

- c. The decrease in Accounts Receivable means that cash collections from customers were more than sales on account. Net income includes the sales number, so to adjust up to the actual cash collected, we add the extra amount. This appears in our spreadsheet as if it is a debit to Cash and a corresponding credit to Accounts Receivable.
- d. 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.
- e. This entry reconciles the prepayment of expenses with their expiration. It is subtracted from net income because cash payments for new prepayments are more than the amounts that were reported as expenses when they expired.
- f. This entry reconciles cash paid to suppliers with purchases on account. It is added because more was purchased on account than was paid in cash.
- g. This entry reconciles the accrual of liabilities for operating expenses with payments for these expenses. The increase in Accrued Liabilities is added because the cash paid for accrued liabilities was less than the expenses accrued. The debit to Cash corresponds to the net credit to Accrued Liabilities.
- h. This entry records the cash purchases of new equipment.
- i. This entry records the cash purchase of intangibles.
- j. This entry records cash provided by borrowing additional long-term debt.
- k. This entry records cash used to repay long-term debt.
- l. This entry records the cash received from issuing stock.
- m. This entry shows that the change in cash (in the top part of the spreadsheet) is accounted for by the net cash flows listed in the bottom part of the spreadsheet.

Check to see that Debits = Credits in your spreadsheet, because if they don't, you've missed something along the way. The bottom part of the spreadsheet can be used to prepare the formal statement of cash flows shown in Exhibit 12.7.

REVIEW THE CHAPTER

DEMONSTRATION CASE A: INDIRECT METHOD



During a recent quarter (ended March 31), Brunswick Corporation reported net income of \$3,800 (all numbers in thousands). The balance in cash and cash equivalents at the beginning of the quarter (on January 1) was \$351,400, and at the end of the quarter (on March 31) it was \$280,000. The company also reported the following activities:

- a. Borrowed \$2,200 of debt.
- b. Accounts receivable increased by \$40,300.
- c. Paid \$31,800 in cash for purchase of property, plant, and equipment.
- d. Recorded depreciation of \$35,600.
- e. Salaries payable increased by \$10,210.
- f. Other accrued liabilities decreased by \$35,000.
- g. Prepaid expenses decreased by \$14,500.
- h. Inventories increased by \$20,810.
- i. Accounts payable decreased by \$10,200.
- j. Issued stock to employees for \$400 in cash.

Required:

Based on this information, prepare the cash flow statement using the indirect method. Evaluate the cash flows reported in the statement.

Suggested Solution

BRUNSWICK CORPORATION
Statement of Cash Flows
For the Quarter Ended March 31



(in thousands)

| | |
|---|------------------|
| Cash Flows from Operating Activities | |
| Net income | \$ 3,800 |
| Adjustments | |
| Depreciation | 35,600 |
| Change in Accounts Receivable | (40,300) |
| Change in Inventories | (20,810) |
| Change in Prepaid Expenses | 14,500 |
| Change in Accounts Payable | (10,200) |
| Change in Salaries Payable | 10,210 |
| Change in Other Accrued Liabilities | (35,000) |
| Net cash provided by (used in) operating activities | <u>(42,200)</u> |
| Cash Flows from Investing Activities | |
| Additions to property, plant, and equipment | (31,800) |
| Net cash provided by (used in) investing activities | <u>(31,800)</u> |
| Cash Flows from Financing Activities | |
| Proceeds from debt borrowings | 2,200 |
| Proceeds from issuance of stock to employees | 400 |
| Net cash provided by (used in) financing activities | <u>2,600</u> |
| Increase (decrease) in Cash and Cash Equivalents | (71,400) |
| Cash and Cash Equivalents, January 1 | <u>351,400</u> |
| Cash and Cash Equivalents, March 31 | <u>\$280,000</u> |

Despite reporting profits this quarter, the company has negative cash flows from operations. This is caused primarily by build-ups of accounts receivable and inventories, with no corresponding reduction in spending for accounts payable and other accrued liabilities. This is potentially troublesome because it suggests the company may be encountering difficulties in selling its products and collecting on past sales. In addition to the drain on cash for operating activities, the company also spent over \$30 million for additional property, plant, and equipment. Financing activities had relatively little effect on cash flows during the period. The company entered this quarter with lots of cash (over \$350 million) and, despite the shortfall in cash flow, still has lots remaining to finance future activities.

DEMONSTRATION CASE B: DIRECT METHOD

During a recent quarter (ended March 29), Cybex International reported that its cash and cash equivalents had increased from \$216 on December 31 to \$469 on March 29 (all amounts in thousands). The company also indicated the following:




- a. Paid \$13,229 to suppliers for inventory purchases.
- b. Borrowed \$2,400 from one of the company's main stockholders.
- c. Paid \$554 in cash for purchase of property, plant, and equipment.
- d. Reported sales on account of \$20,608. The company reported Accounts Receivable of \$13,628 at the beginning of the quarter and \$12,386 at the end of the quarter.
- e. Paid operating expenses to employees and suppliers of services totaling \$6,188.
- f. Cash payments for interest totaled \$1,060.
- g. Made payments of \$2,625 for principal owed on long-term debt.
- h. Paid \$284 cash for other financing activities.
- i. Paid \$57 cash for income taxes.

Required:

Based on this information, prepare the cash flow statement using the direct method. Evaluate the cash flows reported in the statement.

Suggested Solution

| CYBEX INTERNATIONAL Statement of Cash Flows For the Quarter Ended March 29 | |  |
|--|--|---|
| (in thousands) | | |
| Cash Flows from Operating Activities | | |
| Cash collected from customers (\$13,628 + \$20,608 - \$12,386) | | \$21,850 |
| Cash paid to suppliers of inventory | | (13,229) |
| Cash paid to employees and suppliers of services | | (6,188) |
| Cash paid for interest, | | (1,060) |
| Cash paid for income taxes | | (57) |
| Net cash flow provided by operating activities | | <u>1,316</u> |
| Cash Flows from Investing Activities | | |
| Additions to property, plant, and equipment | | (554) |
| Net cash flow provided by (used in) investing activities | | <u>(554)</u> |
| Cash Flows from Financing Activities | | |
| Proceeds from borrowing from a related party (stockholder) | | 2,400 |
| Repayment of long-term debt principal | | (2,625) |
| Payments for other financing activities | | (284) |
| Net cash flow provided by (used in) financing activities | | <u>(509)</u> |
| Increase (decrease) in Cash and Cash Equivalents | | 253 |
| Cash and Cash Equivalents, December 31 | | <u>216</u> |
| Cash and Cash Equivalents, March 29 | | <u>\$ 469</u> |

Cybox reported a net inflow of \$1,316 cash from operating activities during the quarter. These cash flows were more than enough to pay for the property, plant, and equipment purchased this quarter, as indicated by its capital acquisitions ratio of 2.38 ($\$1,316 \div \554). Some of the extra cash from operations that was not used to purchase property, plant, and equipment (also called free cash flow) could be used to pay down debt or to increase the company's cash balance. The financing activities section suggests that the company paid down a significant amount of long-term debt (\$2,625), in part by borrowing funds from a related party (\$2,400). Borrowing from a related party (particularly a major stockholder) is unusual, which would prompt analysts to investigate further. The company's quarterly report explains that its lenders had demanded immediate repayment of their loans because the company had violated its debt covenants. A major stockholder loaned money to the company so that it could make this repayment.

CHAPTER SUMMARY**LO1 Identify cash flows arising from operating, investing, and financing activities. p. 554**

- 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 period is the same amount as the increase or decrease in cash and cash equivalents for the period on the balance sheet. Cash equivalents are highly liquid investments purchased within three months of maturity.