Overview

There is not much that is new in this chapter. Rather, this chapter draws on what was learned in Chapter 5 and subsequent chapters with respect to the statement of cash flows. It then demonstrates some comprehensive problems involving this third financial statement.

At the time when you learned about the statement of cash flows, back in Chapter 5, some of the items that appear on a statement of cash flows had not been introduced. Hence, the material learned in Chapter 5 was a bit simplified. New items, such as the amortization for a bond premium or discount, treasury stock, or the classification of securities (available for sale, trading, held to maturity) were not yet covered—yet they all impact the statement of cash flows.

The six-step process for preparing the statement of cash flows is gone over, once again, but with more details surrounding the above items and more. Also, the differences in the U.S. accounting standards for the statement of cash flows and the GAAP of other countries are discussed.

Finally, the chapter gives you a peak at the final chapter in the book, dealing with financial statement analysis, by going through an analysis of a statement of cash flows for a complex entity.

You are reaching the end of the book so expect a lot of comprehensive, synthesizing kind of problems in this chapter and beyond. You now have the background knowledge to be able to analyze and understand most of the financial accounting questions raised.

Learning Objectives

Refer to the Review of Learning Objectives at the end of the chapter. It is crucial that this section of the chapter is second nature to you before you attempt the homework, a quiz, or exam. This important piece of the chapter serves as your CliffsNotes or “cheat sheet” to the basic concepts and principles that must be mastered.
If after reading this section of the chapter you still don’t feel comfortable with all of the Learning Objectives covered, you will need to spend additional time and effort reviewing those concepts that you are struggling with.

The following “Tips, Hints, and Things to Remember” are organized according to the Learning Objectives (LOs) in the chapter and should be gone over after reading each of the LOs in the textbook.

**Tips, Hints, and Things to Remember**

**LO1 – Prepare a complete statement of cash flows and provide the required supplemental disclosures.**

**How?** Remember that the indirect method is the one most widely used. Hence, you’ll want to focus your efforts on studying how to prepare an indirect method statement of cash flows.

The Financing Activities and Investing Activities sections are the same under either method. For the Operating Activities section, let’s go through a little refresher course on whether you add or subtract changes in account balances.

Think of Accounts Receivable. If the balance in Accounts Receivable decreased, that means more cash was collected (relative to sales revenue). Thus, you can write down the following:

<table>
<thead>
<tr>
<th>Account Balance Change</th>
<th>Effect on Cash Flows Relative to Net Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Assets</td>
<td>–</td>
</tr>
<tr>
<td>Current Liabilities</td>
<td></td>
</tr>
</tbody>
</table>
With only that one example, you can then fill in the rest of the table. Current asset increases go in the opposite direction as decreases, and current liabilities move in the exact opposite direction as current assets. Your completed table should then look like this:

<table>
<thead>
<tr>
<th>Account Balance Change</th>
<th>Effect on Cash Flows Relative to Net Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Assets</td>
<td>-</td>
</tr>
<tr>
<td>Current Liabilities</td>
<td>+</td>
</tr>
</tbody>
</table>

As mentioned back in Chapter 5, don’t try memorizing the above table. Instead, know how to create the table from any given example.

LO2 – Understand the differences among cash flow statements prepared according to U.S. GAAP and IASB standards.

**How?** The statement of cash flows is one of the biggest areas in which the standards vary based on jurisdiction. Ultimately, they will likely converge, like other accounting topics, to become the same or very similar worldwide. The IASB standards are somewhat similar to U.S. GAAP. The major differences involve flexibility on the IASB’s part as to what kind of activities items such as interest and dividends should be classified as. There is only one way to do it under U.S. GAAP.

LO3 – Incorporate material from the entire text into the preparation of a statement of cash flows.

**How?** Hopefully, you remember how to prepare a statement of cash flows from your studies in Chapter 5. If you don’t, you’ll want to start by reviewing Chapter 5. For this chapter, let’s focus primarily on items that have been introduced since Chapter 5.

What happens when a company amortizes its bond discount or premium? Similar to regular depreciation and amortization, cash is not affected. Therefore, an adjustment needs to be made on the statement of cash flows, using the indirect method, since the amortization on the income statement needs to be backed out of income to arrive at cash flows from operating activities. What is different with bond discount or premium amortization when compared to intangible asset amortization is it is not always a positive adjustment to net income.
Think of the journal entry involved to record amortization. Since Bond Discount shows up as a contra account to the Bonds Payable account and, thus, has a debit balance, it is decreased with a credit and Bond Discount Amortization receives a debit (similar to amortization of an intangible asset). Therefore, bond discount amortization is an addition to net income to arrive at the correct cash flow from operating activities.

Since Bond Premium shows up as an addition to the Bonds Payable account and, thus, has a credit balance, it is decreased with a debit and Bond Premium Amortization receives a credit. Thus, bond premium amortization is a reduction in net income (since premium amortization increases net income but doesn’t increase cash) to arrive at the correct cash flow from operating activities.

LO4 – Perform a detailed case analysis of a company’s operations and performance using cash flow data.

How? The case illustrates the importance of the statement of cash flows. The third financial statement should not be ignored in favor of the accrual basis data found on the income statement and balance sheet. One of the key exhibits in Chapter 5, that should be consulted as you go through the Kamila Software case, is Exhibit 5-9. Notice that for the most recent year, Kamila falls under situation number 5. A company with operating cash flow problems being covered by the sale of fixed assets and by shareholder contributions is a risky company to be investing in.

An auditor investigating Kamila would need to do a lot of work on the Accounts Receivable account balance before signing off that $600 is the actual net balance that should be reported. The change in the Accounts Receivable balance jumps out at the analyst more from the statement of cash flows than from the comparative balance sheet. It also highlights the possible premature revenue recognition that may have taken place at Kamila.
The following sections, featuring various multiple choice questions, matching exercises, and problems, along with solutions and approaches to arriving at the solutions, is intended to develop your problem-solving and critical-thinking abilities. While learning through trial and error can be effective for improving your quiz and exam scores, and it can be a more interesting way to study than merely re-reading a chapter, that is only a secondary objective in presenting this information in this format.

The main goal of the following sections is to get you thinking, “How can I best approach this problem to arrive at the correct solution—even if I don’t know enough at this point to easily come up with the proper results?” There is not one simple approach that can be applied to all questions to arrive at the right answer. Think of the following approaches as possibilities, as tools that you can place in your problem-solving toolkit—a toolkit that should be consistently added to. Some of the tools have yet to even be created or thought of. Through practice, creative thinking, and an ever-expanding knowledge base, you will be the creator of the additional tools.

Multiple Choice

**MC21-1 (LO1)** Supplemental disclosures required only when the statement of cash flows is prepared using the indirect method include
a. a schedule reconciling net income with net cash provided by (used in) operating activities.
b. significant noncash investing and financing activities.
c. amounts deducted for depreciation and amortization.
d. amounts paid for interest and taxes.
MC21-2 (LO1) Ellie Company reported net income of $420,000 for 2011. Changes occurred in several balance sheet accounts as follows:

<table>
<thead>
<tr>
<th>Account</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment</td>
<td>$35,000 increase</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>56,000 increase</td>
</tr>
<tr>
<td>Note payable</td>
<td>42,000 increase</td>
</tr>
</tbody>
</table>

Additional information:

- During 2011, Ellie sold equipment costing $35,000, with accumulated depreciation of $16,800, for a gain of $7,000. The transaction was settled 100 percent in cash.
- In December 2011, Ellie purchased equipment costing $70,000 with $28,000 cash and a 12% note payable of $42,000.
- Depreciation expense for the year was $72,800.

In Ellie’s 2011 statement of cash flows, net cash used in investing activities should be
a. $2,800.
b. $16,800.
c. $30,800.
d. $49,000.

MC21-3 (LO1) Ryan, Inc., declared and paid cash dividends of $100,000 on common stock and $75,000 on preferred stock. These dividends would be presented in Ryan’s statement of cash flows as
a. $100,000 reduction in cash flows from investing activities.
b. $175,000 reduction in cash flows from investing activities.
c. $100,000 reduction in cash flows from financing activities.
d. $175,000 reduction in cash flows from financing activities.

MC21-4 (LO2) Which of the following statements is TRUE?

a. The FASB requires dividends paid to be classified as an operating activity.
b. The FASB requires interest paid to be classified as a financing activity.
c. The FASB allows dividends paid to be classified as an operating activity or as a financing activity.
d. The IAS allows dividends paid to be classified as an operating activity or as a financing activity.

MC21-5 (LO3) In preparing a statement of cash flows, which of the following transactions would be considered an investing activity?

a. sale of a business segment
b. issuance of bonds payable at a discount
c. purchase of treasury stock
d. sale of capital stock
MC21-6 (LO3) In preparing a statement of cash flows, sale of treasury stock at an amount greater than cost would be classified as a(n)
a. transfer activity.
b. operating activity.
c. investing activity.
d. financing activity.

MC21-7 (LO3) The following information was taken from the 2011 financial statements of NIN Corporation:

Gross accounts receivable, January 1, 2011 $ 108,000
Gross accounts receivable, December 31, 2011 152,000
Sales on account and cash sales 2,190,000
Increase in Allowance for Bad Debts account balance 5,000

No accounts receivable were written off or recovered during the year. What amount was collected from customers in 2011?
a. $2,239,000
b. $2,234,000
c. $2,146,000
d. $2,141,000

MC21-8 (LO3) The following information is available from the financial statements of Isis Corporation for the year ended December 31, 2011:

Net income $396,000
Depreciation expense 102,000
Decrease in accounts receivable 126,000
Increase in inventories 90,000
Increase in accounts payable 24,000
Payment of dividends 54,000
Purchase of trading securities 10,000
Purchase of available-for-sale securities 22,000
Decrease in income taxes payable 16,000

What is Isis Corporation's net cash flow from operating activities?
a. $430,000
b. $456,000
c. $510,000
d. $532,000
MC21-9 (LO4) The following choices are the cash flow patterns for four different companies in the same industry. Assume that the numbers are all significant (i.e., they are all in the millions and none are nearly zero). Which of the following cash flow patterns describes the company that is likely having the most problems?

<table>
<thead>
<tr>
<th>Operating</th>
<th>Investing</th>
<th>Financing</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. +</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>b. +</td>
<td>–</td>
<td>+</td>
</tr>
<tr>
<td>c. –</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>d. –</td>
<td>–</td>
<td>–</td>
</tr>
</tbody>
</table>

Matching

Matching 21-1 (LO1, LO3) Listed below are the terms and associated definitions from the chapter for LO1 and LO3. Match the correct definition letter with each term number.

___ 1. direct method  
___ 2. financing activities  
___ 3. indirect method  
___ 4. investing activities  
___ 5. noncash investing and financing activities  
___ 6. operating activities  
___ 7. statement of cash flows

a. investing and financing transactions that affect a company’s financial position but not the cash flows during the period; an example is the purchase of land by issuing stock
b. an approach to calculating and reporting cash flow from operating activities that reconciles net income with operating cash flow; net income is adjusted for noncash revenues and expenses, for any gains or losses associated with investing and financing activities, and for changes in current operating assets and liabilities that indicate noncash sources of revenues and expenses
c. includes transactions and events that normally enter into the determination of net income, including interest and taxes
d. includes transactions and events whereby cash is obtained from or repaid to owners and creditors
e. primarily includes purchases and sales of noncurrent assets such as land, buildings, and nontrading financial instruments
f. one of the three primary financial statements; provides information about the cash receipts (inflows) and cash payments (outflows) of a company during a period of time; separated into operating, investing, and financing activities
g. an approach to calculating and reporting cash flow from operating activities that itemizes the major operating cash receipt and cash payment categories
Problems

Problem 21-1 (LO1) A review of the financial records of Baying Hounds Company for the current year revealed the following information:

a. Reported interest expense of $36,000. The Interest Payable balance decreased $4,000.
b. Declared and paid cash dividends of $135,000.
c. Purchased a $400,000 building with a $220,000 long-term mortgage note. The remainder was paid in cash.
d. Issued bonds with a $600,000 par value to retire 6,000 shares of $100 par-value preferred stock.
e. Held-to-maturity securities with a book value of $7,600 were sold for $9,000 during the year.
f. Reported income tax expense of $55,000. The Income Taxes Payable balance increased $15,000.
g. The Accounts Payable balance increased $7,740.
h. Cash of $127,000 was paid to purchase business assets consisting of:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory</td>
<td>$34,700</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>52,400</td>
</tr>
<tr>
<td>Patents</td>
<td>21,000</td>
</tr>
<tr>
<td>Autos and trucks</td>
<td>18,900</td>
</tr>
</tbody>
</table>

i. Sold equipment with a net book value of $95,000 for $99,700.
j. Issued $75,000 in common stock to acquire land with a selling price of $120,000. The difference was paid in cash.

Explain how each of the preceding items is presented in the statement of cash flows using the indirect method, or disclosed in the financial statements of Baying Hounds Company. Indicate “not included” for any item that would not be reported or disclosed. Evaluate each item separately.
Problem 21-2 (LO1, LO3) The following pertains to the Beekeeper Company for the year ended December 31, 2011.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation expense</td>
<td>$ 12,000</td>
</tr>
<tr>
<td>Amortization expense</td>
<td>11,100</td>
</tr>
<tr>
<td>Issuance of common stock</td>
<td>105,000</td>
</tr>
<tr>
<td>Amortization of bond premium</td>
<td>3,500</td>
</tr>
<tr>
<td>Amortization of bond discount</td>
<td>6,750</td>
</tr>
<tr>
<td>Cash dividends paid</td>
<td>18,600</td>
</tr>
<tr>
<td>Increase in inventory</td>
<td>43,500</td>
</tr>
<tr>
<td>Decrease in accounts receivable</td>
<td>68,700</td>
</tr>
<tr>
<td>Decrease in accounts payable</td>
<td>27,600</td>
</tr>
<tr>
<td>Retirement of long-term debt</td>
<td>120,000</td>
</tr>
<tr>
<td>Net loss</td>
<td>15,000</td>
</tr>
<tr>
<td>Proceeds from sale of equipment ($16,000 loss)</td>
<td>63,000</td>
</tr>
<tr>
<td>Purchase of equipment</td>
<td>84,000</td>
</tr>
<tr>
<td>Cash and cash equivalents, beginning of year</td>
<td>200,000</td>
</tr>
</tbody>
</table>

Prepare a statement of cash flows in good form using the indirect method.
Problem 21-3 (LO3) The following schedule shows the net changes in the balance sheet accounts on December 31, 2010, as compared to December 31, 2011, for the Deliverance Company. The statement of cash flows for the year ended December 31, 2011, has not been prepared.

<table>
<thead>
<tr>
<th>Assets</th>
<th>Increase (Decrease)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and cash equivalents</td>
<td>$ 60,000</td>
</tr>
<tr>
<td>Accounts receivable (net)</td>
<td>66,000</td>
</tr>
<tr>
<td>Inventories</td>
<td>37,000</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>2,000</td>
</tr>
<tr>
<td>Property, plant, and equipment (net)</td>
<td>63,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>$228,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>$(46,000)</td>
</tr>
<tr>
<td>Short-term notes payable</td>
<td>(20,000)</td>
</tr>
<tr>
<td>Accrued liabilities</td>
<td>28,500</td>
</tr>
<tr>
<td>Bonds payable</td>
<td>(28,000)</td>
</tr>
<tr>
<td>Less: Amortized bond discount</td>
<td>1,200</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>$(64,300)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Stockholders’ Equity</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock</td>
<td>$ 500,000</td>
</tr>
<tr>
<td>Paid-in capital in excess of par</td>
<td>200,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>(437,700)</td>
</tr>
<tr>
<td>Appropriation of retained earnings for possible plant expansion</td>
<td>30,000</td>
</tr>
<tr>
<td>Total stockholders' equity</td>
<td>$ 292,300</td>
</tr>
</tbody>
</table>

The following additional information has been gathered:

a. The net income for the year ended December 31, 2011, was $172,300.
b. During the year ended December 31, 2011, uncollectible accounts receivable of $26,400 were written off by a debit to Allowance for Bad Debts.
c. A comparison of Property, Plant, and Equipment, as of the end of each year follows:

<table>
<thead>
<tr>
<th>Property, plant, and equipment</th>
<th>December 31, 2011</th>
<th>December 31, 2010</th>
<th>Increase (Decrease)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$570,500</td>
<td>$510,000</td>
<td>$60,500</td>
</tr>
<tr>
<td>Less: Accumulated depreciation</td>
<td>225,500</td>
<td>228,000</td>
<td>(2,500)</td>
</tr>
<tr>
<td></td>
<td>$345,000</td>
<td>$282,000</td>
<td>$63,000</td>
</tr>
</tbody>
</table>
During 2011, machinery was purchased at a cost of $45,000. In addition, machinery that was acquired in 2004 at a cost of $48,000 was sold for $3,600. At the date of sale, the machinery had an undepreciated cost of $4,200. The remaining increase in property, plant, and equipment resulted from the acquisition of a tract of land for a new plant site.

d. The bonds payable mature at the rate of $28,000 every year.
e. In January 2011, the company issued an additional 10,000 shares of common stock at $14 per share upon exercise of outstanding stock options held by key employees. In May 2011, the company declared and issued a 5% stock dividend on its outstanding stock. During the year, a cash dividend was paid on the common stock. On December 31, 2011, there were 840,000 shares of common stock outstanding.
f. The appropriation of retained earnings was made in anticipation of the construction of a new plant.
g. The notes payable relate to operating activities.

Prepare a statement of cash flows for the year ended December 31, 2011, using the indirect method.

Solutions, Approaches, and Explanations

MC21-1
Answer: d
Approach and explanation: The key portion of this question is the fact that we are looking only for disclosures required when the indirect method is used. In other words, the disclosure is not needed when the direct method is used. According to FAS 95, amounts paid for interest and taxes must be disclosed if the indirect method is used. If the direct method is used, these items are already included in the Operating Activities section so no supplemental disclosure is required. That is not the case if the indirect method is used and that is why choice d is the correct one.

Choice a would be correct if we changed the word “indirect” to “direct” in the question.

Significant noncash investing and financing activities (choice b) are required supplemental disclosures regardless of which method (direct or indirect) is used.

Amounts deducted for depreciation and amortization (choice c) are already disclosed in the Operating Activities section on the face of the statement using the indirect method, so they need not be included in any supplemental disclosure again.
MC21-2
Answer: a

Approach and explanation: Go through each part of this question and label each piece according to its activity type. Then, you'll be ready to solve the problem by focusing only on the correctly labeled investing activities.

- Net income should be marked with an “O” since it is an operating activity.
- Equipment gets an “I” since it is an investing activity. (Remember from back in Chapter 5 that, generally speaking, income statement items and changes in current asset and liability balances are operating activities, noncurrent assets are investing activities, and noncurrent liabilities and equity are financing activities.)
- Accumulated depreciation also gets an “I.”
- Note payable receives an “F” since it is a financing activity.
- The first additional information item receives an “I.”
- The second additional information item receives both an “I” and an “F.”
- Depreciation expense is part of the income statement and is an operating activity, so it receives an “O” like net income.

With the labeled information in front of you, net income, note payable, and depreciation expense can be crossed off and ignored.

Equipment increased by $35,000, but it is important to know how that equipment was purchased before jumping to the conclusion that cash was used for the full amount. Since the second bullet point indicates that only $28,000 in cash was paid, net cash used in investing activities related to new equipment was $28,000, not $35,000.

An increase in accumulated depreciation does not affect cash. Cash was affected when previously depreciated equipment was sold, however. Equipment with a book value of $18,200 ($35,000 − $16,800) was sold for a gain of $7,000, or $25,200 ($18,200 + $7,000) total. Thus, net cash received in investing activities related to old equipment sales was $25,200.

Therefore, the overall net cash used in investing activities is the difference between these two items, or $2,800 ($25,200 − $28,000).
MC21-3
Answer: d
Approach and explanation: It doesn’t matter whether a dividend was paid for preferred or common stock. What does matter, for the statement of cash flows, is if it was paid in cash. In this case, both dividends were cash dividends so they should both be included as a reduction in cash flows.

Dividends paid are always a financing activity. In fact, dividends are never an investing activity under U.S. GAAP. Dividends received are not even an investing activity. Rather, they are an operating activity when received. Again, it matters not whether dividends received are for common or preferred stock. Both, if received, would be operating activities.

MC21-4
Answer: d
Approach and explanation: Recall that the IAS is the more flexible standard-setting body when it comes to the statement of cash flows. Therefore, choice c cannot be correct. The FASB doesn’t currently allow any items to be classified as one kind of activity or another. Every transaction is specifically labeled as operating, financing, or investing under FASB. There is no choice or decision making involved under the current U.S. GAAP standards.

Choice a is one of those tricky areas discussed back in Chapter 5. Dividends paid are classified as a financing activity, whereas dividends received are classified as an operating activity.

Choice b is also somewhat difficult as well. Interest on debt (paid or received) is an operating activity, whereas the debt itself is a financing activity (if the debt is a liability to the company) or an investing activity (if the debt is that of another company and funds are being loaned to the other company).

MC21-5
Answer: a
Approach and explanation: Choices c and d are reverse sides of the same thing. Therefore, you can rule them out since they both have to be the same kind of activity even if you don’t know what kind of activity that is. They happen to both be financing activities.
Here, again, is a visual of the discussion we had back in Chapter 5, ignoring the few exceptions:

<table>
<thead>
<tr>
<th>Income Statement</th>
<th>Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating Activities</td>
<td>Current Assets</td>
</tr>
<tr>
<td></td>
<td>Operating Activities</td>
</tr>
<tr>
<td></td>
<td>Long-Term Assets</td>
</tr>
<tr>
<td></td>
<td>Investing Activities</td>
</tr>
<tr>
<td></td>
<td>Current Liabilities</td>
</tr>
<tr>
<td></td>
<td>Operating Activities</td>
</tr>
<tr>
<td></td>
<td>Long-Term Liabilities and Equity</td>
</tr>
<tr>
<td></td>
<td>Financing Activities</td>
</tr>
</tbody>
</table>

From the above, you can easily see that the issuance of bonds serves to increase long-term liabilities and, hence, will also be a financing activity. It does not matter whether the bonds are issued at a discount, par, or premium. Bond issuances and retirements will always be financing activities. The interest paid on the bonds will be operating activities (even though interest expense doesn’t show up as part of operating expenses on a multi-step income statement). The amortization on a bond discount or premium is a noncash activity that will only be reflected on an indirect statement of cash flows as an adjustment to operating activities. For which way the adjustment goes, see the explanation under the How? for LO3 on pages 21-3 and 21-4.

A business segment is a noncurrent asset, so it is an investing activity. It doesn’t matter whether it is a purchase or a sale of a business segment. Both are considered investing activities. The gain or loss on the sale of the business segment is one of the exceptions to the prior graphic which shows the income statement as including operating activities. Gains or losses on the income statement, unlike revenue and expenses, usually relate to investing, rather than operating, activities. Thus, on a statement of cash flows prepared under the indirect method, the full gain or loss (not usually the same number as the amount of cash received on the transaction) on the sale of a business segment would be backed out of net income to arrive at cash flows from operating activities. The amount of cash received for the business segment would show up as a cash inflow from investing activities.

**MC21-6**

Answer: d

Approach and explanation: If you paid attention to the explanation for MC21-5, then this one should have been a no-brainer. There is no such thing as a “transfer activity,” so you can quickly cross off choice a.
Treasury stock is stock in your own company, not an investment in another company. Therefore, it is equity that is affected, and treasury stock transactions are all financing activities.

**MC21-7**

**Answer:** c

**Approach and explanation:** Gross accounts receivable increased by $44,000 during the year. That means less cash was collected than there were in sales. How does the Allowance for Bad Debts account change the facts? The only way that the Allowance for Bad Debts account can increase with no accounts being written off or recovered during the year is for the following journal entry to take place:

\[
\begin{align*}
\text{Bad Debt Expense} & \quad 5,000 \\
\text{Allowance for Bad Debts} & \quad 5,000
\end{align*}
\]

Since that entry doesn’t affect cash, there is no adjustment needed when determining how much cash was collected during the year. If, on the other hand, you were asked to prepare an indirect statement of cash flows, you would need to back out the $5,000 from net income. The easiest way to do so is to look at the change in net accounts receivable ($108,000 – $147,000), rather than gross accounts receivable.

Therefore, the answer is simply $2,146,000 ($2,190,000 – 44,000).

**MC21-8**

**Answer:** d

**Approach and explanation:** First, go through and tag each item as to whether it is an “O” for an operating activity, “I” for an investing activity, or “F” for a financing activity. All items are Os except for payment of dividends, which is an F, and the purchase of available-for-sale securities, which is an I.

For operating activities, start with net income, adjust for noncash items (depreciation and amortization), and then adjust for changes in current assets and current liabilities. See the discussion under the **How?** for LO1 on page 21-2 if you don’t remember how to determine which way the adjustments go.

\[
\begin{align*}
\text{Net income} & \quad $396,000 \\
+ \text{Depreciation expense} & \quad 102,000 \\
+ \text{Decrease in accounts receivable} & \quad 126,000 \\
– \text{Increase in inventories} & \quad (90,000) \\
+ \text{Increase in accounts payable} & \quad 24,000 \\
– \text{Purchase of trading securities} & \quad (10,000) \\
– \text{Decrease in income taxes payable} & \quad (16,000) \\
\text{Total} & \quad $532,000
\end{align*}
\]
Note that even though available-for-sale securities can be a current asset, they are not treated as an operating activity on purchase or sale. Trading securities are always a current asset and are always considered an operating activity on both purchase and sale. Similar to other current assets, if more trading securities are purchased than sold during a period (in this case, $10,000 worth), the increase in the account balance will be a subtraction from net income to arrive at net cash flow from operating activities.

MC21-9
Answer: c
Approach and explanation: The most important column is the Operating Activities one. A company with significant positive cash flow from operating activities is not likely to be the one having the most problems. With that in mind, you can safely cross out choices a and b.

Before we look closer at the remaining choices of c and d, let’s see what general descriptions would fit for choices a and b just in case the problem like this that you get on a test isn’t looking for the company with the most problems.

Choice a is a company doing very well on operations. They are using the excess cash that operating activities are generating to invest in the future and to pay off debt and/or pay dividends to shareholders or buy back outstanding shares of stock.

Choice b is a company in a similar situation except that instead of paying off debt and paying dividends, they are increasing their debt burden and/or issuing additional shares of company stock. They may be doing this because the growth prospects are so good that they want to spend a lot of money on investments. They could be buying up other companies or expanding their own facilities very rapidly.

Situations like choices a and b are the best situations to be in. As an investor, or a potential partner in a strategic alliance like that described in the example in the chapter, these are the companies to look for if you want to increase your odds of maximizing your long-term gains.

Choice d is actually a very uncommon situation for a company to be in. A company can’t have negative cash flows from all three activities for a long period of time. But just because all three are negative doesn’t mean the company is in dire straights. The company may be in its second year. During the first year, significant amounts of cash came in under financing and during this year a bit of that has been paid back. Since the company is still new, operating cash flow hasn’t yet turned positive but investments are still being made for the future (hence, the negative under the Investing column), so the future could still be bright.
Choice c is not a pleasant situation to be in. It means the company is selling off its future in order to cover its present operating cash flow problems. In addition, the operating cash flow shortfalls are causing this company to have to obtain additional debt (probably at unfavorable rates) and/or find more equity investors. If choice c persists for significant periods of time, then the company will likely go bankrupt.

All three kinds of activities are important to examine, but after operating activities, investing activities tend to be the next most important. You want to see a negative number there for a healthy and growing company.

The number for financing activities isn't usually as important as the other two. As a debt or equity investor, you may want to look at the details behind the bottom-line number, however. As a creditor, you’d like to see money being used to pay off existing debt and new money coming into the company from owners rather than from additional creditors. As an owner (equity investor), you’d like to see money coming in from creditors (not additional owner contributions, thus diluting your stake in the business) and you’d like to see dividends being paid, assuming there aren’t better ways for the company to invest their excess cash.

Matching 21-1
1. g
2. d
3. b
4. e
5. a
6. c
7. f

Complete these terminology matching exercises without looking back at the textbook or on to the glossary. After all, you probably won’t have those as a reference at test time. Learning through trial and error causes the item to be learned better and to stick in your memory longer than if you just look at the textbook, glossary, or a dictionary and “cook book” the answers. Sure you may get the answer correct on your first attempt, but missing something is sometimes best for retention. Don’t be afraid of failure while studying and practicing.

Problem 21-1
a. Cash flows from operating activities:
   \[\text{Adjustments:}\]
   \[\text{Less: Decrease in Interest Payable} \quad (4,000)\]
   \[\text{Supplemental disclosure:}\]
   \[\text{Cash payments for interest} \quad 40,000\]

b. Cash flows from financing activities:
   \[\text{Payment of cash dividends} \quad (135,000)\]
c. Cash flows from investing activities:
   Purchase of building $(180,000)

   Supplemental disclosure:
   Issuance of $220,000 long-term mortgage note to acquire a building.

d. Supplemental disclosure:
   Issuance of $600,000 in bonds to retire 6,000 shares of $100 par-value preferred stock.

e. Cash flows from operating activities:
   Adjustments:
   Less: Gain on sale of held-to-maturity securities $(1,400)

   Cash flows from investing activities:
   Sale of held-to-maturity securities $9,000

f. Cash flows from operating activities:
   Adjustments:
   Add: Increase in Income Taxes Payable $15,000

   Supplemental disclosure:
   Cash payments for income taxes $40,000

g. Cash flows from operating activities:
   Adjustments:
   Add: Increase in Accounts Payable $7,740

h. Cash flows from investing activities:
   Purchase of machinery and equipment $(52,400)
   Purchase of patents (21,000)
   Purchase of autos and trucks (18,900)

   Note: Inventory would be analyzed as a net increase (decrease) for the period as an adjustment to net income in the Cash Flows from Operating Activities section.

i. Cash flows from operating activities:
   Adjustments:
   Less: Gain on sale of equipment $(4,700)

   Cash flows from investing activities:
   Sale of equipment $99,700

j. Cash flows from investing activities:
   Purchase of land $(45,000)

   Supplemental Disclosure:
   Issuance of $75,000 in common stock to acquire land.
Problem 21-2

Beekeeper Company
Statement of Cash Flows
For the Year Ended December 31, 2011

Cash flows from operating activities:
Net loss $ (15,000)
Adjustments:
  Depreciation $ 12,000
  Amortization 11,100
  Loss on sale of equipment 16,000
  Decrease in accounts receivable 68,700
  Amortization of bond discount 6,750
  Amortization of bond premium (3,500)
  Increase in inventory (43,500)
  Decrease in accounts payable (27,600) 39,950
Net cash provided by operating activities $ 24,950

Cash flows from investing activities:
  Proceeds from sale of equipment $ 63,000
  Purchase of equipment (84,000)
Net cash used in investing activities (21,000)

Cash flows from financing activities:
  Issuance of common stock $ 105,000
  Retirement of long-term debt (120,000)
  Payment of dividends (18,600)
Net cash used in financing activities (33,600)

Net decrease in cash and cash equivalents $ (29,650)
Cash and cash equivalents, beginning of year 200,000
Cash and cash equivalents, end of year $170,350
Problem 21-3

Deliverance Company
Statement of Cash Flows
For the Year Ended December 31, 2011

Cash flows from operating activities:

Net income $172,300

Adjustments:

Depreciation 41,300\( ^a \)
Amortization of bond discount 1,200
Loss on sale of machinery 600\( ^b \)
Increase in accounts receivable (66,000)
Increase in inventory (37,000)
Increase in prepaid expenses (2,000)
Decrease in accounts payable (46,000)
Decrease in short-term notes payable (20,000)
Increase in accrued liabilities 28,500

Net cash flow provided by operations $ 72,900

Cash flows from investing activities:

Sale of machinery $ 3,600
Purchase of machinery (45,000)
Purchase of land (63,500)\( ^c \)

Net cash flow used by investing activities (104,900)

Cash flows from financing activities:

Issuance of common stock $140,000\( ^d \)
Retirement of bonds (28,000)
Payment of dividends (20,000)\( ^e \)

Net cash flow provided by financing activities 92,000

Net increase in cash and cash equivalents $ 60,000

Note: Completion of the formal statement of cash flows would require disclosure of the beginning and ending cash and cash equivalents.

\( ^a \) Computation of depreciation:

Accumulated depreciation—beginning balance $(228,000)
Accumulated depreciation—machine sold ($48,000 – $4,200) 43,800
Accumulated depreciation—ending balance 225,500
Depreciation expense for the year 2011 $ 41,300

\( ^b \) Computation of loss on sale of machinery:

Book value of machine sold ($48,000 – $43,800) $ 4,200
Proceeds on sale (3,600)
Loss on sale $ 600
Computation of purchase of land:
Property, plant, and equipment—beginning balance $(510,000)
Purchase of machine (45,000)
Sale of machine 48,000
Property, plant, and equipment—ending balance 570,500
Purchase of land $ 63,500

Computation of issuance of common stock:
Additional stock issued as a result of 5% stock dividend: 800,000 × 0.05 = 40,000

Computation of payment of dividends:
Net decrease in retained earnings $ 437,700
Appropriation of retained earnings (30,000)
Stock dividend (40,000 × $14) (560,000)
Net income 172,300
Dividends declared and paid $ 20,000

Glossary

Note that Appendix C in the rear portion of the textbook contains a comprehensive glossary for all of the terms used in the textbook. That is the place to turn to if you need to look up a word but don’t know which chapter(s) it appeared in. The glossary below is identical with one major exception: It contains only those terms used in Chapter 21. This abbreviated glossary can prove quite useful when reviewing a chapter, when studying for a quiz for a particular chapter, or when studying for an exam which covers only a few chapters including this one. Use it in those instances instead of wading through the 19 pages of comprehensive glossary in the textbook trying to pick out just those words that were used in this chapter.

The terms that follow are from the Chapter 5 glossary. They are reproduced below for those who don’t have Volume 1 of this strategy guide or who don’t have it handy while studying Chapter 21.

direct method An approach to calculating and reporting cash flow from operating activities that itemizes the major operating cash receipt and cash payment categories.

financing activities One of three major categories included in a statement of cash flows; includes transactions and events whereby cash is obtained from or repaid to owners and creditors.
indirect method  An approach to calculating and reporting cash flow from operating activities that reconciles net income with operating cash flow; net income is adjusted for noncash revenues and expenses, for any gains or losses associated with investing and financing activities, and for changes in current operating assets and liabilities that indicate noncash sources of revenues and expenses.

investing activities  One of three major categories included in a statement of cash flows; primarily includes purchases and sales of noncurrent assets such as land, buildings, and nontrading financial instruments.

noncash investing and financing activities  Investing and financing transactions that affect a company’s financial position but not the cash flows during the period; an example is the purchase of land by issuing stock.

operating activities  One of three major categories included in a statement of cash flows; includes transactions and events that normally enter into the determination of net income, including interest and taxes.

statement of cash flows  One of the three primary financial statements. The cash flow statement provides information about the cash receipts (inflows) and cash payments (outflows) of a company during a period of time. The statement is separated into cash flows from operating, investing, and financing activities.