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chapter 12

Statement of Cash Flows

In the highly competitive beverage market dominated by giants Coca-Cola and PepsiCo, National Beverage aims at value-conscious consumers seeking flavor variety. With over 50 different flavors available in its well-known Shasta and Faygo carbonated soft drinks, combined with Everfresh juices, LaCroix waters, and Rip It energy products, National Beverage can meet all of the beverage needs of a wide variety of consumers and retailers. For its value strategy to earn profits for shareholders, National Beverage must also be a cost-effective producer. It maintains product quality and cost discipline through centralized purchasing and by owning and operating all of its production and bottling facilities. Its 12 plants, strategically located near customer distribution centers in different markets, reduce distribution costs and allow National Beverage to tailor its products and media promotions to regional tastes. Through difficult economic times, sales and profits at National Beverage continue to grow. As Nick Caporella, chairman and CEO of the company since its founding, said in a recent annual report, the keys to the company's strong performance are:

- Brands that sparkle in tough times
- Fortress balance sheet
- Investor focus that yields appreciation
- Investor cash—returned appropriately

Although it may seem puzzling, growing profitable operations do not always ensure positive cash flow. As we have seen in earlier chapters, this occurs because the timing of revenues and expenses does not always match cash inflows and outflows. As a consequence, National Beverage must carefully manage cash flows as well as profits. For the same reasons, financial analysts must consider the information provided in National Beverage's cash flow statement in addition to its income statement and balance sheet.

Learning Objective

After studying this chapter, you should be able to:

- 12- Classify cash flow statement items as part of net cash flows from operating, investing, and financing activities. p. 590
1
- 12- Report and interpret cash flows from operating activities using the indirect method. p. 597
2
- 12- Analyze and interpret the quality of income ratio. p. 603
3
- 12- Report and interpret cash flows from investing activities. p. 604
4

12- Analyze and interpret the capital acquisitions ratio. p. 606
5

12- Report and interpret cash flows from financing activities. p. 607
6

12- Understand the format of the cash flow statement and additional cash flow disclosures. p. 609
7

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FOCUS COMPANY:

National Beverage Corp.

PRODUCING VALUE FOR CUSTOMERS
AND CASH FLOWS FOR
SHAREHOLDERS IN TOUGH TIMES

www.nationalbeverage.com

UNDERSTANDING THE BUSINESS

Clearly, net income is important, but cash flow is also critical to a company's success. Cash flow permits a company to expand operations, replace worn assets, take advantage of new investment opportunities, and pay dividends to its owners. Some Wall Street analysts go so far as to say "Cash flow is king." Both managers and analysts need to understand the various sources and uses of cash that are associated with business activity.

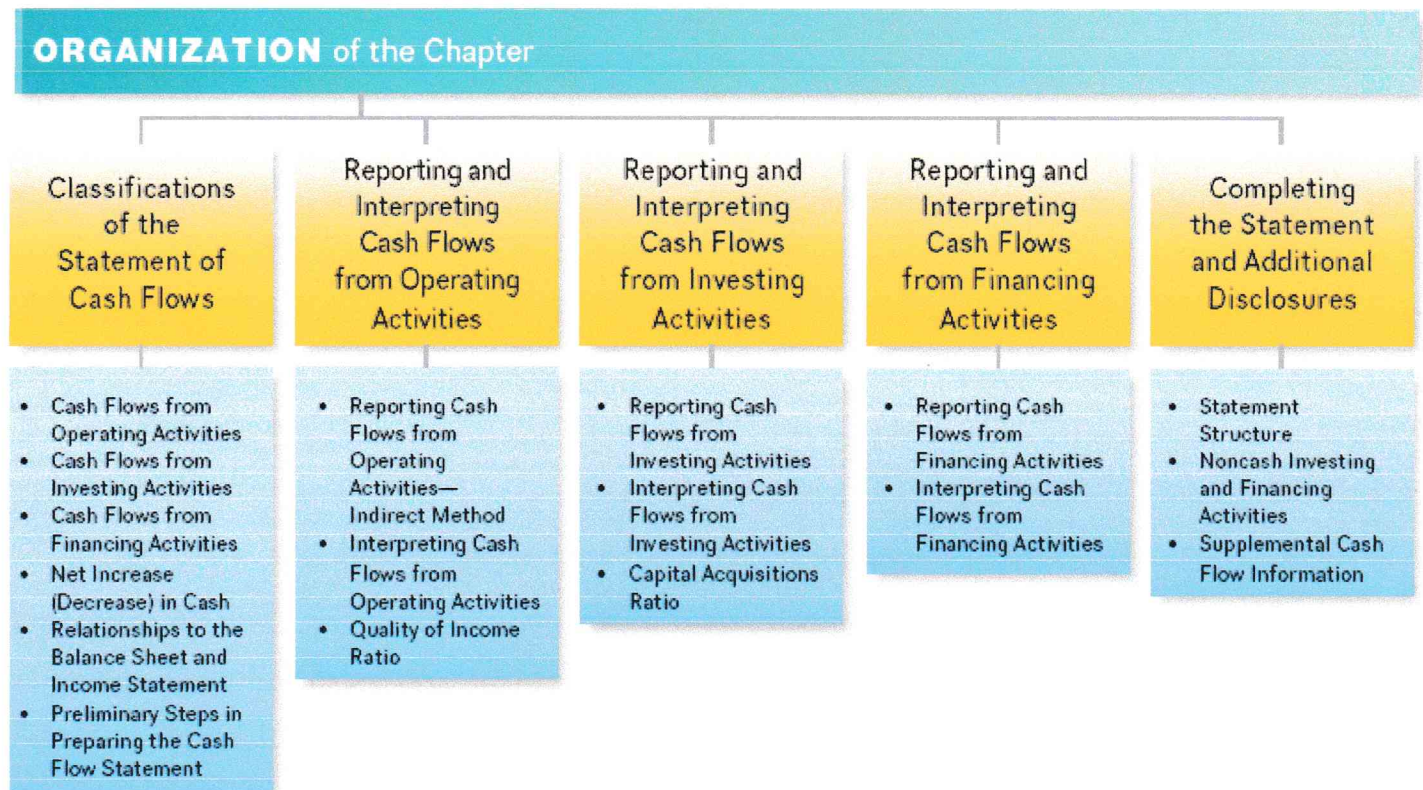
The cash flow statement focuses attention on a firm's ability to generate cash internally, its management of operating assets and liabilities, and the details of its investments and its external financing. It is designed to help both managers and analysts answer important cash-related questions such as these:

- Will the company have enough cash to pay its short-term debts to suppliers and other creditors without additional borrowing?
- Is the company adequately managing its accounts receivable and inventory?
- Has the company made necessary investments in new productive capacity?
- Did the company generate enough cash flow internally to finance necessary investments, or did it rely on external financing?
- Is the company changing the makeup of its external financing?

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We begin our discussion with an overview of the statement of cash flows. Then we examine the information reported in each section of the statement in depth. The chapter ends with a discussion of additional cash flow disclosures.

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CLASSIFICATIONS OF THE STATEMENT OF CASH FLOWS

LEARNING OBJECTIVE 12-1

Classify cash flow statement items as part of net cash flows from operating, investing, and financing activities.

A **CASH EQUIVALENT** is a short-term, highly liquid investment with an original maturity of less than three months.

Basically, the statement of cash flows explains how the amount of cash on the balance sheet at the beginning of the period has become the amount of cash reported at the end of the period. For purposes of this statement, the definition of cash includes cash and cash equivalents. **Cash equivalents** are short-term, highly liquid investments that are both

1. Readily convertible to known amounts of cash, and
2. So near to maturity there is little risk that their value will change if interest rates change.

Generally, only investments with original maturities of three months or less qualify as a cash equivalent under this definition.¹ Examples of cash equivalents are Treasury bills (a form of short-term U.S. government debt), money market funds, and commercial paper (short-term notes payable issued by large corporations).

As you can see in Exhibit 12.1, the statement of cash flows reports cash inflows and outflows in three broad categories: (1) operating activities, (2) investing activities, and (3) financing activities. Together, these three cash flow categories explain the change in cash from the beginning balance to the ending balance on the balance sheet.

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NATIONAL BEVERAGE CORP.
Consolidated Statement of Cash Flows
Year Ended April 30, 2011
(amounts in thousands)

EXHIBIT 12.1

Consolidated Statement
of Cash Flows

REAL WORLD EXCERPT
Annual Report

Cash flows from operating activities:

Net income	\$ 40,754
Adjustments to reconcile net income to cash flow from operating activities:	
Depreciation and amortization	10,771
Changes in assets and liabilities:	
Accounts receivable	(2,078)
Inventory	1,319
Prepaid expenses	(4,219)
Accounts payable	829
Accrued expenses	3,049
Net cash provided by operating activities	<u>50,425</u>

Cash flows from investing activities:

Purchases of property, plant, and equipment	(11,389)
Proceeds from disposal of property, plant, and equipment	77
Purchase of short-term investments	(6,532)
Proceeds from sale of short-term investments	8,406
Net cash used in investing activities	<u>(9,438)</u>

Cash flows from financing activities:

Repayment of principal on long-term debt	(191)
Proceeds from issuance of long-term debt	—
Purchase of treasury stock	—
Proceeds from issuance of stock	4,324
Payment of cash dividends	(106,314)
Net cash used in financing activities	<u>(102,181)</u>

Net decrease in cash and cash equivalents:

Cash and cash equivalents at beginning of period	68,566
Cash and cash equivalents at end of period	<u>\$ 7,372</u>

**Certain amounts have been adjusted for pedagogical purposes.*

Cash Flows from Operating Activities

CASH FLOWS FROM OPERATING ACTIVITIES (cash flows from operations) are cash inflows and outflows directly related to earnings from normal operations.

Cash flows from operating activities (cash flows from operations) are the cash inflows and outflows that relate directly to revenues and expenses reported on the income statement. There are two alternative approaches for presenting the operating activities section of the statement:

The **DIRECT METHOD** of presenting the operating activities section of the cash flow statement reports components of cash

flows from operating activities as gross receipts and gross payments.

1. The **direct method** reports the components of cash flows from operating activities as gross receipts and gross payments.

Inflows	Outflows
Cash received from Customers Dividends and interest on investments	Cash paid for Purchase of services (electricity, etc.) and goods for resale Salaries and wages Income taxes Interest on liabilities

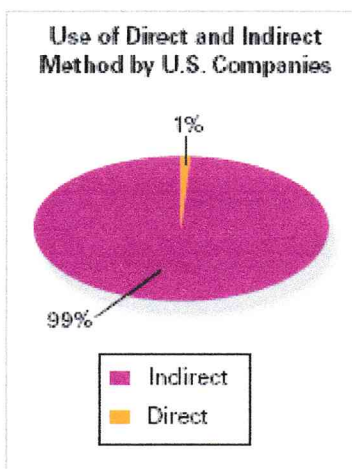
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The difference between the inflows and outflows is called **net cash inflow (outflow) from operating activities**. National Beverage experienced a net cash inflow of \$50,425 (all amounts in

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the FASB recommends the direct method, it is rarely used in the United States. Many financial executives have reported that they do not use it because it is more expensive to implement than the indirect method. Both the

The **INDIRECT METHOD** of presenting the operating activities section of the cash flow statement adjusts net income to compute cash flows from operating activities.



- The **indirect method** starts with net income from the income statement and then eliminates noncash items to arrive at net cash inflow (outflow) from operating activities.

$$\begin{array}{r}
 \text{Net income} \\
 +/- \text{ Adjustments for noncash items} \\
 \hline
 \text{Net cash inflow (outflow) from operating activities}
 \end{array}$$

Ninety-nine percent of large U.S. companies, including National Beverage, use the indirect method.² Notice in Exhibit 12.1 that in the year 2011, National Beverage reported positive net income of \$40.754 but generated positive cash flows from operating activities of \$50,425. Why should income and cash flows from operating activities differ? Remember that on the income statement, revenues are recorded when they are earned, without regard to when the related cash inflows occur. Similarly, expenses are matched with revenues and recorded

For now, the most important thing to remember about the two methods is that they are simply alternative ways to arrive at the same number. The total amount of cash flows from operating activities is always the same (an inflow of \$50,425 in National Beverage's case), regardless of whether it is computed using the direct or indirect method, as illustrated below.

Direct		Indirect	
Cash collected from customers	\$ 598,115	Net income	\$40,754
Cash payments for interest	1,119	Depreciation	10,771
Cash payments to suppliers	(379,391)	Changes in operating assets and liabilities	(1,100)
Cash payments for other expenses	(145,234)		
Cash payments for income taxes	(21,896)		
Net cash provided by operating activities	<u>\$ 50,425</u>	Net cash provided by operating activities	<u>\$50,425</u>

Cash Flows from Investing Activities

CASH FLOWS FROM INVESTING

ACTIVITIES are cash inflows and outflows related to the acquisition or sale of productive facilities and investments in the securities of other companies.

Cash flows from investing activities are cash inflows and outflows related to the purchase and disposal of long-lived productive assets and investments in the securities of other companies. Typical cash flows from investing activities include:

Inflows	Outflows
Cash received from	Cash paid for
Sale or disposal of property, plant, and equipment	Purchase of property, plant, and equipment
Sale or maturity of investments in securities	Purchase of investments in securities

The difference between these cash inflows and outflows is called **net cash inflow (outflow) from investing activities**.

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For National Beverage, this amount was an outflow of \$9,438 for the year 2011. Most of the activity was related to purchases and sales of short-term investments and the purchase and sale of property, plant, and equipment. Since total purchases exceeded cash collected from sales, there was a net cash outflow.

Cash Flows from Financing Activities

CASH FLOWS FROM FINANCING ACTIVITIES are cash inflows and outflows related to external sources of financing (owners and creditors) for the enterprise.

Cash flows from financing activities include exchanges of cash with creditors (debtholders) and owners (stockholders). Usual cash flows from financing activities include the following:

Inflows	Outflows
Cash received from	Cash paid for
Borrowing on notes, mortgages, bonds, etc., from creditors	Repayment of principal to creditors (excluding interest, which is an operating activity)
Issuing stock to owners	Repurchasing stock from owners
	Dividends to owners

The difference between these cash inflows and outflows is called **net cash inflow (outflow) from financing activities**.

National Beverage experienced a net cash outflow from financing activities of \$102,181 for the year 2011. The Financing Activities section of its statement shows that National Beverage paid \$191 in principal on long-term debt and \$106,314 in dividends, and it received \$4,324 for new stock issuances.³

Net Increase (Decrease) in Cash

The combination of the **net cash flows from operating activities, investing activities, and financing activities must equal the net increase (decrease) in cash** for the reporting period. For the year 2011, National Beverage reported a net decrease in cash of \$61,194, which explains the change in cash on the balance sheet from the beginning balance of \$68,566 to the ending balance of \$7,372.

Net cash provided by operating activities	\$ 50,425	
Net cash used in investing activities	(9,438)	
Net cash used in financing activities	(102,181)	
Net decrease in cash and cash equivalents	(61,194)	
Cash and cash equivalents at beginning of period	68,566	} Beginning and ending balances from the balance sheet
Cash and cash equivalents at end of period	\$ 7,372	



PAUSE FOR FEEDBACK

We just discussed the three main sections of the cash flow statement: Cash Flows from Operating Activities, which are related to earning income from normal operations; Cash Flows from Investing Activities, which are related to the acquisition and sale of productive assets; and Cash Flows from Financing Activities, which are related to external financing of the enterprise. The net cash inflow or outflow for the year is the same amount as the increase or decrease

in cash and cash equivalents for the year on the balance sheet. To make sure you understand the appropriate classifications of the different cash flows, answer the following questions before you move on.

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SELF-STUDY QUIZ

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Dr Pepper Snapple Group

Dr Pepper Snapple Group is the third largest nonalcoholic beverage company in the world. A listing of some of its cash flows follows. Indicate whether each item is disclosed in the Operating Activities (O), Investing Activities (I), or Financing Activities (F) section of the statement of cash flows.

- _____ 1. Proceeds from issuance of long-term debt.
- _____ 2. Collections from customers.
- _____ 3. Payment of interest on debt.
- _____ 4. Purchase of property, plant, and equipment.
- _____ 5. Proceeds from disposal of investment securities.

After you have completed your answers, check them with the solutions at the bottom of the page.

To give you a better understanding of the statement of cash flows, we now discuss National Beverage's statement in more detail, including the way in which it relates to the balance sheet and income statement. Then we examine how each section of the statement describes a set of important decisions made by National Beverage's management. Last, we examine how financial analysts use each section to evaluate the company's performance.

Relationships to the Balance Sheet and Income Statement

Preparing and interpreting the cash flow statement requires an analysis of the balance sheet and income statement accounts that relate to the three sections of the cash flow statement. In previous chapters, we emphasized that companies record transactions as journal entries that are posted to T-accounts, which are used to prepare the income statement and the balance sheet. But companies cannot prepare the statement of cash flows using the amounts recorded in the T-accounts because those amounts are based on accrual accounting. Instead, they must analyze the numbers recorded under the accrual method and adjust them to a cash basis. To prepare the statement of cash flows, they need the following data:

1. **Comparative balance sheets** used in calculating the cash flows from all activities (operating, investing, and financing).
2. **Additional details** concerning selected accounts where the total change amount in an account balance during the year does not reveal the underlying nature of the cash flows.

Our approach to preparing and understanding the cash flow statement focuses on the changes in the balance sheet accounts. It relies on a simple relationship:

$$\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$$

First, assets can be split into cash and noncash assets:

$$\text{Cash} + \text{Noncash Assets} = \text{Liabilities} + \text{Stockholders' Equity}$$

If we move the noncash assets to the right side of the equation, then:

$$\text{Cash} = \text{Liabilities} + \text{Stockholders' Equity} - \text{Noncash Assets}$$

solutions to SELF-STUDY QUIZ

1. F,
2. O,
3. O,
4. I,

5. I

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Category	Transaction	Cash Effect	Other Account Affected
Operating	Collect accounts receivable	+Cash	−Accounts Receivable (A)
	Pay accounts payable	−Cash	−Accounts Payable (L)
	Prepay rent	−Cash	+Prepaid Rent (A)
	Pay interest	−Cash	−Retained Earnings (SE)
	Sale for cash	+Cash	+Retained Earnings (SE)
Investing	Purchase equipment for cash	−Cash	+Equipment (A)
	Sell investment securities for cash	+Cash	−Investments (A)
Financing	Pay back debt to bank	−Cash	−Notes Payable—Bank (L)
	Issue stock for cash	+Cash	+Common Stock and Additional Paid-in-Capital (SE)

EXHIBIT 12.2

Selected Cash Transactions and Their Effects on Other Balance Sheet Accounts

Given this relationship, the changes (Δ) in cash between the beginning and the end of the period must equal the changes (Δ) in the amounts on the right side of the equation between the beginning and the end of the period:

$$\Delta \text{ Cash} = \Delta \text{ Liabilities} + \Delta \text{ Stockholders' Equity} - \Delta \text{ Noncash Assets}$$

Thus, **any transaction that changes cash must be accompanied by a change in liabilities, stockholders' equity, or noncash assets.** Exhibit 12.2 illustrates this concept for selected cash transactions.

Preliminary Steps in Preparing the Cash Flow Statement

Based on this logic, we use the following preliminary steps to prepare the cash flow statement:

1. Determine the change in each balance sheet account. From this year's ending balance, subtract this year's beginning balance (i.e., last year's ending balance).
2. Classify each change as relating to operating (O), investing (I), or financing (F) activities by marking them with the corresponding letter. Use Exhibit 12.3 as a guide.

The balance sheet accounts related to earning income (operating items) should be marked with an O. These accounts are often called **operating assets and liabilities**. The accounts that should be marked with an O include the following:

- Most current assets (other than short-term investments, which relate to investing activities, and cash).⁴
- Most current liabilities (other than amounts owed to investors and financial institutions,⁵ all of which relate to financing activities).
- Retained Earnings because it increases by the amount of net income, which is the starting point for the operating section. (Retained Earnings also decreases by dividends declared and paid, which is a financing outflow noted by an F.)

In Exhibit 12.3, all of the relevant current assets and liabilities have been marked with an O. These items include:

- Accounts Receivable
- Inventories

EXHIBIT 12.3

Comparative Balance Sheet
and Current Income
Statement



REAL WORLD EXCERPT
Annual Report

*Related Cash
Flow Section*
Change in Cash
I
O
O
O
I†
O
O
F
F
O and F

NATIONAL BEVERAGE CORP.

Consolidated Balance Sheet
(dollars in thousands)

	April 30, 2011	April 30, 2010	Change
Assets			
Current assets:			
Cash and cash equivalents	\$ 7,372	\$ 68,566	-61,194
Short-term investments	1,493	3,367	-1,874
Accounts receivable	55,912	53,834	+2,078
Inventories	33,353	34,672	-1,319
Prepaid expenses	8,403	4,184	+4,219
Total current assets	106,533	164,623	
Property, plant, and equipment, net	76,277	75,736	+541
Total assets	\$182,810	\$240,359	
Liabilities and Stockholders' Equity			
Current liabilities:			
Accounts payable	\$ 49,257	\$ 48,428	+829
Accrued expenses	26,346	23,297	+3,049
Total current liabilities	75,603	71,725	
Long-term debt	26,871	27,062	-191
Stockholders' equity:			
Contributed capital	15,129	10,805	+4,324
Retained earnings	65,207	130,767	-65,560
Total stockholders' equity	80,336	141,572	
Total liabilities and stockholders' equity	\$182,810	\$240,359	

NATIONAL BEVERAGE CORP.

Consolidated Statement of Income
For the Fiscal Year Ended April 30, 2011
(dollars in thousands)

Net sales	\$600,193
Cost of sales	<u>381,539</u>
Gross profit	218,654
Operating expenses:	
Selling, general, and administrative expense	144,114
Depreciation and amortization expense	<u>10,771</u>
Total operating expenses	154,885
Operating income	63,769
Interest expense	<u>(1,119)</u>
Income before provision for income taxes	62,650
Provision for income taxes	<u>21,896</u>
Net income	<u>\$ 40,754</u>

Certain balances have been adjusted to simplify the presentation.

†The Accumulated Depreciation account is also related to operations because it relates to depreciation.

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Prepaid Expenses

- Accounts Payable
- Accrued Expenses

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As we have noted, retained earnings is also relevant to operations.

The balance sheet accounts related to investing activities should be marked with an I. These include all of the remaining assets on the balance sheet. In Exhibit 12.3 these items include:

- Short-term Investments
- Property, Plant, and Equipment, net

The balance sheet accounts related to financing activities should be marked with an F. These include all of the remaining liability and stockholders' equity accounts on the balance sheet. In Exhibit 12.3 these items include:

- Long-term Debt
- Contributed Capital (which includes common stock and additional paid-in capital)
- Retained Earnings (for decreases resulting from dividends declared and paid)

Next, we use this information to prepare each section of the statement of cash flows.

REPORTING AND INTERPRETING CASH FLOWS FROM OPERATING ACTIVITIES

As noted above, the operating section can be prepared in two formats, and virtually all U.S. companies choose the indirect method. As a result, we discuss the indirect method here and the direct method in Supplement A at the end of the chapter.

Resulting from:

direct or indirect method.

the operating section

Reporting Cash Flows from Operating Activities—Indirect Method

LEARNING OBJECTIVE 12-2

Report and interpret cash flows from operating activities using the indirect method.

Exhibit 12.3 shows National Beverage's comparative balance sheet and income statement. Remember that the indirect method starts with net income and converts it to cash flows from operating activities. This involves adjusting net income for the differences in the timing of accrual basis net income and cash flows. The general structure of the operating activities section is:

Operating Activities

Net income

- Adjustments to reconcile net income to cash
flow from operating activities:
- + Depreciation and amortization expense
 - Gain on sale of investing asset
 - + Loss on sale of investing asset
 - + Decreases in operating assets
 - + Increases in operating liabilities
 - Increases in operating assets
 - Decreases in operating liabilities

Net Cash Flow from Operating Activities

To keep track of all the additions and subtractions made to convert net income to cash flows from operating activities, it is helpful to set up a schedule to record the computations. We will construct a schedule for National Beverage in Exhibit 12.4.

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EXHIBIT 12.4

CONVERSION OF NET INCOME TO NET CASH FLOW FROM OPERATING ACTIVITIES

National Beverage Corp.:
Schedule for Net Cash Flow
from Operating Activities,
Indirect Method (dollars in
thousands)

Items	Amount	Explanation
Net income, accrual basis	\$40,754	From income statement.
Add (subtract) to convert to cash basis:		
Depreciation and amortization	+10,771	Add back because depreciation and amortization expense does not affect cash.
Accounts receivable increase	-2,078	Subtract because cash collected from customers is less than accrual basis revenues.
Inventory decrease	+1,319	Add because purchases are less than cost of goods sold expense.
Prepaid expense increase	-4,219	Subtract because cash prepayments for expenses are more than accrual basis expenses.
Accounts payable increase	+829	Add because cash payments to suppliers are less than amounts purchased on account (borrowed from suppliers).
Accrued expenses increase	+3,049	Add because cash payments for expenses are less than accrual basis expenses.
Net cash provided by operating activities	\$50,425	Reported on the statement of cash flows.

We begin our schedule presented in Exhibit 12.4 with net income of \$40,754 taken from National Beverage's income statement (Exhibit 12.3). Completing the operating section using the indirect method involves two steps:

Step 1: Adjust net income for depreciation and amortization expense and gains and losses on sale of investing assets such as property, plant, and equipment and investments. Recording depreciation and amortization expense does not affect the cash account (or any other operating asset or liability). It affects a noncurrent investing asset (Property, plant, and equipment, net). **Since depreciation and amortization expense are subtracted in computing net income but do not affect cash, we always add each back to convert net income to cash flow from operating activities.** In the case of National Beverage, we need to remove the effect of depreciation and amortization expense by adding back \$10,771 to net income (see Exhibit 12.4).

If National Beverage had sold property, plant, and equipment at a gain or loss, the amount of cash received would be classified as an investing cash inflow. Since all of the cash received is an investing cash flow, an adjustment must also be made in the operating activities section to avoid double counting the gain or loss. **Gains on sales of property, plant, and equipment are subtracted and losses on such sales are added** to convert net income to cash flow from operating activities. We illustrate the relevant computations and adjustments for gains and losses on the sale of long-term assets in Supplement B at the end of the chapter.⁶

Step 2: Adjust net income for changes in assets and liabilities marked as operating (O). Each change in operating assets (other than cash and short-term investments) and liabilities (other than amounts owed to owners and financial institutions) causes a difference between net income and cash flow from operating activities.⁷ When converting net income to cash flow from operating activities, apply the following general rules:

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Add the change when an operating asset decreases or an operating liability increases.

- Subtract the change when an operating asset increases or an operating liability decreases.

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Understanding what makes these assets and liabilities increase and decrease is the key to understanding the logic of these additions and subtractions.

Change in Accounts Receivable

(2017), accounts receivable. Remember that the income statement reflects sales revenue, but the cash flow statement must reflect cash collections from customers. As the following accounts receivable T-account shows, accounts receivable decreases

		Accounts Receivable (A)	
Change \$2,078	Beginning balance	53,834	
	Sales revenue (on account)	600,193	Collections from customers 598,115
	Ending balance	55,912	

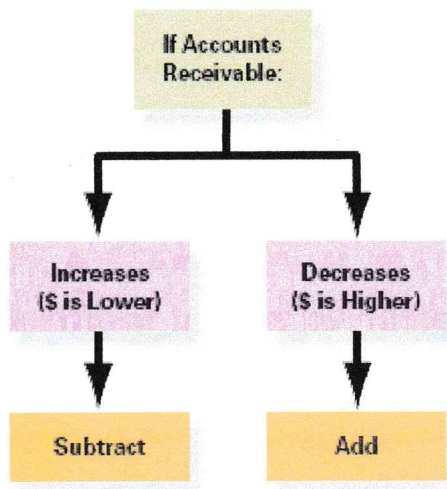
In the National Beverage example, sales revenue reported on the income statement is greater than cash collections from customers by $\$600,193 - \$598,115 = \$2,078$. Since less money was collected from customers, this amount must be subtracted from net income to convert to cash flows from operating activities. Note that this amount is also the same as the **change** in the accounts receivable account:

Ending balance	\$55,912
– Beginning balance	<u>53,834</u>
Change	<u>\$ 2,078</u>

This same underlying logic is used to determine adjustments for the other operating assets and liabilities.

To summarize, the income statement reflects revenues of the period, but cash flow from operating activities must reflect cash collections from customers. Sales on account increase the balance in accounts receivable, and collections from customers decrease the balance.

		Accounts Receivable (A)
Beg.	53,834	
Increase	2,078	
End.	55,912	



The balance sheet for National Beverage Corp. (Exhibit 12.3) indicates an **increase** in accounts receivable of \$2,078 for the period, which means that cash collected from customers is lower than revenue. To convert to cash flows from operating activities, the amount of the increase (the reduced collections) must be **subtracted** in Exhibit 12.4. (A decrease is added.)

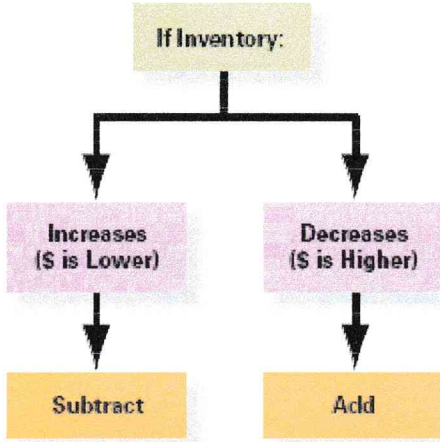
Change in Inventory

The income statement reflects merchandise sold for the period, whereas cash flow from operating activities must reflect cash purchases. As shown in the Inventories T-account, purchases of goods increase the balance in inventory, and recording merchandise sold decreases the balance in inventory.

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Inventories (A)	
Beg. bal.	Cost of goods sold
Purchases	
End. bal.	

Inventories (A)		
Beg.	34,672	Decrease 1,319
End.	33,353	



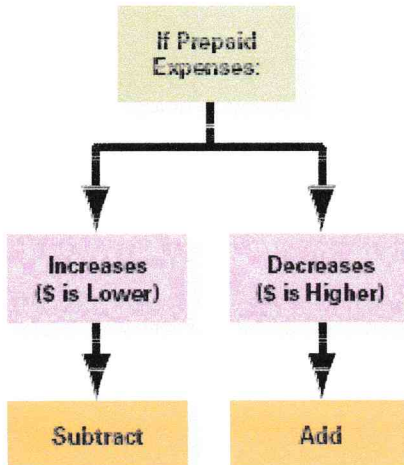
National Beverage's balance sheet (Exhibit 12.3) indicates that inventory **decreased** by \$1,319, which means that the amount of purchases is less than the amount of merchandise sold. The decrease (the extra goods sold) must be added to net income to convert to cash flow from operating activities in Exhibit 12.4. (An increase is subtracted.)

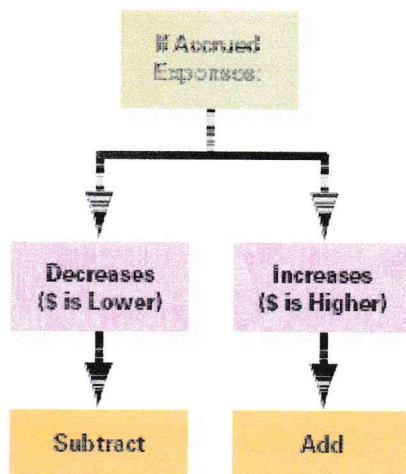
Change in Prepaid Expenses

The income statement reflects revenues of the period. But cash flow from operating activities must reflect the cash payments. Cash prepayments increase the balance in prepaid expenses, and recording of expenses decreases the balance in prepaid expenses.

Prepaid Expenses (A)	
Beg. bal.	Services used (expense)
Cash prepayments	
End. bal.	

Prepaid Expenses (A)		
Beg.	4,164	
Increase	4,219	
End.	8,403	





Summary

We can summarize the typical additions and subtractions that are required to reconcile net income with cash flow from operating activities as follows:

Item	When Item Increases	When Item Decreases
Depreciation and amortization	+	NA
Gain on sale of long-term asset	-	NA
Loss on sale of long-term asset	+	NA
Accounts receivable	-	+
Inventory	-	+
Prepaid expenses	-	+
Accounts payable	+	-
Accrued expense liabilities	+	-

Notice again in this table that to reconcile net income to cash flows from operating activities, you must:

- **Add the change when an operating asset decreases or operating liability increases.**
- **Subtract the change when an operating asset increases or operating liability decreases.**

The cash flow statement for National Beverage (Exhibit 12.1) shows the same additions and subtractions to



INTERNATIONAL PERSPECTIVE



Classification of Interest on the Cash Flow Statement

U.S. GAAP and IFRS differ in the cash flow statement treatment of interest received and interest paid as follows:

	Interest Received	Interest Paid
U.S. GAAP	Operating	Operating
IFRS	Operating or Investing	Operating or Financing

Under U.S. GAAP, interest paid and received are both classified as operating cash flows, because the related revenue and expense enter into the computation of net income. This makes it easier to compare net income to cash flow from operations. It also benefits the financial statement user by ensuring comparability across companies. IFRS, on the other hand, allows interest received to be classified as either operating or investing and interest paid to be classified as either operating or financing. This recognizes that interest received results from investing activities and interest paid, like dividends paid, are payments to providers of financing. However, the alternative classifications may be confusing to financial statement readers. These differences are currently on the agenda of the joint FASB/IASB financial statement presentation project.

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PAUSE FOR FEEDBACK

The indirect method for reporting cash flows from operating activities reports a conversion of net income to net cash flow from operating activities. The conversion involves additions and subtractions for (1) expenses (such as depreciation expense) and revenues that do not affect current assets or current liabilities and (2) changes in each of the individual current assets (other than cash and short-term investments) and current liabilities (other than short-term debt to financial institutions and current maturities of long-term debt, which relate to financing), which reflect differences in the timing of accrual basis net income and cash flows. To test whether you understand these concepts, answer the following questions before you move on.

SELF - STUDY QUIZ

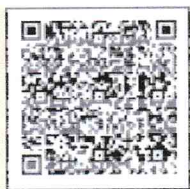
Dr Pepper Snapple Group

Indicate which of the following items taken from Dr Pepper Snapple Group's cash flow statement would be added (+), subtracted (-), or not included (NA) in the reconciliation of net income to cash flow from operations.

- _____ 1. Increase in inventories.
- _____ 2. Amortization expense.
- _____ 3. Decrease in accounts receivable.
- _____ 4. Increase in accounts payable.
- _____ 5. Increase in prepaid expenses.

After you have completed your answers, check them with the solutions at the bottom of the page.

GUIDED HELP



www.mhhe.com/libby8e

For additional step-by-step video instruction on preparing the operating section of the statement of cash flows using the indirect method, go to the URL or scan the QR code in the margin with your smartphone or iPad.

Interpreting Cash Flows from Operating Activities

The operating activities section of the cash flow statement focuses attention on the firm's ability to generate cash internally through operations and its management of current assets and current liabilities (also called **working capital**). Most analysts believe that this is the most important section of the statement because, in the long run, operations are the only source of cash. That is, investors will not invest in a company if they do not believe that cash generated from operations will be available to pay them dividends or expand the company. Similarly, creditors will not lend money if they do not believe that cash generated from operations will be available to pay back the loan. For example, many dot-com companies crashed when investors lost faith in their ability to turn business ideas into cash flows from operations.



A common set of traps followed by financial and profit analysts is to avoid firms with rising net income but falling cash flow from operations. Rapidly rising inventories or receivables often predict a slump in profits and the need for external financing. A true understanding of the meaning of the difference requires a detailed

In the year 2011, National Beverage reported that cash flow from operations was higher than net income. What caused this relationship? To answer these questions, we must carefully analyze how National Beverage's

learn more about the beverage industry. National Beverage normally reports higher cash flow from operations

calculation, keeping those total changes to a minimum. Many analysts compute the quality of income ratio as a general sign of the ability to generate cash through operations.

solutions to [SELF-STUDY QUIZ](#)

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KEY RATIO ANALYSIS



Quality of Income Ratio

Page 603

? ANALYTICAL QUESTION

How much cash does each dollar of net income generate?

% RATIO AND COMPARISONS

$$\text{Quality of Income Ratio} = \frac{\text{Cash Flow from Operating Activities}}{\text{Net Income}}$$

National Beverage Corp.'s ratio for the year 2011 was:

$$\frac{\$50,425}{\$40,754} = 1.24 \text{ (124\%)}$$

COMPARISONS OVER TIME			COMPARISONS WITH COMPETITORS	
National Beverage			Coca-Cola	PepsiCo
2009	2010	2011	2011	2011
1.43	1.66	1.24	1.10	1.38

💡 INTERPRETATIONS

In General The quality of income ratio measures the portion of income that was generated in cash. All other things equal, a higher quality of income ratio indicates greater ability to finance operating and other cash needs from operating cash inflows. A higher ratio also indicates that it is less likely that the company is using aggressive revenue recognition policies to increase net income, and therefore is less likely to experience a decline in earnings in the future. When this ratio does not equal 1.0, analysts must establish the sources of the difference to determine the significance of the findings. There are four potential causes of any difference:

- 1. The corporate lifecycle (growth or decline in sales).** When sales are increasing, receivables and inventory normally increase faster than accounts payable. This often reduces operating cash flows below income, which, in turn, reduces the ratio. When sales are declining, the opposite occurs, and the ratio increases.
- 2. Seasonality.** Seasonal (from quarter to quarter) variations in sales and purchases of inventory can cause the ratio to deviate from 1.0 during particular quarters.
- 3. Changes in revenue and expense recognition.** Aggressive revenue recognition or failure to accrue appropriate expenses will inflate net income and reduce the ratio.
- 4. Changes in management of operating assets and liabilities.** Inefficient management will increase operating assets and decrease liabilities, reducing operating cash flows and the quality of income ratio. More efficient management, such as shortening of payment terms, will have the opposite effect.

Focus Company Analysis During the past three years, National Beverage's quality of income ratio has ranged from 1.24 to 1.66. Its ratio is above that of Coca-Cola but below that of PepsiCo. National Beverage's high ratio would generally be viewed positively by analysts and would prompt them to read the management's discussion and analysis section of the annual report to determine its causes.

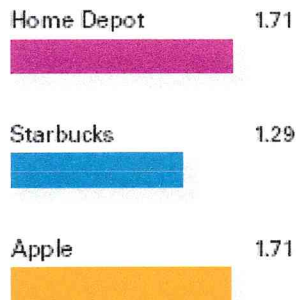
A Few Cautions The quality of income ratio can be interpreted based only on an understanding of the company's business operations and strategy. For example, a low ratio for a quarter can be due simply to normal seasonal changes. However, it also can indicate obsolete inventory, slowing sales, or failed expansion plans. To

test for these possibilities, analysts often analyze this ratio in tandem with the accounts receivable turnover and inventory turnover ratios.

LEARNING OBJECTIVE 12-3

Analyze and interpret the quality of income ratio.

Selected Focus Company Comparisons



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A QUESTION OF ETHICS



Fraud and Cash Flows from Operations

The cash flow statement often gives outsiders the first hint that financial statements may contain errors and irregularities. The importance of this indicator as a predictor is receiving more attention in the United States and internationally. *Investors Chronicle* recently reported on an accounting fraud at a commercial credit company.

... a look at Versailles's cash flow statement—an invaluable tool in spotting creative accounting—should have triggered misgivings. In the company's last filed accounts ... Versailles reported operating profits of ... \$25 million but a cash outflow from operating activities of \$24 million ... such figures should ... have served as a warning. After all, what use is a company to anyone if it reports only accounting profits which are never translated into cash?

As shown in earlier chapters, unethical managers sometimes attempt to reach earnings targets by manipulating accruals and deferrals of revenues and expenses to inflate income. Since these adjusting entries do not affect the cash account, they have no effect on the cash flow statement. A growing difference between net income and cash flow from operations can be a sign of such manipulations. This early warning sign has signaled some famous bankruptcies, such as that of W. T. Grant in 1975. The company had inflated income by failing to make adequate accruals of expenses for uncollectible accounts receivable and obsolete inventory. The more astute analysts noted the growing difference between net income and cash flow from operations and recommended selling the stock long before the bankruptcy.

SOURCE: James Chapman, "Creative Accounting Exposed," *Investors Chronicle*.

REAL WORLD EXCERPT

Investors Chronicle

REPORTING AND INTERPRETING CASH FLOWS FROM INVESTING ACTIVITIES

Reporting Cash Flows from Investing Activities

LEARNING OBJECTIVE 12-4

Report and interpret cash flows from investing activities.

Preparing this section of the cash flow statement requires an analysis of the accounts related to property, plant, and equipment, intangible assets, and investments in the securities of other companies. Normally, the relevant balance sheet accounts include Short-Term Investments and long-term asset accounts such as Long-Term Investments and Property, Plant, and Equipment. The following additional activities are the ones that you will encounter most frequently.

Related Balance Sheet Account(s)	Investing Activity	Cash Flow Effect
Property, plant, and equipment and intangible assets (patents, etc.)	Purchase of property, plant, and equipment or intangible assets for cash	Outflow
	Sale of property, plant, and equipment or intangible assets for cash	Inflow
Short- or long-term investments (stocks and bonds of other companies)	Purchase of investment securities for cash	Outflow
	Sale (maturity) of investment securities for cash	Inflow

Remember this:

- **Only purchases paid for with cash or cash equivalents are included.**
- **The amount of cash that is received from the sale of assets is included, regardless of whether the assets are sold at a gain or loss**

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Items	Cash Inflows (Outflows)	Explanation	EXHIBIT 12.5 National Beverage Corp.: Schedule for Net Cash Flow from Investing Activities (dollars in thousands)
Purchase of property, plant, and equipment	\$(11,389)	Payment in cash for equipment	
Proceeds from disposal of property, plant, and equipment	77	Receipt of cash from sale of equipment	
Purchase of short-term investments	(6,532)	Payment in cash for new investments	
Proceeds from sale of short-term investments	8,406	Receipt of cash from sale of investments	
Net cash inflow (outflow) from investing activities	\$ (9,438)	Reported on the statement of cash flows	

In National Beverage's case, the balance sheet (Exhibit 12.3) shows two investing assets (noted with an I) that have changed during the period: Property, Plant, and Equipment, Net, and Short-Term Investments. To determine the causes of these changes, accountants need to search the related company records.

Property, Plant, and Equipment, Net

Analysis of National Beverage Corp.'s records reveals that the company purchased new property, plant, and equipment for \$11,389 in cash, which is a cash outflow. The company also sold old equipment for \$77 in cash, an amount equal to its net book value. This is a cash inflow. These investing items are listed in the schedule of investing activities in Exhibit 12.5. These items, less the amount of depreciation expense added back in the Operations section (\$10,771), explain the increase in property, plant, and equipment, net, of \$541.

Property, Plant, and Equipment, Net (A)			
Beg.	75,736	Sold	77
Purchased	11,389	Depreciation	10,771
End.	76,277		

Investments

National Beverage's records indicate that it purchased \$6,532 in short-term investments during the year for cash, which is an investing cash outflow. The company also sold short-term investments for \$8,406, an amount equal to their net book value. These investing items are listed in the schedule of investing activities in Exhibit 12.5. They explain the \$1,874 decrease in short-term investments reported on the balance sheet. Changes in long-term investments would be treated in the same fashion.

Short-Term Investments (A)			
Beg.	3,387	Sold	8,406
Purchased	6,532		
End.	1,493		

The net cash flow from investing activities resulting from these four items is a \$9,438 outflow (see Exhibit 12.5).

Interpreting Cash Flows from Investing Activities

Two common ways to assess a company's ability to internally finance its expansion needs are the capital acquisitions ratio and free cash flow.

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On the cash flow statement, the loss of \$1,000 must be removed (added back) in the computation of cash from operating activities, and the total cash collected of \$5,000 must be shown in the investing activities section of the statement.

Page 617

Cash flows from operating activities	
Net income	\$40,754
Adjustments to reconcile net income to cash flow from operating activities:	
Loss on disposal of property, plant, and equipment	1,000
Net cash flow provided by operating activities	<u> </u>
Cash flows from investing activities	
Purchases of property, plant, and equipment	
Proceeds from disposal of property, plant, and equipment	5,000
Net cash used in investing activities	<u> </u>

Chapter Supplement C

T-Account Approach (Indirect Method)

When we began our discussion of preparing the statement of cash flows, we noted that changes in cash must equal the sum of the changes in all other balance sheet accounts. Based on this idea, we used the following three steps to prepare the statement of cash flows:

1. Determine the change in each balance sheet account. From this year's ending balance, subtract this year's beginning balance (i.e., last year's ending balance).
2. Identify the cash flow category or categories to which each account relates.
3. Create schedules that summarize operating, investing, and financing cash flows.

Instead of creating separate schedules for each section of the statement, many accountants prefer to prepare a single large T-account to represent the changes that have taken place in cash subdivided into the three sections of the cash flow statement. Such an account is presented in Panel A of Exhibit 12.9. The cash account in Panel A shows increases in cash as debits and decreases in cash as credits. Note how each section matches the three schedules that we prepared for National Beverage's cash flows presented in Exhibits 12.4, 12.5, and 12.6. Panel B includes the same T-accounts for the noncash balance sheet accounts we used in our discussion of each cash flow statement section in the body of the chapter. Note how each change in the noncash balance sheet accounts has a number referencing the change in the cash account that it accompanies. The statement of cash flows presented in Exhibit 12.1 can be prepared in proper format based on the information in the cash flow T-account.

CHAPTER TAKE-AWAYS

12-1. Classify cash flow statement items as part of net cash flows from operating, investing, and financing activities. p. 590

The statement has three main sections: Cash Flows from Operating Activities, which are related to earning income from normal operations; Cash Flows from Investing Activities, which are related to the acquisition and sale of productive assets; and Cash Flows from Financing Activities, which are related to external financing of the enterprise. The net cash inflow or outflow for the year is the same amount as the increase or decrease in cash and cash equivalents for the year on the balance sheet. Cash equivalents are highly liquid investments with original maturities of three months or less.

12-2. Report and interpret cash flows from operating activities using the indirect method. p. 597

The indirect method for reporting cash flows from operating activities reports a conversion of net income to net cash flow from operating activities. The conversion involves additions and subtractions for (1) noncurrent accruals including expenses (such as depreciation expense) and revenues that do not affect current assets or current liabilities and (2) changes in each of the individual current assets (other than cash and short-term investments) and current liabilities (other than short-term debt to financial

.....
.....

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EXHIBIT 12.9

T-Account Approach to Preparing the Statement of Cash Flows (Indirect Method)

Panel A: Changes in Cash Account

Cash (A)	
Operating	
(1) Net Income	40,754
(2) Depreciation and Amortization	10,771
(4) Inventory	1,319
(6) Accounts Payable	829
(7) Accrued Expenses	3,049
Net cash flow provided by operating activities	50,425
Investing	
(9) Disposals of Property, Plant & Equipment	77
(11) Sales of Short-term Investments	8,406
	11,389 (8) Purchased Property, Plant & Equipment
	6,532 (10) Purchased Short-term Investments
	9,438 Net cash used in investing activities
Financing	
(13) Proceeds from Stock Issuance	4,324
	191 (12) Payment of Long-term Debt
	106,314 (14) Payment of Dividends
	102,181 Net cash used by financing activities
	61,194 Net decrease in cash and cash equivalents

Panel B: Changes in Noncash Accounts

Accounts Receivable (A)		Inventories (A)		Prepaid Expenses (A)	
Beg. bal.	52,824	Beg. bal.	34,672	End. bal.	4,184
(3) Increase	2,078	(4) Decrease	1,319	(5) Increase	4,219
End. bal.	55,912	End. bal.	33,353	End. bal.	8,403
Accounts Payable (L)		Accrued Expenses (L)		Property, Plant & Equipment, Net (A)	
Beg. bal.	48,428	Beg. bal.	23,297	End. bal.	75,738
(6) Increase	829	(7) Increase	3,049	(8) Purchases	11,389
End. bal.	49,257	End. bal.	26,346	(2) Depreciation	10,771
				(9) Disposals	77
End. bal.	49,257	End. bal.	26,346	End. bal.	76,277
Short-term Investments		Long-term Debt (L)		Contributed Capital (SE)	
Beg. bal.	3,367	(12) Payments	191	Beg. bal.	10,506
(10) Purchases	6,532	Borrowings	0	Stock repurchased	0
(11) Disposals	8,406	End. bal.	26,871	(13) Stock issued	4,324
End. bal.	1,493	End. bal.	26,871	End. bal.	15,129
Retained Earnings (SE)					
		Beg. bal.	130,757		
(14) Dividends	106,314	(1) Net income	40,754		
		End. bal.	65,207		

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12-3. Analyze and interpret the quality of income ratio. p. 603

Page 610

The quality of income ratio ($\text{Cash Flow from Operating Activities} \div \text{Net Income}$) measures the portion of income that was generated in cash. A higher quality of income ratio indicates greater ability to finance operating and other cash needs from operating cash inflows. A higher ratio also indicates that it is less likely that the company is using aggressive revenue recognition policies to increase net income.

k. Report and interpret cash flows from investing activities. p. 604

Investing activities reported on the cash flow statement include cash payments to acquire fixed assets, intangibles, and short- and long-term investments and cash proceeds from the sale of fixed assets, intangibles, and short- and long-term investments.

l. Analyze and interpret the capital acquisitions ratio. p. 606

The capital acquisitions ratio ($\text{Cash Flow from Operating Activities} \div \text{Cash Paid for Property, Plant, and Equipment}$) reflects the portion of purchases of property, plant, and equipment financed from operating activities without the need for outside debt or equity financing or the sale of other investments or fixed assets. A high ratio benefits the company because it provides the company with opportunities for strategic acquisitions.

m. Report and interpret cash flows from financing activities. p. 607

Cash inflows from financing activities include cash proceeds from the issuance of short- and long-term debt and common stock. Cash outflows include cash principal payments on short- and long-term debt, cash paid for the repurchase of the company's stock, and cash dividend payments. Cash payments associated with interest are

n. Understand the format of the cash flow statement and additional cash flow disclosures. p. 609

The statement of cash flows splits transactions that affect cash into three categories: Operating, investing, and financing activities. Operating activities include all transactions that affect cash and are not investing or financing activities. Investing and financing activities are investing and financing activities that do not involve cash. They include, for example, purchases of fixed assets with long-term debt or stock, exchanges of fixed assets, and exchanges of debt for stock. These transactions are disclosed only as supplemental disclosures to the cash flow statement along with cash paid for taxes and interest under the indirect method.

Throughout the preceding chapters, we emphasized the conceptual basis of accounting. An understanding of the rationale underlying accounting is important for both preparers and users of financial statements. In Chapter 12, we bring together our discussion of the major users of financial statements and how they analyze and use them. We discuss and illustrate many widely used analytical techniques discussed in earlier chapters, as well as additional techniques. As you study Chapter 13, you will see that an understanding of accounting rules and concepts is essential for effective analysis of financial statements.

KEY RATIOS

The quality of income ratio indicates what portion of income was generated in cash. It is computed as follows (p. 603):

$$\text{Quality of Income Ratio} = \frac{\text{Cash Flow from Operating Activities}}{\text{Net Income}}$$

The capital acquisitions ratio measures the ability to finance purchases of plant and equipment from operations. It is computed as follows (p. 606):

$$\text{Capital Acquisitions Ratio} = \frac{\text{Cash Flow from Operating Activities}}{\text{Cash Paid for Property, Plant, and Equipment}}$$

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FINDING FINANCIAL INFORMATION

Page 620

Balance Sheet

Changes in Assets, Liabilities, and Stockholders' Equity

Statement of Cash Flows

Cash Flows from Operating Activities
 Cash Flows from Investing Activities
 Cash Flows from Financing Activities
 Separate Schedule (or note):
 Noncash investing and financing activities
 Interest and taxes paid

Income Statement

Net Income and Noncurrent Accruals

Notes

Under Summary of Significant Accounting Policies:
 Definition of cash equivalents
 Under Separate Note if not listed on cash flow statement:
 Noncash investing and financing activities
 Interest and taxes paid

KEY TERMS

Cash Equivalent p. 590

Cash Flows from Financing Activities p. 593

Cash Flows from Investing Activities p. 592

Cash Flows from Operating Activities (Cash Flows from Operations) p. 591

Direct Method p. 591

Free Cash Flow p. 606

Indirect Method p. 592

Noncash Investing and Financing Activities p. 610

QUESTIONS

1. Compare the purposes of the income statement, the balance sheet, and the statement of cash flows.
2. What information does the statement of cash flows report that is not reported on the other required financial statements?
3. What are cash equivalents? How are purchases and sales of cash equivalents reported on the statement of cash flows?
4. What are the major categories of business activities reported on the statement of cash flows? Provide an example of these activities.
5. What are the typical cash inflows from operating activities? What are the typical cash outflows from operating activities?
6. Under the indirect method, depreciation expense is added to net income to report cash flows from operating activities. Does depreciation cause an inflow of cash?
7. Explain why cash does change the bottom line for businesses but for earnings is not necessarily relevant on the statement of cash flows. (answer defined as cash inflows)
8. Explain why a \$40,000 increase in inventory during the year must be included in developing cash flows from operating activities. (answer: cash outflow and interest expense)
9. Compare the two methods of reporting cash flows from operating activities in the statement of cash flows.
10. What are the typical cash inflows from investing activities? What are the typical cash outflows from investing activities?