

THE STATEMENT OF CASH FLOWS

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READING

35

LEARNING OUTCOMES

The candidate should be able to:

- a. identify the principal purposes and uses of the statement of cash flows;
- b. compare and contrast the three major classifications (i.e., cash provided or used by operating activities, investing activities, and financing activities) in a statement of cash flows, and describe how noncash investing and financing transactions are reported;
- c. calculate and analyze, using the indirect method, the net cash flow provided or used by operating activities, investing activities and financing activities.

INTRODUCTION

1

Cash flows are the lifeblood of a business. They enable a company to pay expenses, debts, employees' wages, and taxes, and to invest in the assets it needs for its operations. Without sufficient cash flows, a company cannot grow and prosper. Because of the importance of cash flows, one must be alert to the possibility that items may be incorrectly classified in a statement of cash flows and that the statement may not fully disclose all pertinent information. This reading identifies the classifications used in a statement of cash flows and explains how to analyze the statement.

OVERVIEW OF THE STATEMENT OF CASH FLOWS

2

The **statement of cash flows** shows how a company's operating, investing, and financing activities have affected cash during an accounting period. It explains the net increase (or decrease) in cash during the period. For purposes

Note:

U.S. GAAP permits either the direct method or the indirect method in the operating activities section of the cash flows statement. Though FASB expressed a preference for the direct method, more than 99% of all U.S. companies report by using the indirect method. Accountants (e.g., Needles and Powers) generally believe that the indirect method is the best approach (their argument is that it is easier and less costly to prepare); while financial analysts (e.g., White, Sondhi and Fried) generally believe that the direct method conveys better information about operating cash flows. Consequently, the analyst must know how to recast indirect cash flow information to the direct method.

DECISION POINT A USER'S FOCUS

Marriott International is a world leader in lodging and hospitality services. The company believes that maintaining strong cash flows is very important to its future. Its emphasis on cash flows is reflected in its compensation plan for top executives, which gives the greatest weight to cash flows. Why does Marriott place such emphasis on cash flows?

Strong cash flows are critical to achieving and maintaining liquidity. If cash flows exceed the amount a company needs for operations and expansion, it will not

have to borrow additional funds. It can use its excess cash to reduce debt, thereby lowering its debt to equity ratio and improving its financial position. That, in turn, can increase the market value of its stock, which will increase shareholders' value.

The statement of cash flows provides information essential to evaluating a company's liquidity. The Financial Highlights below summarize key components of Marriott's statement of cash flows.¹

MARRIOTT'S FINANCIAL HIGHLIGHTS: Consolidated Statement of Cash Flows (In millions)

	2004	2003	2002
Net cash provided by operating activities	\$891	\$403	\$ 516
Net cash provided by investing activities	287	311	317
Net cash used in financing activities	(637)	(683)	(1,447)
Increase (decrease) in cash and equivalents	\$541	\$ 31	(\$614)

Study Note

Money market accounts, commercial paper (short-term notes), and U.S. Treasury bills are considered cash equivalents because they are highly liquid, temporary (90 days or less) holding places for cash not currently needed to operate the business.

of preparing this statement, **cash** is defined as including both cash and cash equivalents. **Cash equivalents** are investments that can be quickly converted to cash; they have a maturity of 90 days or less when they are purchased. They include money market accounts, commercial paper, and U.S. Treasury bills. A company invests in cash equivalents to earn interest on cash that would otherwise be temporarily idle.

Suppose, for example, that a company has \$1,000,000 that it will not need for 30 days. To earn a return on this amount, the company could place the cash in an account that earns interest (such as a money market account), lend the cash to another corporation by purchasing that corporation's short-term notes (commercial paper), or purchase a short-term obligation of the U.S. government (a Treasury bill).

Because cash includes cash equivalents, transfers between the Cash account and cash equivalents are not treated as cash receipts or cash payments. On the statement of cash flows, cash equivalents are combined with the Cash account. Cash equivalents should not be confused with short-term investments, or marketable securities. These items are not combined with the Cash account on the statement of cash flows; rather, purchases of marketable securities are treated as cash outflows, and sales of marketable securities are treated as cash inflows.

Purposes of the Statement of Cash Flows

The primary purpose of the statement of cash flows is to provide information about a company's cash receipts and cash payments during an accounting period.

¹ Marriott International, Inc., *Annual Report*, 2004.

A secondary purpose is to provide information about a company's operating, investing, and financing activities during the accounting period. Some information about those activities may be inferred from other financial statements, but the statement of cash flows summarizes *all* transactions that affect cash.

Uses of the Statement of Cash Flows

The statement of cash flows is useful to management, as well as to investors and creditors.

- ▶ Management uses the statement of cash flows to assess liquidity, to determine dividend policy, and to evaluate the effects of major policy decisions involving investments and financing. Examples include determining if short-term financing is needed to pay current liabilities, deciding whether to raise or lower dividends, and planning for investing and financing needs.
- ▶ Investors and creditors use the statement to assess a company's ability to manage cash flows, to generate positive future cash flows, to pay its liabilities, to pay dividends and interest, and to anticipate its need for additional financing.

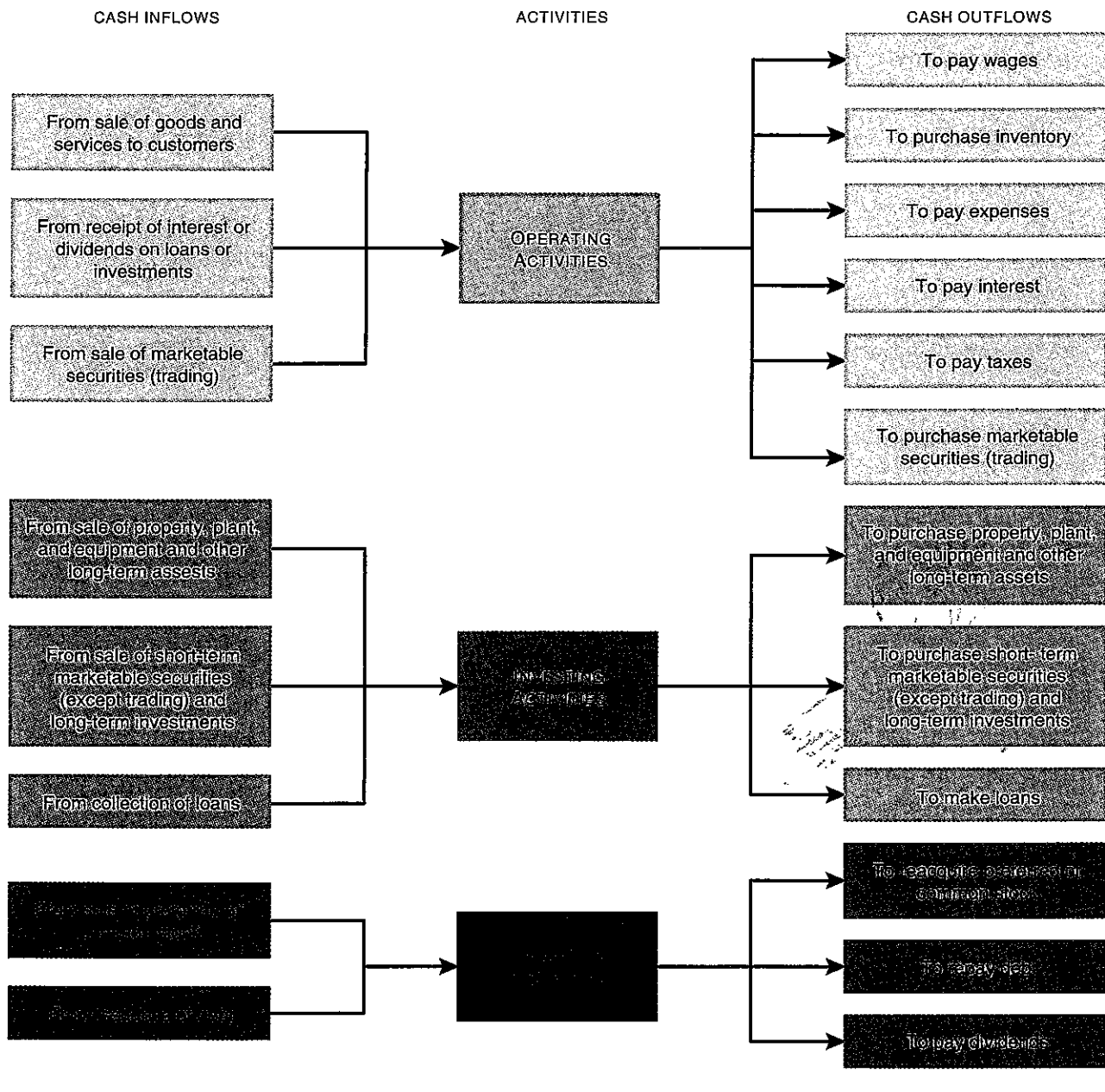
Classification of Cash Flows

The statement of cash flows has three major classifications: operating, investing, and financing activities. The components of these activities are illustrated in Figure 35-1 and summarized below.

1. **Operating activities** involve the cash inflows and outflows from activities that enter into the determination of net income. Cash inflows in this category include cash receipts from the sale of goods and services and from the sale of *trading securities*. Trading securities are a type of marketable security that a company buys and sells for the purpose of making a profit in the near term. Cash inflows also include interest and dividends received on loans and investments. Cash outflows include cash payments for wages, inventory, expenses, interest, taxes, and the purchase of trading securities. In effect, accrual-based income from the income statement is changed to reflect cash flows.
2. **Investing activities** involve the acquisition and sale of property, plant, and equipment and other long-term assets, including long-term investments. They also involve the acquisition and sale of short-term marketable securities, other than trading securities, and the making and collecting of loans. Cash inflows include the cash received from selling marketable securities and long-term assets and from collecting on loans. Cash outflows include the cash expended on purchasing these securities and assets and the cash lent to borrowers.
3. **Financing activities** involve obtaining resources from stockholders and providing them with a return on their investments, and obtaining resources from creditors and repaying the amounts borrowed or otherwise settling the obligations. Cash inflows include the proceeds from stock issues and from short- and long-term borrowing. Cash outflows include the repayments of loans (excluding interest) and payments to owners, including cash

Study Note

Operating activities involve the day-to-day sale of goods and services, investing activities involve long-term assets and investments, and financing activities deal with stockholders' equity accounts and debt (borrowing).

FIGURE 35-1 Classification of Cash Inflows and Cash Outflows

dividends. Treasury stock transactions are also considered financing activities. Repayments of accounts payable or accrued liabilities are not considered repayments of loans; they are classified as cash outflows under operating activities.

Noncash Investing and Financing Transactions

Companies occasionally engage in significant **noncash investing and financing transactions**. These transactions involve only long-term assets, long-term liabilities, or stockholders' equity. For instance, a company might exchange a

long-term asset for a long-term liability, settle a debt by issuing capital stock, or take out a long-term mortgage to purchase real estate. Noncash transactions represent significant investing and financing activities, but they are not reflected on the statement of cash flows because they do not affect current cash inflows or outflows. They will, however, affect future cash flows. For this reason, they are disclosed in a separate schedule or as part of the statement of cash flows.

Format of the Statement of Cash Flows

The Financial Highlights at the beginning of the reading summarize the key components of **Marriott's** statement of cash flows. Exhibit 35-1 presents the full statement.

- ▶ The first section of the statement of cash flows is cash flows from operating activities. When the **indirect method** is used to prepare this section, it begins with net income and ends with cash flows from operating activities. This is the method most commonly used; we discuss it in detail later in the reading.
- ▶ The second section, cash flows from investing activities, shows cash transactions involving capital expenditures (for property and equipment) and loans. Cash outflows for capital expenditures are usually shown separately from cash inflows from their disposal, as they are in Marriott's statement. However, when the inflows are not material, some companies combine these two lines to show the net amount of outflow.
- ▶ The third section, cash flows from financing activities, shows debt and common stock transactions, as well as payments for dividends and treasury stock.
- ▶ A reconciliation of the beginning and ending balances of cash appears at the bottom of the statement. These cash balances will tie into the cash balances of the balance sheets.

Ethical Considerations and the Statement of Cash Flows

Although cash inflows and outflows are not as subject to manipulation as earnings are, managers are acutely aware of users' emphasis on cash flows from

FOCUS ON BUSINESS PRACTICE

How Universal Is the Statement of Cash Flows?

Despite the importance of the statement of cash flows in assessing the liquidity of companies in the United States, there has been considerable variation in its use and format in other countries. For example, in many countries, the statement shows the change in working capital rather than the change in cash and cash equivalents. Although the

European Union's principal directives for financial reporting do not address the statement of cash flows, international accounting standards require it, and international financial markets expect it to be presented. As a result, most multinational companies include the statement in their financial reports. Most European countries will adopt the statement of cash flows by 2006, when the European Union will require the use of international accounting standards.

EXHIBIT 35-1 Consolidated Statement of Cash Flows**Marriott International, Inc., and Subsidiaries
Consolidated Statement of Cash Flows**

	For the Years Ended		
(In millions)	2004	2003	2002
OPERATING ACTIVITIES			
Net income	\$ 594	\$ 476	\$ 439
Adjustments to reconcile to cash provided by operations:			
Income from discontinued operations	2	7	9
Discontinued operations—gain (loss) on sale/exit	—	19	(171)
Depreciation and amortization	166	160	187
Minority interest in results of synthetic fuel operation	(40)	55	—
Income taxes	(63)	(171)	(105)
Timeshare activity, net	113	(111)	(63)
Other	(77)	(73)	223
Working capital changes:			
Accounts receivable	(6)	(81)	(31)
Other current assets	(16)	11	60
Accounts payable and accruals	218	111	(32)
Cash provided by operations	\$ 891	\$ 403	\$ 516
INVESTING ACTIVITIES			
Capital expenditures	\$(181)	\$(210)	\$(292)
Dispositions	402	494	729
Loan advances	(129)	(241)	(237)
Loan collections and sales	276	280	124
Other	(81)	(12)	(7)
Cash provided by investing activities	\$ 287	\$ 311	\$ 317
FINANCING ACTIVITIES			
Commercial paper, net	\$ —	\$(102)	\$ 102
Issuance of long-term debt	20	14	26
Repayment of long-term debt	(99)	(273)	(946)
Redemption of convertible subordinated debt	(62)	—	(347)
Issuance of Class A common stock	206	102	35
Dividends paid	(73)	(68)	(65)
Purchase of treasury stock	(664)	(373)	(252)
Earn-outs received, net	35	17	—
Cash used in financing activities	\$(637)	\$(683)	\$(1,447)
(DECREASE) INCREASE IN CASH AND EQUIVALENTS	\$ 541	\$ 31	\$ (614)
CASH AND EQUIVALENTS, beginning of year	229	198	812
CASH AND EQUIVALENTS, end of year	\$ 770	\$ 229	\$ 198

Source: Marriott International, Inc., *Annual Report*, 2004.

operations as an important measure of performance. Thus, an incentive exists to overstate these cash flows.

By treating operating expenses of about \$10 billion over several years as purchases of equipment, **WorldCom** reduced reported expenses and improved reported earnings. In addition, by classifying payments of operating expenses as investments on the statement of cash flows, it was able to show an improvement in cash flows from operations. The inclusion of the expenditures in the investing activities section did not draw special attention because the company normally had large capital expenditures.

Another way a company can show an apparent improvement in its performance is through lack of transparency, or lack of full disclosure, in its financial statements. For instance, securitization—the sale of batches of accounts receivable—is clearly a means of financing, and the proceeds from it should be shown in the financing section of the statement of cash flows. However, because the accounting standards are somewhat vague about where these proceeds should go, some companies net the proceeds against the accounts receivable in the operating section of the statement and bury the explanation in the notes to the financial statements. By doing so, they make collections of receivables in the operating activities section look better than they actually were. It is not illegal to do this, but from an ethical standpoint, it obscures the company's true performance.

ANALYZING CASH FLOWS

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Like the analysis of other financial statements, an analysis of the statement of cash flows can reveal significant relationships. Two areas on which analysts focus when examining a company's statement of cash flows are cash-generating efficiency and free cash flow.

Cash-Generating Efficiency

Managers accustomed to evaluating income statements usually focus on the bottom-line result. While the level of cash at the bottom of the statement of cash flows is certainly an important consideration, such information can be obtained from the balance sheet. The focal point of cash flow analysis is on cash inflows and outflows from operating activities. These cash flows are used in ratios that measure **cash-generating efficiency**, which is a company's ability to generate cash from its current or continuing operations. The ratios that analysts use to compute cash-generating efficiency are cash flow yield, cash flows to sales, and cash flows to assets. In this section, we compute these ratios for **Marriott** in 2004 using data from Exhibit 35-1 and the following information from Marriott's 2004 annual report. (All dollar amounts are in millions.)

	2004	2003	2002
Net Sales	\$10,099	\$9,014	\$8,415
Total Assets	8,668	8,177	8,296

Cash flow yield is the ratio of net cash flows from operating activities to net income:

$$\begin{aligned}\text{Cash Flow Yield} &= \frac{\text{Net Cash Flows from Operating Activities}}{\text{Net Income}} \\ &= \frac{\$891}{\$594} \\ &= 1.5 \text{ times}\end{aligned}$$

Marriott's cash flow yield of 1.5 times means that its operating activities were generating about 50 percent more cash flow than net income. At a minimum, cash-flow yield should be 1.0, which is the level typical for a service enterprise. However, a firm with significant depreciable assets should have a cash flow yield greater than 1.0 because depreciation expense is added back to net income to arrive at cash flows from operating activities. If special items, such as discontinued operations, appear on the income statement and are material, income from continuing operations should be used as the denominator.

Cash flows to sales is the ratio of net cash flows from operating activities to sales:

$$\begin{aligned}\text{Cash Flows to Sales} &= \frac{\text{Net Cash Flows from Operating Activities}}{\text{Sales}} \\ &= \frac{\$891}{\$10,099} \\ &= 8.8\%\end{aligned}$$

Thus, Marriott generated positive cash flows to sales of 8.8 percent.

Cash flows to assets is the ratio of net cash flows from operating activities to average total assets:

$$\begin{aligned}\text{Cash Flows to Assets} &= \frac{\text{Net Cash Flows from Operating Activities}}{\text{Average Total Assets}} \\ &= \frac{\$891}{(\$8,668 + \$8,177) \div 2} \\ &= 10.6\%\end{aligned}$$

Marriott's cash flows to assets ratio is higher than its cash flows to sales ratio because of its good asset turnover ratio (sales \div average total assets) of 1.2 times (10.6% \div 8.8%). Cash flows to sales and cash flows to assets are closely related to the profitability measures of profit margin and return on assets. They exceed those measures by the amount of the cash flow yield ratio because cash flow yield is the ratio of net cash flows from operating activities to net income.

Free Cash Flow

Free cash flow is the amount of cash that remains after deducting the funds a company must commit to continue operating at its planned level. If free cash flow is positive, it means that the company has met all of its planned cash commitments and has cash available to reduce debt or to expand. A negative free cash flow means that the company will have to sell investments, borrow money, or issue stock in the short term to continue at its planned level; if a company's free cash flow remains negative for several years, it may not be able to raise cash by issuing stocks or bonds. On the statement of cash flows, cash commitments for current and continuing operations, interest, and income taxes are incorporated in cash flows from current operations.

FOCUS ON BUSINESS PRACTICE

Cash Flows Tell All.

In early 2001, the telecommunications industry began one of the biggest market crashes in history. Could it have been predicted? The capital expenditures that telecommunications firms must make for equipment, such as cable lines and computers, are sizable. When the capital expenditures (a negative component of free cash flow) of 41 telecommunications companies are compared with their cash flows from sales over the six years preceding the crash, an interesting pattern emerges. In the first three years, both capital expenditures and cash flows from sales were about

20 percent of sales. In other words, free cash flows were neutral, with operations generating enough cash flows to cover capital expenditures. In the next three years, cash flows from sales stayed at about 20 percent of sales, but the companies' capital expenditure increased dramatically, to 35 percent of sales. Thus, free cash flows turned very negative, and almost half of capital expenditures had to be financed by debt instead of operations, making these companies more vulnerable to the downturn in the economy that occurred in 2001.²

Free cash flow for **Marriott** is computed as follows (in millions):

$$\begin{aligned}\text{Free Cash Flow} &= \text{Net Cash Flows from Operating Activities} - \text{Dividends} - \\ &\quad (\text{Purchases of Plant Assets} - \text{Sales of Plant Assets}) \\ &= \$891 - \$73 - (\$181 - \$402) \\ &= \$1,039\end{aligned}$$

Purchases of plant assets (capital expenditures) and sales (dispositions) of plant assets appear in the investing activities section of the statement of cash flows. When sales of plant assets are small or immaterial, companies can subtract the sales amount from the purchases of plant assets and refer to the result as "net capital expenditures." Dividends appear in the financing activities section. Marriott's positive free cash flow of \$1,039 million was due primarily to its strong operating cash flow of \$891 million and the \$402 million cash it received from the disposition of assets. Cash was used in financing activities in all three years

Study Note

The computation for free cash flow sometimes uses *net capital expenditures* in place of (*purchases of plant assets* - *sales of plant assets*).

FOCUS ON BUSINESS PRACTICE

What Do You Mean, "Free Cash Flow"?

Because the statement of cash flows has been around for less than 20 years, no generally accepted analyses have yet been developed. For example, the term *free cash flow* is commonly used in the business press, but there is no agreement on its definition. An article in *Forbes* defines *free cash flow* as "cash available after paying out capital expenditures and dividends, but *before taxes and*

interest"³ [emphasis added]. An article in *The Wall Street Journal* defines it as "operating income less maintenance-level capital expenditures."⁴ The definition with which we are most in agreement is the one used in *BusinessWeek*: free cash flow is net cash flows from operating activities less net capital expenditures and dividends. This "measures truly discretionary funds—company money that an owner could pocket without harming the business."⁵

² "Deadweight on the Markets," *BusinessWeek*, February 19, 2001.

³ Gary Slutsker, "Look at the Birdie and Say: 'Cash Flow,'" *Forbes*, October 25, 1993.

⁴ Jonathan Clements, "Yacktman Fund is Bloodied but Unbowed," *The Wall Street Journal*, November 8, 1993.

⁵ Jeffery Laderman, "Earnings, Schmearnings—Look at the Cash," *BusinessWeek*, July 24, 1989.



Telecommunications firms must make large capital expenditures for plant assets, such as the radio tower shown here. These expenditures are a negative component of free cash flow, which is the amount of cash that remains after deducting the funds a company needs to operate at its planned level. Between 1998 and 2000, negative free cash flows forced a number of telecommunications firms to rely heavily on debt to finance their capital expenditures, thus increasing their vulnerability to the economic downturn of 2001.

Courtesy of Hartmut Schwarzbach/Peter Arnold, Inc.

primarily because of debt repayments and the purchase of treasury stock. The company relied mainly on the increased cash provided by operations to make up for these cash outflows.

Because cash flows can vary from year to year, analysts should look at trends in cash flow measures over several years. Marriott's management sums up its approach to managing cash flows as follows:

Cash from Operations

We consider [our borrowing] resources, together with cash we expect to generate from operations, adequate to meet short-term and long-term liquidity requirements, finance our long-term growth plans, meet debt service and fulfill other cash requirements.⁶

4

OPERATING ACTIVITIES

To demonstrate the preparation of the statement of cash flows, we will work through an example step by step. The data for this example are presented in Exhibit 35-2, which shows Amir Corporation's income statement for 20x7, and in Exhibit 35-3, which shows Amir's balance sheets for December 31, 20x7 and 20x6. Exhibit 35-3 shows the balance sheet accounts that we use for analysis and whether the change in each account is an increase or a decrease.

⁶ Marriott International, Inc., *Annual Report*, 2004.

EXHIBIT 35-2**Income Statement**

Amir Corporation
Income Statement
For the Year Ended December 31, 20×7

Sales		\$349,000
Cost of goods sold		260,000
Gross margin		<u>\$ 89,000</u>
Operating expenses (including depreciation expense of \$18,500)		73,500
Operating income		<u>\$ 15,500</u>
Other income (expenses)		
Interest expense	(\$11,500)	
Interest income	3,000	
Gain on sale of investments	6,000	
Loss on sale of plant assets	<u>(1,500)</u>	<u>(4,000)</u>
Income before income taxes		<u>\$ 11,500</u>
Income taxes expense		3,500
Net income		<u><u>\$ 8,000</u></u>

The first step in preparing the statement of cash flows is to determine cash flows from operating activities. The income statement indicates how successful a company has been in earning an income from its operating activities, but because that statement is prepared on an accrual basis, it does not reflect the inflow and outflow of cash related to operating activities. Revenues are recorded even though the company may not yet have received the cash, and expenses are recorded even though the company may not yet have expended the cash. Thus, to ascertain cash flows from operations, the figures on the income statement must be converted from an accrual basis to a cash basis.

There are two methods of accomplishing this:

- ▶ The **direct method** adjusts each item on the income statement from the accrual basis to the cash basis. The result is a statement that begins with cash receipts from sales and interest and deducts cash payments for purchases, operating expenses, interest payments, and income taxes to arrive at net cash flows from operating activities.
- ▶ The **indirect method** does not require the adjustment of each item on the income statement. It lists only the adjustments necessary to convert net income to cash flows from operations.

Study Note

The direct and indirect methods relate only to the operating activities section of the statement of cash flows. They are both acceptable for financial reporting purposes.

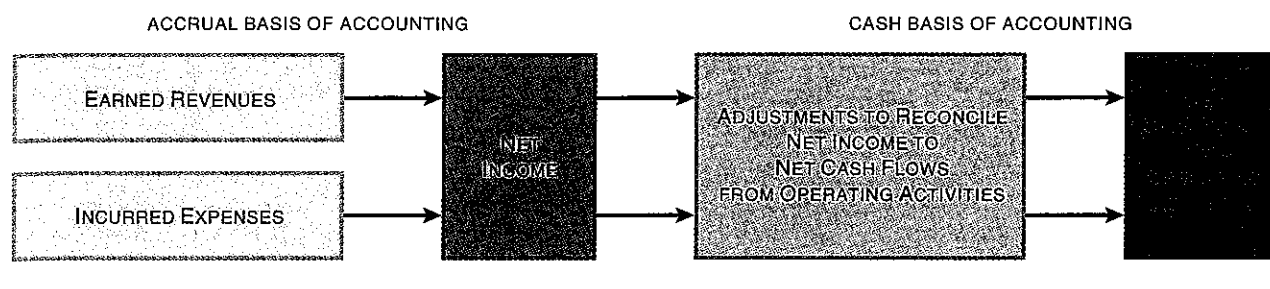
The direct and indirect methods always produce the same net figure. The average person finds the direct method easier to understand because its presentation of operating cash flows is more straightforward than that of the indirect method. However, the indirect method is the overwhelming choice of most companies and accountants. A survey of large companies shows that 99 percent use this method.⁷

⁷ American Institute of Certified Public Accountants, *Accounting Trends & Techniques* (New York: AICPA, 2004).

EXHIBIT 35-3 Comparative Balance Sheets Showing Changes in Accounts

Amir Corporation
Comparative Balance Sheets
December 31, 20×7 and 20×6

	20×7	20×6	Change	Increase or Decrease
Assets				
Current assets				
Cash	\$ 23,000	\$ 7,500	\$ 15,500	Increase
Accounts receivable (net)	23,500	27,500	(4,000)	Decrease
Inventory	72,000	55,000	17,000	Increase
Prepaid expenses	500	2,500	(2,000)	Decrease
Total current assets	<u>\$119,000</u>	<u>\$ 92,500</u>	<u>\$ 26,500</u>	
Investments	\$ 57,500	\$ 63,500	(\$ 6,000)	Decrease
Plant assets	\$357,500	\$252,500	\$105,000	Increase
Less accumulated depreciation	(51,500)	(34,000)	(17,500)	Increase
Total plant assets	<u>\$306,000</u>	<u>\$218,500</u>	<u>\$ 87,500</u>	
Total assets	<u>\$482,500</u>	<u>\$374,500</u>	<u>\$108,000</u>	
Liabilities				
Current liabilities				
Accounts payable	\$ 25,000	\$ 21,500	\$ 3,500	Increase
Accrued liabilities	6,000	4,500	1,500	Increase
Income taxes payable	1,500	2,500	(1,000)	Decrease
Total current liabilities	<u>\$ 32,500</u>	<u>\$ 28,500</u>	<u>\$ 4,000</u>	
Long-term liabilities				
Bonds payable	<u>147,500</u>	<u>122,500</u>	<u>25,000</u>	Increase
Total liabilities	<u>\$180,000</u>	<u>\$151,000</u>	<u>\$ 29,000</u>	
Stockholders' Equity				
Common stock, \$5 par value	\$138,000	\$100,000	\$ 38,000	Increase
Additional paid-in capital	107,000	57,500	49,500	Increase
Retained earnings	70,000	66,000	4,000	Increase
Treasury stock	(12,500)	0	(12,500)	Increase
Total stockholders' equity	<u>\$302,500</u>	<u>\$223,500</u>	<u>\$ 79,000</u>	
Total liabilities and stockholders' equity	<u>\$482,500</u>	<u>\$374,500</u>	<u>\$108,000</u>	

FIGURE 35-2 Indirect Method of Determining Net Cash Flows from Operating Activities

From an analyst's perspective, the indirect method is superior to the direct method because it begins with net income and derives cash flows from operations; the analyst can readily identify the factors that cause cash flows from operations. From a company's standpoint, the indirect method is easier and less expensive to prepare. For these reasons, we use the indirect method in our example.

As Figure 35-2 shows, the indirect method focuses on adjusting items on the income statement to reconcile net income to net cash flows from operating activities. These items include depreciation, amortization, and depletion; gains and losses; and changes in the balances of current asset and current liability accounts. The schedule in Exhibit 35-4 shows the reconciliation of Amir Corporation's net income to net cash flows from operating activities. We discuss each adjustment in the sections that follow.

EXHIBIT 35-4**Schedule of Cash Flows from Operating Activities: Indirect Method**

Amir Corporation
Schedule of Cash Flows from Operating Activities
For the Year Ended December 31, 20×7

Cash flows from operating activities		
Net income		\$ 8,000
Adjustments to reconcile net income to net cash flows from operating activities		
Depreciation	\$18,500	
Gain on sale of investments	(6,000)	
Loss on sale of plant assets	1,500	
Changes in current assets and current liabilities		
Decrease in accounts receivable	4,000	
Increase in inventory	(17,000)	
Decrease in prepaid expenses	2,000	
Increase in accounts payable	3,500	
Increase in accrued liabilities	1,500	
Decrease in income taxes payable	(1,000)	7,000
Net cash flows from operating activities		<u>\$15,000</u>

Depreciation

The investing activities section of the statement of cash flows shows the cash payments that the company made for plant assets, intangible assets, and natural resources during the accounting period. Depreciation expense, amortization expense, and depletion expense for these assets appear on the income statement as allocations of the costs of the original purchases to the current accounting period. The amount of these expenses can usually be found in the income statement or in a note to the financial statements. As you can see in Exhibit 35-2, Amir Corporation's income statement discloses depreciation expense of \$18,500, which would have been recorded as follows:

A	=	L +	SE
-18,500			-18,500

Depreciation Expense	18,500	
Accumulated Depreciation		18,500
To record annual depreciation on plant assets		

Study Note

Operating expenses on the income statement include depreciation expense, which does not require a cash outlay.

Even though depreciation expense appears on the income statement, it involves no outlay of cash and so does not affect cash flows in the current period. Thus, to arrive at cash flows from operations on the statement of cash flows, an adjustment is needed to increase net income by the amount of depreciation expense shown on the income statement.

Gains and Losses

Study Note

Gains and losses by themselves do not represent cash flows; they are merely bookkeeping adjustments. For example, when a long-term asset is sold, it is the *proceeds* (cash received), not the gain or loss, that constitute cash flow.

Like depreciation expense, gains and losses that appear on the income statement do not affect cash flows from operating activities and need to be removed from this section of the statement of cash flows. The cash receipts generated by the disposal of the assets that resulted in the gains or losses are included in the investing activities section of the statement of cash flows. Thus, to reconcile net income to cash flows from operating activities (and prevent double counting), gains and losses must be removed from net income.

For example, on its income statement, Amir Corporation shows a \$6,000 gain on the sale of investments. This amount is subtracted from net income to reconcile net income to net cash flows from operating activities. The reason for doing this is that the \$6,000 is included in the investing activities section of the statement of cash flows as part of the cash from the sale of the investment. Because the gain has already been included in the calculation of net income, the \$6,000 gain must be subtracted to prevent double counting.

Amir's income statement also shows a \$1,500 loss on the sale of plant assets. This loss is already reflected in the sale of plant assets in the investing activities section of the statement of cash flows. Thus, the \$1,500 is added to net income to reconcile net income to net cash flows from operating activities.

Changes in Current Assets

Decreases in current assets other than cash have positive effects on cash flows, and increases in current assets have negative effects on cash flows. A decrease in a current asset frees up invested cash, thereby increasing cash flow. An increase in a current asset consumes cash, thereby decreasing cash flow. For example, look at Amir Corporation's income statement and balance sheets in Exhibits 35-2 and 35-3. Note that net sales in 20x7 were \$349,000 and that Accounts Receivable decreased by \$4,000. Thus, collections were \$4,000 more

than sales recorded for the year, and the total cash received from sales was \$353,000 ($\$349,000 + \$4,000 = \$353,000$). The effect on accounts receivable can be illustrated as follows:

ACCOUNTS RECEIVABLE		
Sales to Customers	Beg. Bal. 27,500	353,000 →
	→ 349,000	
	End. Bal. 23,500	

To reconcile net income to net cash flows from operating activities, the \$4,000 decrease in Accounts Receivable is added to net income.

Inventory can be analyzed in the same way. For example, Exhibit 35-3 shows that Amir's Inventory account increased by \$17,000 between 20x6 and 20x7. This means that Amir expended \$17,000 more in cash for purchases than it included in cost of goods sold on its income statement. Because of this expenditure, net income is higher than net cash flows from operating activities, so \$17,000 must be deducted from net income. By the same logic, the decrease of \$2,000 in Prepaid Expenses shown on the balance sheets must be added to net income to reconcile net income to net cash flows from operations.

Changes in Current Liabilities

The effect that changes in current liabilities have on cash flows is the opposite of the effect of changes in current assets. An increase in a current liability represents a postponement of a cash payment, which frees up cash and increases cash flow in the current period. A decrease in a current liability consumes cash, which decreases cash flow. To reconcile net income to net cash flows from operating activities, increases in current liabilities are added to net income, and decreases are deducted. For example, Exhibit 35-3 shows that from 20x6 to 20x7, Amir's accounts payable increased by \$3,500. This means that Amir paid \$3,500 less to creditors than the amount indicated in the cost of goods sold on its income statement. The following T account illustrates this relationship:

ACCOUNTS PAYABLE		
Cash Payments to Suppliers	← 273,500	Beg. Bal. 21,500
		277,000* ←
		End. Bal. 25,000

*Purchases = Cost of Goods Sold (\$260,000) + Increase in Inventory (\$17,000)

Thus, \$3,500 must be added to net income to reconcile net income to net cash flows from operating activities. By the same logic, the increase of \$1,500 in accrued liabilities shown on the balance sheets must be added to net income, and the decrease of \$1,000 in income taxes payable must be deducted from net income.

FOCUS ON BUSINESS PRACTICE

What Is EBITDA, and Is It Any Good?

Some companies and analysts like to use EBITDA (an acronym for Earnings Before Interest, Taxes, Depreciation, and Amortization) as a short-cut measure of cash flows from operations. But recent events have caused many analysts to reconsider this measure of performance. For instance, when **WorldCom** transferred \$3.8 billion from expenses to capital expenditures in one year, it touted its EBITDA; at the time, the firm was, in fact, nearly bankrupt. The demise of **Vivendi**, the big French company that imploded when it did not have enough cash to pay its

debts and that also touted its EBITDA, is another reason that analysts have had second thoughts about relying on this measure of performance.

Some analysts are now saying that EBITDA is "to a great extent misleading" and that it "is a confusing metric. . . . Some take it for a proxy for profits and some take it for a proxy for cash flow, and it's neither."⁸ Cash flows from operations and free cash flow, both of which take into account interest, taxes, and depreciation, are better and more comprehensive measures of a company's cash-generating efficiency.

Schedule of Cash Flows from Operating Activities

In summary, Exhibit 35-4 shows that by using the indirect method, net income of \$8,000 has been adjusted by reconciling items totaling \$7,000 to arrive at net cash flows from operating activities of \$15,000. This means that although Amir's net income was \$8,000, the company actually had net cash flows of \$15,000 available from operating activities to use for purchasing assets, reducing debts, and paying dividends.

The treatment of income statement items that do not affect cash flows can be summarized as follows:

	<i>Add to or Deduct from Net Income</i>
Depreciation expense	Add
Amortization expense	Add
Depletion expense	Add
Losses	Add
Gains	Deduct

The following summarizes the adjustments for increases and decreases in current assets and current liabilities:

	<i>Add to Net Income</i>	<i>Deduct from Net Income</i>
Current assets		
Accounts receivable (net)	Decrease	Increase
Inventory	Decrease	Increase
Prepaid expenses	Decrease	Increase
Current liabilities		
Accounts payable	Increase	Decrease
Accrued liabilities	Increase	Decrease
Income taxes payable	Increase	Decrease

⁸ Martin Peers and Robin Sidel, "WorldCom Causes Analysts to Evaluate EBITDA's Role," *The Wall Street Journal*, July 15, 2002.

INVESTING ACTIVITIES

5

To determine cash flows from investing activities, accounts involving cash receipts and cash payments from investing activities are examined individually. The objective is to explain the change in each account balance from one year to the next.

Although investing activities center on the long-term assets shown on the balance sheet, they also include any short-term investments shown under current assets on the balance sheet and any investment gains and losses on the income statement. The balance sheets in Exhibit 35-3 show that Amir had no short-term investments and that its long-term assets consisted of investments and plant assets. The income statement in Exhibit 35-2 shows that Amir had a gain on the sale of investments and a loss on the sale of plant assets.

The following transactions pertain to Amir's investing activities in 20x7:

1. Purchased investments in the amount of \$39,000.
2. Sold investments that cost \$45,000 for \$51,000.
3. Purchased plant assets in the amount of \$60,000.
4. Sold plant assets that cost \$5,000 and that had accumulated depreciation of \$1,000 for \$2,500.
5. Issued \$50,000 of bonds at face value in a noncash exchange for plant assets.

In the following sections, we analyze the accounts related to investing activities to determine their effects on Amir's cash flows.

Investments

Our objective in this section is to explain Amir Corporation's \$6,000 decrease in investments. We do this by analyzing the increases and decreases in Amir's Investments account to determine their effects on the Cash account.

Item 1 in the list of Amir's transactions states that its purchases of investments totaled \$39,000 during 20x7. This transaction, which caused a \$39,000 decrease in cash flows, is recorded as follows:

Investments	39,000	
Cash		39,000
Purchase of investments		

A	= L +	SE
+39,000		
-39,000		

Item 2 states that Amir sold investments that cost \$45,000 for \$51,000. This transaction resulted in a gain of \$6,000. It is recorded as follows:

Cash	51,000	
Investments		45,000
Gain on Sale of Investments		6,000
Sale of investments for a gain		

A	= L +	SE
+51,000		+6,000
-45,000		

The effect of this transaction is a \$51,000 increase in cash flows. Note that the gain on the sale is included in the \$51,000. This is the reason we excluded it in computing cash flows from operations. If it had been included in that section, it would have been counted twice.

Study Note

Investing activities involve long-term assets and short- and long-term investments. Inflows and outflows of cash are shown in the investing activities section of the statement of cash flows.

Study Note

The \$51,000 price obtained, not the \$6,000 gained, constitutes the cash flow.

We have now explained the \$6,000 decrease in the Investments account during 20x7, as illustrated in the following T account:

INVESTMENTS			
Beg. Bal.	63,500	Sales	45,000
Purchases	39,000		
End. Bal.	57,500		

The cash flow effects of these transactions are shown in the investing activities section of the statement of cash flows as follows:

Purchase of investments	(\$39,000)
Sale of investments	51,000

Notice that purchases and sales are listed separately as cash outflows and inflows to give readers of the statement a complete view of investing activity. However, some companies prefer to list them as a single net amount.

If Amir Corporation had short-term investments or marketable securities, the analysis of cash flows would be the same.

Plant Assets

For plant assets, we have to explain changes in both the Plant Assets account and the related Accumulated Depreciation account. Exhibit 35-3 shows that from 2006 to 2007, Amir Corporation's plant assets increased by \$105,000 and that accumulated depreciation increased by \$17,500.

Item 3 in the list of Amir's transactions in 2007 states that the company purchased plant assets totaling \$60,000. The following entry records this cash outflow:

A	= L + SE
+60,000	
-60,000	

Plant Assets	60,000	
Cash		60,000
Purchase of plant assets		

Item 4 states that Amir Corporation sold plant assets that cost \$5,000 and that had accumulated depreciation of \$1,000 for \$2,500. Thus, this transaction resulted in a loss of \$1,500. The entry to record it is as follows:

A	= L + SE
+2,500	-1,500
+1,000	
-5,000	

Cash	2,500	
Accumulated Depreciation	1,000	
Loss on Sale of Plant Assets	1,500	
Plant Assets		5,000
Sale of plant assets at a loss		

Note that in this transaction, the positive cash flow is equal to the amount of cash received, \$2,500. The loss on the sale of plant assets is included in the investing

activities section of the statement of cash flows and excluded from the operating activities section by adjusting net income for the amount of the loss. The amount of a loss or gain on the sale of an asset is determined by the amount of cash received and does not represent a cash outflow or inflow.

The investing activities section of Amir's statement of cash flows reports the firm's purchase and sale of plant assets as follows:

Purchase of plant assets	(\$60,000)
Sale of plant assets	2,500

Cash outflows and cash inflows are listed separately here, but companies sometimes combine them into a single net amount, as they do the purchase and sale of investments.

Item 5 in the list of Amir's transactions is a noncash exchange that affects two long-term accounts, Plant Assets and Bonds Payable. It is recorded as follows:

Plant Assets	50,000	
Bonds Payable		50,000
Issued bonds at face value for plant assets		

Study Note

Even though Amir had a loss on the sale of plant assets, it realized a positive cash flow of \$2,500, which will be reported in the investing activities section of its statement of cash flows. When the indirect method is used, the loss is eliminated with an "add-back" to net income.

A	=	L	+ SE
+50,000		+50,000	

Although this transaction does not involve an inflow or outflow of cash, it is a significant transaction involving both an investing activity (the purchase of plant assets) and a financing activity (the issue of bonds payable). Because one purpose of the statement of cash flows is to show important investing and financing activities, the transaction is listed at the bottom of the statement of cash flows or in a separate schedule, as follows:

<i>Schedule of Noncash Investing and Financing Transactions</i>	
Issue of bonds payable for plant assets	<u>\$50,000</u>

We have now accounted for all the changes related to Amir's plant asset accounts. The following T accounts summarize these changes:

PLANT ASSETS			
Beg. Bal.	252,500	Sale	5,000
Cash Purchase	60,000		
Noncash Purchase	50,000		
End. Bal.	357,500		

ACCUMULATED DEPRECIATION			
Sale	1,000	Beg. Bal.	34,000
		Dep. Exp.	18,500
		End. Bal.	51,500

Had the balance sheet included specific plant asset accounts (e.g., Equipment and the related accumulated depreciation account) or other long-term asset accounts (e.g., Intangibles), the analysis would have been the same.

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FINANCING ACTIVITIES

Determining cash flows from financing activities is very similar to determining cash flows from investing activities, but the accounts analyzed relate to short-term borrowings, long-term liabilities, and stockholders equity. Because Amir Corporation does not have short-term borrowings, we deal only with long-term liabilities and stockholders' equity accounts.

The following transactions pertain to Amir's financing activities in 20x7:

1. Issued \$50,000 of bonds at face value in a noncash exchange for plant assets.
2. Repaid \$25,000 of bonds at face value at maturity.
3. Issued 7,600 shares of \$5 par value common stock for \$87,500.
4. Paid cash dividends in the amount of \$4,000.
5. Purchased treasury stock for \$12,500.

Bonds Payable

Exhibit 35-3 shows that Amir's Bonds Payable account increased by \$25,000 in 20x7. Both items 1 and 2 in the list above affect this account. We analyzed item 1 in connection with plant assets, but it also pertains to the Bonds Payable account. As we noted, this transaction is reported on the schedule of noncash investing and financing transactions. Item 2 results in a cash outflow, which is recorded as follows:

A	=	L	+ SE
-25,000		-25,000	

Bonds Payable	25,000	
Cash		25,000
Repayment of bonds at face value at maturity		

This appears in the financing activities section of the statement of cash flows as

Repayment of bonds (\$25,000)

The following T account explains the change in Bonds Payable:

BONDS PAYABLE			
Repayment	25,000	Beg. Bal.	122,500
		Noncash Issue	50,000
		End. Bal.	147,500

If Amir Corporation had any notes payable, the analysis would be the same.

FOCUS ON BUSINESS PRACTICE

How Much Cash Does a Company Need?

Some kinds of industries are more vulnerable to downturns in the economy than others. Historically, because of the amount of debt they carry and their large interest and loan payments, companies in the airline and automotive industries have been hard hit by economic downturns. But research has shown that high-tech companies with large amounts of intangible assets are also hard hit. Biotechnology, pharmaceutical, and computer hardware and soft-

ware companies can lose up to 80 percent of their value in times of financial stress. In contrast, companies with large amounts of tangible assets, such as oil companies and railroads, can lose as little as 10 percent. To survive during economic downturns, it is very important for high-tech companies to use their cash-generating efficiency to build cash reserves. It makes sense for these companies to hoard cash and not pay dividends to the extent that companies in other industries do.⁹

Common Stock

Like the Plant Asset account and its related accounts, accounts related to stockholders' equity should be analyzed together. For example, the Additional Paid-in Capital account should be examined along with the Common Stock account. In 20x7, Amir's Common Stock account increased by \$38,000, and its Additional Paid-in Capital account increased by \$49,500. Item 3 in the list of Amir's transactions, which states that the company issued 7,600 shares of \$5 par value common stock for \$87,500, explains these increases. The entry to record the cash inflow is as follows:

Cash	87,500	A	= L +	SE
Common Stock	38,000	+87,500		+38,000
Additional Paid-in Capital	49,500			+49,500
Issued 7,600 shares of \$5 par value common stock				

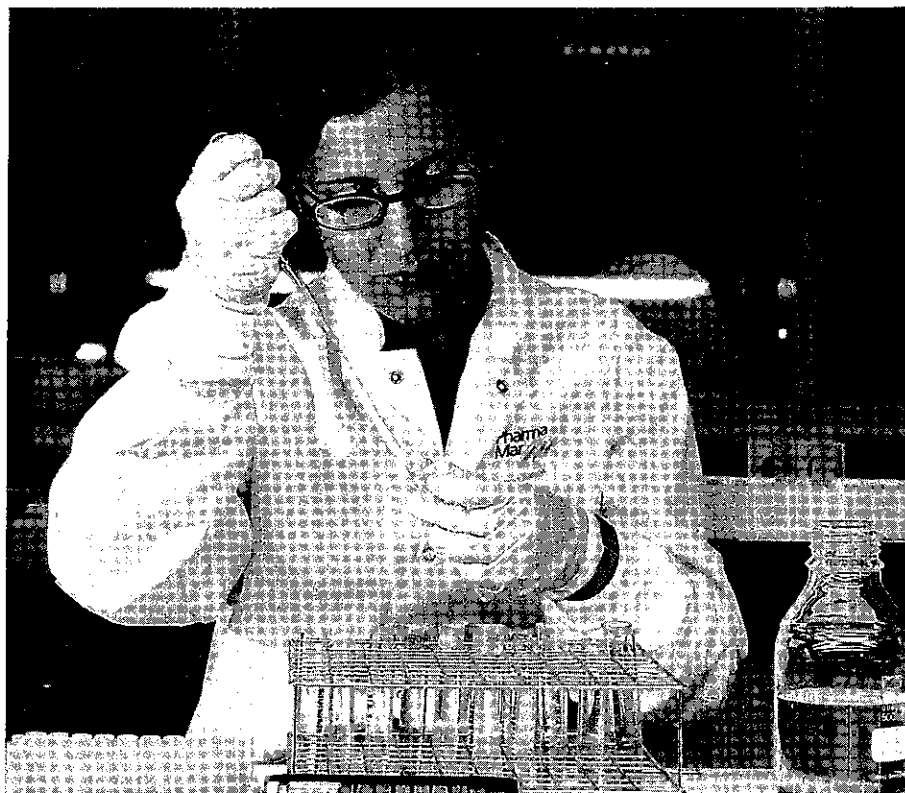
This appears in the financing activities section of the statement of cash flows as

Issue of common stock \$87,000

The following analysis of this transaction is all that is needed to explain the changes in the two accounts during 20x7:

COMMON STOCK		ADDITIONAL PAID-IN CAPITAL	
Beg. Bal.	100,000	Beg. Bal.	57,500
Issue	38,000	Issue	49,500
End. Bal.	138,000	End. Bal.	107,000

⁹Richard Passov, "How Much Cash Does Your Company Need?" *Harvard Business Review*, November 2003.



High-tech companies with large amounts of intangible assets, such as PharmaMar, a pharmaceutical firm based in Madrid, can lose up to 80 percent of their value in times of financial stress. As a hedge against economic downturns, these companies need to build cash reserves, and they may therefore choose to hoard cash rather than pay dividends.

Courtesy of AFP/Getty Images, Inc.

Retained Earnings

At this point, we have dealt with several items that affect retained earnings. The only item affecting Amir's retained earnings that we have not considered is the payment of \$4,000 in cash dividends (item 4 in the list of Amir's transactions). At the time it declared the dividend, Amir would have debited its Dividends account. After paying the dividend, it would have closed the Dividends account to Retained Earnings and recorded the closing with the following entry:

A	=	L +	SE
			-4,000
			+4,000

Retained Earnings	4,000	
Dividends		4,000
To close the Dividends account		

Study Note

It is dividends paid, not dividends declared, that appear on the statement of cash flows.

Cash dividends would be displayed in the financing activities section of Amir's statement of cash flows as follows:

Payment of dividends (\$4,000)

The following T account shows the change in the Retained Earnings account:

RETAINED EARNINGS			
Dividends	4,000	Beg. Bal.	66,000
		Net Income	8,000
		End. Bal.	70,000

Treasury Stock

Many companies buy back their own stock on the open market. These buybacks use cash, as this entry shows:

Treasury Stock	12,500	
Cash		12,500

A	=	L +	SE
-12,500			-12,500

This use of cash is classified in the statement of cash flows as a financing activity:

Purchase of treasury stock (\$12,500)

The T account for this transaction is as follows:

TREASURY STOCK	
Purchase	12,500

Study Note

The purchase of treasury stock qualifies as a financing activity, but it is also a cash outflow.

We have now analyzed all Amir Corporation's income statement items, explained all balance sheet changes, and taken all additional information into account. Exhibit 35-5 shows how our data are assembled in Amir's statement of cash flows.

EXHIBIT 35-5 Statement of Cash Flows: Indirect Method

Amir Corporation Statement of Cash Flows For the Year Ended December 31, 20×7

Cash flows from operating activities	
Net income	\$ 8,000
Adjustments to reconcile net income to net cash flows from operating activities	
Depreciation	\$18,500
Gain on sale of investments	(6,000)
Loss on sale of plant assets	1,500

(Exhibit continued on next page ...)

EXHIBIT 35-5**Statement of Cash Flows: Indirect Method
(continued)**

Amir Corporation
Statement of Cash Flows
For the Year Ended December 31, 20×7

Changes in current assets and current liabilities		
Decrease in accounts receivable	4,000	
Increase in inventory	(17,000)	
Decrease in prepaid expenses	2,000	
Increase in accounts payable	3,500	
Increase in accrued liabilities	1,500	
Decrease in income taxes payable	<u>(1,000)</u>	<u>7,000</u>
Net cash flows from operating activities		<u>\$15,000</u>
Cash flows from investing activities		
Purchase of investments	(\$39,000)	
Sale of investments	51,000	
Purchase of plant assets	(60,000)	
Sale of plant assets	<u>2,500</u>	
Net cash flows from investing activities		<u>(45,500)</u>
Cash flows from financing activities		
Repayment of bonds	(\$25,000)	
Issue of common stock	87,500	
Payment of dividends	(4,000)	
Purchase of treasury stock	<u>(12,500)</u>	
Net cash flows from financing activities		<u>46,000</u>
Net increase (decrease) in cash		<u>\$15,500</u>
Cash at beginning of year		<u>7,500</u>
Cash at end of year		<u><u>\$23,000</u></u>
Schedule of Noncash Investing and Financing Transactions		
Issue of bonds payable for plant assets		<u><u>\$50,000</u></u>

FOCUS ON BUSINESS

MARRIOTT INTERNATIONAL, INC.

As we pointed out in this reading's Decision Point, strong cash flows are a basic ingredient in **Marriott's** plans for the future. Strong cash flows enable a company to achieve and maintain liquidity, to expand, and to increase the value of its shareholders' investments. A company's statement of cash flows provides information essential to evaluating the strength of its cash flows and its liquidity. A user of Marriott's statement of cash flows would want to ask the following questions:

- ▶ Are operations generating sufficient operating cash flows?
- ▶ Is the company growing by investing in long-term assets?
- ▶ Has the company had to borrow money or issue stock to finance its growth?

Using data from Exhibit 35-1, which presents Marriott's statements of cash flows, we can answer these questions. We can gauge Marriott's ability to generate cash flows from operations by calculating its cash flow yields in 2003 and 2004:

Cash Flow Yield		2004	2003
<u>Net Cash Flows from Operating Activities</u>	=	<u>\$891</u>	<u>\$403</u>
Net Income	=	\$594	\$476
	=	1.5 times	0.8 times

As you can see, Marriott's cash flow yield almost doubled over the two years. The 1.5 cash yield in 2004 surpassed the 1.0 level normally considered the minimum acceptable level of cash flows from operations. Because of the increase in cash provided by operations, Marriott's cash flows to sales and assets would also show improvement over the two-year period.

Free cash flow measures the sufficiency of cash flows in a different way. The following computations show that in 2004, Marriott's free cash flow was over \$400 million greater than in 2003:

Free Cash Flow		2004	2003
Net Cash Flows from Operating Activities — Dividends — (Purchases of Plant Assets — Sales of Plant Assets)	=	\$891 — \$73 — (\$181 — \$402)	\$403 — \$68 — (\$210 — \$494)
	=	\$1,039	\$619

Marriott's statement of cash flows shows that the company was investing in long-term assets (\$210 million in 2003 and \$181 million in 2004) but that its sales of assets exceeded its capital expenditures. Thus, the company did not have to rely on borrowing money or issuing stock to finance its growth. In fact, it repaid much more long-term debt than it borrowed and purchased more than three times as much treasury stock as it issued in common stock. Financing activities totaled \$683 million in 2003 and \$637 million in 2004; the sum of these expenditures was less than the sum of Marriott's free cash flows in the two years.

SUMMARY

The statement of cash flows shows how a company's operating, investing, and financing activities have affected cash during an accounting period. For the statement of cash flows, *cash* is defined as including both cash and cash equivalents. The primary purpose of the statement is to provide information about a firm's cash receipts and cash payments during an accounting period. A secondary purpose is to provide information about a firm's operating, investing, and financing activities. Management uses the statement to assess liquidity, determine dividend policy, and plan investing and financing activities. Investors and creditors use it to assess the company's cash-generating ability.

The statement of cash flows has three major classifications: (1) operating activities, which involve the cash effects of transactions and other events that enter into the determination of net income; (2) investing activities, which involve the acquisition and sale of marketable securities and long-term assets and the making and collecting of loans; and (3) financing activities, which involve obtaining resources from stockholders and creditors and providing the former with a return on their investments and the latter with repayment. Non-cash investing and financing transactions are also important because they affect future cash flows; these exchanges of long-term assets or liabilities are of interest to potential investors and creditors.

In examining a firm's statement of cash flows, analysts tend to focus on cash-generating efficiency and free cash flow. Cash-generating efficiency is a firm's ability to generate cash from its current or continuing operations. The ratios used to measure cash-generating efficiency are cash flow yield, cash flows to sales, and cash flows to assets. Free cash flow is the cash that remains after deducting the funds a firm must commit to continue operating at its planned level. These commitments include current and continuing operations, interest, income taxes, dividends, and capital expenditures.

The indirect method adjusts net income for all items in the income statement that do not have cash flow effects (such as depreciation, amortization, and gains and losses on sales of assets) and for changes in liabilities that affect operating cash flows. Generally, increases in current assets have a negative effect on cash flows, and decreases have a positive effect. Conversely, increases in current liabilities have a positive effect on cash flows, and decreases have a negative effect.

Investing activities involve the acquisition and sale of property, plant, and equipment and other long-term assets, including long-term investments. They also involve the acquisition and sale of short-term marketable securities, other than trading securities, and the making and collecting of loans. Cash flows from investing activities are determined by analyzing the cash flow effects of changes in each account related to investing activities. The effects of gains and losses reported on the income statement must also be considered.

Determining cash flows from financing activities is almost identical to determining cash flows from investing activities. The difference is that the accounts analyzed relate to short-term borrowings, long-term liabilities, and stockholders' equity. After the changes in the balance sheet accounts from one accounting period to the next have been explained, all the cash flow effects should have been identified.