Reading 32

ANALYZING STATEMENTS OF CASH FLOWS I

1. (C) +$ 105.

   Explanation

   Using the indirect method, the increase in accounts payable is a source of cash from operations (+25), depreciation expense is a non-cash expense added back in computing cash from operations (+100), and increase in inventory is a use of cash from operations (-20) = 25 + 100 - 20 = 105. The sale of stock and the dividends paid are financing cash flows that are not included in net income, so they do not require adjustment when calculating CFO.

   (Module 32.1, LOS 32.b)

2. (C) Only accounts receivable will increase.

   Explanation

   If a firm sells more than it collects, accounts receivable will increase. If a firm pays suppliers more than it purchases, accounts payable will decrease.

   (Module 32.1, LOS 32.b)

3. (A) Increase in cash of $10,500.

   Explanation

   Cash flow from operations would be calculated as +Net Income $12,000 + Depreciation $1,000 + Loss on sale of machinery $ 500 − A/R $ 2,000 − A/P $1,500 + Income taxes payable $ 500 = $10,500. Repayment of Bonds is a financing activity and would not be included with operating activities. Depreciation is not a cash flow activity and is therefore always added back to net income to calculate CFO. The loss on the sale of machinery is not a cash outflow so it is also added back to calculate CFO. Accounts receivable is subtracted when there is an increase as this increases net income but does not affect cash.

   (Module 32.1, LOS 32.b)

4. (B) $ 4,300,000.

Explanation

Cash provided or used by operating activities under the direct method is computed by adding cash inflows and subtracting cash inputs and cash outflows. Operating Cash inflows for Rockway Inc. for 2005 came from sales ($ 21,000,000) and decrease in accounts receivable ($ 3,000,000 − $ 2,500,000 = $ 500,000) for net cash inflows of ($ 21,000,000 + $ 500,000 =) $ 21,500,000. Operating cash inputs were cost of goods sold ($15,000,000), plus the increase in inventory ($ 3,000,000 − $ 2,400,000 = $600,000) less the increase in accounts payable, (which is a source of funds) ($1,000,000 − $1,400,000 = -$ 400,000) for net cash inputs of ($15,000,000 + $ 600,000 - $ 400,000 =) $15,200,000. Other operating cash outflows were interest paid ($1,000,000) and current income taxes paid ($1,000,000) totalling ($ 2,000,000). Cash provided by operations was ($ 21,500,000 − $15,200,000 − $ 2,000,000 =) $ 4,300,000. Changes in property, plant and equipment, long-term debt and common stock do not affect cash from operations.

(Module 32.1, LOS 32.b)

5. (B) sales, subtracts any increase in accounts receivable, and adds any increase in unearned revenue.

Explanation

To compute cash collections from customers, begin with net sales from the income statement, subtract (add) any increase (decrease) in accounts receivable, and add (subtract) any increase (decrease) in unearned revenue.

(Module 32.3, LOS 32.c)

6. (B) –$ 45,000.

Explanation

Only the preferred stock dividends paid would be considered CFF. Issuing bonds in exchange for equipment and exchanging bonds for stock are both noncash transactions that should be disclosed in a footnote to the Statement of Cash Flows. Interest paid is an operating cash flow under U.S. GAAP.

(Module 32.1, LOS 32.b)

7. (C) $1,000,000.

Explanation

Cash flow from operations (CFO) using the indirect method is computed by taking net income plus non-cash expenses (i.e. depreciation) less gains from the equipment sale. Note that cash flow from operations must be adjusted downward for the amount of the gain on the sale of the equipment. Cash flow from operations is ($ 850,000 + $200,000 – ($100,000 – $50,000)) = $1,000,000. The other information relates to financing cash flows.

(Module 32.1, LOS 32.b)

8. (C) **subtract the change in accounts receivable from net sales.**

Explanation

Cash received from customers is most appropriately calculated by subtracting the change in accounts receivable from net sales.

(Module 32.1, LOS 32.a)

9. (C) **a footnote describing the conversion of the bonds into common stock.**

Explanation

Conversion of bonds into common stock is a non-cash transaction, but the conversion should be disclosed in a footnote to the statement of cash flows. **(Module 32.1, LOS 32.b)**

10. (C) **Neither the IFRS nor U.S. GAAP.**

Explanation

The IFRS allows a firm to classify interest received as either operating or investing cash flow and to classify interest paid as either operating or financing cash flow. U.S. GAAP requires that interest received and paid both be classified as operating cash flows.

(Module 32.3, LOS 32.d)

11. (A) **When recognizing a gain on the sale of fixed assets, the amount is a deduction to operating cash flows.**

Explanation

When recognizing a gain on the sale of fixed assets, the amount is a deduction to operating cash flows. This is because the gain would be double counted in the investing section and in net income. Therefore, the gain must be removed from net income. The direct method of cash flow calculation converts the income statement items to their cash equivalents, not the indirect method. Also, depreciation is added to net income in order to calculate CFO using the indirect method.

(Module 32.1, LOS 32.b)

12. (B) **Both will increase operating cash flow.**

Explanation

A decrease in the accounts receivable amount on the balance sheet indicates that cash collections exceed revenues (sales). This increases operating cash flow because receivables are being collected. An increase in the accounts payable amount on the balance sheet indicates that purchases from suppliers exceed cash payments. This increases operating cash flow because the cash was not used to pay the suppliers.

(Module 32.1, LOS 32.b)

13. (A) **\$ 7,800 million \$ 8,500 million**

Explanation

Cost of goods sold is equal to \$ 7,800 million (\$ 2,000 million beginning inventory + \$ 8,100 million purchases – \$ 2,300 million ending inventory). Cash paid to suppliers is equal to \$ 8,500 million (–\$ 7,800 COGS – \$ 300 million increase in inventory – \$ 400 million decrease in accounts payable). Alternate solution: Cash paid to suppliers is equal to \$8,500 million (– \$ 8,100 million purchases – \$400 decrease in accounts payable).

(Module 32.1, LOS 32.b)

14. (C) $ 10.

Explanation

Purchase of equipment	-$50
Fixed asset sold	-$60
CFI	$10

(Module 32.1, LOS 32.b)

15. (A) $ 70.

Explanation

Sale of common stock	45
Issuance of bonds	25
Financing cash flows	$70

(Module 32.1, LOS 32.b)

16. (B) The direct method starts with sales and follows cash as it flows through the income statement, while the indirect method starts with net income and adjusts for non-cash charges and other items.

Explanation

The main difference between the direct and indirect methods of calculating cash flows is the way that cash flow from operations is calculated. The direct method starts with sales and follows cash as it flows through the income statement, while the indirect method starts with income after taxes and adjusts backwards for non-cash and other items. Both methods will have the same result for operating cash flows. The direct and indirect method calculates the financing and investing cash flows the same way and both methods will result in the same cash flow figure.

(Module 32.3, LOS 32.d)

17. (A) operating or financing cash flow.

Explanation

IFRS allows interest paid to be reported in either the operating or financing section of the cash flow statement. U.S. GAAP requires interest paid to be reported in the operating section of the cash flow statement.

(Module 32.3, LOS 32.d)

18. (B) –$400,000.

Explanation

Dividends declared are net income less the increase in retained earnings ($ 800,000 - $ 300,000 = $ 500,000). Dividends declared less the increase in dividends payable is dividends paid ($ 500,000 – ($ 300,000 - $ 200,000) = $ 400,000). This is a cash outflow so it is a negative number. Dividends paid are always cash flow from financing under U.S. GAAP.

Note that accounts payable changes are included in cash flow from operations (CFO).

(Module 32.1, LOS 32.b)

19. (B) $ 210.

Explanation

Cash flow from operations (CFO) calculated using the indirect method is: net income (100) + depreciation (50) – increase in accounts receivable (10) + decrease in inventory (20) + increase in accounts payable (50) = $210.

(Module 32.1, LOS 32.b)3

20. (B) $ 90.

Explanation

Sale of common stock	$100
Repayment of debt	(10)
Financing cash flows	$ 90

(Module 32.1, LOS 32.b)

21. (A) CFF CFF or CFO

Explanation

U.S. GAAP treats dividends paid as CFF whereas IAS GAAP treats dividends paid as either CFO or CFF.

(Module 32.3, LOS 32.d)

22. (A) add decreases in accounts receivables to net sales.

Explanation

A decrease in accounts receivable represents an increase in cash so this should be added to sales. Increases in accounts payable represent an increase in cash so these should be subtracted from cost of goods sold. Increases in inventory represent a use of cash so these would be added to cost of goods sold.

(Module 32.3, LOS 32.c)

23. (B)

Subtract decrease in unearned revenue	Subtract an inventory writedown

Explanation

Beginning with net sales, calculating cash collected from customers requires the addition (subtraction) of any increase (decrease) in unearned revenue. Cash advances from customers represent unearned revenue and are not included in net sales, so any advances must be added to net sales in order to calculate cash collected. An inventory writedown, as a result of applying the lower of cost or market rule, will reduce ending inventory and increase COGS for the period. However, no cash flow is associated with the writedown, so COGS is reduced by the amount of the writedown in calculating cash paid to suppliers.

(Module 32.3, LOS 32.c)

24. (B) Does not consider Considers

Explanation

The indirect method must add back depreciation expense because the starting point is net income. Since the direct method does not begin with net income it does not need to consider non-cash expenses such as depreciation.

(Module 32.1, LOS 32.b)

25. (C) $ 1,300.

Explanation

indirect Method	
EAT	+1,000
Depreciation	+500
Change in Inv.	+ 100 a source
Change in Accts. Rec.	(300) a use
CFO	1,300
Direct Method	
Net Sales	+3,500
Change in Accts. Rec.	(300) a use
COGS	(1,500)
Cash Taxes	(500)
Change in Inv	+100 a source
CFO	1,300

(Module 32.1, LOS 32.b)

26. (B) $ 23.

Explanation

Using the indirect method, cash flow from operations is net income less increase in accounts receivable, plus increase in accounts payable, less increase in inventory, plus loss on sale of equipment, less gain on sale of real estate. 27 – 4 + 1 – 5 + 8 – 4 = $23 million.

(Module 32.1, LOS 32.b)

27. (B) $10.

Explanation

Item		Amount
Cash payment of dividends	CFF	-$30
Sale of equipment	CFI	+$25
Net income	CFO	+$25
Purchase of land	CFI	-$15
Increase in accounts payable	CFO	+$20
Sale of preferred stock	CFF	+$25
Increase in deferred taxes	CFO	+$5

CFI = Sale of Equipment (+25) + Purchase of Land (–15) = $10.

(Module 32.1, LOS 32.b)

28. (C) the indirect method.

Explanation

Depreciation is a non-cash expense. Only in the indirect method is depreciation added back to net income when determining CFO because net income is only used in the indirect method and not the direct method. The direct method instead starts with cash sales and works down the income statement.

(Module 32.1, LOS 32.b)

29. (A) Net income.

Explanation

Property, Plant, & Equipment and payment of dividends are components of the statement of cash flows under both the direct and indirect methods. Net income is the first figure under the indirect method, but it is not a part of the statement of cash flows under the direct method. The correct response is net income.

(Module 32.1, LOS 32.b)

30. (A) Working capital.

Explanation

Typically, operating activities on the cash flow statement are most closely related to the working capital accounts (current assets and current liabilities) on the balance sheet. Investing activities are typically related to non-current assets. Financing activities are typically related to non-current liabilities for transactions with creditors, or equity for transactions with shareholders.

(Module 32.1, LOS 32.a)

31. (B) $ 4,600,000.

Explanation

$ 3,000,000 + $ 1,500,000 – $ 200,000 + $ 300,000 = $ 4,600,000.

(Module 32.1, LOS 32.b)

32. (A) cash flow from either investing or operations.

Explanation

Under IFRS, interest and dividends received may be shown as either cash flow from operations or cash flow from investing.

(Module 32.3, LOS 32.d)

33. (B) IFRS but not under U.S. GAAP.

Explanation

IFRS permits interest received to be reported as either cash flow from operations or cash flow from investing, and permits dividends paid to be reported as either cash flow from operations or cash flow from financing. U.S. GAAP requires interest received to be reported as cash flow from operations, but requires dividends paid to be reported as cash flow from financing.

(Module 32.3, LOS 32.d)

34. (A) $35.

Explanation

Using the indirect method, CFO = Net income 25 + increase in accounts payable 20 + increase in deferred taxes 5 – profit on sale of equipment 15 = $35. Increases in accounts payable and deferred taxes are sources of operating cash that are not included in net income and must be added. Profit on sale of equipment is a CFI item that must be removed from net income. No adjustment needs to be made for cash payment of dividends (CFF), sale of preferred stock (CFF), or purchase of land (CFI) because they are not included in net income. Only the profit on sale of equipment, not the full proceeds from sale, is included in net income.

(Module 32.1, LOS 32.b)

35. (A) $ 70.

Explanation

Dividends paid	-$30
Stock issued	20
Bonds issued	80
CFF	$70

(Module 32.1, LOS 32.b)

36. (C) $ 202,400 $119,900

Explanation

Cash collections are $ 202,400 ($200,000 sales + $ 2,400 increase in unearned revenue). Cash expenses are $119,900 (–$ 89,000 wages expense – $1,200 decrease in wages payable – $17,000 insurance expense – $1,200 increase in prepaid insurance – $10,400 interest expense – $1,100 decrease in interest payable). Depreciation expense is a non-cash expense.

(Module 32.1, LOS 32.b)

37. (B) Investing cash flows.

Explanation

Investing cash flows are most closely linked with a firm's noncurrent assets. For example, purchases and sales of property, plant, and equipment are classified as investing cash flows.

(Module 32.1, LOS 32.a)

38. (A) –$100,000.

Explanation

The only item involving cash flow from financing (CFF) was the payment of a cash dividend by Juniper. The sale of equipment affects cash flow from investing (CFI), the purchase of land has no effect on cash, and the preferred dividends received are cash flow from operations under U.S. GAAP.

(Module 32.1, LOS 32.b)

39. (C) reduce cost of goods sold by any decreases in inventory.

Explanation

Decreases in inventory represent a source of cash so these would be subtracted from cost of goods sold. Any depreciation and/or amortization included in the cost of goods sold does not represent an actual use of cash, so this amount should be subtracted from cost of goods sold. Decreases in accounts payable represent a use of cash so these should be added to cost of goods sold.

(Module 32.3, LOS 32.c)

40. (A) CFO CFO or CFF

Explanation

U.S. GAAP treats interest paid as CFO whereas IAS GAAP treats interest paid as either CFO or CFF.

(Module 32.3, LOS 32.d)

41. (A) $ 29.

Explanation

Using the indirect method:

Add: Net Income	$10
Add: Depreciation Expense	22
Less: Gain from Sale of Equip.	(6)
Less: Increase in Accounts Receivable	(4)
Add: Decrease in Inventory	2
Add: Increase in Accounts Payable	5
Cash flow from operations (CFO)	29

(Module 32.1, LOS 32.b)

42. (A) Increase in cash of $8,125.

Explanation

Silverstone Company's cash flow from operations would be calculated as +Net Income $8,000 + Inventory $250 - Prepaid exp. $500 + Depreciation $175 + A/P $200 = $8,125. Bonds payable is a financing activity and would not be included in the cash flow from operations. The indirect method takes the change in the non-cash accounts and decreases or increases net income to get to the change in cash flow.

(Module 32.1, LOS 32.b)

43. (A) -$ 5.

Explanation

CFF = 25(Sale of Stock) − 30(Div Paid) = -$ 5

(Module 32.1, LOS 32.b)

44. (A) $ 156.

Explanation

Net Income	+$ 96
Depreciation	+30
Gain on sale of asset	-30
Accts. Rec.	+30
Inventory	+20
Accts. Payable	+20
Wages Payable	-10
CFO	+$156

(Module 32.1, LOS 32.b)

45. (A) $ 925,000 $ 950,000

Explanation

Cash paid for insurance = insurance expense + change in prepaid insurance, so insurance expense = cash paid for insurance – change in prepaid insurance. Insurance expense for 2007 is equal to $ 925,000 [($ 750,000 cash paid for insurance – (–$ 175,000)]. Interest expense for 2007 is equal to $ 950,000 ($ 900,000 cash interest paid + $ 50,000 increase in interest payable).

(Module 32.1, LOS 32.b)

46. (A) $1,000.

Explanation

Adjustments to reconcile net income to cash flow from operating activities will require that depreciation ($800) be added back, and the increase in accounts receivable ($1,000) be subtracted: $1,200 + 800 – 1,000 = $1,000.

(Module 32.1, LOS 32.b)

47. (B) A nonprofitable company that uses LIFO to account for inventory will have higher total cash flow than a nonprofitable company that uses FIFO during a period of rising prices.

Explanation

Because of the impact of income taxes, a profitable company that accounts for inventory using LIFO will have higher total cash flow than a profitable company that uses FIFO. The company that uses LIFO will have higher cost of goods sold, resulting in lower net income and thus lower taxes.

The other statements are accurate:

- A company that issues common stock is not required to pay dividends (which would reduce cash flow from financing). Thus, it may have the same CFF as a firm that issues debt since interest paid on debt is a component of CFO.
- When a company issues bonds at a premium, the proceeds raised at issuance (CFF inflow) are greater than the par value repaid at maturity (CFF outflow). For bonds issued at par, the CFF inflow at issuance is equal to the CFF outflow at maturity.

(Module 32.1, LOS 32.b)

48. (C) Increase in cash of $248.

Explanation

CFO for Moose Printing Corporation is calculated as follows:

+Net Income $225 − A/R $55 + Inventory $33 + Depreciation $65 − A/P $25 + Wages Payable $15 − Deferred taxes $10 = $248.

The purchase of new equipment is an investing activity and therefore is not included in CFO. Dividends paid is a financing activity and is not included in CFO.

(Module 32.1, LOS 32.b)

49. (A) $ 900,000.

Explanation

CFO = sales $ 3,000,000 – change in accounts receivable ($ 200,000 – $ 300,000) – purchases $1,800,000 – other cash operating expenses $ 400,000 = $ 900,000.

Note that no adjustment for inventories is necessary because purchases are given. From the inventory equation, P = COGS + EI - BI.

(Module 32.1, LOS 32.b)

50. (C) indirect method, depreciation must be added to net income, because it is a non-cash expense.

Explanation

The indirect method begins with net income, which has already included all cash and non-cash expenses. Therefore, under the indirect method, depreciation must be added to net income, because it is a non-cash expense.

(Module 32.1, LOS 32.b)

51. (B) $ 5,900,000.

Explanation

Using the indirect method, net income is adjusted by adding back depreciation (a non-cash expense) and changes in working capital: the increase in wages payable and the increase in income taxes payable are sources of cash, and the decrease in interest payable is a use of cash. Dividends paid are financing cash flows under U.S. GAAP.
CFO = $ 3,000,000 + $ 2,500,000 + $ 100,000 + $ 500,000 - $ 200,000 = $ 5,900,000.

(Module 32.1, LOS 32.b)

52. (C) Investing activity Financing activity

Explanation

Under IFRS, interest received may be classified as CFO or CFI, while dividends paid may be classified as CFO or CFF.

(Module 32.3, LOS 32.d)

53. (A) A positive (negative) adjustment to net income when accounts payable increases (decreases).

Explanation

A decrease in accounts payable represents an outflow. Hence, a negative adjustment will be required. Conversely, an increase represents an inflow and a positive adjustment.

(Module 32.1, LOS 32.b)

54. (A) $ 8,000,000.

Explanation

Using the indirect method, CFO is net income increased by 20X5 depreciation ($ 1,000,000) and decreased by the gain recognized on the sale of the plane [$ 10,000,000 sale price − ($ 15,000,000 original cost − $10,000,000 accumulated depreciation including 20X5) = $ 5,000,000]. $ 12,000,000 + $1,000,000 − $ 5,000,000 = $ 8,000,000.

(Module 32.1, LOS 32.b)

55. (C) $ 10,000,000.

Explanation

Investing cash of $ 2 million was used to purchase the cargo plane. Proceeds from the sale of the plane were a source of $ 12 million of investing cash. Net CFI is $ 12 million − $ 2 million = $ 10 million. Under U.S. GAAP, the interest payment is included in cash from operations (CFO) and the dividend payment in cash from financing (CFF). Redemption of the bonds is a use of cash from financing (CFF).

(Module 32.1, LOS 32.b)