and payment information in three categories: *operating, investing, and financing*.

A simplified indirect method statement example is presented as follows.

Consolidated Financial Statements

Cash Flow Statement

	20X2	20X1
Earnings	1,911	1,374
Non-cash adjustments:		
Depreciation	1,024	783
Other adjustments to earnings	43	(16)
Net cash provided from operations	**2,978**	**2,141**
Additions to property, plant & equipment	(2,478)	(1,987)
Net cash used for investing	**(2,478)**	**(1,987)**
Proceeds from issuing new stock	384	247
Payments to repurchase stock	(396)	(278)
Stock dividends paid	(10)	
Net cash used for financing	**(22)**	**(31)**
Change in cash and equivalents during year	**478**	**123**
Cash and equivalents, beginning of year	2,260	2,137
Cash and equivalents, end of year	2,738	2,260

ACTIVITY METHOD PRESENTATION

To improve statement comparability, FASB selected a single approach, the *activity method*, for use in the statement of cash flows. Several years later IASB adopted the same presentation approach.

There are three activity groups included in the statement of cash flows: operating, investing, and financing. Each includes both inflows and outflows. A single listing of inflows and outflows (the sources and uses approach) is no longer acceptable.

Advantages of the Activity Method Approach

- Classifying cash flows into meaningful groups is designed to improve the usefulness of the statement.
- Grouped items should have similar characteristics. The grouping method selected for the cash flow guidance was chosen to make cash flow analysis easier and to enhance the predictive value of financial statements.
- The activity method allows users to evaluate significant relationships within and among the three activity sections. Thus the cash flow effects of three types of related items are grouped and presented independently.

CLASSIFICATION ISSUES

Although potentially useful, the chosen classification scheme also causes some disclosure and use problems:

- The operating, investing, and financing classifications are inherently arbitrary.
  - The classification requirements can result in cash flows related to a specific activity being reported in two or more categories.
  - Similar activities may be inconsistently classified.
- Transactions that are an essential part of normal operations may be classified in other categories.
- Totals, such as cash provided by operations, are subject to misuse.

A more detailed discussion of these and other classification problems associated with the activity method occurs in a later chapter. These issues are influencing projects currently underway and the changes that standard-setters have been considering.

Key Point

When developing a statement of cash flows presentation approach, we believe it makes sense for the organization to select one that is easy for users to use and understand.

Two partial cash flow statements (containing only the investing and financing sections) are found on the following pages.

Why are the presentation approaches shown potentially easy for statement users to understand?

New financial reporting requirements are expected to attempt to improve comparability and understandability by providing additional guidance on cash flow presentation requirements.

Presentation Examples

Rather than randomly displaying investing and financing inflows and outflows many companies use a *grouped activity approach*. This technique shows related inflows and outflows together on the statement of cash flows and makes this information visible to statement users.

Group Company
Partial Statements of Cash Flows
for Years Ending, December 31

(In millions)			
	20X2	**20X1**	**20X0**
Cash Flows From Investing Activities			
Payments for purchase of property, plant, and equipment	$ (202.4)	$ (168.9)	$ (79.6)
Receipts from sales of property, plant, and equipment	31.2	19.9	52.1
Payments for acquisitions of businesses, net of cash acquired	(42.4)	(229.6)	(7.2)
Receipts from dispositions of business, net of cash disposed	88.2	—	—
Payments for purchase of marketable investments	(135.1)	(323.0)	(250.9)
Receipts from sales or maturities of marketable investments	76.1	135.0	108.9
Other investing activities	(49.3)	(3.0)	21.4
Net cash flows used by investing activities	(233.7)	(569.6)	(155.3)
Cash Flows From Financing Activities			
Proceeds from long-term borrowings	.5	1.2	.9
Payments on long-term borrowings	(1.2)	(19.2)	(46.5)
Net borrowings (payments) of short-term debt	(6.5)	(9.6)	7.3
Payments to reacquire common stock, net of issues	(4.9)	(10.8)	(18.0)
Payments of dividends to shareholders	(106.5)	(105.6)	(105.9)
Net cash flows used in financing activities	$ (118.6)	$ (144.0)	$ (162.2)

Another presentation method is identified as the *combination activity approach*. This approach creates an easy to read statement because the inflows and outflows within a classification are presented in the same order. There would be comparative information and an operating section in a complete statement. A number of entities use variations of this format.

Combination Company
Partial Statement of Cash Flows
for the Year Ending December 31, 20X2

Cash Flows From Investing Activities		
Cash inflows from liquidation of investments		
Land sales	$ 30,000	
Building sales	42,500	
Collection of long-term notes	128,000	
		$ 200,500
Cash outflows for acquisition of investments		
Land purchases	50,000	
Building purchases	232,200	
Equipment purchases	43,600	
Advances to affiliates	190,800	
	516,600	
Net cash inflows (outflows) investing activities		$ (316,100)
Cash Flows From Financing Activities		
Cash inflows from		
Borrowing		
Short-term	200,000	
Long-term	535,800	
Sale of common stock	35,400	
		771,200
Cash outflows for		
Debt service (excluding interest)		
Short-term debt repaid	100,000	
Long-term debt repaid	788,100	
Cash dividends paid	364,500	
Reacquisition of common stock	28,500	
		1,281,100
Net cash inflows (outflows) financing activities		$ (509,900)

KNOWLEDGE CHECK

1. In developing reporting requirements for the statement of cash flows, FASB

   a. Did not provide any presentation guidelines because comparability of presentation is not important as long as there is disclosure.
   b. Required entities to use the activity method, which groups inflows and outflows in the same category.
   c. Required firms to use the cash inflow, cash outflow format.
   d. Required the entity to use the all-financial resources approach.

Cash Equivalents

The statement of cash flows presents information on cash receipts and cash payments during the reporting period. The focus is on cash because external statement users typically focus on assessments of future cash flows.

Cash represents coin, currency, bank demand deposits, money orders, and other negotiable instruments that are readily acceptable instead of currency. However, because entities frequently invest excess cash on a short-term basis, the existing cash flow guidance focuses on a cash and cash equivalents definition of funds.

What Is a "Cash Equivalent"?

- A cash equivalent is a short-term liquid asset that the entity views as the same as cash.
- Only assets qualify as cash equivalents. Debt, even when used in the cash management function, never qualifies.
- Cash equivalents must be easily convertible to known amounts of cash and have insignificant credit risk.
- Cash equivalents must not be subject to significant changes in value due to changes in market prices or interest rates. A limit of three months' maturity (to the entity) is specified by the guidance.

The definition of cash equivalents differs from the definition of cash management many organizations use. Some individuals believe this difference in definition may cause an entity to pay less attention to cash flow statement information internally than might be desirable. Additionally, there may be opportunities for "gaming" the cash number if an entity views the cash total as important for external reporting purposes.

The continued use of cash equivalents in the statement of cash flows and the nature of the disclosure of cash management policies will be part of any major reconsideration of financial reporting requirements. It is likely that the cash equivalents category will be eliminated because cash equivalents, no matter how liquid are functionally different from cash.

Selection and Presentation

How Are Cash Equivalents Reported and Disclosed?

Activities that are part of the cash management process and qualify as cash equivalents do not appear on the statement of cash flows except as part of cash and cash equivalents totals.

Assume an entity buys and sells 30-day Treasury bills on a regular basis to minimize its cash bank balances and classifies these as cash equivalents.

- Do not report this activity in the statement of cash flows because the statement reports the inflows and outflows of items that change cash and cash equivalents.
- The purchase and sale of Treasury bills occur within the cash category and do not affect total cash and cash equivalents. This activity is similar to moving money from one checking account to another.

Key Point

An entity should carefully define what types of investments it identifies as *cash equivalents* and then provide adequate disclosure of this definition.

An entity must disclose what types of investments qualify as cash equivalents for its financial reports. Thus, it may choose not to consider some investments that meet FASB's definition as part of its cash equivalents.

For example, an entity may choose to report net changes in short-term investments as cash flows in the investing section rather than treat them as a cash equivalent.

Disclosure Requirements for Cash Equivalents

Disclosure may be part of the accounting policies note.

Disclosure may be a note placed on the bottom of the statement of cash flows itself.

Disclosure may be part of a supplemental note that provides other cash flow information.

If there is a change in the definition of cash equivalents, the entity must disclose the nature of the change and treat it as a change in accounting principle. This means that an entity must restate prior period financial statements when there is a change in the cash equivalent definition, making careful selection of a cash equivalent definition that much more important.

Example Company
Statement of Cash Flows
for the Years Ending December 31

	20X2	**20X1**
Cash flows from operating activities		
Net operating cash inflow (outflow)	xxxx	xxxx
Cash flows from investing activities		
Net investing cash inflow (outflow)	xxxx	xxxx
Cash flows from financing activities		
Net financing cash inflow (outflow)	xxxx	xxxx
Net increase (decrease) in cash and cash equivalents	8,400	(2,300)
Beginning cash and cash equivalents	18,300	20,600
→ Ending cash and cash equivalents	$ 26,700	$ 18,300

Example Company
Balance Sheet
December 31

	20X1	**20X0**
Current Assets		
→ Cash and cash equivalents	$ 26,700	$ 18,300

ACCEPTABLE PRESENTATIONS OF CASH AND CASH EQUIVALENTS INFORMATION

As the prior illustration shows, it is through the cash and cash equivalents total that the balance sheet and statement of cash flows are tied together.

The reconciliation may be to a single line, which is easiest for readers to understand, or by using multiple lines (when an entity has restricted cash).

The following are examples of presentations used to explain how the entity defines *cash and cash equivalents*.

The Common Approach

Many entities use a simple statement that closely follows the example provided in the cash flow reporting guidance. For example:

> Cash and cash equivalents include cash on hand and on deposit along with liquid debt investment instruments with maturities generally of three months or less.

Consolidated Statements

Special characteristics of consolidated statements may lead to cash and cash equivalents disclosures such as the following. This disclosure was part of the reporting entity's summary of significant accounting policies:

> *Cash Equivalents.* All highly liquid investments of the company's document processing subsidiaries with a maturity of three months or less at date of purchase are considered to be cash equivalents and are classified as cash. Similar investments by C&F, Inc. and the company's investment banking subsidiaries are classified as investments and as trading inventories, respectively. Such classifications are consistent with standard industry practices for these subsidiaries.

Specialized Disclosure

An unusual cash activity might also require some type of specialized disclosure such as

> The company considers all short-term, highly liquid investments that are readily convertible to known amounts of cash to be cash equivalents. Included in current year equivalents is a repurchase agreement with a financial institution in the amount of approximately $486,000. The agreement has a 30-day maturity, and is collateralized by Federal National Mortgage Association certificates. The certificates are held by a financial institution in the company's name.

RESTRICTED CASH AND CASH EQUIVALENTS

Until late in 2016, FASB Accounting Standards Codification (ASC) 230, *Statement of Cash Flows*, was silent on the treatment of restricted cash accounts. This lack of guidance resulted in entities presenting cash flows related to restricted cash in many different ways.

How to account for and disclose restricted case was part of a narrow technical project that was added to the FASB agenda in 2014. In November 2016, FASB issued ASU 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash (a consensus of the FASB Emerging Issues Task Force)*.

Under this ASU, a company with restricted cash or restricted cash equivalents or both would include those amounts in cash and cash equivalents for reconciliation purposes. For public and private companies, the consensus opinion concluded the following:

- Transfers between restricted cash and cash or cash equivalents are not part of operating, investing or financing activities.
- Therefore, the required reconciliation in the statement of cash flows should be for cash, cash equivalents and restricted cash, and restricted cash equivalents (where these restrictions exist).
- FASB chose not to define restricted cash with the ASU and left it up to the firms to determine when there were significant cash or cash equivalent restrictions.

The ASU also requires companies to disclose certain information related to restricted cash. For example:

- A for-profit firm may have cash that is legally restricted to pay worker compensation claims. The disclosures would explain the reason for the restriction, the amount restricted, and the amounts added to or taken from these restricted cash assets.
- If restricted cash is in more than one line on the Statement of Financial Position, the firm must provide a schedule showing the line items that make up the cash, cash equivalents, and restricted cash or cash equivalents.
  - This schedule may be on the face of the statement of cash flows or in a footnote disclosure.
  - It is presented for each year there is a cash flow statement

A not-for-profit organization may have a larger variety of restrictions on how it uses its cash based on the desires of donors or other entities that provide cash to the organization. The ASU addresses disclosure requirements and reporting for not-for-profits. We do not address these here because they are beyond the scope of this program.

The effective date for this ASU for public business entities is fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. For all other entities, the effective date is for fiscal years ending after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019.

- Early adoption is permitted, including adoption in an interim period.
- The retrospective transition method is used for all periods presented.

An example of the disclosures firms must make is provided in the following example:

Disclosure Example

December 31, 20X2 (in millions)

Cash and cash equivalents	$2,450
Restricted cash	220
Restricted cash included in other long-term assets	425
Total cash, cash equivalents, and restricted cash shown on the statement of cash flows.	$3,095

Restricted cash is set aside because of an agreement with an insurer who pays specific workers' compensation claims. Restricted cash included in other long-term assets are amounts pledged as collateral for long-term financing arrangements. This lender restriction will lapse when the related long-term debt is paid off.

STRICT CASH CONCEPT OF FUNDS

An entity may choose not to define any items as cash equivalents. This is the approach illustrated below. A growing number of entities use the *pure cash* approach. There are no special disclosures required (or presented) in most situations when an entity makes this choice. However, full disclosure might suggest noting explicitly that there are no cash equivalents.

Cash Company

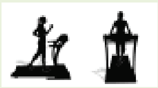
(Dollars in thousands)	**20X2**	**20X1**
Assets		
Current assets		
→ Cash	$ 2,649	$ 2,271
Trade receivables,		
less allowance for doubtful accounts of $997 and $959	20,796	19,151
Inventories	14,295	13,374
Prepaid expenses and other	2,431	2,065
Total current assets	$ 40,171	$ 36,861
Change in cash		
Net increase (decrease) in cash	$ 378	$ (603)
Cash at beginning of year	2,271	2,874
→ Cash at end of year	$ 2,649	$ 2,271

The selection of a pure cash concept may be very logical, particularly in smaller companies.

- If an item is not a cash equivalent, it is part of the investing or financing activities.
- Net reporting rules permit reporting only the change in these items rather than the total inflows and outflows.

The pure cash approach seems likely to become the required approach when there is a major revision of the statement of cash flows guidance. You should be considering the potential impact of such a change on how you capture and report cash and cash equivalent transactions.

Quick Exercise 2-1



Review each of the following situations listed and specify whether the item qualifies as a cash equivalent. Explain why:

1. XYZ Company regularly uses the overnight paper market as a means of earning a return on excess cash.

2. ABC Company is a cyclical firm and early in the year usually is short of cash. During the latter part of the year the Company has excess cash and lends this cash out to suppliers for periods ranging from one to three months.

3. CCB Company actively manages its cash balances. Excess cash is invested to earn a return, usually overnight but sometimes for as long as five days. When cash is short, the company borrows money in the overnight paper market for periods up to three days.

4. AXD Company has established a $5 million line of credit with a local bank. AXD borrows and repays amounts as necessary on a daily basis. The maximum outstanding loan balance during any week has been $4 million and the minimum $1 million.

KNOWLEDGE CHECK

2. Which statement about cash equivalents is correct?

   a. Cash equivalents may be subject to significant changes in value.
   b. A cash equivalent generally has a maturity of three months or less.
   c. Assets and liabilities that management uses in their cash management program may qualify as cash equivalents.
   d. Cash equivalents may have significant interest rate risks.

Gross Versus Net Cash Flow Reporting

The investing and financing sections of the statement of cash flows should present total cash inflows and outflows by category. Examples of total or gross cash flow disclosures include

- disclosing both the proceeds from issuing long-term debt and the payments made to retire long-term debt in the financing section; and
- presenting the receipts from the sale of capital assets and the payments made to buy other capital assets in the investing section.

Showing total inflow and outflow information on the face of the cash flow statement allows users to see how the entity acquired and used cash during the reporting period.

Gross inflow and outflow information can help users make comparisons among entities. It may also help users when they compute certain ratios that analyze liquidity or financial flexibility.

In practice, actual statements sometimes contain or appear to contain netted amounts. Consider the following line item found on one entity's statement:

Funds due to a decrease in long-term borrowing	*$75*

The notes to the statement show that the entity repaid two loans totaling $675 million and replaced them with new loans with a lower yield totaling $600 million. There is disclosure, but the disclosure is not on the face of the statement as required by the requirements of the cash flow guidance. The use of the term *funds* is also not appropriate.

Limited netting is likely to remain an option if cash flow requirements are revised. The rules will probably follow the current guidance on reporting cash flows gross or net. Selective clarification guidance may be provided in a few instances.

PRESENTATION EXAMPLES: GROSS VERSUS NET

The following partial statement examples illustrate how information is shown following the gross presentation requirements for the statement of cash flows.

Blue Green Enterprises
Partial Statements of Cash Flows
for the Years Ending December 31

(Dollars in Thousands)	**20X2**	**20X1**	**20X0**
Cash Flows From Investing Activities			
→ Additions to property and equipment	$ (420)	$ (4,337)	$ (464)
→ Disposition of property and equipment			6
Purchase of and additions to film library		(8,098)	(580)
→ Loans to officers		(1,100)	
→ Payment on officer loans		38	32
Deferred acquisition costs	(752)		
Net cash used by investing activities	$ (1,172)	$ (13,497)	$ (1,006)

Open Ended Company
Partial Statements of Cash Flows
for the Years Ending December 31

(Dollars in Thousands)	**20X2**	**20X1**	**20X0**
Cash Flows From Financing Activities			
Proceeds from sale of common stock	$ —	$ 20,240	$ 60,625
Proceeds from exercise of stock options	329	1,134	437
→ Proceeds from short-term loans		8,200	
→ Issuance of debt	100,000		43,033
→ Repayment of debt	(1,287)	(47,369)	(392)
Net cash provided (used) by financing activities	$ 99,042	$ (17,795)	$ 103,703

Possible Presentation Problems

The presentation of net, rather than gross, investing and financing inflows was quite common before the issuance of the cash flow guidance. A sampling of cash flow statements issued after the effective date of the statement of cash flows guidance shows that netting still appears to take place. Sometimes, explicit disclosures of the gross cash flows exist elsewhere in the financial reports. Often there is no additional disclosure provided.

The netting may be the result of immaterial items. However, it is potentially confusing for statement users and illustrates why there is a need to carefully review how statement presentations are made.

➔ Review the example below. Did the entity sell any significant fixed assets? Were there sales of investments or only purchases? Were any long-term debt issues?

Based on the statement information we do not know. The statement notes for this entity did not provide specific answers to these questions. This type of disclosure lapse is one reason FASB explicitly required gross presentation.

Winter Storm Company
Partial Statements of Cash Flows
for the Years Ending December 31

	20X2	20X1	20X0
Cash Flows From Investing Activities			
→ Purchases of property, plant and equipment, net	$ (149,385)	$ (160,621)	$ (179,446)
Proceeds from sale and leaseback transactions	34,548		57,957
→ Increase in investments and other assets	(9,914)	(5,712)	(4,914)
Net cash flows used in investing activities	(124,751)	(166,333)	(126,403)
Cash Flows From Financing Activities			
Increase (decrease) in short-term borrowing	65,000	(18,000)	18,000
→ Decrease in other long-term debt	(385)	(365)	(340)
Payments on capital lease obligations	(1,467)	(2,382)	(2,338)
Purchase of common stock and changes in retained earnings	(54,038)	(3,144)	(749)
Proceeds on sales under associates stock purchase plan	—	—	73,436
Dividends paid	(75,728)	(74,296)	(71,297)
Other	(2,006)	(822)	839
Net cash flows provided (used) by financing activities	$ (68,624)	$ (99,009)	$ 17,551

Data Collection Issues: Obtaining Gross Amounts

Some accounting systems may not automatically provide gross cash information for items such as the amount of investments or productive assets the entity bought and sold during a period. The accounting system may need modification so the entity can collect total cash inflow and outflow information.

Key Point

Often the accounting system captures the data required for the statement of cash flows at the subsidiary level, but this detail does not roll up to the corporate level. If a statement of cash flows is prepared whenever (at every level of the organization) a balance sheet and income statement is prepared, most gross cash flow information is readily available.

If a system does not provide actual gross cash flow information, the preparation of the statement of cash flows requires gathering new information. The total inflows and outflows of individual accounts should be identified:

- Collect information about which major investing and financing activities do not involve immediate cash flows.
- Identify the account(s) used when the organization does not pay cash. Frequently, this is accounts payable. Part of the account payable analysis involves identifying those amounts paid that are investing or financing activities.

Company Y buys a new machine and agrees to complete payment in six months. The accounting entry is as follows:

Machine	50,000	
Accounts Payable (equipment)		50,000

If Company Y pays for the machine during the reporting period, the cash is an investing outflow. If Y does not make the remaining payment this period, that part of the change in accounts payable is not an operating item. Rather, the change results from a cash flow that will eventually be for an investment activity (the machine). However, you will ultimately report the cash payment to eliminate the payable as a financing outflow. (This potentially confusing classification is discussed in more detail in the next chapter.)

Technical Problem: When Is Netting Allowed?

FASB cash flow guidance currently permits some use of netting. FASB accepted, on a limited basis, the argument that some gross cash inflow and outflow data may not help users assess the future cash flows of the entity. Specifically, FASB ASC 230-10-45-9, *Statement of Cash Flows,* states the following:

Items that qualify for net reporting because their turnover is quick, their amounts are large, and their maturities are short are cash receipts and payments pertaining to any of the following:

a. Investments (other than cash equivalents
b. Loans receivable
c. Debt, providing that the original maturity of the asset or liability is three months or less.

The term *original maturity* means the original maturity to the entity holding the investment:

- Both a three-month U.S. Treasury Bill and a three-year Treasury note purchased three months from maturity qualify as cash equivalents or may be presented net in the investing section of the statement of cash flows.
- A Treasury note purchased three years ago does not become a cash equivalent or qualify for netting in the investment section when its remaining maturity is three months.

The cash flow guidance permits, but does not require, items that qualify for netting to be reported net. These items may be reported as gross inflows and outflows.

Determining which items qualify for netting requires professional judgment. In extreme cases the terms of existing agreements may be changed to achieve a disclosure objective. For instance, an entity might adjust borrowing arrangements if the entity wishes to present only the net change in liability on the statement of cash flows.

In other situations, netting may prove disadvantageous or costly to the firm and gross presentation may be preferable. For example, certain types of loans may have maturity periods from 30 days to three years. It may be easy to collect information on gross cash lending and principal repayments for all of this type of loan. It may be more difficult to separate those loans with original maturities of three months or less.

NET AND GROSS PRESENTATION EXAMPLE

The following examples use line-of-credit agreements to illustrate both the netting approach and presentation on a gross inflow and outflow basis.

A line-of-credit agreement and certain other types of short-term borrowing may present special reporting problems. Often these arrangements do not have a definitive maturity date. If the guidance is interpreted literally, the total inflow and outflow must be presented in these cases. In practice, most entities will net all line-of-credit borrowing and repayment activities. This is an example of applying judgment to the net versus gross presentation decision.

Net Company
Consolidated Statements of Cash Flows
for the Years Ending June 30

	20X2	20X1	20X0
Cash Flows From Financing Activities			
→ Net borrowing under line-of-credit agreement	$ 4,630	$ —	$ —
Proceeds from long-term debt	21,555	—	200
Dividends paid	(726)	(597)	(387)
Proceeds from exercise of stock options	38	680	24
Principal payments on long-term debt	(4,791)	—	(1,325)
Net cash flows provided by (used in) financing activities	$ 20,706	$ 83	$ (1,488)

Gross Company
Consolidated Statements of Cash Flows
for the Years Ending June 30

	20X2	20X1	20X0
Cash Flows From Financing Activities			
→ Borrowings under credit line and capital lease obligations	$ —	$ 5,301	$ 1,710
→ Principal payments on credit line, notes payable, and capital lease obligations	(3,230)	(2,489)	(4,874)
Assumption of long-term debt on acquisition of subsidiary		2,157	
Dividends paid	(6,863)	(7,945)	(9,580)
Purchase shares of capital stock from merger dissenters		(6,377)	
Net cash flows used in financing activities	$ (10,093)	$ (9,353)	$ (12,744)

KNOWLEDGE CHECK

3. Related to netting an investing or financing activity, which statement is NOT correct?

   a. Netting is required whenever an investing or financing activity meets the criteria for netting specified in the guidance.
   b. Netting when the maturity is more than three months is not permitted under the statement of cash flows guidance because users lose too much information.
   c. Netting of investing or financing activities is permitted but not required.
   d. Guidance on netting applies only investing, and financing activities.

Comprehensive Exercises

Comprehensive Exercise 2-1

Analyze each of the following items. Determine whether the listed item would normally be a cash and cash equivalents item. If it is not a cash equivalent, should the item be classified as investing or financing? Can the item be presented net? Briefly explain your decisions.

1. A retail entity has cash in bank demand deposit accounts.

2. An entity has short-term common stock investments in a New York Stock Exchange company.

3. A company bought Treasury bills with a six-month maturity.

4. An entity borrows in the overnight commercial paper market.

5. An entity has a note payable to parent company. The note has no set due date, but the entity typically repays this type of note in 60 days.

6. An entity buys one-year Treasury bills when the maturity date is two months in the future.

7. An entity has notes receivable from suppliers that are callable on demand.

8. A bank has a large amount of Visa credit card receivables. The bank is the Visa card issuer.

9. An entity bought one-year Treasury bills at issue. These Treasury bills mature in one month.

10. An entity has cash in a restricted cash sinking fund. The entity will make a required payment from the fund in two months.

COMPREHENSIVE EXERCISE 2-2

Specify the presentation required for each situation below. Briefly comment on what would be the proper presentation in a statement of cash flows for each situation. Explain the advantages and disadvantages of the solution.

1. An entity has an average outstanding debt of $9 million that it rolls on a daily basis. Based on a 260-day working year, the total cash inflow and outflow is $2.3 billion.

2. An entity incurs a significant amount of debt at the start of each month. By the end of each month the entity has always repaid the debt. Financial reports have not shown any short-term debt in the past five years.

Appendix A

SUPPLEMENTAL PROBLEMS

SUPPLEMENTAL PROBLEM 2-1

Comment on each of the following financial statement disclosures of cash and cash equivalents.

1. Cash and cash equivalents consisted of the following:

	December 31	
(Dollars in Thousands)	20X2	20X1
Cash	$ 8,711	$ 7,364
Time deposits and certificates of deposit	7,811	2,552
Restricted cash balances	6,300	—
Total	$ 22,822	$ 9,916

   Restricted cash balances represent amounts pledged to support bank guarantees issued on several large construction contracts. Time deposits in 20X2 include $6,600,000 pledged as collateral to support letters of credit issued under a reimbursement agreement with a bank.

2. The following is included in the accounting policy note:

   The Company considers all cash instruments with a maturity of three months or less to be cash equivalents. Consequently, certain securities in the consolidated balance sheets meeting this definition have been reflected as cash equivalents in the consolidated statements of cash flows.

SUPPLEMENTAL PROBLEM 2-2

The following information has been abstracted from a company's financial report. What questions can you raise about the information presented related to debt transactions?

Distdebt Consolidated Statements of Cash Flows
for the Years Ended December 31

(in millions of dollars)	20X2	20X1	20X0
Cash Flows From Operating Activities			
Net earnings	$ 829.0	$ 709.6	$ 589.5
Depreciation and amortization	127.9	115.9	104.9
Other operating items	8.8	30.7	15.9
Receivables	(121.1)	(92.0)	29.8
Inventories	(74.6)	4.4	(16.0)
Prepaid expenses	(19.1)	(1.4)	
Accounts payable	76.7	(38.0)	18.9
Accrued expenses and income taxes	73.5	65.4	(44.7)
Other assets and liabilities	79.5	28.3	(2.7)
Net cash provided by operating activities	*980.6*	*822.9*	*695.6*
Cash Flows From Investing Activities			
Proceeds from sales of time deposits and marketable securities	5,050.3	8,242.1	3,650.4
Purchases of time deposits and marketable securities	(4,349.7)	(8,774.7)	(3,898.3)
Additions to fixed assets	(249.1)	(186.5)	(214.9)
Other, net – including net proceeds from sales of businesses	(35.3)	148.3	(53.4)
Net cash provided by (used in) investing activities	*416.2*	*(570.8)*	*(516.2)*
Cash Flows From Financing Activities			
Short-term borrowings	(45.3)	(35.9)	(28.6)
Long-term debt	(3.5)	24.2	23.5
Proceeds from stock options and warrants exercised	37.1	24.0	25.4
Purchase of Treasury stock	(71.0)	(.9)	
Dividends paid	(483.8)	(402.1)	(300.6)
Net cash used in financing activities	*(566.5)*	*(390.7)*	*(280.3)*
Effect of exchange rates on cash	2.5	(1.0)	(1.5)
Increase (decrease) in cash and cash equivalents	832.8	(139.6)	(102.4)
Cash and cash equivalents at beginning of year	353.4	493.0	595.4
Cash and cash equivalents at End of year	$ 1,186.2	$ 353.4	$ 493.0

Distdebt Consolidated Statements of Cash Flows for the Years Ended December 31 (continued)

Liabilities			
	20X2	20X1	20X0
(in millions of dollars)			
Current Liabilities			
Short-term borrowings	$ 173.3	$ 223.4	$ 230.5
Accounts payable	335.8	275.8	252.0
Accrued expenses	519.3	449.8	374.1
U.S. and foreign income taxes payable	135.6	150.4	158.6
Total current liabilities	1,164.0	1,099.4	1,015.2
Other liabilities	263.5	193.0	174.5
Long-term debt	215.2	210.3	157.7
Total liabilities	$ 1,642.7	$ 1,502.7	$ 1,347.4

Note 6 Long-Term Debt and Lines of Credit December 31

(in millions of dollars)	20X2	20X1	20X0
5.7% Debentures due annually			
June 1, 20X0 to 20Y1	$ 5.4	$ 5.4	$ 5.4
8 5/8% Debentures, due annually			
November 1, 20X1 to 20Y2	15.1	15.1	15.1
8 3/8% Promissory notes, due June 4, 20Y2	49.0	47.3	37.5
5.906% Term loan, due June 21, 20Y3	52.1	51.9	41.8
Capitalized lease obligations, due in varying amounts through 20X8	13.8	18.5	22.0
Other, due in varying amounts through 20Y3	79.8	72.1	35.9
	$ 215.2	$ 210.3	$ 157.7

Long-Term Debt at December 31, 20X2 Was Payable
Years Ending December 31

(in millions of dollars)

20X2	$ 15.1
20X3	24.8
20X4	99.6
20X5	60.4
20X6	5.2
20X7 and later	10.1
	$ 215.2

The company has short-term lines of credit with domestic and foreign banks. At December 31, 20X2, the unused portions of these lines of credit were approximately $185 million and $378 million, respectively.

Workspace

Chapter 3

PRESENTATION ISSUES: INVESTING, FINANCING, AND NONCASH ACTIVITIES

Business activities can be complex and take many forms. Exactly how and where to present cash flow information related to these activities remains controversial. This chapter focuses on two preparation and presentation issues that remain troublesome. These two are statement classification and noncash activities. Particular emphasis is given to the presentation of investing, financing, and noncash transactions under current reporting requirements. Operating section presentations and disclosures are considered in detail within this chapter.

LEARNING OBJECTIVES

After completing this chapter, you should be able to do the following:

- Identify cash flow transactions as operating, investing, or financing.
- Recall situations which might result in alternative methods of presentation on the statement of cash flows.
- Indicate how to present and disclose significant transactions that have no direct cash flow effect.
- Identify problems that may be caused by the separation of cash and noncash transactions.

Significant classification changes are anticipated if a revised financial statement presentation document from FASB and International Accounting Standards Board (IASB) is completed. Separate tax and discontinued operations segments are probably going to be required. What is included in the financing section may be modified while a restructured investing section is likely to be combined with operating cash flows within a broad category labeled as business activities. The details of these classification changes are unknown at this time, but the most likely potential changes are noted to help you evaluate current investing and financing section information.

Issues Related to Classification

There is general agreement that classifying cash flows is useful. For cash flow reporting FASB chose to classify cash flows into three groups: operating, investing, and financing.

Basic Classifications

Activities classified as *investing activities* on the statement of cash flows are those activities associated with investments in productive assets and investments in the debt or equity securities of other entities.

Most of the cash flows between the entity and its providers of capital, both debt and equity, are classified as *financing activities*.

The operating section reports the cash effects of most recurring transactions and other events that enter into the determination of net income. It is the default classification under existing guidance. *Operating inflows and outflows* include those activities not defined as investing or financing.

These categories are inherently arbitrary. Examples and exercises show that similar transactions or events may fall into different classifications on the statement of cash flows.

- Currently, the form, rather than the substance, of a cash transaction has more effect on its classification. This result is the opposite of the situation usually found in financial reporting where substance over form is the typical rule.
- The existing classification decisions are almost certainly going to change as the standard-setting bodies move to restructure financial reporting, increase transparency and improve the linkages between statements. Existing classifications will be redefined and additional categories added when the cash flow reporting guidance is revised.

IS IT INVESTING, FINANCING, OR OPERATING?

Classification of a cash transaction as investing, financing, or operating currently focuses on the *nature* of the transaction, not on the reason for the transaction.

A company reacquires $100,000 of Treasury stock because management believes that the company's shares are temporarily undervalued. The $100,000 cash outflow is a financing transaction even though the reason management entered into the transaction was because they believed it was a good investment.

A fairly effective short-cut method of determining the appropriate classification (per FASB guidance) on the statement of cash flows is provided as follows.

- Associate financing cash flows with transactions that deal with the right side of the balance sheet – inflows and outflows related to the entity's own debt and equity.
- Associate investing cash flows with transactions that deal with the left side of the balance sheet – inflows and outflows related to productive assets and investments.
- Operating cash flows are primarily transactions directly related to the revenue and expense items found on the income statement. Examples include sales to customers, purchases of inventory, payment of wages.
  - Gains and losses do not represent cash flows. The total cash flows, such as cash received from the sale of equipment, relate to the activity and are classified like that activity. The gain or loss is simply the difference between the cash flow and the carrying value.
  - Separate nonoperating amounts that are in various accounts for classification and presentation purposes. For example, accounts receivable may include amounts due from customers and amounts due from loans to employees. These are respectively operating and financing items.
  - In many entities accounts payable may be among the most troublesome accounts to classify properly because of the variety of activities that go through this master expenditure control account.
  - All tax payments are considered operating.

Under FASB *Accounting Standards Codification* (ASC) 230, *Statement of Cash Flows*, the financing classification criteria includes resources restricted by donor stipulation for long-term use. Investment income, including restricted interest and dividends, is presented in the financing section, not in the operating section.

Classification Issues

Later portions of the text discuss and illustrate several of the existing classification issues. Keep the following current reporting rules in mind when making decisions on how to present and disclose of specific cash flow items:

- Interest paid is classified as operating, rather than financing.
- Interest and dividends received are classified as operating, not investing.
- Inflows or outflows of noncash resources, such as the issuance of securities for productive assets, are shown on the schedule of noncash transactions and are not presented on the face of the cash flow statement.
- Structural changes between the shareholder and the entity, such as swaps or conversions of equity or debt securities, may result in the need for more explicit cash flow disclosure requirements.
- It is sometimes difficult to determine the proper category for a cash transaction or event. FASB focused on consistency of classification at the request of statement users. The category definitions maximize the uniformity of classification across entities. FASB is examining several areas where there is considerable diversity in classification practices.
- To enhance comparability, the statement of cash flows guidance does not permit alternative classifications for similar events.

Certain transactions or events often appear not to fit the classification groupings provided. Each of the following areas creates classification problems that are discussed in later sections and illustrated with presentation examples or exercises:

- Interest paid or received
- Installment sales or purchases
- Financing transactions made in lieu of investment transactions or vice versa
- Transactions that are noncash in form but not in substance
- Business combinations and segment disposals

In August 2016, FASB issued Accounting Standards Update (ASU) No. 2016-15, *Statement of Cash Flows (Topic 320), Classification of Certain Cash Receipts and Cash Payments (a consensus of the FASB Emerging Issues Task Force)*. This ASU is a narrow scope document which clarifies how certain types of transactions should be classified. Previously these items had been classified differently by firms. Individual items affected by this modification of statement of cash flow reporting are included as appropriate later in the chapter or are addressed as part of one or more of the comprehensive classification exercises.

Quick Exercise 3-1

Classify each of following items as financing, investing, or operating. Explain your classification briefly.

1. The purchase of a building
2. The payment of dividends
3. Cash received from customers
4. The purchase of another business entity for cash
5. Cash paid for Treasury shares
6. Income tax payments
7. Insurance settlement received on inventory damaged by a flood

INTEREST AND DIVIDENDS

The decision to treat cash interest payments, cash interest received and dividends received as operating remains controversial especially when cash dividends paid are treated as financing. A return of capital to the entity is investing, and a return *on* capital is operating. In addition, dividend payments to shareholders are in a different category than interest payments to debt providers. Whether the distinction between a return of and a return on an investment is important in a cash flow context remains unsettled.

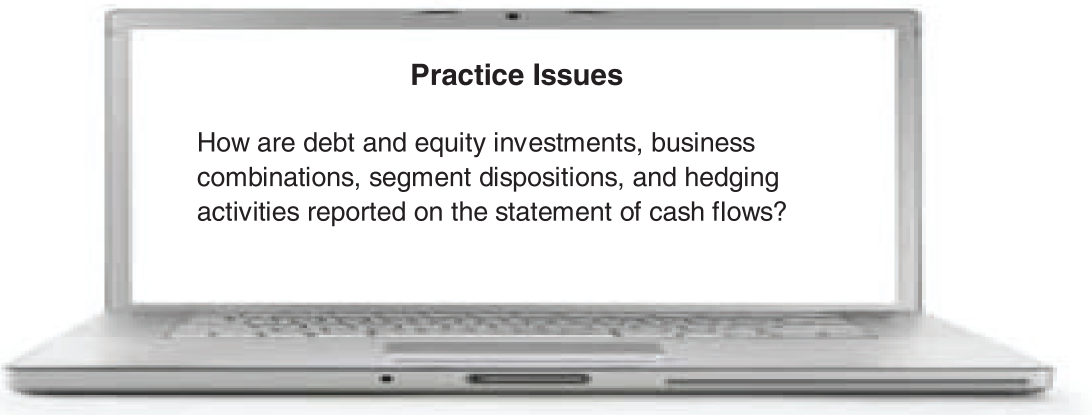
- The existing interest and dividend classifications assume that operating cash flows should reflect the cash activities that produce net income.
- This classification approach avoids problems, such as how to present interest received and paid in banks.
- There is a requirement for explicit disclosure of the amount of cash interest paid during the period.

Questions remain about the propriety of the interest classification decisions. The GASB decision to classify interest in categories other than operations (see discussion in a later chapter) along with the additional flexibility allowed in international cash flow standards is likely to keep this decision a major classification question. A FASB decision to include interest and dividends on restricted assets as financing also has kept the controversy alive.

The following example illustrates the questions and the problems with FASB's classification decisions.

The CF Company buys 100 shares of AZ and 100 shares of BXY for $50 a share. Each year CF receives a dividend of $500 from Company AZ and a stock dividend of 10 shares from Company BXY. CF Company immediately sells the 10 shares of BXY stock for $500. The statement of cash flows would reflect the preceding transactions as follows:

- Purchase of Company AZ stock – $5,000 investing outflow
- Purchase of Company BXY stock – $5,000 investing outflow
- Dividends from Company AZ – $500 operating inflow
- Stock dividend from Company BXY – noncash item
- Sale of Company BXY stock – $500 investing inflow



Special Reporting Rules for Debt and Equity Investments

FASB ASC 320, *Investments–Debt and Equity Securities,* modified the reporting rules for investments in equity securities that have readily determinable fair values and for all investments in debt securities. Although these modifications resulted in substantial balance sheet changes, they had no effect on the statement of cash flows.

Some entities, primarily financial institutions, buy debt and equity securities principally for resale in the near term. These are referred to as *trading securities*. They are reported at fair value on the balance sheet and any unrealized gains and losses are included in earnings.

- FASB ASC 230 classifies trading securities as operating transactions. Thus all cash flows associated with these securities are part of operations.

Debt securities that the entity has the positive intent and ability to hold to maturity are classified as *held-to-maturity securities*. These securities are reported using amortized cost on the balance sheet.

- The interest received on these securities is an operating inflow on the cash flow statement. Principal collections are part of the investing category.

Debt and equity securities not classified as either held-to-maturity securities or trading securities are *available-for-sale securities*. They are reported at fair value on the balance sheet. The unrealized gains and losses are a separate component of shareholders' equity.

- The adjustment to fair value in available-for-sale securities does not have any cash flow implications. Any dividends or interest received are reported as operating cash flows. The collection of proceeds from the sale or maturity of these investments is an investing cash flow when the entity receives the cash.

Entities that are using the equity method for accounting for an investment in another entity may classify distributions received from the investee in either of two ways—the cumulative earnings approach or the nature of distribution approach.

- Under the cumulative earnings approach, distributions received are generally considered a return on investment and classified as operating cash flow. However, if cumulative distributions the firm receives exceed cumulative earnings, the amounts received are a return on investment and classified as investing inflows.
- Under the nature of distribution approach, the amounts received are classified based on the activities of the investee that generated the return as either operating or investing inflows. If this approach is elected and adequate information is not available, a change in accounting principle should be reported.

BUSINESS COMBINATIONS, SEGMENT DISPOSITIONS, AND DEBT REPAYMENTS

Business combinations, disposals of business segments and debt repayments each have the potential for creating classification and disclosure issues on the statement of cash flows. A summary of the general rules for reporting these items under the existing statement of cash flows reporting guidance is provided here.

Reporting Requirements

Total cash outflows associated with the purchase of another entity are investing outflows.

- Individual asset and liability accounts change as the result of the purchase and this change complicates the analysis of the operating section accounts.
- A business combination that results from a stock for stock exchange is part of the schedule of noncash transactions.
- Payments to settle contingent liabilities existing at acquisition that are made soon after acquisition are financing and investing cash flows. Payments not made soon after acquisition are financing up to the amount of the contingency. The remainder are operating cash flows.

The cash inflows from the sale of a segment of the business are investing inflows. The operating cash flows related to the ongoing activities of running the segment are part of the operating section of the statement.

Debt repayment and debt extinguishment costs are classified as cash outflows from financing activities.

- This is explicit guidance from FASB because other classifications were being used in certain situations.

Entities with debt settlements on zero coupon debt and debt with insignificant interest rates (relative to effective rates), should classify payments attributed to the accreted interest related to debt discount as operating cash outflows. Principle payments are financing outflows.

These classification issues are considered in more detail, with disclosure examples in the chapters that focus on operating cash flows.

HEDGING ACTIVITIES

FASB ASC 230-10-45-27 discusses cash receipts and payments related to hedging activities:

> Generally, each cash receipt or payment is to be classified according to its nature without regard to whether it stems from an item intended as a hedge of another item. For example, the proceeds of a borrowing are a financing cash inflow even though the debt is intended as a hedge of an investment, and the purchase or sale of a futures contract is an investing activity even though the contract is intended as a hedge of a firm commitment to purchase inventory. However, cash flows from a derivative instrument that is accounted for as a fair value hedge or cash flow hedge may be classified in the same category as the cash flows from the items being hedged, provided that the derivative instrument does not include an other-than-insignificant financing element at inception, other than a financing element inherently included in an at-the-market derivative instrument with no prepayments (that is, the forward points in an at-the-money forward contract) and that the accounting policy is disclosed. If the derivative instrument includes an other-than-insignificant financing element at inception, all cash inflows and outflows of the derivative instrument shall be considered cash flows from financing activities by the borrower.

> If for any reason hedge accounting for an instrument that hedges an identifiable transaction or event is discontinued, then any cash flows subsequent to the date of discontinuance shall be classified consistent with the nature of the instrument.

Many entities use this optional presentation. The following illustrative disclosure comes from one entity's summary of accounting policies.

> Cash flows resulting from forward contracts are accounted for as hedges of identifiable transactions or events and classified in the same category as the cash flows from the items being hedged.

KNOWLEDGE CHECK

1. Which has more influence on the classification of items in a statement of cash flows?

   a. Substance.
   b. Form.
   c. Management intent.
   d. Investor interests.

2. How should cash interest payments be classified?

   a. Operating activity.
   b. Financing activity.
   c. Investing activity.
   d. Non-cash.

Installment Sales and Purchases

Installment sales or purchases provide a good illustration of the issues that arise with existing classifications. In some situations, installment transactions are a regular part of the entity's activities. In other situations, the installment transaction is simply a method of buying or selling a productive asset.

So the question is – should all installment sales be reported in the same manner on the statement of cash flows?

PURCHASE OF PRODUCTIVE ASSET

The Expansion Company buys a plot of land that it will use for a new plant. The company pays 30 percent down and signs a seven-year note that carries interest at the market rate. The selling entity carries the note.

The initial entry, assuming the purchase took place on December 31, 20X1:

Land	1,000,000	
Cash		300,000
Note payable		700,000

This transaction would be reported as follows:

- An asset, land of $1 million, and a liability, note payable of $700,000, appear on the balance sheet.
- An investing cash outflow of $300,000 appears on the statement of cash flows.
- A noncash schedule item of $700,000 is shown for the note issued to buy the land.

When the company makes a payment of $200,000 on the note on December 31, 20X2, (assuming an interest rate of 12 percent) the entry is as follows:

Interest expense	84,000	
Note payable	116,000	
Cash		200,000

You would report the installment payment as follows:

- Show an expense of $84,000 on the income statement.
- Show an operating cash outflow of $84,000 for the interest.
- Show a financing cash outflow for the $116,000 principal payment.

Certain cash flow classification questions exist for this type of installment purchase:

- Should the note issued to buy the land be shown as if there were an inflow and an outflow of cash rather than on a separate schedule of noncash transactions?
- Is the form of the transaction more important than the substance?

- Is the distinction in classification, based on the transaction form, likely to present problems to statement users?

Both of these issues are explored further elsewhere in this chapter. However, using the rules specified in FASB guidance, the classifications shown in the illustration are appropriate. The cash portion of the purchase of the productive asset is treated as investing and the repayment of debt as financing.

Disclosure of Installment Note Payable

Partial Statement

Install Corporation

Partial Statement of Cash Flows

Cash Flows From Financing Activities

	20X2	20X1	20X0
Proceeds from sale of common stock		$ 14,433	
Capital contribution by shareholders of pooled subsidiary		1,200	
Proceeds from nonrecourse discounted lease rentals	$ 173,444	96,348	$ 26,258
Payments on nonrecourse discounted lease rentals	(47,522)	(50,043)	(23,500)
→ Proceeds from unsecured installment notes	28,000		
→ Payments on unsecured installment notes	(2,000)		
Increase (decrease) in notes payable	4,041	10,071	(9,193)
Other	(1,914)	(1,311)	
Net cash flows provided by (used in) financing activities	$ 154,049	$ 70,698	$ (6,435)

Installment Sale of Inventory

The classification of an installment sale or purchase of inventory also remains controversial. Questions include the following:

- The cash flow associated with either the sale or purchase of inventory is typically classified as operating. Should all of the cash flows related to these transactions therefore be operating?
- The collection of the principal amount of loans to other entities is classified as an investing inflow. A sale of inventory on an installment basis results in a loan to another entity. Should the cash inflows from this sale be investing?
- The payment of principal amounts on loans from other entities is classified as financing outflows. A purchase of inventory on an installment basis results in a loan from another entity. Should the cash outflow from this purchase be financing?

The majority of the board voted to treat all cash flows from installment sales or purchases of inventory items as operating. This decision means these long-term receivable collections represent operating, not investing, transactions. Likewise, outflows for long-term payables related to inventory purchases are operating, not financing. This makes the operating activities section of the statement of cash flows consistent with the classification of these items as operating on the income statement.

Dissenting FASB members argued that activities, such as collections on an installment note receivable from a customer, are similar to collections on loans to another entity. They believed the classification decision for inventory installment sales or purchases was inconsistent with the statement of cash flows objective of grouping like items into similar categories:

- Is form or substance more important? For this classification decision FASB members opted for substance rather than form.

The revised statement classifications that are anticipated when the forthcoming financial presentation guidance is issued (see chapter 6) will probably eliminate most of the issues raised about the classification of installment transactions.

Illustration

Assume that the Expansion Company makes a $1 million sale of inventory on the installment method. The company receives 30 percent down and agrees to accept a series of payments that include interest at the market rate.

The initial entry made by Expansion on December 31, 20X1, is as follows:

Cash	300,000	
Installment receivable	700,000	
Sales		1,000,000

You would report this transaction as follows:

- Show a sale of $1,000,000 on the income statement.
- Report a cash inflow from customers of $300,000 in the operating section of the statement of cash flows (or a subtraction of $700,000 from net income in the reconciliation).

On December 31, 20X2, Expansion receives a $200,000 payment on the receivable, which includes interest of 12 percent. The entry is as follows:

Cash	200,000	
Interest income		84,000
Installment receivable		116,000

You report this transaction as follows:

- Show cash from customers of $116,000 in the operating section of the statement of cash flows (or an addition to net income of $116,000 in the reconciliation).
- Disclose cash interest received for $84,000 in the operating section of the statement of cash flows (or disclose this amount as supplemental information).

DISCLOSURE EXAMPLES

The following partial statements show how the installment sale cash flows are disclosed in the operating section of an indirect and a direct method statement.

Partial Statement: Indirect

Rec-Cai Inc.
Consolidated Statements of Cash Flows
for the Years Ending April 30

	(Dollars in thousands)			
		20X2	**20X1**	**20X0**
	Cash Flows From Operating Activities			
	Net income	$ 163,546	$ 101,828	$ 50,227
	Adjustments to reconcile net income to net cash provided by (used in) operating activities			
	Depreciation and amortization	80,678	58,486	38,573
	Provision for deferred income taxes	78,191	33,993	19,606
→	Increase in noncurrent installment accounts receivable, net	(97,924)	(48,032)	(29,197)
	Foreign currency transaction loss (gain) – before taxes	12,039	1,016	(2,672)
	Changes in other operating assets and liabilities, net of effects of acquisitions			
→	Increase in trade and installment accounts receivable	(139,245)	(85,322)	(67,355)
	(Decrease) increase in accounts payable, accrued expenses and other liabilities	(46,229)	(7,826)	22,769
	(Decrease) increase in taxes payable	(697)	25,955	9,852
	Other	7,566	(7,458)	16,222
	Net cash flows provided by operating activities	$ 57,925	$ 72,640	$ 58,025

Partial Statement: Direct

The Insurance Company
Consolidated Statements of Cash Flows
for the Years Ending December 31

(Dollars in thousands)			
	20X2	**20X1**	**20X0**
Cash Flows From Operating Activities			
Premiums received, net of reinsurance paid	$ 1,483,362	$ 1,335,774	$ 1,112,512
Investment income received, net of expenses paid	132,884	111,774	96,986
Losses and loss expenses paid, net of reinsurance recovered	(814,851)	(711,426)	(637,735)
Acquisition and other underwriting expenses paid	(428,337)	(383,333)	(323,367)
Federal and foreign income taxes paid	(60,500)	(77)	(208)
Dividends paid to policyholders	(15,302)	(11,200)	(7,766)
Proceeds from collection of installment and notes receivable	70,058	111,069	107,130
Premiums financed	(68,002)	(97,648)	(121,923)
Other operating activities providing cash, net	7,813	1,547	19,480
Net cash flows provided by operating activities	$ 307,125	$ 356,480	$ 245,109

Knowledge Check

3. When a productive asset is purchased on an installment basis, how should the repayment of the related installment debt be classified?

   a. Investing.
   b. Financing.
   c. Operating.
   d. Non-cash.

Addressing Diversity in Classification Decisions

In 2016 FASB completed a technical project identified as "clarifying certain existing principles on statements of cash flows." This project was narrowly focused on reducing diversity in the classification of certain types of cash flow items. It also resulted in additional disclosure requirements.

- The intent was to reduce classification diversity by clarifying classification principles without issuing specific rule-based guidance on specific types of cash flows.

These is a particular focus on the guidance related to cash inflows and outflows that might have aspects of more than one type of cash flow classification. An example is provided by FASB ASC 230-10-45-22:

> For example, a cash payment may pertain to an item that could be considered either inventory or a productive asset. If so, the appropriate classification shall depend on the activity that is likely to be the predominant source of cash flows for the item. For example, the acquisition and sale of equipment to be used by the entity or rented to others generally are investing activities. However, equipment sometimes is acquired or produced to be used by the entity or rented to others for a short period and then sold. In those circumstances, the acquisition or production and subsequent sale of those assets shall be considered operating activities.

In the exercises at the end of this chapter and chapter 4, we address several of the areas where there currently is a diversity of practice.

Revised Cash Flow Statement Classifications

IASB and FASB are likely to revise the classifications used on the Statement of Cash Flows when they resume the financial statement project. The new classifications are expected to include

- a business section that includes separate operating, with an operating finance subcategory, and investing categories;
- a financing section that includes financing asset and financing liability categories separated into debt and equity categories; and
- a discontinued operations section, a tax section and a multi-category transaction section.

The new business section of the statement of cash flows would focus on both the operating activities and investing activities of the entity. The operating category is expected to focus on the assets and liabilities an entity uses in its day-to-day activities. These activities generate revenues through the interrelated use of resource. The investing category is expected to encompass assets or liabilities that are used to generate a return without significant synergies with other assets or liabilities.

Exactly what is included in each of these categories is still to be determined and is subject to further discussion and clarification. It is likely that similar items may be classified differently based on the nature of the entities' business activities. For example

- interest received might be operating for a financial institution and
- interest received might be investing for another type of entity.

The financing section is expected to include activities related to obtaining and repaying capital, using both debt and equity categories. The level of details required remains to be determined. Interest paid is likely to be part of this section for nonfinancial institutions. The section initially included a Treasury category consisting of cash and short-term financial assets or liabilities used as substitutes for cash but was tentatively moved to the business section after being reconsidered.

The creation of the discontinued operations and tax sections will make the remaining classifications clearer and easier to understand. The multi-category section may be used for complex acquisitions and disposals.

Chapter 6 includes additional information on the classifications that are likely to be part of the revised financial statement presentation guidance.

Quick Exercise 3-2

Show how to present each of the following items on the statement of cash flows under current reporting rules. Specify the section of the statement, if any, and the reason for the decision.

1. The entity acquires a building for $400,000 using a 10-year mortgage agreement from the local bank that carries a 12 percent interest rate.
2. The entity acquires a building for $500,000. The entity pays the selling company $50,000 in cash. The selling company will carry the mortgage note.
3. A building cost $600,000. The entity agrees to pay the selling entity $100,000 a month, plus interest, for the next six months. The purchaser is a calendar year company.
    a. Assume the entity buys the building on March 1.

    b. Assume the entity buys the building on November 1.

KNOWLEDGE CHECK

4. With the expected changes to cash flow presentation requirements, the new classifications are
    a. Expected to remain unchanged.
    b. Expected to include a tax section.
    c. Not expected to include a discontinued operations section.
    d. Not expected to include a business section with separate operating and investing categories.

Reporting Noncash Transactions

Organizations settle most, but not all, transactions by either giving or receiving cash. Some resource changes result from barter or exchange transactions that never result in any cash inflow or outflow. In other cases, significant activities or events may not result in any current or near- term cash flows. One objective of the statement of cash flows is to provide information not available from the income statement or the balance sheet.

The *all-financial resources* concept of funds was an integral part of *statement of changes in financial position* reporting requirements. This broad concept of funds required entities to report all significant changes in resources, obligations, and residual equities on the face of the statement. The basis for this approach was the presumption that information on the total amount of property bought using cash and using debt or equity securities was important to users.

In the statement of cash flous guidance, FA SB chose to present only cash inflous and outflous on the statement of cash flous.

Requirements

Report investing and financing activities not resulting in cash inflows or outflows in a separate schedule or a narrative presentation.

- The schedule may appear at the bottom of the statement of cash flows.
- The schedule may appear as part of the financial statement notes in either schedule or narrative form.

Do not present investing and financing activities not involving cash flows within the body of the statement of cash flows.

The requirements of the guidance are quite specific. If there is a cash flow, it belongs on the statement of cash flows. If there is not a cash flow, it does not go on the statement of cash flows. This approach is likely to continue as the standard-setting bodies revise cash flow reporting guidance.

Separate disclosure of major noncash investing and financing transactions is necessary. Use judgment in determining what to report in this supplemental schedule.

ILLUSTRATIVE DISCLOSURES RELATED TO NONCASH TRANSACTIONS

The following example included the information in narrative form on the face of the statement.

Consolidated Statement of Cash Flows Years Ending December 31 (millions)	**20X2**	**20X1**	**20X0**
Cash Flows From Operating Activities			
Net income (loss)	$ (256)	$ 282	$ 271
Adjustments for noncash and nonoperating items			
Depreciation and amortization	531	223	202
Amortization of Bridge Facilities fees	327	—	—
Loss (gain) on asset dispositions	112	29	(43)
Equity-method accounting	36	26	24
Changes in related balance sheet accounts			
Receivables	(455)	(13)	(56)
Inventories	(152)	(44)	(48)
Accounts payable and other liabilities	562	27	84
Other balance sheet changes	(5)	(13)	48
Net cash flows provided by operating activities (a)	700	517	482
Cash Flows From Investing Activities			
Acquisition of WCI (a)(b)	(7,933)	—	—
Investments and other acquisitions (b)	(713)	(500)	(353)
Capital expenditures	(612)	(312)	(260)
Proceeds from dispositions (b)	604	11	88
Net cash flows used by investing activities	(8,654)	(801)	(525)
Cash Flows From Financing Activities			
Increase debt (c)	8,071	366	174
Time Warner dividends paid	(57)	(57)	(59)
WCI dividends paid	(45)	—	—
Purchase of common stock	(16)	(158)	(268)
Other	24	17	16
Net cash flows provided (used) by financing activities	7,977	168	(137)
Increase (decrease) in cash and equivalents (d)	$ 23	$ (116)	$ (180)

(*a*) Cash payments of $641 million, $107 million and $98 million were made for interest and $145 million, $200 million and $150 million were made for income taxes during 20X2, 20X1, and 20X0, respectively. In addition, the $7.933 billion cash cost to acquire WCI includes $348 million of financing fees.

(*b*) The noncash effects of 20X2 acquisition and disposition were to increase receivables – $1.268 billion, investments – $864 million; property, plant and equipment – $1.299 billion; excess of cost over net assets acquired – $8.422 billion; other assets $5.430 billion; debt – $1.321 billion; other liabilities – $4.491 billion; and shareholders' equity (Series C Cash Pay Preferred and Series D PIK Preferred)– $5.584 billion; and with respect to dispositions, to increase the net loss – $112 million. The cash cost to acquire WCI of $7.933 billion is reflected net of $358 million of WCI cash at acquisition.

(*c*) Borrowings were $17.071 billion, $378 million and $655 million in 20X2, 20X1, and 20X0, respectively; and repayments were $9 billion, $12 million, and $481 million, respectively.

(*d*) Cash equivalents consist of commercial paper and other investments that are readily convertible into cash, and generally have original maturities of three months or less.

The following example appeared at the bottom of the annual report page containing the statement of cash flows.

(Dollars in Millions)			
	20X2	**20X1**	**20X0**
Noncash Investing and Financing Activities			
Common stock issued for employee stock plans and dividend reinvestment plan	$ 44	$ 54	$ 55
Disposal of assets	140	10	96
Capital lease obligations	15	7	6
Debt exchanged for debt	—	1,196	—
Preferred stock converted to common stock	—	239	—
Contribution of assets and liabilities to equity affiliates	—	128	—

The following schedule and narrative related to noncash transactions were part of the supplemental information in the notes to the financial statements.

Acquisitions of Businesses Included the Following Noncash Transactions

(Dollars in Thousands)

	20X2	20X1
Fair value of net assets acquired, other than cash	$ 3,998	$ 3,908
Notes payable issued to sellers	(1,297)	
Equity investment in affiliate		(1,950)
Minority interest in subsidiary		(1,652)
Cash payments made	$ 2,701	$ 306

Capital lease obligations of $4,314,000 were incurred in 20X2 as a result of the Company entering into leases for equipment.

Non-cash financing has included the issuance of compensatory stock options to employees and stock options to directors, consultants, and others for services (see note 9). Other noncash investing and financing activities include the following:

i. During the year ended January 31, 20X2
   a. The acquisition of Class A common stock for a promissory note, and
   b. The surrender and cancellation of 150,000 shares of Class B common stock (note 8)
ii. In the period January 31, 20X1, to January 31, 20X2
   a. The conversion of loans of $919,783 plus accrued interest into 863,323 shares of Class B common stock and
   b. The contribution of a $180,000 shareholder loan to additional paid-in capital (note 8)
iii. The issuance of stock valued at $17,333 to an officer of the Company in exchange for certain patent rights during the period January 31, 20X1, to January 31, 20X2.

Net cash from operating activities reflects cash payments for interest of $17,555 and $23,520 for the years ended January 31, 20X1, and 20X2, $1,498 for the period January 31, 20X1, to January 31, 20X2, and $42,573 for the cumulative period January 31, 20X1, to January 31, 20X2.

Issues Related to Noncash Transactions

Often an entity has the option of structuring a transaction in a variety of ways. Under existing rules, how an entity structures a transaction can change how it is reported on the statement of cash flows.

Company A acquires a $120,000 machine from Company B. Company A uses $20,000 of cash and borrows the remaining $100,000.

- If Company A borrows the $100,000 from a bank, there is a $100,000 financing inflow and a $120,000 investing outflow.
- If Company A borrows the $100,000 from Company B, there is a $20,000 investing outflow and a $100,000 noncash schedule item.

If Company A has the bank send the $100,000 directly to Company B, how would you report this transaction?

As a practical matter, this type of transaction is a cash transaction and should be reported as an inflow and an outflow on the statement of cash flows. However, a literal reading of the guidance would suggest that this type of transaction should be part of the schedule of noncash transactions.

Use of Data

How individuals use the statement of cash flows information will determine the appropriateness of various presentation options. Answers to the following questions may be important.

- Does the use of a noncash transactions schedule provide the users with the information they need?
- Does the use of a noncash transactions schedule reduce comparability or make ratio analysis less useful?

Major Issues Related to Noncash Transactions

There are several major issues related to noncash transactions, including the following for example:

- What noncash financing or investing transactions are significant enough to require disclosure?
- How are noncash transactions disclosed?
- How does a company report transactions that are identical in substance, but different in form?
- What, if any, disclosure should be made for major noncash operating transactions?
- Does the reporting of noncash transactions in a separate schedule provide adequate information for users of the financial statements?

Use judgment when determining whether a noncash financing or investing transaction is significant enough to warrant disclosure on the schedule of noncash changes. In general, this schedule is most effective if only major noncash activities are reported. Examples of common disclosures include information on lease transactions, business combinations, and conversions of debt to equity.

The distinction between cash and noncash transactions is expected to continue when financial reporting guidelines are changed. However, information related to noncash transactions is probably going to be a fundamental part of the statement of cash flows presentation and disclosure only in the notes will probably no longer be permitted.

KNOWLEDGE CHECK

5. Non-cash investing or financing transactions

   a. Must be disclosed using a separate schedule.
   b. May be included as a separate schedule in the body of the cash flow statement.
   c. May be disclosed using a narrative presentation.
   d. Are not required to be disclosed even when they are significant.

Comprehensive Exercises

Comprehensive Exercise 3-1

For each of the following transactions specify whether the transaction is investing, financing, operating, cash and cash equivalents, or noncash. If a combination of classifications is appropriate, so indicate.

1. A sale of common stock

2. Expenditures for research and development activities

3. Interest earned on long-term investments

4. A gain on the sale of an old plant

5. An investment in short-term T-bills

6. The acquisition of inventory

7. Treasury stock purchases

8. Insurance settlements

9. Borrowing to hedge an investment

10. Capitalized interest

11. The proceeds from the sale of a business

12. Borrowings and repayments on an open line of credit without a specific maturity date

13. Proceeds from corporate owned life insurance policies

14. Cash deposited into a restricted sinking fund that the entity will use to retire long-term debt

15. The sale of 10 percent of the stock of a wholly-owned subsidiary

16. A loan made to the sole owner of the business. The owner sometimes repaid previous loans and sometimes converted the loans to dividends

17. The cash received from a subsidiary company in the form of a loan

18. The interest received by a retailer on loans made to customers

19. The cash paid by a real estate development company to acquire buildings that the company will renovate and sell within a year

20. The sale of new shares received as the result of a stock dividend

21. The write-down of a fixed asset because of structural damage that the entity just discovered

Comprehensive Exercise 3-2

This exercise focuses on the cash flow classification transactions that arise because of more recent accounting codification guidance that is not directly related to the statement of cash flows and transactions where there has been diversity on how firms report in the statement of cash flows. For each situation, specify whether you believe the transaction is investing, financing, operating, or non-cash. If a combination of classifications is appropriate, so indicate.

1. The purchase and sale of "available for sale" equity instruments
2. Receipts of a donation by a nonprofit that will be used to establish a permanent endowment whose earnings can be used only to acquire or improve long term tangible assets
3. Proceeds from the sale of a derivative instrument that included a financing element at its inception
4. Cash debt issue costs paid
5. Signing a long term lease obligation that will require payments at the end of the next 10 years
6. Insurance proceeds received because a building was destroyed by a flood. The firm plans to use the proceeds to buy inventory
7. A firm’s prepaid debt obligations to reduce interest costs
8. Settlements of zero coupon debt
9. Payments for contingencies identified at the time of a business acquisition that are made significantly after the acquisition date

10. Dividends received from equity method investees
11. Cash receipts and payments that have aspects of more than one class of cash flows

COMPREHENSIVE EXERCISE 3-3

Briefly indicate how you believe the following activities should be reported on the statement of cash flows.

1. Small Company acquires a significant new plant facility by using a long-term capital lease. Small paid $100,000 in cash when the lease was signed. The remaining lease obligation, which has a present value of $1.5 million, is properly classified as long-term.

2. Snail Company acquired productive assets with a fair value of $800,000. Snail paid $500,000 in cash and assumed an existing mortgage note from the seller.

3. Fancy Company enters into three significant building acquisitions during the year. All buildings are worth $1 million. The first building was acquired by incurring a capital lease obligation, no cash changed hands. The second building was acquired from the proceeds of industrial revenue bonds. The third building was acquired by issuing short-term notes that are still outstanding at the end of the period.

4. Smooth Company acquired a large new machine from Capital Company by arranging for Big Finance Company to send Capital the $400,000 purchase price while Smooth deposits $80,000 into a Big Finance mutual fund where withdrawal is restricted until Smooth repays the $400,000.

Appendix A

SUPPLEMENTAL PROBLEMS

SUPPLEMENTAL PROBLEM 3-1

Comment on the following suggestions for classification of particular transactions.

1. As part of a refinancing of the company, the firm entered into a significant sale and leaseback transaction. Could this transaction be considered all financing rather than part financing and part investing?

2. Excess cash of $900,000 was used to purchase Treasury stock. Investment analysis indicated that the Treasury stock was the best opportunity available for using this excess cash. Can this type of Treasury stock transaction be classified as investing?

3. A $37 million prepayment was made to a company's pension funds. Although the company agrees that ordinary annual funding is a use of funds by operating activities, they consider this prepayment to be an investment that will reduce future expense and funding requirements. Can this cash flow be classified as investing?

4. Why not classify by the nature of the item? For example, the treatment of interest income and expense as operating is not consistent with the way gains and losses related to debt extinguishment and assets sales are treated.

SUPPLEMENTAL PROBLEM 3-2

Indicate how you would disclose each of the following in a statement of cash flows.

1. Press Company retires long-term debt with a carrying value of $6 million and realizes a loss on the retirement of $1.5 million.

2. Shove Company acquires $5 million of U.S. government securities as part of a transaction that will result in an in-substance defeasance (resulting in the retirement of debt). Shove recognizes a gain of $750,000 when $5.75 million of debt is transferred to the trust that will make future interest and principal payments on the debt.

3. A major flood caused Trouble Company to report an extraordinary loss of $5 million. Cash costs associated with the actual cleanup of the plant and equipment were $1.5 million. The book value of the assets destroyed was $3.5 million. Trouble, which had no flood insurance, plans to replace the plant and equipment quickly at a cost of $8 million.

Supplemental Problem 3-3

Describe how you would classify each of the following transactions for purposes of presentation on the statement of cash flows.

1. A capital lease transaction with a nominal down payment and interest at a market rate.

2. A sales lease transaction on a piece of land held for investment by the entity. Twenty percent is realized in cash at the time the lease agreement is signed. Interest is at a market rate.

3. Assume the same facts as in question 2, except that the lease is for a regularly manufactured inventory item.

4. Executory costs on a capital lease that was treated by the lessor as a direct financing lease are paid by the lessee to the lessor. How would these cash flows be reported on the statement of cash flows?

Chapter 4

OPERATING SECTION PRESENTATION DIRECT OR INDIRECT?

Both the direct method and the indirect method are currently acceptable for presenting operating cash flow information. The decision about how to present operating cash flow information is one of the most controversial aspects of FASB and the International Accounting Standards Board (IASB) work on revising financial statement presentation requirements. This chapter examines each method and discusses the advantages of each. Presentation examples help you evaluate the existing presentation options. The next chapter will examine other issues related to the operating section of the statement of cash flows.

LEARNING OBJECTIVES

After completing this chapter, you should be able to do the following:

- Recall what is included in the operating section.
- Identify differences in the direct and indirect method of reporting operating cash flows.
- Identify current reporting requirements when using the direct and the indirect methods.
- Identify the advantages of the direct and of the indirect methods.
- Recall the steps used to derive operating cash flows using the direct and the indirect method.

An understanding of both operating presentation methods is critical because when the standard-setting bodies reconsider the reporting requirements for the statement of cash flows one of the issues they will address is whether to require the direct method.

Operating Section Presentation

The operating section of the statement of cash flows reports the cash effects of most recurring transactions and other events that enter into the determination of net income. It is the default classification under existing reporting guidance. Operating inflows and outflows include those activities that are not defined as investing or financing.

Cash inflows from *operating activities* include the following:

- Cash receipts from the sale of goods or services and the collection of receivables that arise from the sale of goods and services
- Cash interest received and dividends received
- Other cash receipts not directly identified with financing or investing activities (such as lawsuit settlements or normal insurance settlements)

Cash outflows for *operating activities* include the following:

- Cash payments for trade goods purchased for resale or use in making a product, including notes to suppliers of trade goods and settlements of retirement obligations
- Cash payments to other suppliers and to employees
- Cash paid for taxes, fees, and fines
- Interest paid to creditors, including interest that is accreted on zero or significantly less than effective interest rate bonds.
- Other cash payments not directly identified with financing or investing activities (such as lawsuit settlements, contributions, or payments to settle inadequately recognized contingencies made significantly after an acquisition)

Key Point

Although the cash inflows and outflows noted previously are what constitute the cash flows in the operating section, the operating section of the statement does not have to directly disclose each of these cash inflows and outflows.

There is general agreement that information on cash provided by operations is useful. There is little agreement on what type of presentation approach should be required.

Existing cash flow reporting guidance permits an organization to use either of two methods of presenting the operating section of the statement of cash flows:

- *Direct method* – This method shows both cash inflows and cash outflows as line items in the operating section. This is the method recommended by the standard-setting bodies.
- *Indirect method* – This method starts the operating section with net income. Items that do not require cash are added and those requiring additional cash are subtracted from net income to determine the amount of cash provided by operations.

The total net cash provided (used) by operations *must be the same* whether an entity uses the direct or the indirect method.

This chapter focuses on the issues associated with the choice of the direct or the indirect method of reporting operating cash flows.

Existing cash flow reporting guidance sets minimum line item presentation levels but *encourages entities to experiment with expanded disclosures*. Several examples illustrate potentially useful presentation approaches that provide more information than the minimum required by the guidance. *More extensive disclosure requirements are likely when new guidance for presenting statement of cash flows information is issued.*

Issues to Think About

- How do individuals use components of the cash from operating activities for decision making?
- How understandable are various presentation options for the user?
- What is the value of providing additional details about operations for internal or external users?
- What data collection problems may an entity encounter?

DIRECT AND INDIRECT METHOD BASICS

Key Point

The direct and the indirect methods are both acceptable as methods of presenting operating cash flow information. Current cash flow reporting guidance encourages the use of the direct method, but most public firms continue to use the indirect approach. The use of the direct method is more widespread in smaller nonpublic firms.

The *direct method* emphasizes the inflows of cash from the transfer of products to customers and the outflows of cash caused by production and distribution activities. Operating cash inflows and outflows are obtained directly or by adjusting revenue and expense amounts for changes in asset and liability accruals or deferrals so they become the cash inflow or outflow amounts:

- The statement reports the cash collected from customers, interest, and dividends.
- The statement shows the amount of cash paid for normal operating expenses, plus information on taxes paid and interest cash outflows.
- The operating section presents other cash flows that are not investing or financing.

The *indirect method* starts with comprehensive net income. The portion of revenues and expenses that did not result in cash flows or resulted in additional cash flows are added to or subtracted from net income to determine net cash from operating activities:

- Adjust net income for items, such as gains and losses on capital asset sales, for which the cash flows are investing or financing.
- Adjust net income for changes in operating accrual and deferral accounts, such as accrued taxes payable or prepaid rent revenue. Eliminate amounts related to investing and financing activities that change these accounts.

Examples on the following pages illustrate the direct and indirect methods and allow you to compare the two methods. Note that

- only the cash provided by the operating activities amount is the same on both statements;
- the direct method focuses on cash inflows and outflows while providing only limited detail, particularly of cash outflows; and
- the indirect method focuses on disclosing items that do not use or provide cash.

Directs Inc. and Subsidiaries
Consolidated Statements of Cash Flows
for the Years Ending December 31

	20X2	20X1	20X0
Cash Flows From Operating Activities			
Receipts from customers	$ 659,569	$ 566,779	$ 412,338
Payments to suppliers and employees	(436,097)	(400,614)	(284,313)
Income taxes paid	(78,749)	(88,672)	(58,276)
Interest received	21,286	14,841	12,307
Interest paid	(9,333)	(5,866)	(6,827)
Other, net	6,099	(6,899)	(2,873)
Net cash flows provided by operating activities	$ 162,775	$ 79,569	$ 72,356

Directs Inc. and Subsidiaries

	20X2	20X1	20X0
Reconciliation of net income to net cash flows from operating activities			
Net income	$ 147,076	$ 124,815	$ 72,610
Adjustment needed to reconcile net income to net cash provided by operating activities			
Depreciation and amortization	72,056	56,800	40,973
Loss on sale or retirement of fixed assets	5,134	3,365	821
Income tax benefit from stock option plans	3,946	3,114	2,015
(Increase) decrease in assets			
Receivables	(48,184)	(21,993)	(263)
Inventories	(5,347)	(47,183)	(57,497)
Leased systems and spares additions	(71,951)	(58,852)	(40,282)
Net book value of leased systems sold or retired	17,414	9,997	3,334
Other	(101)	70	(3,464)
Increase (decrease) in liabilities			
Accounts payable and accrued expenses	11,341	16,572	19,546
Income taxes payable	4,532	6,701	3,144
Deferred income and customer advances	28,751	(15,750)	34,621
Deferred taxes	(1,892)	1,913	(3,202)
Net cash flows provided by operating activities	$ 162,775	$ 79,569	$ 72,356

The income statement and a direct method statement of cash flows represent two different flow presentations. The following example illustrates these differences. The related flows are numbered to highlight the differences. This type of presentation approach makes it easier for users to contrast the two major flow statements.

Comparison Company
Consolidated Statements of Income
for the Years Ending June 30

	20X2	20X1	20X0
1 Revenue	$ 78,880	$ 70,183	$ 68,871
Costs and expenses			
Cost of customer services	29,649	26,680	25,054
Selling and administrative expenses	45,805	39,597	41,407
2	75,454	66,277	66,461
Income from operations	3,426	3,906	2,410
Other income (expense)			
3 Interest income	407	364	288
4 Interest expense	(302)	(575)	(334)
Exchange gain (loss)	(148)	9	23
Income before taxes	3,383	3,704	2,387
5 Provision for income taxes (Note 8)	1,349	1,495	1,047
Net income	$ 2,034	$ 2,209	$ 1,340

Comparison Company
Consolidated Statements of Cash Flows
for the Years Ending June 30

	20X2	20X1	20X0
Cash flows from operating activities			
1 Cash received from customers	$ 78,414	$ 69,022	$ 71,645
2 Cash paid to suppliers and employees	(70,033)	(59,317)	(64,395)
3 Interest received	405	277	176
4 Interest paid	(303)	(582)	(355)
5 Income taxes paid	(600)	(209)	(87)
Net cash flows provided by operating activities	$ 7,883	$ 9,191	$ 6,984

KNOWLEDGE CHECK

1. The operating section of the statement of cash flows

   a. Includes only the cash inflow and cash outflow items specifically identified as operating.
   b. Excludes interest paid to creditors.
   c. Includes dividends received and dividends paid on common stock.
   d. Is the default classification and used for items that are not defined as investing or financing.

Current Reporting Requirements

Direct Method

The direct method is recommended, but not required. Existing cash flow reporting guidance suggests that an entity report operating activities by using the direct method. When this approach is used, there are minimum, but not maximum, cash inflow and outflow *disclosures* required.

The minimum operating cash inflow disclosures when using the direct method include

- cash collected from customers;
- interest and dividends received in cash; and
- any other cash receipts related to operations.

The minimum operating cash outflow disclosures when using the direct method include

- cash paid for normal operating expenses, such as payments to employees and suppliers;
- interest paid in cash;
- income taxes paid; and
- any other cash payments related to operations.

An entity may lump most operating cash expenditures into a single outflow category. Although the guidance encourages entities to experiment with statements that provide additional disclosure details, few firms have provided more than the minimum cash outflow disclosure.

An entity using the direct method must also provide a schedule reconciling net income to cash from operating activities. If the indirect method is used in the statement, direct method information is not required. This requirement provides users with additional details about operating cash flows, but discourages the use of the direct method.

Because of uncertainty about the availability of actual cash inflow and cash outflow information, current cash flow reporting rules allow firms to estimate these cash flows by adjusting revenue and expense items for changes in related asset and liability accounts. This is known as the indirect direct method.

For example, adjusting sales for the change in accounts receivable can result in the estimated cash collected from customers in some situations.

Indirect Method

Cash from operating activities using the *indirect method* currently may be presented by *removing* from net income the effects of all deferrals of cash receipts and payments and all accruals of cash receipts and payments.

It is necessary to adjust comprehensive net income for

- deferrals of operating cash receipts and payments, such as those for inventory and prepaid revenues;
- accruals of operating cash receipts and payments, such as those for receivables and payables;

- gains and losses where the related cash flows are part of the investing or financing sections (such as depreciation, sale of capital assets, or debt extinguishment); and
- the gains and losses from the disposition of segments of the business.

The *cash provided by operating activities* calculated by the indirect method equals the amount reported if the entity used the direct method adjust for changes in such items as accounts receivable and payable after eliminating the changes in these accounts related to investing and financing activities.

When using the indirect method, separately disclose the *amount of interest and income taxes paid* in statement notes.

The cash flow reporting guidance requires that a line such as "adjustment to reconcile net earnings to net cash provided" be part of the statement when using the indirect method.

This requirement exists because simply adding or subtracting adjustments such as depreciation or deferred taxes without specifying that these costs did not result in cash flows this period makes indirect method statements more difficult to understand.

The reconciliation of net income to cash provided by operations provides the user with details not available from a minimum disclosure direct method presentation. For example, the reconciliation shows changes in accounts payable, in inventory, and in other accounts. The intent of the reconciliation requirement was to have these items shown separately, not combined.

The level of detail in a complete reconciliation is often high. It is not uncommon for the reconciliation to contain 10, 15, or even 20 items. This detail can make it difficult for users to understand exactly why each item is added to or subtracted from net income.

KNOWLEDGE CHECK

2. When a firm uses the direct method, the statement of cash flows guidance

   a. Specifies the maximum number of cash inflow and outflow line items that must be included.
   b. Requires that major categories of operating cash outflows be presented separately.
   c. Permits interest and taxes paid to be combined within the operating section.
   d. Requires the presentation of a schedule that reconciles net income to operating cash flows.

Advantages of Alternative Presentations

When the exposure draft that preceded the issuance of FASB Statement of Financial Accounting Standards No. 95, *Statement of Cash Flows*, (now incorporated into FASB ASC 230, *Statement of Cash Flows*) proposed requiring the direct method of presenting cash from operations it set off an extensive debate on the merits and costs of these alternative methods. This debate, which continues today, often pits users against preparers and is forcing standard-setting bodies to carefully evaluate the benefits and costs of these presentation options as they consider modifications to financial statement reporting requirements. The next several sections take a closer look at the issues inherent in the financial presentation controversy.

DIRECT METHOD ADVANTAGES

Supporters of the direct method argued that this approach is more consistent with the primary objective of the statement of cash flows.

- The direct method provides information on cash inflows and outflows.
- It emphasizes cash receipts and cash payments.

This emphasis is in sharp contrast to the indirect method which focuses on items that do not result in cash flows.

Other advantages of the direct method include the following:

- There is specific information about cash inflows and outflows from operating items.
- Direct inflow and outflow information is easier to explain to most users than are the added back and subtracted items found in the indirect presentation.
- A direct presentation provides a set of flow amounts not otherwise available to financial statement users.
- Captions such as "cash received from customers" seem to convey more information about the entity than "net increase in receivables, inventory, and payables."
- A direct method statement reports the source of operating cash inflows and outflows directly to facilitate users' assessment of an organization's risk.

The format of a direct method statement of cash flows differs from the indirect method statement of cash flows in the following ways:

- A direct method statement directly reports cash inflows and outflows from various operating activities, such as collections from customers, employee salaries, or inventory purchases.
- The indirect method statement of cash flows on the other hand, as its name implies, is derived from reprocessing and reclassifying data from the income statement to filter out noncash items such as credit sales and purchases, and other adjustments.

At the time existing cash flow reporting guidance was promulgated there was only limited research comparing the predictive value of the direct and the indirect method of presentation. Two later major research studies[1] show that direct method presentation results in a better prediction of future cash flows and earnings than indirect method presentation.[2]

[1] Orpurt, Steven and Yoonseok, Zang, "Do Direct Cash Flow Disclosures Help Predict Future Operating Cash Flows and Earnings?" *Accounting Review*, 84(.3) 2009, 893-935 and Krishnan, Gopal and james Largay, "The Predictive Ability of Direct Method Cash Flow Information" *Accounting Review*, 27 (1), 2000, 215-245.
[2] See chapter 6 for additional discussion.

Additional research, including work done as part of the field testing for proposals on changing financial statement presentations showed the following:[3]

- Analysts in a field test found that the direct method makes it easier for users to understand the sources and uses of cash.
- Analysts surveyed felt direct method information would enable them to better forecast future cash flows and assess degree to which earnings are likely to recur.
- Academic research shows direct cash flow information has better predictive value and there are fewer processing and analytical errors.

Summary Advantages: Direct Method

- Is more intuitive and understandable to users
- Improves user ability to predict future cash flows
- Provides insight into the cash conversion cycle and the relationship between revenues and expenses and cash inflows and outflows
- Leads to better decision making
- Provides data to develop trend and comparison information that is currently not available
- Allows cash inflow and outflow comparisons across entities
- Allows more meaningful cash flow variance analysis
- Permits the analysis of the sensitivity of different cash flows to changes in volume

Indirect Method Advantages

The advantages listed by advocates of using an indirect method presentation of operating information are as follows:

- The method focuses attention on the differences between income and cash flows.
- The reconciliation schedule identifies items that are neither sources nor uses of cash.
- The reconciliation provides multiple links between the statement of cash flows and the statement of financial position.
- It is less costly to prepare.
- The method is more familiar to statement users.

As the direct method statement and related reconciliation example that follows illustrate, there are significant differences between operating cash flows and net income. Note that both statements arrive at the same net cash flows provided by operating activities.

[3] Based on information provided by the "Staff Draft of an Exposure Draft on Financial Statement Presentation,'' FASB, July 1, 2010.

Both Ways Company
Consolidated Statements of Cash Flows
for the Years Ending March 31

	20X2	20X1	20X0
Cash Flows From Operating Activities			
Cash received from customers	$ 53,484	$30,775	$13,527
Interest received	8,362	4,436	1,583
Cash paid for land acquisitions and real estate development	(72,224)	(62,118)	(19,147)
Cash paid to suppliers, employees, and sales representatives	(39,373)	(19,816)	(9,390)
Interest paid	(2,214)	(2,101)	(986)
Income taxes paid	(348)	(440)	37
Proceeds from sales of notes receivable	57,703	20,000	5,752
Other	(797)	(309)	(639)
Net cash flows provided by (used in)operating activities	$ 4,593	$ (29,573)	$ (9,263)

Both Ways Company

Reconciliation of Net Income to Net Cash Flows From Operating Activities			
Income before extraordinary items	$ 13,567	$ 9,355	$ 3,950
Extraordinary item			
Extinguishment of debt	1,500		
Net income	15,067	9,355	3,950
Adjustments to Reconcile Net Income to Net Cash Flows From Operating Activities			
Depreciation and amortization	1,225	653	247
Equity in (earnings) losses of joint ventures	151		
Provision for possible loan losses	100	100	
Tax benefits relating to employee stock options	5	22	
Minority interests in earnings of subsidiaries			675
(Increase) Decrease in Assets Net of Effects From Acquisition of Subsidiary			
Contracts receivable	(331)	(4,647)	(1,861)
Inventory	(21,319)	(25,792)	(4,250)
Other assets, excluding due from officers and other related parties, and loans made for investment	(1,890)	(2,128)	(1,019)
Notes receivable	3,220	(21,528)	(12,123)
Increase (Decrease) in Liabilities Net of Effects From Acquisition of Subsidiary			
Accounts payable and accrued liabilities	(566)	5,557	896
Interest accrual reduction from debenture conversion	677	200	
Increase in income taxes payable	2,798	(7)	243
Increase in deferred income taxes payable	8,086	8,642	3,979
Gain on extinguishment of debt	(2,630)		
Net cash flows provided by (used in) operating activities	$ 4,593	$ (29,573)	$ (9,263)

Additional examples of both direct and indirect method statements are found later in this chapter.

Quick Exercise 4-1

Assume you are preparing the operating section of a statement of cash flows using the indirect method and the following items are among those that are part of the net income adjustment to obtain the cash provided by operation:

a. Depreciation on equipment
b. A gain on the sale of common stock
c. An increase in inventory
d. A loss on the sale of a plant
e. An increase in accounts payable.

Required

1. For each item, specify whether it would be added back or subtracted from net income as part of the adjustment process.

2. For each item, provide an explanation of why it is added back or subtracted from net income. Write your explanation so that someone who is not an accountant can understand the reason for the item being added back or subtracted.

KNOWLEDGE CHECK

3. Which statement reflects an advantage of the indirect method of presenting cash from operations?

   a. The method is easy to explain to nonaccountants.
   b. The method focuses attention on income and cash flow items that are the same.
   c. The method clearly identifies items that are neither sources nor uses of cash flows.
   d. All of the above are advantages of the indirect method.

Direct Method Costs

Most preparers, especially in public companies, have historically opposed any requirement for a direct method presentation. The cost of accumulating actual cash inflow and cash outflow information is often cited as the major detriment.

Prior to the issuance of current cash flow reporting guidance, a research project was undertaken on behalf of FASB. This study found that most smaller firms and many larger firms could readily obtain operating cash inflow and outflow information with some minor accounting system modifications. Discussions with cash managers at several large firms where accountants felt getting operating cash inflow and outflow information was a major problem revealed that operating cash inflow and outflow information was already available within organizational databases, although it was not used in preparing financial reports.

As part of a joint FASB and IASB project on financial statement presentation the boards will be carefully looking at the costs and benefits of requiring a direct method statement and of how much disaggregation of information should be required. The boards will evaluate costs related to

- modifying accounting systems, particularly if actual cash flow information for multiple operating line items were to be required;
- how processes and control procedures may need to be modified;
- how audit costs would change; and
- the nature of training and education costs.

Technical Problems to Think About	
?	• What type of cash flow information is available from your firm's accounting system? • How difficult will it be to provide additional cash flow information that will help users evaluate future cash flows? • How do you use cash flow information internally to help make operating and other decisions?

Knowledge Check

4. The cost of requiring the use of the direct method is often cited as a concern. Which is NOT a cost concern that has been raised?

   a. Systems modification to accumulate actual cash inflows and outflows.
   b. Increased audit costs.
   c. Increased user analysis costs.
   d. Training and education costs.

The Indirect Direct Approach

Given the concerns about the cost of accumulating actual cash in and actual cash outflow information in FASB ASC 230, FASB specifies that a reasonable approximation of direct method cash inflow and outflow information is achieved using the indirect direct approach. In effect, FASB allows firms to back into operating cash inflow and cash outflow amounts rather than collect that data directly using a modified accounting system.

Under this approach, revenue and expense amounts could be adjusted for operating changes in related asset and liability accounts under the following circumstances:

- If all accounts payable relate to inventory acquisitions and all inventory is operating, the cost of goods sold can be adjusted for changes in inventory and accounts payable to obtain the amount of cash paid to suppliers.
- If there are nonoperating items included in an account such as accounts payable, these nonoperating items should be excluded in computing the cash paid to supplier amount.

As a practical matter, allowing the indirect direct method to be used means a firm needs exactly the same information to prepare a direct method statement as an indirect method statement. *There are no cost differences when the use of the indirect direct method is allowed.*

Assume Company A has sales of $100,000 and cash expenses of $70,000. Beginning accounts receivable were $10,000 and ending receivables are $14,000. Included in receivables are loans to employees totaling $1,000 at the beginning of the year and $3,000 at year-end.

Indirect	
Net income	$ 30,000
Adjustment	
Increase in operating receivables	(2,000)
Operating cash flow	$ 28,000
Direct	
Cash from customers	
$100,000 – $11,000 + $9,000	$ 98,000
Cash expenses	(70,000)
Operating cash flow	$ 28,000

Some preparers still seem confused about whether you must separate operating cash from investing or financing activities out of current accounts. The answer is yes. FASB tried to settle this question by specifying that the *cash provided by operating activities total should be the same regardless of whether the direct or the indirect approach is used.* If material, an entity must separate the investing and financing activities out of the operating accruals and deferrals.

Ideally, actual cash inflow and actual outflow amounts for every revenue and expense category would come directly from the accounting system. This direct information would, at least theoretically, eliminate the need for an estimation system. It would allow us to focus questions on what information should be presented on a cash flow statement, not on how we get the information.

Practically, the accumulation of actual cash flow information may be useful internally, but not necessarily better for external reporting purposes:

- The problem of how to handle noncash transactions remains. Many transactions can be structured as either cash or noncash.
- Only a limited amount of detail may be essential in the presentation of a statement of cash flows.
- Actual cash flows may not provide comparative information when complex or special financing or operating arrangements exist.

Company A borrows under a line of credit agreement to finance inventory purchases. Payments received from customers go directly to a lock box to repay the loan. An actual cash flow might not reflect any cash from customers. An adjustment based on the change in receivables would give a better indication of the cash received from customers.

Technical Problems to Think About	
?	If you were required to present direct method operating cash flow information • Could you get this information from your existing accounting system? How sure are you about your answer? • If not, would you use the indirect direct method or would you modify your accounting systems? Why?

Quick Exercise 4-2

The following information is available about an entity's accounts receivable accounts. (This exercise information is based on an example provided in the "Staff Draft of an Exposure Draft on Financial Statement Presentation," FASB, July 1, 2010.)

	Beginning Balance	Sales	Receivable from Acquisition	Cash Collections	Other Entries	Ending Balance
A Co	1,000	2,500		-2,600		900
B Corp	2,500	4,000		-4,500		2,000
C Inc	1,800			-1,700		100
D Co	—		10,000			10,000
HIY Suppliers	2,200			-2,200	4,000 (a)	4,000
PQR Factoring	—			-5,000	5,000 (b)	
W Corp	8,000	23,000				31,000
X Partners	10,000	8,000				18,000
Y Corp	6,400				(6,400) (c)	
Z Co	250	50,000				1,250
	32,150	87,500	10,000	-49,000	2,600	67,250

(a) Receivable for vendor volume incentives included with trade receivables
(b) Amount received from factoring company from sale of Y Corp receivables
(c) Sale of Y Corp receivable to PQR Factoring

Required

Use this information to apply the indirect direct method and determine to amount of cash collected from customers.

KNOWLEDGE CHECK

5. Which statement is NOT correct?

   a. Actual cash inflows and actual cash outflows must be used when presenting the direct method.
   b. It is necessary to separate investing and financing inflows from operating items in current asset or liability accounts to properly measure operating cash inflows or outflows.
   c. It is acceptable to back into cash inflows and cash outflows using the indirect or direct method.
   d. When the direct method is used there must be a cash outflow line for each expense line on the income statement.

What Is Next?

Has your organization carefully examined how it presents operating cash flow information or evaluated how useful the information is to users? If not, you need to because changes in how to present operating cash flow information are probably coming.

In work that was done on financial statement preparation, FASB and IASB had tentatively decided the following:

- To require the direct method of presenting cash from operations in the body of the statement of cash flows—Either the direct or the indirect methods may be used to measure operating cash inflow or cash outflow information.
- To use a business section that includes an expanded operating segment as well as an investing segment—Work will eventually continue on what is included in each of these subsections.
- To require presentation of an indirect method reconciliation as part of the statement of cash flows—This reconciliation will start with operating income rather than net income.
- To require a reconciliation of changes in significant asset and liability accounts—This modified an earlier decision to have entities provide a schedule that reconciles line items on the statement of cash flows with those on the statement of comprehensive income.
- To expand the minimum line item cash outflow disclosures—Exactly what line item information should disclosures require remains under debate.

Although the project that would result in these changes is currently on hold, it may be put back on the active agenda of the standard setting boards after several current projects are wrapped up.

Illustrative Indirect and Direct Method Statements

The indirect method statement presented on the following page is a good illustration of an operating section that conforms to the existing cash flow reporting requirements:

- There is a clear identification of the adjustments for noncash transactions.
- The statement provides details about the adjustments made.
- Working capital changes are part of the adjustments section, but separated for easier use.

Even in this presentation one can raise certain questions about the meaning of selected items included in the reconciliation. For example:

- What is the nature of the noncurrent provision for special items?
- Why is the book value of asset disposals included in the operating section as an addition to net income?
- What types of noncurrent assets and liabilities are included in operations?

The reporting entity, IDM Company, did not provide specific explanations of the nature of these adjustments in either the financial statements or the related notes.

IDM Company
Partial Statement of Cash Flows

For the Years Ending December 31	20X2	20X1	20X0
Cash Flows From Operating Activities (000)			
Income from operations	$ 1,367.4	$ 1,036.8	$ 307.1
Adjustments to reconcile income to net cash flows provided by operating activities			
Depreciation, depletion, and amortization	664.0	645.3	607.2
Reduction of assets to net realizable value	—	—	107.5
Increase in future taxes on income	82.0	96.8	36.3
Equity earnings before additional taxes, net of dividends	(47.1)	(7.1)	(11.9)
Noncurrent provision for special items	—	—	113.8
(Gains) from financing and investment transactions	(20.8)	(32.1)	(17.7)
Book value of asset disposals	19.3	20.0	12.4
Other	14.3	(27.2)	27.1
(Increase) reduction in receivables	74.6	(282.7)	(229.0)
(Increase) in inventories	(198.9)	(108.5)	(49.1)
(Increase) in prepaid expenses and other current assets	(40.3)	(85.2)	(12.9)
Increase in accounts payable and accrued expenses	33.9	87.6	63.5
Increase in taxes, including taxes on income	110.8	315.8	105.2
Net change in noncurrent assets and liabilities	(88.4)	57.6	52.8
Net cash flows provided by operating activities	$ 1,970.8	$ 1,717.1	$ 1,112.3

The Supplemental Corporation statement of cash flows shows only the net changes in working capital on the face of the statement. Information on the change details is in the notes to the financial statements. *This presentation approach also violates the requirements and spirit of existing statement of cash flow reporting requirements because it does not start with comprehensive income.*

Supplemental Corporation
Partial Consolidated Statements of Cash Flows
for the Years Ending June 30

	20X2	20X1	20X0
Cash Flows From Operating Activities			
Net income	$ 2,712,556	$ 1,820,877	$ 6,273,260
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities			
Depreciation and amortization	404,387	365,896	478,911
Gain on sale of investment	(163,677)		
Deferred income taxes	(112,000)	463,000	
Net gain on settlement of and change in Chapter 11 liabilities			(5,731,925)
→ Net changes in working capital items (note 6)	(2,700,366)	(2,383,295)	1,390,570
Net cash flows provided by operating activities:	$140,900	$ 266,478	$ 2,410,816

Supplemental Corporation
Additional Cash Flows Information

The net changes in cash as a result of changes in working capital items, other than cash and indebtedness, for Supplemental Company consist of the following:

	20X2	20X1	20X0
Accounts receivable	$ (628,599)	$ (1,324,825)	$ 782,594
Inventories	(1,898,625)	(1,056,747)	(341,857)
Prepaid expenses	(59,422)	13,479	(48,996)
Accounts payable	92,231	291,611	303,601
Accrued liabilities	102,537	(769,313)	687,728
Income taxes payable	(308,488)	462,500	7,500
Net change	$ (2,700,366)	$ (2,383,295)	$ 1,390,570

The Multiple Company statement presents only a single line item for operating activities above the investing and financing sections. The reconciliation is on the facing page in the statement. The amount of detail in the reconciliation is one reason for using this presentation approach. This is an appropriate presentation method.

Multiple Company
Consolidated Statements of Cash Flows
for the Years Ending December 31

(Dollars in Thousands)			
	20X2	**20X1**	**20X0**
Net Cash Flows Provided by (Used in) Operating Activities	$ 23,700	$ 11,844	$ (21,197)
Cash Flows From Investing Activities			
Proceeds from sales of property and equipment	3,382	3,446	6,352
Payments received on long-term receivables from sale of property	5,391		
Purchase of mortgage note receivable	(15,515)	(7,233)	(11,895)
(Increase) decrease in deferred charges	2,139	(558)	(2,396)
(Additions to) reductions in investments in and advances to unconsolidated affiliates	(359)	110	(4,998)
Net cash flows used in investing activities	(4,962)	(4,235)	(12,937)
Cash Flows From Financing Activities			
Borrowings during the year	169,570	46,430	29,868
Repayments of debt	(180,296)	(55,618)	(17,798)
Dividends paid	(1,695)	(2,147)	(2,197)
Contributions from (distributions to) minority interests	(1,595)	(324)	1,008
Net cash flows provided by (used in) financing activities	(14,016)	(11,659)	10,881
Net increase (decrease) in cash and short-term investments	4,722	(4,050)	(23,253)
Cash and short-term investments at beginning of year	8,622	12,672	35,925
Cash and short-term investments at end of year	$ 13,344	$ 8,622	$ 12,672

Multiple Company
Reconciliation of Net Income (Loss) to Net Cash Flows Provided by (Used in) Operating Activities for the Years Ending December 31

(Dollars in Thousands)	20X2	20X1	20X0
Net income (loss)	$ (96,628)	$ 19,607	$ 16,244
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities			
Depreciation and amortization	8,525	9,037	8,505
Provision for doubtful accounts	11,709	19,347	16,529
Minority interest in earnings	127	540	117
Deferred income tax expense (benefit)	(13,461)	(3,166)	6,977
Loss reserves and write-downs	78,814		
(Gain) loss on asset transactions	12,128	(1,085)	(1,651)
Equity in (earnings) loss of unconsolidated affiliates	(4,549)	116	(4,997)
Extraordinary loss from extinguishment of debt due to exchange of common stock for subordinated notes	550		
Cumulative effect of accounting change	3,834		
Effects of discontinued operations	1,895	(796)	(2,701)
Proceeds from sale of and payments received on installment notes	56,352	17,679	8,510
Sales of undeveloped real estate for installment notes and additions to long-term receivables	(2,852)	(19,548)	(44,112)
(Additions to) reductions in real estate inventories and other inventories	(16,606)	(27,872)	6,110
Payments on working capital guarantees	(12,077)		
Decrease in deferred credits and other liabilities	(3,784)	(9,436)	(5,969)
Increase in receivables	(1,630)	(2,755)	(2,278)
(Increase) decrease in income tax refunds receivable	15,031	(15,719)	(5,128)
(Increase) decrease in prepaid expenses and other current assets	(3,727)	4,263	(3,819)
Increase (decrease) in accrued liabilities	(6,989)	14,165	5,422
Increase (decrease) in income taxes and deferred income taxes	(2,842)	13,478	(4,956)
Decrease in accounts payable	(120)	(6,011)	(14,000)
Net cash flows provided by (used in) operating activities	$ 23,700	$ 11,844	$ (21,197)

Several illustrative direct method presentations appear on the following pages. A number of these statements provide more than the minimum required disclosures. These statements are consistent with FASB's call for experimental displays. The first statement presents only a single period of information, but several more inflow and outflow categories than the minimum specified by the guidance.

Single Year Company
Statement of Cash Flows
for the Year Ending December 31, 20X2

(Dollars in Thousands)

Cash Flows From Operating Activities	
Cash received from customers	$ 40,854
Cash paid to post-petition suppliers	(18,008)
Cash paid on prepetition liabilities	(6,329)
Payroll and payroll taxes paid	(11,216)
Professional fees paid	(753)
Other overhead expenses paid	(3,228)
Insurance proceeds received	477
Interest received	282
Interest paid	(509)
Proceeds from scrap sales	218
Net cash flows provided by operating activities	$ 1,788

Following, the Single Year Company statement has been reconstructed to show the inflow and outflow presentation approach. This approach may be easier to read and use than the more common mixture of inflows and outflows shown previously.

Single Year Company
Statement of Cash Flows
for the Year Ending December 31, 20X2

(Dollars in Thousands)

Cash Flows From Operating Activities		
Inflows		
Cash received from customers	$ 40,854	
Insurance proceeds received	477	
Interest received	282	
Proceeds from scrap sales	218	
		$ 41,831
Outflows		
Cash paid to post-petition suppliers	18,008	
Cash paid on prepetition liabilities	6,329	
Payroll and payroll taxes paid	11,216	
Professional fees paid	753	
Other overhead expenses paid	3,228	
Interest paid	509	40,043
Net cash flows provided by operating activities		$ 1,788

The Sources and Uses Company
Consolidated Statements of Cash Flows
for the Years Ending December 31

(Dollars in Thousands)	20X2	20X1	20X0
Cash Flows From Operating Activities Sources of Cash			
Cash received from customers	$ 5,641.6	$ 5,373.0	$ 4,709.1
Interest received	1.7	2.0	2.0
Income tax refunds received	.2		46.8
Claim settlements			50.0
Insurance recoveries			30.0
Other cash	3.5	9.4	7.0
	5,647.0	5,384.4	4,844.9
Uses of Cash			
Cash paid to suppliers and employees	5,635.2	5,250.1	4,463.5
Interest paid (net of capitalization)	40.7	28.1	15.1
Payment of accrued product support to U.S. Government	27.7		
Income taxes paid	9.7	23.7	42.1
Other cash payments	.9	1.7	4.8
Cash used in operating activities	5,714.2	5,303.6	4,525.5
Net cash flows provided by (used in) operating activities	(67.2)	80.8	319.4
Cash Flows From Investing Activities			
Additions to property, plant and equipment	(294.4)	(364.2)	(384.0)
Proceeds from sales of property, plant and equipment	29.9	3.4	9.5
Investments in affiliates, net of dividends		(4.0)	(4.1)
Other investment activities	2.3	1.8	(.1)
Net cash flows used in investing activities	(262.2)	(363.0)	(378.7)
Cash Flows From Financing Activities			
Borrowings under lines of credit	954.6	335.9	120.6
Repayment of borrowings under lines of credit	(565.9)		
Proceeds from issuance of long-term debt	1.0		
Principal payments of long-term debt and			
capital leases	(2.8)	(.4)	(2.3)
Proceeds from issuance (repurchase) of stock	(1.1)	.2	
Dividends paid	(56.2)	(55.8)	(55.6)
Net cash flows provided by financing activities	329.6	279.9	62.7
Increase (decrease) in cash	.2	(2.3)	3.4
Cash balance at beginning of year	4.8	7.1	3.7
Cash balance at end of year	$ 5.0	$ 4.8	$ 7.1

The Sources and Uses Company
Reconciliation of Net Income to Net Cash Provided by Operating Activities for the Years Ending December 31

(Dollars in Thousands)			
	20X2	**20X1**	**20X0**
Net income	$ 94.2	$ 41.2	$ 214.4
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities			
Depreciation and amortization	246.8	225.6	193.4
Common stock issued to employees	5.3	3.7	4.7
Amortization of restricted award shares	4.1	4.0	4.8
Loss (gain) on fixed asset disposal	(11.2)	(.6)	.8
Undistributed income of affiliates	(3.8)	(4.5)	(4.4)
Decrease (increase) in			
Accounts receivable	(750.4)	(252.6)	(220.1)
Inventoried costs	26.6	(49.3)	(48.7)
Prepaid expenses	(3.4)	(4.6)	(9.9)
Refundable federal income tax		1.9	18.4
Increase (decrease) in			
Progress payments and advances	310.8	17.0	(127.5)
Accounts payable and accruals	28.1	11.3	87.0
Provisions for contract losses	(58.9)	100.5	54.3
Deferred income taxes	50.2	(10.4)	122.9
Income taxes payable	(8.4)	(11.6)	20.7
Other noncash transactions	2.8	9.2	8.6
Net cash flows provided by (used in) operating activities	$ (67.2)	$ 80.8	$ 319.4

Comprehensive Exercises

Comprehensive Exercise 4-1

Explain why you add or subtract each of the identified items to net earnings to obtain total cash provided by operations. Where possible, use nontechnical language an individual not trained in finance or accounting could understand.

The Reconciliation Company
Consolidated Statements of Cash Flows
for the Years Ending December 31

	20X2	20X1	20X0
Cash Flows From Operating Activities			
Continuing Operations:			
Income from continuing operations before extraordinary item	$ 551	$ (599)	$ 155
Income (loss) from discontinued operations	94		
→ Gain on disposal of discontinued operations	(123)		
Adjustments to Reconcile Income to Net Cash Provided by Operating Activities			
→ Depreciation and amortization	422		
Depreciation and amortization – discontinued operations	171	318	286
→ Provision for losses on accounts receivable	43		
Provisions for (recoveries of) losses on accounts receivable – discontinued operations	(12)	(31)	2
→ Deferred taxes	353		
Deferred taxes – discontinued operations	48		76
→ Loss on retirement of equipment	15		
Change in Assets and Liabilities Net of Tax Effects From Purchase of D. S. and L. Inc.			
→ Decrease (increase) in accounts receivable	(452)	330	261
→ Decrease (increase) in inventory – continuing operations	(6)		
Decrease (increase) in prepaid expenses and other	(315)	34	(6)
Decrease (increase) in other assets	(251)	102	(8)
Decrease (increase) in net assets related to discontinued operations		(154)	675
Increase (decrease) in accounts payable	(230)	(3)	(2)
Increase (decrease) in accrued liabilities	93	(72)	114
→ Decrease (increase) in inventory – discontinued operations	5	137	(212)
Increase (decrease) in accrued cleanup costs	(143)	67	
Total adjustments	(259)	728	1,186
Net cash flows provided by operating activities	$ 263	$ 129	$ 1,341

Comprehensive Exercise 4-2

For each situation, specify exactly what should be presented in the statement of cash flows and where the presentation should appear.

1. A truck manufacturer made an installment sale of trucks to a large customer. The sale was for $500,000. The truck manufacturer received $100,000 on the date of the sale. At the end of the year the truck manufacturer received an installment payment of $50,000 plus interest of $40,000.

2. BCD Company spent $2,000,000 constructing a new plant. BCD capitalized interest cost of $100,000 and expensed an additional $300,000 of interest cost.

3. The CDE Company paid $600,000 in income taxes during the current year. This included $200,000 of taxes associated with a $700,000 gain on the sale of a plant. CDE received two million dollars in cash when it sold the plant.

4. The EFG Company made $100,000 of payments for premiums on corporate owned life insurance policies on key executives. During the year the firm also received proceeds of $500,000 after a vice-president died from injuries suffered in an auto accident.

Comprehensive Exercise 4-3

There are two partial cash flow statements provided in the following table. Both have been abstracted from published financial reports. Identify any deficiencies that you find and suggest how the statement might be improved.

Operating Section of Pinch Company
Year Ending December 31

Cash Flows From Operating Activities	20X2	20X1
Net income	$ 2,004	$ 729
Minority interest in consolidated income	393	229
Share in losses of equity affiliates	44	1
Depreciation and amortization	1,575	1,505
Gains on disposal of long-term assets	(55)	(509)
Other resources provided by operations	1,212	632
Resources from operations	5,173	2,587
Changes in assets and liabilities exclusive of effects from acquisitions and translation adjustments	(1,520)	(495)
(Increase) in inventories	(3,245)	(2,136)
Decrease in trade receivables	3,101	1,574
Increase in trade payables	430	201
Increase in other current assets and liabilities	430	201
Net funds provided from operating activities	$ 4,369	$ 1,932

Identify any deficiencies that you find and suggest how the statement might be improved.

Operating Section of HAM Company
Year Ending December 31

	20X2	20X1	20X0
Cash Provided From (Used for) Operations			
Income (loss) from continuing operations	$ 83,223	$ 36,281	$ (57,710)
Companies carried at equity			
Income	(34,537)	(26,991)	(40,304)
Dividends received	33,130	25,409	49,605
Depreciation, depletion, and amortization	33,419	15,288	8,491
Deferred income taxes and other	5,443	(699)	(697)
(Gain) loss on sales and restructuring of investments Restructuring and write-down of investments	8,400	—	96,213
Sales of consolidated subsidiary and investments	(25,290)	(1,799)	(16,748)
Cash provided from continuing operations	103,788	47,489	38,850
Loss from provision for disposal of discontinued operations	—	—	(46,805)
Plant closing	—	—	41,869
Cash used for discontinued operations	—	—	(4,936)
Cash provided from operations	103,788	47,489	33,914
Cash Provided From (Used for) Operating Working Capital			
Receivables	(5,814)	(799)	22,223
Inventories	(11,062)	8,108	15,563
Prepaid expenses	1,776	605	565
Trade payables and other accruals	18,866	5,693	(25,532)
Cash provided from operating working capital	3,766	13,607	12,819
Total cash provided from operations	$107,554	$ 61,096	$46,733

Appendix A

SUPPLEMENTAL PROBLEM

SUPPLEMENTAL PROBLEM 4-1

Classification of items as operating, investing, or financing is not always obvious. Comment on how each of the following transactions should be classified by the firm. Explain the basis of your classification decision.

1. A car rental firm regularly sells automobiles that no longer meet the company's age and mileage requirements. The sales amounts are material.

2.

   a. A utility company uses the same type of inventory and materials in repair activities and new plant construction.

   b. Assume that the utility company does not know exactly which materials will be used for purposes of construction and which for repair activities.

3. A commercial airplane manufacturing company has 90 percent of its inventories tied up in long-term work in process on airplanes and related projects that will not be completed for anywhere from one to three years.

4. A manufacturing company provides a major supplier with cash that will be repaid by providing the manufacturing company with regularly purchased raw materials.

Chapter 5

OPERATING SECTION REPORTING ISSUES

This chapter continues the focus on the operating section. The presentation and reporting issues discussed here exist because of the current statement of cash flows classification requirements. Knowing what these issues are, why they are issues, and how to present information related to these items is an essential element of preparing a useful statement of cash flows that satisfies current reporting guidance. Specifically, this chapter focuses on issues related to reconciliation across financial statements, cash flow from operations totals, the treatment of business combinations and asset dispositions, bad debts, and the sales of receivables.

Several review exercises and a comprehensive example related to statement presentation details are provided to complete the discussion of the general-purpose cash flow reporting requirements.

LEARNING OBJECTIVES

After completing this chapter, you should be able to do the following:

- Recognize why cash flow changes may not reconcile with statement of financial position changes.
- Identify issues related to total cash from operations.
- Recall how to report selected operating items such as interest, taxes, and receivables.
- Indicate how a business combination or disposition affects the statement of cash flows.

Each of the areas discussed can be potentially troublesome in preparing an understandable statement of cash flows. New reporting guidance will eventually address many of the issues discussed in this chapter and may eliminate or mitigate many of the issues discussed.

Lack of Line Item Reconciliation

The following is a powerful argument used by proponents of the indirect method of presenting cash flow information.

There are multiple ties between the balance sheet and the statement of cash flows provided when a reconciliation of net income to net cash provided by operating activities presents changes in accrual and deferral accounts.

Examples of this type of reconciliation linkage have been included in previous illustrations of the indirect method reconciliation, such as the Shake-A-Little exercise in chapter 1.

Do the individual increases or decreases in accounts such as *accrued interest receivable or accounts payable* shown as part of the reconciliation of net income to net cash provided by operating activities always reconcile with the equivalent to the changes shown on comparative balance sheets?

No! In large public companies the adjustments are seldom equivalent to the asset or liability change shown on the statement of financial position.

Think About It

? Why might additions and subtractions to net income on an indirect method cash flow statement not reconcile with changes in related asset and liability accounts?

There are several reasons for a potential lack of articulation between indirect method adjustments and changes in asset and liability accounts, for example:

- A receivable or payable may include investing or financing activities.
- Business acquisitions or segment dispositions reporting requirements can lead to differences.
- Remeasurements to fair value can present further complications.

Ideally, the statement of cash flows would clearly show there is not an equivalency. There should also be at least minimal information that explains why this equivalency does not exist. Practically, there is often little or no explanation provided in existing statements or the related notes because the lack of reconciliation is not addressed in existing reporting guidance.

To illustrate, examine the partial statements reproduced on the next page. Note that the

- balance sheet change in accounts receivable from 20X1 to 20X2 is an increase of $96 million; the change on the statement of cash flows is an increase of $5 million; and
- change in inventories from 20X1 to 20X2 on the balance sheet is $155 million; the increase shown on the statement of cash flows is $76 million.

No Wreck Company Partial Balance Sheet December 31 (Dollars in Millions)		
	20X2	**20X1**
Current Assets		
Cash and cash equivalents	$ 622	$ 680
Marketable securities, at cost, which approximates market value	119	273
→ Accounts receivable, trade, less allowances of $55 (20X1, $41)	953	857
→ Inventories	1,165	1,010
Prepaid expenses and other receivables	413	382
Total current assets	$3,272	$3,202

No Wreck Company Partial Statement of Cash Flows for the Years Ending December 31 (Dollars in Millions)			
	20X2	**20X1**	**20X0**
Cash Flows From Operating Activities			
Net income	$ 833	$ 330	$ 614
Adjustments to reconcile net earnings to cash flows from operating activities:			
Changes in assets and liabilities, net of effects from acquisition of businesses:			
→ (Increase) decrease in accounts receivable, trade, less allowances	(5)	76	(48)
(Increase) decrease in inventories	(76)	(11)	22
→ (Increase) decrease in accounts receivable, trade, (Decrease) increase in accounts payable, accrued liabilities and salaries, wages and commissions	(39)	69	90
Decrease (increase) in other current and noncurrent assets	10	(47)	(23)
Increase in other current and noncurrent liabilities	73	122	19
Net cash flows from operating activities	$ 796	$ 539	$ 674

Why Are These Amounts Different?

The statement footnotes indicate that the changes that do not reconcile are "net" of a business acquisition. A review of the financial statement notes provides information about the acquisition, but no explicit discussion of its cash flow effects. This lack of explicit cash flow information in financial statement notes is quite common. The statement of cash flows is typically not given the same attention in the financial statement notes as are the balance sheet and income statement.

No Disclosure of the Lack of Reconciliation

Often there is nothing in the statement of cash flows about why the reconciliation changes are different from the changes found by examining comparative balance sheets. The example that follows illustrates this situation.

DBC Company		
	20X2	**20X1**
Current Assets		
Cash and equivalents	$77,175	$146,468
Short-term investments	46,323	56,130
Trade receivables, net	339,418	295,835
Inventories	356,425	305,065
Prepaid expenses and other	63,651	38,806
Total current assets	$882,992	$842,304
Current Liabilities		
Loans payable and current portion of long-term obligations	$189,204	$182,585
Accounts payable and other liabilities	336,567	310,431
Total current liabilities	$525,771	$493,016

	20X2	**20X1**
Cash Flows From Operating Activities		
Net income	$161,943	$148,164
Adjustments needed to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	109,217	91,911
Deferred income taxes	22,127	20,675
Gain on sales of businesses and long-term assets	(3,063)	(24,197)
Change in		
Trade receivables	(65,688)	(58,871)
Inventories, prepaid expenses and other assets	(60,253)	(32,952)
Accounts payable and other liabilities	44,810	34,885
Other, net	(6,728)	(21,035)
Net cash flows provided by operating activities	$202,365	$158,580

For example, look at the changes in trade receivables, inventories, or accounts payable on the cash flow statement and compare this to the change amount for these items on the balance sheet.

WHY NON-RECONCILIATION MAY BE A PROBLEM

It is common to assume that the indirect method provides multiple links between the statement of cash flows and the balance sheet. For example, most people (including many accountants) assume the amount added or subtracted from net income on the statement of cash flows equals the difference in the receivables on comparative balance sheets. In fact, this is probably how you were taught to prepare a statement of cash flows while in school and it is the approach we used in the opening chapter to review the fundamentals of preparing a statement of cash flows.

While multiple direct links between the balance sheet and the statement of cash flows reconciliation remain common in smaller organizations, they are (and always have been) uncommon in larger entities:

- A study by the course author subsequent to the issuance of the original cash flow reporting standard showed that a direct reconciliation between the statements of cash flows and comparative balance sheets existed for only four line items found on the balance sheets of the 1,000 largest entities in the United States.
- Prior to the issuance of current cash flow reporting requirements, a study showed that the indirect method working capital change amounts reconciled to balance sheet changes for only half of a random sample of entities that presented the then required changes in working capital analysis.

As shown previously, there are good reasons for this lack of reconciliation. However, the lack of good disclosures and the lack of awareness that these differences exist may be causing problems:

- Lenders are continuing to analyze statements and develop ratios based on balance sheet changes, and often not expanding their ratio analysis to use cash flow information. When there are large differences, the ratio results can be misleading.
- Corporate "game players" have been able to use the difference to hide information. For example, Enron manipulated the operating section of the statement of cash flows through misclassification. The lack of transparent linkages between the three basic financial statements certainly made this misclassification easier to hide.
- Special purpose entities are commonly used to account for securitized sales of product and as a result the associated receivables and liabilities that are usually operating working capital items are not represented on the statement of cash flows.
- Enron used "prepays" from financial institutions to enable it to report positive cash flows from operations.

FORTHCOMING CHANGES?

How can the lack of reconciliation be mitigated?

The lack of reconciliation described in the previous section is symbolic of a fundamental problem that FASB and the International Accounting Standards Board are trying to address in their potential revision of financial statement presentation. A fundamental principle, identified as cohesiveness, is focused on clarifying relationships across financial statements. The board's intent is to have data displayed so that items on the different statements are clearly associated. This type of cohesiveness does not currently exist:

Operating cash flows are separated in the statement of cash flows. There is no similar grouping in the income statement or balance sheet. It is thus difficult to compare operating income with operating cash flows.

The classifications used on the three major statements are expected to be closely related if new financial statement presentation guidance is issued:

These classifications are expected to be quite different from those currently used in financial statements.

A line-by-line reconciliation of cash inflows and outflows to income and expense items was initially proposed by the standard-setting bodies. Feedback from preparers has convinced the boards that the cost of this detailed reconciliation may be too high.

The current expectation is that firms will have to provide an analysis of the change in significant asset and liability accounts as part of the financial statement notes. Typically, this analysis will provide information on changes

- from cash inflows and outflows;
- from routine and non-routine noncash transactions; and
- from accounting allocations, allowance, and remeasurements

Quick Exercise 5-1

The following information about Wreck Company is available to you for the just completed fiscal year:

Cost of goods sold	$ 420,000
Inventory, beginning	100,000
Inventory, ending	120,000
Accounts payable, beginning	90,000
Accounts payable, ending	130,000

During the year Wreck Company purchased another entity, which had inventory of $15,000 and accounts payable of $5,000.

Analysis also shows that accounts payable at the start of the year included $2,000 that was unrelated to operating purchase activities. At year-end this total was $1,000.

Year-end inventory was also written down $5,000 for some obsolete product.

Required:

1. How much cash was paid to suppliers of the goods Wreck sells? Show work.

2. If you prepared an indirect method statement, what would be added back or subtracted from net income related to the information you are given?

KNOWLEDGE CHECK

1. The indirect method of presenting cash flows from operations

   a. Always provides multiple reconciliation points between the statement of cash flows information and balance sheet changes.
   b. May provide multiple reconciliation points between the statement of cash flows information and balance sheet changes.
   c. Never provides reconciliation points between the statement of cash flows information and balance sheet changes.
   d. Has no direct connection to the balance sheet.

2. Which is correct regarding the reporting rules for the statement of cash flows?

   a. Most firms provide specific footnote disclosure when a balance sheet change does not reconcile to the amount added or subtracted in the indirect method operating section.
   b. The lack of reconciliation must be explained when the indirect method is used.
   c. There are no requirements related to reporting the lack of reconciliation in the cash flow guidance.
   d. Reconciliation with balance sheet changes is automatic when using the indirect method, so no explanation is needed.

Using or Misusing the Cash From Operations Total

FASB carefully structured the statement of cash flows presentation to focus attention on the components of the cash flow information rather than on a summary number. There is no "bottom line" on the statement of cash flows. Instead, we reconcile to the balance sheet.

	20X2	20X1	20X0
Net increase (decrease) in cash and cash equivalents	$ 297	$ (559)	$ 175
Cash and cash equivalents at beginning of year	876	1,435	1,260
Cash and cash equivalents at end of year	$1,173	$ 876	$1,435

Cash From Operations and Net Income

Does the long-term amount of cash from operating activities equal the long-term income of an organization?

While conceptually lifetime operating cash flows would equal lifetime income, in practice there are major differences in these amounts. These differences exist because of the classification guidance that currently governs cash flow (and income statement) reporting the following:

- Items included in the investing and financing category influence the net income computation
- Certain expenses, gains, and losses that change comprehensive income never result in cash flows that appear in the operating section of the statement

Assume that an entity makes a long-term common stock investment of $100,000. Three years later the firm sells these shares for a total of $130,000. Assume further that this firm is a cash-based company and had net income of $80,000 each of these three years, before any gain or loss on this transaction:

- The $100,000 outflow to purchase the stock is an investing outflow and has no effect on the operating section of the cash flow statement. There is also no income statement affect associated with this transaction.
- When the stock is sold there is a $130,000 investing inflow on the cash flow statement. The entity's income is increased by $30,000 in the year of the sale. The gain would be subtracted from the firm's income if the indirect method were used. There would be no operating cash inflow reported if the direct method is used.
- Income for the 3 years would be $30,000 higher than operating cash flows.

CASH FLOW PER SHARE INFORMATION PROHIBITED

FASB was aware that some users may wish to use the cash from operating activities subtotal as a surrogate "bottom line." There was concern that FASB's decision to adopt a definition of operating activities that includes the cash effects of most transactions that are part of the income determination process would encourage this practice. The board was aware that it was common to see net income plus depreciation defined as cash flow and to see this amount used as a major part of the analysis process. This is a misleading number.

FASB *Accounting Standards Codification* (ASC) 230, *Statement of Cash Flows*, *prohibits* the presentation of a cash flow per share figure.

This prohibition

- should help avoid the implication that the cash provided by operating activities is an alternative performance measure;
- recognizes there are problems in obtaining a proper numerator to use in the computation; and
- reflects the belief that this per share figure is potentially misleading.

Users continue to compute (at their own risk) a cash flow per share amount for their own use. The prohibition against presentation of a cash flow per share figure keeps entities from giving credibility to this number by presenting it as part of the financial reports.

Despite this prohibition, it appears that users and prepares are sometimes unable to take into account some of the nuances of the statement of cash flows and its relationship to the accrual-based income statement and balance sheet:

- We still see net income plus depreciation incorrectly identified as operating cash flow in the business press.
- Some entities treat operating cash flow amounts as a substitute for income or as a measure of performance, particularly when the income numbers are not favorable.
- Some entities have taken advantage of the non-reconciliation between operating income adjustments and balance sheet changes to manage operating cash flows.

Reconsideration of the nature of the operating category should mitigate some of the problems associated with current classifications.

Quick Exercise 5-2

Assume Simple Company buys a piece of equipment for $100,000. It rents this equipment to a customer for $30,000 a year for five years before scrapping it and giving the customer the now obsolete equipment and ceasing operations. These are Simple Company's only transactions and the firm does not pay taxes or have employees.

Required:

1. Compute Simple Company's total five-year net income and total five-year operating cash flows. Show computations.

2. Explain why these two flow amounts are different.

KNOWLEDGE CHECK

3. Which describes the presentation of cash flow per share information?

   a. Prohibited by the statement of cash flows guidance.
   b. Encouraged as part of full disclosure by the statement of cash flows guidance.
   c. May be disclosed if management explains the nature of this amount.
   d. Cash flow per share information is not addressed in the standard.

Operations: Miscellaneous Classification Items

There are other concerns about the current operating section presentation requirements. Several of these are discussed in the following subsections. These issues are likely to be addressed as part of any major revision of financial statement presentation requirements.

INTEREST AND TAXES PAID

Requirements

An entity must disclose the amount of interest and the amount of taxes paid, either on the face of the statement of cash flows or in financial statement notes:

- If an entity uses the direct method, interest and taxes paid are line item disclosures in the operating section.
- If the entity uses the indirect method, interest and taxes paid must be disclosed in the financial statements (for example, at the bottom of the statement of cash flows) or in the accompanying notes to the financial statements.

Interest paid or received is operating for business entities. An exception is interest capitalized as part of investing activities.

All taxes paid by the entity are classified as operating. Taxes are not associated with transactions classified as investing or financing activities. For example a gain on the sale of fixed assets or on the extinguishment of debt.

When new reporting guidance is issued, we anticipate that

- interest is likely to be classified in multiple sections of the statement of cash flows; and
- a separate tax section will be required for tax-related cash flows.

Disclosure

The following disclosure is typical of the type of information entities provide about interest and taxes when they use the indirect method. An entity may present this data on the face of the statement of cash flows or as part of the notes to the financial statements

Interest Corporation

Additional disclosure of operating cash flows

Cash paid during	20X2	20X1	20X0
Interest	$ 38,723	$ 57,161	$ 41,493
Income taxes	7,668	5,217	3,296

The following is illustrative of direct method disclosure. Note that the interest and taxes paid are part of the operating section.

Surge Corporation Consolidated Statement of Cash Flows Year Ending December 31, 20X2	
(in millions)	
Cash Flows From Operating Activities	
Cash received from customers	$ 2,863.8
Other operating cash receipts	197.4
Cash paid to suppliers	(1,481.0)
→ Interest paid	(147.9)
→ Income taxes paid	(96.3)
Other tax payments	(177.1)
Cash paid to employees and other employee benefits	(385.0)
Other operating cash payments	(320.1)
Net cash flows from operating activities	$ 453.8

Entities commonly provide some information about cash flows in the notes. These disclosures include information on the entity's cash equivalency definition, a schedule of noncash activities, and sometimes discussion of the cash flows of the entity. Detailed supplemental information related to cash flows is still not as common as we find for the income statement or balance sheet. However, the types and variety of disclosures are growing. We anticipate that this growth will continue as new presentation guidance is provided.

Receivables and Bad Debts

Not all accounts receivable arising from sales to customers result in direct cash inflows to the selling entity:

- Receivables may become collateral for loans. The collections remain operating inflows while the loan itself is a financing activity.
- An entity may sell receivables to another entity. The cash proceeds from the sale represent an operating cash inflow. Unless the amounts are so material that the entity must make separate disclosure, the proceeds are treated the same as cash from customers. In the indirect method reconciliation, the change in receivable adjustment takes the sale into account. The loss on the sale is an add-back item.
- Some accounts are written off as bad debts. There is no cash inflow either when recording the expense, or when writing off an account. How to handle the expense and the receivable write-off can be confusing.

The following information is available from Illo Company:

Sales	$100,000
Cash expenses	(80,000)
Bad debt expense	(5,000)
Beginning accounts receivable	$ 12,000
Allowance for bad debts	(2,000)
Ending accounts receivable	$ 16,000
Allowance for bad debts	(3,000)

Analysis shows that net cash from operations equals $12,000, but to obtain this amount under the indirect method you must ignore the noncash bad debt expense and adjust the net income for the net change in receivables.

Net income	$15,000
Increase in net receivables	(3,000)

Direct method analysis would proceed in a normal fashion.

FASB ASC 310, *Receivables*, issued subsequent to FASB ASC 230, clarifies when to consider a loan impaired, how to recognize income, and what to disclose.

The recognition of the impairment does not affect cash flows. An entity reporting under the indirect method will have a larger adjustment for the noncash expense, "bad debt expense."

Sale of Receivables

The following note explains the sale of receivables for XSS Company. A partial illustrative statement of cash flows is also provided.

> XSS sells certain accounts receivable subject to limited recourse. XSS collects proceeds from the sold accounts receivable and reinvests in new accounts receivable for the buyers in accordance with provisions of the agreements. Sales of accounts receivable averaged $325 million, $275 million, and $276 million per month in 20X2, 20X1, and 20X0, respectively. At December 31, 20X2, and December 31, 20X1, the balance of sold accounts receivable that had not been collected was $850 million and $275 million, respectively. In the event of a change in control of XSS, as defined in one of the agreements, XSS may be required to forward all proceeds collected to the buyers; the amount of uncollected accounts receivable subject to this provision was $500 million at December 31, 20X2.
>
> In 20X0, XSS Company began selling certain of its loans receivable subject to limited recourse. XSS Company collects proceeds from the loans and transfers principal collected plus yield based on defined short-term market rates to the buyers. In 20X2 and 20X1, XSS Company sold $240 million

and $575 million, respectively. At December 31, 20X1, and December 31, 20X0, the balance of sold loans receivable that had not been collected was $578 million and $546 million, respectively. In the event of a change in control of XSS, as defined in the agreement, XSS may be required to provide cash collateral in the amount of the uncollected loans receivable to assure compliance with the limited recourse provisions.

	20X2	20X1	20X0
Cash Flows From Operating Activities			
Net income	$965	$756	$219
Adjustments to reconcile net income to net cash provided from operating activities			
Depreciation, depletion, and amortization	1,336	1,369	1,337
Exploratory dry well costs	56	81	30
Inventory market valuation provision	(145)	(23)	8
Pensions	(262)	(252)	(256)
Deferred taxes on income	314	231	30
Gain on disposal of assets	(370)	(176)	(56)
Restructuring credits		(50)	(74)
Changes in current receivables – sold	575		19
Operating turnover	33	(63)	(686)
Inventories	(115)	(115)	(228)
Current accounts payable and accrued expenses	220	295	370
All other items – net	(137)	181	(80)
Net cash flows provided from operating activities	2,470	2,234	633
Cash Flows From Investing Activities			
Capital expenditures	(1,429)	(1,282)	(1,062)
Disposal of assets	988	778	291
Loans to public	(319)	(226)	(329)
Principal collected on loans to public	24	336	402
Sale of loans receivable	240	575	
Investments in affiliates – net	24	(4)	(60)
Net cash flows provided from (used in) investing activities	$ (472)	$177	$ (758)

Quick Exercise 5-3

For each of the situations described below, specify the presentation on a statement of cash flows:

1. The Liquid Company regularly discounts notes receivables from customers to a local bank. Normally Liquid discounts receivables when it receives them. During the current year Liquid accepted notes on sales of $800,000. The entity discounted notes with a face amount of $300,000 and received $280,000. Liquid retained some customer notes and the amount of these unpaid customer notes increased by $35,000 during the year. Interest received and earned on the notes was $29,000.

2. Sales for the current year were $700,000. During the year the company wrote off $26,000 of accounts receivable. The beginning gross accounts receivable balance was $100,000 and the ending gross accounts receivable balance was $65,000. The allowance for doubtful accounts balance increased from $7,000 to $12,000 during the year.

TRANSFERS AND SERVICING OF FINANCIAL ASSETS

Traditionally entities bought or sold financial assets in simple transactions. Goods were sold to another party in exchange for cash or the promise of cash; receivables were sold to a financial institution for immediate cash; and so forth. Today, entities transfer financial assets to other organizations in many ways and the arrangements are often complex. For example, transfers of financial assets include the sales of receivables, with or without servicing rights retained. Transfers also include securitizations, securities, lending transactions, repurchase agreements, wash sales, and a transfer of a portion of a financial asset or a pool of financial assets.

FASB ASC 860, *Transfers and Servicing*, extends the rules on accounting for the transfers of assets. FASB ASC 860 requires that a transfer of a financial asset in which the transferor surrenders control over the financial assets transferred be accounted for as a sale to the extent that consideration over other than beneficial interests in the transferred assets is received in the exchange.

If there is a sale of financial assets under the provisions of FASB ASC 860, any cash received as part of the sale is treated on the statement of cash flows in a manner consistent with the classification of the financial assets sold. Note that cash is often only a tiny part of the original transaction and there should be careful consideration given to how this cash flow is disclosed.

Interest-only strips, loans, or other receivables that can be prepaid or otherwise settled in such a way that the holder would not recover substantially all of its investment must be subsequently measured like investments in debt securities classified as available-for-sale or trading under FASB ASC 320, *Investments–Debt and Equity Securities*:

For cash flow reporting purposes, consider the nature of the transaction when determining whether to classify the cash flow as investing or operating.

A debtor may grant a security interest in certain assets to a lender to serve as collateral for its obligation under a borrowing under other kinds of current or potential obligations.

Interest rate swaps also may grant a security interest in certain assets to a secured party. The cash received in this borrowing is a financing transaction.

If the secured party is permitted to sell or pledge financial assets transferred as collateral, the debtor must reclassify those assets (for example, as securities receivable from broker) and report those assets separately from other assets not so encumbered. The secured party must recognize that collateral as its asset initially measuring them at fair value, and also recognize its obligation to return them. This reclassification has no direct cash flow consequences.

Knowledge Check

4. Cash paid for interest and taxes

   a. Is not required as part of the statement of cash flows or disclosures.
   b. Must be presented on the face of the statement of cash flows.
   c. Must be presented either on the face of the statement of cash flows or in financial disclosures related to the statement.
   d. Is classified as financing transactions.

5. When receivables are

   a. Used as collateral on a loan, the collection of the receivables becomes a financing activity.
   b. Sold the cash inflows are part of operating inflows.
   c. Sold for a loss, the loss is subtracted from net income when the indirect method is used.
   d. Written off as bad debts, the cash inflow and outflow are financing activities.

Business Combinations and Segment Dispositions

Business combinations accounted for as purchases and disposals of business segments are two of the primary reasons changes in the accounts shown in the reconciliation of net income to cash flows do not equal changes in the same accounts in comparative balance sheets.

The cash outflows associated with the purchase of another entity are investing outflows. Part of the purchased assets and liabilities may be short-term items such as inventory or receivables. These items are part of the adjustments typically made to reconcile net income to cash flows from operating activities. Consider the following example:

Example 5-1

XYZ Company buys the assets of ABC Company for $40,000 in cash. The assets of ABC Company consist of $10,000 of inventory, $15,000 of receivables and $15,000 of plant.

At the end of the year XYZ shows an increase in the receivables account of $15,000. All of this increase is attributable to the purchase of ABC. Assuming no bad debts, the cash from customers would equal the sales made. There is no adjustment needed for the reconciliation of net income to cash flow for the change in accounts receivable on the reconciliation.

The Purchase Company example on the next page shows a statement of cash flows presentation where there is a business combination:

- The statement explicitly discloses the cash used for the purchase of another entity in the investing section.
- There is also an explicit link to the same purchase as part of the reconciliation.

When there are multiple acquisitions of other organizations, making this type of disclosure becomes more difficult and more reliance must be placed on financial notes and management discussion to explain the differences:

This disclosure remains a weak spot in many financial reports.

Illustrative Statement

The Purchase Company statement of cash flows shows the acquisition of Sub Company, Inc. in the investing section. The statement shows in the operating section that the changes include the effects of the acquisition of various assets and liabilities.

Purchase Company Consolidated Statements of Cash Flows for the Years Ending June 30			
	20X2	20X1	20X0
Cash Flows From Operating Activities			
Net income	$ 2,593	$ 2,806	$ 2,428
Adjustments to reconcile net income to net cash provided by operating activities			
Depreciation and amortization	1,064	585	550
Provision for losses on accounts receivable	90	2	310
Equity in earnings and interest of investee	(29)	(184)	(181)
→ Changes in assets and liabilities net of effects from purchase of Sub Company, Inc.			
Decrease (increase) in accounts receivable	790	(2,281)	(1,031)
(Increase) in inventory	(4,753)	(1,715)	(997)
(Increase) decrease in prepaid expenses and other assets	(961)	(22)	28
(Decrease) increase in accounts payable and accrued expenses	(1,323)	969	1,002
Increase in deferred taxes	212	188	72
Increase (decrease) in noncurrent liabilities	187	(44)	81
Total adjustments	(4,723)	(2,502)	(166)
Net cash flows (used in) provided by operating activities	(2,130)	304	2,262

Purchase Company Consolidated Statements of Cash Flows for the Years Ending June 30			
	20X2	20X1	20X0
Cash Flows From Investing Activities			
Capital expenditures	(1,364)	(447)	(799)
→ Payment for purchase of Sub company, Inc. net of cash acquired	(17,188)		
Net cash flows (used in) investing activities	(18,552)	(447)	(799)
Cash Flows From Financing Activities			
Net borrowings under line-of-credit agreement	4,630		
Proceeds from long-term debt	21,555		200
Dividends paid	(726)	(597)	(387)
Proceeds from exercise of stock options	38	680	24
Principal payments on long-term debt	(4,791)		(1,325)
Net cash flows provided by used in financing activities	20,706	83	(1,488)
Net increase (decrease) in cash	24	(60)	(25)
Cash at beginning of year	63	123	148
Cash at end of year	$ 87	$ 63	$ 123

Segment Dispositions

Entities have used a variety of presentation approaches when there is a segment disposal:

- If an entity separates discontinued operations cash flows from continuing operations cash flows, it should present these separate cash flows for all periods affected. This disclosure may extend far into the future for items such as postretirement benefits.

- Full reconciliation of all noncash items related to the segment disposal may not be necessary. There should however be identification of major items.
- The operating section includes the operating cash flows. The investing section includes the proceeds from the sale. There may be several reconciling items.

As part of FASB's revision of what constitutes and segment disposal the board specified:

- Separate disclosure of cash flows pertaining to discontinued operations reflected in those categories is not required.
- An entity may chooses to report separately operating cash flows of discontinued operations
- It must do so consistently for all periods affected.
- Disclose operating, investing, and financing cash flow information related to a discontinued operation for all periods where results of discontinued operations are presented on the statement of net income.

It has been tentatively determined that discontinued operations will be reported in separate sections of the three major financial statements. This should reduce the variety of presentation approaches in the statement of cash flows.

The Segment Company example that follows shows one form of cash flow presentation that an entity can use where both a segment disposal and an extraordinary item are present:

- In this illustration, the segment disposal took place at the end of 20X2, thus the line item presentation of discontinued operations operating cash flows in 20X2 and 20X1.
- We have numbered the related items.

Segment Company
Partial Income Statement
for the Years Ending December 31

(Dollars in Millions)			
	20X2	**20X1**	**20X0**
Net earnings from continuing operations before extraordinary charge	$228.4	$255.0	$280.5
Net earnings from discontinued operations			
1 Earnings from operations	2.1	3.1	
2 Gain on sale of B. Company		85.2	
Net earnings before extraordinary charge	228.4	342.3	283.6
3 Extraordinary charge from casualty loss, net of tax benefit		(32.3)	
Consolidated net earnings	$228.4	$310.0	$283.6

Segment Company Consolidated Statements of Cash Flows for the Years Ending December 31			
(Dollars in Millions)			
	20X2	20X1	20X0
Cash Flows From Operating Activities			
Net earnings from continuing operations before extraordinary charge	$228.4	$255.0	$280.5
Reconciliation to cash flow			
Depreciation and amortization	232.4	184.9	159.3
Noncurrent deferred tax provision	5.8	39.3	32.0
Current deferred tax provision	(36.3)	(1.0)	14.3
(Increase) in accounts receivable	(21.0)	(1.7)	(63.0)
(Increase) in inventory	(310.9)	(162.5)	(160.4)
Increase in accounts payable	212.6	184.9	114.0
Other	(1.1)	36.7	40.0
Net cash flows provided by continuing operations	309.9	535.6	416.7
1 Net cash flows provided by discontinued operations		50.3	12.2
	309.9	585.9	428.9
Cash Flows From Investing Activities			
Expenditures for property	(787.2)	(593.8)	(395.1)
Acquisition (disposition) of real estate			
Assets held for remodel		(322.0)	
Assets held for resale	75.2	(100.5)	
Disposals of property	11.4	10.1	7.8

Segment Company Consolidated Statements of Cash Flows for the Years Ending December 31 (continued)			
	20X2	**20X1**	**20X0**
2 Activities of discontinued operations, net		155.2	(21.6)
Net cash flows used in investing activities	(700.6)	(851.0)	(408.9)
Cash Flows From Financing Activities			
Increase in notes payable	353.3		
Additions to long-term debt	450.6	1,000.0	300.0
Purchase and redemption of debt		(558.5)	
3 Charge from casualty loss, net of tax		(32.3)	
Principal payments on long-term debt and capital lease obligations	(19.2)	(10.5)	(121.5)
Repurchase of stock	(339.6)		
Dividends paid	(87.5)	(81.7)	(73.8)
Other	(15.6)	(7.9)	(2.7)
Net cash flows provided by financing activities	342.0	309.1	102.0
Net (decrease)/increase in cash and cash equivalents	(48.7)	44.0	122.0
Cash and cash equivalents at beginning of year	223.8	179.8	57.8
Cash and cash equivalents at end of year	$175.1	$223.8	$179.8

Supplemental Disclosures Examples

The following is a somewhat unusual supplemental cash flow information note from one entity. The statement of cash flows includes each of the summary net cash flow amounts for which this note provides inflows and outflows information. There is also information about a business combination as well as interest and tax cash flow information.

NOTE 15: Supplemental Cash Flow Information

The following is supplemental cash flow information provided for the years ended December 31, 20X2, 20X1, and 20X0:

(Millions of dollars)

	20X2	20X1	20X0
Gross maturities of short-term investments	$5,551	$14,151	$6,227
Gross purchases of short-term investments	(6,365)	(12,554)	(7,596)
Net cash provided (used) by short-term investments	(814)	1,597	(1,369)
Gross proceeds from issuance of notes payable	2,891	11,650	11,214
Gross repayments of notes payable	(2,806)	(12,676)	(10,822)
Net cash provided (used) by notes payable	85	(1,026)	392
Gross noncash provisions charged to income	834	489	627
Cash payments of previously deferred items	(264)	(343)	(388)
Noncash provisions in excess of cash payments	570	146	239

During 20X1, the Company purchased all of the capital stock of Tricentrol PLC. In connection with the acquisition, liabilities were assumed as follows:

(Millions of dollars)

Net fair value of assets acquired	$ 710
Cash paid for capital stock	(454)
Liabilities assumed	256

Liabilities assumed consisted of $132 million of long-term debt and $124 million outstanding under short-term credit facility.

Interest paid during the years ended December 31, 20X2, 20X1, and 20X0, was $818 million, $850 million and $1,119 million, respectively.

Income taxes paid during the years ended December 31, 20X2, 20X1, and 20X0, were $1,267 million, $1,053 million, and $795 million, respectively.

Comprehensive Illustration

Napper Corporation Consolidated Balance Sheets		
	April 27, 20X2	April 28, 20X1
Assets		
Cash and cash equivalents (including restricted cash of approximately $5.0 million and $5.6 million at April 27, 20X2, and April 28, 20X1, respectively)	$ 9,308,047	$ 10,113,748
Contracts receivable, net	9,928,602	8,699,969
Notes receivable, net	42,881,842	32,771,795
Investment in securities	26,469,714	32,031,308
Inventory, net	40,113,942	31,125,859
Property and equipment, net	3,634,478	3,914,226
Debt issuance costs	1,724,387	1,289,285
Other assets	5,556,201	2,907,227
Total assets	$139,617,213	$122,853,417
Liabilities and Shareholders' Equity		
Accounts payable	$ 1,906,170	$1,854,023
Accrued liabilities and other	10,079,007	11,998,781
Line of credit and notes payable	11,524,150	14,436,535
Deferred income taxes	3,742,928	791,181
Mortgage-backed notes payable	25,772,299	12,165,878
Commitments and contingencies		
8 1/4% convertible subordinated debentures	34,739,000	34,739,000
Total liabilities	$ 87,763,554	$ 75,985,398
Shareholders' Equity		
Preferred stock, $.01 par value 1,000,000 shares authorized; none issued	—	—
Common stock, $.01 par value, 90,000,000 shares authorized; 17,795,974 and 17,083,001 shares outstanding at April 27, 20X2, and April 28, 20X1, respectively	177,960	170,830
Capital-in-excess of par value	61,099,625	59,172,395
Retained earnings (deficit)	(9,423,926)	(12,475,206)
Total shareholders' equity	51,853,659	46,868,019
Total liabilities and shareholders' equity	$139,617,213	$122,853,417

Napper Corporation
Consolidated Statements of Income
Years Ending

	April 27 20X2	April 28 20X1	April 29 20X0
Revenues			
Sales of real estate	$63,389,112	$53,348,816	$45,100,165
Interest income and other	7,951,523	10,191,207	16,515,093
	71,340,635	63,540,023	61,615,258
Costs and expenses:			
Cost of real estate sold	30,773,203	28,449,739	28,712,204
Selling, general and administrative expense	26,443,598	22,651,903	19,569,900
Interest expense	6,551,153	7,284,153	10,764,169
Provision for losses and write-downs	795,000	1,550,000	1,480,000
	64,562,954	59,935,795	60,526,273
Income from operations	6,777,681	3,604,228	1,088,985
Other income	1,174,770	1,726,398	397,454
Income before income taxes	7,952,451	5,330,626	1,486,439
Provision for income taxes	3,021,931	1,873,837	118,232
Net income	$ 4,930,520	$ 3,456,789	$ 1,368,207
Income per common share			
Primary and Fully Diluted:			
Net income	$ .25	$ .18	$ .07

	April 27 20X2	April 28 20X1	April 29 20X0
Cash Flows From Operating Activities			
Cash received from customers including cash collected as servicer of notes receivable to be remitted to investors	$50,738,479	$39,218,756	$39,481,063
Interest received	5,194,172	7,385,143	16,772,930
Cash paid for land acquisitions and real estate development	(25,618,038)	(16,121,269)	(11,043,337)
Cash paid to suppliers, employees and sales representatives	(28,432,333)	(22,878,531)	(20,697,722)
Interest paid	(5,811,807)	(7,919,977)	(13,307,320)
Net income taxes (paid)/recovered	(2,292,671)	(526,587)	67,534
Land gains taxes paid	—	(997,181)	—
Proceeds from sales of notes receivable	—	49,535	842,865
Proceeds from legal settlements	797,015	—	—
Proceeds from borrowings collateralized by notes receivable	20,693,016	7,495,243	16,249,171
Payments on borrowings collateralized by notes receivable	(7,086,595)	(60,629,366)	(19,229,760)
Proceeds from sale of Class A REMIC Certificates, net of transaction costs and amount paid to repurchase notes receivable	—	64,559,769	—
Proceeds from sale of Class B REMIC Certificates	8,352,973	—	—
Proceeds from amortization of other receivables	—	3,713,417	905,834
Net cash flows provided by operating activities	16,534,211	13,348,952	10,041,258
Cash Flows From Investing Activities			
Net cash flow from purchases and sales of property and equipment	(719,516)	21,145	510,058
Additions to other long-term assets	(869,316)	(232,829)	(208,429)
Net cash flows provided/(used) by investing activities	(1,588,832)	(11,684)	301,629

	April 27 20X2	April 28 20X1	April 29 20X0
Cash Flows From Financing Activities			
Net borrowings (repayments) under credit line facility	152,342	(1,831,806)	(3,958,395)
Proceeds from issuance of other debt	—	—	1,792,552
Borrowings under repurchase agreement	—	6,500,000	—
Payments under repurchase agreement	(6,500,000)	—	—
Borrowings under short-term secured debt	facility	6,500,000	—
Payments under short-term secured debt facility	(6,500,000)	—	—
Payments on other long-term debt	(9,458,542)	(23,788,228)	(17,008,270)
Proceeds from exercise of employee stock options	56,096	33,000	—
Payment for dividends in lieu of fractional shares	(976)	—	—
Net cash flow used by financing activities	(15,751,080)	(19,087,034)	(19,174,113)
Net decrease in cash and cash equivalents	(805,701)	(5,749,766)	(8,831,226)
Cash and cash equivalents at beginning of year	10,113,748	15,863,514	24,694,740
Cash and cash equivalents at end of year	9,308,047	10,113,748	15,863,514
Restricted cash and cash equivalents at end of year	5,039,036	5,596,812	11,552,382
Unrestricted cash and cash equivalents at end of year	$ 4,269,011	$ 4,516,936	$ 4,311,132

	April 27 20X2	April 28 20X1	April 29 20X0
Reconciliation of Net Income to Net Cash Flow Provided by Operating Activities			
Net income	$4,930,520	$3,456,789	$1,368,207
Adjustments to reconcile net income to net cash flow provided by operating activities:			
Depreciation and amortization	1,660,475	1,556,735	2,448,867
(Gain)/loss on sale of property and equipment	(173,902)	417,578	249,320
Operational provision for losses and write-downs	795,000	1,550,000	1,480,000
Loss on sale of Class B REMIC Certificates	238,395	—	—
Nonoperational recoveries	—	—	(100,000)
Write-off of portion of debt issuance costs	—	1,344,733	—
Proceeds from borrowings collateralized by notes receivable net of principal repayments	13,606,421	(53,693,123)	(2,980,588)
(Increase) decrease in assets:			
Contracts receivable	(1,228,633)	(3,579,717)	(754,367)
Investment in securities	5,323,199	(5,455,135)	(1,156,852)
Inventory	4,556,303	10,890,778	10,957,114
Other assets	(2,656,580)	3,374,615	893,595
Notes receivable	(11,601,107)	53,006,185	(1,355,074)
Increase (decrease) in liabilities:			
Accounts payable and accrued liabilities and other	(1,867,627)	(1,411,638)	(1,760,164)
Deferred income taxes	2,951,747	1,891,152	751,200
Net cash flow provided by operating activities	$ 16,534,211	$13,348,952	$10,041,258

	April 27 20X2	April 28 20X1	April 29 20X0
Supplemental Schedule of Noncash Operating and Financing Activities			
Inventory acquired through financing	$12,806,899	$ 9,301,548	$5,341,560
Inventory acquired through foreclosure, "insubstance foreclosure" or deedback in lieu of foreclosure	$ 737,487	$ 677,899	$5,465,086
Revolving line of credit fee added to mortgage-backed indebtedness	$ —	$ 500,000	$ —
Forgiveness of indebtedness owed to creditors in exchange for real estate	$ —	$ 562,000	$ —
Investment in securities	$ —	$15,836,662	$ —
Nonmonetary exchange of joint venture assets for other assets	$ —	$ —	$2,832,351

NAPPER NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Cash and Cash Equivalents

The Company invests cash in excess of immediate operating requirements in cash equivalent short-term time deposits and money market instruments, generally with original maturities of three months or less. The Company maintains cash and cash equivalents with various financial institutions. These financial institutions are located throughout the country and Company policy is designed to limit exposure to any one institution. However, a significant portion of the Company's unrestricted cash is maintained with a single bank and, accordingly, the Company is subject to credit risk. Periodic evaluations of the relative credit standing of financial institutions maintaining Company deposits are performed to evaluate and mitigate, if necessary, credit risk.

At April 27, 20X2, cash and cash equivalents included $3.5 million restricted under mortgage-backed note agreements, $95,000 securing letters of credit, $88,000 securing a road development bond, and $1.3 million of customer deposits on real estate maintained in escrow accounts. At April 28, 20X1, cash and cash equivalents included $3.7 million restricted under mortgage-backed note agreements, $93,000 securing letters of credit, and $1.8 million of customer deposits on real estate maintained in escrow accounts.

Summary of Current Statement of Cash Flows Requirements

- FASB ASC 230 establishes standards for cash flow reporting. It supersedes prior cash flow guidance and requires a statement of cash flows as part of a full set of financial statements for all business entities in place of a statement of changes in financial position.
- FASB ASC 230 requires that a statement of cash flows classify cash receipts and payments according to whether they stem from operating, investing, or financing activities and provides definitions of each category.
- The effects of investing and financing transactions not affecting cash should be in a separate schedule.
- Use a cash or cash and cash equivalents definition of funds. Develop and disclose a definition of cash equivalents.
- Report total cash inflows and outflows. You may net high turnover investing and financing items with an original maturity of three months or less.
- Use either the direct or the indirect method in presenting cash from operations. The recommended method is the direct method.
- Provide a reconciliation of net income to cash flows from operations.
- Identify and report the effects of exchange rate changes on cash balances held in local currencies.
- Do not present a cash flow per share number associated with cash provided by operations.
- Base statement classification on the nature of the transaction, not the reason for the transaction.

KNOWLEDGE CHECK

6. Cash flows related to the disposal of a segment of a business will all appear

   a. In the investing section of the statement of cash flows.
   b. In the financing section of the statement of cash flows.
   c. In the operating section of the statement of cash flows.
   d. On the statement of cash flows based in both the investing and operating segments.

Comprehensive Exercises

Comprehensive Exercise 5-1: Presentation

Describe how you would report each of the following on a direct method statement of cash flows. Indicate the nature of the difference if the indirect method were used.

1. Construction, Inc. is constructing a building for Firm B under contract. The percentage of completion method is considered appropriate. During the year the firm recognized revenue of $800,000 and expenses of $600,000, collected cash of $500,000, and spent cash on the building that totaled $700,000.

2. A total of $24,000 is recorded as bad debt expense during the year. Accounts written off during the year equaled $18,000. The sales for the period were $350,000 and the net accounts receivable balance was $65,000 at the end of the period and $50,000 at the beginning of the period.

3. A manufacturing company recognized $140,000 as its share of the income of a company in which it holds a 30 percent ownership. Dividends during the year from the investment equaled $50,000.

4. The income tax expense of a firm for the year was $200,000. During the year the deferred tax asset increased by $5,000 and the taxes payable account increased $14,000.

5. An entity spent $500,000 building a new asset during the year. In addition, 20 percent of the $100,000 interest cost incurred was capitalized. When the new building was finished, the old building, which had a book value of $80,000, was sold and a $20,000 loss recognized.

6. The company paid a $40,000 life insurance premium on its officers during the year. The cash surrender value increased $10,000. Late in the year, one of the officers was killed in an automobile accident and the company received a $250,000 settlement.

7. A company wrote-down fixed assets that represented excess capacity. The write-down totaled $200,000.

COMPREHENSIVE EXERCISE 5-2: PRESENTATION

Specify how you would show the following transactions on a statement of cash flows.

1. ABC Company sells receivables without recourse for $200,000 instead of borrowing this amount of money.

2. The Smoke Brothers automobile dealership sells cars with a down payment of $2,000. The customers pay for the cars over a three-year period and Smoke Brothers carries the note and collects from the customers.

3. The Way to Go Company shows two large gains on the income statement. The first represents a gain from a debt extinguishment and the second is a large income tax refund.

4. A large sale is made by Do Me Right Company, which accepts a $30,000 noninterest- bearing note from Buy Company. Buy Company pays $5,000 a year on this note.

5. A computer company sells a $14,000 computer on a sales-type lease, receiving $3,000 in cash. The lease carries a market rate of interest.

6. A manufacturing company regularly buys equity securities with the intent of quickly disposing of these securities at a higher price. During the past year it bought $100,000 of securities and sold these securities for $110,000.

7. New Growth Company pays $100,000 to employees who were terminated. This payment represents two months of wages for each employee and will help these employees transition to new jobs.

8. A nonprofit entity received an unrestricted donation of shares in a publically traded firm. These shares were sold for $200,000 the fair value at the time of donation immediately after the donation was made.

9. Short Time Company buys piece of equipment for $300,000 that it will use on a single 30 day job and then sells the used equipment to one of its customers for $280,000.

10. Mega Company made a strategic shift in its business plans and disposed of its division that repaired small appliances. The sale netted Mega $500,000 and the carrying value of the division was $400,000.

COMPREHENSIVE EXERCISE 5-3: CLASSIFICATION ISSUES

Each of the following situations are illustrative of where there has been diversity in how items are classified. FASB has a technical project underway to consider what additional classification and/ or disclosure guidance is required.

Indicate how you would recommend classifying these items.

1. XYZ Company has a 30 percent interest in ABC Company which it accounts for using the equity method. ABC paid a large special dividend during this reporting that was three times the regular dividends that XYZ has been receiving.

2. A consulting firm has chosen to carry life insurance policies on all of its partners to help protect itself against the loss of their expertise. The company is the beneficiary of the policy and receives the proceeds when there is a death.

3. Investor Company completed the acquisition of a private company last year. As part of the acquisition, Investor agreed to pay key executives of the acquired firm, who were also the firm's former owners, an additional $1 million dollars if several key performance benchmarks were met. The performance measures were met.

4. Debtor Company raised cash by issuing zero coupon bonds early in the year. Later in the year there was an unexpected drop in interest rates and Debtor Company repurchased the bonds.

COMPREHENSIVE EXERCISE 5-4: COMPUTATIONAL

Use the Gam Company information to prepare statements of cash flows for 20X2 using the direct and indirect methods that conform to the cash flow standard requirements. There is workspace on the following pages.

Gam Company
Balance Sheet
December 31

	20X2	20X1
Assets		
Current assets		
Cash and cash equivalents	$40,000	$45,000
Accounts receivable	235,000	215,000
Inventories	250,000	210,000
	525,000	470,000
Property, at cost		
Land	25,000	20,000
Building	140,000	100,000
Machinery and equipment	310,000	225,000
Less: accumulated depreciation	(115,000)	(85,000)
Other assets		
Noncurrent accounts receivable	15,000	10,000
Total assets	$900,000	$740,000
Liabilities and Stockholders' Equity		
Current liabilities		
Short-term debt	$ 10,000	$ 20,000
Accounts payable	120,000	85,000
Income taxes payable	20,000	25,000
Accrued liabilities	15,000	20,000
	165,000	150,000

Gam Company Balance Sheet December 31		
Long-term debt	200,000	160,000
Deferred income taxes	20,000	10,000
Total liabilities	385,000	320,000
Stockholders' equity		
Common stock, $1 par	35,000	30,000
Additional paid-in capital	150,000	130,000
Retained earnings	330,000	260,000
Total stockholders' equity	515,000	420,000
Total liabilities and stockholders' equity	$900,000	$740,000

Gam Company Income Statement for the Year Ending December 31, 20X2		
Net sales		$ 1,790,000
Gain on sale of machinery		10,000
		1,800,000
Less		
Cost of sales	$1,090,000	
Selling and administrative	510,000	
Interest	20,000	1,620,000
Income before taxes		180,000
Income tax expense		75,000
Operating income		105,000
Extraordinary loss		15,000
Net income		$ 90,000

Additional Information is found on the following page.

Additional Information

1. Depreciation for the year totaled $35,000 and is part of cost of sales.
2. Gam bought another entity during the year for $75,000. The assets and liabilities purchased were the following:

Accounts receivable	$ 10,000
Inventory	20,000
Land	5,000
Building	25,000
Machinery	30,000
Accounts payable	15,000

3. Gam sold machinery and equipment costing $15,000 for $20,000. Accumulated depreciation was $5,000.
4. The extraordinary loss was from a freak flood. Cleanup costs were $10,000, and the flood destroyed a brand-new $15,000 building. The loss reduced taxes paid by $10,000.
5. Accrued liabilities primarily represent sales commissions.
6. The entity acquires buildings for $20,000 in cash and $10,000 in long-term debt.
7. Gam purchased machinery and equipment costing $70,000 during the year.
8. The entity sold common stock during the period for $25,000.
9. Dividends paid totaled $20,000.
10. The entity retired long-term debt for $30,000.
11. Short-term borrowings totaled $310,000, all with a maturity of less than three months.
12. Noncurrent accounts receivables are normal trade items. Gam made sales of $88,000 on extended payment terms during the year.
13. There are no interest accruals at the end of either year.
14. Cash equivalents include short-term Treasury bills.

Workspace

Workspace

Workspace

Appendix A

SUPPLEMENTAL PROBLEMS

Supplemental Problem 5-1

Ben Company has provided you with an income statement for the three months ended March 31, 20X2, and a balance sheet for the beginning and end of this three-month period. Prepare a statement of cash flows using both the direct method and the indirect method.

Ben Company Income Statement Data for the Three Months Ending March 31, 20X2		
Sales	$238,507	
Interest income	4,300	
Gain on sale of equipment	2,400	
Equity in earnings of 30% owned company	5,880	
Gain on condemnation of land	10,700	
		$261,787
Cost of sales	136,407	
General and administrative expenses	22,010	
Depreciation	3,250	
Interest expense	1,150	
Income tax expense	39,588	202,405
Net income	$ 59,382	

Ben Company Balance Sheet Data March 31		
	20X2	20X1
Cash	$ 71,400	$ 17,300
Treasury bills – six months	7,300	16,500
Accounts receivable, net	49,320	24,320
Inventory	48,590	31,090
Total current assets	176,610	89,210
Land	18,700	40,000
Building	250,000	250,000
Equipment	81,500	8,000
Accumulated depreciation	(18,250)	(15,000)
Investment in 30% owned company	80,200	76,320
Total	$588,760	$448,530
Accounts payable	$37,330	$21,220
Dividends payable	8,000	
Income taxes payable	14,616	
Total current liabilities	59,946	21,220
Other liabilities	186,000	186,000
Bonds payable	115,000	50,000
Discount on bonds payable	(2,150)	(2,300)
Deferred income taxes	846	510
Preferred stock		30,000
Common stock	110,000	80,000
Retained earnings	119,118	83,100
Total	$588,760	$448,530

Additional Information

Your review of the financial records and discussions with appropriate officers of the Ben Company reveal the following:

1. On January 3 the company sold all the equipment it owned at year-end for $10,400. This equipment was new and had not been properly depreciated.
2. The company's preferred stock was convertible into common stock at a rate of one share of preferred for two shares of common. All stock is no-par and was converted.
3. On January 30 three acres of land were condemned. An award of $32,000 in cash was received on March 22. No new land has been purchased.
4. On March 3 the company purchased new equipment for cash.
5. On March 15, $65,000 of bonds payable were issued by the company at par. Cash was received. On the same date $25,000 of maturing bonds were refinanced per an agreement that had existed at year-end.
6. The tax rate for all items is 40 percent.
7. A dividend of $2,000 was received from the equity in earnings of the 30 percent owned company.
8. Included in general and administrative expenses is $1,300 of bad debt expense. The allowance for bad debts increased from $800 to $2,100 during the three months.
9. Treasury bill purchases during the first three months of 20X2 totaled $180,000. Redemptions were $189,200.
10. All interest income came from Treasury bills and has been received as of March 31.

Supplemental Problem 5-2

The financial statements of Triangle Company are reproduced here and on the following pages along with selected financial note information. Comment on the statement of cash flows presentation used by this firm.

Triangle Company
Balance Sheets

In Thousands

	December 31, 20X2	**January 2, 20X1**
Assets		
Current assets		
Cash	$16,936	$5,170
Notes and accounts receivable, net	36,149	30,649
Inventories	22,734	34,905
Prepaid expenses	1,210	1,498
Total current assets	77,029	72,222
Notes and contracts receivable	12,533	12,620
Net investment in direct financing and sales type leases	1,458	3,701
Property for resale or sublease, at lower of cost or market	3,083	1,943
Property, plant, and equipment, at cost, less accumulated depreciation and amortization	41,967	43,115
Other assets	3,194	2,142
Total assets	$139,264	$135,743

Triangle Company Balance Sheets		In Thousands
	December 31, 20X2	**January 2, 20X1**
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable, trade	$12,888	$16,606
Other current liabilities	25,991	23,399
Current portion of long-term debt	9,655	2,752
Total current liabilities	48,534	42,757
Long-term debt	35,362	43,790
Deferred income	13,372	14,679
Deferred income taxes	1,596	3,960
Other liabilities	3,028	3,074
Total liabilities	101,892	108,260
Commitments and contingent liabilities Stockholders' equity		
Serial Preferred stock	2,433	2,433
Common stock, Class A	846	1,075
Common stock, Class B	86	86
Capital surplus	15,380	33,906
Notes receivable from officer/director	(449)	(516)
Retained earnings	40,395	30,497
	58,691	67,481
Less: Treasury stock, at cost	21,319	39,998
Total stockholders' equity	37,372	27,483
Total liabilities and stockholders' equity	$139,264	$135,743

Triangle Company
Statement of Operations

(In Thousands Except Per Share Data)

	20X2 Fifty-Two Weeks	20X1 Fifty-Three Weeks	20X0 Fifty-Two Weeks
Sales	$350,156	$359,872	$398,834
Cost of sales	194,095	207,777	240,937
Gross profit	156,061	152,095	157,897
Delivery, selling, general, and administrative expenses	135,507	135,508	145,459
Operating income	20,554	16,587	12,438
Interest income	3,869	3,476	2,898
Other expense, net	(497)	(417)	(1,517)
Interest expense	(6,000)	(4,694)	(3,981)
Income before income taxes and extraordinary items	17,926	14,952	9,838
Income tax provision	7,733	7,347	5,229
Income before extraordinary items	10,193	7,605	4,609
Extraordinary items	12	(230)	
Net income	$10,205	$7,375	$4,609
Income per common share (computed on weighted average common and common equivalent shares outstanding)			
Income before extraordinary items	$6.21	$3.76	$1.89
Extraordinary items	.01	(.12)	
Net income	$6.22	$3.64	$1.89

Triangle Company
Statement of Cash Flows

(In Thousands)

	20X2 Fifty-Two Weeks	20X1 Fifty-Two Weeks	20X0 Fifty-Three Weeks
Cash Flows From Operating Activities			
Cash received from customers			
Cash paid to suppliers and employees	$ 343,215	$ 353,114	$ 392,654
Interest received	(306,020)	(334,962)	(364,318)
Interest paid	3,676	3,978	3,133
Income taxes paid	(5,453)	(2,946)	(4,069)
Cash received from lawsuit settlement	(9,569)	(5,765)	(5,824)
Cash contributions to charities	88		
Net cash provided by operating activities	(77)	(93)	(93)
	25,860	13,326	21,483
Cash Flows From Investing Activities			
Proceeds from the sale of property, plant and equipment and liquor licenses			
Payments received on notes from the sale of property, plant and equipment and liquor licenses	31,614	22,728	14,688
Capital expenditures	143	131	72
Loan made to Arden Group, Inc.	(42,180)	(36,407)	(18,408)
Stock Bonus Plan			
Net cash used in investing activities	(560)		
	(10,983)	(13,548)	(3,648)

Triangle Company Statement of Cash Flows			(In Thousands)
Cash Flows From Financing Activities			
Principal payments under capital lease obligations			
Proceeds from issuance of long-term debt			
Principal payments on long-term debt	(2,578)	(3,361)	(3,304)
Repurchase of 7% subordinated income debentures		3,188	
Repurchase of 8 1/4% debentures	(104)		(468)
Repurchase of Class A Common Stock	(23)	(119)	
Repurchase of Serial Preferred stock	(23)	(2)	
Payments made related to exchange offer			
Dividends paid	(76)	(3,464)	(8,440)
Net cash used in financing activities		(1,176)	
Net increase (decrease) in cash	(307)	(657)	(307)
Cash at beginning of year	(3,111)	(5,591)	(12,519)
Cash at end of year	11,766	(5,813)	5,316
	5,170	10,983	5,667
	$16,936	$5,170	$ 10,983

	20X2 Fifty-Two Weeks	20X1 Fifty-Two Weeks	20X0 Fifty-Three Weeks
Reconciliation of Net Income to Net			
Cash Provided by Operating Activities			
Net income	10,205	7,375	4,609
Adjustments to reconcile net income to net cash provided by operating activities			
Extraordinary items from nonoperating activities	(12)	424	
Depreciation and amortization	13,964	15,504	15,141
Provision for losses on accounts and notes receivable	2,384	797	667
Net gain from the sale of property, plant and equipment and liquor licenses	(741)	(786)	(1,526)
Interest differential on note payable	15	13	11
Excess of purchase price over market value of Class A Common stock Discount received for early repayment of note Change in assets and liabilities net of effects from noncash investing and financing activities (Increase) decrease in assets			1,577
Notes and accounts receivable	(6,891)	(6,933)	(8,949)
Inventories	12,171	(12,901)	11,615
Prepaid expenses	288	518	(306)
Net investment in direct financing and since sales type leases	518	479	451
Other assets	(1,257)	497	(428)
Notes receivable from officer/director	67	(10)	(11)
Increase (decrease) in liabilities			
Accounts payable and other current liabilities	(1,126)	2,438	(6,740)
Deferred income	(1,307)	4,177	3,098
Deferred income taxes	(2,372)	540	2,555
Other liabilities	(46)	1,194	(281)
Net cash provided by operating activities	25,860	13,326	21,483

Chapter 6

ONGOING DEVELOPMENTS IN THE STATEMENT OF CASH FLOWS REPORTING

A joint FASB and IASB project that focused on restructuring financial reporting requirements was nearly complete before being placed on hold pending the completion of other significant financial reporting issues. When resumed, this project is expected to significantly alter the classification and the display of information on each of the three major financial statements and expand the explanatory information that accompanies financial reports.

After a brief summary of how the existing IASB cash flow reporting requirements differ from accounting principles generally accepted in the United States of America (U.S. GAAP), this chapter summarizes the major changes in cash flow reporting that had been agreed to by the two standard setting boards. Many of these changes have been identified earlier as part of the discussion of current cash flow reporting requirements. The purpose here is to provide an overview of the preliminary views related to cash flow reporting.

LEARNING OBJECTIVES

After completing this chapter, you should be able to do the following:

- Identify how cash flow reporting requirements under International Financial Reporting Standards (IFRS) differ from U.S. GAAP.
- Recall changes in not-for-profit cash flow statement presentation that are being considered by FASB.
- Identify the fundamental principles and tentative classifications that are expected to be used when new financial presentation guidance is issued by IASB and FASB.

IAS 7: Statement of Cash Flows

International Accounting Standard (IAS) 7, *Statement of Cash Flows*, became effective for firms reporting under IFRS in 1994. The following discussion focuses specifically on the major areas where IAS 7 differs from FASB cash flow reporting requirements discussed throughout this text (details related to reporting by financial institutions and futures, forwards, and so forth are excluded from this discussion).

	IAS 7	FASB ASC 230
Cash and cash equivalents	Requires that entities explain changes in both cash and in cash equivalents.	FASB guidance requires only a presentation of the combined change.
Bank overdrafts	Allows overdrafts in cash equivalents if the overdraft is repayable on demand and the bank balance of the entity regularly fluctuates from positive to negative.	Most companies take a best practices approach and report overdraft-related cash flows as financing activities.
Interest	May be included in either the operating or financing segment as long as the classification used remains consistent.	Interest is operating under U.S. GAAP.
Direct method reconciliation	There is no requirement for a reconciliation.	Must reconcile net income to cash from operating activities.
Operating activities presentation	IAS allows firms to present operating activities using a modified indirect method. Individual revenue and expense items from the income statement may be adjusted for noncash or additional cash items.	No modified indirect method under U.S. GAAP.
Noncash investing and financing activities	Information on noncash investing and financing activities is disclosed in a footnote. Presentation in a separate schedule on the face of the statement of cash flows is not permitted.	Presentation in a separate schedule on the face of the statement of cash flows permitted.
Restricted cash	Requires disclosure of information about cash held, but not available for use (restricted cash).	Silent on the treatment of restricted cash.
Other recommended data	IAS 7 recommends providing information on the amount of unused borrowing capacity and on the amount of cash flow used to increase operating capacity.	FASB ASC 230 does not recommend this type of data.

KNOWLEDGE CHECK

1. Under IAS 7, interest

    a. Is always classified only as an operating activity.
    b. May be classified as either an operating or investing activity as long as the classification is consistent.
    c. May be classified as either an operating or financing activity as long as the classification is consistent.
    d. Is not shown on the statement of cash flow, but appears in a separate schedule.

Proposals for Revisions to Financial Statement Preparation for Not-for-Profit Entities

FASB has an active project on their technical agenda entitled: *Financial Statement of Not-for-Profit Entities*. The purpose of the project is to reexamine guidance for not-for-profit financial statement preparation. The board hopes to improve the following:

- Net asset classification requirements
- Information in the statement and note related to liquidity, financial performance, and cash flows

Several tentative decisions directly related to the statement of cash flows had been reached as of October 2014. These changes are as follows:

- Require not-for-profit entities to use the direct method for reporting on operating activities. The use of the indirect method would no longer be permitted.
- Remove the existing requirement to provide a reconciliation of the change in net assets to net cash flows (the indirect method)
- Reclassify certain cash inflows and outflows so there will be better alignment of the categories on the statement of cash flows with those proposed for the revised statement of activities.
  - Cash gifts with donor-imposed restrictions requiring their use to purchase, construct, or otherwise acquire long-lived assets for operating purposes would become part of *operating* (rather than financing).
  - Cash payments made to purchase, construct, or otherwise acquire long- lived assets for operating purposes would become part of *operating* (rather than investing).
  - Cash from the sale of long-lived assets would be *operating* cash flow (rather than investing).
  - Cash received from dividends and interest income would be *investing* (rather than operating).
  - Cash interest payments would become *financing (*rather than operating).

These changes would result in more consistent cash flow presentation for not-for-profit entities. Currently, many but not all not-for-profits use the direct method for presenting cash inflows and outflows in the operating section. There also appears to be general consensus that the reconciliation adds little value for not-for-profit financial statement users.

The classification changes help address several of the classification problem areas that were identified and discussed in prior sections of this manual.

- By moving major operations related property, plant and equipment cash flows into the operating section, the operating cash flows better reflect the "business activities" for the not-for-profit.
- By moving interest and dividends out of operations, these inflows and outflows are now classified with the investing or financing activities that caused them to exist.

The proposed changes are quite consistent with the types of changes that are described in the following section on possible changes for business entities.

Proposals for Revisions to Financial Statement Preparation for Business Entities

FASB and IASB have jointly pursued an extensive reconsideration of financial reporting requirements as part of the effort to converge accounting standards internationally. As part of this project, the standard-setting bodies have reached many tentative conclusions about what and how to report financial information.

In October 2008, IASB published the discussion paper, *Preliminary Views on Financial Statement Presentation*. Several firms experimented with the proposal presentations and the comment period ended in the spring of 2009. The boards used this input to continue to revise their tentative decisions while continuing to gather information on several issues. An internal staff exposure draft was prepared in July of 2010 and is available on FASB's website. The preliminary views document and the subsequent staff exposure draft propose significant changes to all financial statements. The major changes that affect the statement of cash flows are summarized later in the chapter.

The financial reporting project is presently on hold while the boards finish work on a variety of financial reporting issues. The project was put on hold because of limitation in the capacity of FASB and IASB boards to deal with standard setting issues. The boards are also doing further study of issues such as the cost of the direct method and reporting by financial institutions.

One of the key objectives of the revision process is to improve the ability of statement users to employ financial statement information to help them assess the amounts, timing, and uncertainty of future cash flows. There was explicit recognition that

- how financial information is communicated is critical,
- the relationship between statements is currently unclear, and
- some degree of standardization improves comparability and understandability.

Cohesiveness and Disaggregation

Cohesiveness and disaggregation are the foundation of the tentative decisions on financial statement presentation. Information should be presented so

- the principle activities of the entity are clear,
- the cash flows of the entity are apparent, and
- relationships between resources and obligations and the effects of changes in these items are faithfully represented across statements.

Factors that determine which items to disaggregate and present include the function, nature, and measurement of items:

- Selling goods, making goods, providing services, advertising, and administration are examples of function.
- Economic characteristics or attributes that differ or flows (cash and income) that respond differently to events represent the nature of items. For example, wholesale and retail revenues differ. Material and labor costs differ.
- Certain assets and liabilities are measured differently.

There is also expected to be more comprehensive segment or line-of-business information provided within the financial statements.

Cohesiveness should clarify relationships across financial statements so these statements complement each other by displaying data so it clearly associates related information.

Statements should be structured with related information in the same sections, categories, and subcategory. These classifications should be presented in a consistent manner so the statements complement each other (that is, put items in same place in each statement).

Cohesiveness is currently lacking because the three basic statements evolved as reporting needs arose and thus were not specifically designed to work together.

The tentative classifications identified by the boards (see the table on the following page) reflect the broad nature of the cohesiveness concept.

Statement Classification

The following table summarizes the classifications that are part of each statement per the tentative conclusions reached by the boards. Examples of the type of items in each category, section, and subcategory are provided.

Statement of Financial Position	Statement of Comprehensive Income	Statement of Cash Flows
Business *Operating* Cash, inventory, receivables, PPE *Operating finance* Pension or lease liability *Investing* Security investments	Business *Operating* Revenue, cost of sales, operating expenses *Operating finance* Return on plan assets, interest on leases *Investing* Interest income, dividends, equity income	Business *Operating* Cash from customers Cash paid to employees Purchase of PPE *Operating finance* Cash interest on leases Cash contributions to pension plan *Investing* Interest received Sale of securities Purchase of securities
Financing *Debt* Short-term debt Long-term debt Interest payable Dividends payable *Equity* Common stock	Financing *Debt* Interest expense	Financing *Debt* Proceeds from debt issuance Repayment of debt Interest paid Dividends paid *Equity* Cash from issuance of shares
Income Taxes Taxes payable Deferred taxes	Income Taxes Tax expense operating Tax on individual gains and losses in comprehensive income	Income Taxes Taxes paid
Discontinued Operations	Discontinued Operations	Discontinued Operations
Multi-Category Transaction	Multi-Category Transaction	Multi-Category Transaction

Quick Exercise 6-1

1. After reviewing the statement classification table on the prior page what changes in classification from the current statement of cash flows can you identify?

2. For the classification changes you identify think about the reasons for making this reclassification.

Modified Classifications on the Statement of Cash Flows

REVISED CLASSIFICATIONS

The classification decisions management makes for assets and liabilities in the statement of financial position will determine the classifications used in the statement of cash flows (and comprehensive income).

- If a bond owned by the entity is classified as investing in the business section, the interest received will be an investing cash flow on the statement of cash flows.

The same item may be classified differently based on the nature of the business or business segment of an entity.

- A financial institution would categorize interest paid and received within the operating segment while a manufacturing company would show the interest received in the investing segment and interest paid in the financing category.

Key Point

The nature of the transaction and how the cash inflows and outflows related to the way the firm uses assets and liabilities will be the basis of classification. Substance takes precedence over form, unlike current cash flow classification.

BUSINESS SECTION

Cash flows related to an entity's income generating activities would be reported in the business section of the statement. There are two categories within the business section of the statement of cash flows, the operating section and the investing section.

Operating Category

Operating activities generate revenues (and related cash flows) through the interrelated use of resources. Examples of such activities include

- cash collected from customers for products or services,
- cash paid to suppliers.
- cash paid to employees,
- cash paid for property plant and equipment or received from selling these assets, and
- cash paid for advertising or administrative costs.

There is no *operating finance* subsection on the modified statement of cash flows and the cash flows related to these items are presented at the bottom of the operating activities section.

Investing Category

The investing section of the cash flow statement includes cash flows related to items that individually generate returns. Examples include the cash flow from

- dividends and interest,
- investment sales or purchases,
- nonfinancial asset transactions,
- rents and royalties,
- securities transactions, and
- equity method investments.

The business category and the operating segment within the business category are far broader than the operating classification used for existing statements of cash flows.

FINANCING SECTION

This section includes cash flows associated with the entity's capital structure. Only liabilities and equity related cash flows belong in this section. The objective is to make the cash flows associated with the entity's long-term financing and equity transactions transparent. What is financing will vary with the nature of an entity's business.

The cash flows related to financing are not shown in separate debt and equity categories on the statement of cash flows. Examples of financing cash flows include

- issuance and repayment of debt,
- interest and dividends paid,
- sale of common stock, and
- purchase of Treasury shares.

The financing category clearly separates activities used to finance the entities overall operations from those activities related to normal business operations, such as financing receivables, making securities investments, or borrowing from suppliers.

Note that the statement of cash flows does not separately identify cash flows related to debt and equity transactions (as is done on the statement of financial position). It is presumed that the nature of these cash flows will be apparent to users of the financial statements.

INCOME TAXES SECTION

A separate income tax section is part of the statement of cash flows (and the statement of financial position):

All cash flows related to the payment of income taxes will be part of the income tax section.

On the statement of comprehensive income the taxes will continue to be allocated among operating income and individual items that are part of comprehensive income:

- There will be separation of cash flows related to operating income and comprehensive income items on the statement of cash flows.

The creation of the income tax category means that income taxes are no longer included in the operations category as is required under current cash flow reporting rules.

KNOWLEDGE CHECK

2. The business classification of the restructured statement of cash flows proposed by IASB and FASB in their preliminary financial statement reporting documents includes

   a. Information on financing activities.
   b. Information on income taxes.
   c. Discontinued operations.
   d. Investing cash flows.

DISCONTINUED OPERATIONS SECTION

Operations that meet the criteria laid out in accounting standards to be considered discontinued will be reported in a separate section on each of the financial statements.

When operations are discontinued the cash flows associated with these operations will no longer be present. Statement users are likely to evaluate the cash flows and income producing activities of the entity differently:

- Separation is expected to help users evaluate the operations of the entity going forward.

MULTI-CATEGORY SECTION

Some transactions result in the entity receiving or giving up assets and liabilities (and the related cash flows) that fall into multiple classifications. Examples include

- a purchase of a controlling share of another entity in a cash for stock transaction and
- the sale of a subsidiary that is not a discontinued segment.

These types of transactions are presented in the multi-category section of the three major financial statements.

- Cash flows related to the acquisition or disposition of a group of assets or liabilities that qualify will be shown in this segment of the cash flow statement.

This category was created rather than having firms make allocations to multiple sections and categories of the statement of cash flows:

- This category may prove controversial when the comment period on the proposed changes opens.

Once classification decisions are made an entity is expected to use that presentation on a consistent basis.

Quick Exercise 6-2

How would the following items be classified on the statement of cash flow if the proposed classifications are adopted by FASB and IASB?

1. A purchase of a building
2. The payment of dividends
3. Cash received from customers
4. The purchase of another business entity for cash
5. Cash paid for Treasury shares
6. Income tax payments
7. Sale of long-term bonds
8. Common stock investment
9. Interest received on leased asset
10. Cash from sale of a line of business

Knowledge Check

3. When the statement of cash flows is modified, the new guidance is expected to

   a. Continue to use the three existing classifications: investing, financing, and operating.
   b. Use additional classifications, including a separate tax classification.
   c. Require the indirect method of reporting operating activities.
   d. Eliminate the requirement that an indirect reconciliation be presented if the direct method is used for operating activities.

Statement of Cash Flows: Other Tentative Decisions

In addition to the classification changes discussed previously, a number of other significant changes are expected to be a fundamental part of the revised statement of cash flows. These changes are briefly discussed as follows and reflect the tentative decisions reached to date.

Cash Only

There will no longer be any cash equivalents – a pure cash approach is used in the statement of cash flows:

- The statement will reconcile to the change in cash on the statement of financial position.
- Items that meet the definition of cash equivalents in existing statements should qualify for net treatment in the appropriate statement of cash flows category.

Noncash transactions are not part of the statement of cash flows:

- Information on noncash transactions should be reported in a financial statement note.
- Presentation of a schedule of noncash transactions on the face of the statement would no longer be allowed.

Netting

Gross cash receipts and cash payments should be presented in sections and categories:

- There should be consistency with asset, liability, and equity classifications.
- There should be consistency with income and expense classifications.

Gross amounts of cash receipts and payments are generally more relevant. However, net amounts may be used in situations that are generally consistent with current statement of cash flow netting rules. Netting is permitted when

- cash flows reflect the activities of the customer, rather than the entity:
  - Demand deposits of a bank
  - Rents collected for and paid to owners of the property; and
- cash receipts and payments where turnover is quick, amounts large, and maturities short:
  - Advances and repayments of principal amounts relating to credit card customers
  - Some short-term investment transactions
  - Short-term borrowings with a maturity of three months or less.

DIRECT METHOD REQUIRED

The direct method should be used to present all cash inflows and outflows – including those from operating activities. Operating examples include cash received from customers, cash paid for labor, and cash paid for advertising.

In all sections and categories there should be sufficient disaggregation by class of cash flows so the statement shows broadly how the entity generates and uses cash. This means the cash flow items shown should linked with related income or expense items. In assessing when aggregation is appropriate the entity should consider the size and variability of noncash items and timing differences between cash flows and comprehensive income amounts. An entity should disaggregate cash flows that do not occur every period.

A direct method statement was chosen as a presentation approach because it

- is more intuitive and understandable to users,
- helps users predict future cash flows,
- improves insight into the cash conversion cycle and relationships between revenues and expenses and cash flows,
- provides information that leads to better decision making, and
- helps users develop trends and comparisons that are currently unavailable.

Users generally favor the direct method because they feel it can help them

- compare similar types of cash flows across entities,
- raise relevant questions about the amount, timing and uncertainty of cash flows that differ from income and expense items,
- perform cash flow variance analysis, and
- analyze the sensitivity cash flows to volume changes.

Preparers generally oppose the direct method, with cost being the primarily stated reason, as well as

- capturing actual cash inflows and outflows requires extensive systems modifications,
- there are also business process analysis, staff training, and internal-control-related costs associated with these systems modifications, and
- audit fees and ongoing transaction costs would increase and be recurring.

To help minimize the cost of accumulating information that may not be produced by existing systems the board's determined that

- cash flow line items not be required to align on a line-by-line basis with comprehensive income line items and
- entities may derive cash flows using the indirect or direct approach.

REQUIRED RECONCILIATION

As an integral part of the statement the entity shall provide a reconciliation of income or loss from operating activities to net cash flows from operating activities. Adjust operating income for the effects of

- noncash operating income items,
- changes in operating assets or liabilities, and
- cash flows from the purchase, sale, or settlement of operating assets or liabilities.

Analysis of Changes in Assets and Liabilities

Initially a multicolumn reconciliation schedule such as the one shown in the following table was going to be an integral part of linking the statement of cash flows and statement of comprehensive income.

A	B	C	D	E	F	G
Caption in statement of cash flows	Changes in assets and liabilities excluding transactions with owners				Statement of comprehensive income	
	Not from remeasurements		From remeasurements			
	Cash flows	Accruals, allocations and other	Recurring valuation adjustments	All other	Comprehensive income (B+C+D+E)	Caption in statement of comprehensive income

After study of the results of company experimentation with the proposed financial statement presentation and consideration of generally negative comment letters, IASB and FASB have tentatively decided to abandon the reconciliation schedule and substitute footnote disclosures of changes in significant asset and liability line items.

This analysis will show changes from

- cash inflows and outflows.
- noncash transactions both recurring and nonrecurring, and
- accounting allocations, allowances, and remeasurements.

The analysis of changes should be provided in a separate note to the financial statements.

ONGOING DEVELOPMENTS

Before issuing a formal exposure draft the boards will analyze additional field work related to options for presenting the direct method of cash flows and special issues related to reporting by financial institutions. As developments in these and other areas occur this information will be provided as part of a text supplement.

ACCOUNTING AND AUDITING GLOSSARY

Account – Formal record that represents, in words, money or other unit of measurement, certain resources, claims to such resources, transactions or other events that result in changes to those resources and claims.

Account Payable – Amount owed to a creditor for delivered goods or completed services.

Account Receivable – Claim against a debtor for an uncollected amount, generally from a completed transaction of sales or services rendered.

Accountants' Report – Formal document that communicates an independent accountant's (1) expression of limited assurance on financial statements as a result of performing inquiry and analytic procedures (Review Report); (2) results of procedures performed (type of Attestation Report); (3) non-expression of opinion or any form of assurance on a presentation in the form of financial statements information that is the representation of management (Compilation Report); or (4) an opinion on an assertion made by management in accordance with the Statements on Standards for Attestation Engagements (Attestation Report). An accountant's report does not result from the performance of an audit.

Accounting – Recording and reporting of financial transactions, including the origination of the transaction, its recognition, processing, and summarization in the financial statements.

Accounting Change – Change in (1) an accounting principle; (2) an accounting estimate; or (3) the reporting entity. The correction of an error in previously issued financial statements is not an accounting change.

Accrual Basis – Method of accounting that recognizes revenue when earned, rather than when collected. Expenses are recognized when incurred rather than when paid.

Accrued Expense – An expense incurred during an accounting period for which payment is not due until a later accounting period. This results from the purchase of services which at the time of accounting have only been partly performed, are not yet billable, or have not been paid for.

Accumulated Depreciation – Total depreciation pertaining to an asset or group of assets from the time the assets were placed in service until the date of the financial statement or tax return. This total is the contra account to the related asset account.

Additional Paid in Capital – Amounts paid for stock in excess of its par value or stated value. Also, other amounts paid by stockholders and charged to equity accounts other than capital stock.

Adjusting Entries – Accounting entries made at the end of an accounting period to allocate items between accounting periods.

Amortization – The process of reducing a recognized liability systematically by recognizing revenues or by reducing a recognized asset systematically by recognizing expenses or costs. In accounting for postretirement benefits, amortization also means the systematic recognition in net periodic postretirement benefit cost over several periods of amounts previously recognized in other comprehensive income, that is, gains or losses, prior service cost or credits, and any transition obligation or asset.

Analytical Procedures – Substantive tests of financial information which examine relationships among data as a means of obtaining evidence. Such procedures include (1) comparison of financial information with information of comparable prior periods; (2) comparison of financial information with anticipated results (e.g., forecasts); (3) study of relationships between elements of financial information that should conform to predictable patterns based on the entity's experience; and (4) comparison of financial information with industry norms.

Annual Report – The annual report to shareholders is the principal document used by most public companies to disclose corporate information to their shareholders. It is usually a state-of-the-company report, including an opening letter from the Chief Executive Officer, financial data, results of continuing operations, market segment information, new product plans, subsidiary activities, and research and development activities on future programs. The Form 10-K, which must be filed with the SEC, typically contains more detailed information about the company's financial condition than the annual report.

Assertion – Explicit or implicit representations by an entity's management that are embodied in financial statement components and for which the auditor obtains and evaluates evidential matter when forming his/her opinion on the entity's financial statements.

Audit Risk – The risk that the auditor may unknowingly fail to modify appropriately his/ her opinion on financial statements that are materially misstated.

Audit Sampling – Application of an audit procedure to less than 100% of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class.

Auditors' Report – Written communication issued by an independent certified public accountant (CPA) describing the character of his/her work and the degree of responsibility taken. An auditor's report includes a statement that the audit was conducted in accordance with generally accepted auditing standards (GAAS), which require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, as well as a statement that the auditor believes the audit provides a reasonable basis for his/ her opinion.

Bad Debt – All or portion of an account, loan, or note receivable considered to be uncollectible.

Balance Sheet – Basic financial statement, usually accompanied by appropriate disclosures that describe the basis of accounting used in its preparation and presentation of a specified date the entity's assets, liabilities, and the equity of its owners. Also known as a statement of financial condition.

Bond – One type of long-term promissory note, frequently issued to the public as a security regulated under federal securities laws or state blue sky laws. Bonds can either be registered in the owner's name or are issued as bearer instruments.

Book Value – Amount, net or contra account balances, that an asset or liability shows on the balance sheet of a company. Also known as carrying value.

Business Combinations – Combining of two entities. Under the purchase method of accounting, one entity is deemed to acquire another and there is a new basis of accounting for the assets and liabilities of the acquired company.

Business Segment – Any division of an organization authorized to operate, within prescribed or otherwise established limitations, under substantial control by its own management.

Capital Stock – Ownership shares of a corporation authorized by its articles of incorporation. The money value assigned to a corporation's issued shares. The balance sheet account with the aggregate amount of the par value or stated value of all stock issued by a corporation.

Capitalized Cost – Expenditure identified with goods or services acquired and measured by the amount of cash paid or the market value of other property, capital stock, or services surrendered. Expenditures that are written off during two or more accounting periods.

Carrying Value – Amount, net or contra account balances, that an asset or liability shows on the balance sheet of a company. Also known as book value.

Cash Basis – A special purpose framework in which revenues and expenditures are recorded when they are received and paid.

Cash Equivalents – Short-term (generally less than three months), highly liquid investments that are convertible to known amounts of cash.

Cash Flows – Net of cash receipts and cash disbursements relating to a particular activity during a specified accounting period.

Casualty Loss – Sudden property loss caused by theft, accident, or natural causes.

Change in Engagement – A request, before the completion of the audit (review), to change the engagement to a review or compilation (compilation) of financial statements.

Class Actions – A federal securities class action is a court action filed on behalf of a group of shareholders under Rule 23 of the Federal Rules of Civil Procedure. Instead of each shareholder bringing an individual lawsuit, one or more shareholders bring a class action for the entire class of shareholders.

Common Stock – Capital stock having no preferences generally in terms of dividends, voting rights, or distributions.

Companies, Going Public – Companies become public entities for different reasons, but usually to raise additional capital. The SEC has prepared a guide for companies – Q&A: Small Business and the SEC – that provides a basic understanding about the various ways companies can become public and what securities laws apply. The SEC also has a list of some of the registration and reporting forms and related regulations that pertain to small and large companies.

Comparative Financial Statement – Financial statement presentation in which the current amounts and the corresponding amounts for previous periods or dates also are shown.

Compilation – Presentation in the form of financial statements information that is the representation of management (owners) without the accountant's assurance as to conformity with generally accepted accounting principles (GAAP).

Comprehensive Income – Change in equity of a business entity during a period from transactions and other events and circumstances from nonowner sources. The period includes all changes in equity except those resulting from investments by owners and distributions to owners.

Confirmation – Auditor's receipt of a written or oral response from an independent third party verifying the accuracy of information requested.

Consolidated Financial Statements – Combined financial statements of a parent company and one or more of its subsidiaries as one economic unit.

Consolidation – The presentation of a single set of amounts for an entire reporting entity. Consolidation requires elimination of intra-entity transactions and balances.

Contingent Liability – Potential liability arising from a past transaction or a subsequent event.

Continuing Accountant – An accountant who has been engaged to audit, review, or compile and report on the financial statements of the current period and one or more consecutive periods immediately prior to the current period.

Control Risk – Measure of risk that errors exceeding a tolerable amount will not be prevented or detected by an entity's internal controls.

Controls Tests – Tests directed toward the design or operation of an internal control structure policy or procedure to assess its effectiveness in preventing or detecting material misstatements in a financial report.

Current Asset – Asset that one can reasonably expect to convert into cash, sell, or consume in operations within a single operating cycle, or within a year if more than one cycle is completed each year.

Current Liability – Obligation whose liquidation is expected to require the use of existing resources classified as current assets, or the creation of other current liabilities.

Current Value – (1) Value of an asset at the present time as compared with the asset's historical cost. (2) In finance, the amount determined by discounting the future revenue stream of an asset using compound interest principles.

Debt – General name for money, notes, bonds, goods, or services which represent amounts owed.

Definite Criteria – A special purpose framework using a definite set of criteria having substantial support that is applied to all material items appearing in financial statements, such as the price-level basis of accounting.

Depreciation – Expense allowance made for wear and tear on an asset over its estimated useful life.

Derivatives – Derivatives are financial instruments whose performance is derived, at least in part, from the performance of an underlying asset, security or index. For example, a stock option is a derivative because its value changes in relation to the price movement of the underlying stock.

Detection Risk – Risk that the auditor will not detect a material misstatement.

Disclosure – Process of divulging accounting information so that the content of financial statements is understood.

Discount – Reduction from the full amount of a price or debt.

Dividends – Distribution of earnings to owners of a corporation in cash, other assets of the corporation, or the corporation's capital stock.

Earnings Per Share (EPS) – The amount of earnings attributable to each share of common stock. For convenience, the term is used to refer to either earnings or loss per share.

Employee Stock Options Plans – An employee stock ownership plan is an employee benefit plan that is described by the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code of 1986 as a stock bonus plan, or combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock. Also called an employee share ownership plan.Employee Stock Options Plans should not be confused with the term "ESOPs," or Employee Stock Ownership Plans, which are retirement plans.

Employee Stock Ownership Plans (ESOPs) – An employee stock ownership plan (ESOP) is a retirement plan in which the company contributes its stock to the plan for the benefit of the company's employees. With an ESOP, you never buy or hold the stock directly. This type of plan should not be confused with employee stock options plans, which are not retirement plans. Instead, employee stock options plans give the employee the right to buy their company's stock at a set price within a certain period of time.

Equity – Residual interest in the assets of an entity that remains after deducting its liabilities. Also, the amount of a business' total assets, less total liabilities. Also, the third section of a balance sheet, the other two being assets and liabilities.

Equity Security – Any security representing an ownership interest in an entity (for example, common, preferred, or other capital stock) or the right to acquire (for example, warrants, rights, and call options) or dispose of (for example, put options) an ownership interest in an entity at fixed or determinable prices. However, the term does not include convertible debt or preferred stock that by its terms either must be redeemed by the issuing entity or is redeemable at the option of the investor.

Error – Act that departs from what should be done; imprudent deviation, unintentional mistake or omission.

Executive Compensation: Where to Find in SEC Reports – The federal securities laws require clear, concise and understandable disclosure about compensation paid to CEOs and certain other high-ranking executive officers of public companies. You can locate information about executive pay in (1) the company's annual proxy statement; (2) the company's annual report on Form 10 -K; and (3) registration statements filed by the company to register securities for sale to the public.

Expenditures – Expenditures to which capitalization rates are to be applied are capitalized expenditures (net of progress payment collections) for the qualifying asset that have required the payment of cash, the transfer of other assets, or the incurring of a liability on which interest is recognized (in contrast to liabilities, such as trade payables, accruals, and retainages on which interest is not recognized).

Extraordinary Items – Events and transactions distinguished by their unusual nature and by the infrequency of their occurrence. Extraordinary items are reported separately, less applicable income taxes, in the entity's statement of income or operations.

Fair Disclosure, Regulation FD – On August 15, 2000, the SEC adopted Regulation FD to address the selective disclosure of information by companies and other issuers. Regulation FD provides that when an issuer discloses material nonpublic information to certain individuals or entities – generally, securities market professionals, such as stock analysts, or holders of the issuer's securities who may well trade on the basis of the information – the issuer must make public disclosure of that information. In this way, the new rule aims to promote the full and fair disclosure.

Fair Market Value – Price at which property would change hands between a buyer and a seller without any compulsion to buy or sell.

Federal Securities Laws – The laws that govern the securities industry, include the Securities Act of 1933; Securities Exchange Act of 1934; Investment Company Act of 1940; Investment Advisers Act of 1940; and Public Utility Holding Company Act of 1935.

Financial Statements – Presentation of financial data including balance sheets, income statements and statements of cash flow, or any supporting statement that is intended to communicate an entity's financial position at a point in time and its results of operations for a period then ended.

First In, First Out (FIFO) – Accounting method of valuing inventory under which the costs of the first goods acquired are the first costs charged to expense. Commonly known as FIFO.

Fiscal Year – Period of 12 consecutive months chosen by an entity as its accounting period which may or may not be a calendar year.

Fixed Asset – Any tangible asset with a life of more than one year used in an entity's operations.

Foreign Currency Translation – Restating foreign currency in equivalent dollars; unrealized gains or losses are postponed and carried in Stockholder's Equity until the foreign operation is substantially liquidated.

Form 10-K – This is the report that most publicly traded companies file with the SEC on an annual basis. It provides a comprehensive overview of the company's business and financial condition. Some companies choose to send their Form 10-K to their shareholders instead of sending a separate annual report. Currently, Form 10-K must be filed with the SEC within 90 days after the end of the company's fiscal year.

Form 10-Q – The Form 10-Q is a report filed quarterly by most reporting companies. It includes unaudited financial statements and provides a continuing view of the company's financial position during the year. The report must be filed for each of the first three fiscal quarters of the company's fiscal year and is currently due within 45 days of the close of the quarter. In addition to Form 10-Q, companies provide annual reports to their shareholders and file Form 10-K on an annual basis with the SEC.

Form 8-K – This is the "current report" used to report material events or corporate changes that have previously not been reported by the company in a quarterly report (Form 10-Q) or annual report (Form 10-K).

Forms 3, 4, 5 – Corporate insiders-meaning a company's officers and directors, and any beneficial owners of more than 10% of a class of the company's equity securities registered under Section 12 of the Securities Exchange Act of 1934 – must file with the SEC a statement of ownership regarding those securities. The initial filing is on Form 3. Changes in ownership are reported on Form 4. Insiders must file a Form 5 to report any transactions that should have been reported earlier on a Form 4 or were eligible for deferred reporting.

Fraud – Willful misrepresentation by one person of a fact inflicting damage on another person.

Gain – Excess of revenues received over costs relating to a specific transaction.

General Ledger – Collection of all assets, liability, owners' equity, revenue, and expense accounts.

Generally Accepted Accounting Principles (GAAP) – Conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. The highest level of such principles is set by the Financial Accounting Standards Board (FASB).

Generally Accepted Auditing Standards (GAAS) – Standards set by the American Institute of Certified Public Accountants (AICPA) which concern the auditor's professional qualities and judgment in the performance of his/ her audit and in the actual report.

Going Concern – Assumption that a business can remain in operation long enough for all of its current plans to be carried out.

Going Private – A company "goes private" when it reduces the number of its shareholders to fewer than 300 and is no longer required to file reports with the SEC.

Goodwill – An asset representing the future economic benefits arising from other assets acquired in a business combination or an acquisition by a not for profit entity that are not individually identified and separately recognized.

Gross Income – A tax term meaning all income from whatever source derived, except as otherwise provided in the income tax code.

Guaranty – Legal arrangement involving a promise by one person to perform the obligations of a second person to a third person, in the event the second person fails to perform.

Hedges – Protect an entity against the risk of adverse price or interest-rate movements on its assets, liabilities, or anticipated transactions. A hedge is used to avoid or reduce risks by creating a relationship by which losses on positions are counterbalanced by gains on separate positions in another market.

Historical Cost – The generally accepted method of accounting used in the primary financial statements that is based on measures of historical prices without restatement into units, each of which has the same general purchasing power.

Income – Inflow of revenue during a period of time.

Income Statement – Summary of the effect of revenues and expenses over a period of time.

Income Tax Basis – A special purpose framework that the reporting entity uses or expects to use to file its income tax return for the period covered by the financial statements.

Initial Public Offerings (IPO) – IPO stands for initial public offering and occurs when a company first sells its shares to the public.

Initial Public Offerings, Lockup Agreements – Lockup agreements prohibit company insiders – including employees, their friends and family, and venture capitalists – from selling their shares for a set period of time. In other words, the shares are "locked up." Before a company goes public, the company and its underwriter typically enter into a lockup agreement to ensure that shares owned by these insiders do not enter the public market too soon after the offering.

Insider Trading – "Insider trading" actually includes both legal and illegal conduct. The legal version is when corporate insiders – officers, directors, and employees – buy and sell stock in their own companies. Illegal insider trading refers generally to buying or selling a security, in breach of a fiduciary duty or other relationship of trust and confidence, while in possession of material, nonpublic information about the security. Insider trading violations may also include "tipping" such information, securities trading by the person "tipped," and securities trading by those who misappropriate such information.

Intangible Asset – Asset having no physical existence such as trademarks and patents.

Interest – Payment for the use or forbearance of money.

Interim Financial Statements – Financial statements that report the operations of an entity for less than one year.

Internal Control – Process designed to provide reasonable assurance regarding achievement of various management objectives such as the reliability of financial reports.

Inventory – Tangible property held for sale, or materials used in a production process to make a product.

Investment – Expenditure used to purchase goods or services that could produce a return to the investor.

Journal – Any book containing original entries of daily financial transactions.

Last In, First Out (LIFO) – Accounting method of valuing inventory under which the costs of the last goods acquired are the first costs charged to expense. Commonly known as LIFO.

Lease – Conveyance of land, buildings, equipment, or other assets from one person (Lessor) to another (Lessee) for a specific period of time for monetary or other consideration, usually in the form of rent.

Leasehold – Property interest a lessee owns in the leased property.

Ledger – Any book of accounts containing the summaries of debit and credit entries.

Lessee – Person or entity that has the right to use property under the terms of a lease.

Lessor – Owner of property, the temporary use of which is transferred to another (lessee) under the terms of a lease.

Liability – Debts or obligations owed by one entity (Debtor) to another entity (Creditor) payable in money, goods, or services.

Listing and Delisting Requirements – Before a company can begin trading on an exchange or the Nasdaq Stock Market, it must meet certain initial requirements or "listing standards." The exchanges and the Nasdaq Stock Market set their own standards for listing and continuing to trade. The SEC does not set listing standards. The initial listing requirements mandate that a company meet specified minimum thresholds for the number of publicly traded shares, total market value, stock price, and number of shareholders. After a company starts trading, it must continue to meet different standards set by the exchanges or the Nasdaq Stock Market. Otherwise, the company can be delisted. These continuing standards usually are less stringent than the initial listing requirements.

Long-Term Debt – Debt with a maturity of more than one year from the current date.

Loss – Excess of expenditures over revenue for a period or activity. Also, for tax purposes, an excess of basis over the amount realized in a transaction.

Lower of Cost or Market – Valuing assets for financial reporting purposes. Ordinarily, "cost" is the purchase price of the asset and "market" refers to its current replacement cost. Generally accepted accounting principles (GAAP) requires that certain assets (e.g., inventories) be carried at the lower of cost or market.

Management Discussion and Analysis (MD&A) – SEC requirement in financial reporting for an explanation by management of significant changes in operations, assets, and liquidity.

Manipulation – Manipulation is intentional conduct designed to deceive investors by controlling or artificially affecting the market for a security. Manipulation can involve a number of techniques to affect the supply of, or demand for, a stock. They include spreading false or misleading information about a company; improperly limiting the number of publicly-available shares; or rigging quotes, prices, or trades to create a false or deceptive picture of the demand for a security.

Marketable Securities – Stocks and other negotiable instruments which can be easily bought and sold on either listed exchanges or over-the-counter markets.

Mark-to-Market – Method of valuing assets that results in adjustment of an asset's carrying amount to its market value.

Matching Principle – The concept that all costs and expenses incurred in generating revenues must be recognized in the same reporting period as the related revenues.

Materiality – Magnitude of an omission or misstatements of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would change or be influenced.

Mergers – Mergers are business transactions involving the combination of two or more companies into a single entity. Most state laws require that mergers be approved by at least a majority of the company's shareholders if the merger will have a significant impact on the company.

Modified Cash Basis – A special purpose framework that begins with the cash basis method (see **Cash Basis**) and applies modifications having substantial support, such as recording depreciation on fixed assets or accruing income taxes.

Nasdaq – Nasdaq stands for the National Association of Securities Dealers Automated Quotation System. Unlike the New York Stock Exchange where trades take place on an exchange, Nasdaq is an electronic stock market that uses a computerized system to provide brokers and dealers with price quotes. The National Association of Securities Dealers, Inc. owns and operates The Nasdaq Stock Market.

Net Assets – Excess of the value of securities owned, cash, receivables, and other assets over the liabilities of the company.

Net Income – Excess or deficit of total revenues and gains compared with total expenses and losses for an accounting period.

Net Sales – Sales at gross invoice amounts less any adjustments for returns, allowances, or discounts taken.

Net Worth – Similar to equity, the excess of assets over liabilities.

Nonpublic Entity – Any entity other than (a) one whose securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally; (b) one that makes a filing with a regulatory agency in preparation for the sale of any class of its securities in a public market; or (c) a subsidiary, corporate joint venture, or other entity controlled by an entity covered by (a) or (b).

No-Par Stock – Stock authorized to be issued but for which no par value is set in the articles of incorporation. A stated value is set by the board of directors on the issuance of this type of stock.

No-Par Value – Stock or bond that does not have a specific value indicated.

Notional – Value assigned to assets or liabilities that is not based on cost or market (e.g., the value of a service not yet rendered).

Objectivity – Emphasizing or expressing the nature of reality as it is apart from personal reflection or feelings; independence of mind.

Paid in Capital – Portion of the stockholders' equity which was paid in by the stockholders, as opposed to capital arising from profitable operations.

Par Value – Amount per share set in the articles of incorporation of a corporation to be entered in the capital stocks account where it is left permanently and signifies a cushion of equity capital for the protection of creditors.

Parent Company – Company that has a controlling interest in the common stock of another.

Predecessor Accountant – An accountant who (a) has reported on the most recent compiled or reviewed financial statements or was engaged to perform but did not complete a compilation or review of the financial statements, and (b) has resigned, declined to stand for reappointment, or been notified that his or her services have been or may be terminated.

Preferred Stock – Type of capital stock that carries certain preferences over common stock, such as a prior claim on dividends and assets.

Premium – (1) Excess amount paid for a bond over its face amount. (2) In insurance, the cost of specified coverage for a designated period of time.

Prepaid Expense – Cost incurred to acquire economically useful goods or services that are expected to be consumed in the revenue-earning process within the operating cycle.

Prescribed Form – Any standard preprinted form designed or adopted by the body to which it is to be submitted, for example, forms used by industry trade associations, credit agencies, banks, and governmental and regulatory bodies other than those concerned with the sale or trading of securities. A form designed or adopted by the entity whose financial statements are to be compiled is not considered to be a prescribed form.

Present Value – Current value of a given future cash flow stream, discounted at a given rate.

Principal – Face amount of a security, exclusive of any premium or interest. The basis for interest computations.

Proxy Statement – The SEC requires that shareholders of a company whose securities are registered under Section 12 of the Securities Exchange Act of 1934 receive a proxy statement prior to a shareholder meeting, whether an annual or special meeting. The information contained in the statement must be filed with the SEC before soliciting a shareholder vote on the election of directors and the approval of other corporate action. Solicitations, whether by management or shareholders, must disclose all important facts about the issues on which shareholders are asked to vote.

Purchase Method of Accounting – Accounting for a merger by adding the acquired company's assets at the price paid for them to the acquiring company's assets.

Quiet Period – The term "quiet period," also referred to as the "waiting period," is not defined under the federal securities laws. The quiet period extends from the time a company files a registration statement with the SEC until SEC staff declares the registration statement "effective." During this period, the federal securities laws limit what information a company and related parties can release to the public. Rule 134 of the Securities Act of 1933 discusses these limitations.

Ratio Analysis – Comparison of actual or projected data for a particular company to other data for that company or industry in order to analyze trends or relationships.

Real Property – Land and improvements, including buildings and personal property that is permanently attached to the land or customarily transferred with the land.

Receivables – Amounts of money due from customers or other debtors.

Reconciliation – Comparison of two numbers to demonstrate the basis for the difference between them.

Registration Under the Securities Act of 1933 – Often referred to as the "truth in securities" law, the Securities Act of 1933 has two basic objectives: (1) To require that investors receive financial and other significant information concerning securities being offered for public sale; and (2) To prohibit deceit, misrepresentations, and other fraud in the sale of securities. The SEC accomplishes these goals primarily by requiring that companies disclose important financial information through the registration of securities. This information enables investors, not the government, to make informed judgments about whether to purchase a company's securities.

Regulation D Offerings – Under the Securities Act of 1933, any offer to sell securities must either be registered with the SEC or meet an exemption. Regulation D (or Reg D) provides three exemptions from the registration requirements, allowing some smaller companies to offer and sell their securities without having to register the securities with the SEC.

Regulatory Basis – A special purpose framework that the reporting entity uses to comply with the requirements or financial reporting provisions of a governmental regulatory agency to whose jurisdiction the entity is subject. An example is a basis of accounting insurance companies use pursuant to the rules of a state insurance commission.

Reissued Report – A report issued subsequent to the date of the original report that bears the same date as the original report. A reissued report may need to be revised for the effects of specific events; in these circumstances, the report should be dual-dated with the original date and a separate date that applies to the effects of such events.

Related Party Transaction – Business or other transaction between persons who do not have an arm's-length relationship (e.g., a relationship with independent, competing interests). The most common is between family members or controlled entities. For tax purposes, these types of transactions are generally subject to a greater level of scrutiny.

Research and Development (R&D) – Research is a planned activity aimed at discovery of new knowledge with the hope of developing new or improved products and services. Development is the translation of research findings into a plan or design of new or improved products and services.

Retained Earnings – Accumulated undistributed earnings of a company retained for future needs or for future distribution to its owners.

Revenue Recognition – Method of determining whether or not income has met the conditions of being earned and realized or is realizable.

Revenues – Sales of products, merchandise, and services; and earnings from interest, dividend, rents.

Review – Accounting service that provides some assurance as to the reliability of financial information. In a review, a certified public accountant (CPA) does not conduct an examination under generally accepted auditing standards (GAAS). Instead, the accountant performs inquiry and analytical procedures that provide the accountant with a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the statements for them to be in conformity with GAAP or, if applicable, with a special purpose framework.

Risk Management – Process of identifying and monitoring business risks in a manner that offers a risk/return relationship that is acceptable to an entity's operating philosophy.

Security – Any kind of transferable certificate of ownership including equity securities and debt securities.

Short-Term – Current; ordinarily due within one year.

SSARS – Statements on Standards for Accounting And Review Services issued by the AICPA Accounting and Review Services Committee (ARSC).

Start-up Costs – (1) Costs, excluding acquisition costs, incurred to bring a new unit into production. (2) Costs incurred to begin a business.

Statement of Cash Flows – A statement of cash flows is one of the basic financial statements that is required as part of a complete set of financial statements prepared in conformity with generally accepted accounting principles. It categorizes net cash provided or used during a period as operating, investing and financing activities, and reconciles beginning and ending cash and cash equivalents.

Statement of Financial Condition – Basic financial statement, usually accompanied by appropriate disclosures that describe the basis of accounting used in its preparation and presentation as of a specified date, the entity's assets, liabilities, and the equity of its owners. Also known as *balance sheet.*

Statutory Basis – See **Regulatory Basis**.

Straight-Line Depreciation – Accounting method that reflects an equal amount of wear and tear during each period of an asset's useful life. For instance, the annual straight-line depreciation of a $10,000 asset expected to last ten years is $1,000.

Strike Price – Price of a financial instrument at which conversion or exercise occurs.

Submission of Financial Statements – Presenting to a client or third party's financial statements that the accountant has prepared either manually or through the use of computer software.

Subsequent Event – Material event that occurs after the end of the accounting period and before the publication of an entity's financial statements. Such events are disclosed in the notes to the financial statements.

Successor Accountant – An accountant who has been invited to make a proposal for an engagement to compile or review financial statements and is considering accepting the engagement or an accountant who has accepted such an engagement.

Tangible Asset – Assets having a physical existence, such as cash, land, buildings, machinery, or claims on property, investments or goods in process.

Tax – Charge levied by a governmental unit on income, consumption, wealth, or other basis.

Third Party – All parties except for members of management who are knowledgeable about the nature of the procedures applied and the basis of accounting and assumptions used in the preparation of the financial statements.

Trade Date – Date when a security transaction is entered into, to be settled on at a later date. Transactions involving financial instruments are generally accounted for on the trade date.

Treasury Bill – Short-term obligation that bears no interest and is sold at a discount.

Treasury Bond – Long-term obligation that matures more than five years from issuance and bears interest.

Treasury Note – Intermediate-term obligation that matures one to five years from issuance and bears interest.

Treasury Stock – Stock reacquired by the issuing company. It may be held indefinitely, retired, issued upon exercise of stock options, or resold.

Trial Balance – A trial balance consists of a listing of all of the general ledger accounts and their corresponding debit or credit balances. Also, in a trial balance, no attempt is made to establish a mathematical relationship among the assets, liabilities, equity, revenues, and expenses except that total debits equal total credits.

Unearned Income – Payments received for services which have not yet been performed.

Updated Report – A report issued by a continuing accountant that takes into consideration information that he/she becomes aware of during his/her current engagement and that re-expresses his/her previous conclusions or, depending on the circumstances, expresses different conclusions on the financial statements of a prior period as of the date of his/her current report.

Valuation Allowance – Method of lowering or raising an object's current value by adjusting its acquisition cost to reflect its market value by use of a contra account.

Variance – Deviation or difference between an estimated value and the actual value.

Work in Progress – Inventory account consisting of partially completed goods awaiting completion and transfer to finished inventory.

Working Capital – Excess of current assets over current liabilities.

Working Papers – (1) Records kept by the auditor of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in the course of the audit. (2) Any records developed by a certified public accountant (CPA) during an audit.

Yield – Return on an investment an investor receives from dividends or interest expressed as a percentage of the cost of the security.

INDEX

L

N

O

R

S

T

STATEMENT OF CASH FLOWS: PREPARATION, PRESENTATION, AND USE

BY TOM KLAMMER, PH.D., CPA

Solutions

CL4FCFS GS-0417-0A

Course Code: 746421

SOLUTIONS

CHAPTER 1

Quick Exercise 1-1 Solution

You probably noted the following features:

- The title is the Statement of Cash Flows.
- The statement is comparative.
- There are three major sections of the statement: operating, investing, and financing.
- There are cash inflows and cash outflows presented in each section.
- The use of the change in cash to reconcile the beginning and ending balance sheet cash amounts.
- The operations section presented uses the direct method.

Quick Exercise 1-2 Solution

Individual answers will vary.

Quick Exercise 1-3 Solution

Classifications are based on the summary lists found in the chapter. An explanation of the reasons for using these classifications is addressed in subsequent chapters.

Investing outflows

Financing inflow

Noncash item, shown on the schedule of noncash activities

Investing outflow

Operating inflow

Operating outflow

Financing outflow

Investing inflow

Quick Exercise 1-4 Solutions

1. Interest paid is $225,000.

   Start with the $240,000 expense and subtract the $15,000 accrual increase. If what you owe increases, you did not pay this amount in cash this period.

2. *Direct method*

$260,000 is shown as a cash outflow for wages

The wage expense of $280,000 is reduced by the $20,000 increase in wages payable (an amount you did not pay this year).

Indirect method

Add the $20,000 increase in accrued wages to the net income. There is more expense than cash outflow, thus making income smaller than operating cash flow.

3. The firm collected $285,000 from customers

Sales	–	Inc. A.R.	+	Pur. Rec.
$300,000	–	$20,000	+	$5,000

The purchase of the receivable in an acquisition means that the accounts receivable balance would have only increased $15,000 from the firm's regular operations.

Comprehensive Exercise 1-1 Solutions

Direct Method Statement

Shake-A-Little Company
Statement of Cash Flows
For the Year Ending December 31, 20X2

Operating Cash Flows		
Cash collected from customers ($600,000 – $3,000)	$ 597,000	
Cash interest collected ($20,000 + $6,000 – $5,000)	21,000	$ 618,000
Less: Cash paid for operating activities		
CGS +/– INV +/– AP ($360,000 – $5,000 – $1,000)	354,000	
Salaries + decrease in salaries pay. ($150,000 + $2,000)	152,000	
Advertising – increase in accrued advertising ($32,000 – $2,000)	30,000	
Interest – Increase in accrued interest ($15,000 – $2,000)	13,000	
Taxes	10,000	559,000
Net cash provided by operations	59,000	
Investing Activities		
Cash inflow		
Sale of machine		7,000
Cash outflow		
Acquisition of plant, property, and equipment*		(60,000)
Net cash used by investing activities		(53,000)

Shake-A-Little Company
Statement of Cash Flows
For the Year Ending December 31, 20X2 (continued)

Financing Activities		
Cash provided by financing activities		
Sale of common stock	10,000	
Bonds payable	130,000	140,000
Cash used for financing activities		
Retirement of bonds	100,000	
Dividend payment	40,000	(140,000)
Net cash from financing activities		—
Net increase in cash balance		6,000
Beginning cash		2,000
Ending cash		8,000

* Cash paid for acquisition is determined using information on changes in the plant, property, and equipment account.

PPE	– Dep.	– Asset Sold	+ Acc. Dep.	– PPE	= Equipment Purchased
$280,000	– $30,000	– $20,000	+ $10,000	– $300,000	= ($60,000)

Indirect Method Statement

Shake-A-Little Company
Statement of Cash Flows
For the Year Ending December 31, 20X2

Operating Cash Flows		
Net income		$ 20,000
Adjustments to reconcile net income to net cash provided		
Noncash long-term items included in income		
Depreciation	$ 30,000	
Loss on sale of asset	3,000	33,000
		53,000
Changes in working capital asset and liability items		
Accounts receivable increase	(3,000)	
Inventory decrease	5,000	
Accounts payable increase	1,000	

Shake-A-Little Company
Statement of Cash Flows
For the Year Ending December 31, 20X2 (continued)

Unearned interest increase	1,000	
Accrued advertising increase	2,000	
Accrued interest increase	2,000	
Salaries payable decrease	(2,000)	6,000
Net cash provided by operations		59,000
Investing Activities		
Cash inflow		
Sale of machine	7,000	7,000
Cash outflow		
Acquisition of plant, property, and equipment*	60,000	(60,000)
Net cash from investing activities		(53,000)
Financing Activities		
Cash provided by financing activities		
Sale of common stock	10,000	
Bonds payable	130,000	140,000
Cash used for financing activities		
Retirement of bonds	100,000	
Dividend payment	40,000	(140,000)
Net cash from financing activities		----
Net increase in cash balance		6,000
Beginning cash		2,000
Ending cash		8,000

* Cash paid for acquisition is determined using information on changes in the plant, property, and equipment account.

PPE	– Dep. Sold	– Asset	+ Acc. Dep.	– PPE	= Equipment Purchased
$280,000	– $30,000	– $20,000	+ $10,000	– $300,000	= ($60,000)

Supplemental Problem 1-1 Solutions

Indirect Method

Skip Company
Statement of Cash Flows

Cash flows from operating activities		
Net income		$60,000
Adjustment to reconcile net income to net cash provided by operating activities		
Depreciation		9,000
Gain on sale of asset		(3,000)
Adjustments for working capital changes		
Increase in accounts receivable		(20,000)
Increase in unearned revenue		10,000
Increase in inventory		(2,000)
Increase in accounts payable		8,000
Increase in accrued wages		4,000
Increase in prepaid insurance		(3,000)
Net cash flows provided by operating activities		63,000
Cash flows from investing activities		
Acquisition of fixed assets	$(13,000)	
Sale of productive asset	11,000	(2,000)
Cash flows from financing activities		
Issuance of long-term debt	12,000	
Retirement of long-term debt	(9,000)	
Payment of dividends	(2,000)	1,000
Increase in cash		$62,000

Direct Method

Skip Company Statement of Cash Flows		
Cash flows from operating activities		
Cash collected from customers		$ 140,000 (1)
Cash paid to suppliers	$ 44,000 (2)	
Other cash expenses	33,000 (3)	77,000
Net cash flows provided by operating activities		63,000
Cash flows from investment activities		
Acquisition of fixed assets	$ (13,000)	
Sale of productive assets	11,000	(2,000)
Cash flows from financing activities		
Issuance of long-term debt	$ 12,000	
Retirement of long-term debt	(9,000)	
Payment of dividends	(2,000)	1,000
Increase in cash		$ 62,000
.....		
.....		

The reconciliation (the operating section of the indirect method statement) would also be a required presentation.

Supplemental Problem 1-2 Solutions

Compute the cost of equipment purchased using the information in the equipment account and the accumulated depreciation. First, consider the equipment discarded.

Beg. Acc. Dep.	+ Dep. Exp.	– End. Acc. Dep.	=
$30,000	+ $5,000	– $32,000	= $3,000

Cost of Equipment Purchased =

End	– [Beg.	– Disposal]	=
$62,000	– [$58,000	– $3,000]	= $7,000

Note: The reconciliation schedule would be the same as the operating section of the indirect method statement.

Direct Method

X-Ray Company
Statement of Cash Flows
For the Year Ending December 31, 20X2

Cash flows from operating activities		
Cash collected from customers		
(Sales – increase in receivable)		
($100,000 – $2,000)		$98,000
Less: cash paid for operating expenses		
CGS +/– change in inventory and		
change in accounts payable		
$50,000 + $5,000 increase	$55,000	
Selling and administrative expenses	20,000	75,000
Net cash flows provided by operating activities	23,000	
Cash flows from investing activities		
Cash outflows		
Acquisition of land	12,000	
Acquisition of equipment	7,000	(19,000)
Cash flows from financing activities		
Cash Outflows		
Payment of dividends		(10,000)
Net increase (decrease) in cash balance		(6,000)
Beginning cash		30,000
Ending cash		$24,000

Indirect Method

X-Ray Company
Statement of Cash Flows
For the Year Ending December 31, 20X2

Cash flows from operating activities		
Net income		$25,000
Adjustment to reconcile net income to net cash provided by operations		
Depreciation		5,000
		30,000
Changes in working capital items		
Accounts receivable increase	$ (2,000)	
Inventories increase	(5,000)	(7,000)
Net cash provided by operating activities		23,000
Cash flows from investing activities		
Cash outflows		
Acquisition of land	12,000	
Acquisition of equipment	7,000	(19,000)
Cash flows from financing activities		
Cash outflows		
Payment of dividends		(10,000)
Net increase (decrease) in cash balance		(6,000)
Beginning cash		30,000
Ending cash		$24,000

Supplemental Problem 1-3 Solutions

(1)	Sales	$ 1,000,000
	Decrease in accounts receivable	50,000
	Cash collected from customers	$ 1,050,000
(2)	Cost of goods sold	$500,000
	Decrease in inventory	(110,000)
	Increase in accounts payable	(100,000)
	Cash paid to suppliers	$ 290,000
(3)	General expenses	$ 300,000
	Increase in prepaid advertising	10,000
	Cash paid for general expenses	$ 310,000
(4)	Interest expense	$ 25,000
	Discount amortization	(5,000)
	Interest paid	$ 20,000
(5)	Tax expense	$ 70,000
	Decrease in taxes payable	50,000
	Taxes paid	$ 120,000
(6)	Entry made to sell equipment	
	Loss	15,000
	Acc. depreciation	60,000
	*Cash	5,000
	Equipment	80,000
(7)	Ending balance – equipment	$ 380,000
	Beg. balance less sale	
	$250,000 – $80,000	170,000
	Equipment purchased	$ 210,000
(8)	Ending balance – marketable securities	$ 70,000
	Beg. balance less sale	
	$50,000 – $30,000	20,000
	Purchase of marketable securities	$ 50,000

(9) Bonds payable

	$ 75,000	Beginning balance
$ 50,000	5,000	Amortization
		Bonds repaid
	????	Bonds sold
	$ 100,000	Ending balance
Bonds Sold = $70,000		

Noncash adjustment		
Depreciation	$ 40,000	
Loss on sale of equipment	15,000	– see (6)
Amortization	5,000	– see (4)

Direct Method

EXX Company
Statement of Cash Flows
For the Year Ending December 31, 20X2

Cash flows from operating activities		
Inflows		
Cash from customers (1)		$ 1,050,000
Outflows		
Cash paid to suppliers (2)	$ 290,000	
Cash paid for general expenses (3)	310,000	
Interest paid (4)	20,000	
Taxes paid (5)	120,000	740,000
Net cash flows from operating activities		310,000
Cash flows from investing activities		
Inflows		
Sale of equipment (6)	5,000	
Sale of marketable securities	30,000	35,000
Outflows		
Paid for land	50,000	
Building and equipment (7)	210,000	
Marketable securities purchased (8)	50,000	310,000
Net cash flows used investing activities		(275,000)
Cash flows from financing activities		
Inflows		
Bonds sold (9)		70,000
Outflows		
Bonds repaid	50,000	
Dividends paid	50,000	100,000
Net cash flows used in financing activities		(30,000)
Increase in cash		5,000
Beginning cash		45,000
Ending cash		$ 50,000

Reconciliation

EXX Company
Reconciliation
Net Income to Operating Cash Flow

Net income	$50,000	
Adjustment to reconcile net income to net cash flows from operating activities		
Depreciation	$40,000	
Loss on sale of equipment	15,000	
Discount amortization	5,000	60,000
		110,000
Additions		
Decrease in accounts receivable	50,000	
Decrease in inventory	110,000	
Increase in accounts payable	100,000	260,000
Deductions		
Decrease in taxes payable	50,000	
Increase in prepaid advertising	10,000	(60,000)
Net cash provided by operating activities		$310,000

Solutions to Knowledge Check Questions

1.

a. Incorrect. The cash flow statement provides information about the firm's liquidity, but it is not a direct predictor of this liquidity.
b. Incorrect. The cash flow statement is the second flow statement (the income statement is the other).
c. Incorrect. The cash flow statement does not replace any part of the income statement.
d. Correct. The cash flow statement provides information on cash inflows and outflows during a period.

2.

a. Incorrect. Short-term receivables do not qualify as funds (cash equivalents) for the statement of cash flows.
b. Incorrect. Short-term stock investments do not qualify as funds (cash equivalents) because they carry significant market risk.
c. Correct. The cash flow standard specifically defines cash and cash equivalents as the change in funds that the statement is to explain.
d. Incorrect. Working capital includes many items that do not qualify as cash equivalents.

3.

a. Incorrect. Operating activities do not include an investment in the debt of another entity. The interest earned on this investment would be part of operating activities.
b. Correct. This type of transaction is an example of an investing activity per the classifications adopted by the standard-setters.
c. Incorrect. Financing activities would be the issuance or repayment of our own debt, not the purchase of the debt of another company.
d. Incorrect. Cash was used for the investment so it does not qualify as a noncash transaction.

4.

a. Incorrect. The statement of cash flows is not a working capital statement.
b. Incorrect. The standard does not require the indirect method.
c. Incorrect. The standard recommends, but does not require the direct method.
d. Correct. FASB opted not to require a particular presentation approach, partly because of uncertainty about the cost of the direct method.

5.

a. Incorrect. It is relatively easy to determine the actual cash dividends paid during the year.
b. Incorrect. The interest a firm receives is readily obtainable from accounting records.
c. Correct. It is typically necessary to review the activities that affect the long-term debt account(s) to get cash flow information. This information may require additional analysis.
d. Incorrect. All firms indicated that they had information on dividends paid and interest. However, some firms indicated that the amount of debt related cash inflows and outflows may not be directly available in the accounting records.

CHAPTER 2

Quick Exercise 2-1 Solutions

1. This is a cash equivalent. This investment is the type of item cited by the guidance. The overnight paper market investment is short-term, highly liquid, and has little or no market risk.
2. This is not a cash equivalent. There is credit risk, the chance of not being repaid, so these loans to suppliers should be classified as investments rather than cash equivalents. In addition, if the firm needed to discount these loans to a bank there would be a cost.

   The firm may net these loans to suppliers because they have a maturity of less than three months. The firm's borrowings early in the year are financing but they may be netted if the maturity is less than three months.

3. In theory, both the borrowing and investing activities would qualify as cash equivalents, because they are an integral part of cash management function. However, this is not the proper classification by the statement of financial position reporting rules.

   The cash investing activities are just like those described in situation 1, and do qualify as a cash equivalent under the guidance. Given the rules of the guidance, the borrowings are not part of cash equivalents. They may be reported net in the financing section. The lending activities would be part of the cash equivalents.

4. The borrowing and repayment does not qualify as a cash equivalent according to the guidance. Disclose the net change in the borrowed amounts in the financing section. Disclosure of the line of credit is also desirable.

Comprehensive Exercise 2-1 Solutions

1. Bank demand deposits are cash equivalents. This is a normal cash item.
2. Common stock investments are investing items and changes should be presented gross. These investments do not have a three-month or less maturity and are always subject to market risk.
3. The maturity of these treasury bills makes them investing activities that the firm should present on a gross inflow and outflow basis. This answer represents a strict interpretation of the guidance. Firms sometimes do not follow the netting rules this strictly.
4. You may net changes in overnight commercial paper borrowings in the financing section. They do not qualify as cash equivalents because they are debt of the entity.
5. These notes are financing activities and are presented gross on the individual company statement. You would eliminate these payables and receivables on a consolidated statement. There is no maturity date, so the three-month definition is not met.
6. The key is the original maturity to the purchasing entity. Therefore, these treasury bills could be part of the cash equivalents because they mature in two months. They could also be shown as net items in the investment section if the firm does not define them as cash equivalents.
7. Notes receivable, such as those for loans to suppliers, would not be cash equivalents because of the market risk. Even though due on demand, collection may not be possible since the borrowing firm probably does not have the ready cash needed to repay the notes. It would be possible to discount the notes, but this would be costly. These notes are callable on demand are considered to have maturities of three months or less. You may net them in the investment section of the statement of cash flows. (Notes receivable from trade sales are considered to be operating.)
8. Credit card receivables (VISA, for example) are explicitly classified in the guidance as having maturities of less than three months. They may be presented as net investing items. They do not qualify as cash equivalents because of the risk of noncollection.
9. Since the maturity, when purchased, was more than three months, these treasury bills are investment items that should be presented gross. The current maturity of one month does not change the initial classification. Liquidity and cash flow reporting are different.
10. Restricted cash amounts are now included with cash and cash equivalents even if these amounts are shown in one or more separate line items on the Statement of Financial Position. A restricted cash sinking fund for bonds would seem to be an investing activity (the debt has not yet been legally repaid). When the money was put into the sinking fund, it was simply transferred from cash to restricted cash; and this would not appear on the statement of cash flows. When the money is used to redeem the bonds, there would be a financing cash outflow.

Comprehensive Exercise 2-2 Solutions

There are no correct answers to either of these situations. Both the gross and net methods have advantages and disadvantages.

1. If the firm is rolling the debt on a daily basis, a strong conceptual argument could be made that this $9 million should be a cash equivalent. This treatment would permit the net change, if any, to be part of the reconciliation of cash and cash equivalents on the statement of cash flows. This, however, is not acceptable under the cash flow guidance (because this is debt of the entity).

   The guidance does permit netting of this type of cash inflow and outflow. A daily rollover is much shorter than the three-month maximum acceptable for presenting net, rather than gross, information. This presentation achieves almost the same effect as including these activities in cash equivalents. If there was no change in the total outstanding at the end of the period, nothing appears on the face of the cash flow statement.

   It would be important to provide disclosure about the type of arrangement that allows the firm to roll the $9 million on a daily basis. Users need information to evaluate what risks exist that this cash might not be available. You could also argue that the $2.3 billion is reflective of what actually happened to cash inflow and outflow during the period and that the firm should provide disclosure on any total that large.

   The guidance does not prohibit showing gross inflows and outflows for short-term items. However, most individuals are likely to feel that the presentation of a $2.3 million inflow and outflow in the financing section of the cash flow statement might be misleading. This is of particular concern if it is much larger than other items included on the statement.

2. Reporting the cash inflows from loans and the cash outflows for the loan repayments is more informative for the user than a statement showing nothing about this rather significant financing activity of the entity. This seems to be precisely the type of information we should show on a statement of cash flows. It represents information not available in other financial statements. It is also useful to the statement reader in evaluating how the entity carries out business activities.

   The guidance permits net presentation of this type of activity and most firms choose this approach.

   The guidance did not specifically require disclosure of the extent of this type of borrowing. This form of disclosure is implicit in other guidance related to debt. It might have been advisable for the cash flow guidance to make supplemental disclosure items of major netted items more explicit.

Supplemental Problem 2-1 Solutions

1. Several comments and questions could be raised about the definition of cash and cash equivalents used by this company.

   Regular time deposits are as easily accessed as demand deposit accounts, and may logically be cash equivalents. A firm could also choose to treat them as investments. In this case, questions may exist about the ability of the firm to make use of the time deposit cash for regular operations (they are to be used as collateral). It would seem more appropriate to classify these deposits as an investment than as a cash equivalent.

   If the certificates of deposit have maturities longer than three months, should they be considered cash equivalents? Clearly, managers often consider these certificates as near cash and the firm can convert them to cash with only a small interest penalty. That stated, a strong case can be made that longer-term certificates of deposit are more properly classified as investments. The firm made an investment decision when it bought CDs. Technically, there is some interest risk (the penalty period).

In this case, the loans are explicitly tied to guarantees on construction loans and probably are not available to the firm for regular use. An investment classification seems more appropriate.

2. This treatment does not seem to be consistent with the specification in the guidance that the balance in the cash and cash equivalent account shown on the statement of cash flows reconcile with a line item on the balance sheet.

   In this case, the company has both a cash account and an investment account on the balance sheet. There is no cash and cash equivalent total presentation.

Supplemental Problem 2-2 Solutions

A variety of questions may be raised about the information presented. These questions include the following:

- Is the terminology within the financing section clear? For example, is this the net change in short-term borrowing? What is meant by the title long-term debt? Is the amount shown what was repaid?
- Why does the $45.3 million change in short-term borrowing on the cash flow statement not reconcile to the $50.1 million dollar decline in short-term debt shown on the balance sheet?
- Were there new debt issuances or only repayments? If only repayments, why does the $3.5 million change in long-term debt not reconcile to the $4.9 million dollar increase on the balance sheet?
- The schedule of long-term debt seems to indicate that additional debt was issued while some lease debt was repaid. This debt issuance if it occurred is not shown on the statement of cash flows.

It does not appear that this company complied with the gross reporting requirements of the guidance. (Note. There was no indication anywhere in the financial report that would help the user answer the questions raised above.)

Solutions to Knowledge Check Questions

1.

a. Incorrect. Comparability was a major concern of FASB, and they specified that cash flows be presented in specific categories on the face of the statement.
b. Correct. The activity method was chosen as the required method to improve comparability. This method groups inflows and outflows of cash by broad classifications, such as investing and financing.
c. Incorrect. The cash flow guidance requires firms to categorize the inflows and outflows of cash as operating, investing, or financing rather than simply listing all cash inflows and all cash outflows.
d. Incorrect. FASB specifically rejected the all-financial resources and required firms to show noncash transactions outside the cash flow statement.

2.

a. Incorrect. By definition, a cash equivalent must not be subject to significant changes in value.
b. Correct. To qualify as a cash equivalent an asset must not be subject to significant changes in value due to changes in market prices or interest rates. FASB decided that a maturity of less than three months should meet this qualification.
c. Incorrect. Only assets can qualify as cash equivalents. The board did not permit firms to base cash equivalency on cash management practices.
d. Incorrect. Cash equivalents must not have significant interest rate risks.

3.

a. Correct. Netting is permitted if the criteria specified in the standard are met, but netting is not required.
b. Incorrect. Netting is permitted in limited circumstances even though the board believes gross information is a more useful presentation approach.
c. Incorrect. Netting is permitted, but not required, when specific criteria of a maturity of three months or less are met.
d. Incorrect. Netting guidance applies only to the investing and operating categories.

CHAPTER 3

Quick Exercise 3-1 Solutions

You would classify these transactions as follows:

1. A purchase of a building – Purchase of a building is an investing outflow, assuming cash is paid.
2. The payment of dividends – Payment of dividends is a financing outflow. Receipt of dividends is an operating inflow.
3. Cash received from customers – Cash received from customers is an operating inflow.
4. The purchase of another business entity for cash – The purchase of another entity is an investing outflow. The individual assets and liabilities acquired are taken into account in the analysis done for the statement of cash flows.
5. Cash paid for treasury shares – The purchase of treasury shares is a financing outflow.
6. Income tax payments – Income tax payments are all classified as operating outflows. The guidance does not require a separation of the tax effects associated with investing and financing items, or even of discontinued operations.
7. Insurance settlement received on inventory damaged by a flood – The insurance settlement on the inventory damage is an operating cash inflow, subject to separate disclosure.

Quick Exercise 3-2 Solutions

1. The loan is a financing inflow.

   The cash paid for the building is an investing outflow.
   The interest paid is an operating outflow.
   All of these classifications are clearly specified in the guidance.

2. The $50,000 is an investing outflow.

   The $450,000 is shown on the schedule of noncash transactions.
   Only cash inflows or outflows appear on the statement of cash flows.

3. The $600,000 is an investing outflow. The firm made the entire payment during the year and we treat the transaction as a cash purchase. The interest paid is operating.

   The firm would show a $200,000 investing outflow. There would also be $400,000 shown on the schedule of noncash transactions. Remember that the firm must report the $400,000 of debt on the year-end financial statement. The interest paid is operating.

Comprehensive Exercise 3-1 Solutions

You would normally classify these transactions as follows:

1. Sale of common stock is a financing inflow (assuming this is the sale of the entity's own common stock). It is an investing inflow if it represents the sale of stock held for investment purposes.
2. Expenditures for research and development are operational outflows. Note the classification difference with the building purchase even though generating future profits is the reason for the expenditure.
3. Interest earned on long-term investments (to the extent received in cash) is an operating inflow. There is some concern about the consistency of this treatment. The sale of an investment is an investing inflow. One difference is that firms receive interest payments regularly, but sell investments less frequently.
4. The gain on the sale of an old plant is a noncash amount. The cash flow from the sale itself is reported in the investment section. Subtract the gain from net income if the indirect method is used to determine cash provided by operations. Under the direct method, the gain is not considered because it is a noncash item. The gain would show up on the required reconciliation to net income.
5. Investments in short-term T bills are typically cash equivalents (assuming a maturity of three months or less). There is no inflow and outflow information disclosed. If these are not cash equivalents, these investments are investing outflows. Only the net change needs to appear in the investing section of the statement.
6. Acquisitions of inventory items are operating outflows when the payments are made to suppliers.
7. Treasury stock purchases are financing cash outflows. This is the purchase of the entity's own stock, and thus financing (even if done for investment purposes).
8. Insurance settlements are classified based on the nature of the loss. Most insurance settlements are operating, but it is important to review carefully the reason for the settlement. For example, insurance proceeds from a building fire are investing inflows, just as if you sold the building. Insurance proceeds from an inventory loss are operational, although they may be in a separate operating category.
9. The borrowing is a financing inflow even though it was specifically for the purposes of an investment transaction. This is no different from borrowing using a bank note and using the proceeds to acquire a machine. Several limited exceptions related to futures contracts are permitted.
10. Capitalized interest is part of the investing outflows, just as payments to the manufacturer of a machine are investing outflows. This is an exception to the normal treatment for interest, just as this amount is not a period expense on the income statement.
11. The proceeds from a sale of a business are investing inflows. More detail on this classification is found in the operating chapters.
12. Technically the borrowings and repayments under an open line of credit are financing transactions that should be reported gross. Practically, firms argue these are financing transactions due on demand that have a practical maturity of three months or less. If accepted, this allows the presentation of these items net in the financing section. In practice, most firms do present line of credit changes on a net basis.
13. The cash received in a settlement of a corporate-owned life insurance policy is a cash inflow from investing activities. Note that the premiums on these policies may be classified as investing outflows, operating outflows, or a combination of the two.
14. A strong case for treating the deposit as an investing outflow, particularly if there is a separate balance sheet classification. This restriction is probably sufficiently strong to merit not including the sinking fund cash as part of cash equivalents (although this is where the GASB suggested restricted cash amounts be placed). The debt is not yet retired, so the item is not a financing outflow.
15. The sale of the stock is an investing inflow. Although this is much like a sale of the entity's own stock, the subsidiary stock is an investment of the entity.

16. The loan is an investing outflow unless analysis shows that it is actually a dividend payment and it has been shown this way in the statement of financial position. There should be basic classification consistency across statements for this type of transaction. An argument could also be made for classifying this as an operating item—wages.
17. The cash received from the subsidiary is a financing inflow on the separate statements of the firms. Eliminate this item on consolidated statements.
18. The interest is an operating cash inflow.
19. The cash paid for these buildings represents an operating cash outflow. These buildings are the inventory of this particular company. An argument could be made that these are investments because this is where most firms record building acquisitions. However the operating classification is more appropriate in this situation.
20. The sale of the stock is an investing inflow. The receipt of the stock dividends has no cash flow effect.
21. The write-down would result in no cash flow effect and no inflow or outflow. It is part of the reconciliation.

Comprehensive Exercise 3-2 Solutions

1. The purchase and sale of "available for sale" equity instruments.

   These transactions are part of the investing category. The "available for sale" category includes debt and/ or equity securities that are carried at fair value, but the acquisitions and sales are not considered operating.

2. Receipts of a donation by a nonprofit that will be used to establish a permanent endowment whose earnings can be used only to acquire or improve long term tangible assets.

   The donation would be classified in the financing section. It is similar to a business entity issuing additional stock.

3. Proceeds from the sale of a derivative instrument that included a financing element at its inception.

   The proceeds represent a financing inflow. The financing element is simply another way of issuing debt for the entity.

4. Cash debt issue costs paid.

   Debt issue costs are typically treated as a reduction of the proceeds from debt financing and thus are part of financing and are included in that category on the statement of cash flows.

5. Signing a long term lease obligation that will require payments at the end of the next 10 years.

   This is a non-cash transaction at the time the lease is signed because no cash changed hands.

6. Insurance proceeds received because a building was destroyed by a flood. The firm plans to use the proceeds to buy inventory.

   The cash inflow is classified as an investing inflow. The firm involuntarily relinquished its ability to use the building and was compensated for the loss. When the firm buys inventory this will be an operating outflow.

7. A firm prepays its debt obligations to reduce future interest costs.

   The prepayment seems to be financing, because it eliminates the outstanding principle on its debt. However, some firms have treated this type of transaction as operating because they see it analogous to interest payments.

8. Settlements of zero coupon debt.

   The portion of the cash payment attributable to accreted interest is an operating cash outflow. The principle portion is a financing outflow.

9. Payments for contingent liabilities identified at the time of a business acquisition that are made significantly after the acquisition date.

   The cash paid up to the recognized contingency is a financing activity and any excess is an operating cash outflow.

10. Dividends received from equity method investees.

    The entity may use the cumulative earnings approach where amounts received are operating, unless the distributions exceed the earnings since the investment, where amounts are investing inflows. The entity may also choose the nature of the distribution approach (as discussed in the chapter text).

11. Cash receipts and payments that have aspects of more than one class of cash flows.

    Unless specific guidance exists, classify based on the nature of the underlying cash flows. If the proper classifications cannot be separately identified use the predominant source of the cash flow as a guide for classification.

Comprehensive Exercise 3-3 Solutions

1. If substance were the basis for classification, it would seem logical to report the transaction as follows:

Investing activities, outflows		
Cash paid to lease plant	$100,000	
Capital lease obligation to acquire plant	1,500,000	$1,600,000
Financing activities, inflows		
Lease obligation to acquire plant	$1,500,000	

   However, the cash flow guidance specifically excludes this type of noncash transaction from the body of the statement. Instead the following presentation would be used.

Investing activities	
Cash paid to lease plant	$100,000
Schedule of noncash activities	
Capital lease obligation for plant	$1,500,000

2. The treatment would be the same as shown in situation one. The $500,000 would be an investing outflow, and the $300,000 is part of the schedule of noncash activities. The distinction of the $300,000 as a noncash item seems somewhat artificial. It could be argued that separate disclosure of the $300,000 just clutters the statement and that reporting an $800,000 outflow for productive assets

and a $300,000 inflow from a mortgage note would be equally informative. This approach is not acceptable.

3. There would be practical merit in simply reporting that $3,000,000 was used to acquire buildings. The financing section could distinguish the three different types of financing methods used to acquire the buildings by reporting each as cash inflows. However, the guidance requires the lease and the short-term note acquisition to be part of the noncash schedule. This type of artificial distinction may lead to checks changing hands in many situations.
4. Following the guidance literally, Smooth would show an $80,000 investing outflow (which is not part of the cash paid for capital expenditures). Smooth would also show a noncash transaction for the $400,000.

   One could argue that Smooth borrowed $400,000, and that Smooth should show a financing inflow and a counterbalancing $400,000 outflow. Smooth could have gotten the cash from Big Finance rather than having it sent directly to Capital.

Supplemental Problem 3-1 Solutions

1. There is merit to the argument that this type of transaction is a financing activity. After all, that was the intent of management. However, this same argument can be made for many common investing transactions. There is also merit to having consistency of classification in cash flow statements. This is the approach FASB adopted in the cash flow guidance. Nothing prohibits management from specifically commenting on why it completed various cash transactions.
2. Treasury stock transactions are specifically identified in the guidance as financing activities. Although management may have made the acquisition for investment purposes, accounting has normally treated transactions in the equity securities of the entity in a different manner than normal investments.
3. There is merit to the argument that this type of sizable prepayment may be made for investment purposes. However, one of the functions of the cash flow provided by operations classification on the cash flow statement is to show how accrual-based income differs from cash inflows and outflows. The payment now involves a cash flow and will thus reduce future cash flows. Therefore, it seems logical to show this type of transaction as operating, as required by the guidance.
4. There is substantial merit to this suggestion. The classification scheme that is utilized in the guidance is somewhat arbitrary and artificial. A classification scheme based on the nature of the item and perhaps different terminology from "cash provided by operations" might minimize some presentation issues. If there were significant differences between what was included in determining net income and the operating cash flows, there would be less concern for a "cash flow per share" number, and less fear of a "cash-based income statement."

Supplemental Problem 3-2 Solutions

1. The financing outflows should show $7.5 million for the repayment of long-term debt. The loss on the retirement is part of the reconciliation of net cash flow from operations and net income.
2. The only cash flow that takes place is the $5 million dollar outflow for the U.S. government securities. In a normal situation, these are investing outflows on the statement of cash flows. In this situation, the use of the securities as part of an in-substance defeasance means that they were acquired to effect a debt retirement (through the establishment of a dedicated trust that has responsibility for making the actual interest and debt repayments). The $5 million would logically seem to qualify as a financing outflow under these circumstances, but the cash flow guidance does not seem to permit this type of classification.

   The schedule of noncash investing and financing activities would have to include a disclosure that $5 million in investments and $5.75 million in long-term debt transferred to a trust in an in-substance defeasance and that a $750,000 gain resulted.

3. The gains and losses are noncash flows and ignored in the operations section when using a direct method presentation. If and when the cash is expended for the new equipment, this cash outflow will be an investing outflow. The $1.5 million cleanup costs associated with the flood are most logically classified as investing outflows, because the costs were incurred in conjunction with plant and equipment. Cash inflows related to these items are investment activities. However, as a practical matter this type of loss is a period expense, even though extraordinary, and thus classified as operating.

Supplemental Problem 3-3 Solutions

1. The payment made on the lease is an investing outflow and the interest is an operating outflow. The remainder of the lease is shown on the schedule of noncash activities.
2. The cash received is an investing inflow and the interest is an operating inflow. The remainder of the transaction is on the schedule of noncash activities.
3. The cash received is operating rather than investing. No disclosure is required on the schedule of noncash activities.
4. These payments are not part of the operating activities of the entity. They are investing cash flows. Often only the net change appears in the investing section. The lessor often receives and pays out these amounts within a three-month period.

Solutions to Knowledge Check Questions

1.

a. Incorrect. Although substance is usually the basis for classification decisions in financial statements, it is generally not the most important basis for determining how to classify a cash flow.
b. Correct. The form of a transaction, rather than why the transaction took place is the primary basis for classification in the statement of cash flows. FASB felt comparison across statements was enhanced by this approach.
c. Incorrect. Management intent has no standing in determining how an item should be classified on the statement of cash flows.
d. Incorrect. Investor interests have no standing in determining how an item should be classified on the statement of cash flows.

2.

a. Correct. Cash interest payments should be treated as operating rather than as financing.
b. Incorrect. One controversial classification decision made by FASB was not to treat cash interest payments as financing.
c. Incorrect. Interest paid or received does not represent an investing activity.
d. Incorrect. Interest payments are cash outflows and thus do not represent noncash transactions.

3.

a. Incorrect. Using the rules specified in the standard, the cash portion of the purchase of the productive asset is treated as investing but not the related repayment of the debt.
b. Correct. Although the cash portion of the installment purchase of the productive asset is treated as investing, the repayment of debt is treated as financing.
c. Incorrect. The repayment of debt is not an operating activity.
d. Incorrect. The repayment is a cash outflow and therefore does not represent a noncash transaction.

4.

a. Incorrect. Significant modification of the classifications used on the statement of cash flows and other financial statements are anticipated.
b. Correct. A tax section is expected to be included.
c. Incorrect. A discontinued operations section is expected to be included.
d. Incorrect. A business section with separate operating and investing categories is expected to be used.

5.

a. Incorrect. Firms use a wide variety of disclosure approaches to report noncash transactions. A separate schedule is but one of the options.
b. Incorrect. Activities not involving cash flows may not be presented within the body of the cash flow statement.
c. Correct. A narrative presentation is one of the options that firms may use to disclose noncash activities.
d. Incorrect. Disclosure of significant noncash activities is required.

Chapter 4

Quick Exercise 4-1 Solutions

1.

a. Depreciation on equipment – Depreciation is added back to net income.
b. A gain on the sale of common stock – A gain is subtracted from net income.
c. An increase in inventory – An increase in inventory is subtracted from net income.
d. A loss on the sale of a plant – A loss is added to net income.
e. An increase in accounts payable – An increase in accounts payable is added to net income.

2.

a. The depreciation is a noncash expense that allocates the cost of a fixed asset to expense over the life of the asset. The cash outflow occurred when the equipment was paid for, often at the time it was purchased.
b. The cash flow is the amount received from the sale of the stock and would be part of the investing section. The gain is a measure of the amount over the book value that was received and included in the investing cash flow. The gain increased income but did not result in a cash inflow, so it must be subtracted to arrive at the cash from operations amount.
c. If inventory was purchased for cash, more cash was used than the amount expensed as part of cost of sales, thus it is necessary to reduce net income because of the greater outflow.
d. A loss indicates that less cash was received on the sale than the carrying value of the plant. The cash received is part of investing cash flow. The loss is a noncash amount and thus must be added because it reduced net income.
e. Since accounts payable rose, the firm owes more and did not use cash to pay for the increased amount owed. This means the cash from operations will be larger by the amount of the increase.

Quick Exercise 4-2 Solution

Indirect Direct Method Cash from Customers – Derived by Changes in Balances

Beginning Balance	32,150
Sales	87,500
Less ending balance	(67,250)
	52,400
Transactions with those other than customers	
Acquisition	10,000
Change in noncustomer receivable (HIJ Suppliers)	1,800
Account reduction from factoring	(6,400)
Cash from Customers	57,800

Comprehensive Exercise 4-1 Solutions

1. Gain on the disposal of discontinued operations – A noncash item that we must subtract out because it increased net income. Report the cash received from this sale in the investing section as a cash inflow.
2. Depreciation and amortization – The cash flows occurred when the firm acquired the long-term assets being depreciated or when the firm repaid the debt used to purchase the assets. The expense amounts are simply cost allocations that require no direct cash outflow.
3. Provisions for losses on accounts receivable – Represent a noncash expense that we must add back. The net income went down, but the firm did not pay out any cash. The total cash collected from customers will differ because these loss provisions may not be accurate.
4. Deferred taxes – Base the amount of cash paid to the government on tax laws, not financial reporting rules (ignoring alternative minimum tax rules). For financial reporting purposes, expenses accrue (a more correct representation of what has occurred than the term deferral) prior to the time the tax is paid. This addition on the cash flow statement simply means that the firm paid less cash for taxes than it charged to expense in the income statement.
5. Loss on retirement of equipment – A noncash item that we must add back because it decreased net income but the firm did not pay out any cash.
6. Decrease in Accounts Receivable – Revenue recognition increases accounts receivables. Cash collection follows the revenue. If the receivables decrease by $452,000 during the year, then the firm collected more cash than it recognized as revenue. Note that this amount is different from the change in receivables on the balance sheet because of the purchase of another entity.
7. Increase in Inventories – Assume the firm purchases inventory for cash. A $6,000 increase in inventory means that the firm paid $6,000 more for inventory than it shows as an expense (cost of sales). On a cash basis this $6,000 is part of the "from operations" amount, so it is necessary to subtract this change.
8. Decrease in Accounts Payable – The change in accounts payable is often closely associated with the change in inventory and cost of sales. Assuming no change in inventory level, a $230,000 decrease in accounts payable means that the firm paid out more cash than it shows as cost of sales. Subtract the $230,000 to get the "cash from operations" figure.

Comprehensive Exercise 4-2 Solutions

1. The statement of cash flows guidance specifies that installment sales transactions that are for operating activities result in operating cash flows. The statement of cash flows would include the following for this transaction, assuming a direct method presentation.

Cash collected from customers	$150,000
Interest received	40,000

   Assume the firm recognized the entire amount of the sale as revenue, the reconciliation of operating cash flow to income would include a $350,000 subtraction for installment sales revenue not collected.

2. The investing outflows for plant construction total $2,100,000. The interest outflow in the operations section is $300,000. Capitalized interest is an investing item.
3. The entire $600,000 is an operating cash outflow. Do not reduce the proceeds from the sale of the plant by the tax effects of the transaction. Significant tax payments or savings related to activities classified as financing or investing mean the firm should provide supplemental disclosures for users.
4. The premium payments may be classified as cash outflows for investing activities, operating activities, or a combination of these two types of activities. For example, a firm may choose to separate the risk cost and the cash value buildup. The receipt of a settlement for the vice president's death is a cash inflow from investing activities.

Comprehensive Exercise 4-3 Solutions

1. After examining the operating section of this statement the following comments might be made:
   - There is no specification that the firm is adjusting net income for items that did not require cash. This was an explicit requirement in the guidance.
   - The subheading, resources from operations, is questionable. Resources are like the general term "funds" and have no precise meaning in this context.

2. There are several questions that could be raised after examining this statement.
   - The statement starts with income from continuing operations, rather than net income.
   - There is no specification of why items are added back or subtracted as required by the guidance.
   - The split of equity income recognized from the dividends received makes it much easier to understand the reconciliation. This is a good presentation approach.
   - The sale of consolidated subsidiary and investments is apparently a gain (but this is not clear from the wording in the statement).
   - The disclosure of the operating cash flow from discontinued operating activity is helpful.
   - The initial cash provided by operations number shown on the statement is not actually cash from operations. It seems to be working capital from operations.
   - The statement seems to be a mixture of cash and working capital within the operating section.

Supplemental Problem 4-1 Solutions

1. The sale of automobiles by a rental car company is logically an operating item. Although the automobile sales are not the primary business of the firm, the cash flows from these sales are an important part of the overall operating activities of the firm. The sales are also regular enough to qualify as a second line of business for the firm. The firm is in the used car business. In addition, car rental companies typically classify automobiles as inventory.

There is also a case for classifying the sales as investment inflows. The automobiles represent productive assets needed to operate the primary business of the firm (renting cars). The guidance specifically identifies long-term assets sales as investment activities. **Note.** This is the classification if the firm has a large fleet of cars used by salespersons.

2.
   a. The expenditures for inventory and materials used in repair activity are operating. The cash paid for new plant construction inventory and materials is investing.
   b. Make an estimate of the portion of the inventory and materials that the firm will use for repair and construction activities. Base the estimate on past experience and current levels of repair and construction activities. Reasonable estimates are adequate for reporting purposes.

3. The cash expenditures for these inventory items that are part of airplanes awaiting completion are operating. The business of the airplane manufacturing company is to make airplanes. The fact that the operating cycle is more than a year does not change these inventories into long-term productive assets. Use the same classification for the related projects, unless the expenditures were for plant or other long-term productive assets.
4. The cash loan to a supplier is normally an investing outflow. In this case, you could make a strong case that the cash outflow is a prepayment for the acquisition of inventory. Treat the loan as an operating outflow. This approach eliminates the problem of how to handle the noncash repayment in the schedule of noncash activities.

Solutions to Knowledge Check Questions

1.

a. Incorrect. The operating section does not only include cash inflow and cash outflow items specifically identified as operating.
b. Incorrect. The operating section includes interest paid to creditors.
c. Incorrect. Dividends paid on the company's own stock is part of the financing section.
d. Correct. This is the default classification and is used for items that are not defined as investing or financing.

2.

a. Incorrect. The standard specifies the minimum, not maximum, number of cash inflow and outflow line items that must be included.
b. Incorrect. All operating cash outflows except interest and taxes may be combined into a single line item on a direct method statement.
c. Incorrect. Interest paid and taxes paid should both be shown as separate line items in a direct method presentation.
d. Correct. A reconciliation schedule is required when the direct method is used because there are only minimal direct method line items required.

3.

a. Incorrect. The wide variety of addbacks and subtractions generally make the indirect method more difficult to explain to nonaccountants.
b. Incorrect. The indirect method focuses attention on differences in income and cash flow items.
c. Correct. The indirect method uses a reconciliation to show items that are not cash flows, but are included in income.
d. Incorrect. Two of the previous answers are incorrect.

4.

a. Incorrect. The cost of systems modification to accumulate actual cash inflows and outflows is a concern.
b. Incorrect. Many suggest there will be increased audit costs if the direct method is required.
c. Correct. Users indicate that analysis will be easier and quicker, thus lowering costs.
d. Incorrect. The cost of education and training has been raised as a concern.

5.

a. Correct. The indirect direct method may be used in place of actual cash inflow and outflow data, making this statement incorrect and thus the correct response here.
b. Incorrect. This statement is correct. Items must be put into the appropriate categories.
c. Incorrect. The use of the indirect method is allowed, making this a correct statement.
d. Incorrect. There are only minimal line item disclosures specified for the direct method and it is permissible to combine all operating cash outflows except interest and taxes into a single line item.

CHAPTER 5

Quick Exercise 5-1 Solution

Inventory				
Beginning inventory		100,000		
From subsidiary acquisition		15,000		
Cost of goods sold		(420,000)		
Write-down		(5,000)		
Ending inventory		(120,000)		
Purchases of inventory		(430,000)	Calculated	
Accounts Payable				
		Adjustment		
Beginning balance	90,000	(2,000)	88,000	
Subsidiary acquisition			5,000	
Purchases of inventory			430,000	
Less ending balance	130,000	(1,000)	(129,000)	
Cash paid for inventory			394,000	Calculated

Indirect

Subtract $10,000 for inventory increase net of write-downs and acquisition.

Add $36,000 for accounts payable increase.

Check

Cost of goods sold expense was $420,000 + $10,000 – 36,000 = $394,000 paid for goods.

If income had been a negative $420,000, the adjustments would have made it a negative $394,000 cash outflow.

Quick Exercise 5-2 Solution

The net income each year will be $10,000 ($30,000 Rent – $20,000 depreciation) for a total of $50,000 of income over five years.

The operating cash flows each year will be $30,000 ($10,000 net income + $20,000 noncash expense) (or $30,000 cash from customers less no expense). This makes the total cash from operations $150,000 over five years.

The $100,000 difference is because the cash outflow for the equipment is classified as investing, not as operating.

Note: This is one area where a change is expected when financial reporting presentation requirements are implemented.

Quick Exercise 5-3 Solutions

1. The cash received from the discounting activity is part of operating cash inflows.

   The following could be shown on a direct method statement. It is permissible to combine the first two items.

Cash received from customers	$ 465,000
Cash received from discounting customer notes	280,000
Cash interest received	29,000

Computation

$800,000 – $300,000 = $500,000 – $35,000 rec. increase = $465,000

The following could be shown in the reconciliation.

Net income XXX	
Adjustments	
Increase in customer notes	(35,000)
Loss on discounting customer notes	20,000

2. The cash collected from customers totals $709,000. The computation is as follows:

Accounts Receivable – Net

Beginning balance	$ 93,000
Sales on account	700,000
Bad debt entry reduces net receivable	(31,000)
	762,000
Ending balance	(53,000)
Collections	$709,000

The write-off has no effect on the net receivable balance.

For the reconciliation ignore the $31,000 bad debt expense, because the net change in accounts receivable already reflects this noncash item. Only the $40,000 change in net accounts receivable, the increase, is subtracted from net income. The firm did not collect this amount of cash, but it did recognize the sales as revenue.

To illustrate, assume that bad debts were the only expense.

Revenue	$700,000
Expense	(31,000)
Net income	669,000
Decrease in receivables	40,000
Cash from operations	$709,000

Comprehensive Exercise 5-1 Solutions

1. The firm is a construction company, so the cash inflows and outflows related to construction activities are operating.

   On a *direct method* statement the $500,000 cash received is an operating inflow. The $700,000 paid out is an operating outflow.

   On an indirect method statement (or in the reconciliation) you subtract the $300,000 increase in receivables (billed or unbilled) from net income. The $100,000 difference between the amount expensed and the amount spent is also subtracted from the net income. Assuming this was the only contract, the net income would be $200,000. There would be $400,000 of adjustments resulting in a cash outflow from operating activities of negative $200,000.

2. The cash collected from customers totals $311,000. You compute this as follows:

Accounts Receivable – Net

Beginning balance	$50,000
Sales on account	350,000
Bad debt entry reduces net receivable	(24,000)
	376,000
Ending balance	(65,000)
Collections	$311,000

The write-off has no effect on the net receivable balance.

For the reconciliation, you may ignore the $24,000 bad debt expense. The net change in accounts receivable already reflects this noncash item. Only the $15,000 change in net accounts receivable, the increase, is subtracted from net income. This is the amount of cash not collected, but included in income.

To illustrate, assume that bad debts were the only expense.

Revenue	$350,000
Expense	(24,000)
Net Income	326,000
Increase in receivables	(15,000)
Cash from operations	$311,000

3. The dividends received of $50,000 are operating inflows.

   On the reconciliation subtract the equity income of $140,000 and add the $50,000 of dividends received.

4. The cash taxes paid are $191,000

Expense	+ Increase deferred	– Increase in tax asset payable
$200,000	+ $5,000	– $14,000

   On the reconciliation subtract the $5,000 and add the $14,000 back to the net income.

5. There would be an investment outflow of $520,000 (the building cost plus 20 percent of the interest). There is an investing inflow of $60,000 for the sale of the building.

   Within the operating section there is an $80,000 interest outflow.

   On the reconciliation the loss of $20,000 is added back to net income.

6. The $40,000 paid out for the insurance premium is an operating outflow. The difference in the amount paid and the increase in cash surrender value is an expense. The $250,000 received after the accident is an operating inflow, but classified in the other inflow category.

   There is only $30,000 of insurance expense, so you subtract the additional $10,000 in premium paid from net income.

   The income statement shows a gain for the difference between the $250,000 and the cash surrender value of the policy. Subtract the gain in the reconciliation. Show the $250,000 inflow shown in a direct method operating statement.

7. The write-down has no cash flow effect and is not reported on a direct method statement. Add back the $200,000 to net income using the indirect method.

Comprehensive Exercise 5-2 Solutions

1. The cash inflow from the sale of the receivables is an operating inflow. This is similar to regular collection, but separate disclosure is desirable if the amounts are material.
2. All cash received is operating. The cars are inventory items for the dealer, so this type of installment is operating.
3. Both of the gains are noncash items and subtracted in the reconciliation. The cash received for the income tax refund is an operating inflow, and the cash paid to extinguish the debt is a financing outflow.
4. If this is the sale of a normal inventory item, all of the cash inflows are operating. The portion of the cash received that represents interest (which is imputed) is separated within the statement of cash flows.
5. All of the cash received is operating because the sale of computers is the company's business.
6. These purchase and sales of these securities are considered operating outflows because they occur within a trading account. The firm could choose to show a $20,000 net in a direct method operating section or show the gross inflows and outflows. Some firms argue that these types of transactions are really investments and have chosen to show them in the investing section gross.
7. The payments to the former employees would be operating outflows. Terminating employees does not represent any type of segment disposal.
8. This type of unrestricted donation would be reported in the operating section of the cash flow statement. Likewise the donations would be treated as revenue in the "income statement." If the donor had restricted the use of the sale proceeds to long-term assets, the cash flow would be part of financing.
9. Although the purchase of equipment it typically classified as part of the investing section of the statement of cash flow, some firms have argued that the type of transaction illustrated here should be considered operating, particularly if it is a regular activity for the firm.
10. Mega Company has disposed of a segment of the business and the cash inflow would be shown as an investing inflow on the statement of cash flows. The operating related to this segment prior to the sale would be part of operating cash flows. Information about these operating cash flows should be disclosed.

Comprehensive Exercise 5-3: Classification Issues

1. XYZ Company has a 30 percent interest in ABC Company which it accounts for using the equity method. ABC paid a large special dividend during this reporting that was three times the regular dividends that XYZ has been receiving.

   There is diversity in practice about the classification of cash payments received from equity method investees and whether the payments represent a return on investment, which is an operating activity in the statement of cash flows, or a return of investment, which is an investing activity.

2. A consulting firm has chosen to carry life insurance policies on all of its partners to help protect itself against the loss of their expertise. The company is the beneficiary of the policy and receives the proceeds when there is a death.

   Some entities classify the insurance proceeds as cash flows provided by an operating activity because the proceeds are used to reduce overall employment expenses, but others classify the insurance proceeds as cash flows provided by an investing activity because the insurance policy is being used as an investment strategy.

3. Investor Company completed the acquisition of a private company last year. As part of the acquisition Investor agreed to pay key executives of the acquired firm, who were also the firm's former owners, an additional $1 million dollars if several key performance benchmarks were met.

   There is diversity in practice about the classification of cash payments for contingent consideration made subsequent to a business combination. Topic 230 not does provide explicit guidance as to whether these cash payments should be classified as operating, investing, or financing activities.

4. Debtor company raised cash by issuing zero coupon bonds early in the year. Later in the year there was an unexpected drop in interest rates and Debtor Company repurchased the bonds.

   Some entities concluded that the settlement of a zero coupon bond is only a repayment of principal and should be classified as a financing activity. Other entities concluded that there is an interest component that should be displayed as an operating activity and the principal repayment as a financing activity.

Comprehensive Exercise 5-4 Solutions

Direct Method

Amounts on the direct method statement are coded by number to computation used to obtain that amount provided below.

Gam Company Statement of Cash Flows For the Year Ending December 31, 20X2		
Cash Flows from Operating Activities		
Inflows		
1. Cash collected from customers		$1,775,000
Outflows		
2. Cash paid for operating expenses	$1,570,000	
3. Interest paid	20,000	
4. Taxes paid	60,000	1,650,000
Net cash flows provided by operating activities		125,000
Cash Flows from Investing Activities		
Inflows		
5. Sale of machinery and equipment		20,000
Outflows		
6. Purchase of entity	75,000	

Gam Company Statement of Cash Flows For the Year Ending December 31, 20X2 (continued)		
7. Cash cleanup costs on flood	10,000	
8. Acquisition of buildings for cash	20,000	
9. Purchase of machinery and equipment	70,000	
		175,000
Net cash flows used in investing activities		(155,000)
Cash Flows from Financing Activities		
Inflows		
10. Common stock sold	25,000	
11. Long-term debt issued for cash	60,000	
		85,000
Outflows		
12. Long-term debt repaid	30,000	
13. Dividends paid	20,000	
14. Net decrease in short-term borrowing	10,000	
		60,000
Net cash flows from financing activities		25,000
Decrease in cash and cash equivalents		(5,000)
Beginning cash		45,000
Ending cash		$40,000
Schedule of Noncash Activities		
Buildings were acquired with the issuance of $10,000 in long-term bonds.		

Indirect Method

Gam Company Statement of Cash Flows For the Year Ending December 31, 20X2		
Cash Flows from Operating Activities		
Net income	$90,000	
Adjustments needed to reconcile net income to net cash provided by operating activities		
Depreciation	35,000	
15. Flood loss	25,000	
Gain on sale of machinery	(10,000)	
Increase in noncurrent receivables	(5,000)	
Increase in deferred taxes	10,000	
Change in current assets and liabilities, net of purchased amounts		
Increase in current receivable	(10,000)	
Increase in inventory	(20,000)	
Increase in accounts payable	20,000	
Decrease in accrued liabilities	(5,000)	
Decrease in taxes payable	(5,000)	
Net cash flow from operating activities	$ 125,000	
Cash Flows from Operating Activities		
Inflows		
5. Sale of machinery and equipment		20,000
Outflows		
6. Purchase of entity	$75,000	
7. Cash cleanup costs on flood	10,000	
8. Acquisition of buildings for cash	20,000	
9. Purchase of machinery and equipment	70,000	175,000
Net cash flows used in investing activities		(155,000)

Gam Company Statement of Cash Flows For the Year Ending December 31, 20X2 (continued)		
Cash Flows from Financing Activities		
Inflows		
10. Common stock sold	$25,000	
11. Long-term debt issued for cash	60,000	85,000
Outflows		
12. Long-term debt repaid	$30,000	
13. Dividends paid	20,000	
14. Net decrease in short-term borrowing	10,000	60,000
Net cash flows provided by financing activities		25,000
Decrease in cash and cash equivalents		(5,000)
Beginning cash		45,000
Ending cash		$40,000
Schedule of Noncash Activities		
Buildings were acquired with the issuance of $10,000 in long-term bonds.		

Explanation of Amounts on Direct Method

1.

Beg. acc. rec. – current	$ 215,000
+Beg. acc. rec. – noncurrent	10,000
+Sales	1,790,000
+Acc. rec. acquired in entity purchase	10,000
End. acc. rec. – current	(235,000)
End. acc. rec. – noncurrent	(15,000)
Cash collected from customers	$1,775,000

2.

Cost of sales	$1,090,000
+ Selling and administrative expenses	510,000
Depreciation expense	(35,000)
+ Increase in inventory net of inventory acquired in purchase	20,000
Increase in accounts payable net of payables acquired in purchase	(20,000)
+ Decrease in accrued liabilities	5,000
Cash paid for operating expenses (suppliers, employees and administration)	$1,570,000

3. Given, since there was no accrual or prepaid interest
4.

Tax expense	75,000
Tax savings on extraordinary item	(10,000)
+ Decrease in taxes payable	5,000
Increase in deferred income tax	(10,000)
Taxes paid	60,000

5. Given
6. Given
7. Given
8. Given
9. Given – example of how to compute if necessary

Beg. mach. and equipment	$225,000
+ Machinery acquired in entity purchase	30,000
Machinery sold	(15,000)
End. mach. and equipment	(310,000)
Machinery and equipment purchased	$ (70,000)

10. Given
11.

Beg. long-term debt	160,000
Debt repaid	(30,000)
+ Debt issued for building	10,000
End. long-term debt	(200,000)
Bonds issued for cash	(60,000)

12. Given
13. Given
14. Change in short-term debt on balance sheet

Explanation of Additional Amounts on Indirect Method

15.

Extraordinary loss	15,000
+Tax savings on extraordinary item (part of net decrease in taxes payable)	10,000
Flood loss	25,000

Remember extraordinary loss on income statement is net of tax effect.

Cash Inflow Account Analysis

[1]

Sales-net	1,790,000
Trade receivables-net – (Inc.) Dec.	(15,000)
Unearned revenue – Inc. (Dec.)	—
Cash from customers	1,775,000

[2]

Interest revenue	—
Accrued interest rec. – (Inc.) Dec.	—
Interest rec. – advance – Inc. (Dec.)	—
Cash interest	—

[3]

Dividend revenue	—
Investment income	—
Dividends receivable – (Inc.) Dec.	—
Investments-equity method – (Inc.) Dec.	—
Cash dividends received	—

Cash Inflow Account Analysis

[4]

Other income – xxxx	—
A-I-xxxx – (Inc.) Dec	—
L-I-xxxx – Inc. (Dec.)	—
Cash from xxxx	—

[5]

Cost of sales	(1,055,000)
Inventory – (Inc.) D	(20,000)
Acc. pay. – trade – Inc. (Dec.)	20,000
Cash paid to suppliers	(1,055,000)

[6]

Salaries and benefits	—
Prepaid wages – (Inc.) D	—
Wages payable – Inc. (Dec.)	—
Cash paid to employees	—

[7]

SG&A expenses	(510,000)
Misc. prepaids – (Inc.) D	—
Misc. payables – Inc. (Dec.)	(5,000)
Cash paid for SG&A	(515,000)

Cash Inflow Account Analysis

[8]

Interest expense	(20,000)
Premium (discount) amortization	—
Prepaid interest exp. – (Inc.) D	—
Accrued interest exp. – Inc. (Dec.)	—
Cash interest paid	(20,000)

[9]

Income tax expense	(65,000)
Prepaid income tax – (Inc.) D	—
Income tax payable – Inc. (Dec.)	(5,000)
Deferred tax asset – (Inc.) D	—
Deferred tax liability – Inc. (Dec)	10,000
Cash income tax paid	(60,000)

[10]

Other expense – cccc	—
A-L-cccc – (Inc.) D	—
L-L-cccc – Inc. (Dec.)	—
Cash paid-cccc	—

[11]

Net cash – segment operations	—
Oper. seg. receivables	—
Oper.	—
Cash received (paid) sold segment	—

Note. Cash paid for operating expenses is the sum of 6, 7, and 8.

Supplemental Problem 5-1 Solutions

Direct Method

Ben Company
Statement of Cash Flows
For the Three Months Ending March 31, 20X2

Cash flows from operating activities		
1. Cash received from customers	$ 212,207	
2. Interest collected	4,300	
3. Dividends from equity investment	2,000	
Cash provided by operations		$ 218,507
4. Cash paid for production costs	137,797	
5. Cash paid for general and administrative costs	20,710	
6. Interest paid	1,000	
7. Income tax paid	24,636	
Cash disbursed for operating activities		184,143
Net cash flows from operating activities		34,364
Cash flows from investing activities		
8. Cash received from sale of land	32,000	
9. Cash received from sale of equipment	10,400	
10. Sale of treasury bills	189,200	
11. Cash used to acquire equipment	(81,500)	
12. Purchased treasury bills	(180,000)	
Net cash flows used in investing activities		(29,900)
Cash flows from financing activities		
13. Cash received from issuance of bonds payable	90,000	
14. Cash used to retire bonds	(25,000)	
15. Cash used to pay dividends	(15,364)	
Net cash flows provided by financing activities		49,636
Net increase in cash and cash equivalents		54,100
Beginning cash and cash equivalents		17,300
Ending cash and cash equivalents		$ 71,400
Schedule of noncash investing and financing activities		
16. Common stock issued in conversion of preferred stock		$ 30,000
Financing of bond		25,000

A reconciliation of net income to net cash provided by operating activities should also be represented.

Indirect Method

Ben Company
Statement of Cash Flows
For the Three Months Ending March 31, 20X2

Cash flows from operating activities		
Net income		$59,382
Adjustments needed to reconcile net income to net cash flows from operating activities		
Depreciation	$3,250	
Interest amortization	150	
Deferred taxes	336	
Equity income not collected as dividends	(3,880)	
		(144)
Nonoperational items included in income		
Gain on sale of equipment	(2,400)	
Gain on sale of land	(10,700)	
		(13,100)
Changes in current items		
Increase in accounts receivable	(25,000)	
Increase in inventory	(17,500)	
Increase in accounts payable	16,110	
Increase in taxes payable	14,616	
		(11,774)
Net cash flows from operating activities		34,364
Cash flows from investing activities		
Cash received from sale of land	32,000	
Cash received from sale of equipment	10,400	
Sale of treasury bills	189,200	
Cash used to acquire equipment	(81,500)	
Purchased treasury bills	(180,000)	
Net cash flows used in investing activities		(29,900)
Cash flows from financing activities		
Cash received from issuance of bonds payable	$ 90,000	
Cash used to retire bonds	(25,000)	
Cash used to pay dividends	(15,364)	
Net cash flows provided by financing activities		49,636
Net increase in cash and cash equivalents		54,100
Beginning cash and cash equivalents		17,300
Ending cash and cash equivalents		$ 71,400
Schedule of noncash investing and financing activities		
Common stock issued in conversion of preferred stock		$ 30,000
Financing of bond		25,000

Explanation of Amounts on Direct Method

The amounts are computed using only the information provided. It is not necessary to keep the books so you can directly provide the "cash collected from customers" or "cash used for various expenses." Reasonable approximation of these amounts can be obtained without a change in the accounting system. These estimates are as good as those used for the indirect format.

a. Sales less the increase in net accounts receivable less the increase in bad debts, which is really a reduction of net sales.

$238,507 – (49,320 – 24,320) – 1,300 = $212,207

b. Given
c. Given
d. Cost of sales less increase in accounts payable plus increase in inventory.

$136,407 – (37,330 – 21,220) + (48,590 – 31,090) = $137,797

e. General and administrative expense less $1,300 bad debts.
f. Interest less reduction in discount on bonds payable.
g. Income tax expense less increase in taxes payable and less increase in deferred taxes.

$39,588 – 14,616 – (846 – 510) = $24,636

h. Given
i. Given
j. Given
k. Sold all of equipment owned so must have acquired ending amount.
l. Given
m. The total of bonds refinanced and the increase in the account.
n. Given

13. Dividends declared would be known. Here are the computed and then deducted dividends not yet paid.

$83,100 + 59,382 – 119,118 = $23,364

$23,364 – 8,000 = $15,364

14. The conversion is the noncash item that must be disclosed.

Cash Inflow Account Analysis

[1]		
	Sales-net	237,207
	Trade receivables-net – (Inc.) D	(25,000)
	Unearned revenue – Inc. (Dec.)	—
	Cash from customers	212,207
[2]		
	Interest revenue	4,300
	Accrued interest rec. – (Inc.) D	—
	Interest rec. – advance – Inc. (Dec.)	—
	Cash interest received	4,300

[3]		
	Dividend revenue	—
	Investment income	5,880
	Dividends receivable – (Inc.) D	—
	Investments-equity method – (Inc.) De	(3,880)
	Cash dividends received	2,000
[4]		
	Other income – xxxx	—
	A-I-xxxx – (Inc.) D	—
	L-I-xxxx – Inc. (Dec.)	—
	Cash from xxxx	—
[5]		
	Cost of sales	(136,407)
	Inventory – (Inc.) D	(17,500)
	Acc. pay. – trade – I	16,110
	Cash paid to suppliers	(137,797)
[6]		
	Salaries and benefits	—
	Prepaid wages – (Inc.) D	—
	Wages payable – Inc. (Dec.)	—
	Cash paid to employees	—
[7]		
	SG&A expenses	(20,710)
	Misc. prepaids – (Inc.) D	—
	Misc. payables – Inc. (Dec.)	—
	Cash paid for SG&A	(20,710)
[8]		
	Interest expense	(1,150)
	Premium (discount) amortization	150
	Prepaid interest exp. – (Inc.) D	—
	Accrued interest exp. – Inc. (Dec.)	—
	Cash interest paid	(1,000)
[9]		
	Income tax expense	(39,588)
	Prepaid income tax – (Inc.) D—	
	Income tax payable – Inc. (Dec.)	14,616
	Deferred tax asset – (Inc.) D—	
	Deferred tax liability – Inc. (Dec	336
	Cash income tax paid	(24,636)

[10]		
	Other expense – cccc	—
	A-L-cccc – (Inc.) D—	—
	L-L-cccc – Inc. (Dec.)	—
	Cash paid – cccc	—
[11]		
	Net cash – segment operations	—
	Oper. seg. receivables	—
	Oper. seg. payables	—
	Cash received (paid) sold segment	—

Supplemental Problem 5-2 Solutions

A variety of comments about the Triangle Company statement may be made. A few suggestions are provided.

- In general the presentation seems to be in conformity with the requirements of the statement of cash flows guidance.
- The direct method statement includes explicit line items for "other" inflows and outflows such as the contributions and the lawsuit settlement.
- There is gross presentation of investing activities. The gain on the sale is properly excluded from net income and the total proceeds shown in the investing section.
- The reconciliation starts with the net income amount and there is a specification of why adjustments are made.
- The change in assets and liabilities on the adjustment shows that they will not reconcile to the balance sheet change.
- There is no net presentation, but the disclosure that no borrowings took place under the line of credit is an example of appropriate supplemental disclosure.
- The extraordinary item information indicates that a noncash exchange took place.
- The implication of the presentation is that the firm has no cash equivalents (although this is not totally clear).

Solutions to Knowledge Check Questions

1.

a. Incorrect. Although this was an argument raised in favor of the indirect method, there are many cases (such as when there is a merger) that the change in balance sheet accounts will not reconcile.
b. Correct. There can be multiple reconciliation points as long as items such as receivables or payables are not influenced by segment disposals, mergers, or the existence of imbedded investing or financing balances.
c. Incorrect. In smaller firms multiple reconciliation points may exist, but reconciliation is uncommon in larger, more complex firms.
d. Incorrect. Changes added and subtracted using the indirect approach will sometimes reflect the changes in balance sheet accounts during the period.

2.

a. Incorrect. There are seldom, if ever explicit footnote disclosures of the lack of reconciliation provided by entities.
b. Incorrect. The guidance is silent on the lack of reconciliation. In fact, even board members were surprised about how often this reconciliation does not exist.
c. Correct. The guidance simply requires that the cash from operations be equal under the direct and the indirect approaches. It is silent on explaining the relationship with balance sheet changes.
d. Incorrect. There are many instances where there is not reconciliation between balance sheet changes.

3.

a. Correct. FASB specifically prohibits entities from presenting a cash flow per share amount.
b. Incorrect. FASB did not encourage a cash flow per share amount as part of full disclosure.
c. Incorrect. FASB does not discuss anything about a management explanation as to the nature of this amount in the guidance.
d. Incorrect. FASB took the unusual action of specifically prohibiting the disclosure of a cash flow per share amount.

4.

a. Incorrect. Disclosure of both cash paid for interest and taxes is required.
b. Incorrect. The guidance does not require disclosure of cash paid for interest and taxes on the face of the statement of cash flows.
c. Correct. The guidance requires that these cash flow numbers be presented, but provides flexibility on the placement of the presentation.
d. Incorrect. Interest and taxes are part of the operating section.

5.

a. Incorrect. The receivable collections still represent an operating inflow. The use of the receivables on collateral has no effect on the classification of cash inflows from the collection of those receivables.
b. Correct. The sale simply changed when the cash was received.
c. Incorrect. The loss on the receivable sale is added back to net income to get the cash from operations amount.
d. Incorrect. There is no cash inflow or outflow associated with writing off bad debt expense.

6.

a. Incorrect. Only the cash flows from the disposal of the segment that are investing are shown in the investing section of the statement.
b. Incorrect. The cash flows from the disposal of a business segment are not financing.
c. Incorrect. Only the operating cash flows are shown in the operating section.
d. Correct. Operating cash flows are shown as operating while the proceeds from the sale are shown in the investing section.

Chapter 6

Quick Exercise 6-1 Solution

This is a discussion question and no solution is provided.

Quick Exercise 6-2 Solutions

1. A purchase of a building – *Business operating section*
2. The payment of dividends – *Financing section*
3. Cash received from customers – *Business operating section*
4. The purchase of another business entity for cash – *Multi-category section*
5. Cash paid for treasury shares – *Financing section*
6. Income tax payments – *Income tax section*
7. Sale of long-term bonds – *Financing section*
8. Common stock investment – *Business investing section*
9. Interest received on leased asset – *Business operating section*
10. Cash from sale of a line of business – *Disposal of segment section*

Solutions to Knowledge Check Questions

1.

a. Incorrect. Under IAS 7, interest is not always classified only as an operating activity.
b. Incorrect. Interest under IAS 7 may not be classified as investing.
c. Correct. Under IAS 7, a firm may classify interest as either operating or financing as long as the classification is used consistently.
d. Incorrect. Interest paid is a cash flow and must be shown on the statement of cash flows.

2.

a. Incorrect. There is a separate financing section in the proposed statement of cash flows.
b. Incorrect. Income-tax-related cash flows will be in a separate category on the statement of cash flows.
c. Incorrect. The business section includes operating cash flows and investment cash flows. Discontinued operations are in a separate section.
d. Correct. Investing cash flows along with operating cash flows are part of the business section on the proposed statement of cash flows.

3.

a. Incorrect. The new guidance is not expected to continue simply to use the three existing classifications: operating, investing, and financing.
b. Correct. One of several new classifications anticipated is a separate classification for tax- related cash flows.
c. Incorrect. The proposed new guidance requires the direct, not the indirect method for reporting operating cash flows.
d. Incorrect. The proposed guidance is expected to require a supplemental schedule prepared using the indirect method.

Learn More

AICPA CPE

Thank you for selecting AICPA as your continuing professional education provider. We have a diverse offering of CPE courses to help you expand your skillset and develop your competencies. Choose from hundreds of different titles spanning the major subject matter areas relevant to CPAs and CGMAs, including:

- Governmental & Not-for-Profit accounting, auditing, and updates
- Internal control and fraud
- Audits of Employee Benefit Plans and 401(k) plans
- Individual and corporate tax updates
- A vast array of courses in other areas of accounting & auditing, controllership, management, consulting, taxation, and more!

Get your CPE when and where you want

- Self-study training options that includes on-demand, webcasts, and text formats with superior quality and a broad portfolio of topics, including bundled products like –
    - CPExpress for immediate access to hundreds of one and two-credit hour online courses for just-in-time learning at a price that is right
    - Annual Webcast Pass offering live Q&A with experts and unlimited access to the scheduled lineup, all at an incredible discount.
- Staff training programs for audit, tax and preparation, compilation and review
- Certificate programs offering comprehensive curriculums developed by practicing experts to build fundamental core competencies in specialized topics
- National conferences presented by recognized experts
- Affordable AICPA courses on-site at your organization – visit **aicpalearning.org/on-site** for more information.
- Seminars sponsored by your state society and led by top instructors. For a complete list, visit **aicpalearning.org/publicseminar**.

Take control of your career development

The AICPA | CIMA Competency and Learning website at **https://competency.aicpa.org** brings together a variety of learning resources and a self-assessment tool, enabling tracking and reporting of progress toward learning goals.

Visit the AICPA store at cpa2biz.com/CPE to browse our CPE selections.

Why AICPA?

Think of All the Great Reasons to Join the AICPA.

CAREER ADVOCACY SUPPORT
On behalf of the profession and public interest on the federal, state and local level.

PROFESSIONAL & PERSONAL DISCOUNTS
Save on travel, technology, office supplies, shipping and more.

ELEVATE YOUR CAREER
Five specialized credentials and designations (ABV®, CFF®, CITP®, PFS™ and CGMA®) enhance your value to clients and employers.

HELPING THE BEST AND THE BRIGHTEST
AICPA scholarships provide more than $350,000[1] to top accounting students.

GROW YOUR KNOWLEDGE
Discounted CPE on webcasts, self-study or on-demand courses & more than 60 specialized conferences & workshops.

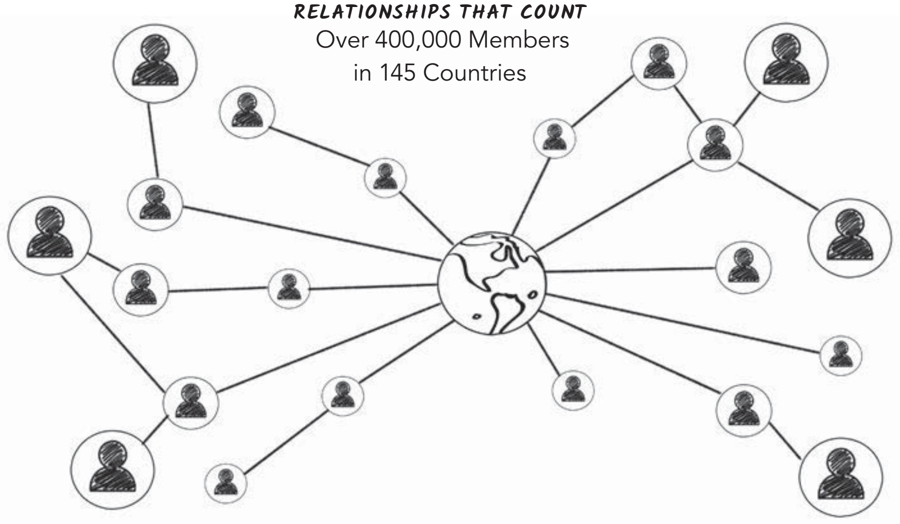
PROFESSIONAL GUIDANCE YOU CAN COUNT ON
Technical hotlines & practice resources, including Ethics Hotline, Business & Industry Resource Center and the Financial Reporting Resource Center.

KEEPING YOU UP TO DATE
With news and publications from respected sources such as the *Journal of Accountancy*.

MAKING MEMBERS HAPPY
We maintain a 94%+ membership renewal rate.

FOUNDED ON INTEGRITY
Representing the profession for more than 125 years.

RELATIONSHIPS THAT COUNT
Over 400,000 Members
in 145 Countries



AICPA®

TO JOIN, VISIT:
aicpa.org/join or call 888.777.7077.

1. Source: AICPA Academic & Career Awareness