

PROBLEMS

P4-1

Note: This problem does not specify whether a direct or indirect method statement should be prepared. Preparation of both is recommended.

Journal entries:

a1. Inventory	49,000	
Cash		49,000
a2. Cash	73,500	
Sales		73,500
a3. Inventory	49,000	
Cost of goods sold		49,000
b. Prepaid rent	4,000	
Cash		4,000
c. Retained earnings	2,000	
Cash		2,000

Implied:

d. Salaries and wages expense	11,000	
Cash		11,000

Adjustments:

A1. Interest expense	4,000	
Interest payable		4,000
10% of \$40,000 = \$4,000		
A2. Wages expense	1,000	
Wages payable		1,000
A3. Rent expense	6,000	
Prepaid rent		6,000
\$3,000 + (\$4,000/8 months)*6 months = \$6,000.		

(The following closes all revenue and expense accounts to an account called 'Income Summary.' The balance in Income Summary should be equal to Net Income as shown on the income statement, below. Income Summary is then closed to Retained Earnings. This is an alternative to closing the revenue and expense accounts directly to retained earnings and provides a convenient check on the net income number on the income statement.)

C1. Sales Revenue	73,500	
Income Summary		73,500
C2. Income Summary	49,000	
COGS		49,000
C3. Income Summary	6,000	
Rent Expense		6,000
C4. Income Summary	4,000	
Interest Expense		4,000
C5. Income Summary	12,000	
Salaries Expense		12,000
C6. Income Summary	2,500	
Retained Earnings		2,500

To do a direct method cash flow statement, we analyze the cash T-account. We find that:

Operating items:

- b is payment of rent
- a1 is a payment to suppliers
- a2 is collections from customers
- d is payment of salaries and wages

Investing items:

none

Financing items:

- c is payment of dividends

The direct method cash flow statement is:

**Sampson, Inc.
Cash Flow Statement
for Year Ended 12/31/04
(in thousands)**

Operations:	
Collections from customers	\$ 73.5
Payments to suppliers	(49.0)
Payments for salaries	(11.0)
Payments for rent	(4.0)
Cash Flows from Operations	<u>\$ 9.5</u>
Investing:	
None	_____
Cash Flows for Investing	<u>—</u>
Financing:	
Dividends	\$ (2.0)
Cash Flows for Financing	<u>\$ (2.0)</u>
Change in Cash	<u>\$ 7.5</u>

Sampson, Inc.
Cash Flow Statement
for Year Ended 12/31/04
(in thousands)

Operations:	
Net income	\$ 2.5
Decrease in prepaid rent	2.0
Increase in wages payable	1.0
Increase in interest payable	<u>4.0</u>
Cash Flows from Operations	<u>\$ 9.5</u>
Investing:	
None	—
Cash Flows for Investing	<u>—</u>
Financing:	
Dividends	<u>\$ (2.0)</u>
Cash Flows for Financing	<u>\$ (2.0)</u>
Change in Cash	<u>\$ 7.5</u>

P4-2

Journal entries (amounts in thousands)

- | | | | |
|-----------|---|----------------|----------------|
| a. | Accounts receivable | 3,000.0 | |
| | Sales | | 3,000.0 |
| b. | Cash | 3,100.0 | |
| | Accounts receivable | | 3,100.0 |
| c. | This is information for the cost of goods sold adjustment. See T-accounts. | | |
| d. | Buildings & machinery | 50.0 | |
| | Cash | | 50.0 |
| e. | Cash | 1.5 | |
| | Accumulated depreciation | 8.0 | |
| | Loss on sale of machinery | 0.5 | |
| | Buildings & machinery | | 10.0 |
| f. | This is information for the depreciation adjustment. | | |
| g. | This is information for the interest adjustment. | | |

h. This is information for the interest adjustment.		
i. Cash	14.0	
Retained earnings		14.0
j. This is information for the wages adjustment.		
k. Wages expense	57.0	
Wages payable		57.0
l. Miscellaneous expenses		
Cash	50.0	50.0
m. Interest payable		
Cash	7.0	7.0
n. Inventory		
Accounts payable	2,820.0	2,820.0
o. Accounts payable		
Cash	2,700.0	2,700.0
p. This is information for the rent adjustment.		
q. Prepaid rent	25.0	
Cash		25.0
r. Other accrued expenses		
Cash	5.0	5.0
s. This is information for the accrued liabilities adjustment.		
t. Tax expense	12.0	
Taxes payable		12.0
u. This is information for the taxes adjustment.		
Adjusting entries—(calculations below)		
A1. Cost of goods sold	2,800.0	
Inventory		2,800.0
A2. Rent expense	27.0	
Prepaid rent		27.0
A3. Wages payable	53.0	
Cash		53.0
A4. Miscellaneous expenses	9.0	
Other accrued liabilities		9.0

A5. Taxes payable	11.0	
Cash		11.0
A6. Depreciation expense	14.0	
Accumulated depreciation		14.0
A7. Interest expense	6.0	
Interest payable		6.0
A8. Interest expense	2.4	
Interest payable		2.4
(Closing entries.)		
C1. Sales	3,000.0	
Income summary		3,000.0
C2. Income summary	2,800.0	
Cost of goods sold		2,800.0
C3. Income summary	57.0	
Wages expense		57.0
C4. Income summary	59.0	
Miscellaneous expense		59.0
C5. Income summary	27.0	
Rent expense		27.0
C6. Income summary	12.0	
Tax expense		12.0
C7. Income summary	8.4	
Interest expense		8.4
C8. Income summary	0.5	
Loss on sale of machinery		0.5
C9. Income summary	14.0	
Depreciation expense		14.0

(Close the balance in income summary to retained earnings.)

C10. Income summary	22.1	
Retained earnings		22.1

Calculations for adjusting entries:

The inventory, unpaid wages, prepaid rent, other accrued liabilities, and unpaid taxes at the end of the year are given, and are best analyzed in the T-accounts given below.

Depreciation:

$$\frac{1}{10} \times \$140,000 = \$14,000.$$

Interest:

Senior debt:

$$0.06 \times \$100,000 = \$6,000.$$

Subordinated debt:

$$0.08 \times \$30,000 = \$2,400.$$

<table border="0" style="width: 100%; border-collapse: collapse;"> <tr> <th colspan="2" style="text-align: center; border-bottom: 1px solid black;">Sales</th> </tr> <tr> <td style="width: 50%;"></td> <td style="text-align: right; border-right: 1px solid black;">3,000.0</td> </tr> <tr> <td style="border-top: 1px solid black;">c1</td> <td style="border-top: 1px solid black; border-right: 1px solid black;">3,000.0</td> </tr> </table>	Sales			3,000.0	c1	3,000.0	a	<table border="0" style="width: 100%; border-collapse: collapse;"> <tr> <th colspan="2" style="text-align: center; border-bottom: 1px solid black;">Cost of Goods Sold</th> </tr> <tr> <td style="width: 50%;"></td> <td style="text-align: right; border-right: 1px solid black;">2,800.0</td> </tr> <tr> <td style="border-top: 1px solid black;">c2</td> <td style="border-top: 1px solid black; border-right: 1px solid black;">2,800.0</td> </tr> </table>	Cost of Goods Sold			2,800.0	c2	2,800.0	I	<table border="0" style="width: 100%; border-collapse: collapse;"> <tr> <th colspan="2" style="text-align: center; border-bottom: 1px solid black;">Miscellaneous Expense</th> </tr> <tr> <td style="width: 50%;"></td> <td style="text-align: right; border-right: 1px solid black;">50.0</td> </tr> <tr> <td style="border-top: 1px solid black;">c2</td> <td style="border-top: 1px solid black; border-right: 1px solid black;">9.0</td> </tr> <tr> <td style="border-top: 1px solid black;">A4</td> <td style="border-top: 1px solid black; border-right: 1px solid black;">59.0</td> </tr> </table>	Miscellaneous Expense			50.0	c2	9.0	A4	59.0	A6	<table border="0" style="width: 100%; border-collapse: collapse;"> <tr> <th colspan="2" style="text-align: center; border-bottom: 1px solid black;">Depreciation Expense</th> </tr> <tr> <td style="width: 50%;"></td> <td style="text-align: right; border-right: 1px solid black;">14.0</td> </tr> <tr> <td style="border-top: 1px solid black;">c4</td> <td style="border-top: 1px solid black; border-right: 1px solid black;">14.0</td> </tr> </table>	Depreciation Expense			14.0	c4	14.0																				
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2.

**REVIEW Co.
Balance Sheet
as of 12/31/2006**

Cash	\$254.5	Accounts Payable	\$183.0
Accounts Receivable	240.0	Wages Payable	17.0
Inventory	95.0	Interest Payable	4.4
Prepaid Rent	<u>30.0</u>	Taxes Payable	7.0
Total Current Assets	<u>\$619.5</u>	Other Accrued Liabilities	<u>9.0</u>
		Total Current Liabilities	<u>\$220.4</u>
Buildings & Machinery	\$140.0		
Less: Accumulated Depreciation	<u>(31.0)</u>	Senior Debt	\$100.0
Buildings & Machinery, net	\$109.0	Subordinated Debt	<u>30.0</u>
Land	<u>25.0</u>	Total Long-term Liabilities	<u>\$130.0</u>
Total Non-current Assets	<u>\$134.0</u>	Total Liabilities	<u>\$350.4</u>
Total Assets	<u>\$753.5</u>		
		Shareholders' Equity	
		Common Stock	\$ 15.0
		Add'l Paid-in Capital	115.0
		Retained Earnings	<u>273.1</u>
		Total Shareholders' Equity	<u>\$403.1</u>
		Total Liabilities & Shareholders' Equity	<u>\$753.5</u>

3.

**REVIEW Co.
Income Statement
for Year Ended 12/31/2006**

Sales	\$ 3,000.0
Cost of Goods Sold	<u>(2,800.0)</u>
Gross Margin	\$ 200.0
Other Expenses:	
Wages	(57.0)
Depreciation	(14.0)
Interest	(8.4)
Rent	(27.0)
Taxes	(12.0)
Miscellaneous	(59.0)
Loss on Sale of Machine	<u>(0.5)</u>
Net Income	<u>\$ 22.1</u>

4.

REVIEW Co.
Cash Flow Statement
for Year Ended 12/31/2006

Operations:	
Net Income	\$ 22.1
Addbacks:	
Depreciation	14.0
Loss on Sale of Machinery	0.5
Changes in accounts that require additions:	
Accounts Receivable	100.0
Prepaid Rent	2.0
Accounts Payable	120.0
Wages Payable	4.0
Interest Payable	1.4
Taxes Payable	1.0
Other Accrued Liabilities	4.0
Changes in accounts that require subtractions:	
Inventory	<u>(20.0)</u>
Cash flow from operations	<u>\$249.0</u>
Investing:	
Sale of machinery	\$ 1.5
Purchase of machinery	<u>(50.0)</u>
Cash flows for investing	<u>\$ (48.5)</u>
Financing:	
Payment of dividends	\$ (14.0)
Change in Cash	<u><u>\$186.5</u></u>
Supplemental disclosure:	
Cash paid for interest	\$ 7.0
Cash paid for taxes	\$ 11.0

Indirect Method Worksheet

	Explanation							
	dr	cr	ref	dr	cr	ref	dr	cr
Accounts Receivable	340.0				100.0	AR	240.0	
Inventory	75.0		INV	20.0			95.0	
Prepaid Rent	32.0				2.0	PREPR	30.0	
Buildings & Machinery	100.0		PURCH	50.0	10.0	SALE	140.0	
Accumulated Depreciation		25.0	SALE	8.0	14.0	DEPR		31.0
Land	25.0						25.0	
Accounts Payable		63.0			120.0	AP		183.0
Wages Payable		13.0			4.0	WP		17.0
Interest Payable		3.0			1.4	IP		4.4
Taxes Payable		6.0			1.0	TP		7.0
Other Accrued Liabilities		5.0			4.0	OAL		9.0
Senior Debt		100.0						100.0
Subordinated Debt		30.0						30.0
Common Stock		15.0						15.0
Add'l Paid-in Capital		115.0						115.0
Retained Earnings		265.0	DIV	14.0	22.1	NI		273.1
	572.0	640.0					530.0	784.5
Beg Cash	68.0			Cash		EndCash	254.5	
	640.0		BB	68.0			784.5	
				Operations				
			NI	22.1				
			DEPR	14.0				
			LOSSALE	0.5	20.0	INV		
			AR	100.0				
			PREPs	2.0				
			AP	120.0				
			WP	4.0				
			IP	1.4				
			TP	1.0				
			OAL	4.0				
			CFO	249.0				
				Investing				
			EQUIPSAL	1.5	50.0	EQPURCH		
			E					
					48.5			
				Financing				
					14	DIV		
					14	CFF		
			ChinCash	186.5				
			EB	254.5				

P4-3

This problem can be done by working backwards through the indirect method cash flow worksheet.

Indirect Method Worksheet								
			Explanation					
	dr	cr	ref	dr	cr	ref	dr	cr
Accounts Rec.	380		AR	60			440	
Inventories	560		INV	80			640	
Land	100				20	Land	80	
Buildings & Equipment	810		Acq B&E	260	70	Sale B&E	1,000	
Other Long-term Assets	280				80	Sale OLTA	200	
Accumulated Depreciation		320	Sale B&E	40	120	Depr		400
Accounts Payable		510			50	AP		560
Other Current Liabilities		260	OCL	90				170
Bonds Payable		120			80	IssBonds		200
Common Stock		280			120	IssCS		400
Ret. Earnings		680	Div	400	400	NI		680
	2,130	2,170					2,360	2,410
Beg Cash	40			Cash		EndCash	50	
	2,170		BB	40			2,410	
				Operations				
			NI	400	60	AR		
			Depr	120	80	INV		
			AP	50	90	OCL		
			CFO	340				
				Investing				
			Land	20	260	Acq B&E		
			Sale B&E	30				
			Sale OLTA	80				
					130	CFI		
				Financing				
			IssBonds	80	400	Div		
			IssCS	120				
					200	CFF		
			ChinCash	10				
			EB	50				

**ABC Widget Company
Balance Sheet
at December 31, 2003**

Cash	\$ 40
Accounts receivable	380
Inventory	<u>560</u>
Total current assets	<u>\$ 980</u>
Buildings & equipment	\$ 810
Accumulated depreciation	<u>(320)</u>
Buildings & equipment, net	\$ 490
Land	100
Other long-term assets	<u>280</u>
Total long-term assets	<u>\$ 870</u>
Total assets	<u>\$1,850</u>
Accounts payable	\$ 510
Other current liabilities	<u>260</u>
Total current liabilities	<u>\$ 770</u>
Bonds payable	\$ 120
Total liabilities	<u>\$ 890</u>
Common stock	\$ 280
Retained earnings	<u>680</u>
Total stockholders' equity	<u>\$ 960</u>
Total liabilities and stockholders' equity	<u>\$1,850</u>

Active Company
Statement of Cash Flows (Indirect Method)
For the Year Ended
December 31, 2004
(in thousands)

Operations:

Net Income	36.0
Add: Expenses not requiring cash and losses	
Depreciation expense	54.0
Amortization expense	10.0
Noncash compensation	10.0
Loss on sale of equipment	2.0
Subtract: Gains	
Gain on sale of land	(3.0)
Gain on repayment of mortgage	<u>(1.0)</u>
Cash Flow from Operations	<u>\$108.0</u>

Investing:

Sold equipment	\$ 4.0
Sold land	8.0
Purchased equipment	<u>(44.0)</u>
Cash Flow for Investing	<u>\$ (32.0)</u>

Financing:

Repaid mortgage	\$ (9.0)
Dividends	<u>(10.0)</u>
Total Financing	<u>\$ (19.0)</u>
Change in cash	<u>\$ 57.0</u>

Active Company
Statement of Cash Flows (Direct Method)
For the Year Ended
December 31, 2001
(in thousands)

Operations:

Collections from customers	\$1,200.0
Payments:	
Suppliers	(788.0)
Wages	(270.0)
Interest	(12.0)
Taxes	(22.0)
Cash Flow from Operations	<u>\$ 108.0</u>
Investing:	
Sold equipment	\$ 4.0
Sold land	8.0
Purchased equipment	<u>(44.0)</u>
Cash Flow for Investing	<u>\$ (32.0)</u>
Financing:	
Repaid mortgage	\$ (9.0)
Dividends	<u>(10.0)</u>
Total Financing	<u>\$ (19.0)</u>
Change in cash	<u>\$ 57.0</u>

P4-5

- a. Microsoft uses the indirect method in preparing the statement of cash flows. The indirect method shows how net income must be adjusted to get back to cash flow from operations.**
- b. Unearned revenue represents cash received from customers prior to the delivery of goods or performance of a service. Because the service has not been performed, unearned revenue is a liability. It is added back because the cash received is not reflected in net income, but represents an increase in cash for the year.**
- b. Recognition of unearned revenue means that the company has performed a service in the current period where the cash was received in prior periods. The performance of the service results in a reduction of unearned revenue and an increase in revenue, thereby increasing net income. However, since the cash was received in prior periods, the income appears higher than the amount of cash received for that income. Therefore, it must be deducted.**
- c. Answers may vary. Among the items that might be viewed positively are:
 - 1. The company has \$13.4 billion in net cash flow from operating activities.**
 - 2. The company has not relied on any financing to fund operations for the year.**
 - 3. The company has repurchased \$6 billion of common stock, reducing the number of shares outstanding. This is viewed positively by remaining stockholders. Fewer shares outstanding will result in a favorable supply/demand environment and also increase earnings per share.****
- d. Investors may view the large purchases of investments as negative. In a growing company, investors prefer to see acquisitions of plant and equipment. Microsoft has an unusually high amount of buying and selling of investments, which is not the core business of the company. Investors would want to know the nature of such investments. The return on these investments may not be adequate to compensate for the risk associated with a high growth company. The implication is that Microsoft cannot find any suitable opportunities for long-term growth. Alternatively, the additions to property and equipment were relatively small, not good news if the company is a high growth company.**

Common stock investors may want to see cash dividends to offset some of the investment risk of owning common stock. Microsoft paid no common stock dividends from 1999 to 2001.

The amount of depreciation and amortization in the 2001 income statement (\$1,536) exceeds the amount spent investing in property and equipment (\$1,103). This suggests that Microsoft may not have spent enough in 2001 to compensate for its usage of assets.

- e. **Gains on investments are deducted because the entire cash flow is considered an investing activity. Since the gain is included in net income, it must be deducted so that the cash flows from operations do not “double count” the gain.**
Losses on investments are added because they are losses that do not represent cash outflows. A loss means that the company sold the securities for less than their balance sheet carrying value. However, the transaction resulted in a positive cash flow, all of which is reflected in the investing section. The loss is added back because it did not result in the use of cash by the company even though it resulted in a reduction of net income.
- f. **The income statement is prepared on the accrual basis, where revenues are recognized in the period earned and expenses in the period incurred, regardless of the receipt or payment of cash. It is aimed at reflecting economic performance. Therefore, the timing of cash receipts or payments may not be the same as the timing of the expense or revenue recognition. Additionally, some expenses, such as depreciation and amortization, reduce income but do not consume cash.**
- g. **1. The exchange of common stock for land is a significant non-cash activity. Since it is a non-cash transaction, it will not be part of the cash flows. However, it must be reported separately under the caption “significant non-cash investing and financing activities.”**
2. Interest paid is an operating activity. It will be part of net income. Any change in interest payable will be added to or deducted from net income to arrive at the cash provided by operating activities.
- h. **The accounting change represented an after-tax adjustment reducing Microsoft’s net income by \$375 million. The adjustments are related to the valuations of derivative investments reported by Microsoft. While the adjustment resulted in a loss, it did not require the use of cash. Therefore, the adjustment is added back to net income to arrive at cash provided by operating activities.**

P4-6

- a. **The statement of cash flows helps investors and creditors assess the amounts of cash flows from three categories of activities: operating, investing and financing. The cash flow statement describes the changes in an entity’s cash over a period of time by grouping the increases and decreases to cash into one of the three categories. Investors and creditors can then use the net change in cash for the individual categories and the company as a whole to make investment and credit decisions.**

- b. Answers may vary. Among those items that might be of interest to a banker would be:
1. The company had positive cash provided by operations in 2000 and 2001.
 2. The company was able to pay off \$90,000,000 of long-term debt over the two years.
 3. The total cash position of the company increased in both 2000 and 2001.
 4. The company repaid \$1,234,000 of short-term bank borrowings over the two years.
 5. Cash provided by operating activities is the company's primary source of funds.
- c. Existing creditors would be encouraged by any of the items listed in b. Also, the Management Discussion and Analysis points out that the company was in compliance with all loan covenants as of March 31, 2001.
- d. The primary source of funds is cash provided by operations.
- e. THC paid no dividends in 2000 or 2001. MD & A indicates that the company may not pay dividends or make other payments with respect to capital stock that exceed 33 percent of the Company's cumulative consolidated net income. To avoid violating the loan covenant, it would not be wise for the company to pay a dividend at this time.

P4-7

Net income:	\$910,000
+ Amortization expense	40,000
– Increase in Accounts receivable	(10,000)
– Increase in inventory	(2,000)
– Decrease in accounts payable	(20,000)
+ Increase in interest payable	<u>2,000</u>
= Cash provided by operations	
before depreciation adjustment	\$920,000
+ Depreciation expense	<u>100,000</u>
= Cash provided by operations	<u>\$1,020,000</u>

Note to Instructor: Dividends are a financing activity; the change in dividends payable is not relevant to computing the cash provided by operating activities.