

***Cash Flow Construction***  
Indirect Method Statement of Cash Flows

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## Partitioning Cash Flows

Cash flow activity can be partitioned in many ways. Consider, the following example.

### Star Therapeutics, Inc.

The income statement. . .

Year-ended March 31,	2016	2015
Amounts in (000's)		
Net Sales	\$ 20,359	\$ 14,518
Cost of sales	<u>8,480</u>	<u>6,916</u>
Gross profit	11,879	7,602
Costs and expenses:		
Selling, general and administrative expense	4,791	3,777
Research and development	<u>113</u>	<u>70</u>
Total costs and expenses	<u>4,904</u>	<u>3,847</u>
Operating income	6,975	3,755
Interest income	<u>97</u>	<u>50</u>
Earnings before income taxes	7,072	3,805
Income taxes	<u>2,762</u>	<u>1,199</u>
Net earnings	\$ <u><u>4,310</u></u>	\$ <u><u>2,606</u></u>

## Star Therapeutics, Inc. (cont'd)

## The balance sheet. . .

	2016	2015
Assets		
Current Assets:		
Cash	\$ 1,809	\$ 1,219
Marketable securities	1,029	416
Accounts receivable, net	2,872	2,126
Inventories	4,011	1,845
Income taxes refundable	-	84
Prepaid expenses	145	125
Deferred income taxes	<u>356</u>	<u>154</u>
Total current assets	10,222	5,969
Property and equipment, net	500	346
Other assets, net	<u>56</u>	<u>56</u>
	\$ <u>10,778</u>	\$ <u>6,371</u>
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	\$ 399	\$ 514
Accrued expenses	424	283
Income taxes payable	<u>180</u>	<u>-</u>
Total current liabilities	1,003	797
Shareholders' equity:		
Common stock	6,791	6,832
Retained earnings (deficit)	3,052	(1,258)
Treasury stock	<u>(68)</u>	<u>-</u>
Total shareholders' equity	<u>9,775</u>	<u>5,574</u>
	\$ <u>10,778</u>	\$ <u>6,371</u>

The One-Minute Cash Flow Statement. . .

Star Therapeutics, Inc.  
Cash Flow Statement  
Year Ended March 31, 2016

Beginning Cash	\$ 1,219
Net Cash Flow	<u>590</u>
Ending Cash	\$ 1,809

The one-minute cash flow is nothing more than a reporting of the net change in cash.

- Lacks detail
- Why the change in cash?

## The Ten-Minute Cash Flow (balance sheet changes):

Star Therapeutics, Inc.  
Cash Flow Statement  
Year Ended March 31, 2016

## Sources of cash:

## Decreases in assets:

Dec. in income taxes refundable	\$ 84
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## Increases in liabilities and shareholders' equity:

Inc. in accrued expenses	141
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Inc. in income taxes payable	180
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Inc. in retained earnings	<u>4,310</u>
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Total sources of cash	\$ 4,715
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## Uses of cash:

## Increases in assets:

Inc. in marketable securities	\$ (613)
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Inc. in accounts receivable, net	(746)
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Inc. in inventories	(2,166)
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Inc. in prepaid expenses	(20)
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Inc. in deferred income taxes	(202)
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Inc. in property and equipment, net	(154)
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## Decreases in liabilities and shareholders' equity:

Dec. in accounts payable	(115)
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Dec. in paid in capital, net	<u>(109)</u>
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Total uses of cash	<u>(4,125)</u>
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Change in cash	\$ 590
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## Balance sheet changes

- Provides detail
- Still, questions arise.
  - Are cash flows sustainable?
  - What portion of cash flow is from operations versus other sources?



The "???"-Minute Cash Flow (indirect method):

Star Therapeutics, Inc.  
Cash Flow Statement  
Year Ended March 31, 2016

Cash Provided by Operations:

Net income		\$ 4,310
Depreciation expense	\$ 114	
Inc. in accounts receivable, net	(746)	
Inc. in inventories	(2,166)	
Dec. in income taxes refundable	84	
Inc. in prepaid expenses	(20)	
Inc. in deferred income taxes	(202)	
Dec. in accounts payable	(115)	
Inc. in accrued expenses	141	
Inc. in income taxes payable	<u>180</u>	<u>(2,730)</u>
Cash Provided by Operations		1,580

Investing Expenditures:

Inc. in marketable securities	(613)	
Inc. in property and equipment, net (adjusted for depreciation expense)	<u>(268)</u>	
Cash (Used) by Investments		(881)

Financing Expenditures:

Dec. in paid-in-capital, net		<u>(109)</u>
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Change in cash		\$ 590
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The "??? + ?"-Minute Cash Flow (direct method):

Star Therapeutics, Inc.  
Cash Flow Statement  
Year Ended March 31, 2016

Cash Provided by Operations:

Cash from sales	\$ 19,613
Cash production costs	(10,647)
Cash operating expenses	(4,783)
Other cash income	97
Income taxes paid	<u>(2,700)</u>
 Cash Provided by Operations	 1,580

Investing Expenditures:

Inc. in marketable securities	(613)
Inc. in property and equipment, net (adjusted for depreciation expense)	<u>(268)</u>
 Cash (Used) by Investments	 (881)

Financing Expenditures:

Dec. in paid-in-capital, net	<u>(109)</u>
 Change in cash	 \$ 590

## Indirect and Direct Methods:

- Detailed partitioning
- Helps answer the question, why the change in cash?
- Helps answer the question, are cash flows sustainable?
- Operating cash flows separated
- Other cash flows: investing and financing are separated

## Cash Flow Statement Storefront Furniture, Inc.

Year-ended Amounts in (000's)	2016	2015
Cash flows from operating activities:		
Cash received from customers	\$ 122,918	\$ 109,369
Cash paid to suppliers and employees	(113,063)	(104,533)
Income taxes paid, net of refunds	(1,911)	(3,876)
Interest paid	(388)	(208)
Interest received	232	188
Other receipts, net	<u>800</u>	<u>1,239</u>
Net cash provided by operating activities	<u>8,588</u>	<u>2,179</u>
Cash flows from investing activities:		
Proceeds from sale of property and equipment	6,594	2
Capital expenditures	(10,686)	(4,961)
Sale (acquisitions) of marketable securities	<u>137</u>	<u>191</u>
Net cash used in investing activities	<u>(3,955)</u>	<u>(4,768)</u>
Cash flows from financing activities:		
Net borrowings (payments) under line of credit	(601)	2,736
Proceeds from issuance of long-term debt	200	200
Payments to reduce long-term debt	(455)	(2,363)
Proceeds from issuance of common stock	122	3,578
Dividends paid	(1,090)	(798)
Purchase of treasury stock	<u>(2,957)</u>	<u>(2,096)</u>
Net cash provided by (used in) financing activities	<u>(4,781)</u>	<u>1,257</u>
Net increase (decrease) in cash and cash equivalents	(148)	(1,332)
Cash at beginning of year	<u>471</u>	<u>1,803</u>
Cash at end of year	\$ <u><u>323</u></u>	\$ <u><u>471</u></u>

## Storefront Furniture, Inc. (cont'd)

From the cash flow statement . . .

Year-ended Amounts in (000's)	2016	2015
Net earnings	\$ <u>7,207</u>	\$ <u>6,782</u>
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	2,175	1,888
Provision for deferred compensation	634	554
Payments made for deferred compensation	(449)	(1,730)
Deferred income taxes	2,150	404
Provision for losses on accounts receivable	179	68
Loss (gain) on disposition of assets	(5,253)	(2)
Loss (gain) on sale of marketable securities	-	(18)
Change in operating assets and liabilities:		
Decrease (increase) in accounts receivable	(2,021)	(1,832)
Decrease (increase) in inventories	(1,127)	(2,008)
Decrease (increase) in prepaid expenses	(293)	(78)
Decrease (increase) in cash value of life insurance	(140)	(120)
Decrease (increase) in other assets	320	135
Increase (decrease) in accounts payable	4,080	(1,633)
Increase (decrease) in accrued expenses	<u>1,126</u>	<u>(231)</u>
Total adjustments	<u>1,381</u>	<u>(4,603)</u>
Net cash provided by operating activities	\$ <u>8,588</u>	\$ <u>2,179</u>

## Indirect and direct methods:

The two methods differ only in the manner in which cash flows from operations are presented

- Net cash flows from operating activities are equal under both methods
- The manner of presentation and the total of net cash flows from investing and financing activities are the same under both methods

The FASB recommends use of the direct method

- Gross operating cash activity is presented
- The operating section is effectively, a cash-basis income statement
- Provides more information to investors and creditors than the indirect method
  - Actual cash inflows and outflows, not "net" amounts

FASB recommendations notwithstanding, most companies use the indirect method

- Direct method statement requires providing also an indirect method statement - the reconciliation of net income to cash from operations
- Some companies indicate that their accounting systems are not set up to capture gross cash flow activity

## A Closer Look at Cash Flow Classification

### Cash provided (used) by operating activities (Operating cash flow):

The cash effects of transactions that enter into the determination of net income such as cash receipts from sales of goods and services and cash payments to suppliers and employees for acquisitions of inventory and services. Excluded are gains and losses related to investing activities, such as sales of investments or fixed assets, or related to financing activities, such as early debt retirement.

### Cash provided (used) by investing activities (Investing cash flow):

Cash receipts and payments involving long-term assets, including making and collecting loans and acquiring and disposing of investments and property, plant and equipment.

### Cash provided (used) by financing activities (Financing cash flow):

Cash receipts and payments involving liability and stockholders' equity items, including obtaining cash from creditors and repaying amounts borrowed and obtaining capital from owners and providing them with a return on and a return of, their investments.

## Cash Flow Classification Exercise #1

Required: Indicate whether the following items should be classified as:

O – Operating,

I - Investing, or

F - Financing

- \_\_\_\_\_ 1. Proceeds from sales of products
- \_\_\_\_\_ 2. Purchases of inventory
- \_\_\_\_\_ 3. Cash paid for operating expenses
- \_\_\_\_\_ 4. Interest income received
- \_\_\_\_\_ 5. Dividend income received
- \_\_\_\_\_ 6. Interest expense paid
- \_\_\_\_\_ 7. Dividends paid
- \_\_\_\_\_ 8. Income taxes paid
- \_\_\_\_\_ 9. Cash disbursed for purchase of investment
- \_\_\_\_\_ 10. Proceeds from sale of equipment
- \_\_\_\_\_ 11. Loss on sale of equipment
- \_\_\_\_\_ 12. Proceeds from issuing debt
- \_\_\_\_\_ 13. Cash paid to repurchase common stock



## Cash Flow Classification Exercise #2

Required: Indicate whether the following items should be classified as:

O – Operating,

I - Investing, or

F - Financing

- \_\_\_\_\_ 1. Increases in book overdrafts, the excess of outstanding checks over cash balances reported by the bank.
- \_\_\_\_\_ 2. Cash used in the operations of a discontinued segment during the period leading up to disposition.
- \_\_\_\_\_ 3. Proceeds from the liquidation of investments in short-term debt instruments classified as trading securities.
- \_\_\_\_\_ 4. Proceeds from a sale of accounts receivable.
- \_\_\_\_\_ 5. Cash provided by an outsized increase in the time taken to satisfy accounts payable.
- \_\_\_\_\_ 6. Cash paid for interest capitalized to a building under construction.
- \_\_\_\_\_ 7. Tax benefits received as the result of the sale of an investment at a loss.
- \_\_\_\_\_ 8. Cash tied up in notes receivable taken from customers at the time of sale.
- \_\_\_\_\_ 9. Tax benefits from the exercise of unqualified stock options.
- \_\_\_\_\_ 10. Cash provided from the liquidation of inventory acquired in a corporate acquisition.
- \_\_\_\_\_ 11. Taxes paid on a gain realized when long-term debt was settled early.
- \_\_\_\_\_ 12. Proceeds received when accounts receivable were pledged as collateral for a loan.

## Cash Flow Classification Exercise #2 (cont'd)

- \_\_\_\_\_ 13. Cash paid to retire long-term debt early.
- \_\_\_\_\_ 14. Cash paid in litigation related to product liability claims.
- \_\_\_\_\_ 15. Cash received from the sale of a building to be leased back.
- \_\_\_\_\_ 16. Insurance proceeds resulting from damage sustained by property, plant and equipment.
- \_\_\_\_\_ 17. Cash received from litigation related to product liability.

## Calculating Cash Provided by Operating Activities Barton Industries, Inc.

The income statement . . .

Year-ended March 31, Amounts in (000's)	2016	2015
Net Sales	\$ 220,014	\$ 213,216
Cost of sales	<u>154,294</u>	<u>150,334</u>
Gross profit	65,720	62,882
Selling, general and administrative	<u>47,054</u>	<u>41,135</u>
Operating income	18,666	21,747
Other income (expense):		
Interest	(1,922)	(1,905)
Gain on sale of equipment	<u>4,000</u>	<u>--</u>
Earnings before income taxes	20,744	19,842
Income taxes	<u>8,194</u>	<u>7,838</u>
Net earnings	\$ <u>12,550</u>	\$ <u>12,004</u>

Depreciation expense in the amount of \$6,010 is included in cost of sales.

## Barton Industries, Inc. (cont'd)

## The balance sheet. . .

	2016	2015	Inc (Dec)
Assets			
Current Assets:			
Cash	\$ 2,929	\$ 4,151	(1,222)
Accounts receivable, net	22,321	27,967	(5,646)
Inventories	21,582	28,865	(7,283)
Prepaid expenses	<u>3,697</u>	<u>3,729</u>	(32)
Total current assets	50,529	64,712	
Property and equipment, net	49,616	34,417	15,199
Other assets	<u>2,461</u>	<u>1,829</u>	<u>632</u>
	\$ <u>102,606</u>	\$ <u>100,958</u>	<u>1,648</u>
Liabilities and Shareholders' Equity			
Current liabilities:			
Notes payable	\$ -	\$ 2,595	(2,595)
Accounts payable	7,567	9,431	(1,864)
Income taxes	2,124	186	1,938
Other accrued liabilities	16,419	14,436	1,983
Current portion of long-term debt	<u>401</u>	<u>3,643</u>	(3,242)
Total current liabilities	26,511	30,291	
Deferred income taxes	1,951	1,628	323
Long-term debt	15,031	16,774	(1,743)
Shareholders' equity:			
Common stock	886	883	3
Additional paid-in capital	7,146	6,714	432
Retained earnings	56,341	44,668	11,673
Less treasury stock	<u>(5,260)</u>	<u>-</u>	<u>(5,260)</u>
	<u>59,113</u>	<u>52,265</u>	
Total liabilities and shareholders' equity	\$ <u>102,606</u>	\$ <u>100,958</u>	<u>1,648</u>

Other assets are operating-related.

Calculating Operating Cash Flow  
Barton Industries, Inc. (cont'd)

Start with net income

Adjust for non-operating gains and losses to move them to investing or financing sections:

    Subtract gains and add losses –

        On sales of investments or PP&E (investing items)

        On early retirement of debt (financing items)

Add non-cash expenses such as depreciation and amortization expense

Adjust for:

    (Increase) Decrease in operating-related assets

        Accounts receivable

        Inventory

        Prepaid expenses

        Deferred tax assets

        Other assets – operating-related only

    Increase (Decrease) in operating-related liabilities

        Accounts payable

        Accrued expenses payable

        Deferred tax liabilities

        Other liabilities – operating-related only

Calculating Operating Cash Flow  
Barton Industries, Inc. (cont'd)

Net earnings	\$ 12,550
Gain on sale of equipment	(4,000)
Depreciation	6,010
Accounts receivable↓	5,646
Inventories↓	7,283
Prepays↓	32
Other assets↑	(632)
Accounts payable↓	(1,864)
Income taxes payable↑	1,938
Other accrued liabilities↑	1,983
Deferred income tax liability↑	<u>323</u>
Operating cash flow	\$ 29,269

Calculating Investing Cash Flow  
Barton Industries, Inc. (cont'd)

To calculate cash provided (used) by investing activities:

For depreciable assets:

Calculate the change in book value (net of accumulated amortization or depreciation, if any) -

An increase is a (use) of cash, a decrease is a source of cash

Adjust for depreciation and amortization expense as an additional (use) of cash

Adjust for gain or loss on sale of assets -

A gain is a source of cash

A loss is a (use) of cash

Overall total is capital expenditures net of dispositions

## Investing Cash Flow Example Depreciable Assets

Beginning and ending cost and accumulated depreciation amounts:

	Beginning	Ending
Depreciable assets - cost	\$1,000	\$ 1,000
Accumulated depreciation	<u>(600)</u>	<u>(700)</u>
Depreciable assets - book value	\$ 400	\$ 300

No purchases or sales of depreciable assets. Depreciation of \$100 was recorded during the year.

Calculating investing cash flow:

Decrease in depreciable assets book value	\$ 100
Depreciation expense	<u>(100)</u>
Capital expenditures, net	\$ 0



## Investing Cash Flow Example Depreciable Assets

Beginning and ending cost and accumulated depreciation amounts:

	Beginning	Ending
Depreciable assets - cost	\$1,000	\$ 1,400
Accumulated depreciation	<u>(600)</u>	<u>(800)</u>
Depreciable assets - book value	\$ 400	\$ 600

Depreciable assets were purchased during the year for \$400. Depreciation of \$200 was recorded during the year.

Calculating investing cash flow:

Increase in depreciable assets book value	\$ (200)
Depreciation expense	<u>(200)</u>
Capital expenditures, net	\$ (400)

## Investing Cash Flow Example Depreciable Assets

Beginning and ending cost and accumulated depreciation amounts:

	Beginning	Ending
Depreciable assets - cost	\$ 2,000	\$ 1,900
Accumulated depreciation	<u>(800)</u>	<u>(700)</u>
Depreciable assets - book value	\$ 1,200	\$ 1,200

Depreciable assets were purchased during the year for \$900. Depreciable assets with cost of \$1,000 and accumulated depreciation of \$300 were sold for \$600. A loss on sale of \$100 was recorded. Depreciation of \$200 was recorded during the year.

Calculating investing cash flow:

Increase in depreciable assets book value	\$ 0
Loss on sale	(100)
Depreciation expense	<u>(200)</u>
Capital expenditures, net	\$ (300)

Capital expenditures net consist of depreciable assets purchased for \$(900) and proceeds from sale of depreciation assets of \$600.

## Calculating Investing Cash Flow

For nondepreciable assets (investments in stocks and bonds)

Calculate the change in the investment balance during the year.

An increase is a (use) of cash, a decrease is a source of cash

Adjust for gain or loss on sale of assets

A gain is a source of cash

A loss is a (use) of cash

Overall total is net cash (used) provided by purchases or sales of investments

Calculating Investing Cash Flow  
Barton Industries, Inc. (cont'd)

Property and equipment, net↑	\$ (15,199)	
Gain on sale of equipment	4,000	
Depreciation	<u>(6,010)</u>	
Capital expenditures, net		\$(17,209)

There were no other investing activities.

## Calculating Financing Cash Flow

To calculate cash provided (used) by financing activities:

Calculate the change in debt principal

An increase is a source of cash, a decrease is a (use) of cash  
Adjust for Gain (Loss) on debt retirement

Calculate the change in all paid in capital accounts (excluding retained earnings)

An increase is a source of cash, a decrease is a (use) of cash

Calculate the change in retained earnings unexplained by net income

Beginning retained earnings  
+ Plus net income  
- Minus ending retained earnings  
= Dividends (change sign)

A decline in retained earnings unexplained by net income consists of a use of cash for dividends paid.

For Treasury Stock purchases:

An increase in treasury stock (becomes more negative) is a (use) of cash, as shares are repurchased.

A decrease in treasury stock (becomes less negative) is a source of cash, as shares previously repurchased are resold.

Calculating Financing Cash Flow  
Barton Industries, Inc. (cont'd)

Notes payable↓		\$ (2,595)
Current portion of long-term debt↓	\$ (3,242)	
Long-term debt↓	<u>(1,743)</u>	
Repayment of long-term debt		(4,985)
Common stock↑	\$ 3	
Additional paid-in capital	<u>432</u>	
Common stock financing		435
Dividends paid:		
Beginning R/E	\$ 44,668	
Plus net income	12,550	
Minus ending R/E	<u>-56,341</u>	
Dividends paid		(877)
Treasury stock↑		<u>(5,260)</u>
Financing cash flow		\$ (13,282)

Barton Industries, Inc.  
Overall Change in Cash

Operating cash flow	\$ 29,269
Investing cash flow	(17,209)
Financing cash flow	<u>(13,282)</u>
Change in cash	\$ (1,222)

Calculating Operating, Investing and Financing Cash Flow  
Forders, Inc.  
(all amounts in 000s)

Required: use the attached financial statements to calculate operating, investing and financing cash flow. All three should sum to the actual change in cash.

Special note:

Depreciation expense in the amount of \$7,519 is included in cost of goods sold.

Other current assets and current liabilities are operating-related. Other noncurrent liabilities are financing-related.

Calculations:

## Forders, Inc. (cont'd)

The income statement . . .

Year-ended March 31, Amounts in (000's)	2016	2015
Net Sales	\$ 316,494	\$ 231,572
Costs and expenses:		
Cost of sales	249,369	182,309
Selling, general and administrative	<u>29,472</u>	<u>25,358</u>
	<u>278,841</u>	<u>207,667</u>
Operating income	37,653	23,905
Loss on disposal of investment	(1,000)	
Interest expense	<u>(962)</u>	<u>(4,102)</u>
Income before income taxes	35,691	19,803
Income taxes	<u>6,187</u>	<u>594</u>
Income before cumulative effect of an accounting change	29,504	19,209
Cumulative effect of an accounting change	<u>-</u>	<u>1,780</u>
Net income	\$ <u><u>29,504</u></u>	\$ <u><u>20,989</u></u>



## Forders, Inc. (cont'd)

## The Balance Sheet . . .

	2016	2015	Inc (Dec)
Assets			
Current Assets:			
Cash and cash equivalents	\$ 57,707	\$ 34,869	22,838
Accounts receivable, net	8,847	12,840	(3,993)
Inventories	29,020	18,048	10,972
Deferred income taxes	2,954	-	2,954
Other current assets (operating)	<u>893</u>	<u>674</u>	219
Total current assets	99,421	66,431	
Net property and equipment	30,803	27,372	3,431
Deferred income taxes	1,277	-	1,277
Investments	<u>5,274</u>	<u>6,850</u>	<u>(1,576)</u>
	<u>\$ 136,775</u>	<u>\$ 100,653</u>	<u>36,122</u>
Liabilities and Shareholders' Equity			
Current liabilities:			
Current portion of long-term debt	\$ 590	\$ 616	(26)
Accounts payable	5,591	5,315	276
Income taxes payable	9,131	758	8,373
Accrued expenses	<u>27,986</u>	<u>21,369</u>	6,617
Total current liabilities	43,298	28,058	
Long-term debt	4,516	17,327	(12,811)
Deferred income taxes	-	1,175	(1,175)
Accrued warranty liability	3,962	2,852	1,110
Other long-term liabilities (financing)	2,457	1,924	533
Shareholders' equity:			
Common stock	34,100	32,535	1,565
Additional paid-in capital	43,687	41,715	1,972
Retained earnings (accumulated deficit)	4,740	(24,764)	29,504
Cumulative translation adjustment	<u>15</u>	<u>(169)</u>	184
Total shareholders' equity	<u>82,542</u>	<u>49,317</u>	
	<u>\$ 136,775</u>	<u>\$ 100,653</u>	<u>36,122</u>

Calculating Operating, Investing and Financing Cash Flow  
DHTK Corp.  
(all amounts in 000s)

Required: use the attached financial statements to calculate operating, investing and financing cash flow for 2016. All three should sum to the actual change in cash.

Special note:

No income statement is provided. Net income for 2016 was \$5,790. Deducted in arriving at this amount were depreciation of fixed assets for \$1,616 and amortization of intangibles for \$403. A gain on early retirement of debt for \$424 was included in net income.

Income tax provision is \$2,500.

Other noncurrent assets are investing-related.

Computations:

DHTK Corp.  
Balance Sheet  
(amounts in thousands)

	2016	2015	Inc. (Dec.)
Assets			
Current Assets:			
Cash and equivalents	\$ 26,671	\$ 22,289	4,382
Accounts receivable, net	6,825	7,245	(420)
Inventories	6,595	5,526	1,069
Deferred tax benefit	354	95	259
Prepaid expenses	<u>557</u>	<u>418</u>	139
Total current assets	41,002	35,573	
Fixed assets, net	4,254	4,731	(477)
Intangibles, net	2,458	2,861	(403)
Other assets (Investing)	<u>448</u>	<u>948</u>	<u>(500)</u>
	\$ <u>48,162</u>	\$ <u>44,113</u>	<u>4,049</u>
Liabilities and Shareholders' Equity			
Current liabilities:			
Accounts payable	\$ 2,819	\$ 3,425	(606)
Current portion of long term debt	786	1,168	(382)
Notes payable	--	742	(742)
Accrued payroll, payroll taxes and benefits	751	651	100
Accrued expenses	1,088	785	303
Income taxes payable	664	733	(69)
Accrued warranty	332	269	63
Deferred revenue	<u>16</u>	<u>121</u>	<u>(105)</u>
Total current liabilities	6,456	7,894	
Long term debt	1,572	2,519	(947)
Deferred tax liability	<u>232</u>	<u>169</u>	63
Total liabilities	8,260	10,582	
Shareholders' equity:			
Common stock	8,928	8,347	581
Retained earnings	<u>30,974</u>	<u>25,184</u>	<u>5,790</u>
Total shareholders' equity	<u>39,902</u>	<u>33,531</u>	
	\$ <u>48,162</u>	\$ <u>44,113</u>	<u>4,049</u>

## Worksheet for Indirect Method Cash Flow Statement

On the next page a worksheet is provided as an aid in preparing an indirect method cash flow statement.

Begin by entering net income.

Depreciation and amortization expense should be entered as a source in the operating section and a use in the investing section.

Gains on assets sales should be entered as a use in the operating section and a source in the investing section.

Losses on asset sales should be entered as a source in the operating section and a use in the investing section.

Gains on debt retirement should be entered as a use in the operating section and a source in the financing section.

Losses on debt retirement should be entered as a source in the operating section and a use in the financing section.

Complete the worksheet by entering all balance sheet changes in proper sections, operating, investing or financing.

Pay attention to whether other assets and liabilities are operating, investing or financing-related.

## Worksheet for Indirect Method Cash Flow Statement

Company: \_\_\_\_\_

Year: \_\_\_\_\_

Operating cash flow:

Net income

(Gain) loss on disposal of PP&amp;E

(Gain) loss on disposal of investments

Depreciation expense

Amortization expense

Changes in operating-related assets:

Decrease (increase) receivables

Decrease (increase) inventory

Decrease (increase) prepaids

Decrease (increase) in tax refund receivable

Decrease (increase) in deferred tax assets

Decrease (increase) in other oper. current assets

Decrease (increase) in other oper. noncurrent assets

Changes in operating-related liabilities:

Increase (decrease) accounts payable

Increase (decrease) accruals

Increase (decrease) deferred revenue

Increase (decrease) in taxes payable

Increase (decrease) in deferred tax liabilities

Increase (decrease) in other oper. current liab.

Increase (decrease) in other oper. noncurrent liab.

Increase (decrease) in accrued interest payable

Subtotal: Changes in operating assets &amp; liabilities

Operating cash flow

## Worksheet for Indirect Method Cash Flow Statement (cont'd)

Company: \_\_\_\_\_

Operating cash flow \_\_\_\_\_

Investing cash flow:

Decrease (increase) in PP&amp;E, net \_\_\_\_\_

Depreciation and amortization (expense) \_\_\_\_\_

Gain (loss) on sale of PP&amp;E \_\_\_\_\_

Capital expenditures \_\_\_\_\_

Decrease (increase) in investments \_\_\_\_\_

Gain (loss) on sale of investments \_\_\_\_\_

Equity method income (loss) \_\_\_\_\_

(Purchase) sale of investments \_\_\_\_\_

Decrease (increase) in goodwill &amp; intangibles \_\_\_\_\_

Amortization (expense) and impairment (charge) \_\_\_\_\_

(Purchase) sale of intangibles \_\_\_\_\_

Decrease (increase) in other assets \_\_\_\_\_

Gain (loss) on sale of other non-operating assets \_\_\_\_\_

(Purchase) sale of other non-operating assets \_\_\_\_\_

Investing cash flow \_\_\_\_\_

Financing cash flow:

Increase (decrease) in short-term debt \_\_\_\_\_

Increase (decrease) in long-term debt \_\_\_\_\_

Gain (loss) on debt retirement \_\_\_\_\_

Net long-term debt financing (retirement) \_\_\_\_\_

Increase (decrease) in equity \_\_\_\_\_

(Beg.) R/E \_\_\_\_\_

Net (income) loss \_\_\_\_\_

End R/E \_\_\_\_\_

Dividends declared \_\_\_\_\_

Increase (decrease) in Dividends Payable \_\_\_\_\_

Dividends (paid) \_\_\_\_\_

Increase (decrease) other non-operating liabilities \_\_\_\_\_

Other unexplained increase (decrease) in R/E \_\_\_\_\_

Financing cash flow \_\_\_\_\_

Change in cash \_\_\_\_\_

Preparing an Indirect-Method Format Cash Flow Statement  
Jewel's Jewelers, Inc.

Income statement and balance sheet data for Jewel's Jewelers, Inc. are provided below. Use the blank worksheet provided to prepare a cash flow statement in the indirect format for the year ended January 31, 2016.

For the year ended January 31, 2016 the provision for depreciation and amortization of property and equipment amounted to \$1,634 (in 000s).

Other noncurrent assets are investing related.

Other current liabilities are operating related. Other noncurrent liabilities are financing related.

Amounts in (000's)

Year-ended January 31, Amounts in (000's)	2016	2015
Sales	\$ 290,344	\$ 230,488
Cost of sales	<u>145,833</u>	<u>118,348</u>
Gross profit	144,511	112,140
Selling, general and administrative expense	<u>100,318</u>	<u>78,449</u>
Operating income (loss)	44,193	33,691
Other income (expense):		
Interest (expense)	(826)	(2,174)
Other (expense)	<u>(335)</u>	<u>(323)</u>
Income (loss) before income taxes	43,032	31,194
Provision for income taxes	<u>18,131</u>	<u>14,374</u>
Income before extraordinary items	24,901	16,820
Extraordinary items	<u>-</u>	<u>(644)</u>
Net income (loss)	\$ <u>24,901</u>	\$ <u>16,176</u>

## Jewel's Jewelers, Inc. (cont'd)

	Jan. 31, 2016	Jan. 31, 2015	Inc. (Dec.)
Assets			
Current Assets:			
Cash and equivalents	\$ 1,599	\$ 12,861	(11,262)
Accounts receivable, net	25,525	25,710	(185)
Inventories	103,771	70,778	32,993
Prepaid expenses	<u>6,544</u>	<u>4,589</u>	1,955
Total current assets	137,439	113,938	
Property and equipment, net	22,437	12,086	10,351
Other assets (Investing)	<u>2,772</u>	<u>645</u>	<u>2,127</u>
	<u>\$ 162,648</u>	<u>\$ 126,669</u>	<u>35,979</u>
Liabilities and Shareholders' Equity			
Current liabilities:			
Short-term borrowings	\$ 7,253	\$ -	7,253
Accounts payable	23,645	20,895	2,750
Accrued liabilities	11,853	9,126	2,727
Merchandise and other customer credits	6,525	5,276	1,249
Income taxes payable	3,995	9,913	(5,918)
Other current liabilities (Operating)	<u>2,339</u>	<u>1,956</u>	383
Total current liabilities	55,610	47,166	
Other long-term liabilities (Financing)	1,647	1,807	(160)
Deferred income taxes	6,198	6,075	123
Shareholders' equity:			
Common stock	102	86	16
Additional paid-in capital	54,573	50,096	4,477
Retained earnings	45,047	21,530	23,517
Foreign currency translation adjustment	(438)		(438)
Treasury stock	<u>(91)</u>	<u>(91)</u>	<u>0</u>
Total shareholders' equity	<u>99,193</u>	<u>71,621</u>	<u>27,572</u>
	<u>\$ 162,648</u>	<u>\$ 126,669</u>	<u>35,979</u>



## Worksheet for Indirect Method Cash Flow Statement

Company: \_\_\_\_\_

Year: \_\_\_\_\_

## Operating cash flow:

Net income \_\_\_\_\_

(Gain) loss on disposal of PP&amp;E \_\_\_\_\_

(Gain) loss on disposal of investments \_\_\_\_\_

Depreciation expense \_\_\_\_\_

Amortization expense \_\_\_\_\_

## Changes in operating-related assets:

Decrease (increase) receivables \_\_\_\_\_

Decrease (increase) inventory \_\_\_\_\_

Decrease (increase) prepaids \_\_\_\_\_

Decrease (increase) in tax refund receivable \_\_\_\_\_

Decrease (increase) in deferred tax assets \_\_\_\_\_

Decrease (increase) in other oper. current assets \_\_\_\_\_

Decrease (increase) in other oper. noncurrent assets \_\_\_\_\_

## Changes in operating-related liabilities:

Increase (decrease) accounts payable \_\_\_\_\_

Increase (decrease) accruals \_\_\_\_\_

Increase (decrease) deferred revenue \_\_\_\_\_

Increase (decrease) in taxes payable \_\_\_\_\_

Increase (decrease) in deferred tax liabilities \_\_\_\_\_

Increase (decrease) in other oper. current liab. \_\_\_\_\_

Increase (decrease) in other oper. noncurrent liab. \_\_\_\_\_

Increase (decrease) in accrued interest payable \_\_\_\_\_

Subtotal: Changes in operating assets &amp; liabilities \_\_\_\_\_

Operating cash flow \_\_\_\_\_

## Worksheet for Indirect Method Cash Flow Statement (cont'd)

Company: \_\_\_\_\_

Operating cash flow \_\_\_\_\_

Investing cash flow:

Decrease (increase) in PP&amp;E, net \_\_\_\_\_

Depreciation and amortization (expense) \_\_\_\_\_

Gain (loss) on sale of PP&amp;E \_\_\_\_\_

Capital expenditures \_\_\_\_\_

Decrease (increase) in investments \_\_\_\_\_

Gain (loss) on sale of investments \_\_\_\_\_

Equity method income (loss) \_\_\_\_\_

(Purchase) sale of investments \_\_\_\_\_

Decrease (increase) in goodwill &amp; intangibles \_\_\_\_\_

Amortization (expense) and impairment (charge) \_\_\_\_\_

(Purchase) sale of intangibles \_\_\_\_\_

Decrease (increase) in other assets \_\_\_\_\_

Gain (loss) on sale of other non-operating assets \_\_\_\_\_

(Purchase) sale of other non-operating assets \_\_\_\_\_

Investing cash flow \_\_\_\_\_

Financing cash flow:

Increase (decrease) in short-term debt \_\_\_\_\_

Increase (decrease) in long-term debt \_\_\_\_\_

Gain (loss) on debt retirement \_\_\_\_\_

Net long-term debt financing (retirement) \_\_\_\_\_

Increase (decrease) in equity \_\_\_\_\_

(Beg.) R/E \_\_\_\_\_

Net (income) loss \_\_\_\_\_

End R/E \_\_\_\_\_

Dividends declared \_\_\_\_\_

Increase (decrease) in Dividends Payable \_\_\_\_\_

Dividends (paid) \_\_\_\_\_

Increase (decrease) other non-operating liabilities \_\_\_\_\_

Other unexplained increase (decrease) in R/E \_\_\_\_\_

Financing cash flow \_\_\_\_\_

Change in cash \_\_\_\_\_

## **The Earnings Quality Indicator (EQI)**

Because earnings altered through creative accounting practices do not change operating cash flow, the relationship between earnings and cash flow can be used to detect creative accounting practices.

In particular, a ratio of adjusted cash flow from operations less adjusted income from continuing operations, all divided by revenue, or the Earnings Quality Indicator, (EQI), is sensitive to earnings changes that are not cash flow backed.

$$\text{EQI} = (\text{CF} - \text{Income}) / \text{Revenue},$$

Where,

CF = adjusted cash flow from operations

Income = adjusted income from continuing operations

We speak here of adjusted cash flow from operations. This cash flow measure consists of cash provided by operations adjusted for nonrecurring and nonoperating cash flow items.

Income from continuing operations should also be adjusted for obvious, material nonrecurring items of income or expense.

The objective here is to surface income items that are not so obvious.

## Using EQI

Once adjusted cash flow and income have been calculated, the EQI ratio can be computed.

Declines in the EQI ratio will be an indication that earnings are growing faster than operating cash flow.

Closer examination should be made to determine why that is the case.

It is possible that creative accounting steps are being taken to boost earnings temporarily.

A sudden increase in the ratio, caused by an increase in operating cash flow in excess of an increase in earnings, while of less concern, should also be examined.

Such a development may be the result of a concerted effort to manage earnings downward in an effort to store them for future periods.

### Using the EQI Ratio (cont'd)

Operating cash flow is inherently more volatile than operating earnings. Accordingly, it should be expected that the adjusted cash flow-to-income ratio will vary around its general trend.

To discern broad movements, it may be necessary to compare the ratio for a current period with the mean or average ratio calculated over two or three previous periods.

The number of periods used depends on the volatility of the company's operating earnings and cash flow and the number of periods of data available.

## Understanding EQI

EQI is a measure of what can be termed "excess cash margin."

It is calculated as net cash margin (operating cash flow / revenue) less net earnings margin (earnings / revenue).

Thus, it is the excess of net cash margin over net earnings margin.

It is when the relationship of the two – net cash margin and net earnings margin – change that one must look more closely to determine why.

## Stable EQI Microsoft Corp.

Microsoft Corp., Operating Cash Flow, Revenue, Operating Earnings, and  
Calculation of EQI, Years Ending December 31, 2011 – 2015 (millions of dollars)

	2011	2012	2013	2014	2015
--	------	------	------	------	------

Obtained from statement of cash flows:

Reported operating cash flow <sup>a</sup>	\$ 26,994	\$31,626	\$28,833	\$32,231	\$29,080
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Obtained from income statement:

Revenue	\$69,983	\$73,723	\$77,849	\$86,833	\$93,580
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Obtained from income statement:

Reported operating earnings <sup>b</sup>	\$23,150	\$21,699	\$21,863	\$22,074	\$18,789
--	----------	----------	----------	----------	----------

EQI:	5.5%	13.5%	9.0%	11.7%	11.0%
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<sup>a</sup>No significant adjustments were noted.

<sup>b</sup>Adjusted in 2012 for \$4,721 tax-effected goodwill impairment charge, 2015 for \$6,596 tax-effected restructuring impairment and restructuring charge.

Strong Cash Generation  
Stable EQI  
Apple, Inc.

Apple, Inc., Operating Cash Flow, Revenue, Operating Earnings, and Calculation of EQI, Years Ending 2011 - 2015 (millions of dollars)

	2011	2012	2013	2014	2015
Obtained from statement of cash flows:					
Operating cash flow <sup>a</sup>	\$ 37,529	\$50,856	\$53,666	\$59,713	\$81,266
Obtained from income statement:					
Revenue (REV)	\$108,249	\$156,508	\$170,910	\$182,795	\$233,715
Obtained from income statement:					
Operating earnings (OE) <sup>b</sup> :					
	\$ 25,922	\$41,733	\$37,037	\$39,510	\$53,394
EQI:	12.2%	5.8%	9.7%	11.1%	11.9%

<sup>a</sup>No significant adjustments noted.

<sup>b</sup>No significant adjustments noted.

Operating cash flow growth matches growth in revenue and net income. EQI remains relatively stable, though rising and falling with no discernible pattern.



## Declining EQI and a Closer Look Target Corp.

Target Corp., Operating Cash Flow, Revenue, Operating Earnings, and EQI, Years Ending February 2001 - February 2007  
(millions of dollars)

	2001	2002	2003	2004	2005	2006	2007
Obtained from statement of cash flows:							
Adjusted operating cash flow <sup>a</sup>	\$2,134	\$2,012	\$1,590	\$3,160	\$3,808	\$4,451	\$4,862
(Increase) in accounts receivable	--	(1,193)	(2,194)	(744)	(209)	(244)	(226)
Obtained from income statement:							
Revenue	36,851	39,826	43,917	46,781	46,839	52,620	59,490
Obtained from income statement:							
Adjusted operating earnings <sup>a</sup>	\$1,264	\$1,368	\$1,654	\$1,841	\$1,885	\$2,408	\$2,787
EQI:	2.36%	1.62%	-.15%	2.82%	4.11%	3.88%	3.49%

<sup>a</sup>No significant adjustments were noted.

<sup>b</sup>Increase in company's credit card receivables was biggest factor explaining year-to-year changes in operating cash flow.

Note that EQI was 2.36% in the year ended February 3, 2001, which was the year before it introduced its own credit card. During the year in which its card was introduced, the year ended February 2, 2002, accounts receivable increased \$1,193 million, creating a drag on operating cash flow. As a result, as earnings increased to \$1,368 million that year from \$1,264 million in 2001, operating cash flow declined to \$2,012 million from \$2,134 million in 2001. EQI declined to 1.62% in 2002 from 2.36% in 2001.

During the year ended February 1, 2003, accounts receivable increased another \$2,194 million. That year, operating cash flow declined even more and EQI became negative, dropping to -.15%. Clearly the trend was not a promising one.

The increase in credit card receivables slowed to \$744 million in the year ended January 31, 2004. As a result, that year the company generated significantly more operating cash flow, \$3,160 million, than it had in any recent reporting period. EQI also improved to 2.82%, higher than it was in the year ended February 3, 2001, before the company introduced its own credit card.

In subsequent years, the significant increases in receivables noted earlier did not continue and EQI stabilized at higher levels – to-date, problems have been averted.

EQI Steadies  
Target Corp. (cont'd)

Target Corp., Operating Cash Flow, Revenue, Operating Earnings, and  
Calculation of EQI, Years Ending January 2013 – 2015 (millions of dollars)

	2013	2014	2015
Obtained from statement of cash flows:			
Operating cash flow <sup>a</sup>	\$5,568	\$7,519	\$5,131
Obtained from income statement:			
Revenue (REV)	\$71,960	\$71,279	\$72,618
Obtained from income statement:			
Operating earnings (OE) <sup>b</sup> :			
	\$3,315	\$2,694	\$2,449
EQI:	3.1%	6.8%	3.7%

<sup>a</sup>No significant adjustments noted.

<sup>b</sup>No significant adjustments noted.

## EQI Surfaces Problems

### Krispy Kreme Doughnuts, Inc.

Operating Cash Flow, Revenue, Income from Continuing Operations and EQI:  
Krispy Kreme Doughnuts, Inc., Years Ending February 1, 2001, 2002, 2003, and  
2004 (thousands of dollars)

	2001	2002	2003	2004
Obtained from statement of cash flows:				
Reported cash flow provided				
by continuing operations	\$ 32,112	\$ 36,210	\$ 51,036	\$ 95,553
Adjustments:				
Tax benefit from stock options	(595)	(9,772)	(13,795)	(42,806)
Adjusted cash flow provided by				
Operations	31,517	26,438	37,241	52,747
Obtained from income statement:				
Revenue	300,715	394,354	491,549	665,592
Reported income from				
Continuing operations	\$14,725	\$26,378	\$33,478	\$57,087
Adjustment:				
Arbitration award after tax			5,445	(315)
Adjusted income from contin. Ops	\$14,725	\$26,378	\$38,923	\$56,772
EQI	5.6%	.02%	-.3%	-.6%

For Krispy Kreme, the year ended February 1, 2004 was the last one before an internal investigation and an SEC inquiry were begun into how transactions with affiliates were handled.

While operating cash flow didn't turn negative, it is clear from the above presentation that operating cash flow was not growing as fast as income from continuing operations.

The balance sheet showed a build up of accounts receivable and notes receivable from affiliates.

## EQI Surfaces Problems (cont'd)

### Xerox Corp.

Operating Cash Flow, Operating Income, and Calculation of EQI: Xerox Corp., Years Ending December 31, 1994, 1995, 1996, 1997, 1998, and 1999 (thousands of dollars)

	1994	1995	1996	1997	1998	1999
Obtained from statement of cash flows:						
Reported cash flow provided						
by continuing operations	\$ 479	\$ 599	\$ 324	\$ 472	(\$1,165)	\$1,224
Adjustments:						
Cash payments related to restructuring						
- net of tax <sup>a</sup>	254	199	118		199	262
	(423 x .6)	(331 x .6)	(197 x .6)		(332 x .6)	(437 x .6)
Proceeds from securitization of finance receivables <sup>b</sup>						(1,495)
Adjusted cash flow provided (used)						
by continuing operations	<u>\$ 733</u>	<u>\$ 798</u>	<u>\$ 442</u>	<u>\$ 472</u>	<u>(\$ 966)</u>	<u>(\$ 9)</u>
Obtained from income statement:						
Revenue	15,084	16,588	17,378	18,144	19,447	19,228
Reported income from						
Continuing operations	\$ 794	\$1,174	\$1,206	\$1,452	\$585	\$1,424
Adjustments:						
Restructuring charge and asset impairment						
- net of tax <sup>a</sup>					919	
					(1,531 x .6)	
Inventory charge - net of tax <sup>a</sup>					68	
					(113 x .6)	
Gain on affiliate sales of stock						
- net of tax <sup>a</sup>				(7)		
			(11 x .6)			
Adjusted income from continuing operations	<u>\$ 794</u>	<u>\$1,174</u>	<u>\$1,199</u>	<u>\$1,452</u>	<u>\$1,572</u>	<u>\$1,424</u>
EQI:	-.4%	-2.3%	-4.4%	-5.4%	-13.1%	-7.5%

## Xerox Corp.

Xerox Corp. has been singled out by the SEC for premature revenue recognition.

Before filing its financial statements with the Commission for the year ended December 31, 2000, the Company was forced to restate results for 1998 and 1999.

Xerox conceded that, ". . . it had 'misapplied' a range of accepted accounting rules, including some related to its huge copier-leasing business."

Evidence of creative accounting practices is evident from the deteriorating EQI seen for the Company.

## EQI Surfaces Problems (Cont'd)

### Enron Corp.

Operating Cash Flow, Operating Income, and Calculation of EQI: Enron Corp., Years Ending December 31, 1996, 1997, 1998, 1999, 2000, and 1st 6 months of 2001 (millions of dollars)

	1996	1997	1998	1999	2000 6Mo	2001
Obtained from statement of cash flows:						
Reported cash flow provided						
by continuing operations	\$ 884	\$ 211	\$ 1,640	\$ 1,228	\$ 4,779	(\$1,337)
Adjustments:						
Increase in customer deposits					(1,881)	
Increase in A/P days					(4,365)	
Unexplained "other"					(1,113)	
Net (proceeds) from sale, cost						
to purchase investments	<u>192</u>	<u>(31)</u>	<u>(713)</u>	<u>(1,390)</u>	<u>(543)</u>	<u>(304)</u>
Adjusted cash flow provided (used)						
by continuing operations	<u>\$ 1,076</u>	<u>\$ 180</u>	<u>\$ 927</u>	<u>(\$ 162)</u>	<u>\$(3,123)</u>	<u>(\$1,641)</u>
Obtained from income statement:						
Revenue	\$13,289	\$20,273	\$31,260	\$40,112	\$100,789	\$100,189
Reported income from						
Continuing operations	\$584	\$105	\$703	\$1,024	\$979	\$810
Adjustments:						
Contract restructure charge*		<u>405</u>				
Impairment of assets*			<u>196</u>	<u>265</u>		--
Adjusted income from						
continuing operations	<u>\$584</u>	<u>\$510</u>	<u>\$899</u>	<u>\$1,289</u>	<u>\$979</u>	<u>\$810</u>
*After tax.						
EQI:	3.7%	-1.63%	.09%	-3.62%	-4.07%	-2.5%

Aggressive income reporting by Enron resulting in a continuing decline in the EQI.

## EQI Surfaces Problems (Cont'd)

### Beazer Homes USA, Inc.

Beazer Homes USA, Inc., Operating Cash Flow, Revenue, Operating Earnings,  
and Calculation of EQI, Years Ending Sept. 2002 – 2006.  
(millions of dollars)

	2002	2003	2004	2005	2006
Obtained from statement of cash flows:					
<u>Adjusted operating cash flow<sup>a</sup></u>	<u>59.5</u>	<u>(41.0)</u>	<u>(73.7)</u>	<u>(84.3)</u>	<u>(304.5)</u>
Obtained from income statement:					
<u>Revenue (REV)</u>	<u>2,641</u>	<u>3,117</u>	<u>3,907</u>	<u>4,995</u>	<u>5,462</u>
Obtained from income statement:					
<u>Adjusted operating earnings (OE)<sup>b</sup></u>	<u>122.6</u>	<u>302.7</u>	<u>236</u>	<u>392.7</u>	<u>388.8</u>
EQI:	-2.39%	-11.03%	-7.93%	-9.55%	-12.69%
Stock price	20	20	35	35 80	40...low of <5

<sup>a</sup>Adjustments for tax benefits from stock options were immaterial.

<sup>b</sup>2003 adjusted for goodwill impairment of \$130.

Have New Problems Developed for Home Builders?  
 Beazer Homes USA, Inc. (cont'd)

Beazer Homes USA, Inc., Operating Cash Flow, Revenue, Operating Earnings,  
 and Calculation of EQI, Years Ending Sept. 2013 – 2015 (millions of dollars)

	2013	2014	2015
Obtained from statement of cash flows:			
Operating cash flow <sup>a</sup>	\$-174.6	\$-160.5	\$-81.0
Obtained from income statement:			
Revenue (REV)	\$1,288	\$1,464	\$1,627
Obtained from income statement:			
Operating earnings (OE) <sup>b</sup> :			
	\$-32.1	\$34.9	\$346.6
EQI:	-11.1%	-13.4%	-26.3%

<sup>a</sup>No significant adjustments noted.

<sup>b</sup>No significant adjustments noted.



# Where's the Cash Flow?

## EQI at Decker's Turns Negative

### Stock Price Suffers

Operating Cash Flow, Operating Income, and Calculation of EQI: Decker's, Inc.,  
Years Ending December 31, 2007, 2008, 2009, 2010, and 2011\_  
(millions of dollars)

	2007	2008	2009	2010	2011
Obtained from statement of cash flows:					
Reported cash flow provided					
by continuing operations	\$ 61	\$ 53	\$185	\$140	\$ 30
Obtained from income statement:					
Revenue	\$449	\$689	\$813	\$1,001	\$1,377
Reported income from					
Continuing operations	\$66	\$74	\$117	\$158	\$199
EQI:	-1.11%	-3.05%	8.36%	-1.80%	-12.27%

Within 30 days of the company's release of its 2011 results the company's stock price declined by 33%.



Forders, Inc.  
Solution Note

**Operating cash flow:**

Net income		\$ 29,504
Loss on disposal of investment		1,000
Depreciation expense		7,519
Accounts receivable↓		3,993
Inventories↑		(10,972)
Current deferred income tax assets↑		(2,954)
Other current assets↑		(219)
Noncurrent deferred income tax assets↑		(1,277)
Accounts payable↑		276
Income taxes payable↑		8,373
Accrued expenses payable↑		6,617
Noncurrent deferred income tax liabilities↓		(1,175)
Accrued warranty liability↑		<u>1,110</u>
<b>Operating cash flow</b>		<b><u>41,795</u></b>

**Investing cash flow:**

Net property and equipment↑	\$ (3,431)	
Depreciation expense	<u>(7,519)</u>	
Net capital expenditures		(10,950)
Investments↓	1,576	
Loss on sale	<u>(1,000)</u>	
Proceeds from sale of investments		<u>576</u>
<b>Investing cash flow</b>		<b><u>(10,374)</u></b>

**Financing cash flow:**

Current portion of long-term debt↓	\$ (26)	
Long-term debt↓	<u>(12,811)</u>	
Repayment of long-term debt		\$ (12,837)
Other long-term liabilities↑		533
Common stock↑	1,565	
Additional paid-in capital↑	<u>1,972</u>	
Common stock financing		3,537
Dividends paid:		
Beginning (deficit)	(24,764)	
Plus net income	29,504	
Less ending retained earnings	<u>- 4,740</u>	
Dividends paid		0
Cumulative translation adjustment		<u>184</u>
<b>Financing cash flow</b>		<b><u>(8,583)</u></b>

Change in cash \$ 22,838

## Solution: Cash Flow Exercise

## DHTK Corp.

Net income	\$ 5,790
Depreciation	1,616
Amortization	403
Gain on debt retirement	(424)
Dec. in accounts receivable	420
Inc. in inventory	(1,069)
Inc. in deferred tax benefit	(259)
Inc. in prepaid expenses	(139)
Dec. in accounts payable	(606)
Inc. in accrued payroll, payroll taxes and benefits	100
Inc. in accrued expenses	303
Dec. in income taxes payable	(69)
Inc. in accrued warranty	63
Dec. in deferred revenue	(105)
Inc. in deferred tax liability	<u>63</u>
Cash provided by operating activities	\$ 6,087

## Investing activities:

Decrease in fixed asset, net	\$ 477
Depreciation	(1,616)
Decrease in intangibles, net	403
Amortization	(403)
Decrease in other assets	<u>500</u>
Cash (Used) in Investing Activities	(639)

## Financing activities:

Decrease in current portion of long-term debt	(382)
Decrease in notes payable	(742)
Gain on debt retirement	424
Decrease in long-term debt	(947)
Increase in common stock	581
Dividends paid	
(Increase in retained earnings of \$5,790 equals net income)	<u>0</u>
Cash (Used) in Financing Activities	<u>(1,066)</u>
Increase in cash	\$ 4,382

## Jewel's Jeweler's Indirect Cash Flow Solution

### Operating cash flow:

Net income		24,901
Depreciation expense		1,634
Changes in operating-related assets:		
Decrease (increase) receivables	185	
Decrease (increase) inventory	(32,993)	
Decrease (increase) prepaids	(1,955)	
Changes in operating-related liabilities:		
Increase (decrease) accounts payable	2,750	
Increase (decrease) accruals	3,110	
Increase (decrease) deferred revenue	1,249	
Increase (decrease) in taxes payable	(5,918)	
Increase (decrease) in deferred tax liabilities	123	
Subtotal: Changes in operating assets & liabilities		<u>(33,449)</u>
<b>Operating cash flow</b>		<b>(6,914)</b>

### Investing cash flow:

Decrease (increase) in PP&E, net	(10,351)	
Depreciation and amortization (expense)	(1,634)	
Capital expenditures		(11,985)
Decrease (increase) in investments		<u>(2,127)</u>
<b>Investing cash flow</b>		<b>(14,112)</b>

### Financing cash flow:

Increase (decrease) in short-term debt		7,253
Increase (decrease) in long-term debt		(160)
Increase (decrease) in common stock & APIC		4,493
Other comprehensive income		(438)
Beg. R/E	21,530	
Net (income) loss	+24,901	
End R/E	<u>-45,047</u>	
Dividends declared		<u>(1,384)</u>
Financing cash flow		9,764
<b>Change in cash</b>		<b>(11,262)</b>

