Statement of Financial Accounting Standards No. 95

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Statement of Cash Flows

November 1987

Financial Accounting Standards Board
of the Financial Accounting Foundation
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Paragraph Numbers

FAS 95: Statement of Cash Flows

FAS 95 Summary

This Statement establishes standards for cash flow reporting. It supersedes APB Opinion No. 19, *Reporting Changes in Financial Position*, and requires a statement of cash flows as part of a full set of financial statements for all business enterprises in place of a statement of changes in financial position.

This Statement requires that a statement of cash flows classify cash receipts and payments according to whether they stem from operating, investing, or financing activities and provides definitions of each category.

This Statement encourages enterprises to report cash flows from operating activities directly by showing major classes of operating cash receipts and payments (the direct method). Enterprises that choose not to show operating cash receipts and payments are required to report the same amount of net cash flow from operating activities indirectly by adjusting net income to reconcile it to net cash flow from operating activities (the indirect or reconciliation method) by removing the effects of (a) all deferrals of past operating cash receipts and payments and all accruals of expected future operating cash receipts and payments and (b) all items that are included in net income that do not affect operating cash receipts and payments. If the direct method is used, a reconciliation of net income and net cash flow from operating activities is required to be provided in a separate schedule.

This Statement requires that a statement of cash flows report the reporting currency equivalent of foreign currency cash flows, using the current exchange rate at the time of the cash flows. The effect of exchange rate changes on cash held in foreign currencies is reported as a separate item in the reconciliation of beginning and ending balances of cash and cash equivalents.

This Statement requires that information about investing and financing activities not resulting in cash receipts or payments in the period be provided separately.

This Statement is effective for annual financial statements for fiscal years ending after July 15, 1988. Restatement of financial statements for earlier years provided for comparative purposes is encouraged but not required.

INTRODUCTION

1. This Statement establishes standards for providing a statement of cash flows in general-purpose financial statements. This Statement supersedes APB Opinion No. 19, *Reporting Changes in Financial Position*, and requires a business enterprise to provide a statement of cash flows in place of a statement of changes in financial position. It also requires that specified information about noncash investing and financing transactions and other events be provided separately.

2. Opinion 19 permitted but did not require enterprises to report cash flow information in the statement of changes in financial position. Since that Opinion was issued, the significance of information about an enterprise's cash flows has increasingly been recognized. In FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, paragraph 13, the Board says, "A full set of financial statements for a period should show: . . . Cash flows during the period." Moreover, certain problems have been identified in current practice, including the ambiguity of terms such as *funds*, lack of comparability arising from diversity in the focus of the statement (cash, cash and short-term investments, quick assets, or working capital) and the resulting differences in definitions of funds flows from operating activities (cash or working capital), differences in the format of the statement (sources and uses format or activity format), variations in classifications of specific items in an activity format, and the reporting of net changes in amounts of assets and liabilities rather than gross inflows and outflows. The lack of clear objectives for the statement of changes in financial position has been suggested as a major cause of that diversity.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Scope

3. A business enterprise that provides a set of financial statements that reports both financial position and results of operations shall also provide a statement of cash flows for each period for which results of operations are provided. This Statement supersedes or amends the accounting pronouncements listed in Appendix D.

Purpose of a Statement of Cash Flows

4. The primary purpose of a statement of cash flows is to provide relevant information about the cash receipts and cash payments of an enterprise during a period.

5. The information provided in a statement of cash flows, if used with related disclosures and information in the other financial statements, should help investors, creditors, and others to (a)assess the enterprise's ability to generate positive future net cash flows; (b) assess the enterprise's ability to meet its obligations, its ability to pay dividends, and its needs for external financing; (c) assess the reasons for differences between net income and associated cash receipts and payments; and (d) assess the effects on an enterprise's financial position of both its cash and noncash investing and financing transactions during the period.

6. To achieve its purpose of providing information to help investors, creditors, and others in making those assessments, a statement of cash flows should report the cash effects during a period of an enterprise's operations, its investing transactions, and its financing transactions. Related disclosures should report the effects of investing and financing transactions that affect an enterprise's financial position but do not directly affect cash flows during the period. A reconciliation of net income and net cash flow from operating activities, which generally provides information about the net effects of operating transactions and other events that affect net income and operating cash flows in different periods, also should be provided.

Focus on Cash and Cash Equivalents

7. A statement of cash flows shall explain the change during the period in cash [1] and cash equivalents. The statement shall use descriptive terms such as *cash* or *cash and cash equivalents* rather than ambiguous terms such as *funds*. The total amounts of cash and cash equivalents at the beginning and end of the period shown in the statement of cash flows shall be the same amounts as similarly titled line items or subtotals shown in the statements of financial position as of those dates.

8. For purposes of this Statement, cash equivalents are short-term, highly liquid investments that are both:

a. Readily convertible to known amounts of cash
b. So near their maturity that they present insignificant risk of changes in value because of changes in interest rates.

Generally, only investments with original maturities [2] of three months or less qualify under that definition.

9. Examples of items commonly considered to be cash equivalents are Treasury bills, commercial paper, money market funds, and federal funds sold (for an enterprise with banking operations). Cash purchases and sales of those investments generally are part of the enterprise's cash management activities rather than part of its operating, investing, and financing activities, and details of those transactions need not be reported in a statement of cash flows.

10. Not all investments that qualify are required to be treated as cash equivalents. An

enterprise shall establish a policy concerning which short-term, highly liquid investments that satisfy the definition in paragraph 8 are treated as cash equivalents. For example, an enterprise having banking operations might decide that all investments that qualify except for those purchased for its trading account will be treated as cash equivalents, while an enterprise whose operations consist largely of investing in short-term, highly liquid investments might decide that all those items will be treated as investments rather than cash equivalents. An enterprise shall disclose its policy for determining which items are treated as cash equivalents. Any change to that policy is a change in accounting principle that shall be effected by restating financial statements for earlier years presented for comparative purposes.

Gross and Net Cash Flows

11. Generally, information about the gross amounts of cash receipts and cash payments during a period is more relevant than information about the net amounts of cash receipts and payments. However, the net amount of related receipts and payments provides sufficient information not only for cash equivalents, as noted in paragraph 9, but also for certain other classes of cash flows specified in paragraphs 12, 13, and 28.

12. For certain items, the turnover is quick, the amounts are large, and the maturities are short. For certain other items, such as demand deposits of a bank and customer accounts payable of a broker-dealer, the enterprise is substantively holding or disbursing cash on behalf of its customers. Only the net changes during the period in assets and liabilities with those characteristics need be reported because knowledge of the gross cash receipts and payments related to them may not be necessary to understand the enterprise's operating, investing, and financing activities.

13. Items that qualify for net reporting because their turnover is quick, their amounts are large, and their maturities are short are cash receipts and payments pertaining to (a) investments (other than cash equivalents), (b) loans receivable, and (c) debt, providing that the original maturity of the asset or liability is three months or less.[3]

Classification of Cash Receipts and Cash Payments

14. A statement of cash flows shall classify cash receipts and cash payments as resulting from investing, financing, or operating activities.[4]

Cash Flows from Investing Activities

15. Investing activities include making and collecting loans and acquiring and disposing of debt or equity instruments and property, plant, and equipment and other productive assets, that is, assets held for or used in the production of goods or services by the enterprise (other than materials that are part of the enterprise's inventory).

16. Cash inflows from investing activities are: [5]

a. Receipts from collections or sales of loans made by the enterprise and of other entities' debt instruments (other than cash equivalents) that were purchased by the enterprise
b. Receipts from sales of equity instruments of other enterprises and from returns of investment in those instruments
c. Receipts from sales of property, plant, and equipment and other productive assets.

17. Cash outflows for investing activities are:

a. Disbursements for loans made by the enterprise and payments to acquire debt instruments of other entities (other than cash equivalents)
b. Payments to acquire equity instruments of other enterprises
c. Payments at the time of purchase or soon before or after purchase [6] to acquire property, plant, and equipment and other productive assets.[7]

Cash Flows from Financing Activities

18. Financing activities include obtaining resources from owners and providing them with a return on, and a return of, their investment; borrowing money and repaying amounts borrowed, or otherwise settling the obligation; and obtaining and paying for other resources obtained from creditors on long-term credit.

19. Cash inflows from financing activities are:

a. Proceeds from issuing equity instruments
b. Proceeds from issuing bonds, mortgages, notes, and from other short- or long-term borrowing.

20. Cash outflows for financing activities are:

a. Payments of dividends or other distributions to owners, including outlays to reacquire the enterprise's equity instruments
b. Repayments of amounts borrowed
c. Other principal payments to creditors who have extended long-term credit.[8]

Cash Flows from Operating Activities

21. Operating activities include all transactions and other events that are not defined as investing or financing activities in paragraphs 15-20. Operating activities generally involve producing and delivering goods and providing services. Cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net

income.

22. Cash inflows from operating activities are:

a. Cash receipts from sales of goods or services, including receipts from collection or sale of accounts and both short- and long-term notes receivable from customers arising from those sales
b. Cash receipts from returns on loans, other debt instruments of other entities, and equity securities—interest and dividends
c. All other cash receipts that do not stem from transactions defined as investing or financing activities, such as amounts received to settle lawsuits; proceeds of insurance settlements except for those that are directly related to investing or financing activities, such as from destruction of a building; and refunds from suppliers.

23. Cash outflows for operating activities are:

a. Cash payments to acquire materials for manufacture or goods for resale, including principal payments on accounts and both short- and long-term notes payable to suppliers for those materials or goods
b. Cash payments to other suppliers and employees for other goods or services
c. Cash payments to governments for taxes, duties, fines, and other fees or penalties
d. Cash payments to lenders and other creditors for interest
e. All other cash payments that do not stem from transactions defined as investing or financing activities, such as payments to settle lawsuits, cash contributions to charities, and cash refunds to customers.

24. Certain cash receipts and payments may have aspects of more than one class of cash flows. For example, a cash payment may pertain to an item that could be considered either inventory or a productive asset. If so, the appropriate classification shall depend on the activity that is likely to be the predominant source of cash flows for the item. For example, the acquisition and sale of equipment to be used by the enterprise or rented to others generally are investing activities. However, equipment sometimes is acquired or produced to be used by the enterprise or rented to others for a short period and then sold. In those circumstances, the acquisition or production and subsequent sale of those assets shall be considered operating activities.

Foreign Currency Cash Flows

25. A statement of cash flows of an enterprise with foreign currency transactions or foreign operations shall report the reporting currency equivalent of foreign currency cash flows using the exchange rates in effect at the time of the cash flows. An appropriately weighted average exchange rate for the period may be used for translation if the result is substantially the same as if the rates at the dates of the cash flows were used.[9] The statement shall report the effect of

exchange rate changes on cash balances held in foreign currencies as a separate part of the reconciliation of the change in cash and cash equivalents during the period.

Content and Form of the Statement of Cash Flows

26. A statement of cash flows for a period shall report net cash provided or used by operating, investing, and financing activities [10] and the net effect of those flows on cash and cash equivalents during the period in a manner that reconciles beginning and ending cash and cash equivalents.

27. In reporting cash flows from operating activities, enterprises are encouraged to report major classes of gross cash receipts and gross cash payments and their arithmetic sum—the net cash flow from operating activities (the direct method). Enterprises that do so should, at a minimum, separately report the following classes of operating cash receipts and payments:[11]

a. Cash collected from customers, including lessees, licensees, and the like
b. Interest and dividends received
c. Other operating cash receipts, if any
d. Cash paid to employees and other suppliers of goods or services, including suppliers of insurance, advertising, and the like
e. Interest paid
f. Income taxes paid
g. Other operating cash payments, if any.

Enterprises are encouraged to provide further breakdowns of operating cash receipts and payments that they consider meaningful and feasible. For example, a retailer or manufacturer might decide to further divide cash paid to employees and suppliers (category (d) above) into payments for costs of inventory and payments for selling, general, and administrative expenses.

28. Enterprises that choose not to provide information about major classes of operating cash receipts and payments by the direct method as encouraged in paragraph 27 shall determine and report the same amount for net cash flow from operating activities indirectly by adjusting net income to reconcile it to net cash flow from operating activities (the indirect or reconciliation method). That requires adjusting net income to remove (a) the effects of all deferrals of past operating cash receipts and payments, such as changes during the period in inventory, deferred income, and the like, and all accruals of expected future operating cash receipts and payments, such as changes during the period in receivables and payables,[12] and (b) the effects of all items whose cash effects are investing or financing cash flows, such as depreciation, amortization of goodwill, and gains or losses on sales of property, plant, and equipment and discontinued operations (which relate to investing activities), and gains or losses on extinguishment of debt (which is a financing activity).

29. The reconciliation of net income to net cash flow from operating activities described in paragraph 28 shall be provided regardless of whether the direct or indirect method of reporting net cash flow from operating activities is used. That reconciliation shall separately report all major classes of reconciling items. For example, major classes of deferrals of past operating cash receipts and payments and accruals of expected future operating cash receipts and payments, including at a minimum changes during the period in receivables pertaining to operating activities, in inventory, and in payables pertaining to operating activities, shall be separately reported. Enterprises are encouraged to provide further breakdowns of those categories that they consider meaningful. For example, changes in receivables from customers for an enterprise's sale of goods or services might be reported separately from changes in other operating receivables. In addition, if the indirect method is used, amounts of interest paid (net of amounts capitalized) and income taxes paid during the period shall be provided in related disclosures.

30. If the direct method of reporting net cash flow from operating activities is used, the reconciliation of net income to net cash flow from operating activities shall be provided in a separate schedule. If the indirect method is used, the reconciliation may be either reported within the statement of cash flows or provided in a separate schedule, with the statement of cash flows reporting only the net cash flow from operating activities. If the reconciliation is presented in the statement of cash flows, all adjustments to net income to determine net cash flow from operating activities shall be clearly identified as reconciling items.

31. Except for items described in paragraphs 12 and 13, both investing cash inflows and outflows and financing cash inflows and outflows shall be reported separately in a statement of cash flows—for example, outlays for acquisitions of property, plant, and equipment shall be reported separately from proceeds from sales of property, plant, and equipment; proceeds of borrowings shall be reported separately from repayments of debt; and proceeds from issuing stock shall be reported separately from outlays to reacquire the enterprise's stock.

Information about Noncash Investing and Financing Activities

32. Information about all investing and financing activities of an enterprise during a period that affect recognized assets or liabilities but that do not result in cash receipts or cash payments in the period shall be reported in related disclosures. Those disclosures may be either narrative or summarized in a schedule, and they shall clearly relate the cash and noncash aspects of transactions involving similar items. Examples of noncash investing and financing transactions are converting debt to equity; acquiring assets by assuming directly related liabilities, such as purchasing a building by incurring a mortgage to the seller; obtaining an asset by entering into a capital lease; and exchanging noncash assets or liabilities for other noncash assets or liabilities. Some transactions are part cash and part noncash; only the cash portion shall be reported in the statement of cash flows.

Cash Flow per Share

33. Financial statements shall not report an amount of cash flow per share. Neither cash flow nor any component of it is an alternative to net income as an indicator of an enterprise's performance, as reporting per share amounts might imply.

Effective Date and Transition

34. The provisions of this Statement shall be effective for annual financial statements for fiscal years ending after July 15, 1988. Earlier application is encouraged. This Statement need not be applied in financial statements for interim periods in the initial year of application, but cash flow information for those interim periods shall be restated if reported with annual financial statements for that fiscal year. Restatement of comparative annual financial statements for earlier years is encouraged but not required.

The provisions of this Statement need not be applied to immaterial items.

This Statement was adopted by the affirmative votes of four members of the Financial Accounting Standards Board. Messrs. Lauver, Leisenring, and Swieringa dissented.

Messrs. Lauver, Leisenring, and Swieringa dissent to this Statement's requirements to classify interest and dividends received and interest paid as cash flows from operating activities. They believe that interest and dividends received are returns on investments in debt and equity securities that should be classified as cash inflows from investing activities. They believe that interest paid is a cost of obtaining financial resources that should be classified as a cash outflow for financing activities.

Messrs. Lauver, Leisenring, and Swieringa also dissent to this Statement's requirement to classify certain cash receipts and payments according to the nature of an earlier transaction rather than according to the nature of the cash receipts and payments. Under this Statement, an enterprise that sells merchandise in one year for an installment note receivable and receives principal payments on the note in subsequent years will classify those principal payments as operating cash inflows. They believe that those principal payments should be classified as cash inflows from investing activities because they represent a return of the enterprise's investment in the installment note. Classifying those principal payments as operating cash inflows denies receipt of the installment note as a noncash investing activity, is inconsistent with the enterprise's recovery of its investment in that note, and is inconsistent with the treatment of the receipt of principal payments on other investments in debt instruments as cash inflows from investing activities. They also note that this Statement will result in similar inconsistencies for the purchase of inventory in exchange for a note payable.

Messrs. Lauver and Swieringa also dissent to this Statement's permitted use of the indirect method of reporting net cash flow from operating activities. They believe that by permitting the continued use of the indirect method, the Board has foregone the opportunity to make a significant contribution to the quality of financial reporting and to enhanced user understanding of cash flows from operating activities. Reporting information about cash received from customers, cash paid to suppliers and employees, income taxes paid, and other operating receipts and payments (the direct method) provides a description of the operating activities of an entity during a period that is both more informative and more consistent with the primary purpose of a statement of cash flows, which is described in paragraph 4 of this Statement as "to provide relevant information about the cash receipts and cash payments of an enterprise during a period."

Because the indirect method does not result in reporting separately major classes of gross operating cash flows, Messrs. Lauver and Swieringa believe that method is inconsistent with the conclusion in paragraph 11 that " generally, information about gross amounts of cash receipts and cash payments during a period is more relevant than information about the net amounts of cash receipts and payments." Further, permitting use of the indirect method makes this Statement internally inconsistent because major classes of gross cash flows from investing and financing activities are required to be reported separately while major classes of gross operating cash flows are not. In addition, presenting a reconciliation of net income and net cash flow from operating activities within the statement of cash flows rather than in a separate schedule results in including the effects of certain noncash transactions and other events within the statement of cash flows. Messrs. Lauver and Swieringa believe that is confusing and counter to the primary purpose of a statement of cash flows.

Mr. Lauver believes the internal inconsistencies in the provisions of this Statement concerning the classification of cash flows identified in the preceding paragraphs result from putting other objectives ahead of the Statement's stated objective of providing relevant information about cash receipts and payments. He believes that by adopting the view that the cash effects of transactions and events that enter into the determination of net income are cash flows from operating activities (paragraph 21), this Statement, in spite of comments to the contrary (paragraph 33), attempts to establish net cash from operating activities as an alternative performance indicator, an objective that he believes is undesirable. Further, that objective makes each of the three categories misleading by excluding from investing and financing categories cash receipts and payments that stem from investing and financing activities and ought to be included in those categories. The result is that none of the three required categories of cash flows is aptly named and all of them are, therefore, likely to be misunderstood.

Mr. Lauver observes that a statement of cash flows involves no issues of recognition, measurement, or estimation; by definition it includes only the effects of identifiable, unquestioned transactions. In that circumstance, the financial reporting function involves only two tasks. The first is to aggregate similar cash receipts and payments to facilitate communication and understanding and to do so consistently. The second is to accurately characterize the various aggregations so that they are unlikely to be misunderstood. He believes this Statement fails to do either.

Members of the Financial Accounting Standards Board:

Dennis R. Beresford, *Chairman*
Victor H. Brown
Raymond C. Lauver
James J. Leisenring
David Mosso
C. Arthur Northrop
Robert J. Swieringa

Appendix A: BACKGROUND INFORMATION

35. As part of its work on the conceptual framework, the FASB issued a Discussion Memorandum in December 1980, *Reporting Funds Flows, Liquidity, and Financial Flexibility*, which discussed funds flow reporting issues. Major issues raised in the Discussion Memorandum relating to funds flow reporting included (a) the concept of funds that should be adopted as the focus of the funds flow statement, (b) the reporting of transactions that have no direct impact on funds, (c) the approaches for presenting information about funds flows, (d) the presentation of information about funds flows from operations, (e) the separation of funds flow information about investing activities into outflows for maintenance of operating capacity, expansion of operating capacity, or nonoperating purposes, and (f) summary indicators of funds flows. The Board received 190 letters of comment in response to the Discussion Memorandum. In May 1981, a public hearing was held to discuss the issues raised in the Discussion Memorandum. Thirty-two individuals and organizations appeared at the hearing.

36. In November 1981, the Board issued an Exposure Draft of a proposed concepts Statement, *Reporting Income, Cash Flows, and Financial Position of Business Enterprises*. That Exposure Draft discussed the role of a funds statement and guides for reporting components of funds flows, concluding that funds flow reporting should focus on cash rather than on working capital. One hundred twenty-six comment letters were received in response to the November 1981 Exposure Draft. After considering those comment letters, the Board decided not to issue a final Statement on that subject. Instead, the Board chose to consider the subject in connection with its study of recognition and measurement concepts. In December 1983, the Board issued another Exposure Draft of a concepts Statement, *Recognition and Measurement in Financial Statements of Business Enterprises*, which also discussed the role of the cash flow statement. One hundred four comment letters were received on that Exposure Draft. In December 1984, the Board issued FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, which includes general guidance on a statement of cash flows and concludes that, in concept, a cash flow statement should be part of a full set of financial statements.

37. During its deliberations on the 1981 Exposure Draft, the FASB decided that detailed cash flow reporting issues should be addressed only at the standards level, but deferred consideration of the standards project until the results of a voluntary initiative by the Financial Executives Institute(FEI) were assessed. In late 1981, the FEI encouraged its members to change to a focus on cash and short-term investments in their funds statements. It also encouraged enterprises to experiment with alternative formats, such as grouping items by operating, investing, and financing activities. That experimentation with cash flow reporting in statements of changes in financial position was in keeping with the existing authoritative literature, Opinion 19, which allowed flexibility in the focus and form of the statement.

38. In 1984, the Financial Executives Research Foundation of the FEI published *The Funds Statement: Structure and Use*, a research study on funds statements that solicited views of both preparers and users on virtually all of the issues pertaining to funds flows discussed in the Discussion Memorandum and that analyzed the results of the experimentation encouraged by the FEI. The study pointed out several areas of diversity in current practice, including different definitions of *funds*, different definitions of *cash* and *cash flow from operations*, and different forms of presentation in the statement.

39. In April 1985, the Board added to its agenda a cash flow reporting project of limited scope to (a) establish the objectives of a statement of cash flows, (b) define the few major components of cash flows to be presented in the statement, and (c) decide whether to require a statement of cash flows as part of a full set of financial statements for all enterprises.

40. In May 1985, the FASB staff organized a Task Force on Cash Flow Reporting. In June 1985, the FASB staff met with the task force to discuss appropriate objectives for a statement of cash flows. In November 1985, the staff met again with the task force to discuss the identification and definition of the major elements of cash flows, the classification of certain transactions, the reporting of noncash transactions, and the methods for presenting cash flow from operating activities. In March 1986, an Advisory Group on Cash Flow Reporting by Financial Institutions was organized. In April 1986, the FASB staff met with the advisory group to discuss whether a statement of cash flows should be included in a complete set of financial statements of a financial institution as well as other cash flow reporting issues related to financial institutions. In March and April 1986, the staff communicated with the FASB Small Business Advisory Group and the Technical Issues Committee of the Private Companies Practice Section of the American Institute of Certified Public Accountants (AICPA) on whether a statement of cash flows should be required of small businesses as part of a full set of financial statements.

41. The Board issued an Exposure Draft, *Statement of Cash Flows*, in July 1986. It proposed standards for cash flow reporting to require a statement of cash flows as part of a full set of financial statements of all business enterprises in place of a statement of changes in financial position.

42. The Board received more than 450 comment letters in response to that Exposure Draft. In

December 1986, the FASB staff met with an informal group of securities analysts who specialize in financial institutions to discuss users' needs for information about a financial institution's cash flows. In January 1987, the FASB staff held a special meeting to discuss the numerous comments received on the manner of reporting cash flows from operating activities. Representatives of the Financial Analysts Federation, the Financial Executives Institute, the National Association of Accountants, and the Robert Morris Associates participated in that meeting. In February 1987, the FASB staff met with the task force to discuss comments received on the Exposure Draft, and in March 1987, the staff met with the Advisory Group on Cash Flow Reporting by Financial Institutions.

43. The Board considered the comment letters and information obtained at those meetings in developing this Statement. Appendix B discusses the basis for the Board's conclusions, including changes made to the provisions of the 1986 Exposure Draft.

Appendix B

BASIS FOR CONCLUSIONS

CONTENTS

Paragraph Numbers

Appendix B: BASIS FOR CONCLUSIONS

Introduction

44. This appendix discusses factors deemed significant by members of the Board in reaching the conclusions in this Statement. It includes descriptions of alternatives considered by the Board with reasons for accepting some and rejecting others. Individual Board members gave greater weight to some factors than to others.

Need for Cash Flow Information

45. The Board decided to require a statement of cash flows as part of a full set of financial statements on the basis of the objectives and concepts set forth in FASB Concepts Statement No. 1, *Objectives of Financial Reporting by Business Enterprises*, and Concepts Statement 5.

46. Paragraph 37 of Concepts Statement 1 states that:

> Financial reporting should provide information to help present and potential investors and creditors and other users in assessing the amounts, timing, and uncertainty of prospective cash receipts from dividends or interest and the proceeds from the sale, redemption, or maturity of securities or loans. The prospects for those cash receipts are affected by an enterprise's ability to generate enough cash to meet its obligations when due and its other cash operating needs, to reinvest in operations, and to pay cash dividends. . . .

Paragraph 39 states that:

> . . . since an enterprise's ability to generate favorable cash flows affects both its ability to pay dividends and interest and the market prices of its securities, expected cash flows to investors and creditors are related to expected cash flows to the enterprise in which they have invested or to which they have loaned funds.

Paragraph 49 states that:

> Financial reporting should provide information about how an enterprise obtains and spends cash, about its borrowing and repayment of borrowing, about its capital [equity] transactions, including cash dividends and other distributions of enterprise resources to owners, and about other factors that may affect an enterprise's liquidity or solvency.

47. Paragraph 13 of Concepts Statement 5 states that the "amount and variety of information that financial reporting should provide about an entity require several financial statements." A full set of financial statements for a period should show cash flows during the period. Paragraph 52 describes the role of information in the statement of cash flows as follows:

> It provides useful information about an entity's activities in generating cash through operations to repay debt, distribute dividends, or reinvest to maintain or expand operating capacity; about its financing activities, both debt and equity; and about its investing or spending of cash. Important uses of information about an entity's current cash receipts and payments include helping to assess factors such as the entity's liquidity, financial flexibility, profitability, and risk.

Statements of Cash Flows and Other Information on Liquidity, Financial Flexibility, Profitability, and Risk

48. The statement of cash flows is not the only financial statement that provides information on liquidity, financial flexibility, profitability, and risk. Concepts Statement 5 discusses the complementary role of the other financial statements:

> A statement of financial position provides information about an entity's assets, liabilities, and equity and their relationships to each other at a moment in time. The statement delineates the entity's resource structure—major classes and amounts of assets—and its financing structure—major classes and amounts of liabilities and equity. [paragraph 26]
>
> Important uses of information about an entity's financial position include helping users to assess factors such as the entity's liquidity, financial flexibility, profitability, and risk. [paragraph 29]
>
> Financial statements complement each other. For example:
>
> a. Statements of financial position include information that is often used in assessing an entity's liquidity and financial flexibility, but a statement of financial position provides only an incomplete picture of either liquidity or financial flexibility unless it is used in conjunction with at least a cash flow statement. . . .
>
> c. Statements of cash flows commonly show a great deal about an entity's current cash receipts and payments, but a cash flow statement provides an incomplete basis for assessing prospects for future cash flows because it cannot show interperiod relationships. Many current cash receipts, especially from operations, stem from activities of earlier periods, and many current cash payments are intended or expected to result in future, not current, cash receipts. Statements of earnings and comprehensive income, especially if used in conjunction with statements of financial position, usually provide a

> better basis for assessing future cash flow prospects of an entity than do cash flow statements alone. [paragraph 24, subparagraphs b and d and footnote references omitted]

Cash Instead of Working Capital

49. In light of those objectives and concepts, which were reinforced by the Board's observation of a trend in practice toward statements of changes in financial position that focused on cash flows, the Board concluded that a statement of cash flows should be required to help investors, creditors, and others assess future cash flows, provide feedback about actual cash flows, evaluate the availability of cash for dividends and investment and the enterprise's ability to finance growth from internal sources, and identify the reasons for differences between income and net cash flows. Nearly all of the respondents to both the Discussion Memorandum and the Exposure Draft [13] agreed with those objectives of a statement of cash flows.

50. To achieve those objectives requires that the statement focus on flows of cash rather than flows of working capital. An overwhelming majority of respondents agreed with that focus. Many made negative comments on the usefulness of working capital as a concept of funds, generally questioning its relevance since positive working capital does not necessarily indicate liquidity nor does negative working capital necessarily indicate illiquidity.

Cash and Cash Equivalents

51. Cash is the most useful concept of funds because decisions of investors, creditors, and others focus on assessments of future cash flows. However, enterprises commonly invest cash in excess of immediate needs in short-term, highly liquid investments, and whether cash is on hand, on deposit, or invested in a short-term financial instrument that is readily convertible to a known amount of cash is largely irrelevant to users' assessments of liquidity and future cash flows. The Board therefore decided that a statement of cash flows should focus on the aggregate of cash and cash equivalents.

52. Respondents to the Exposure Draft generally agreed with the focus on cash and cash equivalents. Many, however, asked the Board to provide more guidance on which short-term, highly liquid investments qualify as cash equivalents. Others questioned whether particular instruments, such as marketable equity securities that management intends to hold for only a short period of time, might qualify.

53. The Board agreed to provide more guidance on the short-term, highly liquid investments that qualify as cash equivalents. In developing the guidance in paragraph 8 of this Statement, the Board noted that the objective of enterprises' cash management programs generally is to earn interest on temporarily idle funds rather than to put capital at risk in the hope of benefiting from favorable price changes that may result from changes in interest rates or other factors. Although any limit to the maturity of items that can qualify as cash equivalents is somewhat arbitrary, the Board decided to specify a limit of three months or less. The Board believes that that limit will

result in treating as cash equivalents only those items that are so near cash that it is appropriate to refer to them as the "equivalent" of cash.

54. Some respondents to the Exposure Draft expressed concern that a reader of the financial statements might not be able to relate the amount of cash and cash equivalents in the statement of cash flows to a line item in the statement of financial position. The Board agreed that being able to trace the change in cash and cash equivalents in the statement of cash flows to related amounts in successive statements of financial position is desirable. It therefore decided to require that the total amounts of cash and cash equivalents at the beginning and end of the period shown in the statement of cash flows be the same amounts as similarly titled line items or subtotals in the statements of financial position as of those dates.

55. Banks and other financial institutions commonly carry three-month Treasury bills, commercial paper, and similar short-term financial instruments in their trading and investments accounts, in which they are commingled with longer-term investments. Those institutions generally contend that purchases and sales of those items are part of their trading or investing activities—not part of their cash management program—and they prefer not to treat those items as cash equivalents in a statement of cash flows, which would require segregating them from other items in their trading and investment accounts.

56. The Board noted that the reason for focusing a statement of cash flows on cash and cash equivalents is to recognize and accommodate common practices in cash management. Accordingly, the Board agreed that items that meet the definition of cash equivalents that are part of a larger pool of investments properly considered investing activities need not be segregated and treated as cash equivalents. Because that decision will result in differences between enterprises in the items treated as cash equivalents, the Board decided that each enterprise should disclose its policy for treating items as cash equivalents.

Scope

57. Respondents from financial institutions, particularly commercial banks, generally said that a statement of cash flows would not be useful for their industry. Some commentators specifically mentioned that a statement of cash flows would be particularly useful for small businesses, but a few asked that small businesses be exempted from at least some provisions of the Exposure Draft. A few respondents to the Exposure Draft referred to the fact that investment companies were permitted to provide a statement of changes in net assets rather than a statement of changes in financial position and asked that they be exempted from a requirement to provide a statement of cash flows.

Financial Institutions

58. Financial institutions, particularly commercial banks, have long contended that their statements of changes in financial position are not meaningful. In response to the Exposure

Draft, most asserted that a statement of cash flows would be equally meaningless. Banks 14
generally have contended that the nature of their business and the resulting nature of their cash flows are significantly different from the cash flows of nonfinancial enterprises and that those differences render information about a bank's cash flows virtually meaningless. Banks who responded to the Exposure Draft generally said that their cash flows are much more complex and interrelated than those of other enterprises and that a bank's cash flows are much larger in relation to net income and net assets than are the cash flows of a nonfinancial enterprise. They commented that a bank creates money through its lending activities. That, they said, makes cash the "product" of a bank's earning activities, just as finished goods are the product of a manufacturer's earning activities. Accordingly, banks often asserted that a statement of cash flows for a bank is analogous to a combined statement of cash and inventory flows for a nonfinancial company. For those reasons, banks argued that a statement of cash flows would not prove helpful in evaluating their liquidity.

59. The Board considered, but was not persuaded by, the arguments that a statement of cash flows of a financial institution, especially a bank, would not provide useful information. The Board concluded that the differences between the activities of banks and the activities of other business enterprises do not warrant excluding banks from a requirement to provide a statement of cash flows as part of a full set of financial statements. The Board recognizes that banks are unique in some ways, just as each other kind of business enterprise has unique attributes. While a bank is unique in the sense that cash can be viewed as its product, a bank needs cash for essentially the same reasons a manufacturer does—to invest in its operations, to pay its obligations, and to provide returns to its investors. To survive, a bank—like a manufacturer—must generate positive (or at least neutral) cash flows from its operating, investing, and financing activities over the long run.

60. A bank raises cash from depositors, money market operations and other purchases of funds, issuing long-term debt and equity securities, loan repayments by borrowers, investment sales and maturities, and net interest and fees earned. It uses cash to meet deposit withdrawals, liability maturities, loan commitments, and for investment and other purposes. Those cash flows are integral to a bank's investing (largely lending) activities and its financing (largely borrowing and deposit gathering) activities and should be reflected in its financial statements. As is true for nonbank enterprises, a bank's net cash flow from operating activities may differ significantly from its net income because of noncash revenue and expense items, such as interest accruals, depreciation, amortization of goodwill, provision for probable credit losses, and deferred income taxes. While the cash flows of a bank may be larger, the turnover faster, and the reliance on borrowed funds greater than for a nonfinancial enterprise, the Board decided that the substance of a bank's cash flows is similar to that of a nonfinancial enterprise. Concerning the relative size of a bank's cash flows, the Board noted that a bank's assets and liabilities also are much larger in relation to its equity than is common for nonfinancial enterprises; that does not mean that the gross amounts of a bank's assets, liabilities, and changes in them are unimportant information.

61. The Board considered the argument that the solvency of a bank depends more on

maintaining an adequate spread between the cost of funds and interest received than on adequate cash flows. The Board noted that maintenance of an adequate margin between expenses and revenues is essential to the viability of all enterprises and is not unique to banks and other financial institutions.

62. The Board also considered the argument that other information such as interest rate sensitivities and maturity schedules of loans and borrowings is more useful than a statement of cash flows in assessing a bank's liquidity, financial flexibility, profitability, and risk and that this other information should therefore be substituted for a statement of cash flows. The Board acknowledged the potential usefulness of that information but rejected the argument for substitution, noting that, as Concepts Statement 5 states, the assessment of liquidity, financial flexibility, profitability, and risk for any enterprise requires more information than just a statement of cash flows.[15]

63. The Board also considered the proposal in the AICPA Exposure Draft of a proposed Statement of Position, *Reporting Funds Flows, Liquidity, and Financial Flexibility for Banks* (October 1, 1985), cited by several respondents to the Exposure Draft, that a funds flow statement for banks should focus on changes in "earning assets" (for example, loans and investments in securities) rather than cash. The Board rejected that proposal, noting that a statement with that focus would not be a statement of cash flows and would be analogous to providing a statement for a manufacturing company that focused on changes in inventories and fixed assets as if they constituted "funds."

64. Banks who responded to the Exposure Draft generally said that they do not now have the systems in place to obtain all the information on gross cash flows pertaining to loans and various other items that would be needed to comply with the provisions of the Exposure Draft. If the Board decided not to exempt them from a requirement to provide a statement of cash flows, the banks asked to be permitted to report net rather than gross cash flows for more items than the Exposure Draft permitted. They also asked for more flexibility in designating items as cash equivalents.

65. After considering the comments of financial institutions and other enterprises on the Exposure Draft, the Board decided to permit all enterprises to report net rather than gross cash flows for the items specified in paragraphs 12-13 and discussed in paragraphs 78-80 of this appendix. The Board also decided to permit all enterprises a specified degree of flexibility to establish a policy on what items are treated as cash equivalents, as provided in paragraph 10 and discussed in paragraphs 52-56 of this appendix.

Small Businesses

66. The Board considered information provided by its Small Business Advisory Group and others in deciding whether small businesses should be exempted from providing a statement of cash flows. Many commentators said that cash flow information is particularly useful for small

businesses, and very few asked that small business be exempted from a requirement to provide a statement of cash flows as part of a full set of financial statements. The Board concluded that a statement of cash flows is useful to those who use the financial statements of small businesses and that no exemption should be provided.

Investment Companies

67. As mentioned in paragraph 57, a few respondents to the Exposure Draft asked that investment companies be permitted to substitute a statement of changes in net assets for a statement of cash flows. The Board noted that the content and format of the two statements are quite different. While the Board recognizes that information about some investment companies' cash flows may be less important than similar information for other kinds of enterprises, the Board decided that information about cash flows is still relevant and that investment companies should not be exempted from a requirement to provide a statement of cash flows.

Not-for-Profit Organizations

68. The Exposure Draft did not include not-for-profit organizations within its scope. A few respondents to that document said that a statement of cash flows is also useful for not-for-profit organizations and suggested that those organizations be included in the scope of the final Statement.

69. Exclusion of not-for-profit organizations from the scope of this document means only that the Board has not yet decided whether not-for-profit organizations should be required to provide a statement of cash flows. The Board has completed work on concepts of financial reporting for not-for-profit organizations and is currently considering certain standards issues. The FASB staff is currently working with a task force of the AICPA that is developing a paper on financial statement display for not-for-profit organizations. That paper will consider, among other things, whether not-for-profit organizations should report cash receipts and payments and, if so, how. Upon consideration of that paper, the Board will decide whether to add to its agenda a project on financial statement display for not-for-profit organizations.

Noncash Transactions

70. Noncash transactions commonly recognized in financial statements include conversion of debt to equity, acquisition of assets by assuming liabilities including capital lease obligations, and some of the nonmonetary transactions addressed in APB Opinion No. 29, *Accounting for Nonmonetary Transactions*. Those transactions result in no cash inflows or outflows in the period in which they occur but generally have a significant effect on the prospective cash flows of a company. For example, a capitalized lease obligation requires future lease payments in cash, and conversion of debt to equity generally will eliminate nondiscretionary payments of interest on the debt. The net effect on assets and liabilities of assuming debt to acquire an asset is similar to that of borrowing cash to buy the asset.

71. Many respondents to the Discussion Memorandum said that certain types of noncash transactions should be treated as cash flow equivalents and that they should be included in the body of the statement. That generally is the way in which those transactions have been reported in the statement of changes in financial position under Opinion 19. Other respondents, however, said that noncash transactions should be disclosed in the notes to a statement of cash flows because to include them in the statement would complicate it and limit its ability to provide meaningful information about cash flows.

72. The Exposure Draft required noncash investing and financing transactions to be disclosed either in the statement of cash flows or in a separate schedule to provide more complete information about an enterprise's investing and financing activities during the period. If included in the statement of cash flows, the Exposure Draft required that the reporting distinguish between activities that involved cash receipts and payments in the current period and those that did not.

73. A majority of the respondents to the Exposure Draft who addressed this issue urged that noncash transactions be excluded from the statement of cash flows and reported in a separate schedule. They generally said that to include those transactions within the statement would unduly complicate it and detract from its objective of providing information about an enterprise's cash receipts and cash payments during a period.

74. The Board agreed that excluding noncash transactions from the statement of cash flows would better achieve the statement's objective without resulting in implementation difficulties. This Statement thus requires that information about noncash investing and financing transactions be reported in related disclosures. If there are only a few such transactions, it may be convenient to include them on the same page as the statement of cash flows. Otherwise, the transactions may be reported elsewhere in the financial statements, clearly referenced to the statement of cash flows.

Emphasis on Gross Cash Receipts and Cash Payments

75. The Board decided that, in general, meaningful assessments of cash flows require reporting of gross, rather than net, cash receipts and cash payments.[16] For example, reporting only the net change in property, plant, and equipment would obscure the investing activities of the enterprise by not disclosing separately the capital expenditures and proceeds from sales of assets.

76. For a few items, information on both cash receipts and cash payments may be no more relevant than information about only the net change. For example, the gross payments and receipts from purchasing and selling short-term, highly liquid investments—cash equivalents—are, in essence, merely movements from one form of "cash" to another and thus are not meaningfully reported as cash flows. For other items, the gross cash flows may be frequent and large in relation to other cash flows, and for others, such as demand deposits in a bank, the

enterprise is holding or disbursing cash on behalf of its customers. For items with those characteristics, the net cash flow during a period generally is sufficient to assess an enterprise's liquidity.

77. The Exposure Draft noted that the issue of which cash flows should be reported gross and which can be netted without unduly obscuring useful information is of special significance to banks and other financial institutions. For those enterprises as well as for nonfinancial enterprises, the Board decided that information about gross cash flows should generally be presumed to be relevant. However, reporting only net cash flows is acceptable for certain items. Examples include assets and liabilities in which the amounts are turned over very quickly, sometimes overnight, or in which an enterprise receives and pays cash for the convenience of a customer (for example, the demand deposits of a bank or the customer accounts payable of a broker-dealer). The Exposure Draft indicated that those items are common for financial institutions. Accordingly, the Exposure Draft discussed the very limited netting of cash flows that it permitted in the context of financial institutions.

78. Many respondents to the Exposure Draft said that nonfinancial enterprises also may have items for which the turnover is quick, the maturities are short, and the amounts are large. Short-term debt such as revolving credit arrangements and commercial paper obligations were frequently cited examples. Respondents generally expressed the view that net reporting of those items also should be permitted. In addition, as discussed in paragraph 64, financial institutions who responded to the Exposure Draft generally asked the Board to permit more reporting of net cash flows for items such as loans, investments, and short-term debt.

79. The Board generally agreed that nonfinancial as well as financial enterprises may have items for which the gross cash flows are not sufficiently relevant to require reporting them. For very short-term investments, loans, and debt, relatively insignificant differences in the maturities of items may result in large differences in gross cash flows between enterprises or between periods that are not particularly meaningful. For example, an enterprise that issues seven-day commercial paper and rolls it over every week would report financing cash inflows and outflows four times those of an enterprise that issues one-month paper. While all gross cash flows are potentially relevant, the large reported differences in situations such as that described may not be sufficiently meaningful to require reporting of gross cash flows. The Board therefore decided to permit cash flows stemming from all investments, loans, and debt with original maturities of three months or less to be reported net.

80. Some respondents specifically asked that cash flows stemming from credit card receivables be reported net. The Board noted that credit card receivables, including those with extended payment terms, might be considered to fall within the category of loans with original, scheduled maturities of three months or less since they generally may, at the customer's option, be paid in full when first billed without incurring interest charges. As a practical expedient, the Board decided to permit cash flows stemming from credit card receivables to be reported net.

Classification of Cash Receipts and Payments

81. The Board believes that a statement of cash flows is more useful if cash flows are classified into meaningful groups. The usefulness of classification in financial statements is addressed by Concepts Statement 5, paragraph 20:

> Classification in financial statements facilitates analysis by grouping items with essentially similar characteristics and separating items with essentially different characteristics. Analysis aimed at objectives such as predicting amounts, timing, and uncertainty of future cash flows requires financial information segregated into reasonably homogeneous groups. For example, components of financial statements that consist of items that have similar characteristics in one or more respects, such as continuity or recurrence, stability, risk, and reliability, are likely to have more predictive value than if their characteristics are dissimilar.

82. A popular classification of cash (or funds) flows in the past has been to separate sources from uses of cash (or funds). Many companies, especially smaller ones and financial institutions, continue to use that classification, which enables investors, creditors, and others to identify the total funds (however defined) obtained and disposed of during the period. The disadvantage of a sources and uses classification is that it does not focus on categories of related cash flows. Investors, creditors, and others consider the relationships among certain components of cash flows to be important to their analysis of financial performance. Also, the sources and uses classification has sometimes led to a listing of changes in balance sheet amounts that explains little about the enterprise's ability to meet obligations and pay dividends or about its needs for external financing.

83. Classification of cash flows according to whether they stem from operating, investing, or financing activities has become more popular in recent years. One reason the Board cited for adding this project to its agenda was that transactions were not being classified comparably across companies and that clearer guidelines for classification of cash flows were necessary.

84. The Board decided that grouping cash flows provided by or used in operating, investing, and financing activities enables significant relationships within and among the three kinds of activities to be evaluated. It links cash flows that are often perceived to be related, such as cash proceeds from borrowing transactions and cash repayments of borrowings. Thus, the statement reflects the cash flow effects of each of the major activities of the enterprise. Those relationships and trends in them provide information useful to investors and creditors. Almost all of the respondents to the Exposure Draft agreed that cash flows should be classified as operating, investing, and financing.

85. The Exposure Draft provided general guidelines for classifying cash flows. Some

respondents asked the Board to provide more precise definitions. Others asked that enterprises be given more flexibility to classify their cash flows in accordance with what they consider to be the nature of their business.

86. While there is widespread agreement that the classification of cash flows according to whether they stem from operating, investing, or financing activities provides useful information, the Board notes that the three categories are not clearly mutually exclusive. For items at the margin, a reasonable case often may be made for alternative classifications. Paragraphs 88-90 and 93-96 discuss certain of those items. The Board concluded that, in general, comparability across enterprises in classifying similar items is desirable. This Statement therefore provides somewhat more precise definitions of the three categories of cash flows than did the Exposure Draft.

87. Notwithstanding the desirability of reasonably clear and precise definitions of the three categories of cash flows, the Board recognizes that the most appropriate classification of items will not always be clear. In those circumstances, the appropriate classification generally should depend on the nature of the activity that is likely to be the predominate source of cash flows for the item. For example, the presumption is that the acquisition or production of productive assets is an investing activity. However, productive assets are sometimes acquired or produced to be a direct source of the enterprise's revenues, such as assets to be rented to others for a short period and then sold. In those circumstances, the nature of those assets may be similar to inventory in a retailing business. Accordingly, the acquisition or production and subsequent sale of such assets are appropriately classified as operating activities.

Interest Paid and Received

88. The Exposure Draft required interest paid and interest and dividends received to be classified as cash flows from operating activities. That classification is consistent with the view that, in general, cash flows from operating activities should reflect the cash effects of transactions and other events that enter into the determination of net income.

89. Some respondents to the Exposure Draft favored classifying interest paid as a cash outflow for financing activities and interest and dividends received as cash inflows from investing activities. Those respondents generally said that interest paid, like dividends paid, is a direct consequence of a financing decision and thus should be classified as a cash outflow for financing activities. That is, both interest and dividends are returns *on* the capital provided by creditors and investors, and both should be classified with returns *of* those amounts because the distinction between returns *of* and returns *on* investment is largely irrelevant in the context of cash flows. Respondents made similar comments for interest and dividends received.

90. The Board considered those views and, as mentioned in paragraph 86, noted that a reasonable case can be made for alternative classifications of certain items. However, the Board also noted that virtually all enterprises classify interest received and paid as operating cash flows under Opinion 19. In particular, interest received and paid were commonly considered to be

operating cash flows of banks and other financial institutions. In addition, the Board perceived widespread support for the notion that operating cash flows should, insofar as possible, include items whose effects are included in determining net income to facilitate an understanding of the reasons for differences between net income and net cash flow from operating activities and net income. The Board therefore was not convinced that changing the prevalent practice in classifying interest received and paid would necessarily result in a more meaningful presentation of cash flows. This Statement does, however, require that the amount of interest paid during a period (net of amounts capitalized) be disclosed, which will permit users of financial statements who wish to consider interest paid as a financing cash outflow to do so.

Income Taxes Paid

91. The Exposure Draft required all income taxes paid to be classified as operating cash outflows. A few respondents suggested allocating income taxes paid to investing and financing transactions.

92. The Board decided that allocation of income taxes paid to operating, investing, and financing activities would be so complex and arbitrary that the benefits, if any, would not justify the costs involved. This Statement requires that the total amount of income taxes paid be disclosed for reasons discussed in paragraph 121.

Installment Sales and Purchases

93. A somewhat difficult classification issue arises for installment sales and purchases of inventory by an enterprise for which cash inflows or outflows may occur several years after the date of the transaction. Those transactions can be viewed as having aspects of both operating and investing activities (for a sale by the enterprise) or operating and financing activities (for a purchase by the enterprise). The Exposure Draft treated cash flows stemming from installment sales and purchases in accordance with that view. Only cash flows occurring "soon before or after" the time of sale or purchase would have been operating cash flows. Subsequent principal payments on the related notes would have been investing cash inflows or financing cash outflows.

94. Some respondents to the Exposure Draft suggested that the classification of a cash receipt or payment should be determined by the original purpose for which it is received or paid. Thus, all cash flows related to the sale or purchase of inventory would be operating cash flows regardless of when they were received or paid. Those respondents generally pointed out that, under the approach in the Exposure Draft, cumulative net cash flow from operating activities over the life of an enterprise that finances most of its sales under installment plans might be negative. They considered that to be an inappropriate and confusing result.

95. The Board agreed that all cash collected from customers or paid to suppliers from the sale or purchase of inventory should be classified as operating cash flows. That classification is consistent with the notion that operating cash flows generally should include items that are

included in net income.

96. A related issue involves principal payments on a seller-financed mortgage on productive assets. Some have argued that all such principal payments should be classified as investing cash outflows rather than financing cash outflows. They said that they consider that classification to be more consistent with classifying all principal receipts and payments on sales and purchases of inventory as operating cash flows. The Board decided, however, that all principal payments on mortgages should be classified as financing cash outflows. The reason for that conclusion is largely pragmatic—the Board believes that it would be unduly burdensome to require enterprises to keep track of seller-financed versus third-party mortgages throughout the generally long period of time that a mortgage is outstanding. Some also consider all principal payments on mortgages to be financing cash outflows.

Maintenance and Expansion Investment Expenditures

97. The Board considered whether to require further classification of investment expenditures into expenditures for maintenance of existing capacity and expenditures for expansion into new capacity. That further classification would provide information designed to be used by investors, creditors, and others in calculating an amount sometimes described as "discretionary cash flow," with the idea that maintenance expenditures are nondiscretionary and only the cash remaining after such expenditures is free for discretionary purposes, such as paying dividends.

98. Most respondents said that the cash flows related to investing activities should not be allocated between those for maintenance of capacity and those for expansion. They said that those allocations would necessarily be arbitrary and the costs to compile the information would exceed the benefits provided.

99. The Board noted that substantial implementation difficulties would result if all enterprises were required to distinguish between expenditures for maintenance and those for expansion and that the subjectivity involved in making that distinction could result in numbers that would be unreliable. Accordingly, the Board decided not to require that disclosure.

Foreign Currency Cash Flows

100. The purpose of a statement of changes in financial position under Opinion 19 was to explain all important changes in financial position, regardless of whether they directly affected cash or working capital. That purpose suggested that the effects of changes in exchange rates on items reported in the statement of changes in financial position should be disclosed if material. Opinion 19 permitted a degree of flexibility in the statement of changes in financial position, and enterprises used alternative formats and terminology to report the effects of exchange rate changes.

101. The purpose of a statement of cash flows, on the other hand, is to report cash receipts and

cash payments during a period, classified into meaningful categories. The effects of exchange rate changes on assets and liabilities denominated in foreign currencies, like those of other price changes, may affect the amount of a cash receipt or payment. But exchange rate changes do not themselves give rise to cash flows, and their effects on items other than cash thus have no place in a statement of cash flows. To achieve its objective, a statement of cash flows should reflect the reporting currency equivalent of cash receipts and payments that occur in a foreign currency. Because the effect of exchange rate changes on the reporting currency equivalent of cash held in foreign currencies affects the change in an enterprise's cash balance during a period but is not a cash receipt or payment, the Board decided that the effect of exchange rate changes on cash should be reported as a separate item in the reconciliation of beginning and ending balances of cash.

102. Some respondents to the Exposure Draft objected to the requirement to report the reporting currency equivalent of foreign currency cash receipts and payments. They generally said that they do not obtain cash flow information from their foreign subsidiaries but rather prepare the consolidated statement of changes in financial position from the consolidated balance sheet and income statement, perhaps supplemented by certain information about gross increases and decreases in asset and liability accounts after translation to U.S. dollars. Other respondents supported the Exposure Draft's requirement only for foreign subsidiaries whose functional currency is other than the reporting currency. For foreign subsidiaries whose functional currency is the reporting currency, they generally favored some variation of a method that would include in the statement of cash flows the effects of exchange rate changes on all items classified as cash flows from operating, investing, and financing activities.

103. The Board noted that exchange rate changes affect only the amount of a cash receipt or payment (that is, the effects of rate changes are not themselves cash flows) regardless of whether the asset or liability on which an effect arises is held directly by a domestic enterprise, by a foreign subsidiary whose functional currency is the reporting currency, or by a foreign subsidiary whose functional currency is other than the reporting currency. Accordingly, this Statement clarifies that the requirement to report the reporting currency equivalents of cash receipts and payments denominated in foreign currencies applies to all such cash flows.

104. The Board considered the assertions that the requirements concerning reporting cash receipts and payments that occur in a foreign currency would be unduly burdensome because they would require enterprises to obtain cash flow information from their foreign subsidiaries. Although Opinion 19 did not directly address how to report the effects of exchange rate changes, the Board noted that Opinion 19 did require the reporting of gross funds flows, including, for example, both outlays to acquire property, plant, and equipment and proceeds from disposing of property, plant, and equipment. That is, while Opinion 19 required that the effects of exchange rate changes be included in a statement of changes in financial position, it did not necessarily provide that those effects should be reported in a way that results in line items that are not funds flows but rather are net changes, or gross increases and decreases, in translated asset and liability accounts. The Board therefore believes that full compliance with Opinion 19 would require

obtaining some information about the cash flows of foreign subsidiaries. As exchange rates change, the methods that some respondents advocate might report, for example, an asset acquisition or disposition in a period in which none occurred and might even report an asset acquisition when in fact a disposition occurred. Whether or not Opinion 19 intended that result, it is inappropriate in a statement intended to report cash receipts and payments.

105. The Board is aware that enterprises use various approximation techniques to meet the present requirements of reporting foreign-currency denominated assets, liabilities, revenues, expenses, and other items in the income statement and the statement of financial position. For example, appropriately weighted average exchange rates generally are used to translate revenues and expenses. Such methods also are acceptable in complying with the provisions of this Statement concerning foreign-currency-denominated cash flows provided that it is reasonable to expect that the results are substantially the same as if more precise data were used.

Reporting Net Cash Flow from Operating Activities

106. The Board considered two principal alternatives for reporting net cash flow from operating activities. The *direct method* shows as its principal components operating cash receipts and payments, such as cash received from customers and cash paid to suppliers and employees, the sum of which is *net cash flow from operating activities*. The *indirect method* starts with net income and adjusts it for revenue and expense items that were not the result of operating cash transactions in the current period to reconcile it to *net cash flow from operating activities*. The indirect method thus does not disclose operating cash receipts and payments. Paragraph 10 of Opinion 19 permitted either method, but the indirect method prevailed in practice under that Opinion.

107. The principal advantage of the direct method is that it shows operating cash receipts and payments. Knowledge of the specific sources of operating cash receipts and the purposes for which operating cash payments were made in past periods may be useful in estimating future operating cash flows. The relative amounts of major classes of revenues and expenses and their relationship to other items in the financial statements are presumed to be more useful than information only about their arithmetic sum—net income—in assessing enterprise performance. Likewise, amounts of major classes of operating cash receipts and payments presumably would be more useful than information only about their arithmetic sum—net cash flow from operating activities—in assessing an enterprise's ability to generate sufficient cash from operating activities to pay its debt, to reinvest in its operations, and to make distributions to its owners.

108. The principal advantage of the indirect method is that it focuses on the differences between net income and net cash flow from operating activities. Concepts Statement 1, paragraph 43, states that:

> The primary focus of financial reporting is information about an enterprise's performance provided by measures of earnings [comprehensive income] and its

> components. Investors, creditors, and others who are concerned with assessing the prospects for enterprise net cash inflows are especially interested in that information. Their interest in an enterprise's future cash flows . . . leads primarily to an interest in information about its earnings [comprehensive income] rather than information directly about its cash flows. Financial statements that show only cash receipts and payments during a short period, such as a year, cannot adequately indicate whether or not an enterprise's performance is successful.

Some investors and creditors may assess future cash flows in part by first estimating future income based in part on reports of past income and then converting those future income estimates to estimates of future cash flows by allowing for leads and lags between cash flows and income. Information about similar leads and lags in the past are likely to be helpful in that process. Identifying differences between income items and related cash flows also can assist investors and creditors who want to identify the differences between enterprises in the measurement and recognition of noncash items that affect income.

109. Many providers of financial statements have said that it would be costly for their companies to report gross operating cash receipts and payments. They said that they do not presently collect information in a manner that will allow them to determine amounts such as cash received from customers or cash paid to suppliers directly from their accounting systems.

110. The Exposure Draft said that the Board recognized the advantages of both approaches and concluded that neither method provided benefits sufficient to justify requiring one and prohibiting the other. Enterprises therefore would have been permitted to use either method.

111. A majority of respondents to the Exposure Draft asked the Board to require use of the direct method. Those respondents, most of whom were commercial lenders, generally said that amounts of operating cash receipts and payments are particularly important in assessing an enterprise's external borrowing needs and its ability to repay borrowings. They indicated that creditors are more exposed to fluctuations in net cash flow from operating activities than to fluctuations in net income and that information on the amounts of operating cash receipts and payments is important in assessing those fluctuations in net cash flow operating activities. They also pointed out that the direct method is more consistent with the objective of a statement of cash flows—to provide information about cash receipts and cash payments—than the indirect method, which does not report operating cash receipts and payments.

112. Both commercial lenders and equity analysts who responded to the Exposure Draft asked that more detail on cash flows from operating activities be required. Some said that degree of detail is more important than manner of presentation.

113. Most of the providers of financial statements who addressed the issue supported allowing a choice between the direct and indirect methods. They generally said that requiring the direct method would impose excessive implementation costs and that they believe that the indirect

method provides more meaningful information.

114. Because of the extensive attention in the comment letters on the Exposure Draft to the manner of reporting operating cash flows, the Board gave particular consideration to that issue in its deliberations leading to the issuance of this Statement. As mentioned in paragraph 42, the FASB staff held a special meeting with representatives of interested groups of constituents to obtain more information about the benefits and costs of the direct and indirect methods. Because most enterprises said that they cannot now obtain amounts of gross operating cash receipts and payments directly from their accounting systems, the Board considered means by which those amounts might be determined indirectly. Together with other efforts, the FASB staff commissioned an informal interview survey of a limited number of enterprises concerning the potential costs they might incur in indirectly determining amounts of operating cash receipts and payments.

Indirectly Determining Amounts of Operating Cash Receipts and Payments

115. Given sufficiently detailed information, major classes of operating cash receipts and payments may be determined indirectly by adjusting revenue and expense amounts for the change during the period in related asset and liability accounts. For example, cash collected from customers may be determined indirectly by adjusting sales for the change during the period in receivables from customers for the enterprise's delivery of goods or services. Likewise, cash paid to suppliers and employees may be determined indirectly by adjusting cost of sales and expenses (exclusive of depreciation, interest, and income taxes) for the change during the period in inventories and payables for operating items. That procedure, of course, requires the availability of information concerning the change during the period in the appropriate classes of receivables and payables.[17] The more detailed the categories of operating cash receipts and payments to be reported, the more complex the procedure for determining them.

116. Based on information available to the Board during its deliberations, it seems likely that amounts of operating cash receipts and payments at the minimum level of detail specified in paragraph 27 often may be determined indirectly without incurring unduly burdensome costs over those involved in appropriately applying the indirect method. For example, determining net cash flow from operating activities by the indirect method requires the availability of the total amount of operating receivables. That is, any receivables for investing or financing items must be segregated. Within the total amount of operating receivables, information on receivables from customers for an enterprise's delivery of goods or services may well be available separately from those for interest and dividends. Thus, it may be possible to determine indirectly cash collected from customers and interest and dividends received using much the same information needed to determine net cash flow from operating activities using the indirect method.

117. The same procedure may be used to determine cash paid to suppliers and employees. Determining net cash flow from operating activities by the direct method requires the availability of the total amount of payables pertaining to operating activities. Within that amount, payables

to suppliers and employees may well be available separately from those for interest and taxes. The Board understands, however, that determining operating cash payments in more detail than the minimum specified in paragraph 27 might involve significant incremental costs over those already required to apply the indirect method because information on subcategories of payables to suppliers and employees may not be available.

118. The Board believes that many enterprises may well be able to determine amounts of operating cash receipts and payments at the minimum level of detail that this Statement encourages (paragraph 27) indirectly at reasonable cost by the procedure discussed in the foregoing paragraphs. But few, if any, companies have experimented with the procedure, and the degree of difficulty encountered in applying it undoubtedly would vary depending on the nature of an enterprise's operations and the features of its current accounting system.

Conclusion on Reporting Net Cash Flow from Operating Activities

119. The Board believes that both the direct and the indirect methods provide potentially important information. The more comprehensive and presumably more useful approach would be to use the direct method in the statement of cash flows and to provide a reconciliation of net income and net cash flow from operating activities in a separate schedule—thereby reaping the benefits of both methods while maintaining the focus of the statement of cash flows on cash receipts and payments. This Statement therefore encourages enterprises to follow that approach. But most providers and users of financial statements have little or no experience and only limited familiarity with the direct method, while both have extensive experience with the indirect method. Not only are there questions about the ability of enterprises to determine gross amounts of operating cash receipts and payments, as already discussed, but also little information is available on which specific categories of operating cash receipts and payments would be most meaningful.

120. Major change in financial reporting often is the result of an evolutionary process, which may involve interactions between the voluntary efforts of providers of financial statements and the actions of standards setters. Many areas of financial reporting, and reporting cash flows in particular, have benefited from the voluntary efforts of enterprises to improve their reporting practices. The Board decided that further movement toward a more comprehensive approach to reporting operating cash flows should be permitted to develop as both providers and users of financial statements gain experience with information on cash flows prepared in accordance with the provisions of this Statement.

121. To provide information about the gross amounts of at least those operating cash flows that are likely to be readily available, this Statement requires enterprises that use the indirect method of reporting net cash flow from operating activities to disclose amounts of interest and income taxes paid. The Board believes that that information usually will be readily available. This Statement also requires enterprises that use the indirect method to report separately changes in inventory, receivables, and payables. With that information, users may be able to make their

own rough approximations of operating cash receipts and payments at a minimum level of detail using the indirect procedure discussed in paragraphs 116 and 117.

Cash Flow per Share

122. The Board considered whether cash flow per share should be reported. The Board concluded that reporting cash flow per share would falsely imply that cash flow, or some component of it, is a possible alternative to earnings per share as a measure of performance. The Board also noted other problems with calculating cash flow per share, including differing opinions about the appropriate numerator for the indicator (for example, whether it should be net cash flow from operating activities or an amount after deducting principal repayments on debt) and the appropriate denominator for the indicator (for example, whether it should be the same as the number of shares outstanding used for the earnings per share calculation).

123. A major problem in reporting cash flow per share data is investor understanding. Investors over many years have become accustomed to seeing operating data per share computed only for earnings. Moreover, the measurement problems associated with reporting earnings on a per share basis have been considered and largely settled. To report other data on a per share basis invites the danger that investors, creditors, and others may confuse those measures with the conventional accounting measure of earnings per share.

124. Earnings per share focuses attention on earnings available for common stockholders, and that concept guides the calculation of, and adjustments to, the numerator and denominator of the ratio. Earnings is suitable for the numerator of the ratio because the concepts underlying its calculation, such as capital maintenance (the distinction between the return *of* capital and return *on* capital), focus on return to stockholders *on* their investment. Net cash flow from operating activities is not comparable to net income because recovery of capital is not a factor in its calculation, and net cash flow from operating activities includes both returns *on* and returns *of* investment.

125. A majority of the respondents to the Exposure Draft who addressed the issue agreed that cash flow per share should not be reported. A few, however, asked whether the Board intended to preclude reporting of per unit amounts of cash flow distributable under the terms of a partnership agreement or other agreement between an enterprise and its owners. Reporting a contractually determined per unit amount is not the same as reporting a cash flow per share amount intended to provide information useful to all investors and creditors and thus is not precluded by this Statement.

Effective Date and Transition

126. The Exposure Draft would have been effective for fiscal years ending after June 30, 1987 and would have required enterprises to effect the change in accounting by restating financial statements for earlier years presented for comparative purposes.

127. Some respondents to the Exposure Draft said that restatement of prior years' financial statements for their companies would be difficult and expensive, if not virtually impossible, because certain data on gross cash flows were not collected for earlier periods. The major problem areas mentioned were foreign subsidiaries' cash flows and gross cash flows pertaining to loans and deposits of banks. Because of the need to develop systems for gathering that information, those respondents generally asked that the effective date of a final Statement be deferred at least a year from that in the Exposure Draft. A few banks asked that the effective date be deferred until years ending after December 15, 1989. They said that they needed additional time to get data-gathering systems in place by the beginning of the year of adoption.

128. The Board recognizes that some enterprises will need to develop data-gathering systems and thus decided to make this Statement effective for fiscal years ending after July 15, 1988 and not to require its application in interim statements during the year of adoption. The Board, however, decided against a further delay of the effective date. The Board noted that reasonable approximations are generally acceptable.

129. The Board also was persuaded by respondents that requiring restatement of prior years' financial statements might be unduly burdensome for some enterprises and thus decided to encourage but not require restatement. However, not restating prior years' statements of changes in financial position to comply with the provisions of this Statement may result in a significant degree of noncomparability and may also make for an awkward presentation. For example, an enterprise that formerly presented its statement of changes in financial position in a sources and uses format and considered "funds" to be working capital might find it difficult to present those statements on the same page as a statement of cash flows. The Board therefore expects that enterprises with the ability to restate generally will do so.

Appendix C: ILLUSTRATIVE EXAMPLES

130. This appendix provides illustrations for the preparation of statements of cash flows. Example 1 illustrates a statement of cash flows under both the direct method and the indirect method for a domestic manufacturing company. Example 2 illustrates a statement of cash flows under the direct method for a manufacturing company with foreign operations. Example 3 illustrates a statement of cash flows under the direct method for a financial institution. These illustrations are intended as examples only. Also, the illustrations of the reconciliation of net income to net cash provided by operating activities may provide detailed information in excess of that required for a meaningful presentation. Other formats or levels of detail may be appropriate for particular circumstances.

Example 1

131. Presented below is a statement of cash flows for the year ended December 31, 19X1 for Company M, a U.S. corporation engaged principally in manufacturing activities. This statement of cash flows illustrates the direct method of presenting cash flows from operating activities, as encouraged in paragraph 27 of this Statement.

COMPANY M
CONSOLIDATED STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED DECEMBER 31, 19X1
Increase(Decrease) in Cash and Cash Equivalents

Cash flows from operating activities:		
Cash received from customers	$13,850	
Cash paid to suppliers and employees	(12,000)	
Dividend received from affiliate	20	
Interest received	55	
Interest paid (net of amount capitalized)	(220)	
Income taxes paid	(325)	
Insurance proceeds received	15	
Cash paid to settle lawsuit for patent infringement	(30)	
Net cash provided by operating activities		$1,365
Cash flows from investing activities:		
Proceeds from sale of facility	600	
Payment received on note for sale of plant	150	
Capital expenditures	(1,000)	
Payment for purchase of Company S, net of cash acquired	(925)	
Net cash used in investing activities		(1,175)
Cash flows from financing activities:		
Net borrowings under line-of-credit agreement	300	
Principal payments under capital lease obligation	(125)	
Proceeds from issuance of long-term debt	400	
Proceeds from issuance of common stock	500	
Dividends paid	(200)	
Net cash provided by financing activities		875
Net increase in cash and cash equivalents		1,065
Cash and cash equivalents at beginning of year		600

Cash and cash equivalents at end of year		$1,665

Reconciliation of net income to net cash provided by operating activities:

Net income		$ 760
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	$ 445	
Provision for losses on accounts receivable	200	
Gain on sale of facility	(80)	
Undistributed earnings of affiliate	(25)	
Payment received on installment note receivable for sale of inventory	100	
Change in assets and liabilities net of effects from purchase of Company S:		
Increase in accounts receivable	(215)	
Decrease in inventory	205	
Increase in prepaid expenses	(25)	
Decrease in accounts payable and accrued expenses	(250)	
Increase in interest and income taxes payable	50	
Increase in deferred taxes	150	
Increase in other liabilities	50	
Total adjustments		605
Net cash provided by operating activities		$1,365

Supplemental schedule of noncash investing and financing activities:

The Company purchased all of the capital stock of Company S for $950. In conjunction with the acquisition, liabilities were assumed as follows:

Fair value of assets acquired	$1,580
Cash paid for the capital stock	(950)
Liabilities assumed	$ 630

A capital lease obligation of $850 was incurred when the Company entered into a lease for new equipment.

Additional common stock was issued upon the conversion of $500 of long-term debt.

Disclosure of accounting policy:
For purposes of the statement of cash flows, the Company considers all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents.

132. Presented below is Company M's statement of cash flows for the year ended December 31, 19X1 prepared using the indirect method, as described in paragraph 28 of this Statement.

Company M
Consolidated Statement of Cash Flows
For the Year Ended December 31, 19X1
Increase (Decrease) in Cash and Cash Equivalents

Cash flows from operating activities:		
Net income		$ 760
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	$ 445	
Provision for losses on accounts receivable	200	
Gain on sale of facility	(80)	
Undistributed earnings of affiliate	(25)	
Payment received on installment note receivable for sale of inventory	100	
Change in assets and liabilities net of effects from purchase of Company S:		
Increase in accounts receivable	(215)	
Decrease in inventory	205	
Increase in prepaid expenses	(25)	
Decrease in accounts payable and accrued expenses	(250)	
Increase in interest and income taxes payable	50	
Increase in deferred taxes	150	
Increase in other liabilities	50	
Total adjustments		605
Net cash provided by operating activities		1,365
Cash flows from investing activities:		
Proceeds from sale of facility	600	
Payment received on note for sale of plant	150	
Capital expenditures	(1,000)	
Payment for purchase of Company S, net of cash acquired	(925)	
Net cash used in investing activities		(1,175)
Cash flows from financing activities:		
Net borrowings under line-of-credit agreement	300	
Principal payments under capital lease obligation	(125)	
Proceeds from issuance of long-term debt	400	
Proceeds from issuance of common stock	500	

Dividends paid	(200)	
Net cash provided by financing activities		875
Net increase in cash and cash equivalents		1,065
Cash and cash equivalents at beginning of year		600
Cash and cash equivalents at end of year		$1,665

Supplemental disclosures of cash flow information:

Cash paid during the year for:	
Interest (net of amount capitalized)	$220
Income taxes	325

Supplemental schedule of noncash investing and financing activities

The Company purchased all of the capital stock of Company S for $950. In conjunction with the acquisition, liabilities were assumed as follows:

Fair value of assets acquired	$1,580
Cash paid for the capital stock	(950)
Liabilities assumed	$ 630

A capital lease obligation of $850 was incurred when the Company entered into a lease for new equipment.

Additional common stock was issued upon the conversion of $500 of long-term debt.

Disclosure of accounting policy:

For purposes of the statement of cash flows, the Company considers all highly liquid debt instruments purchased with a maturity of three months or less to be cash equivalents.

133. Summarized below is financial information for the current year for Company M, which provides the basis for the statements of cash flows presented in paragraphs 131 and 132:

Company M
Consolidated Statement of Financial Position

	1/1/X1	12/31/X1	Change
Assets:			
Cash and cash equivalents	$ 600	$ 1,665	$1,065
Accounts receivable (net of allowance for losses of $600 and $450)	1,770	1,940	170
Notes receivable	400	150	(250)
Inventory	1,230	1,375	145
Prepaid expenses	110	135	25
Investments	250	275	25
Property, plant, and equipment, at cost	6,460	8,460	2,000
Accumulated depreciation	(2,100)	(2,300)	(200)
Property, plant, and equipment, net	4,360	6,160	1,800
Intangible assets	40	175	135
Total assets	$8,760	$11,875	$3,115
Liabilities:			
Accounts payable and accrued expenses	$1,085	$ 1,090	$ 5
Interest payable	30	45	15
Income taxes payable	50	85	35
Short-term debt	450	750	300
Lease obligation	—	725	725
Long-term debt	2,150	2,425	275
Deferred taxes	375	525	150
Other liabilities	225	275	50
Total liabilities	4,365	5,920	1,555
Stockholders' equity:			
Capital stock	2,000	3,000	1,000
Retained earnings	2,395	2,955	560
Total stockholders' equity	4,395	5,955	1,560
Total liabilities and stockholders' equity	$8,760	$11,875	$3,115

Company M
Consolidated Statement of Income
For the Year Ended December 31, 19X1

Sales	$13,965
Cost of sales	(10,290)
Depreciation and amortization	(445)
Selling, general, and administrative expenses	(1,890)
Interest expense	(235)
Equity in earnings of affiliate	45
Gain on sale of facility	80
Interest income	55
Insurance proceeds	15
Loss from patent infringement lawsuit	(30)
Income before income taxes	1,270
Provision for income taxes	(510)
Net income	$ 760

134. The following transactions were entered into by Company M during 19X1 and are reflected in the above financial statements:

a. Company M wrote off $350 of accounts receivable when a customer filed for bankruptcy. A provision for losses on accounts receivable of $200 was included in Company M's selling, general, and administrative expenses.
b. Company M collected the third and final annual installment payment of $100 on a note receivable for the sale of inventory and collected the third of four annual installment payments of $150 each on a note receivable for the sale of a plant. Interest on these notes through December 31 totaling $55 was also collected.
c. Company M received a dividend of $20 from an affiliate accounted for under the equity method of accounting.
d. Company M sold a facility with a book value of $520 and an original cost of $750 for $600 cash.
e. Company M constructed a new facility for its own use and placed it in service. Accumulated expenditures during the year of $1,000 included capitalized interest of $10.
f. Company M entered into a capital lease for new equipment with a fair value of $850. Principal payments under the lease obligation totaled $125.
g. Company M purchased all of the capital stock of Company S for $950. The acquisition was recorded under the purchase method of accounting. The fair values of Company S's assets

and liabilities at the date of acquisition are presented below:

Cash	$ 25
Accounts receivable	155
Inventory	350
Property, plant, and equipment	900
Patents	80
Goodwill	70
Accounts payable and accrued expenses	(255)
Long-term note payable	(375)
Net assets acquired	$950

h. Company M borrowed and repaid various amounts under a line-of-credit agreement in which borrowings are payable 30 days after demand. The net increase during the year in the amount borrowed against the line-of-credit totaled $300.
i. Company M issued $400 of long-term debt securities.
j. Company M's provision for income taxes included a deferred provision of $150.
k. Company M's depreciation totaled $430, and amortization of intangible assets totaled $15.
l. Company M's selling, general, and administrative expenses included an accrual for incentive compensation of $50 that has been deferred by executives until their retirement. The related obligation was included in other liabilities.
m. Company M collected insurance proceeds of $15 from a business interruption claim that resulted when a storm precluded shipment of inventory for one week.
n. Company M paid $30 to settle a lawsuit for patent infringement.
o. Company M issued $1,000 of additional common stock of which $500 was issued for cash and $500 was issued upon conversion of long-term debt.
p. Company M paid dividends of $200.

135. Based on the financial data from the preceding example, the following computations illustrate a method of indirectly determining cash received from customers and cash paid to suppliers and employees for use in a statement of cash flows under the direct method.

Cash received from customers during the year:

Customer sales		$13,965
Collection of installment payment for sale of inventory		100
Gross accounts receivable at beginning of year	$2,370	
Accounts receivable acquired in purchase of Company S	155	
Accounts receivable written off	(350)	
Gross accounts receivable at end of year	(2,390)	

Excess of new accounts receivable over collections from customers			(215)
Cash received from customers during the year			$13,850

Cash paid to suppliers and employees during the year:

Cost of sales			$10,290
General and administrative expenses		$1,890	
Expenses not requiring cash outlay (provision for uncollectible accounts receivable)		(200)	
Net expenses requiring cash payments			1,690
Inventory at beginning of year		(1,230)	
Inventory acquired in purchase of Company S		(350)	
Inventory at end of year		1,375	
Net decrease in inventory from Company M's operations			(205)
Adjustments for changes in related accruals:			
Account balances at beginning of year			
Accounts payable and accrued expenses	$1,085		
Other liabilities	225		
Prepaid expenses	(110)		
Total		1,200	
Accounts payable and accrued expenses acquired in purchase of Company S		255	
Account balances at end of year			
Accounts payable and accrued expenses	1,090		
Other liabilities	275		
Prepaid expenses	(135)		
Total		(1,230)	
Additional cash payments not included in expense			225
Cash paid to suppliers and employees during the year			$12,000

Example 2

136. Presented below is a consolidating statement of cash flows for the year ended December 31, 19X1 for Company F, a multinational U.S. corporation engaged principally in manufacturing activities, which has two wholly owned foreign subsidiaries— Subsidiary A and Subsidiary B. For Subsidiary A, the local currency is the functional currency. For Subsidiary B, which operates in a highly inflationary economy, the U.S. dollar is the functional currency.

Company F
Consolidating Statement of Cash Flows
For the Year Ended December 31, 19X1
Increase (Decrease) in Cash and Cash Equivalents

	Parent Company	Subsidiary A	Subsidiary B	Eliminations	Consolidated
Cash flows from operating activities:					
Cash received from customers	$4,610 [a]	$888 [a]	$561 [a]	$(430)	$5,629
Cash paid to suppliers and employees	(3,756) [a]	(806) [a]	(370) [a]	430	(4,502)
Interest paid	(170)	(86)	(135)	—	(391)
Income taxes paid	(158)	(25)	(21)	—	(204)
Interest and dividends received	57	—	—	(22)	35
Miscellaneous cash received (paid)	—	45	(5)	—	40
Net cash provided by operating activities	583	16	30	(22)	607
Cash flows from investing activities:					
Proceeds from sale of equipment	150	116	14	—	280
Payments for purchase of equipment	(450)	(258)	(15)	—	(723)
Net cash used in investing activities	(300)	(142)	(1)	—	(443)
Cash flows from financing activities:					
Proceeds from issuance of short-term debt	20	75	—	—	95
Intercompany loan	(15)	—	15	—	—
Proceeds from issuance of long-term debt	—	165	—	—	165
Repayment of long-term debt	(200)	(105)	(35)	—	(340)
Payment of dividends	(120)	(22)	—	22	(120)
Net cash provided by (used in) financing activities	(315)	113	(20)	22	(200)
Effect of exchange rate changes on cash	—	9 [b]	(5) [b]	—	4
Net change in cash and cash equivalents	(32)	(4)	4	—	(32)

Cash and cash equivalents at beginning of year	255	15	5	—	- 275
Cash and cash equivalents at end of year	$ 223	$ 11	$ 9	$ —	$ 243

[a] The computation of this amount is provided in paragraph 145.

[b] The computation of this amount is provided in paragraph 146.

Reconciliation of net income to net cash provided by operating activities:

	Parent Company	Subsidiary A	Subsidiary B	Eliminations	Consolidated
Net income	$417	$50	$(66)	$(37)	$364
Adjustments to reconcile net income to net cash provided by operating activities:					
Depreciation and amortization	350	85	90	—	525
(Gain) loss on sale of equipment	(115)	—	25	—	(90)
Writedown of facility to net realizable value	50	—	—	—	50
Exchange gain	—	—	(115)	—	(115)
Provision for deferred taxes	90	—	—	—	90
Increase in accounts receivable	(85)	(37)	(9)	—	(131)
(Increase) decrease in inventory	(80)	(97)	107	15	(55)
Increase (decrease) in accounts payable and accrued expenses	(41)	16	(6)	—	(31)
Increase (decrease) in interest and taxes payable	(3)	(1)	4	—	—
Net cash provided by operating activities	$583	$16	$30	$(22)	$607

Disclosure of accounting policy:

Cash in excess of daily requirements is invested in marketable securities consisting of Treasury bills with maturities of three months or less. Such investments are deemed to be cash equivalents for purposes of the statement of cash flows.

137. Summarized below is financial information for the current year for Company F, which provides the basis for the statement of cash flows presented in paragraph 136.

Company F
Consolidating Statement of Financial Position
December 31, 19X1

	Parent Company	Subsidiary A	Subsidiary B	Eliminations	Consolidated
Assets:					
Cash and cash equivalents	$ 223	$ 11	$ 9	$ —	$ 243
Accounts receivable	725	95	20	—	840
Intercompany loan receivable	15	—	—	(15)	—
Inventory	630	281	96	(15)	992
Investments	730	—	—	(730)	—
Property, plant, and equipment, net	3,305	1,441	816	—	5,562
Other assets	160	11	—	—	171
Total assets	$5,788	$1,839	$941	$(760)	$7,808
Liabilities:					
Accounts payable and accrued expenses	$ 529	$ 135	$ 38	$ —	$ 702
Interest payable	35	11	4	—	50
Taxes payable	45	5	2	—	52
Short-term debt	160	135	—	—	295
Intercompany debt	—	—	15	(15)	—
Long-term debt	1,100	315	40	—	1,455
Deferred taxes	342	—	—	—	342

Total liabilities	2,211	601	99	(15)	2,896
Stockholders' equity:					
Capital stock	550	455	275	(730)	550
Retained earnings	3,027	554	567	(15)	4,133
Cumulative translation adjustment	—	229	—	—	229
Total stockholders' equity	3,577	1,238	842	(745)	4,912
Total liabilities and stockholders' equity	$5,788	$1,839	$941	$(760)	$7,808

Company F
Consolidating Statement of Income
For the Year Ended December 31, 19X1

	Parent Company	Subsidiary A	Subsidiary B	Eliminations	Consolidated
Revenues	$4,695	$925	$570	$(430)	$5,760
Cost of sales	(3,210)	(615)	(406)	415	(3,816)
Depreciation and amortization	(350)	(85)	(90)	–	(525)
General and administrative expenses	(425)	(110)	(65)	–	(600)
Interest expense	(165)	(90)	(135)	–	(390)
Interest and dividend income	57	–	–	(22)	35
Gain (loss) on sale of equipment	115	–	(25)	–	90
Miscellaneous income (expense)	(50)	45	(5)	–	(10)
Exchange gain	–	–	115	–	115
Income before income taxes	667	70	(41)	(37)	659
Provision for income taxes	(250)	(20)	(25)	–	(295)
Net income	$ 417	$ 50	$ (66)	$ (37)	$ 364

138. The U.S. dollar equivalents of one unit of local currency applicable to Subsidiary A and to Subsidiary B are as follows:

	Subsidiary A	Subsidiary B
1/1/X1	.40	.05
Weighted average	.43	.03
12/31/X1	.45	.02

The computation of the weighted-average exchange rate for Subsidiary A excludes the effect of Subsidiary A's sale of inventory to the parent company at the beginning of the year discussed in paragraph 142(a).

139. Comparative statements of financial position for the parent company and for each of the foreign subsidiaries are presented below.

COMPARATIVE STATEMENTS OF FINANCIAL POSITION

	Parent Company			Subsidiary A Local Currency			Subsidiary A U.S. Dollars			Subsidiary B Local Currency			Subsidiary B U.S. Dollars		
	1/1/X1	**12/13/X1**	**Change**	**1/1/X1**	**12/31/X1**	**Change**	**1/1/X1**	**12/31/X1**	**Change**	**1/1/X1**	**12/31/X1**	**Change**	**1/1/X1**	**12/31/X1**	**Change**
Assets															
Cash and cash equivalents	$ 255	$ 223	$ (32)	LC 38	LC 25	LC (13)	$ 15	$ 11	$ (4)	LC 100	LC 449	LC 349	$ 5	$ 9	$ 4
Accounts receivable	640	725	85	125	210	85	50	95	45	700	1,000	300	35	20	(15)
Intercompany loan receivable	–	15	15	–	–	–	–	–	–	–	–	–	–	–	–
Inventory	550	630	80	400	625	225	160	281	121	2,900	3,200	300	203	96	(107)
Investments	730	730	–	–	–	–	–	–	–	–	–	–	–	–	–
Property, plant, and equipment, net	3,280	3,305	25	3,075	3,202	127	1,230	1,441	211	6,200	5,900	(300)	930	816	(114)
Other assets	170	160	(10)	25	25	–	10	11	1	–	–	–	–	–	–
Total assets	$5,625	$5,788	$163	LC3,663	LC4,087	LC424	$1,465	$1,839	$ 374	LC9,900	LC10,549	LC 649	$1,173	$941	$(232)
Liabilities:															
Accounts payable and accrued expenses	$ 570	$ 529	$ (41)	LC 263	LC 300	LC 37	$ 105	$ 135	$ 30	LC2,100	LC 1,900	LC(200)	$ 105	$ 38	$ (67)
Interest payable	40	35	(5)	15	24	9	6	11	5	200	200	–	10	4	(6)
Taxes payable	43	45	2	25	12	(13)	10	5	(5)	–	120	120	–	2	2
Short-term debt	140	160	20	125	300	175	50	135	85	–	–	–	–	–	–
Intercompany debt	–	–	–	–	–	–	–	–	–	–	500	500	–	15	15
Long-term debt	1,300	1,100	(200)	550	700	150	220	315	95	3,000	2,000	(1,000)	150	40	(110)
Deferred taxes	252	342	90	–	–	–	–	–	–	–	–	–	–	–	–
Total liabilities	2,345	2,211	(134)	978	1,336	358	391	601	210	5,300	4,720	(580)	265	99	(166)
Stockholders' equity:															
Capital stock	550	550	–	1,300	1,300	–	455	455	–	1,375	1,375	–	275	275	–
Retained earnings	2,730	3,027	297	1,385	1,451	66	526	554	28	3,225	4,454	1,229	633	567	(66)
Cumulative translation adjustment	–	–	–	–	–	–	93	229	136	–	–	–	–	–	–
Total stockholders' equity	3,280	3,577	297	2,685	2,751	66	1,074	1,238	164	4,600	5,829	1,229	908	842	(66)
Total liabilities and stockholders' equity	$5,625	$5,788	$163	LC3,663	LC4,087	LC424	$1,465	$1,839	$ 374	LC9,900	LC10,549	LC649	$1,173	$941	$(232)

140. Statements of income in local currency and U.S. dollars for each of the foreign subsidiaries are presented below.

STATEMENTS OF INCOME
FOR THE YEAR ENDED DECEMBER 31, 19X1

	Subsidiary A		Subsidiary B	
	Local Currency	U.S. Dollars	Local Currency	U.S Dollars
Revenues	LC2,179	$ 925 [a]	LC19,000	$ 570
Cost of sales	(1,458)	(615) [b]	(9,667)	(406)
Depreciation and amortization	(198)	(85)	(600)	(90)
General and administrative expenses	(256)	(110)	(2,167)	(65)
Interest expense	(209)	(90)	(4,500)	(135)
Gain (loss) on sale of equipment	–	–	150	(25)
Miscellaneous income (expense)	105	45	(167)	(5)
Exchange gain	–	–	–	115
Income before income taxes	163	70	2,049	(41)
Provision for income taxes	(47)	(20)	(820)	(25)
Net income	LC 116	$ 50	LC 1,229	$ (66)

141. The following transactions were entered into during the year by the parent company and are reflected in the above financial statements:

a. The parent company invested cash in excess of daily requirements in Treasury bills. Interest earned on such investments totaled $35.
b. The parent company sold excess property with a net book value of $35 for $150.
c. The parent company's capital expenditures totaled $450.
d. The parent company wrote down to its estimated net realizable value of $25 a facility with a net book value of $75.
e. The parent company's short-term debt consisted of commercial paper with maturities not exceeding 60 days.
f. The parent company repaid long-term notes of $200.
g. The parent company's depreciation totaled $340, and amortization of intangible assets totaled $10.
h. The parent company's provision for income taxes included deferred taxes of $90.
i. Because of a change in product design, the parent company purchased all of Subsidiary A's beginning inventory for its book value of $160. All of the inventory was subsequently sold by the parent company.

j. The parent company received a dividend of $22 from Subsidiary A. The dividend was credited to the parent company's income.
k. The parent company purchased from Subsidiary B $270 of merchandise of which $45 remained in the parent company's inventory at year-end. Intercompany profit on the remaining inventory totaled $15.
l. The parent company loaned $15, payable in U.S. dollars, to Subsidiary B.
m. Company F paid dividends totaling $120 to shareholders.

142. The following transactions were entered into during the year by Subsidiary A and are reflected in the above financial statements. The U.S. dollar equivalent of the local currency amount based on the exchange rate at the date of each transaction is included. Except for the sale of inventory to the parent company (transaction (a) below), Subsidiary A's sales and purchases and operating cash receipts and payments occurred evenly throughout the year.

a. Because of a change in product design, Subsidiary A sold all of its beginning inventory to the parent company for its book value of LC400 ($160).
b. Subsidiary A sold equipment for its book value of LC275 ($116) and purchased new equipment at a cost of LC600 ($258).
c. Subsidiary A issued an additional LC175 ($75) of 30-day notes and renewed the notes at each maturity date.
d. Subsidiary A issued long-term debt of LC400 ($165) and repaid long-term debt of LC250 ($105).
e. Subsidiary A paid a dividend to the parent company of LC50 ($22).

143. The following transactions were entered into during the year by Subsidiary B and are reflected in the above financial statements. The U.S. dollar equivalent of the local currency amount based on the exchange rate at the date of each transaction is included. Subsidiary B's sales and operating cash receipts and payments occurred evenly throughout the year. For convenience, all purchases of inventory were based on the weighted-average exchange rate for the year. Subsidiary B uses the FIFO method of inventory valuation.

a. Subsidiary B had sales to the parent company as follows:

	Local Currency	**U.S. Dollars**
Intercompany sales	LC9,000	$ 270
Cost of sales	(4,500)	(180)
Gross profit	LC4,500	$ 90

b. Subsidiary B sold equipment with a net book value of LC200 ($39) for LC350 ($14). New equipment was purchased at a cost of LC500 ($15).

c. Subsidiary B borrowed $15 (LC500), payable in U.S. dollars, from the parent company.
d. Subsidiary B repaid LC1,000 ($35) of long-term debt.

144. Statements of cash flows in the local currency and in U.S. dollars for Subsidiary A and Subsidiary B are presented below.

STATEMENTS OF CASH FLOWS
FOR THE YEAR ENDED DECEMBER 31, 19X1
Increase (Decrease) in Cash

	Subsidiary A		Subsidiary B	
	Local Currency	U.S. Dollars	Local Currency	U.S Dollars
Cash flows from operating activities:				
Cash received from customers	LC2,094 [a]	$888 [a]	LC18,700 [a]	$561 [a]
Cash paid to suppliers and employees	(1,902) [a]	(806) [a]	(12,334) [a]	(370) [a]
Interest paid	(200)	(86) [b]	(4,500)	(135) [b]
Income taxes paid	(60)	(25) [b]	(700)	(21) [b]
Miscellaneous receipts (payments)	105	(45) [b]	(167)	(5) [b]
Net cash provided by operating activities	37	16	999	30
Cash flows from investing activities:				
Proceeds from sale of equipment	275	116 [c]	350	14 [c]
Payments for purchase of equipment	(600)	(258) [c]	(500)	(15) [c]
Net cash used in investing activities	(325)	(142)	(150)	(1)
Cash flows from financing activities:				
Net increase in short-term debt	175	75 [c]	–	–
Proceeds from intercompany loan	–	–	500	15 [c]
Proceeds from issuance of long-term debt	400	165 [c]	–	–
Repayment of long-term debt	(250)	(105) [c]	(1,000)	(35) [c]
Payment of dividends	(50)	(22) [c]	–	–
Net cash provided by (used in) financing activities	275	113	(500)	(20)
Effect of exchange rate changes on cash	–	9 [d]	–	(5) [d]
Net increase (decrease) in cash	(13)	(4)	349	4
Cash at beginning of year	38	15	100	5
Cash at end of year	LC 25	$ 11	LC 449	$ 9

Reconciliation of net income to net cash provided by operating activities:

	Subsidiary A		Subsidiary B	
	Local Currency	U.S. Dollars	Local Currency	U.S Dollars
Net income	LC116	$50	LC1,229	$(66)
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	198	85 [a]	600	90 [b]
(Gain) loss on sale of equipment	–	–	(150)	25 [b]
Exchange gain	–	–	–	(115) [c]
Increase in accounts receivable	(85)	(37) [a]	(300)	(9) [a]
Increase decrease in inventory	(225)	(97) [a]	(300)	107 [d]
Increase (decrease) in accounts payable and accrued expenses	37	16[a]	(200)	(6) [a]
Increase (decrease) in interest and taxes payable	(4)	(1)[a]	120	4 [a]
Net cash provided by operating activities	LC 37	$16	LC 999	$30

145. Presented below is the computation of cash received from customers and cash paid to suppliers and employees as reported in the consolidating statement of cash flows for Company F appearing in paragraph 136.

	Parent Company	Subsidiary A		Subsidiary B	
		Local Currency	U.S. Dollars	Local Currency	U.S. Dollars
Cash received from customers during the year:					
Revenues	$4,695	LC2,179	$925	LC19,000	$570
Increase in accounts receivable	(85)	(85)	(37)	(300)	(9)
Cash received from customers	$4,610	LC2,094	$888	LC18,700	$561
Cash paid to suppliers and employees during the year:					
Cost of sales	$3,210	LC1,458	$615	LC 9,667	$406

Effect of exchange rate changes on cost of sales	–	–	–	–	(116) [a]
General and administrative expenses	425	256	110	2,167	65
Total operating expenses requiring cash payments	3,635	1,714	725	11,834	355
Increase in inventory	80	225	97	300	9
(Increase) decrease in accounts payable and accrued expenses	41	(37)	(16)	200	6
Cash paid to suppliers and employees	$3,756	LC1,902	$806	LC12,334	$370

146. Presented below is the computation of the effect of exchange rate changes on cash for Subsidiary A and Subsidiary B:

COMPUTATION OF EFFECT OF EXCHANGE RATE CHANGES ON CASH

	Subsidiary A		Subsidiary B	
Effect on beginning cash balance:				
Beginning cash balance in local currency	LC 38		LC100	
Net change in exchange rate during the year	× .05		× (.03)	
Effect on beginning cash balance		$2		$(3)
Effect from operating activities during the year:				
Cash provided by operating activities in local currency	LC 37		LC 999	
Year-end exchange rate	× .45		× .02	
Operating cash flows based on year-end exchange rate	$ 16 [a]		$ 20	
Operating cash flows reported in the statement of cash flows	16		30	
Effect from operating activities during the year		0		(10)
Effect from investing activities during the year:				
Cash used in investing activities in local currency	LC(325)		LC(150)	
Year-end exchange rate	× .45		× .02	
Investing cash flows based on year-end exchange rate	$(146)		$(3)	
Investing cash flows reported in the statement of cash flows	(142)		(1)	
Effect from investing activities during the year		(4)		(2)
Effect from financing activities during the year:				
Cash provided by (used in) financing activities in local currency	LC 275		LC(500)	
Year-end exchange rate	× .45		× .02	

Financing cash flows based on year-end exchange rate	$124		$(10)	
Financing cash flows reported in the statement of cash flows	113		(20)	
Effect from financing activities during the year		11		10
Effect of exchange rate changes on cash		$ 9		$(5)

Example 3

147. Presented below is a statement of cash flows for Financial Institution, Inc., a U.S. corporation that provides a broad range of financial services. This statement of cash flows illustrates the direct method of presenting cash flows from operating activities, as encouraged in paragraph 27 of this Statement.

FINANCIAL INSTITUTION, INC.
STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED DECEMBER 31, 19X1
Increase (Decrease) in Cash and Cash Equivalents

Cash flows from operating activities:		
Interest received	$5,350	
Fees and commissions received	1,320	
Financing revenue received under leases	60	
Interest paid	(3,925)	
Cash paid to suppliers and employees	(795)	
Income taxes paid	(471)	
Net cash provided by operating activities		$ 1,539
Cash flows from investing activities:		
Proceeds from sales of trading andinvestment securities	22,700	
Purchase of trading and investment securities	(25,000)	
Net increase in credit card receivables	(1,300)	
Net decrease in customer loans with maturities of 3 months or less	2,250	
Principal collected on longer term loans	26,550	
Longer term loans made to customers	(36,300)	
Purchase of assets to be leased	(1,500)	
Principal payments received under leases	107	
Capital expenditures	(450)	
Proceeds from sale of property, plant, and equipment	260	
Net cash used in investing activities		(12,683)

Cash flows from financing activities:		
Net increase in demand deposits, NOW accounts, and savings accounts	3,000	
Proceeds from sales of certificates of deposit	63,000	
Payments for maturing certificates of deposit	(61,000)	
Net increase in federal funds purchased	4,500	
Net increase in 90-day borrowings	50	
Proceeds from issuance of nonrecourse debt	600	
Principal payment on nonrecourse debt	(20)	
Proceeds from issuance of 6-month note	100	
Proceeds from issuance of long-term debt	1,000	
Repayment of long-term debt	(200)	
Proceeds from issuance of common stock	350	
Payments to acquire treasury stock	(175)	
Dividends paid	(240)	
Net cash provided by financing activities		10,965
Net decrease in cash and cash equivalents		(179)
Cash and cash equivalents at beginning of year		6,700
Cash and cash equivalents at end of year		$ 6,521

Reconciliation of net income to net cash provided by operating activities:

Net income		$1,056
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	$ 100	
Provision for probable credit losses	300	
Provision for deferred taxes	58	
Gain on sale of trading and investment securities	(100)	
Gain on sale of equipment	(50)	
Increase in taxes payable	175	
Increase in interest receivable	(150)	
Increase in interest payable	75	
Decrease in fees and commissions receivable	20	
Increase in accrued expenses	55	
Total adjustment		483
Net cash provided by operating activities		$1,539

Supplemental schedule of noncash investing and financing activities:

Conversion of long-term debt to common stock	$ 500

Disclosure of accounting policy:

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, and federal funds sold. Generally, federal funds are purchased and sold for one-day periods.

148. Summarized below is financial information for the current year for Financial Institution, Inc., which provides the basis for the statement of cash flows presented in paragraph 147:

FINANCIAL INSTITUTION, INC.
STATEMENT OF FINANCIAL POSITION

	1/1/X1	12/31/X1	Change
Assets:			
Cash and due from banks	$ 4,400	$ 3,121	$(1,279)
Federal funds sold	2,300	3,400	1,100
Total cash and cash equivalents	6,700	6,521	(179)
Investment and trading securities	9,000	11,400	2,400
Credit card receivables	8,500	9,800	1,300
Loans	28,000	35,250	7,250
Allowance for credit losses	(800)	(850)	(50)
Interest receivable	600	750	150
Fees and commissions receivable	60	40	(20)
Investment in direct financing lease	–	421	421
Investment in leveraged lease	–	392	392
Plant, property, and equipment, net	525	665	140
Total assets	$52,585	$64,389	$11,804
Liabilities:			
Deposits	$38,000	$43,000	$ 5,000
Federal funds purchased	7,500	12,000	4,500
Short-term borrowings	1,200	1,350	150
Interest payable	350	425	75
Accrued expenses	275	330	55
Taxes payable	75	250	175
Dividends payable	0	80	80
Long-term debt	2,000	2,300	300
Deferred taxes	–	58	58
Total liabilities	49,400	59,793	10,393
Stockholders' equity:			
Common stock	1,250	2,100	850
Treasury stock	0	(175)	(175)
Retained earnings	1,935	2,671	736
Total stockholders' equity	3,185	4,596	1,411
Total liabilities and stockholders' equity	$52,585	$64,389	$11,804

FINANCIAL INSTITUTION, INC.
STATEMENT OF INCOME
FOR THE YEAR ENDED DECEMBER 31, 19X1

Revenues:		
Interest income	$5,500	
Fees and commissions	1,300	
Gain on sale of investment securities	100	
Lease income	60	
Gain on sale of equipment	50	
Total revenues		$7,010
Expenses:		
Interest expense	4,000	
Provision for probable credit losses	300	
Operating expenses	850	
Depreciation	100	
Total expenses		5,250
Income before income taxes		1,760
Provision for income taxes		704
Net income		$1,056

149. The following transactions were entered into by Financial Institution, Inc., during 19X1 and are reflected in the above financial statements:

a. Financial Institution sold trading and investment securities with a book value of $22,600 for $22,700 and purchased $25,000 in new trading and investment securities.
b. Financial Institution had a net decrease in short-term loans receivable (those with original maturities of 3 months or less) of $2,250. Financial Institution made longer term loans of $36,300 and collected $26,550 on those loans. Financial Institution wrote off $250 of loans as uncollectible.
c. Financial Institution purchased property for $500 to be leased under a direct financing lease. The first annual rental payment of $131 was collected. The portion of the rental payment representing interest income totaled $52.
d. Financial Institution purchased equipment for $1,000 to be leased under a leveraged lease. The cost of the leased asset was financed by an equity investment of $400 and a long-term nonrecourse bank loan of $600. The first annual rental payment of $90, of which $28 represented principal, was collected and the first annual loan installment of $74, of which $20 represented principal, was paid. Pretax income of $8 was recorded.
e. Financial Institution purchased new property, plant, and equipment for $450 and sold property, plant, and equipment with a book value of $210 for $260.

f. Customer deposits with Financial Institution consisted of the following:

	1/1/X1	12/31/X1	Increase
Demand deposits	$ 8,000	$ 8,600	$ 600
NOW accounts and savings accounts	15,200	17,600	2,400
Certificates of deposit	14,800	16,800	2,000
Total deposits	$38,000	$43,000	$5,000

Sales of certificates of deposit during the year totaled $63,000; certificates of deposit with principal amounts totaling $61,000 matured. For presentation in the statement of cash flows, Financial Institution chose to report gross cash receipts and payments for both certificates of deposit with maturities of three months or less and those with maturities of more than three months.

g. Short-term borrowing activity for Financial Institution consisted of repayment of a $200 90-day note and issuance of a 90-day note for $250 and a 6-month note for $100.
h. Financial Institution repaid $200 of long-term debt and issued 5-year notes for $600 and 10-year notes for $400.
i. Financial Institution issued $850 of common stock, $500 of which was issued upon conversion of long-term debt and $350 of which was issued for cash.
j. Financial Institution acquired $175 of treasury stock.
k. Financial Institution declared dividends of $320. The fourth quarter dividend of $80 was payable the following January.
l. Financial Institution's provision for income taxes included a deferred provision of $58.
m. In accordance with paragraph 7, footnote 1, of this Statement, interest aid includes amounts credited directly to demand deposit, NOW, and savings accounts.

Appendix D: AMENDMENTS TO EXISTING PRONOUNCEMENTS

150. This Statement supersedes Opinion 19 and the three AICPA Accounting Interpretations of Opinion 19.

151. This Statement amends the following pronouncements as follows:

a. APB Opinion No. 28, *Interim Financial Reporting*. In paragraph 33, the two references to the phrase *funds flow data* are replaced by the phrase *cash flow data*.
b. FASB Statement No. 7, *Accounting and Reporting by Development Stage Enterprises*. In paragraph 11(c), the phrase *A statement of changes in financial position, showing the sources and uses of financial resources* is replaced by the phrase *A statement of cash flows, showing the cash inflows and cash outflows*. Footnote 8 is deleted.

152. Many pronouncements issued by the Accounting Principles Board (APB) and the FASB contain references to the phrase (a) *a complete set of financial statements that present financial position, results of operations, and changes in financial position*, (b) *statement of changes in financial position*, or (c) *changes in financial position*. All such references appearing in paragraphs that establish standards or the scope of a pronouncement are hereby replaced by references to the phrase (a) *a complete set of financial statements that present financial position, results of operations, and cash flows*, (b) *statement of cash flows*, or (c) *cash flows*, respectively. That conclusion requires amendments to the following existing pronouncements:

a. APB Opinion No. 20, *Accounting Changes*, paragraph 3.
b. APB Opinion No. 22, *Disclosure of Accounting Policies*, paragraphs 6, 7, 8, and 12.
c. Opinion 28, paragraph 2.
d. Statement 7, paragraph 10.
e. FASB Statement No. 14, *Financial Reporting for Segments of a Business Enterprise*, paragraphs 3 and 7 (as amended by FASB Statement No. 24, *Reporting Segment Information in Financial Statements That Are Presented in Another Enterprise's Financial Report)*.
f. Statement 24, paragraphs 1 and 5 and footnote 2.
g. FASB Statement No. 69, *Disclosures about Oil and Gas Producing Activities*, footnote 3.
h. FASB Technical Bulletin No. 82-1, *Disclosure of the Sale or Purchase of Tax Benefits through Tax Leases*, paragraph 4.

153. Some pronouncements issued by the APB or FASB contain references to the phrase (a) *a complete set of financial statements*, (b) *a full set of financial statements*, or (c) *a complete set of annual financial statements* without a specific reference to the phrase *changes in financial position*. Because this Statement redefines what constitutes a complete or full set of financial statements, this Statement effectively amends the intent of those pronouncements even though the terminology in those pronouncements was not changed. The affected pronouncements are as follows:

a. Statement 7, footnote 6.
b. FASB Statement No. 21, *Suspension of the Reporting of Earnings per Share and Segment Information by Nonpublic Enterprises*, footnote 4.
c. FASB Statement No. 36, *Disclosure of Pension Information*, paragraph 8.
d. FASB Statement No. 57, *Related Party Disclosures*, footnote 2.
e. Statement 69, paragraphs 7, 8, and 41.

Footnotes

FAS95, Footnote 1--Consistent with common usage, *cash* includes not only currency on hand but demand deposits with banks or other financial institutions. *Cash* also includes other kinds of accounts that have the general characteristics of demand deposits in that the customer may deposit additional funds at any time and also effectively may withdraw funds at any time without prior notice or penalty. All charges and credits to those accounts are cash receipts or payments to both the entity owning the account and the bank holding it. For example, a bank's granting of a loan by crediting the proceeds to a customer's demand deposit account is a cash payment by the bank and a cash receipt of the customer when the entry is made.

FAS95, Footnote 2--*Original maturity* means original maturity to the entity holding the investment. For example, both a three-month U.S. Treasury bill and a three-year Treasury note purchased three months from maturity qualify as cash equivalents. However, a Treasury note purchased three years ago does not become a cash equivalent when its remaining maturity is three months.

FAS95, Footnote 3--For this purpose, amounts due on demand are considered to have maturities of three months or less. For convenience, credit card receivables of financial services operations--generally, receivables resulting from cardholder charges that may, at the cardholder's option, be paid in full when first billed, usually within one month, without incurring interest charges and that do not stem from the enterprise's sale of goods or services--also are considered to be loans with original maturities of three months or less.

FAS95, Footnote 4--Each cash receipt or payment is to be classified according to its nature without regard to whether it stems from an item intended as a hedge of another item. For example, the proceeds of a borrowing are a financing cash inflow whether or not the debt is intended as a hedge of an investment, and the purchase or sale of a futures contract is an investing activity without regard to whether the contract is intended as a hedge of a firm commitment to purchase inventory.

FAS95, Footnote 5—Receipts from disposing of loans, debt or equity instruments, or property, plant, and equipment include directly related proceeds of insurance settlements, such as the proceeds of insurance on a building that is damaged or destroyed.

FAS95, Footnote 6--Generally, only advance payments, the down payment, or other amounts paid at the time of purchase or soon before or after purchase of property, plant, and equipment and other productive assets are investing cash outflows. Incurring directly related debt to the seller is a financing transaction, and subsequent payments of principal on that debt thus are financing cash outflows.

FAS95, Footnote 7--Payments to acquire productive assets include interest capitalized as part of the cost of those assets.

FAS95, Footnote 8--Refer to footnote 6 which indicates that most principal payments on seller-financed debt directly related to a purchase of property, plant, and equipment or other productive assets are financing cash outflows.

FAS95, Footnote 9--Paragraph 12 of FASB Statement No. 52, *Foreign Currency Translation*, recognizes the general impracticality of translating revenues, expenses, gains, and losses at the exchange rates on dates they are recognized and permits an appropriately weighted average exchange rate for the period to be used to translate those elements. This Statement applies that provision to cash receipts and cash payments.

FAS95, Footnote 10--Separate disclosure of cash flows pertaining to extraordinary items or discontinued operations reflected in those categories is not required. An enterprise that nevertheless chooses to report separately operating cash flows of discontinued operations shall do so consistently for all periods affected, which may include periods long after sale or liquidation of the operation.

FAS95, Footnote 11--Paragraphs 115-118 in Appendix B and paragraph 135 in Appendix C, respectively, discuss and illustrate a method by which those major classes of gross operating cash receipts and payments generally may be determined indirectly.

FAS95, Footnote 12--Adjustments to net income to determine net cash flow from operating activities shall reflect accruals for interest earned but not received and interest incurred but not paid. Those accruals may be reflected in the statement of financial position in changes in assets and liabilities that relate to investing or financing activities, such as loans or deposits. However, interest credited directly to a deposit account that has the general characteristics described in paragraph 7, footnote 1, is a cash outflow of the payor and a cash inflow of the payee when the entry is made.

FAS95, Appendix B, Footnote 13--Unless otherwise indicated, references throughout this appendix to *respondents* generally include respondents to both the Discussion Memorandum and the 1986 Exposure Draft.

FAS95, Appendix B, Footnote 14--For convenience and because most of the controversy over funds statements for financial institutions has focused on commercial banks, this section uses the term *banks*. Most of the points discussed, however, apply also to thrifts and other kinds of financial institutions.

FAS95, Appendix B, Footnote 15--The Board is considering in another project on its agenda the kinds of information about financial instruments that should be disclosed in the financial statements of both financial and nonfinancial enterprises to help in assessing, among other things, liquidity, financial flexibility, profitability, and risk.

FAS95, Appendix B, Footnote 16--Presenting cash flow from operating activities by the indirect method, which this Statement permits, results in net reporting of operating cash receipts and payments. The basis for the Board's decision to permit continued use of the indirect method is discussed in paragraphs 106-121.

FAS95, Appendix B, Footnote 17--For the resulting operating cash receipts and payments to be accurate, the effects of all noncash entries to accounts receivable and payable, inventory, and other balance sheets accounts used in the calculation must be eliminated. For example, the change in accounts receivable would have to be determined exclusive of any bad debt write-offs and other noncash charges and credits to customer accounts during the period.

FAS95, Par. 140, Appendix C, Footnote a--This amount was computed as follows:

Sale to parent company at beginning of year	LC 400 @.40 = $160
Sales to customers	LC1,779 @.43 = 765
Total sales in U.S. dollars	$925

FAS95, Par. 140, Appendix C, Footnote b--This amount was computed as follows:

Cost of sale to parent company at beginning of year	LC 400 @ .40 = $160
Cost of sales to customers	LC1,058 @ .43 = 455
Total cost of sales in U.S. dollars	$615

FAS95, par. 144, *Statement of Cash Flows*, Footnote a—The computation of this amount is provided in paragraph 145.

FAS95, Par. 144, *Statement of Cash Flows*, Footnote b—This amount represents the U.S. dollar equivalent of the foreign currency cash flow based on the weighted-average exchange rate for the year.

FAS95, Par. 144, *Statement of Cash Flows*, Footnote c--This amount represents the U.S. dollar equivalent of the foreign currency cash flow based on the exchange rate in effect at the time of the cash flow.

FAS95, Par. 144, *Statement of Cash Flows*, Footnote d--The computation of this amount is provided in paragraph 146.

FAS95, Par. 144, *Reconciliation of net income to net cash provided by operating activities*, Footnote a—This amount represents the U.S. dollar equivalent of the foreign currency amount based on the weighted-average exchange rate for the year.

FAS95, Par. 144, *Reconciliation of net income to net cash provided by operating activities*, Footnote b—This amount represents the U.S. dollar equivalent of the foreign currency amount based on historical exchange rates.

FAS95, Par. 144, *Reconciliation of net income to net cash provided by operating activities*, Footnote c--This amount represents the U.S. dollar equivalent of the foreign currency cash flow based on the exchange rate in effect at the time of the cash flow.

FAS95, Par. 144, *Reconciliation of net income to net cash provided by operating activities*, Footnote d—This amount represents the difference between beginning and ending inventory after remeasurement into U.S. dollars based on historical exchange rates.

FAS95, Appendix C, Footnote a--This adjustment represents the difference between cost of sales remeasured at historical exchange rates ($406) and cost of sales translated based on the weighted-average exchange rate for the year ($290). The adjustment is necessary because cash payments for inventory, which were made evenly throughout the year, were based on the weighted-average exchange rate for the year.

FAS95, Par. 146, Appendix C, Footnote a--This amount includes the effect of rounding.