

MBA in Food & Agribusiness

Financial Management

The Statement of Cashflows
(IAS 7)

P 1. Analyze each transaction listed in the table that follows and place X's in the appropriate columns to indicate the transaction's classification and its effect on cash flows using the indirect method.

Transaction	Cash Flow Classification				Effect on Cash Flows		
	Operating Activity	Investing Activity	Financing Activity	Noncash Transaction	Increase	Decrease	No Effect
1. Increased accounts payable.							
2. Decreased inventory.							
3. Increased prepaid insurance.							
4. Earned a net income.							
5. Declared and paid a cash dividend.							
6. Issued stock for cash.							
7. Retired long-term debt by issuing stock.							
8. Purchased a long-term investment with cash.							
9. Sold trading securities at a gain.							
10. Sold a machine at a loss.							
11. Retired a fully depreciated equipment.							
12. Decreased interest payable.							
13. Purchased available-for-sale securities (long-term).							
14. Decreased dividends receivable.							
15. Decreased accounts receivable.							
16. Converted bonds to common stock.							
17. Purchased 90-day Treasury bill.							

Answer

Transaction		Cash Flow Classification				Effect on Cash Flows		
		Operating Activity	Investing Activity	Financing Activity	Noncash Transaction	Increase	Decrease	No Effect
1.	Increased accounts payable.	X				X		
2.	Decreased inventory.	X				X		
3.	Increased prepaid insurance.	X					X	
4.	Earned a net income.	X				X		
5.	Declared and paid a cash dividend.			X			X	
6.	Issued stock for cash.			X		X		
7.	Retired long-term debt by issuing stock.				X			X
8.	Purchased a long-term investment with cash.		X				X	
9.	Sold trading securities at a gain.	X				X		
10.	Sold a machine at a loss.	X	X			X		
11.	Retired fully depreciated equipment.				X			X
12.	Decreased interest payable.	X					X	
13.	Purchased available-for-sale securities (long-term).		X				X	
14.	Decreased dividends receivable.	X				X		
15.	Decreased accounts receivable.	X				X		
16.	Converted bonds to common stock.				X			X
17.	Purchased 90-day Treasury bill.				X*			X

*Cash equivalent.

Cash Flows from Operating Activities

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	<u>(1,000)</u>	<u>7,000</u>
Net cash flows from operating activities		<u>\$15,000</u>

Cash Flows from Investing Activities

**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	2,500	
Net cash flows from investing activities		<u>(45,500)</u>

Cash Flows from Financing Activities

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>

Statement of Cash Flows (exhibit)

Amir Corporation	
Statement of Cash Flows	
For the Year Ended December 31, 20x7	
Net cash flows from operating activities	\$15,000
Net cash flows from investing activities	(45,500)
Net cash flows from financing activities	46,000
Net increase (decrease) in cash	<u>\$15,500</u>
Cash at beginning of year	7,500
Cash at end of year	<u><u>\$23,000</u></u>

Statement of Cash Flows: Indirect Method

P 2. The comparative balance sheets for Sharma Fabrics, Inc., for December 31, 20x8 and 20x7 appear on the following page.

Additional information about Sharma Fabrics's operations during 20x8 is as follows: (a) net income, \$56,000; (b) building and equipment depreciation expense amounts, \$30,000 and \$6,000, respectively; (c) equipment that cost \$27,000 with accumulated depreciation of \$25,000 sold at a gain of \$10,600; (d) equipment purchases, \$25,000; (e) patent amortization, \$6,000; purchase of patent, \$2,000; (f) funds borrowed by issuing notes payable, \$50,000; notes payable repaid, \$30,000; (g) land and building purchased for \$324,000 by signing a mortgage for the total cost; (h) 3,000 shares of \$20 par value common stock issued for a total of \$100,000; and (i) paid cash dividend, \$18,000.

Required

1. Using the indirect method, prepare a statement of cash flows for Sharma Fabrics, Inc.
2. Why did Sharma Fabrics have an increase in cash of \$134,400 when it recorded net income of only \$56,000? Discuss and interpret.
3. Compute and assess cash flow yield and free cash flow for 20x8. What is your assessment of Sharma's cash-generating ability?

Sharma Fabrics, Inc.
Comparative Balance Sheets
December 31, 20x8 and 20x7

	20x8	20x7
Assets		
Cash	\$189,120	\$ 54,720
Accounts receivable (net)	204,860	150,860
Inventory	225,780	275,780
Prepaid expenses	—	40,000
Land	50,000	—
Building	274,000	—
Accumulated depreciation, building	(30,000)	—
Equipment	66,000	68,000
Accumulated depreciation, equipment	(29,000)	(48,000)
Patents	8,000	12,000
Total assets	<u>\$958,760</u>	<u>\$553,360</u>
Liabilities and Stockholders' Equity		
Accounts payable	\$ 21,500	\$ 73,500
Notes payable (current)	20,000	—
Accrued liabilities	—	24,600
Mortgage payable	324,000	—
Common stock, \$10 par value	360,000	300,000
Additional paid-in capital	114,400	74,400
Retained earnings	118,860	80,860
Total liabilities and stockholders' equity	<u>\$958,760</u>	<u>\$553,360</u>

Answer

1.	Statement of cash flows prepared		
Sharma Fabrics, Inc. Statement of Cash Flows For the Year Ended December 31, 20x7			
Cash flows from operating activities			
	Net income		\$ 56.000
Adjustments to reconcile net income to net cash flows from operating activities			
	Depreciation, building	\$ 30.000	
	Depreciation, equipment	6.000	
	Amortization, patent	6.000	
	Gain on sale of equipment	(10.600)	
Changes in current assets and current liabilities			
	Increase in accounts receivable	(54.000)	
	Decrease in inventory	50.000	
	Decrease in prepaid expenses	40.000	
	Decrease in accounts payable	(52.000)	
	Decrease in accrued liabilities	(24.600)	(9.200)
Net cash flows from operating activities			\$ 46.800

Answer (cont)

Cash flows from investing activities			
	Purchase of equipment	(\$ 25.000)	
	Sale of equipment	12.600	
	Purchase of patent	<u>(2.000)</u>	
Net cash flows from investing activities			(14.400)
Cash flows from financing activities			
	Issue of notes payable	\$ 50.000	
	Repayment of notes payable	(30.000)	
	Issue of common stock	100.000	
	Payment of dividends	<u>(18.000)</u>	
Net cash flows from financing activities			<u>102.000</u>
Net increase (decrease) in cash			\$134.400
Cash at beginning of year			<u>54.720</u>
Cash at end of year			<u><u>\$189.120</u></u>

Answer (cont)

Schedule of Noncash Investing and Financing Transactions	
Issue of mortgage for land	\$ 50.000
Issue of mortgage for building	<u>274.000</u>
	<u><u>\$324.000</u></u>

Answer (cont)

Cash Flow Yield	=	Net Cash Flows from Operating Activities		
		Net Income		
	=	\$46.800	=	0,8 times
		\$56.000		
Free Cash Flow	=	Net Cash Flows from Operating Activities œ Dividends œ		
		(Purchases of Plant Assets œ Sales of Plant Assets)		
	=	\$46.800	-	\$18.000 - (\$25.000 - \$12.600)
	=	\$16.400		

Statement of Cash Flows: Indirect Method

P 6. O'Brien Corporation's comparative balance sheets as of December 31, 20x8 and 20x7 and its income statement for the year ended December 31, 20x8 are presented on the following page.

During 20x8, O'Brien Corporation engaged in these transactions:

- a. Sold furniture and fixtures that cost \$17,800, on which it had accumulated depreciation of \$14,400, at a gain of \$3,500.
- b. Purchased furniture and fixtures in the amount of \$19,800.
- c. Paid a \$10,000 note payable and borrowed \$20,000 on a new note.
- d. Converted bonds payable in the amount of \$50,000 into 2,000 shares of common stock.
- e. Declared and paid \$3,000 in cash dividends.

Required

1. Using the indirect method, prepare a statement of cash flows for O'Brien Corporation. Include a supporting schedule of noncash investing transactions and financing transactions.

2. What are the primary reasons for O'Brien Corporation's large increase in cash from 20x7 to 20x8, despite its low net income?
3. Compute and assess cash flow yield and free cash flow for 20x8. Compare and contrast what these two performance measures tell you about O'Brien's cash-generating ability.

**O'Brien Corporation
Comparative Balance Sheets
December 31, 20x8 and 20x7**

	20x8	20x7
Assets		
Cash	\$ 82,400	\$ 25,000
Accounts receivable (net)	82,600	100,000
Merchandise inventory	175,000	225,000
Prepaid rent	1,000	1,500
Furniture and fixtures	74,000	72,000
Accumulated depreciation, furniture and fixtures	<u>(21,000)</u>	<u>(12,000)</u>
Total assets	<u>\$394,000</u>	<u>\$411,500</u>
Liabilities and Stockholders' Equity		
Accounts payable	\$ 71,700	\$100,200
Income taxes payable	700	2,200
Notes payable (long-term)	20,000	10,000
Bonds payable	50,000	100,000
Common stock, \$20 par value	120,000	100,000
Additional paid-in capital	90,720	60,720
Retained earnings	<u>40,880</u>	<u>38,380</u>
Total liabilities and stockholders' equity	<u>\$394,000</u>	<u>\$411,500</u>

**O'Brien Corporation
Income Statement
For the Year Ended December 31, 20x8**

Sales		\$804,500
Cost of goods sold		<u>563,900</u>
Gross margin		\$240,600
Operating expenses (including depreciation expense of \$23,400)		224,700
Income from operations		\$ 15,900
Other income (expenses)		
Gain on sale of furniture and fixtures	\$ 3,500	
Interest expense	<u>(11,600)</u>	<u>(8,100)</u>
Income before income taxes		\$ 7,800
Income taxes expense		<u>2,300</u>
Net income		<u>\$ 5,500</u>

Answer

O'Brien Corporation		
Statement of Cash Flows		
For the Year Ended December 31, 20x8		
Cash flows from operating activities		
Net income		\$ 5.500
Adjustments to reconcile net income to net cash flows from operating activities		
Depreciation	\$23.400	
Gain on sale of furniture and fixtures	(3.500)	
Changes in current assets and current liabilities		
Decrease in accounts receivable	17.400	
Decrease in merchandise inventory	50.000	
Decrease in prepaid rent	500	
Decrease in accounts payable	(28.500)	
Decrease in income taxes payable	(1.500)	<u>57.800</u>
Net cash flows from operating activities		\$63.300

Answer (cont)

Cash flows from investing activities			
	Sale of furniture and fixtures*	\$ 6.900	
	Purchase of furniture and fixtures	(<u>19.800</u>)	
Net cash flows from investing activities			(12.900)
Cash flows from financing activities			
	Repayment of notes payable	(\$10.000)	
	Issue of notes payable	20.000	
	Payment of dividends	(<u>3.000</u>)	
Net cash flows from financing activities			<u>7.000</u>
Net increase (decrease) in cash			\$57.400
Cash at beginning of year			<u>25.000</u>
Cash at end of year			<u><u>\$82.400</u></u>

Answer (cont)

Schedule of Noncash Investing and Financing Transactions						
Conversion of bonds into common stock						<u><u>\$50.000</u></u>
*	<u>\$17.800</u>	-	<u>\$14.400</u>	+	<u>\$3.500</u>	= <u>\$6.900</u>

Answer (cont)

Cash Flow Yield	=	Net Cash Flows from Operating Activities		
		Net Income		
20x8	=	\$63.300	=	11,5 times
		\$5.500		
Free Cash Flow	=	Net Cash Flows from Operating Activities œ Dividends œ		
		(Purchases of Plant Assets œ Sales of Plant Assets)		
20x8	=	\$63.300	-	\$3.000 - (\$19.800 - \$6.900)
	=	\$47.400		