# Solutions to Practice Problems – Statement of Cash Flows

**Requirement 1**

Use the following information to prepare the cash flow from operating activities section of the cash flow statement for Bridgewood, Ltd. for 2011, using both the direct and indirect methods. You can use the spreadsheet provided on the next page as a guide in preparing the direct method cash flow from operating activities.



**Cash flow from operating activities (direct method)**

We can compute the cash flow from operating activities by moving line by line down the income statement, making the appropriate adjustments to each line in order to arrive at the corresponding cash flow amount.

|  |  |  |  |
| --- | --- | --- | --- |
| **Revenue/Expense line item** | **Amount** | **Adjustment to arrive at corresponding cash flow** | **Corresponding cash inflow/outflow** |
| Sales | 850 | Subtract from sales revenue the increase in A/R of 10 | 840: collection from customers |
| Cost of goods sold | (610) | Add to expense the increase in inventory of 45  Decrease from expense the increase in A/P of 10 | (645): payment for inventory purchased |
| Rent expense | (56) | Subtract from expense the decrease in prepaid rent of 8 | (48): payment for rent |
| Depreciation | (22) | Add back; depreciation is not a cash outflow | 0 |
| Interest expense | (30) | Subtract from expense the increase in interest payable of 8 | (22): interest payments |
| Gain from sale of noncurrent assets | 14 | Subtract the gain; it is not a cash flow; the proceeds from the sale *is* the cash flow and it appears in cash inflow from investing activities | 0 |
| Tax expense | (41) | No adjustment; the beginning and ending balances in taxes payable is zero | (41): tax payments |
| Net income | 105 |  | 84: cash flow from operations |

Using the indirect method:



**Requirement 2**

1. Please state the effect of each of the following transactions on the firm’s current-period cash flow from operating, investing, and financing activities. Ignore any effect that the transactions might have on the firm’s tax payments.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  |  | CFO | CFI | CFF |
|  | The firm sells equipment for $50,000 this period. The equipment had an original cost of $100,000 and accumulated depreciation of $80,000. | **0** | **+$50** | **0** |
|  | The firm sells goods to customers for $40,000. The goods that were sold cost the firm $25,000 and were paid for in a prior period. All sales are on account and will be paid next period. | **0** | **0** | **0** |
|  | The firm purchases a building for $2,000,000 this period. The seller provides the financing for the purchase. No payments on the loan are made this period. | **0** | **0** | **0** |
|  | Wage expense of $30,000 is incurred this period. Payments to workers this period totaled $25,000. | **-$25** | **0** | **0** |
|  | A bank loan for $100,000 was taken out this period. No payments were made on the loan this period. | **0** | **0** | **+$100** |
|  | Interest of $2,000 and dividends of $1,000 were paid by the firm during the period. | **-$2** | **0** | **-$1** |
|  | Customers placed orders for $7,000 of goods to be delivered next period. No payments are made this period. | **0** | **0** | **0** |

1. Ignoring the impact of taxes, is depreciation a source of cash?

**No. It appears as an adjustment to net income in the calculation of cash flow from operating activities to account for the fact that while depreciation reduces net income, it is not a cash outflow.**

1. Do accounting policies affect total cash flows?

**No. Total cash flows are independent of when we recognize revenues and expenses for accounting purposes.**

### Requirement 3: The following excerpts are from Endo Pharmaceutical’s 2010 10-K:



1. How much cash was collected from customers during 2010? Please use the changes in operating assets and liabilities as listed on the cash flow statement in your calculations. How much different would your answer be in you instead used the changes as given on the balance sheet?

|  |  |  |
| --- | --- | --- |
|  | **Using changes**  **from CF statement** | **Using changes**  **from balance sheet** |
| **Sales** | **$ 1,716,229** | **$ 1,716,229** |
| **- Δ A/R** | **- 84,659** | **- 224,306** |
| **= Cash collected** | **$ 1,631,570** | **$ 1,491,923** |

1. Which of these two methods is the correct one to use in calculating cash collected from customers?

**The correct method to use is the one that employs the changes on the cash flow statement. This is because the increase in accounts receivable on the balance sheet reflects not only the company’s underlying transactions with its customers, but also the impact of its business acquisitions on the level of its receivables.**

1. How much cash was paid to suppliers for inventory? In your calculations, assume that all accounts payable pertain to inventory. Please use the changes in assets and liabilities as given on the cash flow statement, rather than those from the balance sheet.

|  |  |
| --- | --- |
|  | **Using changes**  **from CF statement** |
| **COGS** | **$ -504,757** |
| **- Δ Inventory** | **- -13,894** |
| **+ Δ A/P** | **+ 30,145** |
| **= Cash paid to suppliers** | **$ -460,718** |

**Requirement 4:**

**Under the indirect method**:

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Item** | **Cherokee example** | **Source** |
|  | Net income | $7,719 | I/S |
|  | Adjustment for non-cash items: |  | I/S |
|  | Depreciation | $75 |  |
|  | Amortization | $1,474 |  |
|  | Change in non-cash operating assets: |  | B/S |
|  | Receivables | $295 |  |
|  | Other current assets | $7 |  |
|  | Deferred taxes (current) | ($607) |  |
|  | Deferred taxes (non-current) | ($714) |  |
|  | Change in operating liabilities: |  | B/S |
|  | Accounts payable | $900 |  |
|  | Accrued expenses | $2,762 |  |
|  | Income taxes payable | $597 |  |
| = | Cash flow from operating activities | $12,508 |  |

**Under the direct method**:

* Whereas the indirect method adjusts net income to arrive at CFO, we can view the direct method as adjusting net income on a line-by-line basis.
* Because the dollar amount of CFO must be the same under the direct and indirect methods, we must make sure to account for every adjustment found in the indirect method statement, and no more.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Income statement** | | **Adjustments** | | **Cash flow from operating activities** | |
| Royalty revenues | $30,777 | ΔA/R | $295 | $31,072 | Cash collected from customers |
| SG&A expenses | (16,322) | ΔOther current assets  ΔA/P  ΔAccrued expenses | 7  900  2,762 | (12,653) | Cash paid to suppliers |
| Depreciation | (75) | Depreciation | 75 |  | --- |
| Amortization of  trademarks | (1,474) | Amortization | 1,474 |  | --- |
| Interest and other income | 13 |  |  | 13 | Cash received for interest |
| Income tax provision | (5,200) | ΔCurrent def. tax  ΔNon-current def. tax  ΔTaxes payable | (607)  (714)  597 | (5,924) | Cash paid for taxes |
| Net income | $7,719 |  |  | $12,508 | Cash from operations |