CHAPTER

Reporting and Interpreting Cash Flows

5

After studying this chapter, you should be able to:

LEARNING OBJECTIVES

1. Classify cash flow statement items as part of net cash flows from operating, investing, and financing activities. p. 283
2. Report and interpret cash flows from operating activities using the indirect method. p. 239
3. Analyze and interpret the quality of income ratio. p. 245
4. Report and interpret cash flows from investing activities. p. 247
5. Analyze and interpret the capital acquisitions ratio. p. 249
6. Report and interpret cash flows from financing activities. p. 250
7. Explain the impact of additional cash flow disclosures. p. 253

FOCUS COMPANY:

Andrew Peller Limited

MANAGING PRODUCTION AND CASH FLOWS IN A SEASONAL BUSINESS

www.andreswines.com



Andrew Peller, who immigrated to Canada from Hungary in 1927, founded Andrés Wines Ltd. in 1961 to produce wine using grapes from the fertile Okanagan Valley in British Columbia. Thirty years later, in 1991, the company established Peller Estates as the preeminent premium wine label in Canada, offering a variety of white and red wines produced in the Niagara Peninsula. Over the next 15 years, the company continued to grow and expand its business and markets to become Canada's second largest producer and marketer of wines. By 2006, the company's sales exceeded $200 million, and its name was changed to Andrew Peller Limited, in honour of its founder.

Although it may seem puzzling, growing profitable operations does not always ensure positive cash flow. Also, seasonal fluctuations in sales, purchases of inventory, and advertising expenditures may bring **high profits** and **net cash outflows** in some quarters and **losses** and **net cash inflows** in others. As we have seen in earlier chapters, this occurs because the timing of revenues and expenses does not always match cash inflows and outflows. As a consequence, Andrew Peller Limited (APL) must carefully manage cash flows as well as profits. For the same reasons, financial analysts must consider the information provided in APL's cash flow statement in addition to its income statement and its balance sheet.

UNDERSTANDING THE BUSINESS

Clearly, net income is an important indicator of performance, but cash flow is also critical to a company's success. Cash flow permits a company to expand its operations, replace worn assets, take advantage of new investment opportunities, and pay dividends to its owners. Some financial analysts go as far as saying that "cash flow is king." Both managers and analysts need to understand the various sources and uses of cash that are associated with business activity.

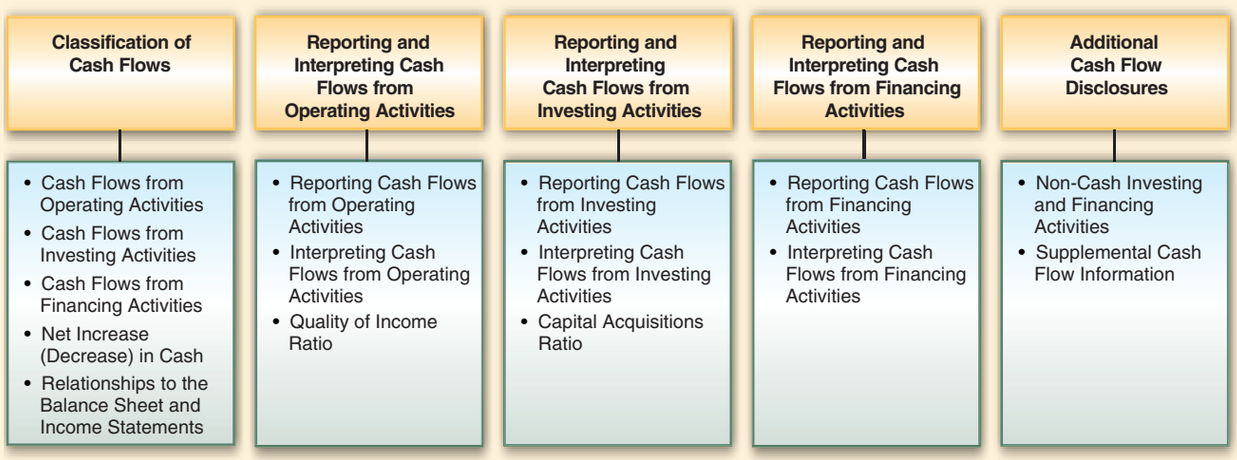
The cash flow statement focuses attention on a firm's ability to generate cash internally, its management of current assets and current liabilities, and the details of its investments and its external financing. It is designed to help both managers and analysts answer important cash-related questions such as these:

- Will the company have enough cash to pay its short-term debts to suppliers, employees, taxation authorities, and other creditors without additional borrowing?
- Is the company adequately managing its accounts receivable, inventory, and other current assets?
- Has the company made necessary investments in new productive capacity?
- Did the company generate enough cash flow internally to finance necessary investments, or did it rely on external financing?
- Is the company changing the proportion of debt and equity in its capital structure?

Andrew Peller Limited (APL) is a particularly good example to illustrate the importance of the cash flow statement. Like all companies in its industry, APL's wine production, inventory purchases and sales vary with the seasons. This seasonal variation has surprising effects on cash flows and net income.

We begin our discussion with an overview of the cash flow statement. We then use APL's cash flow statement for the second quarter of fiscal year 2007 to provide detailed coverage of the preparation, reporting, and interpretation of information in the cash flow statement.

ORGANIZATION OF THE CHAPTER



CLASSIFICATION OF CASH FLOWS

A **CASH EQUIVALENT** is a short-term, highly liquid investment with an original maturity of less than three months.

Basically, the cash flow statement explains how the cash balance at the beginning of the period changed to another cash balance at the end of the period. For purposes of this statement, the definition of *cash* includes cash and cash equivalents. **Cash equivalents** are short-term, highly liquid investments that are both

1. readily convertible to known amounts of cash.
2. so near their maturity that there is a little risk that their value will change if interest rates change.

Generally, an investment qualifies as a cash equivalent only when it has an original maturity of three months or less from the date of acquisition. Examples of cash equivalents are Treasury bills (a form of short-term government debt), money market funds, and commercial paper (short-term notes payable issued by large corporations).

As you can see in Exhibit 5.1, the cash flow statement reports cash inflows and outflows based on three broad categories: (1) operating activities, (2) investing activities, and (3) financing activities. To improve comparability, section 1540 of the *CICA Handbook* defines each category included in the required statement. These definitions (with explanations) are presented in the following sections.

LEARNING OBJECTIVE 1

Classify cash flow statement items as part of net cash flows from operating, investing, and financing activities.

EXHIBIT **5.1**

Consolidated Cash Flow Statement

REAL WORLD EXCERPT

Andrew Peller Limited

QUARTERLY REPORT

ANDREW PELLER LIMITED
Consolidated Statements of Cash Flows—Unaudited
As at September 30, 2006
(in thousands of dollars)

	Three Months Ended September 30, 2006
Cash provided by (used in)	
Operating activities	
Net earnings	2,556
Items not affecting cash:	
Amortization of plant and equipment	1,908
Future income taxes	69
	4,533
Changes in non-cash operating working capital items related to operations	(2,608)*
	1,925
Investing activities	
Purchase of property and equipment	(1,770)
Proceeds from long-term investments	88
	(1,682)
Financing activities	
Repayment of long-term debt	(1,563)
Increase in bank indebtedness	2,098
Payment of dividends	(778)
	(243)
Net cash flow and cash balance, end of period	-0-**

The balances of certain accounts have been adjusted to simplify the presentation.

*Changes in non-cash operating working capital items:	
Increase in accounts receivable	$(6,005)
Increase in inventories	(1,739)
Increase in prepaid expenses	(1,172)
Increase in accounts payable	6,213
Increase in accrued liabilities	565
Decrease in income taxes payable	(470)
	$(2,608)

**Normally, the net cash flow is not equal to zero, and the cash balances at the beginning and end of the period are different from zero. In this specific case, APL did not have any cash either at the beginning or at the end of the period as shown on its balance sheet in Exhibit 5.3. In fact, it borrowed from the bank to cover the shortfall in cash.

CASH FLOWS FROM OPERATING ACTIVITIES

CASH FLOWS FROM OPERATING ACTIVITIES (cash flows from operations) are cash inflows and outflows directly related to earnings from normal operations.

Cash flows from operating activities (cash flows from operations) are the cash inflows and cash outflows that directly relate to revenues and expenses reported on the income statement. These cash flows are not affected by accruals, deferrals, and allocations that result from the timing of revenue and expense recognition. There are two alternative approaches for presenting the operating activities section of the statement:

The **DIRECT METHOD** of presenting the Operating Activities section of the cash flow statement reports components of cash flows from operating activities as gross receipts and gross payments.

1. The **direct method** reports the components of cash flows from operating activities listed as gross receipts and gross payments

Inflows	Outflows
Cash received from	*Cash paid for*
Customers	Purchase of goods for resale and services (electricity, etc.)
Dividends and interest on investments	Salaries and wages
	Income taxes
	Interest on liablities

The difference between the inflows and outflows is called the *net cash inflow* ***(outflow)*** *from operating activities.* APL experienced a net cash inflow of $1,925 from its operations for the second quarter of fiscal year 2007.[1] The *CICA Handbook* recommends the direct method, but it is rarely seen in practice. The direct method is the required format in a number of countries. Many financial executives have reported that they do not use it because it is more expensive to implement than the indirect method.

The **INDIRECT METHOD** of presenting the Operating Activities section of the cash flow statement adjusts net income to compute cash flows from operating activities.

2. The **indirect method** starts with net income and then eliminates non-cash items to arrive at net cash inflow (outflow) from operating activities.

Net income
+/− Adjustments for non-cash items
Net cash inflow (outflow) from operating activities

Notice in Exhibit 5.1 that in the second quarter of 2007, APL reported net income of $2,556 but generated positive cash flows from operating activities of $1,925. Why do net income and cash flow from operating activities differ? Recall that the income statement is prepared under the accrual concept, whereby revenues are recorded when earned without regard to when the related cash is collected. Similarly, expenses are matched with revenues and recorded in the same period as the revenues without regard to when the related cash payments are made.

In this chapter, we present computations of net cash inflow (outflow) from operating activities using the indirect method because of its extensive use in actual financial reporting.[2] In addition, we show in Chapter Supplement B how cash flows from operations can be computed using the direct method.

For now, the most important thing to remember about the two methods is that they are simply alternative ways to compute the same amount. The total amount of **cash flows from operating activities is *always the same*** (an inflow of $1,925 in APL's case), **regardless of whether it is computed using the direct or indirect method**.

[1] APL's fiscal year starts on April 1 and ends on March 31 instead of the calendar year (January 1–December 31) that is used by most companies. As a result, APL's first quarter starts on April 1 and ends on June 30, and its second quarter starts on July 1 and ends on September 30.

[2] A recent survey of 200 companies revealed that only one company used the direct method in its 2005 annual report. N. Chlala, L. Martel, A. Lavigne, and C. Byrd, *Financial Reporting in Canada 2006.* Toronto, CICA, 2006, p. 100.

CASH FLOWS FROM INVESTING ACTIVITIES

CASH FLOWS FROM INVESTING ACTIVITIES are cash inflows and outflows related to the acquisition or sale of productive facilities and investments in the securities of other companies.

Cash flows from investing activities are cash inflows and outflows related to the purchase and disposal of long-term productive assets and investments in the securities of other companies. Typical cash flows from investing activities include:

Inflows	Outflows
Cash received from	*Cash paid for*
Sale or disposal of property, plant and equipment	Purchase of property, plant and equipment
Sale or maturity of investments in securities	Purchase of investments in securities

The difference between these cash inflows and outflows is called ***net cash inflow (outflow) from investing activities***.

For APL, this amount was an outflow of $1,682 for the second quarter of 2007. The Investing Activities section of the statement shows APL's long-term investment strategy. The Management Discussion and Analysis (MD&A) section of the report indicates that the company was continuing to invest in expanding its production facilities.

CASH FLOWS FROM FINANCING ACTIVITIES

CASH FLOWS FROM FINANCING ACTIVITIES are cash inflows and outflows related to external sources of financing (owners and creditors) for the enterprise.

Cash flows from financing activities include exchanges of cash with external sources (owners and creditors) to finance the enterprise and its operations. Usual cash flows from financing activities include these:

Inflows	Outflows
Cash received from	*Cash paid for*
Borrowing on notes, mortgages, bonds, etc., from creditors	Repayment of principal to creditors (excluding interest, which is an operating activity)
Issuing shares to shareholders	Repurchasing shares from owners
	Dividends to shareholders

The difference between these cash inflows and outflows is called ***net cash inflow (outflow) from financing activities***.

For APL, this amount was an outflow of $243 for the second quarter of 2007. The Financing Activities section of the statement shows that APL repaid $7,083,000 to its creditors during the period increased its borrowings from banks, and paid $778 to shareholders.

NET INCREASE (DECREASE) IN CASH

The combination of **the net cash flows from operating activities, investing activities, and financing activities must equal the net increase (decrease) in cash** for the reporting period. For the second quarter of 2007, APL reported a net change of zero in cash. In fact, APL did not report any cash on its balance sheets at June 30, 2006, and September 30, 2006. The cash it generated from operations was not sufficient to pay for the acquisition of property and equipment, and to repay long-term debt, which led APL to borrow from banks to cover the shortfall in cash. Note that significant cash transactions took place during the quarter even though the cash balances were zero at both the beginning and end of this quarter.

	(in thousands)
Net cash provided by operating activities	$1,925
Net cash used in investing activities	(1,682)
Net cash used in financing activities	(243)
Net increase in cash and cash equivalents	0
Cash and cash equivalents at beginning of period	0
Cash and cash equivalents at end of period	$ 0

SELF-STUDY **QUIZ 5-1**

Canadian Tire Corporation

Canadian Tire Corporation is a network of businesses engaged in retail, financial services, and petroleum. A listing of some of its cash flows follows. Indicate whether each item is disclosed in the Operating Activities (O), Investing Activities (I), or Financing Activities (F) section of the statement. (Refer to Exhibit 5.1 as a guide.)

_____ *a.* Purchase of short-term investments
_____ *b.* Net income
_____ *c.* Change in trade accounts receivable
_____ *d.* Additions to property and equipment
_____ *f.* Change in inventories
_____ *g.* Change in accrued liabilities
_____ *h.* Depreciation and amortization
_____ *i.* Issuance of common shares

After you complete your answers, check them with the solutions on page 255.

To give you a better understanding of the cash flow statement, we now discuss in more detail APL's statement and the way that it relates to the balance sheet and income statement. Then we examine the way that each section of the statement describes a set of important decisions that APL's management made. We also discuss the way financial analysts use each section to evaluate the company's performance.

RELATIONSHIPS TO THE BALANCE SHEET AND INCOME STATEMENTS

Preparing and interpreting the cash flow statement require analyzing the balance sheet and income statement accounts that relate to the three sections of the cash flow statement. As we discussed in previous chapters, accountants record transactions as journal entries that are posted to specific ledger accounts. The accounts' balances are then used to prepare the income statement and the balance sheet. Companies cannot prepare the cash flow statement by using amounts recorded in the specific accounts because these amounts are based on accrual accounting. Instead, accountants must analyze the amounts recorded under the accrual basis and adjust them to a cash basis. To prepare the cash flow statement, they need the following data:

1. **Comparative balance sheets** that are used in computing the cash flows from all activities (operating, investing, and financing).
2. A **complete income statement,** which is used primarily in identifying cash flows from operating activities.
3. **Additional details** concerning selected accounts that reflect different types of transactions and events. Analysis of individual accounts is necessary because often the net change in an account balance during the year does not reveal the underlying nature of the cash flows.

Our approach to preparing and understanding the cash flow statement focuses on the changes in the balance sheet accounts. It relies on a simple algebraic manipulation of the balance sheet equation

$$\textbf{Assets} = \textbf{Liabilities} + \textbf{Shareholders' Equity}$$

First, assets can be split into cash and non-cash assets:

$$\textbf{Cash} + \textbf{Non-Cash Assets} = \textbf{Liabilities} + \textbf{Shareholders' Equity}$$

If we move the non-cash assets to the right side of the equation, then

$$\textbf{Cash} = \textbf{Liabilities} + \textbf{Shareholders' Equity} - \textbf{Non-Cash Assets}$$

Given this relationship, the change in cash (Δ) between the beginning and end of the period must equal the changes (Δ) in the amounts on the right side of the equation during the same period:

$$\Delta\,\textbf{Cash} = \Delta\,\textbf{Liabilities} + \Delta\,\textbf{Shareholders' Equity} - \Delta\,\textbf{Non-Cash Assets}$$

Thus, **any transaction that changes cash must be accompanied by a change in liabilities, shareholders' equity, or non-cash assets**.

In general, increases in cash are associated with decreases in non-cash asset accounts, and increases in liability and shareholders' equity account. In contrast, cash decreases when non-cash assets increase, and when liabilities or shareholders' equity decrease.

Exhibit 5.2 illustrates this concept along with a sample of cash transactions that affect different asset, liability, and equity accounts.

Next, we will compute the change in each balance sheet account (ending balance 2 beginning balance and classify each change as relating to operating (O), investing (I), or financing (F) activities, based on APL's quarterly financial statements.

Exhibit 5.3 shows APL's comparative balance sheets at the end of the first and second quarters of 2007, and its income statement for the second quarter of 2007. **The balance sheet accounts related to earning income (operating items) should be marked with an O**. These accounts include the following:

- most current assets (other than short-term investments which relate to investing activities).[3]
- most current liabilities (other than amounts owed to investors and financial institutions,[4] all of which relate to financing activities).
- retained earnings because it increases by the amount of net income, which is the starting point of the Operating section. (Retained earnings also decreases by the amount of dividends declared and paid, which is a financing outflow noted by an F.)

In Exhibit 5.3, all of the relevant current assets and liabilities have been marked with an O. These items include Accounts receivable, Inventories, Prepaid expenses, Bank indebtedness, Accounts payable, Accrued liabilities, Dividends payable, and Income taxes payable. As we have noted, Retained earnings is also relevant to operations.

The balance sheet accounts related to investing activities should be marked with an I. **These include all of the remaining assets on the balance sheet**. In Exhibit 5.3, these are Property, plant and equipment, Goodwill, and Other assets.

The balance sheet accounts related to financing activities should be marked with an F. **These include all of the remaining liability and shareholders' equity accounts on the balance sheet.** In Exhibit 5.3, these are Share capital and Retained earnings (for decreases resulting from dividends declared and paid).

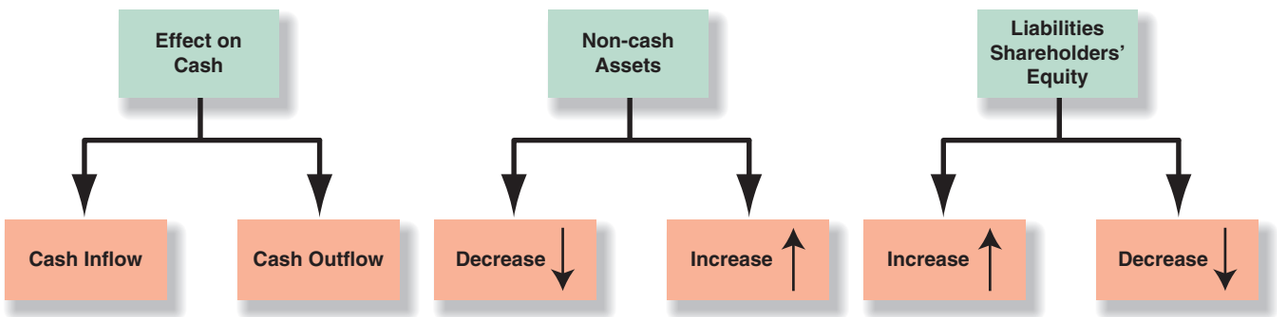


EXHIBIT **5.2**
Selected Cash Transactions and Their Effects on Other Balance Sheet Accounts

Category	Transaction	Effect on Cash	Other Account Affected
Operating	Collect accounts receivable	+Cash	−Accounts Receivable (A)
	Pay accounts payable	−Cash	−Accounts Payable (L)
	Prepay rent	−Cash	+Prepaid Rent (A)
	Pay interest	−Cash	−Retained Earnings (SE)
	Sale for cash	+Cash	+Retained Earnings (SE)
Investing	Purchase equipment for cash	−Cash	+Equipment (A)
	Sell investment securities for cash	+Cash	−Investments
Financing	Pay back debt to bank	−Cash	−Notes Payable—Bank (L)
	Issue shares for cash	+Cash	+Share Capital (SE)

[3]Certain noncurrent assets such as long-term receivables from customers and noncurrent liabilities such as postretirement obligations to employees are considered to be operating items. These items are covered in advanced accounting courses.

[4]Examples of the accounts excluded are Dividends Payable, Short-Term Borrowing (or Bank Indebtedness), and Current Portion of Long-Term Debt (representing long-term debt with an original term longer than one year that is due within one year of the statement date).

In the next sections of this chapter, we use this information to prepare the cash flow statement.

EXHIBIT **5.3**

Andrew Peller Limited: Comparative Balance Sheet and Current Income Statement (In thousands)

ANDREW PELLER LIMITED
Consolidated Balance Sheet—unaudited
(in thousands of dollars)

Related Cash Flow Section		Sept 30, 2006	June 30, 2006	*Change*
	Assets			
	Current Assets			
O	Accounts receivable	27,687	21,682	6,005
O	Inventories	71,870	70,131	1,739
O	Prepaid expenses	4,490	3,318	1,172
	Total current assets	104,047	95,131	
	Property, plant, and equipment (net)	84,863	85,001	−138
I*	Long-term investments	8,131	8,219	−88
I	Goodwill	36,171	36,171	0
I	Total assets	233,212	224,522	
	Liabilities			
	Current liabilities			
	Bank indebtedness	44,080	41,982	2,098
F	Accounts payable	18,423	12,210	6,213
O	Accrued liabilities	7,134	6,569	565
O	Dividends payable	917	778	139
F	Income taxes payable	—	470	−470
O	Current portion of long-term debt	5,897	5,892	5
F	Total current liabilities	76,451	67,901	
	Long-term debt	51,430	52,998	−1,568
F	Future income taxes	12,514	12,445	69
O	Total liabilities	140,395	133,344	
	Shareholders' Equity			
	Share capital	7,375	7,375	0
F	Retained earnings	85,442	83,803	1,639
O and F	Total shareholders' equity	92,817	91,178	
	Total liabilities and shareholders' equity	233,212	224,522	

The balances of certain accounts have been adjusted to simplify the presentation.
*The accumulated amortization account is also related to operations because amortization expense is added back to net income.

ANDREW PELLER LIMITED
Consolidated Statement of Earnings—Unaudited
(in thousands of dollars)

	Quarter ended Sept. 30, 2006
Net Sales	59,413
Cost of goods sold	34,369
Gross margin	25,044
Selling, general and administrative	17,880
Amortization of plant and equipment	1,908
Operating income	5,256
Interest expense	1,383
Income before income taxes	3,873
Provision for income taxes	1,317
Net income	**2,556**

REPORTING AND INTERPRETING CASH FLOWS FROM OPERATING ACTIVITIES—INDIRECT METHOD

The operating section can be prepared in one of two formats: the direct method and the indirect method. The next section presents the indirect method and Chapter supplement B describes the direct method.

Remember that:

1. Cash flow from operating activities is always the same regardless of whether it is computed using the direct or indirect method.
2. The investing and financing sections are always presented in the same manner regardless of the format of the operating section.

REPORTING CASH FLOWS FROM OPERATING ACTIVITIES

LEARNING OBJECTIVE 2
Report and interpret cash flows from operating activities using the indirect method.

We have learned that under accrual accounting, revenues are recognized when earned and expenses are recognized when incurred to generate revenues (the matching principle), regardless of the timing of cash receipts and payments. Consequently, net income includes both cash and non-cash elements related to revenues, expenses, gains, and losses.

Net income = Cash elements +/− Non-cash elements

The direct method focuses on the cash elements of net income by computing cash receipts and cash payments to arrive at net cash flows from operating activities. In contrast, the indirect method starts with net income and eliminates non-cash elements to arrive at the same result.

Cash elements = Net income +/− Non-cash elements

Keeping track of all the additions and subtractions made to convert net income to cash flows from operating activities is facilitated by setting up a schedule to record the computations. We construct such a schedule for Sleeman in Exhibit 5.5 on page.

Preparation of the operating section using the indirect method involves the following steps:

Step 1: Begin the Operating Activities section with net income reported on the income statement. We begin our schedule presented in Exhibit 5.4 with net income of $2,556 taken from APL's income statement (Exhibit 5.3).

Step 2: Adjust net income for the effects of items marked O on Exhibit 5.3 that reflect differences in the timing of accrual basis net income and cash flows. The following adjustments are the ones most frequently encountered:

Income Statement Amounts or Balance Sheet Changes	Impact on the Cash Flow Statement
Net Income	Starting point for computation
Amortization expense	Added
Decreases in current assets	Added
Increases in current liabilities	Added
Increases in current assets	Subtracted
Decreases in current liabilities	Subtracted

This step is completed in two parts:

Step 2a: Adjust net income for amortization expense. Recording amortization expense does not affect the cash account (or any other current asset or liability). It affects a noncurrent asset (such as Equipment, net). **Since amortization expense is subtracted in computing net income, but does not affect cash, we always add it back** to convert net income to cash flow from operating activities.[5] In the case of APL, we need to remove the effect of amortization expense by adding back $1,908 to net income (see Exhibit 5.4).[6]

Step 2b: Adjust net income for changes in current assets and current liabilities marked as operating (O). Each **change** in current assets (other than cash and short-term investments) and current liabilities (other than amounts owed to owners and financial institutions) causes a difference between net income and cash flow from operating activities.[7] When converting net income to cash flow from operating activities, apply the following general rules:

- **Add the change when a current asset decreases or current liability increases.**
- **Subtract the change when a current asset increases or current liability decreases.**

Understanding what makes these current assets and current liabilities increase and decrease is the key to understanding the logic of these additions and subtractions.

Change in Accounts Receivable We illustrate this logic with the first operating item (O) listed on APL's Balance sheet (Exhibit 5.3), accounts receivable. Remember that the income statement reflects sales revenue, but the cash flow statement must reflect cash collections from customers. As the following accounts receivable T-account illustrates, when sales revenues are recorded, accounts receivable increases, and when cash is collected from customers, accounts receivable decreases.

Accounts Receivable (A)

Change +6,005	Beginning balance	21,682		
	Sales revenue (on account)	59,413	Collections from customers	54,308
	Ending balance	27,687		

[5]The fact that amortization is added back to net income may lead the reader to conclude that amortization expense is a source of cash. Nothing could be further from the truth! In fact, amortization is a process of allocation of the cost of assets that have been amortized in the past regardless of the timing of payments for the assets.

[6]Gains and losses on sales of equipment and investments are dealt with in a similar manner and are discussed in Chapter Supplement A. Other similar additions and subtractions are discussed in more advanced accounting courses.

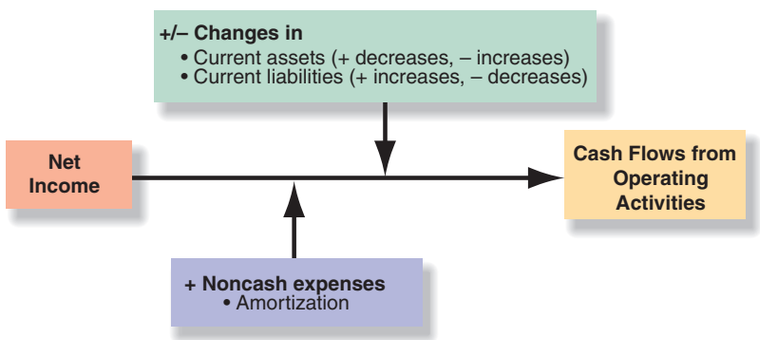
[7]Certain noncurrent assets such as long-term receivables from customers and noncurrent liabilities such as postretirement obligations to employees are considered to be operating items. These items are covered in advanced accounting courses.

EXHIBIT **5.4**

Andrew Peller Limited: Schedule for Net Cash Flow from Operating Activities, Indirect Method (in thousands)

Conversion of net income to net cash flow from operating activities:

Items	Amount	Explanation
Net income, accrual basis	$ 2,556	From income statement.
Add (subtract) to convert to cash basis:		
Depreciation and amortization expense	+1,908	Add because depreciation and amortization expense is a non-cash expense.
Future income tax expense	+69	Add because the future income tax expense is a non-cash expense.
Increase in accounts receivable	−6,005	Subtract because cash collected from customers is less than accrual basis revenues.
Increase in inventories	−1,739	Subtract because cost of goods sold expense is more than purchases.
Increase in prepaid expenses	−1,172	Subtract because accrual basis expenses are less than cash prepayments for expenses.
Increase in accounts payable	+6,213	Add because purchases on account (due to suppliers) are more than cash payments to suppliers.
Increase in accrued liabilities	565	Add because accrual basis expenses are more than the cash payments for expenses.
Decrease in income taxes payable	−470	Subtract because the income tax expense reported on the income statement is less than the income taxes paid.
Net cash inflow from operating activities	$1,925	Reported on the cash flow statement.



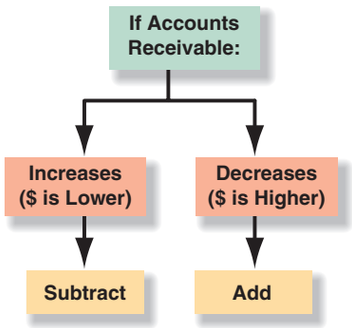
In the APL example, sales revenue on account reported on the income statement is larger than cash collections from customers by $59,413 − $54,308 = $6,005.[8] Since less money was collected from customers, this amount must be subtracted from net income to convert to cash flows from operating activities. Note that this amount is also the same as the **change** in the accounts receivable account:

Ending balance	$21,682
−Beginning balance	27,687
Change	+$ 6,005

[8]The amount of cash collected from customers is the same, regardless of the mix of cash sales and credit sales. To make sure, assume that sales are 20 percent cash and 80 percent on account, and calculate the amount of cash collected from customers during the period.

This same underlying logic is used to determine adjustments for the other current assets and liabilities.

To summarize, the income statement reflects revenues of the period, but cash flow from operating activities must reflect cash collections from customers. Sales on account increase the balance in accounts receivable, and collections from customers decrease the balance.



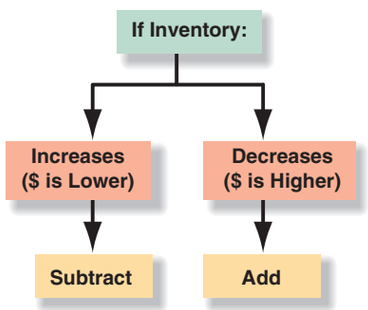
Accounts Receivable (A)	
Beg.	21,682
Increase	6,005
End.	27,687

The balance sheet for APL indicates an **increase** in accounts receivable of $6,005 for the period, which means cash collected from customers is higher than revenue. To convert to cash flows from operating activities, the amount of the decrease must be **subtracted** from net income in Exhibit 5.5. (A decrease is added to net income.)

Change in Inventory The income statement reflects merchandise sold for the period, whereas cash flow from operating activities must reflect cash purchases.

Both the change in inventory and the change in accounts payable (borrowing from suppliers) determine the magnitude of this difference. It is easiest to think about the change in inventory in terms of the simple case in which the company pays cash to suppliers of inventory. We address the added complexity involved when purchases are made on account when we discuss the adjustment for the change in accounts payable.

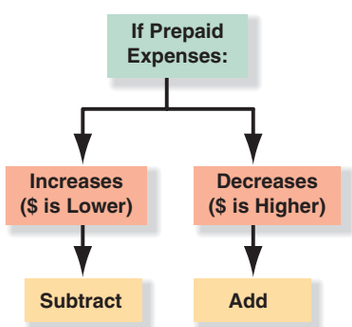
Since purchases of goods increase the balance in inventory and cost of goods sold decreases the balance in inventory, the change in inventory is the difference between purchases and the cost of goods sold.



Inventories (A)	
Beg.	70,131
Increase	1,739
End.	71,870

APL's balance sheet indicates that inventory **increased** by $1,739, which means that the amount of purchases is larger than the amount of merchandise sold. The increase must be **subtracted** from net income to convert to cash flow from operating activities in Exhibit 5.4. (An increase is subtracted from net income.)

Change in Prepaid Expenses The income statement reflects expenses of the period, but cash flow from operating activities must reflect the cash payments. Cash prepayments increase the balance in prepaid expenses, and expenses recognized during the period decrease the balance in prepaid expenses.



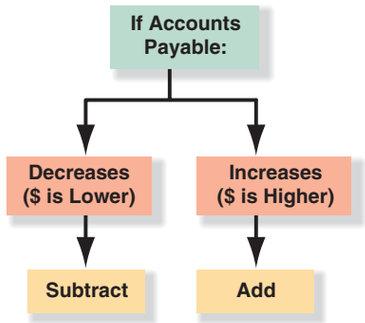
Prepaid Expenses (A)	
Beg.	3,138
Increase	1,172
End.	4,490

The APL balance sheet indicates an **increase** of $1,172 in prepaid expenses, which means that the amount of expenses is lower than new cash prepayments. The increase (the extra payments) must be **subtracted** net income in Exhibit 5.4. (A decrease is added to net income.)

Change in Accounts Payable Cash flow from operations must reflect cash purchases, but not all purchases are for cash. Purchases on account increase accounts payable, and cash paid to suppliers decreases accounts payable.

Accounts Payable (L)	
Beg.	12,210
Increase	6,213
End.	18.423

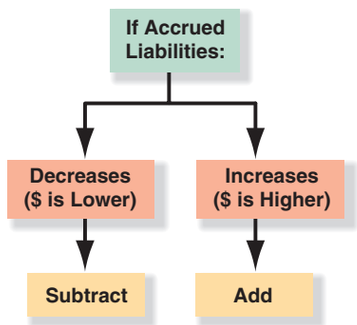
APL's accounts payable **increased** by $6,213, which means that cash payments were lower than purchases on account, and this increase (the lower payments) must be **added** to net income in Exhibit 5.4. (A decrease is subtracted from net income.)



Change in Accrued Liabilities The income statement reflects all accrued expenses, but the cash flow statement must reflect actual payments for those expenses. Recording accrued expenses increases the balance in Accrued liabilities and cash payments for the expenses decrease Accrued liabilities.

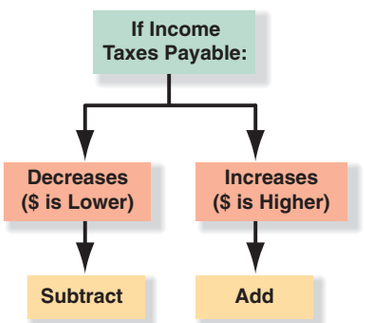
Accounts Liabilities (L)	
Beg.	6,569
Increase	565
End.	7,134

APL's accrued liabilities **increased** by $565, which indicates that accrual-basis expenses are larger than cash paid for the expenses. The increase must be **added** to net income in Exhibit 5.4. (A decrease is subtracted from net income.)



Income Taxes Payable (L)			
		Beg.	470
Decrease	470		
		End.	0

APL's accrued liabilities **decreased** by $470, which indicates that accrual-basis expenses are lower than cash paid for the expenses. The decrease must be **subtracted** from net income in Exhibit 5.4 (An increase is added to net income.)



Summary We can summarize the typical additions and subtractions that are required to reconcile net income with cash flow from operating activities as follows:

	Additions and Subtractions to Reconcile Net Income to Cash Flow from Operating Activities	
Item	**When Item Increases**	**When Item Decreases**
Amortization	+	NA
Accounts receivable	−	+
Inventory	−	+
Prepaid expenses	−	+
Accounts payable	+	−
Accrued expenses (liabilities)	+	−

Notice in this table that an *increase in an asset or a decrease in a liability* is always *subtracted* to reconcile net income to cash flows from operating activities. A *decrease in an asset or an increase in a liability* is always *added* to reconcile net income to cash flows from operating activities. The cash flow statement for APL. (Exhibit 5.1) shows the same additions and subtractions to reconcile net income to cash flows from operating activities described in Exhibit 5.4.

It is important to note again that the net cash inflow or outflow is the same regardless of whether the direct or indirect method of presentation is used (in this case, an inflow of $1,925). The two methods differ only in terms of the details reported on the statement.

A more detailed illustration showing both the direct and indirect methods of computing cash flows from operations is available on the Online Learning Centre Web site at **www.mcgrawhill.ca/college/libby/student/resources**.

SELF-STUDY **QUIZ 5-3**

Canadian Tire Corporation

Indicate which of the following items taken from Canadian Tire Corporation's cash flow statement would be added (+), subtracted (−), or not included (0) in the reconciliation of net income to cash flow from operations.

_____ *a.* Increase in inventories.
_____ *b.* Net borrowings from bank.
_____ *c.* Depreciation and amortization.
_____ *d.* Decrease in trade accounts receivable.
_____ *e.* Increase in trade accounts payable and accrued expenses.
_____ *f.* Increase in prepaid expenses and other current assets.

After you complete your answers, check them with the solutions on page 255.



INTERPRETING CASH FLOWS FROM OPERATIONS

The Operating Activities section of the cash flow statement focuses attention on the firm's ability to generate cash internally through operations and its management of working capital (current assets minus current liabilities). Many analysts regard this as the most important section of the statement because, in the long run, operations are the only source of cash. Investors should not invest in a company if they believe that it will not be able to pay them dividends or make reinvestments with cash generated from operations. Similarly, creditors should not lend money if they believe that cash generated from operations will not be available to pay back the loan. For example, many Internet-based companies crashed when investors lost faith in their ability to turn business ideas into cash from operations.

A common rule followed by financial and credit analysts is to avoid firms with rising net income but falling cash flow from operations. Rapidly rising inventories require the use of cash until goods are sold. Similarly, rapidly rising accounts receivable also delay the collection of cash. Rising inventories and accounts receivable often predict a future slump in profits as revenues fall. This increases the need for external financing as overall cash inflows from operations decline. In the first quarter of fiscal year 2007, APL exhibited just such a pattern. Is this a sign of troubled waters ahead for APL? Why, as indicated in the following chart, did net income increase slightly in the following quarter, but cash flow from operations showed a significant rebound?

	Net Income		Cash Flows from Operations
1st quarter, 2007	$2,376	>	(892)
2nd quarter, 2007	$2,556	<	$1,925

To answer these questions, we must carefully analyze how APL's operating activities are reported in the cash flow statement. At the same time, we also must learn more about the wine industry to properly interpret this information.

Fluctuating Cash Flows from Operations: A Warning Sign? In the first quarter, APL's net income was $2,376 (in thousands), yet it reported a use of cash for operations of $892. Does this suggest that APL may be facing more difficult times?

Analysts who cover the wine industry know that this is a result of seasonal fluctuations in wine sales to distributors. They recognize that wine sales are low in months of April to June (the first quarter for APL), and that sales are higher during the second quarter (July to September) in anticipation of fall. The higher sales volume in the second quarter requires a buildup of inventories over time to meet demand in the fall months, which leads to cash payments to suppliers and employees exceeding cash collections from customers. The imbalance in cash inflows and outflows increases the need for external financing. However, the use of cash for operations during the first quarter is followed by a net cash inflow from operations in the second quarter, when sales and collections from customers increase. This normal seasonal fluctuation in sales is clearly not a sign of problems for APL.

Managers sometimes attempt to boost declining sales by extending credit terms (for example from 30 to 60 days) or by lowering credit standards (that is, lending to riskier customers). The resulting increase in accounts receivable can cause net income to outpace cash flow from operations. As a consequence, many analysts view this pattern as a warning sign.

Analyzing Inventory Changes An unexpected increase in inventory can be another cause for net income to outpace cash flow from operations. Such inventory growth can be a sign that planned sales growth did not materialize. A decline in inventory can be a sign that the company is anticipating lower sales in the next quarter. Many analysts compute the quality of income (or quality of earnings) ratio as a general warning sign of these and similar problems.

QUALITY OF INCOME RATIO

KEY RATIO ANALYSIS



ANALYTICAL QUESTION → How much cash does each dollar of net income generate?

RATIO AND COMPARISONS → The quality of income ratio is useful in answering this question. It is computed as follows:

$$\text{Quality of income Ratio} = \frac{\text{Cash Flow from Operating Activities}}{\text{Net Income}}$$

APL's ratio for the year* 2006 is:

Comparisons over Time			Comparisons with Competitors	
Andrew Peller (annual)			Constellation Brands	Foster's Group
2004	2005	2006	2006	2006
0.43	0.79	3.14	1.34	0.72

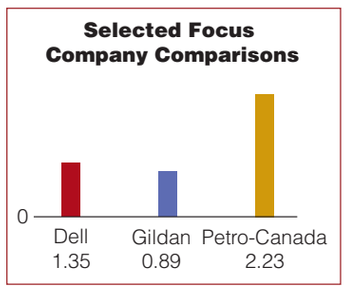
*We use the ratio for the annual period to eliminate the effects of seasonaly it.

INTERPRETATIONS

In General → The quality of income ratio measures the portion of income that was generated in cash. All other things being equal, a higher quality of income ratio indicates a greater ability to finance operating and other cash needs from operating cash inflows.[9] A higher ratio also indicates that it is less likely that the company is using aggressive revenue recognition policies to increase net income. When this ratio does not equal 1.0, analysts must establish the source

LEARNING OBJECTIVE 3

Analyze and interpret the quality of income ratio.



[9]When a net loss is reported, a more negative ratio indicates greater ability to finance the company from operations.

of the difference to determine the significance of the findings. There are four potential causes of any difference:

1. *The corporate life cycle (growth or decline in sales).* When sales are increasing, receivables and inventory normally increase faster than accounts payable. This often reduces operating cash flows below income, which, in turn, reduces the ratio. When sales are declining, the opposite occurs, and the ratio increases.
2. *Seasonality.* As was the case for APL, seasonal variations in sales and purchases of inventory can cause the ratio to deviate from 1.0.
3. *Changes in revenue and expense recognition.* Aggressive revenue recognition or failure to accrue appropriate expenses will inflate net income and reduce the ratio.
4. *Changes in management of operating assets and liabilities.* Inefficient management will increase operating assets and decrease liabilities, which will reduce operating cash flows and reduce the ratio. More efficient management will have the opposite effect.

Focus Company Analysis → APL's quality of income ratio has increased from 0.43 to 3.14 during the last three years. As we noted earlier, the difference between net income and cash flow from operations in the case of APL for the first quarter of 2007 was not a cause for alarm. It was due to normal seasonal changes in sales and receivables. The increase in the ratio in 2006 is due primarily to change in inventory levels. Its ratio for 2006 is higher than the quality of income ratio achieved by both constellation Brands and Foster's Group. The wide variation in APL's ratio would prompt analysts to contact management to determine its causes.

A Few Cautions → The quality of income ratio can be interpreted only based on an understanding of the company's business operations and strategy. For example, a low ratio can be due simply to normal seasonal changes. However, it also can indicate obsolete inventory, slowing sales, or failed expansion plans. Analysts often analyze this ratio in tandem with the accounts receivable turnover and inventory turnover ratios to test for these possibilities.*

*K. G. Palepu, P. M. Healy, and V. L. Bernard, *Business Analysis and Valuation Using Financial Statements,* 2e. Cincinnati, OH: South-Western, 2000.



FINANCIAL **ANALYSIS**

CLASSIFICATION OF CASH FLOWS

We indicated in Chapter 4 that managers may speed up the recognition of revenues or delay the recognition of expenses in order to increase the reported net income, which would reflect positively on their performance and compensation. For this reason, analysts also examine the cash flow from operations, because cash receipts and payments are less susceptible to manipulation. However, the reported operating cash flow can be influenced by classifying certain operating cash flows as investing cash flows.

Certain companies, such as Nortel Networks Limited, General Motors Corp., and Harley-Davidson Inc., provide loans or other financial assistance (known as vendor financing) to their customers to help them buy the companies' products. These loans reduce cash and increase the amount of receivables. The reduction in cash and corresponding increase in receivables are the result of an operating transaction. But these companies tended to classify such transactions as investing activities rather than operating activities in order to avoid their negative effects on operating cash flows. Recently, the U.S. Securities and Exchange Commission required that cash flows resulting from vendor financing be classified as operating cash flows instead of investing cash flows. This requirement has resulted in significant reductions of operating cash flows for companies that followed this practice. For example, the operating cash flows of General Motors Corp. and Ford Motor Company for the year 2003 declined by US$4.4 billion and US$2.1 billion, respectively. The reclassification of cash flows has implications for a proper evaluation of operating cash flows and related analyses, such as the quality of income ratio discussed below.

Source: Michael Rapoport, "Cash flow takes an SEC hit," *National Post*, March 24, 2005, p. FP15.

FRAUD AND CASH FLOWS FROM OPERATIONS

A QUESTION OF ETHICS

The cash flow statement often gives outsiders the first hint that financial statements may contain errors and irregularities. The importance of this indicator as a predictor is receiving more attention following corporate scandals in the United States, as *Forbes* reported:

REAL WORLD EXCERPT

Forbes

> From July 1997 to July 2002 the SEC launched 227 investigations of suspected financial misreporting, 126 of them relating to revenue recognition. Improper timing of sales is the biggest offense—borrowing from the next quarter in a desperate effort to make the analysts happy for the quarter. The SEC also found 80 cases of utterly fictitious revenues and 21 cases of improperly valued revenues...
>
> ... How do you protect yourself as an investor? Spend as much time with the cash flow statement as with the profit-and-loss statement that precedes it. If a company is counting dubious transactions in its revenues, in all likelihood the buyers haven't paid yet, and the cash flow from operations will be anemic in relation to reported profit.*

As noted in earlier chapters, unethical managers sometimes attempt to reach earnings targets by manipulating accruals and deferrals of revenues and expenses to inflate income. Since these adjustments do not affect the cash account, they have no effect on the cash flow statement. As a consequence, a growing difference between net income and cash flow from operations can be a sign of such manipulations. This early warning sign has been evident before some famous bankruptcies, such as that of W. T. Grant. This company had inflated income by failing to make adequate accruals of expenses for uncollectable accounts receivable and obsolete inventory. The growing difference between net income and cash flow from operations that resulted was noted by the more astute analysts who recommended selling the stock long before the bankruptcy.

*Source: Andrew T. Gillies, "Is That Revenue for Real," *Forbes*, April 14, 2003, p. 161.

REPORTING AND INTERPRETING CASH FLOWS FROM INVESTING ACTIVITIES

REPORTING CASH FLOWS FROM INVESTING ACTIVITIES

LEARNING OBJECTIVE 4

Report and interpret cash flows from investing activities.

Preparing this section of the cash flow statement requires analyzing the accounts related to property, plant, and equipment; intangible assets; and investments in the securities of other companies, and lending to other than customers. Normally, the relevant balance sheet accounts include short-term investments and long-term asset accounts such as Long-Term Investments and Property, Plant, and Equipment. The following relationships are the ones that you will encounter most frequently:

Related Balance Sheet Account(s)	Investing Activity	Cash Flow Effect
Property, plant, and equipment and intangible assets (e.g., patents)	Purchase of property, plant, and equipment or intangible assets for cash	Outflow
	Sale of property, plant, and equipment or intangible assets for cash	Inflow
Short- or long-term investments in shares and bonds issued by other companies	Purchase of investment securities for cash	Outflow
	Sale (maturity) of investment securities for cash	Inflow

Typical investing activities include the following:

1. Cash expenditures that include the acquisition of tangible productive assets such as buildings and equipment or intangible assets such as trademarks and patents. **Only purchases paid for with cash or cash equivalents are included.**
2. Cash proceeds from the sale of productive assets or intangible assets. This is the amount of cash that was received from the sale of assets, regardless of whether the assets were sold at a gain or a loss.
3. Purchase of short- or long-term investments for cash. These investments can include shares or bonds issued by other companies, guaranteed investment certificates, or government securities with maturities of more than three months. (Remember that those with maturities of three months or less are cash equivalents.)
4. Cash proceeds from the sale or maturity of short- or long-term investments. Again, this is the amount of cash that was received from the sale, regardless of whether the assets were sold at a gain or a loss.

In the case of APL, the analysis of changes in the balance sheet (shown in Exhibit 5.3) indicates that two long-term assets (noted with an I) have changed during the period: Property, Plant, and Equipment (net), and Long-Term Investments. To determine the causes of changes in these assets, accountants need to search the related company records.

Property, Plant, and Equipment (net) The company's Property, Plant, and Equipment (PPE) decreased by an amount of $138, net of accumulated amortization. Typically, the net change in PPE is the result of three main changes: (1) purchase of new assets, (2) disposal of old assets, and (3) periodic amortization of these assets. The purchase of assets increases the balance of PPE, the disposal of assets decreases the balance of PPE by the net book value (original cost−accumulated amortization) of the assets disposed of, and the periodic amortization increases the accumulated amortization, which in turn reduces the balance of PPE.

During the second quarter of 2007, APL purchased new property, plant, and equipment for cash in the amount of $1,770, which is a cash outflow. This amount less the amortization expense of $1,908, which is added to the net income in the Operations section of the cash flow statement, explains the net decrease in PPE of $138.

Property, Plant, and Equipment (net)

Beg.	85,001	Amortization	1,908
Purchases	1,770		
End.	84,863		

Cash purchases and sales of plant and equipment are listed separately on the cash flow statement.

Long-Term Investments APL's records indicate that it sold long-term investments at book value during the quarter and received $88 in cash. This transaction explains the decrease in the account balance.

Long-Term Investments (A)

Beg.	8,219	Sale	88
End.	8,131		

These investing items are listed in the schedule of investing activities in Exhibit 5.5, and result in a cash outflow of $1,682.

EXHIBIT **5.5**

Andrew Peller Limited. Schedule for Net Cash Flow from Investing Activities (in thousands)

Items from Balance Sheet and Account Analysis	Cash Inflow (Outflows)	Explanation
Additions to property, plant, and equipment	($1,770)	Payment in cash for buildings and equipment.
Proceeds from long-term investments	88	Receipt of cash for sale of investments.
Net cash inflow (outflow) from investing activities	($1,682)	Reported on the cash flow statement.

INTERPRETING CASH FLOWS FROM INVESTING ACTIVITIES

Two common ways of assessing a company's ability to finance its expansion needs from internal sources are the capital acquisitions ratio and free cash flow.

CAPITAL ACQUISITIONS RATIO

KEY RATIO **ANALYSIS**

LEARNING OBJECTIVE 5
Analyze and interpret the capital acquisitions ratio.

ANALYTICAL QUESTION → To what degree was the company able to finance purchases of property, plant, and equipment with cash provided by operating activities?

RATIO AND COMPARISONS → Since capital expenditures for plant and equipment often vary greatly from year to year, this ratio is often computed over longer periods of time than one year, such as the three-year period used here. It is computed as follows:

$$\text{Capital Acquisitions Ratio} = \frac{\text{Cash Flow from Operating Activities}}{\text{Cash Paid for Property, Plant, and Equipment}}$$

The 2004 through 2006* ratio for APL is:

$$\frac{\$29{,}903}{\$22{,}732} = 1.32$$

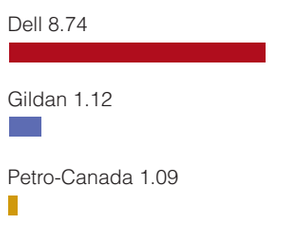
Comparisons over Time		Comparisons with Competitors	
Andrew Peller		Constellation Brands	Foster's Group
2001–2003	2004–2006	2004–2006	2004–2006
1.15	1.32	3.07	2.47

INTERPRETATIONS

In General → The capital acquisitions ratio reflects the portion of purchases of property, plant, and equipment financed from operating activities without the need for outside debt or equity financing or the sale of other investments or fixed assets. A high ratio indicates less need for outside financing for current and future expansion. This provides the company with opportunities for strategic acquisitions, avoids the cost of additional debt, and reduces the risks of bankruptcy that come with additional leverage (see Chapter 11).

Focus Company Analysis → Although APL's ratio has increased from 1.15 to 1.32 in recent years, it is significantly lower than its competitors. To many, the tangible nature of plant and equipment may suggest that it is a low-risk investment. When companies in an industry build more productive capacity than is necessary to meet customer demand, however, the costs of maintaining and financing idle plant can drive a company to ruin. While APL produces and markets its own wine and premium beer, both Constellation Brands and Foster's Group market wine, beer, and other alcoholic beverages produced by other companies, in addition to marketing their own brands. By marketing other brands, these two companies reduce their need to invest in additional productive capacity to expand their operations. These differences in operating strategies are reflected in the companies' capital acquisitions ratio.

Selected Focus Company Comparisons



A Few Cautions → Since the needs for investment in plant and equipment differ dramatically across industries (for example, airlines versus pizza delivery restaurants), a particular firm's ratio should be compared only with its prior years' figures or with other firms in the same industry. Also, a high ratio may indicate a failure to update plant and equipment, which can limit a company's ability to compete in the future.

*Since capital expenditures for plant and equipment vary greatly from year to year, this ratio is often computed over longer periods of time than one year, such as three years.



FINANCIAL ANALYSIS

FREE CASH FLOW

FREE CASH FLOW = Cash Flows from Operating Activities − Dividends − Capital Expenditures

Managers and analysts also often calculate **free cash flow** as a measure of the firm's ability to pursue long-term investment opportunities. It is normally calculated as follows:

Free Cash Flow = Cash Flows from Operating Activities − Dividends − Capital Expenditures

Any positive free cash flow is available for additional capital expenditures, investments in other companies, and mergers and acquisitions, without the need for external financing. While free cash flow is considered a positive sign of financial flexibility, it also can represent a hidden cost to shareholders. Sometimes managers use free cash flow to pursue unprofitable investments just for the sake of growth or for perquisites for management use (such as fancy offices and corporate jets). In these cases, the shareholders would be better off if free cash flow were paid as additional dividends or used to repurchase the company's shares in the open market.

REPORTING AND INTERPRETING CASH FLOWS FROM FINANCING ACTIVITIES

REPORTING CASH FLOWS FROM FINANCING ACTIVITIES

LEARNING OBJECTIVE 6
Report and interpret cash flows from financing activities.

Financing activities are associated with generating capital from creditors and owners. This section reflects changes in two current liabilities, *notes payable to financial institutions* (often called *short-term debt*), *current portion of long-term debt,* as well as changes in *long-term liabilities and shareholders' equity accounts.* These balance sheet accounts relate to the issuance and retirement of debt, repurchase of shares, and the payment of dividends. The following relationships are the ones that you will encounter most frequently:

Related Balance Sheet Account(s)	Cash Flow Financing Activity	Effect
Short-term debt (notes payable)	Borrowing cash from bank or other financial institution	Inflow
	Repayment of loan principal	Outflow
Long-term debt	Issuance of long-term debt for cash	Inflow
	Repayment of principal on long-term debt	Outflow
Share capital	Issuance of shares for cash	Inflow
	Repurchase (retirement) of shares with cash	Outflow
Retained earnings	Payment of cash dividends	Outflow

Financing activities are associated with generating capital from creditors and owners. Typical financing activities include the following:

1. *Proceeds from issuance of short- and long-term debt.* This represents cash received from borrowing from banks and other financial institutions, and issuance of long-term debt (e.g., notes) to the public. **If the debt is issued for other than cash** (for example, issued directly to a supplier of equipment to pay for a purchase), **it is not included on the statement**.

2. *Principal payments on short- and long-term debt.* Cash outflows associated with debt include the periodic repayment of principal as well as interest payments. Cash repayments of principal are listed as cash flows from financing activities. **Interest payments are cash flows from operating activities.**
3. *Proceeds from the issuance of common shares.* This represents cash received from the sale of common shares to investors. If the shares are issued for other than cash (for example, issued directly to an employee as part of salary), the amount is not included in the statement.
4. *Purchase of shares for retirement.* This cash outflow includes cash payments for repurchase of the company's own shares from shareholders.
5. *Cash dividends.* This is the amount of cash dividends paid to shareholders during the year. Some students wonder why cash payments made to creditors (interest) are shown as an operating activity but cash payments to owners (dividends) are shown as a financing activity. Remember that interest is reported on the income statement and is, therefore, directly associated with earning income (it is an operating activity). Dividend payments are not reported on the income statement because they represent a distribution of income. Dividends are more appropriately shown as a financing activity.

To compute cash flows from financing activities, you should review changes in debt and shareholders' equity accounts. In the case of APL, analysis of changes in the balance sheet account balances indicates that bank operating loans, long-term obligations and retained earnings changed during the period (noted with an F).

Short-Term Debt Company records indicate that the change in bank indebtedness resulted from additional borrowing of $2,098 in cash. This item is listed in Exhibit 5.6.

Bank Indebtedness (L)

	Beg.	41,982
Payment	Additional loans	2,098
	End.	44,080

Long-Term Debt The company's long-term debt, including the current portion, decreased from $58,890 to $57,327. Therefore, APL repaid $1,563 of its long-term debt during the second quarter of 2007, as shown in Exhibit 5.6.

Long-Term Debt (L)

		Beg.	58,890
Payment	1,563		
		End.	57,327

Retained Earnings The change in retained earnings resulted from the addition of net income and the declaration of dividends.

Retained Earning (SE)

		Beg.	83,803
Dividends declared	917	Net income	2,556
		End.	85,442

EXHIBIT **5.6**

Andrew Peller Limited. Schedule for Net Cash Flow from Financing Activities (in thousands)

Items from Balance Sheet and Account Analysis	Cash Inflow (Outflows)	Explanation
Increase in bank indebtedness	2,098	Additional borrowing from banks
Long-term obligations—principal repayments	(1,563)	Repayment of the principal amount of long-term debt, including the current portion
Payment of dividends	(778)	Payment of cash dividends to shareholder
Net cash outflow for investing activities	($243)	Reported on the cash flow statement

Dividends Payable The dividends payable at June 30, 2006 were paid during the quarter ended September 30, 2006.

Dividends Payable (L)

		Beg.	778
Payment	778	Dividends declared	917
		End.	917

INTERPRETING CASH FLOWS FROM FINANCING ACTIVITIES

The long-term growth of a company is normally financed from three sources: internally generated funds (cash from operating activities), the issuance of shares, and money borrowed on a long-term basis. As we discuss in Chapter 11, companies can adopt a number of different capital structures (the balance of debt and equity). The financing sources that management uses to fund growth will have an important impact on the firm's risk and return characteristics. The cash flow statement shows how management has elected to fund its growth. This information is used by analysts who wish to evaluate the capital structure and growth potential of a business.



FINANCIAL ANALYSIS

INTERPRETATION OF CASH FLOW PATTERNS

The cash flow statement depicts the relationships among the operating, investing, and financing activities. Throughout this chapter, we have illustrated the reporting and interpretation of APL's cash flows for the second quarter of 2007. These cash flows are specific to one company for a specified time period. To generalize, the table below shows the eight possible patterns of cash flows generated from (used for) operating, investing, and financing activities. A general explanation for each observed pattern is also provided.

TABLE 1
Analysis of Cash Flow Statements: Patterns

	1	2	3	4	5	6	7	8
Cash Flow from Operating	+	+	+	+	−	−	−	−
Cash Flow from Investing	+	−	+	−	+	−	+	−
Cash Flow from Financing	+	−	−	+	+	+	−	−

General explanation of each pattern:

1. The company is using cash generated from operations, from the sale of long-term assets, and from financing to build its cash reserves. This is a very liquid company, possibly looking for acquisitions. This pattern is very unusual.
2. The company is using cash generated from operations to buy long-term assets and to reduce its debt or distribute cash dividends to shareholders. This pattern reflects a mature, successful firm.
3. The company is using cash from operations and from the sale of fixed assets to reduce its debt or distribute cash dividends to shareholders. It is actually downsizing its operations.
4. The company is using cash from operations and from borrowing (or from equity investment) to expand. This pattern is typical of many growing companies.
5. The company's operating cash flow problems are covered by the sale of long-term assets and by borrowing or shareholder contributions. The company is selling its fixed assets to stay in business, and the fact that investors are willing to supply the financing indicates that they apparently expect a turnaround in operating cash flows.
6. The company experiences a shortfall in cash flow from operations and from investing activities. The deficiency in cash is financed by long-term debt or investments by shareholders. This pattern is most typical of a young, fast-growing company.

7. The company is financing operating cash flow shortages, paying its debtholders and/or its shareholders via the sale of long-term assets. The company is actually shrinking.
8. The company is using cash reserves to finance operations, pay long-term creditors and/or investors, and acquire new long-term assets. This unusual scenario is possible only if cash previously accumulated is being used to meet these cash outflows.

Source: Adapted from M. T. Dugan, B. E. Gup, and W. D. Samson, "Teaching the Statement of Cash Flows," *Journal of Accounting Education*, Vol. 9, 1991, pp. 33–52.

Self-Study **Quiz 5-2**

Canadian Tire Corporation

Indicate which of the following items taken from Canadian Tire Corporation's cash flow statement would be reported in the Investing section (I) or Financing section (F) and whether the amount would be an inflow (+) or an outflow (−).

_____ *a.* Net payments on borrowings from bank.

_____ *b.* Purchase of property and equipment for cash.

_____ *c.* Purchase of other (intangible) assets for cash.

_____ *d.* Proceeds from sale (issuance) of common shares.

After you complete your answers, check them with the solutions on page 255.

ADDITIONAL CASH FLOW DISCLOSURES

LEARNING OBJECTIVE 7
Explain the impact of additional cash flow disclosures.

The formal cash flow statement for APL is shown in Exhibit 5.1. As you can see, it is a simple matter to construct the statement after the detailed analysis of the accounts and transactions has been completed (shown in Exhibits 5.4, 5.5, 5.6, and 5.7). If the company uses the direct method for computing cash flow from operations, it must present the reconciliation of net income to cash flow from operations (the indirect method as presented in Exhibit 5.4) as a supplemental schedule. Companies also must provide two other disclosures related to the cash flow statement.

NON-CASH INVESTING AND FINANCING ACTIVITIES

Certain transactions are important investing and financing activities but have no cash flow effects. These are called **non-cash investing and financing activities**. For example, the purchase of a $100,000 building with a $100,000 mortgage given by the former owner does not cause either an inflow or an outflow of cash. As a result, these non-cash activities are not listed in the three main sections of the cash flow statement. Section 1540 of the *CICAHandbook* requires supplemental disclosure of these transactions in either narrative or schedule form. APL's cash flow statement does not list any non-cash investing and financing activities. The following schedule from the 2006 annual report of Gildan Activewear Inc. provides examples of these non-cash transactions.

NON-CASH INVESTING AND FINANCING ACTIVITIES are transactions that do not have direct cash flow effects; they are reported as a supplement to the cash flow statement in narrative or schedule form.

REAL WORLD EXCERPT

Gildan Activewear

ANNUAL REPORT

b) Supplemental cash flow disclosure (in thousands of dollars)

	2006	2005	2004
Non-cash transactions			
Additions to fixed assets included in accounts payable and accrued liabilities	2,979	740	3,473
Issuance of shares on acquistion of Kentucky Derby	460	—	—

Source: Gildan Activewear Inc., annual report 2006, page 64

SUPPLEMENTAL CASH FLOW INFORMATION

Companies that use the indirect method of presenting cash flows from operations also must provide two other figures: cash paid for interest and for income taxes. These are normally listed at the bottom of the statement or in the notes.

DEMONSTRATION CASE

Redhook Ale Brewery

During the year ended December 31, 2007, Redhook Ale Brewery, a craft brewer, reported net income of $3,182 (all numbers in thousands), and cash and cash equivalents of $472 at the beginning and $24,676 at the end of the year. It also engaged in the following activities:

a. Paid $18,752 in principal on debt.
b. Received $46,202 in cash from initial public offering of common shares.
c. Incurred other non-current accrued operating expenses of $857.
d. Paid $18,193 in cash for purchase of fixed assets.
e. Accounts receivable increased by $881.
f. Borrowed $16,789 from various lenders.
g. Refundable deposits payable increased by $457.
h. Inventories increased by $574.
i. Made cash deposits on equipment of $5,830.
j. Income tax refund receivable decreased by $326.
k. Sold (issued) shares to employees for $13 in cash.
l. Accounts payable decreased by $391.
m. Received $4 from other investing activities.
n. Accrued expenses increased by $241.
o. Prepaid expenses increased by $565.
p. Recorded amortization of $1,324.
q. Paid $5 cash for other financing activities.

Required:

Based on this information, prepare the cash flow statement for the year ended December 31, 2007. Use the indirect method to compute the cash flow from operating activities.

We strongly recommend that you prepare your own answer to this requirement and then check it with the solution below.

SUGGESTED SOLUTION

REDHOOK ALE BREWERY
CASH FLOW STATEMENT
FOR THE YEAR ENDED DECEMBER 31, 2007 (IN THOUSANDS)

Operating activities	
Net income	$3,182
Add (deduct) items not affecting cash:	
Amortization	1,324
Other non-current accrued expenses	857
Increase in accounts receivable	(881)
Increase in inventories	(574)
Decrease in income taxes receivable	326
Increase in prepaid expenses	(565)
Decrease in accounts payable	(391)
Increase in accrued expenses	241
Increase in refundable deposits payable	457
Net cash flow from operating activities	3,976
Investing activities	
Expenditures for fixed assets	(18,193)
Deposits on equipment	(5,830)
Other	4
Net cash flow from investing activities	(24,019)

(continued)

Financing activities	
Proceeds from debt	16,789
Repayment of debt	(18,752)
Proceeds from sale of shares (IPO)	46,202
Proceeds from sale of shares (options)	13
Other	(5)
Net cash flow from financing activities	44,247
Increase in cash and cash equivalents	24,204
Cash and cash equivalents:	
Beginning of year	472
End of year	$24,676

SOLUTIONS TO **SELF-STUDY QUIZZES**

Self-Study Quiz 5-1

a. I, *b.* 0, *c.* 0, *d.* I, *e.* 0, *f.* 0, *g.* 0, *h.* 0, *i.* F, *j.* 0.

Self-Study Quiz 5-2

a. 0, *b.* 0, *c.* +, *d.* 0, *e.* −, *f.* −.

Self-Study Quiz 5-3

a. −, *b.* 0, *c.* +, *d.* +, *e.* +, *f.* −.

Self-Study Quiz 5-4

a. F−, *b.* I−, *c.* I−, *d.* F+.

Chapter Supplement A

Adjustment for Gains and Losses: Indirect Method

The operating activities section of the cash flow statement may include an adjustment for gains and losses reported on the income statement. The transactions that cause gains and losses should be classified on the cash flow statement as operating, investing, or financing activities, depending on their dominant characteristics. For example, if the sale of a productive asset (e.g., a delivery truck) produced a gain, it would be classified as an investing activity.

An adjustment must be made in the Operating Activities section to avoid double counting of the gain or loss. To illustrate, consider the following entry for Andrew Peller Limited to record the sale of a delivery truck:[10]

Cash (+A)	8,000	
Accumulated amortization (−XA, +A)	4,000	
Property, plant, and equipment (−A)		10,000
Gain on sale of assets (+Gain, +SE)		2,000

Assets		= Liabilities	+ Shareholders' Equity	
Cash	+8,000		Gain on sale of assets	+2,000
Accumulated amortization	+4,000			
Property, plant, and equipment	−10,000			

[10] The disposal of assets and the resulting gains or losses are discussed in detail in Chapter 9.

The $8,000 inflow of cash is an investing cash inflow, but the gain of $2,000 is also reported on the income statement. Because the gain is included in the computation of net income, it is necessary to remove (subtract) the $2,000 gain from the Operating Activities section of the statement to avoid double counting.

When a loss is reported on the income statement, it also must be removed from cash flows from operating activities. Consider the following entry to record the sale of assets:

Cash (+A)	41,000	
Accumulated amortization (−XA, +A)	15,000	
Loss on sale of assets (−Loss, −SE)	12,000	
Property, plant, and equipment (−A)		68,000

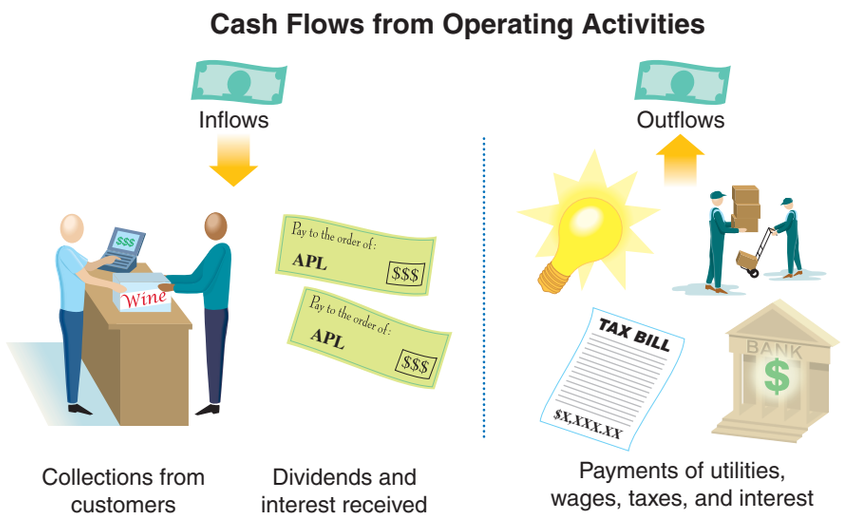
Assets		= Liabilities	+ Shareholders' Equity	
Cash	+41,000		Loss on sale of assets	+2,000
Accumulated amortization	+15,000			
Property, plant, and equipment	−68,000			

On the cash flow statement, the loss of $12,000 must be removed (added to net income) in the computation of cash flow from operating activities, and the total cash collected of $41,000 must be shown in the investing activities section of the statement.

Chapter Supplement B

Reporting Cash Flows From Operating Activities—Direct Method

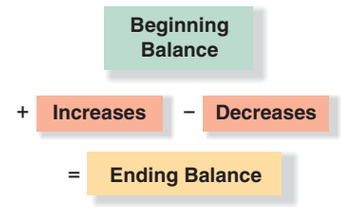
Exhibit 5.3 shows APL's comparative balance sheets at the end of the first and second quarters of 2007, and its income statement for the second quarter of 2007. Recall that the direct method reports gross cash receipts and gross cash payments related to operating activities. It presents a summary of all operating transactions that resulted in either a debit or a credit to cash.



Converting revenue and expense items from an accrual basis to a cash basis

The computation of cash receipts and payments requires adjusting each item on the income statement from an accrual basis. To facilitate this process, we analyze the change in the balances of each current asset and current liability account by examining the type of transactions that affect the account. This process helps us determine the amount of cash received or paid during the accounting period.

We will use the following relation to analyze the changes in each current asset and liability account:



Converting Revenues to Cash Inflows When sales are recorded, accounts receivable increase, and when cash is collected, accounts receivable decrease. Hence, the change from the beginning balance of Accounts Receivable (AR_B) to the ending balance (AR_E) can be represented as follows:

In general	APL's example
Accounts receivable, beginning (known)	$21,682
+ Sales revenue (known)	+59,413
− Cash collections from customers (computed)	−A
= Accounts receivable, ending (known)	=$27,687

The beginning and ending balances of accounts receivable are reported on the balance sheet, and sales revenue is reported on the income statement. However, the amount collected from customers is not reported on either statement, but can be derived from the relation above.

Using information from APL's income statement and balance sheet presented in Exhibit 5.3, we can compute the cash collected from customers as follows:

Accounts Receivable

Beg.	21,682		
Sales	59,413	Collections	**53,408**
End.	27,687		

Cash collections = $21,682 + $59,413 − $27,687 = $53,408[11]

The beginning balance of accounts receivable increases the cash received from customers on the assumption that all amounts owed to the company at the beginning of the period are collected during the period. In contrast, the ending balance of accounts receivable is deducted from sales revenue because these receivables have already been included in sales revenue, but have not yet been collected from customers.

Converting Cost of Goods Sold to Cash Paid to Suppliers The cost of goods sold during the accounting period may be greater or smaller than the amount of cash paid to suppliers of merchandise during the period. The computation of the cash paid to suppliers is a two-stage process. First, we analyze the change in the Inventory account to determine the amount of merchandise purchases during the period, and then we analyze the change in the Accounts Payable account to compute the amount of cash payments to suppliers using the following relations:

In general	APL's example
Inventories, beginning (known)	$70,131
+ Merchandise purchases (computed)	+A
− Cost of goods sold (known)	−34,369
= Inventories, ending (known)	=$71,870

In general	APL's example
Accounts payable, beginning (known)	$12,210
+ Merchandise purchases (computed)	+A
− Cash payments to suppliers (computed)	−B
= Accounts payable, ending (known)	=$18,423

[11]We assume that all scales are made on account. However, the amount of cash collected from customers is the same regardless of the mix of cash and credit sales. To be sure, assume that sales are 20-percent cash and 80-percent on account, and compute the amount of cash collected from customers during the period. You can use other percentages as well.

The beginning and ending balances of inventory and accounts payable are reported on the balance sheet, and the cost of goods sold is reported on the income statement. However, the amount of merchandise purchases and the payments to suppliers are not reported on either statement, but can be derived from the relations above.

Using information from APL's income statement and balance sheet presented in Exhibit 5.3, we can compute the cash paid to suppliers as follows:

Inventory

Beg.	70,131		
Purchases	**36,108**	Cost of goods sold	34,369
End.	71,870		

Accounts Payable

		Beg.	12,210
Cash payments	**29,895**	Purchases	**36,108**
		End.	18,423

Merchandise purchases = $34,369 + $71,870 − $70,131 = $36,108

The ending balance of inventory is added to cost of goods sold to determine the cost of goods that were available for sale during the period. Given that part of the merchandise was available at the beginning of the period, it is deducted from the goods available to determine the amount of purchases during the period.

Cash payments to suppliers = $36,108 + $12,210 – $18,423 = $29,895[12]

The beginning balance of accounts payable is added to merchandise purchases to determine the total amount payable to suppliers. The ending balance of accounts payable is then deducted from that total because these payables have not been paid to suppliers yet.

Converting Other Operating Expenses to a Cash Outflow The total amount of any operating expense on the income statement may differ from the cash payment for that expense during the accounting period. Some expenses are paid before they are recognized as expenses (e.g., prepaid rent). When prepayments are made, the balance in the asset Prepaid Expenses increases; when prepaid expenses are used up and recognized as expenses for the period, the account balance decreases. Other expenses are paid for after they are recognized in the same or previous periods. In this case, when expenses are recorded, the balance in the account Accrued Liabilities increases; when payments are made, the account balance decreases. The computation of the cash paid for operating expenses is therefore a two-stage process. First, we analyze the change in the Prepaid Expenses (PE) account to determine the amount of cash paid during the period, and then we analyze the change in the Accrued Liabilities (AL) account to compute the amount of cash that was paid during the period for various other expenses, as shown in the following relations:

In general	APL's example
Prepaid expenses, beginning (known)	$3,318
+ Cash payments for future (deferred) expenses (unknown)	+A
− Prepaid expenses that were used up during the period (unknown)	−B
= Prepaid expenses, ending (known)	=$4,490

In general	APL's example
Accrued liabilities, beginning (known)	$6,569
+ Expenses accrued during the period (unknown)	+C
− Cash payments for accrued expenses (unknown)	−D
= Accrued liabilities, ending (known)	=$7,134

The beginning and ending balances of prepaid expenses and accrued liabilities are reported on the balance sheet. But, the prepaid expenses (B) that were used up during the period are not reported separately on the income statement. Hence, we cannot compute the amount of cash (A) paid for future expenses. Similarly, the expenses (C)

[12]We assume that all purchases are made on account. However, the amount of cash paid to suppliers is the same regardless of the mix of cash and credit purchases. To be sure, assume that purchases are 10-percent cash and 90-percent on account, and compute the amount of cash paid to suppliers during the period. You can use other percentages as well.

that accrued during the period are not reported separately on the income statement, which makes it difficult to compute the amount of cash (D) paid during the period to settle accrued expenses. However, the amounts B and C are reported together on the income statement as operating expenses (or selling, general, and administrative expenses). By combining the two relations, we can then compute the sum of A and D, which represents the payments made for other expenses.

Using information from APL's income statement and balance sheet presented in Exhibit 5.3, we can compute the cash paid for other expenses as follows:

Cash paid for other expenses =	**$17,880**	(general, selling, and administrative expenses, reflecting prepayments that expired during the quarter and accrued expenses)
+	**4,990**	(prepaid expenses, end of quarter)
−	**3,318**	(prepaid expenses, beginning of quarter)
+	**6,569**	(accrued liabilities, beginning of quarter)
−	**7,134**	(accrued liabilities, end of quarter)
=	**$18,487**	

Prepaid Expenses

Beg.	3,318	Prepayments that expired	unknown
Cash payments	Unknown		
End.	4,490		

Accrued Liabilities

Cash payments	Unknown	Beg.	6,569
		Unpaid expenses	unknown
		End.	7,134

Similar analysis can be applied to computing the cash payments for interest and income taxes. Sleeman reports interest expense of $1,383. Since there is no balance in Interest Payable, interest paid must be equal to interest expense.

APL's income tax expense equals $1,317. This expense usually consists of two components: an amount that is currently payable to the federal and provincial taxation authorities, and another amount labelled Future Income Taxes. Future income taxes result from temporary differences that exist between the accounting principles that underlie financial reporting and tax rules that govern the preparation of tax returns. These differences relate to the timing of recognition of revenues and expenses for financial reporting (that is based on accrual accounting) compared to taxation rules that essentially use a cash basis of accounting.

The computation of cash paid for income taxes should take into consideration changes in two accounts: Income Taxes Payable and Future Income Taxes. Since there is no balance in Income Taxes Payable, income taxes paid is computed as follows:

Income tax expense	$1,317
+ Income taxes payable, begining	470
− Income taxes payable, ending	0
	1,787
Increase in future income tax liability	69
Cash payments for income taxes	$1,718

The operating cash inflows and outflows are accumulated in Exhibit 5.4.

EXHIBIT **5.7**

Andrew Peller Limited. Schedule of Net Cash Flow From Operating Activities, Direct Method (in thousands)

Cash flows from operating activities		
Cash collected from customers		$53,408
Cash payments		
–to suppliers	$29,895	
–for other operating expenses	18,487	
–for interest	1,383	
–for income taxes	1,718	51,483
Net cash provided by operating activities		$1,925

To summarize, the following adjustments must commonly be made to convert income statement items to the related operating cash flow amounts:

Income Statement Account	+/− Change in Balance Sheet Account(s)	= Operating Cash Flow
Sales revenue	+ Beginning accounts receivable − Ending accounts receivable	= Collections from customers
Cost of goods sold	− Beginning inventory + Ending inventory + Beginning accounts payable − Ending accounts payable	= Payments to suppliers of inventory
Other operating expenses	− Beginning prepaid expenses + Ending prepaid expenses + Beginning accrued liabilities − Ending accrued liabilities	= Payments to suppliers of services (e.g., rent, utilities, wages)
Interest expense	+ Beginning interest payable − Ending interest payable	= Payments for interest
Income tax expense	+ Beginning income taxes payable − Ending income taxes payable +/− Changes in future incomes tax assets and liabilities	= Payments for income taxes

INTERNATIONAL PERSPECTIVE — AUSTRALIAN PRACTICES

REAL WORLD EXCERPT

Foster's Brewing

ANNUAL REPORT

Foster's Brewing is the first name in Australian beer and a major player in world beverage markets. Following Australian GAAP, which require use of the direct method of presentation, Foster's cash flow from operations is presented as follows:

STATEMENT OF CASH FLOWS FOR THE YEAR ENDED 30 JUNE 2006
(dollars in million)

Cash Flows from Operating Activities

Receipts from customers	6,841.4
Payments to suppliers, governments, and employees	(5,564.1)
Interest received	41.6
Borrowing costs	(273.8)
Income taxes paid	(210.0)
Net cash flows from operating activities	835.1

Note that Foster's combines payments to suppliers, government and employees, but other companies report these items separately. Like Canadian companies that choose the direct method, Foster's reports the indirect presentation in a note to the financial statements.

SELF-STUDY QUIZ 5-4

Indicate which of the following items taken from the cash flow statement would be added (+), subtracted (−), or not included (0) in the cash flow from operations section when the direct method is used.

_____ *a.* Increase in inventories.
_____ *b.* Payment of dividends to shareholders.
_____ *c.* Cash collections from customers.
_____ *d.* Purchase of plant and equipment for cash.
_____ *e.* Payment of interest to debtholders.
_____ *f.* Payment of taxes to the taxation authorities.

After you complete your answers, check them with the solutions on page 255.

Chapter Supplement C

Spreadsheet Approach—Cash Flow Statement: Indirect Method

As situations become more complex, the analytical approach that we used to prepare the cash flow statement for Andrew Peller Limited. becomes cumbersome and inefficient. In actual practice, most companies use a spreadsheet approach to prepare the cash flow statement. The spreadsheet is based on the same logic that we used in our previous illustration. Its primary advantage is that it offers a more systematic way to keep track of data. You may find it useful even in simple situations.

Exhibit 5.8 shows the spreadsheet to prepare APL's cash flow statement. It is organized as follows:

1. Four columns to record dollar amounts are established. The first column is for the beginning balances for items reported on the balance sheet; the next two columns reflect debit and credit changes to those balances; the final column contains the ending balances for the balance sheet accounts.
2. On the left of the top half of the spreadsheet, each account name from the balance sheet is entered.
3. On the left of the bottom half of the spreadsheet, the name of each item that will be reported on the cash flow statement is entered.

Changes in the various balance sheet accounts are analyzed in terms of debits and credits in the top half of the spreadsheet, with the offsetting debits and credits being recorded in the bottom half of the spreadsheet in terms of their impact on cash flows. Each change in the non-cash balance sheet accounts explains part of the change in the Cash account. To illustrate, let us examine each of the entries on the spreadsheet for APL shown in Exhibit 5.8. You will note that they follow each of the items presented in the schedule to prepare the cash flow statement shown in Exhibits 5.4, 5.5, and 5.6.

a. This entry is used to start the reconciliation; net income is shown as an inflow in the Operating Activities section to be reconciled by the non-cash entries. The credit to Retained Earnings reflects the effects of the original closing entry. This is the starting point for the reconciliation.

b. Amortization expense is a non-cash expense. It is added back to net income because this type of expense does not cause a cash outflow when it is recorded. The credit to Accumulated Amortization reflects the effects of the original entry to record amortization.

c. This entry reconciles the accrual of future income tax liabilities with payments for these liabilities. It is added because cash payments for these liabilities were less than new accruals.

d. This entry reconciles the change in accounts receivable during the period with net income. It is added to net income because cash collections from customers exceeded sales revenue.

e. This entry reconciles the purchases of inventory with cost of goods sold. It is subtracted from net income because more inventory was purchased than was sold.

f. This entry reconciles the prepayment of expenses with their expiration. It is subtracted from net income because new cash prepayments exceeded than the amounts that expired and were recorded as expenses during the period.

g. This entry reconciles cash paid to suppliers with purchases on account. It is added to net income because less cash was paid than was borrowed during the period.

h. This entry reconciles the accrual of expenses with related payments. It is added to net income because cash payments for these expenses were less than the accrued liabilities.

i. This entry reconciles income taxes expense with related payments. It is subtracted from net income because cash payments exceeded the expense.

EXHIBIT **5.8**

Spreadsheet to Prepare Cash Flow Statement, Indirect Method

ANDREW PELLER LIMITED
Quarter Ended September 30, 2006
(in thousands of dollars)

Items from Balance Sheet	Beginning Balances June 30, 2006	Analysis of Change Debit	Analysis of Change Credit	Ending Balances September 30, 2006
Accounts receivable	21,682	(d) 6,005		27,687
Inventories	70,131	(e) 1,739		71,870
Prepaid expenses	3,318	(f) 1,172		4,490
Property, plant and equipment (net)	85,001	(j) 1,770	(b) 1,908	84,863
Long term investments	8,219		(k) 88	8,131
Goodwill	36,171			36,171
Bank indebtedness	41,982		(l) 2,098	44,080
Accounts payable	12,210		(g) 6,213	18,423
Accrued liabilities	6,569		(h) 565	7,134
Dividends payable	778	(o) 778	(n) 917	917
Income taxes payable	470	(i) 470		—
Current portion of long-term debt	5,892		(m) 5	5,897
Long term debt	52,998	(m) 1,568		51,430
Future income taxes	12,445		(c) 69	12,514
Share capital	7,375			7,375
Retained earnings	83,803	(n) 917	(a) 2,556	85,442

	Inflows	Outflows	Subtotals
Cash Flow Statement			
Cash flows from operating activities			
Net income	(a) 2,556		
Adjustments to reconcile net income to net cash provided by operating activities:			
Amortization of plant and equipment	(b) 1,908		
Future income taxes	(c) 69		
Changes in noncash working capital items			
Accounts receivable		(d) 6,005	
Inventories		(e) 1,739	
Prepaid expenses		(f) 1,172	
Accounts payable	(g) 6,213		
Accrued liabilities	(h) 565		
Income taxes payable		(i) 470	
			1,925
Cash flows from investing activities			
Purchase of property and equipment		(j) 1,770	
Proceeds from long term investments	(k) 88		
			(1,682)
Cash flows from financing activities			
Increase in bank indebtedness	(l) 2,098		
Repayment of long-term debt		(m) 563	
Payment of dividends		(o) 778	
			(243)
Net increase (decrease) in cash and cash equivalents	(p)	1,970	—
	13,497	13,497	

j. This entry records the purchases of new plant and equipment for cash.

k. This entry records the decrease in long-term investments.

l. This entry records the increase in bank indebtedness.

m. This entry shows the repayment of principal on long-term debt, including the current portion.

n and *o.* These entries show the declaration and payment of cash dividends.

The preceding entries complete the spreadsheet analysis because all accounts are reconciled. The accuracy of the analysis can be checked by adding the two analysis columns to verify that Debits = Credits. You should also note that the debits and credits to the balance sheet accounts directly match those recorded in the T-accounts presented in the body of the chapter. The formal cash flow statement can be prepared directly from the spreadsheet.

The analytical technique that you have learned for preparing the cash flow statement will help you deal with other significant business problems. For example, this type of analysis is useful for developing cash budgets for a business. Many small businesses that experience rapid sales growth get into serious financial difficulties because they did not forecast the cash flow effects associated with credit sales and large increases in inventory.

CHAPTER **TAKE-AWAYS**

1. **Classify cash flow statement items as part of net cash flows from operating, investing, and financing activities. p. 283**
   The statement has three main sections: Cash Flows from Operating Activities, which are related to earning income from normal operations; Cash Flows from Investing Activities, which are related to the acquisition and sale of productive assets; and Cash Flows from Financing Activities, which are related to external financing of the enterprise. The net cash inflow or outflow for the year is the same amount as the increase or decrease in cash and cash equivalents for the year. Cash equivalents are highly liquid investments with original maturities of less than three months.
2. **Report and interpret cash flows from operating activities using the indirect method. p. 239**
   The indirect method for reporting cash flows from operating activities reports a conversion of net income to net cash flow from operating activities. The conversion involves additions and subtractions for (1) non-current accruals including expenses (such as amortization expense) and revenues that do not affect current assets or current liabilities, and (2) changes in each of the individual current assets (other than cash and short-term investments) and current liabilities (other than short-term debt to financial institutions and current portion of long-term debt, which relate to financing), that reflect differences in the timing of accrual basis net income and cash flows.
3. **Analyze and interpret the quality of income ratio. p. 245**
   The quality of income ratio (Cash Flow from Operating Activities ÷ Net Income) measures the portion of income that was generated in cash. A higher quality of income ratio indicates greater ability to finance operating and other cash needs from operating cash inflows. A higher ratio also indicates that it is less likely that the company is using aggressive revenue recognition policies to increase net income.
4. **Report and interpret cash flows from investing activities. p. 247**
   Investing activities reported on the cash flow statement include cash payments to acquire property, plant, and equipment, and short- and long-term investments. They also include cash proceeds from the sale of these assets.
5. **Analyze and interpret the capital acquisitions ratio. p. 249**
   The capital acquisitions ratio (Cash Flow from Operating Activities ÷ Cash Paid for Property, Plant, and Equipment) reflects the portion of purchases of property, plant, and equipment financed from operating activities without the need for outside debt or equity financing or the sale of other investments or other long-term assets. A high ratio is beneficial because it provides the company with opportunities for strategic acquisitions.

6. **Report and interpret cash flows from financing activities. p. 250**
   Cash inflows from financing activities include cash proceeds from issuance of short- and long-term debt and share capital. Cash outflows include principal payments on short- and long-term debt, cash paid for the repurchase of the company's shares, and dividend payments. Cash payments associated with interest relate to operating activities.
7. **Explain the impact of additional cash flow disclosures. p. 253**
   Non-cash investing and financing activities are investing and financing activities that do not involve cash. They include, for example, purchases of long-term assets with long-term debt or shares, exchanges of long-term assets, and exchanges of debt for shares. These transactions are disclosed only as supplemental disclosures to the cash flow statement along with cash paid for taxes and interest under the indirect method.

The previous four chapters discussed the important steps in the accounting process that lead to the preparation of the four basic financial statements. This end to the internal portions of the accounting process, however, is just the beginning of the process of communicating accounting information to external users.

In the next chapter, we discuss the important players in this communication process, the many statement format choices available, the additional note disclosures required for both private and public companies, and the process, manner, and timing of the transmission of this information to users. At the same time, we discuss common uses of the information in investment analysis, debt contracts, and management compensation decisions. These discussions will help you consolidate much of what you have learned about the financial reporting process from previous chapters. It will also preview many of the important issues we will address later in the book.

KEY RATIO

The **quality of income ratio** indicates what portion of income was generated in cash. It is computed as follows (p. 245):

$$\text{Quality of Income Ratio} = \frac{\text{Cash Flow from Operating Activities}}{\text{Net Income}}$$

The **capital acquisitions ratio** measures the ability to finance purchases of property, plant, and equipment from operations. It is computed as follows (p. 249):

$$\text{Capital Acquisitions Ratio} = \frac{\text{Cash Flow from Operating Activities}}{\text{Cash Paid for Property, Plant, and Equipment}}$$

FINDING FINANCIAL INFORMATION

BALANCE SHEET
Changes in Assets, Liabilities, and Shareholders' Equity

INCOME STATEMENT
Net Income and Accruals

CASH FLOW STATEMENT
Cash Flows from Operating Activities
Cash Flows from Investing Activities
Cash Flows from Financing Activities
Separate Schedule (or note):
- Non-cash investing and financing activities
- Interest and taxes paid

NOTES
Under Summary of Significant Accounting Policies
- Definition of cash equivalents

Under Separate Note
- If not listed on cash flow statement:
  - Non-cash investing and financing activities
  - Interest and taxes paid

KEY TERMS

Cash Equivalent p. 232
Cash Flows from Financing Activities p. 235
Cash Flows from Investing Activities p. 235
Cash Flows from Operating Activities (Cash Flows from Operations) p. 234
Direct Method p. 234
Free Cash Flow p. 250
Indirect Method p. 234
Non-Cash Investing and Financing Activities p. 253

QUESTIONS

1. Compare the purposes of the income statement, the balance sheet, and the cash flow statement.
2. What information does the cash flow statement report that is not reported on the other required financial statements? How do investors and creditors use that information?
3. What are cash equivalents? How are purchases and sales of cash equivalents reported on the cash flow statement?
4. What are the major categories of business activities reported on the cash flow statement? Define each of these activities.
5. What are the typical cash inflows from operating activities? What are the typical cash outflows for operating activities?
6. Under the indirect method, amortization expense is added to net income to compute cash flows from operating activities. Does amortization cause an inflow of cash?
7. Explain why cash paid during the period for purchases and for salaries is not specifically reported as cash outflows on the cash flow statement under the indirect method.
8. Explain why a $50,000 increase in inventory during the year must be included in developing cash flows for operating activities under both the indirect method.
9. Compare the two methods of reporting cash flows from operating activities in the cash flow statement.
10. What are the typical cash inflows from investing activities? What are the typical cash outflows for investing activities?
11. What are the typical cash inflows from financing activities? What are the typical cash outflows for financing activities?
12. What are non-cash investing and financing activities? Give two examples. How are they reported on the cash flow statement?
13. A company used cash for both operating and investing activities, but had positive cash flow from financing activities. What does this cash flow pattern suggest about this company?

EXERCISES

E5–1 Determining Cash Flow Statement Effects of Transactions LO1

Leon's Furniture

Leon's Furniture Limited is an Ontario-based retailer of home furnishings. For each of the following first-quarter transactions, indicate whether *net cash inflows (outflows)* from operating activities (O), investing activities (I), or financing activities (F) are affected and whether the effect is an inflow (+) or outflow (−), or (NE) if the transaction has no effect on cash. (*Hint:* Determine the journal entry recorded for the transaction. The transaction affects net cash flows if, and only if, the account Cash is affected.)

_____ 1. Paid cash to purchase new equipment.
_____ 2. Purchased raw materials inventory on account.
_____ 3. Collected cash from customers.
_____ 4. Recorded an adjusting entry to record an accrued salaries expense.

_____ 5. Recorded and paid interest on debt to creditors.
_____ 6. Repaid principal on revolving credit loan from the bank.
_____ 7. Paid rent for the following period.
_____ 8. Sold used equipment for cash at book value.
_____ 9. Made payment to suppliers.
_____ 10. Declared and paid cash dividends to shareholders.

■ LO1

E5–2 Determining Cash Flow Statement Effects of Transactions

Dell Inc.

Dell Inc. is a leading manufacturer of personal computers and servers for the business and home markets. For each of the following transactions, indicate whether *net cash inflows (outflows)* from operating activities (O), investing activities (I), or financing activities (F) are affected and whether the effect is an inflow (+) or outflow (−), or (NE) if the transaction has no effect on cash. (*Hint:* Determine the journal entry recorded for the transaction. The transaction affects net cash flows if, and only if, the account Cash is affected.)

_____ 1. Recorded and paid income taxes to the federal government.
_____ 2. Issued common shares for cash.
_____ 3. Paid rent for the following period.
_____ 4. Recorded an adjusting entry for expiration of a prepaid expense.
_____ 5. Paid cash to purchase new equipment.
_____ 6. Issued long-term debt for cash.
_____ 7. Collected cash from customers.
_____ 8. Purchased raw materials inventory on account.
_____ 9. Recorded and paid salaries to employees.
_____ 10. Purchased new equipment by signing a three-year note.

■ LO2

E5–3 Interpreting Amortization Expense from a Management Perspective

QuickServe, a chain of convenience stores, was experiencing some serious cash flow difficulties because of rapid growth. The company did not generate sufficient cash from operating activities to finance its new stores, and creditors were not willing to lend money because the company had not produced any income for the previous three years. The new controller for QuickServe proposed a reduction in the estimated life of store equipment to increase amortization expense; thus, "we can improve cash flows from operating activities because amortization expense is added back on the cash flow statement." Other executives were not sure that this was a good idea because the increase in amortization would make it more difficult to have positive earnings: "Without income, the bank will never lend us money."

Required:

What action would you recommend for QuickServe? Why?

■ LO2

E5–4 Reporting and Interpreting Cash Flows from Operating Activities from an Analyst's Perspective (Direct and Indirect Method)

Kane Company completed its income statement and balance sheet for 2009 and provided the following information:

Service revenue		$52,000
Expenses		
Salaries	$42,000	
Amortization	7,300	
Utilities	7,000	
Other	1,700	58,000
Net loss		($ 6,000)
Decrease in accounts receivable	$12,000	
Purchase of a small service machine	5,000	
Increase in salaries payable	9,000	
Decrease in unearned service revenue	4,000	

Required:

1. Present the Operating Activities section of the cash flow statement for Kane Company using the indirect method.
2. What were the major reasons that caused Kane to report a net loss but positive cash flow from operations? Why are the reasons for the difference between cash flow from operations and net income important to financial analysts?

E5–5 Reporting and Interpreting Cash Flows from Operating Activities from an Analyst's Perspective (Indirect Method) ■ LO2

Coolbrands International, Inc.

Coolbrands International, Inc., manufactures and distributes ice cream, porbet, frozen yogurt, and other frozen dairy-based snacks. The company's annual report for 2005 contained the following information (in thousands):

	2005
Net loss	$(74,070)
Depreciation and amortization	60,567
Decrease in receivables	13,815
Decrease in inventories	4,500
Increase in prepaid expenses	2,207
Increase in accounts payable	5,842
Increase in accrued liabilities	8,744
Increase in income taxes payable	4,935
Reduction of long-term debt	4,007
Additions to equipment	12,409

Required:

1. Based on this information, compute the cash flow from operating activities using the indirect method.
2. What were the major reasons that caused Coolbrands to report a net loss but positive cash flow from operations? Why are the reasons for the difference between cash flow from operations and net income important to financial analysts?

E5–6 Inferring Balance Sheet Changes from the Cash Flow Statement ■ LO2

Colgate-Palmolive

A cash flow statement for Colgate-Palmolive reported the following information (in millions):

Operating Activities	Current Year
Net income	$477.0
Amortization	192.5
Cash effect of changes in	
Receivables	(38.0)
Inventories	28.4
Other current assets	10.6
Payables	(10.0)
Other	(117.8)
Net cash provided by operations	$542.7

Required:

Based on the information reported on the cash flow statement for Colgate-Palmolive, determine whether the following accounts increased or decreased during the year: Receivables, Inventories, Other Current Assets, and Payables.

E5–7 Inferring Balance Sheet Changes from the Cash Flow Statement ■ LO2

Apple Computer, Inc.

A cash flow statement for Apple Computer contained the following information (in thousands):

Operations	Current Year
Net income	$310,178
Amortization	167,958
Changes in assets and liabilities	
Accounts receivable	(199,401)
Inventories	418,204
Other current assets	33,616
Accounts payable	139,095
Income taxes payable	50,045
Other current liabilities	39,991
Other adjustments	(222,691)
Cash generated by operations	$736,995

Required:

For each of the asset and liability accounts listed on the cash flow statement, determine whether the account balances increased or decreased during the current year.

■ LO2, 3 **E5–8 Analyzing Cash Flows from Operating Activities; Interpreting the Quality of Income Ratio**

PepsiCo



An annual report for PepsiCo contained the following information (in millions):

Net income	$4,078
Depreciation and amortization	1,308
Increase in accounts receivable	272
Increase in inventory	132
Decrease in prepaid expenses	56
Increase in accounts payable	220
Increase in taxes payable	609
Decrease in other current liabilities	38
Cash dividends paid	1,642
Repurchase of shares	3,012

Required:

1. Compute the cash flows from operating activities for PepsiCo using the indirect method.
2. Compute the quality of income ratio.
3. What were the major reasons why Pepsi's quality of income ratio did not equal 1.0?

■ LO4, 6 **E5–9 Reporting Cash Flows from Investing and Financing Activities**

Pan American Silver Corp.

Pan American Silver Corp. is a mining company based in British Columbia. In a recent quarter, it reported the following activities:

Net income	$16,355
Purchase of property, plant, and equipment	18,026
Shares issued for cash	698
Repayment of bank loans	2,202
Cash collection from customers	57,608
Depreciation and amortization	4,234
Income taxes paid	1,505
Payments for products and services	39,771
Proceeds from sale of short-term investments	13,714

Required:

Based on this information, present the Investing and Financing Activities sections of the cash flow statement.

■ LO4, 6 **E5–10 Reporting and Interpreting Cash Flows from Investing and Financing Activities with Discussion of Management Strategy**

Sobeys

Sobeys Inc. is one of Canada's two national retail grocery and food distributors. The company owns or franchises more than 1,300 corporate and franchised stores in all 10 provinces under retail banners that include Sobeys, Garden Market IGA, IGA, IGA Extra, and Price Chopper. In a recent year, it reported the following activities (in millions):

Net income	$115.9
Purchases of property and equipment	424.2
Decrease in accounts payable and accrued liabilities	77.8
Issue of shares	8.6
Depreciation and amortization	136.1
Proceeds from sale of discontinued operations	412.7
Repayment of long-term debt	147.5
Increase in accounts receivable	2.8
Payment of dividends	15.8

Required:

1. Based on this information, present the Investing and Financing Activities sections of the cash flow statement.
2. What do you think was management's plan for the use of the cash generated by the sale of discontinued operations?

E5–11 Analyzing and Interpreting the Capital Acquisitions Ratio ■ LO5

Boston Beer



A recent annual report for Boston Beer Company contained the following data for the three most recent years (in millions):

	2005	2004	2003
Cash flow from operating activities	$ 28.8	$19.3	$19.6
Cash flow from investing activities	(13.8)	(13.8)	15.0
Cash flow from financing activities	(9.3)	(2.6)	(27.4)

Assume that all investing activities involved acquisition of new plant and equipment.

Required:

1. Compute the capital acquisitions ratio for the three-year period in total.
2. What portion of Boston Beer's investing activities was financed from external sources or pre-existing cash balances during the three-year period?
3. What do you think is the likely explanation for the large amount of cash flow from financing activities during 2003?

E5–12 Reporting Non-Cash Transactions on the Cash Flow Statement; Interpreting the Effect on the Capital Acquisitions Ratio ■ LO7

An analysis of Martin Corporation's operational asset accounts provided the following information:

a. Acquired a large machine that cost $26,000, paying for it by signing a $15,000, 12-percent interest-bearing note due at the end of two years, and 500 common shares with a market value of $22 per share.

b. Acquired a small machine that cost $8,700. Full payment was made by transferring a tract of land that had a book value of $8,700.

Required:

1. Show how this information should be reported on the cash flow statement.
2. What would be the effect of these transactions on the capital acquisitions ratio? How might these transactions distort interpretation of the ratio?

E5–13 (Supplement B) Matching Items Reported to Cash Flow Statement Categories (Direct Method) ■ LO7

BHP Billiton

The Australian company BHP Billiton is one of the world's biggest mining companies. Some of the items included in its annual consolidated cash flow statement presented using the *direct method* are listed below.

Indicate whether each item is disclosed in the Operating Activities (O), Investing Activities (I), or Financing Activities (F) section of the statement or (NA) if the item does not appear on the statement.

_____ 1. Dividends paid
_____ 2. Income taxes paid
_____ 3. Interest received
_____ 4. Net income
_____ 5. Payments for property, plant, and equipment
_____ 6. Payments in the course of operations
_____ 7. Proceeds from ordinary share issues
_____ 8. Proceeds from the sale of property, plant, and equipment
_____ 9. Receipts from customers
_____ 10. Repayment of loans

E5–14 (Supplement B) Comparing the Direct and Indirect Methods

To compare the computation of cash flow from operations under the direct and indirect methods, enter check marks to indicate which items are used with each method.

Cash Flows (and Related Changes)	Method of Computing Cash Flows from Operations: Direct	Indirect
1. Collections from customers		
2. Increase or decrease in accounts receivable		
3. Payments to suppliers		
4. Increase or decrease in inventory		
5. Increase or decrease in accounts payable		
6. Payments to employees		
7. Increase or decrease in wages payable		
8. Amortization expense		

E5–15 (Supplement B) Reporting Cash Flows from Operating Activities (Direct Method)

The following information pertains to Day Company:

Sales		$80,000
Expenses		
Cost of goods sold	$50,000	
Amortization	7,000	
Salaries	11,000	68,000
Net income		$12,000
Increase in accounts receivable	$ 4,000	
Decrease in merchandise inventory	8,000	
Increase in salaries payable	500	

Required:

Present the Operating Activities section of the cash flow statement for Day Company using the direct method.

E5–16 (Supplement C) Preparing a Cash Flow Statement, Indirect Method: Complete Spreadsheet

An analysis of accounts showed the following:

a. Purchased an operational asset, $20,000, and issued common shares in full payment.

b. Purchased a long-term investment for cash, $15,000.

c. Paid cash dividend, $12,000.

d. Sold operational asset for $2,000 cash (cost, $21,000, accumulated amortization, $19,000).

e. Sold 500 shares at $12 per share cash.

List of Accounts	Beginning Balances 12/31/2006	Analysis of Change: Debit	Analysis of Change: Credit	Ending Balances 12/31/2007
Income statement items				
Sales			$140,000	
Cost of goods sold		$59,000		
Amortization expense		7,000		
Wage expense		28,000		
Income tax expense		9,000		
Interest expense		5,000		
Other expenses		15,800		
Net income		16,200		

Balance sheet items		
Cash	$ 16,500	$ 11,200
Accounts receivable	22,000	22,000
Merchandise inventory	68,000	75,000
Long-term Investments		15,000
Operational assets	114,500	113,500
Total debits	$221,000	$236,700
Accumulated amortization	$ 32,000	$ 20,000
Accounts payable	17,000	14,000
Wages payable	2,500	1,500
Income taxes payable	3,000	4,500
Bonds payable	54,000	54,000
Share capital	100,000	126,000
Retained earnings	12,500	16,700
Total credits	$221,000	$236,700

	Inflows	Outflows
Cash flow statement		
Cash flows from operating activities:		
Cash flows from investing activities:		
Cash flows from financing activities:		
Net increase (decrease) in cash		
Totals		

Required:

1. Complete the spreadsheet for the cash flow statement using the indirect method to compute the cash flows from operating activities.
2. Compute and explain the quality of income ratio and the capital acquisitions ratio.
3. What can you conclude about the company's management of cash?

E5–17 (Supplement C) Preparing a Cash Flow Statement, Direct Method: Complete Spreadsheet

Refer to the information in E5–17.

Required:

1. Complete the spreadsheet for the cash flow statement using the direct method to compute the cash flows from operating activities.
2. As the accountant who prepares the company's cash flow statement, would you prefer to use the direct method or the indirect method to report the cash flows from operations? Explain.

PROBLEMS

P5–1 Preparing the Cash Flow Statement (AP5–1) LO1, 2, 4, 6, 7

Selected financial information for Frank Corporation is presented below.

Selected 2005 Transactions:

a. Purchased investment securities for $5,000 cash.

b. Borrowed $15,000 on a two-year, 8-percent interest-bearing note.

c. During 2007, sold machinery for its net book value; received $11,000 in cash.

d. Purchased machinery for $50,000; paid $9,000 in cash and signed a four-year note payable to the dealer for $41,000.

e. At December 31, 2007, declared and paid a cash dividend of $10,000.

Selected account balances at December 31, 2006 and 2007 are as follows:

	December 31	
	2007	2006
Cash	$76,000	$21,000
Accounts receivable	17,000	12,000
Inventory	52,000	60,000
Accounts payable	7,000	10,000
Accrued wages payable	800	1,000
Income taxes payable	5,000	3,000

One-fourth of the sales and one-third of the purchases were made on credit.

FRANK CORPORATION
Income Statement
For the Year Ended December 31, 2007

Sales revenue		$400,000
Cost of goods sold		268,000
Gross profit		132,000
Expenses		
Salaries and wages	$51,000	
Amortization	9,200	
Rent (no accruals)	5,800	
Interest (no accruals)	12,200	
Income tax	$11,800	
Total expenses		90,000
Net income		$ 42,000

Required:

1. Prepare a cash flow statement for the year ended December 31, 2007. Use the indirect method to compute the cash flow from operating activities. Include any additional required note disclosures.
2. Compute and explain the quality of income ratio and the capital acquisitions ratio.

■ LO2 **P5–2 Preparing Cash Flow Statement (Indirect Method)**

eXcel

The comparative balance sheets of Mikos Inc. as at December 31, 2007 and 2008, and its income statement for the year ended December 31, 2008, are presented below.

MIKOS INC.
Comparative Balance Sheets
December 31

	2008	2007
Assets		
Cash	$ 9,000	$ 17,000
Short-term investments	45,000	20,000
Accounts receivable	68,000	26,000
Inventories, at cost	54,000	40,000
Prepaid expenses	4,000	6,000
Land	45,000	70,000
Buildings and equipment, net	280,000	179,000
Intangible assets	24,000	28,000
	$529,000	$386,000
Liabilities and Shareholders' Equity		
Accounts payable	$ 17,000	$ 40,000
Income tax payable	6,000	1,000
Accrued liabilities	10,000	-0-
Long-term notes payable	110,000	150,000
Share capital	200,000	60,000
Retained earnings	186,000	135,000
	$529,000	$386,000

MIKOS INC. Income Statement For the Year Ended December 31, 2008		
Sales		$850,000
Cost of goods sold	$430,000	
Amortization expense—intangible assets	4,000	
—buildings and equipment	33,000	
Operating expenses	221,000	
Interest expense	12,000	700,000
Income before income taxes		150,000
Income tax expense		45,000
Net income		$105,000

Additional information:

a. Land was sold for cash at book value.

b. The short-term investments will mature in February 2009.

c. Cash dividends were declared and paid in 2008.

d. New equipment with a cost of $166,000 was purchased for cash, and old equipment was sold at book value.

e. Long-term notes of $10,000 were paid in cash, and notes of $30,000 were converted to shares.

f. Accounts payable pertain to merchandise suppliers.

Required:

1. Prepare a cash flow statement for Mikos Inc. for the year ended December 31, 2008. Use the indirect method to report cash flow from operating activities.
2. Assume the role of a bank loan officer who is evaluating this company's cash flow situation. Analyze the cash flow statement you prepared in requirement 1.
3. What additional information does the cash flow statement provide that is not available on either the balance sheet or the income statement? Explain.

P5–3 Comparing Cash Flows from Operating Activities (Indirect Method) (AP5–2) ■ LO2

Beta Company's accountants just completed the financial statements for the year and have provided the following information (in thousands):

Income Statement for 2007		
Sales revenue		$20,600
Expenses and losses:		
Cost of goods sold	$9,000	
Amortization	2,000	
Salaries	5,000	
Rent	2,500	
Insurance	800	
Utilities	700	
Interest	600	20,600
Net income		$ 0

Selected Balance Sheet Accounts		
	2007	2006
Merchandise inventory	$ 82	$ 60
Accounts receivable	380	450
Accounts payable	240	210
Salaries payable	29	20
Rent payable	2	6
Prepaid rent	2	7
Prepaid insurance	14	5

Other Data:
The company signed long-term notes for $20,000 during the year.

Required:

1. Prepare the Operating Activities section of the cash flow statement for 2007 using the indirect method.
2. As a financial analyst, would you prefer to see the cash flow from operations reported using the direct method or the indirect method? Justify your answer.
3. As the accountant who prepares the company's cash flow statement, would you prefer to use the direct or the indirect method to report the cash flow from operations? Explain.

■ LO2, 3, 5

P5–4 (Supplement A) Preparing Cash Flow Statement with Sale of Equipment (Indirect Method) (AP5–3)

McGregor Corp.'s accountants prepared the balance sheets and income statement to be reported in the company's annual report for 2008, and you have been asked to prepare the company's cash flow statement for 2008 based on the following financial information.

McGREGOR CORP.
Balance Sheets
As at December 31

	2008	2007
Assets		
Cash	$ 16,000	$ 4,000
Accounts receivable	40,000	27,000
Merchandise inventory	28,000	20,000
Prepaid expenses	9,000	5,000
Equipment, at cost	60,000	24,000
Less: Accumulated amortization	(10,000)	(7,000)
Total Assets	$143,000	$73,000
Liabilities and Shareholders' Equity		
Accounts payable	$ 10,000	$ 8,000
Income taxes payable	2,000	5,000
Wages payable	-0-	15,000
Long-term notes payable	60,000	43,000
Common shares	7,000	1,000
Retained Earnings	64,000	1,000
Total Liabilities and Shareholders' Equity	$143,000	$73,000

McGREGOR CORP.
Income Statement
For the Year Ended December 31, 2008

Sales revenues		$762,000
Cost of goods sold	$410,000	
Wages expense	122,000	
General expenses	24,000	
Amortization expense	4,000	
Interest expense	5,000	
Gain on sale of equipment	(3,000)	562,000
Income before income taxes		200,000
Income tax expense		60,000
Net income		$140,000

Note: Equipment which originally cost $7,000 was sold for $9,000 cash during 2008. It had a net book value of $6,000 at the date of sale.

Required:

1. Prepare a cash flow statement for McGregor Corp. for the year ended December 31, 2008. Use the indirect method to report cash flows from operating activities.
2. Using the cash flow statement you prepared above, compute and explain each of the following: (a) quality of income ratio, (b) capital acquisitions ratio, and (3) free cash flow.

P5–5 (Supplements A and B) Preparing Cash Flow Statement with Sale of Equipment (Direct Method) (AP5–4)

Refer to the information for McGregor Corp. in P5–4.

Required:

1. Compute the following amounts:
   a. Cash collected from customers
   b. Cash paid to suppliers of merchandise
   c. Cash paid for general expenses
2. Prepare a cash flow statement for McGregor Corp. for the year ended December 31, 2008. Use the direct method to report cash flows from operating activities.
3. What additional information does the cash flow statement provide that is not available on either the balance sheet or the income statement?

P5–6 (Supplement B) Preparing a Cash Flow Statement—Direct Method

Refer to the information for Frank Corporation in P5–1.

Required:

1. Prepare a cash flow statement for the year ended December 31, 2007. Use the direct method to compute the cash flow from operating activities. Include any additional require note disclosures.
2. Is the direct method of reporting cash flow from operating activities easier to prepare than the indirect method? Explain.
3. Is the direct method of reporting cash flow from operating activities easier to understand than the indirect method? Explain.

P5–7 (Supplement C) Preparing Cash Flow Statement Spreadsheet, Cash Flow Statement, and Schedules Using the Indirect Method (AP5–5)

eXcel

Hunter Company is developing its annual financial statements at December 31, 2008. The statements are complete except for the cash flow statement. The completed comparative balance sheets and income statement are summarized:

	2008	2007
Balance sheet at December 31		
Cash	$ 44,000	$ 18,000
Accounts receivable	27,000	29,000
Merchandise inventory	30,000	36,000
Property, plant, and equipment (net)	75,000	72,000
	$176,000	$155,000
Accounts payable	$ 25,000	$ 22,000
Wages payable	800	1,000
Note payable, long term	38,000	48,000
Share capital	80,000	60,000
Retained earnings	32,200	24,000
	$176,000	$155,000
Income statement for 2008		
Sales		$100,000
Cost of goods sold		(61,000)
Other expenses		(27,000)
Net income		$ 12,000

Additional Data:

a. Bought equipment for cash, $9,000.
b. Paid $10,000 on the long-term note payable.
c. Issued common shares for $20,000 cash.
d. Declared and paid a $3,800 cash dividend.
e. Incurred expenses that included amortization, $6,000; wages, $10,000; taxes, $3,000; other, $8,000.

Required:

1. Prepare a cash flow statement spreadsheet using the indirect method to report cash flows from operating activities.
2. Prepare the cash flow statement for the year ended December 31, 2008.
3. Prepare a schedule of non-cash investing and financing activities, if necessary.
4. Evaluate the company's use of the cash flow generated from (or used for) operations.

ALTERNATE PROBLEMS

LO1, 2, 4, 6, 7 **AP5–1 Preparing the Cash Flow Statement (Direct and Indirect Methods)** (P5–1)

Stonewall Company was organized on January 1, 2007. During the year ended December 31, 2007, the company provided the following data:

Income Statement	
Sales revenue	$ 80,000
Cost of goods sold	(35,000)
Amortization expense	(4,000)
Other expenses	(32,000)
Net income	$ 9,000
Balance Sheet	
Cash	$ 48,000
Accounts receivable	18,000
Merchandise inventory	15,000
Machinery (net)	25,000
Total assets	$106,000
Accounts payable	$ 10,000
Accrued expenses (liabilities)	21,000
Dividends payable	2,000
Note payable, short term	15,000
Share capital	54,000
Retained earnings	4,000
Total liabilities and shareholders' equity	$106,000

Analysis of Selected Accounts and Transactions:

a. Issued 3,000 common shares for cash, at $18 per share.

b. Borrowed $15,000 on a one-year, 8-percent interest-bearing note; the note was dated June 1, 2007.

c. Paid $29,000 to purchase machinery.

d. Purchased merchandise for resale at a cost of $50,000; paid $40,000 cash and the balance on account. The company uses a perpetual inventory system.

e. Exchanged plant machinery with a book value of $2,000 for office machines with a market value of $2,000.

f. Declared a cash dividend of $5,000 on December 15, 2007 payable to shareholders on January 15, 2008.

g. Because this is the first year of operations, all account balances are zero at the beginning of the year; therefore, the changes in the account balances are equal to the ending balances.

Required:

1. Prepare a cash flow statement for the year ended December 31, 2007. Use the indirect method to report cash flow from operating activities.
2. Compute and explain the quality of income ratio and the capital acquisitions ratio.

AP5–2 Comparing Cash Flows from Operating Activities (Indirect Method) (P5–3) ■ LO2

Pan American Silver Crop.

The accountants of Pan American Silver Corp. completed the balance sheet at September 30, 2007, and the income statement for the quarter ended on that date and have provided the following information (in thousands):

Income Statement

Sales revenue		$26,382
Investment income, net		94
Gain on sale of assets		3,523
		29,999
Expenses		
Operating	$28,448	
Depreciation and amortization	3,020	
Reclamation	330	
Exploration	438	
General and administration	1,452	33,688
Net loss		($ 3,689)

Selected Balance Sheet Accounts

	Sept. 30 2007	June 30 2007
Short-term investments	$ 513	$ 13
Accounts receivable	2,067	4,877
Inventories	5,369	7,595
Prepaid expenses	5,615	5,595
Accounts payable	8,414	10,302
Accrued liabilities	5,343	8,793
Current portion of bank loans	1,975	4,209

Required:

1. Prepare the Operating Activities section of the cash flow statement using the indirect method.
2. Companies that use the direct method to report cash flows from operations are also required to disclose in the notes a reconciliation of net income to cash flows from operating activities. What additional information does this disclosure requirement provide to users of financial statements? Explain.

AP5–3 (Supplement A) Preparing Cash Flow Statement with Sale of Equipment (Indirect Method) (P5–4) ■ LO2, 3, 5

Steven Cheng, the sole shareholder and manager of Musical Instruments Ltd. (MIL), has approached you and asked you to prepare a cash flow statement for his company. MIL sells different types of flutes and wind instruments to bands, orchestras and music stores. Steven is presently worried about the meeting that he has scheduled in two weeks with a lending officer of his bank. It is time for a review of the bank loan. This also involves a review of MIL's profitability and financial position.

Steven provided you with the following condensed financial statements for the fiscal years ended December 31, 2007 and 2008. He assures you that the financial statements are free of any omissions or misstatements, and that they conform to generally accepted accounting principles.

MUSICAL INSTRUMENTS LTD.
Balance Sheets as at December 31
(In thousands of dollars)

	2008	2007
Assets		
Current assets		
Cash	$ 500	$ 1,700
Short-tern investments	1,000	4,000
Accounts receivable	28,150	5,300
Inventories	5,000	15,000
Total current assets	34,650	26,000
Noncurrent assets		
Furniture and fixtures, at cost	29,500	13,000
Less: accumulated amortization	(12,000)	(6,000)
Investments	1,000	1,500
Total non-current assets	18,500	8,500
Total assets	$53,150	$34,500
Liabilities and Shareholders' Equity		
Current liabilities		
Bank loan	$ 9,000	$ 4,000
Accounts payable	8,500	6,550
Dividends payable	-0-	300
Total current liabilities	17,500	10,850
Noncurrent liabilities		
Mortgage notes payable	14,000	-0-
Total liabilities	31,500	10,850
Shareholders' equity		
Share capital	12,000	11,000
Retained earnings	9,650	12,650
Total shareholders' equity	21,650	23,650
Total liabilities and shareholders' equity	$53,150	$34,500

MUSICAL INSTRUMENTS LTD.
Statements of Income and Retained Earnings
For the Years Ended December 31

	2008	2007
Sales revenue	$245,000	$220,000
Cost of goods sold	(160,000)	(140,000)
Gross profit	85,000	80,000
Operating expenses:		
Amortization	(6,600)	(3,000)
Selling and general	(71,900)	(72,000)
Operating income	6,500	5,000
Interest expense	(2,400)	(800)
Loss on sale of furniture	(300)	-0-
Gain on sale of investments	200	-0-
Income before income taxes	4,000	4,200
Income tax expense (@25%)	(1,000)	(1,050)
Net income	3,000	3,150
Retained earnings—January 1	12,650	9,800
Dividends declared	(6,000)	(300)
Retained earnings—December 31	$ 9,650	$12,650

Additional information:

a. In 2008, MIL sold older obsolete furniture with an original cost of $1,000 and $600 of accumulated amortization up to the date of sale.

b. During 2008, one of the noncurrent investments which had cost $500 was sold at a gain of $200.

c. The company considers short-term investments as cash equivalents.

Required:

1. Prepare a cash flow statement for MIL for the year ended December 31, 2008. Use the indirect method to report cash flows from operating activities.
2. Using the cash flow statement you prepared above, compute and explain each of the following: (a) quality of income ratio, (b) capital acquisitions ratio, and (3) free cash flow.
3. In an effort to improve the company's financial performance, Steven Cheng proposed that the furniture and fixtures can be amortized over a longer period. This change will decrease amortization expense by $1,000 in 2007 and by $2,000 in 2008. As a professional accountant, would this proposed change be acceptable to you? Explain.

AP5–4 (Supplement A) Preparing Cash Flow Statement with Sale of Equipment (Direct Method) (P5–5)

Refer to the information for Musical Instruments Ltd. (MIL) in AP5–3.

Required:

1. Compute the following amounts:
   a. Cash collected from customers
   b. Cash paid to suppliers of merchandise
   c. Cash received for sale of obsolete furniture
   d. Cash received for sale of non current investments.
2. Prepare a cash flow statement for MIL for the year ended December 31, 2008. Use the direct method to report cash flows from operating activities.
3. Discuss the importance of the cash flow statement to users of financial statements. What additional information does it provide that is not reported in the other financial statements? Explain by referring to the statement that you prepared in requirement 2 above.

AP5–5 (Supplement B) Preparing a Cash Flow Statement – Direct Method (P5–6)

Refer to the information for Frank Corporation in AP5–1.

Required:

1. Prepare a cash flow statement for the year ended December 31, 2007. Use the direct method to compute the cash flow from operating activities. Include any additional require note disclosures.
2. Is the direct method of reporting cash flow from operating activities easier to prepare than the indirect method? Explain.
3. Is the direct method of reporting cash flow from operating activities easier to understand than the indirect method? Explain.

AP5–6 (Supplement C) Preparing Cash Flow Statement Spreadsheet and Cash Flow Statement Using the Indirect Method: Includes Non-Cash Investing and Financing Activity and Sale of an Asset at Book Value (P5–6)

Choo-Foo Company is developing its 2007 annual report. The following information is provided:

	2007	2006
Cash	$22,400	$21,000
Accounts receivable	21,000	18,000
Inventory	32,000	35,000
Prepaid insurance	1,400	2,400
Long-term investments	9,300	12,500
Property, plant, and equipment (net)	59,600	31,100
Patent	1,500	2,000
Accounts payable	15,000	27,000
Wages payable	1,000	4,000
Income taxes payable	2,200	2,000
Note payable, long term	10,000	20,000
Share capital	86,000	53,000
Retained earnings	33,000	16,000

Other Information:

a. Sold long-term investments at book value for $3,200 cash. Purchased machinery by issuing 3,000 shares that had a market value of $11 per share.

b. Revenues for the year totalled $150,000.

c. Expenses for the year included: amortization, $5,000; insurance, $2,000; wages, $48,500; income taxes, $7,000; and cost of goods sold, $62,000.

Required:

1. Prepare a cash flow statement spreadsheet using the indirect method to report cash flows from operating activities.
2. Prepare the cash flow statement for the year ended December 31, 2007.
3. Prepare a schedule of non-cash investing and financing activities.
4. Evaluate the company's use of the cash flow generated from (or used for) operations.

CASES AND PROJECTS

FINDING AND INTERPRETING FINANCIAL INFORMATION

LO2, 4, 6 **CP5–1**
Van Houtte

Finding Financial Information

Refer to the financial statements of Van Houtte Inc. given in Appendix B of this book.

Required:

1. Which of the two basic reporting approaches for the cash flows from operating activities did the company adopt?
2. What amount of cash did the company pay for taxes during the current year?
3. Explain why the gain on disposal of fixed assets was deducted in the reconciliation of net income to net cash provided by operating activities.
4. What was the amount of free cash flow for the year ended March 31, 2007?
5. Has the company paid cash dividends during the last two years? How did you know?

LO3, 5 **CP5–2**
The Forzani Group

Finding Financial Information

Refer to the Online Learning Centre Web site at **www.mcgrawhill.ca/college/libby/student/resources** for the financial statements of The Forzani Group Ltd.

Required:

1. What were the three largest adjustments to reconcile net income to the net cash provided by operating activities? Refer to the cash flow statement and to note 7. Explain the direction of the effect of each adjustment in the reconciliation.
2. What have been The Forzani Group's major uses of cash over the past two years? What have been its major sources of cash for these activities?
3. What was the amount of free cash flow for the year ended January 28, 2007? What does this imply about the company's financial flexibility?

LO2, 4, 6 **CP5–3**
Van Houtte



Comparing Companies

Refer to the Online Learning Centre Web site at **www.mcgrawhill.ca/college/libby/student/resources** for the financial statements of The Forzani Group Ltd. and to Appendix B of this book for the financial statements of Van Houtte Inc.

Required:

1. Compute the quality of income ratio for both companies for the current year. How might the difference in their sales growth rates explain the difference in the ratio? Sales Growth Rate = (Current Year's Sales − Prior Year's Sales) ÷ Prior Year's Sales.
2. Compute the capital acquisitions ratio for both companies for the current year. Compare their abilities to finance purchases of property, plant, and equipment with cash provided by operating activities.

LO2, 3, 4, 5, 6 **CP5–4**
Van Houtte

Using Financial Reports: Analyzing Van Houtte's Cash Flow Statement

Van Houtte Inc. is the largest gourmet coffee roasting organization in Canada, and one of the leading coffee service specialists in North America. Its cash flow statements for fiscal years 2006 and 2005 and the related note are shown below.

Consolidated Statements of Cash Flows
Years ended April 1, 2006 and April 2, 2005
(in thousands of dollars)

	2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net earnings:	**$22,506**	$21,706
Adjustments for:		
Depreciation of fixed assets	**30,405**	28,536
Amortization of financial expenses (*note 3*)	**1,405**	271
Amortization of other assets	**3,385**	2,480
Future income taxes (*note 4*)	**356**	1,308
Change in fair value of interest rate swaps	**(2,169)**	—
Non-controlling interest	**1,944**	2,125
Share in net earnings of companies subject to significant influence, net of dividends received	**(13)**	(72)
Increase in value of investment in preferred shares and dividends (*note 7*)	**(1,559)**	—
Stock-based compensation (*note 13*)	**418**	413
Gain on disposal of fixed assets	**(314)**	(254)
Loss (gain) on disposal of businesses	**(921)**	304
Other elements	**(10)**	169
	55,433	56,986
Net change in non-cash balances related to working capital items (*note 17*)	**(7,622)**	3,698
	47,811	60,684
CASH FLOWS FROM INVESTING ACTIVITIES:		
Business acquisitions (*note 18*)	**(9,545)**	(9,330)
Additions to fixed assets	**(29,764)**	(27,986)
Proceeds from disposal of fixed assets	**3,105**	1,043
Acquisition of investments	**(177)**	(944)
Increase in other assets	**(2,012)**	(2,187)
	(38,393)	(39,404)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Issue of subordinate voting shares (*note 13*)	**287**	1,214
Redemption of subordinate voting shares for cancellation (*note 13*)	**(5,200)**	(94)
Increase in long-term debt.	**65,197**	43,424
Decrease in long-term debt.	**(57,778)**	(59,228)
Dividends	**(9,183)**	(5,176)
Dividends paid to non-controlling shareholders of subsidiaries	**(1,973)**	(1,817)
	(8,650)	(21,677)
Effect of exchange rate changes on cash denominated in foreign currency	**(310)**	(1,606)
Increase (decrease) in cash	**458**	(2,003)
Cash, beginning of year	**5,338**	7,341
Cash, end of year	**$ 5,796**	$ 5,338

See accompanying notes to consolidated financial statements.

NOTE 17
Additional information on cash flows

	2006	2005
Operating activities:		
Changes in non-cash operating working capital items:		
(Increase) decrease in the undernoted items:	**$(1,739)**	$ (4,850)
Accounts receivable	**(1,927)**	(1,270)
Inventories	**(671)**	(9)
Prepaid expenses		
(Decrease) increase in the undernoted items:		
Accounts payable and accrued liabilities	**(5,263)**	6,058
Income taxes payable	**346**	2,542
Employee future benefits	—	(173)
Working capital acquired	**1,258**	1,400
Consolidation of joint ventures (*note 1b*))	**374**	—
	$(7,622)	$ 3,698
Cash payments of interest and income taxes were as follows:		
Interest paid	**$ 4,754**	$ 3,786
Income taxes paid	**$ 7,691**	$ 3,163
Additions to fixed assets financed by accounts payable	**$ 1,643**	$ 1,147
Additions to fixed assets financed by capital lease obligations	**$ 215**	$ 236

Source: Van Houtte Inc., annual report 2006, pages 24 and 39.

Required:

1. The cash flows from operating activities show that "depreciation of fixed assets" is added to "net earnings". Is depreciation (or amortization) a source of cash? Explain.
2. Was the cash collected from customers during fiscal year 2006 higher or lower than Van Houtte's sales revenue for that year? Explain.
3. Explain why Van Houtte's cash flow from operations decreased in 2006 compared to 2005, while its net earnings increased during the same year?
4. Did Van Houtte expand during 2005 and 2006? If so, how did the company pay for its expansion? Explain.
5. Compute and analyze Van Houtte's quality of income ratio, capital acquisitions ratio, and free cash flow for both years.

LO 2, 3, 4, 5, 6 CP5–5 Using Financial Reports: Analyzing Research In Motion's Cash Flow Statement

Research in Motion

Research In Motion (RIM) is a leading designer, manufacturer, and marketer of innovative wireless solutions for the worldwide mobile communications market. Its products are used around the world and include the BlackBerry® wireless platform, software development tools, and software/hardware licensing agreements. RIM's cash flow statements for fiscal years 2007, 2006, and 2005 are shown below.

RESEARCH IN MOTION LIMITED
Consolidated Statements of Cash Flows
(United States dollars, in thousands)

	For the Year Ended		
	March 3, 2007	March 4, 2006 (Restared-note 4)	February 26, 2005 (Restared-note 4)
Cash flows from operating activities			
Net income	**$631,572**	$374,656	$ 205,612
Items not requiring an outlay of cash:			
Amortization	**126,355**	85,873	66,760
Deferred income taxes	**101,576**	77,154	(144,642)
Share-based payment (note 4)	**19,063**	2,551	2,899
Other	**(315)**	507	(137)
Net changes in working capital items (note 18(a))	**(142,582)**	(390,650)	147,490
Net cash provided by operating activities	**735,699**	150,091	277,982
Cash flows from financing activities			
Issuance of share capital	**44,534**	23,269	54,151
Excess tax benefits from share-based compensation (note 12(b))	**6,000**	—	—
Common shares repurchased pursuant to Common Share Repurchase Program (note 12(a))	**(203,933)**	(391,212)	—
Repayment of long-term debt	**(262)**	(229)	(199)
Net cash provided by (used in) financing activities	**(153,661)**	(368,172)	53,952
Cash flows from investing activities			
Acquisition of investments	**(100,080)**	(103,179)	(615,098)
Proceeds on sale or maturity of investments	**86,583**	61,495	18,385
Acquisition of capital assets	**(254,041)**	(178,732)	(109.363)
Acquisition of intangible assets	**(60,303)**	(23,702)	(17,061)
Business acquisitions (note 9)	**(116,190)**	(3,795)	(3,888)
Acquisition of short-term investments	**(163,147)**	(199,194)	(227,072)
Proceeds on sale or maturity of short-term investments	**242,601**	514,431	76,022
Net cash provided by (used in) investing activities	**(364,577)**	67,324	(878,075)
Effect of foreign exchange loss (gain) on cash and cash equivalents	**173**	(57)	76
Net increase (decrease) in cash and cash equivalents for the year	**217,604**	(150,814)	(546,065)
Cash and cash equivalents, beginning of year	**459,540**	610,354	1,156,419
Cash and cash equivalents, end of year	**$677,144**	$459,540	$ 610,354

See notes to be consolidated financial statements.
Source: Research in Motion, Annual Report 2007, p. 64.

8. SUPPLEMENTAL INFORMATION

(a) Cash flows resulting from net changes in working capital items are as follows:

	For the year ended		
	March 3, 2007	March 4, 2006	February 26, 2005
Trade receivables	$(254,370)	$ (87,528)	$(126,177)
Other receivables	(8,300)	(18,727)	(7,326)
Inventory	(121,238)	(42,034)	(49,653)
Other current assets	(16,827)	(11,876)	(1,346)
Accounts payable	47,625	11,031	32,894
Accrued liabilities	119,997	59,398	18,618
Accrued litigation and related expenses	—	(435,610)	351,218
Restricted cash	—	111,978	(75,717)
Income taxes payable	83,310	17,985	5,242
Deferred revenue	7,221	4,733	(263)
	$(142,582)	$(390,650)	$ 147,490

Source: Research in Motion, Annual Report, 2007, p. 98.

Required

1. Have RIM's trade receivables increased or decreased during fiscal year 2007? By how much have its trade receivables changed during the past three years? Explain.
2. How does the change in inventory during fiscal year 2007 affect cash? Explain.
3. Explain why RIM shows a decrease in cash flow from operations from fiscal year 2005 to 2006 while it reported an increase in net income.
4. How did the company finance the acquisition of long-term assets during fiscal year 2006 and 2007? Explain.
5. What additional information does the cash flow statement provide that is not available on either the balance sheet or the income statement?

CP5–6 Using Financial Reports: Analyzing Celestica's Cash Flow Statement

LO2, 3, 4, 5, 6

Celestica Inc.

Celestica Inc. is a world leader in providing electronics manufacturing services to original equipment manufacturers, communications, and other industries. Celestica provides a wide variety of products and services to its customers, including complex printed circuit board assemblies such as PC motherboards and communication and networking cards. These assem blies end up in servers, workstations, personal computers, peripherals, and communications devices. Celestica also offers supply chain management, as well as design, global distribution, and post-sales repair services. Celestica operates facilities in the Americas, Europe, and Asia. Its cash flow statements for the years 2004 to 2006 are shown below.

CELESTICA INC.
Consolidated Statements of Cash Flows
(in millions of U.S. dollars)

	Year ended December 31		
	2004	2005	2006
Cash provided by (used in):			
Operations:			
Net loss	$ (854.1)	$ (46.8)	$ (150.6)
Items not affecting cash:			
Depreciation and amortization	207.7	152.7	134.2
Deferred income taxes	234.6	(15.6)	55.2
Accretion of convertible debt	17.6	7.6	—
Non-cash charge for option issuances	7.6	9.0	5.1
Restructuring charges	35.3	11.0	47.9
Other charges	482.4	(15.3)	34.6
Gain on settlement of principal component of convertible debt (*Note 8*)	(32.9)	(13.9)	—
Inventory write-down related to restructuring	61.2	—	—

(continued)

Other	1.9	14.5	1.9
Changes in non-cash working capital items:			
Accounts receivable	(253.0)	42.0	(24.8)
Inventories	85.6	—	(172.0)
Prepaid and other assets	(12.9)	17.3	2.7
Income taxes recoverable	(50.0)	(24.4)	72.1
Accounts payable and accrued liabilities	(113.8)	51.2	108.0
Income taxes payable	43.6	29.0	(75.1)
Non-cash working capital changes	(300.5)	115.1	(89.1)
Cash provided by (used in) operations	(139.2)	218.3	39.2
Investing:			
Acquisitions, net of cash acquired/indebtedness assumed (*Note 3*)	(39.6)	(6.5)	(19.1)
Purchase of capital assets	(142.2)	(158.5)	(189.1)
Proceeds, net of cash divested from sale of operations or assets	101.3	50.9	1.0
Other	0.6	2.2	(0.7)
Cash used in vesting activities	(79.9)	(111.9)	(207.9)
Financing:			
Increase in long-term debt (*Note 7*)	500.0	250.0	—
Long-term debt issue costs	(12.0)	(4.2)	—
Repayment of long-term debt	(41.1)	(3.4)	(0.6)
Deferred financing costs	(4.0)	(1.1)	—
Repurchase of convertible debt (*Note 8*)	(299.7)	(352.0)	—
Issuance of share capital	14.6	8.0	5.3
Other	1.3	(3.5)	(1.3)
Cash provided by (used in) financing activities	159.1	(106.2)	3.4
Increase (decrease) in cash	(60.0)	0.2	(165.3)
Cash, beginning of year	1,028.8	968.8	969.0
Cash, end of year	$ 968.8	$ 969.0	$ 803.7

Cash is comprised of cash and short-term investments.
Supplemental cash flow information (*Note 19*).

See accompanying notes to consolidated financial statements.

Required:

1. The cash flows from operating activities show that "depreciation and amortization" is added to "net loss." Are depreciation and amortization a source of cash? Explain.
2. How does the change in inventory during 2006 affect cash? Explain.
3. Compare the changes in non-cash working capital items across the three years. What conclusions can you draw from this comparison?
4. Compute and analyze Celestica's capital acquisitions ratio and free cash flow for the three years.
5. Has Celestica become more or less risky during 2006? What other financial statement might include information that would help you confirm your answer? Explain.
6. Analyze the company's pattern of cash flows from operating, investing, and financing activities over the three years. What conclusion can you draw from the changing pattern of cash flows? Explain.
7. Obtain a copy of Celestica's cash flow statement for the year 2007 through the company's Web site (**www.celestica.com**) or the SEDAR service (**www.sedar.com**). Did the company's cash flow situation in 2007 improve or deteriorate relative to previous years? Explain.
8. As a potential investor in Celestica's shares, what additional information would you need before making your decision whether or not to invest in this company's shares?

LO1, 2 **CP5–7** **Using Financial Reports: Analyzing a U.K. Cash Flow Statement**

Geox.



Geox S.p.A. is an Italy-based company active in the footwear and apparel manufacturing industry, which include classic, casual and sports footwear, as well as apparel for men, women and children. The company's products are sold in over 70 countries worldwide through a widespread distribution network. Geox prepares its financial statements in accordance with the International Financial Reporting Standards. Its cash flow statements for the years 2006 and 2005 are shown below.

Cash Flow Statement
(Thousands of Euro)

	Notes	2006	2005
Cash Flow From Operating Activities:			
Net income	**22**	**97,262**	**75,253**
Adjustments to reconcile net income to net cash provided (used) by operating activities:			
Depreciation and amortization	8	18,564	18,104
Increase in (use of) deferred taxes and other provisions		(1,741)	(1,683)
Provisions for employee severance indemnities, net		663	1,071
Other non-cash items due to adoption of IAS/IFRS		755	(4,601)
		18,241	12,891
Change in current assets /liabilities:			
Accounts receivable		(9,633)	(16,855)
Other assets		(7,217)	(1,358)
Inventories		(23,401)	(27,572)
Accounts payable		13,991	20,001
Other liabilities		3,345	3,680
Taxes payable		(9,477)	5,521
		(32,392)	(16,583)
Other:			
IPO tax benefit cancelled by EU		—	(6,281)
		—	(6,281)
Operating cash flow		**83,111**	**65,280**
CASH FLOW USED IN INVESTING ACTIVITIES:			
Capital expenditure on intangible fixed assets	13	(11,193)	(12,835)
Capital expenditure on tangible fixed assets	14	(16,189)	(18,944)
		(27,382)	(31,779)
Disposals		845	2,415
(Increase) decrease in financial assets		(890)	15,682
Cash flow used in investing activities		**(27,427)**	**(13,682)**
CASH FLOW FROM (USED IN) FINANCING ACTIVITIES:			
Increase (decrease) in short-term bank borrowings, net		9	(3,930)
Loans:			
Proceeds		2,818	11,007
Repayments		(12,474)	(34,229)
Dividends	34	(22,001)	(15,510)
Increase in share capital		—	1,582
Cash flow from financing activities		**(31,648)**	**(41,080)**
Increase in cash and cash equivalents		**24,036**	**10,518**
Cash and cash equivalents, beginning of the period	**21**	**61,513**	**50,570**
Effect of translation differences on cash and cash equivalents		(623)	425
Cash and cash equivalents, end of the period	**21**	**84,926**	**61,513**
Supplementary information to the cash flow statement:			
Interest paid during the period		572	1,564
Taxes paid during the period		47,542	29,488

Source: Annual Report, Goex, S.p.A. 2006, p. 44

Required:

1. The cash flows from operating activities show that "depreciation and amortization" is added to net income. Are depreciation and amortization a source of cash? Explain.
2. Geox reported sales of €612,258 during 2006. Compute the amount of cash collected from customers during the year, assuming all sales are on account.
3. How does the change in accounts payable during 2006 affect cash?
4. Did Geox expand during 2005 and 2006? If so, how did the company pay for its expansion? Explain.

5. Compute and analyze Geox's quality of income ratio, capital acquisitions ratio and free cash flow for the two years.
6. As a potential investor in Geox's shares, what additional information would you need before making your decision whether or not to invest in the company's shares?

CP5–8 (Supplements A and B) Using Financial Reports: Analyzing Operating Cash Flows of Foster's Group

Foster's Group is a global multi-beverage Australian company that produces and markets a variety of beer, wine, spirits, cider and non-alcohol beverages. Foster's reports its cash flows from operating activities using the direct method. Its cash flow statement for 2006 included the following information (in millions of Australian dollars):

	Fiscal Year Ended 30 June	
	2006	2005
Cash flows from operating activities		
Receipts from customers	6,841.4	5,789.8
Payment to suppliers, governments and employees	(5,564.1)	(4,975.0)
Dividends received	0.1	2.9
Interest received	41.6	132.3
Borrowing costs	(273.8)	(241.0)
Income taxes paid	(210.0)	(185.6)
Net cash flows from operating activities	**835.2**	**523.4**

Foster's also presents a reconciliation of net income to cash flow from operating activities in a note to its financial statements. A condensed version of this reconciliation, which is essentially the indirect method of reporting cash flows from operations, is presented below.

	Fiscal Year Ended 30 June	
	2006	2005
Reconciliation of net cash flows from operating activities to profit after income tax		
Profit for the year	1,169.8	925.2
Depreciation and amortization	163.9	149.7
(Profit)/loss on disposal of non-current assets	(10.7)	(14.8)
(Profit)/loss on disposal of intangibles	(733.2)	(57.5)
(Profit)/loss on disposal of discontinued operations	(13.1)	(459.5)
Other non-cash items, net	137.9	211.4
Changes in working capital items		
receivables	29.7	(14.4)
inventories	59.8	14.8
other assets	46.5	3.9
accounts payable	(7.7)	(84.9)
accrued liabilities	(7.7)	(150.5)
Net cash flows from operating activities	**835.2**	**523.4**

Required:

1. As a user of financial statements, would you prefer to see the cash flows from operating activities reported using the direct method or the indirect method? Explain.
2. Did Foster's sales to its customers exceed the amount it collected from them during fiscal year 2006? Can you determine Foster's sales during fiscal year 2006? Show computations.
3. Assume for simplicity that Foster's purchases its inventories from trade suppliers. Did Foster's pay its trade suppliers for all the purchases it made during fiscal year 2006? Support your answer with detailed computations.
4. Compute and interpret the quality of income ratios for both years 2005 and 2006.
5. What additional information is reported under the indirect method, but is not reported under the direct method.

CRITICAL THINKING CASE

CP5–9 Making a Decision as a Financial Analyst: Analyzing Cash Flow for a New Company

■ **LO2**

Carlyle Golf, Inc.

Carlyle Golf, Inc., was formed in September of last year. The company designs, contracts for the manufacture of, and markets a line of men's golf apparel. A portion of the cash flow statement for Carlyle follows:

	Current Year
Cash flows from operating activities	
Net income	$(460,089)
Depreciation	3,554
Non-cash compensation (stock)	254,464
Deposits with suppliers	(404,934)
Increase in prepaid assets	(42,260)
Increase in accounts payable	81,765
Increase in accrued liabilities	24,495
Net cash flows	$(543,005)

Management expects a solid increase in sales in the near future. To support the increase in sales, it plans to add $2.2 million to inventory. The company did not disclose a sales forecast. At the end of the current year, Carlyle had less than $1,000 in cash. It is not unusual for a new company to experience a loss and negative cash flows during its start-up phase.

Required:

As a financial analyst recently hired by a major investment bank, you have been asked to write a short memo to your supervisor evaluating the problems facing Carlyle. Emphasize typical sources of financing that may or may not be available to support the expansion.

FINANCIAL REPORTING AND ANALYSIS TEAM PROJECT

CP5–10 Team Project: Analyzing Cash Flows

■ **LO1, 2, 3, 4, 5, 6**



As a team, select an industry to analyze (industry lists can be found at **www.investors.reuters.com/Industries.aspx** and **www.hoovers.com**; click on Companies & Industries). Each team member should acquire the annual report for one publicly traded company in the industry, with each member selecting a different company. (Library files, the SEDAR service at **www.sedar.com**, or the company itself are good sources.)

Required:

On an individual basis, each team member should then write a short report answering the following questions about the selected company. Discuss any patterns across the three companies that your team observes. Then, as a team, write a short report comparing and contrasting your companies.

1. Which of the two basic reporting approaches for cash flows from operating activities did the company adopt?
2. What is the quality of income ratio for the most current year? What were the major causes of differences between net income and cash flow from operations?
3. What is the capital acquisitions ratio for the three-year period presented in total? How is the company financing its capital acquisitions?
4. What portion of the cash from operations in the current year is being paid to shareholders in the form of dividends?