EXERCISES

Ex. 14–1

There were net additions, such as depreciation and amortization of intangible assets of $389 million, to the net loss reported on the income statement to convert the net loss from the accrual basis to the cash basis. For example, depreciation is an expense in determining net income, but it does not result in a cash outflow. Thus, depreciation is added back to the net loss in order to determine cash flow from operations. A second large item that is added to the net loss is the decrease in air traffic liability of $318 million. This represents a reduction in unused, but paid, tickets (unearned revenue) between the two balance sheet dates.

The cash from operating activities detail is provided as follows for class discussion:

CONTINENTAL AIRLINES, INC.
Cash Flows from Operating Activities
(Selected from Statement of Cash Flows)
(in millions)

CASH FLOWS FROM OPERATING ACTIVITIES

Net income (loss) .................................................................................. $ (68)

Adjustments to reconcile net income (loss) to net cash flow provided by operating activities:
Depreciation and amortization ............................................................ 389
Special charges .................................................................................... 67
Gain on disposition of investments .................................................... (204)
Undistributed equity in the income of other companies ................... (62)
Other, net............................................................................................... (18)

Changes in certain assets and liabilities:
Decrease (increase) in accounts receivable ........................................ (56)
Decrease (increase) in spare parts and supplies ............................... (7)
Decrease (increase) in prepaid expenses ......................................... (59)
Increase (decrease) in accounts payable ........................................... 80
Increase (decrease) in air traffic liability ........................................... 318
Increase (decrease) in other liabilities............................................ 77

Net cash provided by (used in) operating activities ....................... $457
Ex. 14–2

a. Cash receipt, $83,000
d. Cash payment, $100,000
e. Cash receipt, $500,000
b. Cash receipt, $392,000
c. Cash payment, $560,000
g. Cash payment, $320,000
f. Cash payment, $44,000
h. Cash payment, $40,000

Ex. 14–3

a. investing
g. investing
d. financing
h. investing
c. financing
i. investing
d. financing
j. financing
e. financing
k. operating
f. financing

Ex. 14–4

a. deducted
g. added
b. deducted
h. deducted
c. added
i. deducted
d. added
j. deducted
e. added
k. added
f. added
Ex. 14–5

a. Net income ................................................................. $720,000

Adjustments to reconcile net income to net cash
flow from operating activities:

Depreciation ................................................................. 32,700

Changes in current operating assets and liabilities:

Increase in accounts receivable ................. (2,850)
Decrease in merchandise inventory ................. 4,530
Increase in prepaid expenses ....................... (2,100)
Increase in accounts payable ....................... 5,100
Decrease in wages payable ......................... (4,500)

Net cash flow from operating activities ........... $752,880

b. Cash flows from operating activities shows the cash inflow or outflow from a
company’s day-to-day operations. Net income reports the excess of revenues
over expenses for a company using the accrual basis of accounting. Reven-
ues are recorded when they are earned, not necessarily when cash is re-
ceived. Expenses are recorded when they are incurred and matched against
revenue, not necessarily when cash is received. As a result, the cash flows
from operating activities differs from net income because it does not use the
accrual basis of accounting.

Ex. 14–6

a. Cash flows from operating activities:

Net income ................................................................. $378,000

Adjustments to reconcile net income to net cash
flow from operating activities:

Depreciation ................................................................. 112,500

Changes in current operating assets and liabilities:

Decrease in accounts receivable ....................... 4,320
Increase in inventories ....................................... (24,300)
Decrease in prepaid expenses ......................... 1,080
Decrease in accounts payable ......................... (6,840)
Increase in salaries payable ............................... 1,350

Net cash flow from operating activities ........... $466,110

b. Yes. The amount of cash flows from operating activities reported on the
statement of cash flows is not affected by the method of reporting such
flows.
Ex. 14–7

a. Cash flows from operating activities:

Net income ............................................................................... $190,500

Adjustments to reconcile net income to net cash flow from operating activities:

Depreciation.................................................................................. 21,600
Gain on disposal of equipment ........................................ (12,600)

Changes in current operating assets and liabilities:

Increase in accounts receivable ........................................... (3,360)
Decrease in inventory ............................................................... 1,920
Decrease in prepaid insurance .................................................. 720
Decrease in accounts payable ................................................. (2,280)
Increase in income taxes payable............................................. 720

Net cash flow from operating activities................................. $197,220

Note: The change in dividends payable would be used to adjust the dividends declared in obtaining the cash paid for dividends in the Financing Activities section of the statement of cash flows.

b. Cash flows from operating activities reports the cash inflow or outflow from a company’s day-to-day operations. Net income reports the excess of revenues over expenses for a company using the accrual basis of accounting. Revenues are recorded when they are earned, not necessarily when cash is received. Expenses are recorded when they are incurred and matched against revenue, not necessarily when cash is received. As a result, the cash flows from operating activities differs from net income because it does not use the accrual basis of accounting.

Ex. 14–8

Dividends declared ............................................................. $260,000
Add decrease in dividends payable........................................ 9,500
Dividends paid to stockholders during the year .............. $269,500

The company probably had four quarterly payments—the first one being $74,500 declared in the preceding year and three payments of $65,000 each—of dividends declared and paid during the current year. Thus, $269,500 [$74,500 + (3 × $65,000)] is the amount of cash payments to stockholders. The $65,000 of dividends payable at the end of the year will be paid in the next year.
Ex. 14–9

Cash flows from investing activities:
Cash received from sale of equipment ...................... $43,500

[The loss on the sale, $9,500 ($43,500 proceeds from sale less $53,000 book value), would be added to net income in determining the cash flows from operating activities if the indirect method of reporting cash flows from operations is used.]

Ex. 14–10

Cash flows from investing activities:
Cash received from sale of equipment ...................... $110,500

[The loss on the sale, $11,000 ($110,500 proceeds from sale less $121,500 book value), would be added to net income in determining the cash flows from operating activities if the indirect method of reporting cash flows from operations is used.]

Ex. 14–11

Cash flows from investing activities:
Cash received from sale of land ................................. $68,250
Less: Cash paid for purchase of land ........................ 74,500

(The gain on the sale of land, $22,650, would be deducted from net income in determining the cash flows from operating activities if the indirect method of reporting cash flows from operations is used.)

Ex. 14–12

Cash flows from financing activities:
Cash received from sale of common stock ............... $1,755,000
Less: Cash paid for dividends .................................... 260,550

Note: The stock dividend is not disclosed on the statement of cash flows.
Ex. 14–13

Cash flows from investing activities:

Cash paid for purchase of land ................................... $307,500

A separate schedule of noncash investing and financing activities would report the purchase of $405,000 land with a long-term mortgage note, as follows:

Purchase of land by issuing long-term mortgage note .... $405,000

Ex. 14–14

Cash flows from financing activities:

Cash received from issuing bonds payable .............. $448,000
Less: Cash paid to redeem bonds payable ............... 147,200

Note: The discount amortization of $2,800 would be shown as an adjusting item (increase) in the Cash Flows from Operating Activities section under the indirect method.

Ex. 14–15

a. Net cash flow from operating activities ................. $243,750
Add: Increase in accounts receivable .................. $ 9,750
   Increase in prepaid expenses ...................... 2,025
   Decrease in income taxes payable ..................  5,250
   Gain on sale of investments ........................ 9,000
           26,025
Deduct: Depreciation ............................................ $20,100
   Decrease in inventories ............................. 13,050
   Increase in accounts payable ...................... 3,600
Net income, per income statement ..................... 36,750
           36,750
           269,775
           269,775

Note to Instructors: The net income must be determined by working backward through the cash flows from the Operating Activities section of the statement of cash flows. Hence, those items that were added (deducted) to determine net cash flow from operating activities must be deducted (added) to determine net income.
Ex. 14–15  (Concluded)

b. Shinlund's net income differed from cash flows from operations because of:
   - $20,100 of depreciation expense which has no effect on cash flows from operating activities,
   - a $9,000 gain on sale of investments. The proceeds from this sale, which include the gain, are reported in the Investing section of the statement of cash flows.
   - Changes in current operating assets and liabilities that are added or deducted depending on their effect on cash flows:
     Increase in accounts receivable, $9,750
     Increase in prepaid expenses, $2,025
     Decrease in income taxes payable, $5,250
     Decrease in inventories, $13,050
     Increase in accounts payable, $3,600

Ex. 14–16

a.  

<table>
<thead>
<tr>
<th>JONES SODA CO.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Flows from Operating Activities</td>
</tr>
<tr>
<td>(in thousands)</td>
</tr>
</tbody>
</table>

Cash flows from operating activities:
Net income ................................................................. $\text{-10,547}
Adjustments to reconcile net income to net cash flow from operating activities:
Depreciation................................................................. 811
Loss on inventory write down and fixed assets ........ 2,248
Stock-based compensation expense (noncash)........ 727
Changes in current operating assets and liabilities:
Decrease in accounts receivable ....................... 364
Decrease in inventory.......................... .................. 210
Decrease in prepaid expenses .................. 206
Decrease in accounts payable .................. (165)
Decrease in accrued liabilities .................. (1,117)
Net cash flow from operating activities .............. $\text{-7,263}

b. Jones Soda is struggling financially. The company has weak earnings and weak cash flow from operating activities. The company had grown quickly in prior years, but the recent downturn in the economy appears to be hurting the company. The decrease in accounts receivable is likely due to a reduction in sales. The decreases in accounts payable and accrued liabilities suggest that the company is reducing its cost of goods sold and operating expenses. The company appears to be reducing its size (i.e., going into a period of negative growth). This is not a healthy trend.
Ex. 14–17

a.  

HOBSON MEDICAL EQUIPMENT INC.  
Statement of Cash Flows  
For the Year Ended December 31, 2012

<table>
<thead>
<tr>
<th>Cash flows from operating activities:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income ................................................................................... $195</td>
<td></td>
</tr>
<tr>
<td>Adjustments to reconcile net income to net cash flow from operating activities:</td>
<td></td>
</tr>
<tr>
<td>Depreciation ........................................................................... 18</td>
<td></td>
</tr>
<tr>
<td>Gain on sale of land ................................................................ (45)</td>
<td></td>
</tr>
<tr>
<td>Changes in current operating assets and liabilities:</td>
<td></td>
</tr>
<tr>
<td>Increase in accounts receivable ......................................... (48)</td>
<td></td>
</tr>
<tr>
<td>Increase in inventories ................................................................ (39)</td>
<td></td>
</tr>
<tr>
<td>Increase in accounts payable ............................................. 9</td>
<td></td>
</tr>
<tr>
<td>Net cash flow from operating activities ........................................ $ 90</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash flows from investing activities:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received from sale of land .................................................. $ 75</td>
<td></td>
</tr>
<tr>
<td>Less cash paid for purchase of equipment ........................................ 30</td>
<td></td>
</tr>
<tr>
<td>Net cash flow provided by investing activities .................................... 45</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash flows from financing activities:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received from sale of common stock ......................................... $105</td>
<td></td>
</tr>
<tr>
<td>Less cash paid for dividends ....................................................... 42*</td>
<td></td>
</tr>
<tr>
<td>Net cash flow provided by financing activities .................................... 63</td>
<td></td>
</tr>
</tbody>
</table>

Increase in cash ............................................................................... $198
Cash at the beginning of the year ............................................. 96
Cash at the end of the year ....................................................... $294

*$60 – $18 = $42

b. Hobson’s net income was less than the cash flows from operations because of:

- $18 of depreciation expense which has no effect on cash flows from operating activities.
- a $45 gain on sale of investment. The proceeds from this sale, which include the gain, are reported in the Investing section of the statement of cash flows.
- Changes in current operating assets and liabilities that are added or deducted depending on their effect on cash flows:
  - Increase in accounts receivable, $48
  - Increase in inventories, $39
  - Decrease in accounts payable, $9
1. The increase in accounts receivable should be deducted from net income in the Cash Flows from Operating Activities section.
2. The gain on sale of investments should be deducted from net income in the Cash Flows from Operating Activities section.
3. The increase in accounts payable should be added to net income in the Cash Flows from Operating Activities section.
4. The correct amount of cash at the beginning of the year, $180,576, should be added to the increase in cash.
5. The final amount should be the amount of cash at the end of the year, $267,480.
A correct statement of cash flows would be as follows:

**Hough Inc.**

**Statement of Cash Flows**
**For the Year Ended December 31, 2012**

<table>
<thead>
<tr>
<th>Cash Flows from Operating Activities</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income</td>
<td>$266,544</td>
</tr>
<tr>
<td>Adjustments to reconcile net income to net cash flow from operating activities:</td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>75,600</td>
</tr>
<tr>
<td>Gain on sale of investments</td>
<td>(12,960)</td>
</tr>
<tr>
<td>Changes in current operating assets and liabilities:</td>
<td></td>
</tr>
<tr>
<td>Increase in accounts receivable</td>
<td>(20,520)</td>
</tr>
<tr>
<td>Increase in inventories</td>
<td>(26,568)</td>
</tr>
<tr>
<td>Increase in accounts payable</td>
<td>7,992</td>
</tr>
<tr>
<td>Decrease in accrued expenses payable</td>
<td>(1,944)</td>
</tr>
<tr>
<td>Net cash flow from operating activities</td>
<td>$288,144</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash Flows from Investing Activities</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received from sale of investments</td>
<td>$183,600</td>
</tr>
<tr>
<td>Less: Cash paid for purchase of land</td>
<td>$194,400</td>
</tr>
<tr>
<td>Cash paid for purchase of equipment</td>
<td>324,360</td>
</tr>
<tr>
<td>Net cash flow used for investing activities</td>
<td>(335,160)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash Flows from Financing Activities</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash received from sale of common stock</td>
<td>$231,120</td>
</tr>
<tr>
<td>Less: Cash paid for dividends</td>
<td>97,200</td>
</tr>
<tr>
<td>Net cash flow provided by financing activities</td>
<td>$133,920</td>
</tr>
<tr>
<td>Increase in cash</td>
<td>$86,904</td>
</tr>
<tr>
<td>Cash at the beginning of the year</td>
<td>180,576</td>
</tr>
<tr>
<td>Cash at the end of the year</td>
<td>$267,480</td>
</tr>
</tbody>
</table>

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Ex. 14–19

a. Sales............................................................................. $513,750  
   Plus decrease in accounts receivable balance ...... 32,625  
   Cash received from customers.............................. $546,375 

b. Income tax expense.................................................... $34,500  
   Plus decrease in income tax payable ...................... 3,900  
   Cash payments for income taxes ........................... $38,400 

c. Because cash received from customers exceeded sales made on account by $32,625 during the current year.

Ex. 14–20

Cost of merchandise sold ................................................. $10,680*  
Add increase in merchandise inventories ...................... 124  
Deduct increase in accounts payable .............................. (547)  
Cash paid for merchandise ............................................... $10,257 

*In millions

Ex. 14–21

a. Cost of merchandise sold .......................................... $627,900  
   Add decrease in accounts payable ......................... 6,006  
   Deduct decrease in inventories .............................. (9,464)  
   Cash payments for merchandise ........................... $624,442 

b. Operating expenses other than depreciation ........... $109,200  
   Add decrease in accrued expenses payable ............ 728  
   Deduct decrease in prepaid expenses ................... (910)  
   Cash payments for operating expenses ................. $109,018
Ex. 14–22

a. Cash flows from operating activities:
   Cash received from customers .................. $279,900
   Deduct: Cash payments for merchandise ... $161,820
   Cash payments for operating expenses ........... 52,740
   Cash payments for income taxes ................ 13,020
   Net cash flow from operating activities ...... $52,320

Computations:
1. Sales .................................................. $273,600
   Add decrease in accounts receivable ........... 6,300
   Cash received from customers ................ $279,900

2. Cost of merchandise sold ......................... $155,400
   Add: Increase in inventories .................. $2,100
       Decrease in accounts payable ............ 4,320
   Cash payments for merchandise ............ $161,820

3. Operating expenses other than depreciation .... $ 55,440
   Deduct: Decrease in prepaid expenses ....... $2,040
       Increase in accrued expenses payable ... 660
   Cash payments for operating expenses ..... $ 52,740

4. Income tax expense ................................ $ 11,580
   Add decrease in income tax payable .......... 1,440
   Cash payments for income taxes .......... $ 13,020

b. The direct method directly reports cash receipts and payments. The cash received less the cash payments is the net cash flow from operating activities. Individual cash receipts and payments are reported in the Cash Flows from Operating Activities section.

   The indirect method adjusts accrual-basis net income for revenues and expenses that do not involve the receipt or payment of cash to arrive at cash flows from operating activities.
Ex. 14–23

Cash flows from operating activities:

Cash received from customers ..................... $650,910
Deduct: Cash payments for merchandise .. $238,225
Cash payments for operating expenses .................... 170,755
Cash payments for income taxes .. 58,500

Net cash flow from operating activities ........    $183,430

Computations:

1. Sales .......................................................... $657,800
Deduct increase in accounts receivable .................... 6,890
Cash received from customers ................................ $650,910

2. Cost of merchandise sold ................................... $227,500
Add increase in inventories ................................... 17,875
Cash payments for merchandise ........................... $245,375
Deduct increase in accounts payable ........................... 7,150
Cash payments for merchandise .................... $238,225

3. Operating expenses other than depreciation ........ $170,300
Add decrease in accrued expenses payable ................... 2,600
Cash payments for operating expenses ................ $172,900
Deduct decrease in prepaid expenses .................... 2,145
Cash payments for operating expenses ................ $170,755

Ex. 14–24

a. Cash flows from operating activities ................ $385,000
Less cash paid for maintaining property, plant, and equipment ........................................ 116,000*
Free cash flow .................................................... $269,000

*Property, plant, and equipment to maintain productive capacity: $145,000 × 80% = $116,000

b. Free cash flow is often used to measure the financial strength of a business. The more free cash flow that a business has, the easier it will be for the company to pay the interest on the loan and repay the loan principal. Iglesias’ free cash flow is 70% of cash flows from operations, which is very strong.
Ex. 14–25

a. Fiscal year ended
   May 31, 2010
   (all numbers in thousands)

   Cash flows from operating activities .........................   $3,164.2
   Less capital expenditure to maintain existing capacity:
   Purchases of property and equipment .............. $335.1
   Percent to maintain productive capacity............ × 90% (301.5)
   Free cash flow .............................................................   $2,862.7

b. Free cash flow is often used to measure the financial strength of a business. The more free cash flow that a business has, the easier it will be for the company to pay the interest on the loan and repay the loan principal.

c. Yes. Nike’s free cash flow is extremely strong, and is 9.5 times greater than the capital expenditures necessary to maintain capacity.

Ex. 14–26

Cash flow from operating activities................................. $900,000
Less investments in fixed assets to maintain current production ....................................................... 412,500*
Free cash flow ...................................................................... $487,500

*$550,000 × 75%