Cash Flow Statement

(Cheat Sheet)

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Cash Flow Statement

The cash flow statement is officially known as the *statement of cash flows (SCF)*. It reports the major cash inflows and outflows that have occurred during the accounting period specified in its heading. Expressed another way, the SCF for the calendar year 2023 will list the major cash flows that caused the change in a corporation's cash and cash equivalents from December 31, 2022 to December 31, 2023.

The cash flow statement is especially useful because a corporation's income statement is prepared under the *accrual method of accounting*. This means the income statement reports *revenues earned* (not cash receipts) and *expenses incurred* (not cash payments). Since many investors and financial analysts believe that "cash is king" the annual cash flow statement is one of the five required annual financial statements whenever financial statements are distributed to people outside of the corporation. (The other four required financial statements are: income statement, statement of comprehensive income, balance sheet, and statement of stockholders' equity.)

Format of SCF

The statement of cash flows has three major sections:

- Cash flows from **operating activities**
- Cash flows from **investing activities**
- Cash flows from **financing activities**

In addition, the SCF must disclose some **supplemental** or **supplementary information**, including significant noncash transactions (such as an exchange of shares of stock for land), income taxes paid, and interest paid.

How Amounts Are Presented

Each significant cash inflow and each significant cash outflow will be reported in one of the three sections noted above (operating, investing, financing).

A *positive amount* on the SCF means:

- *a cash inflow*
- cash was provided
- it was good for the corporation's cash
- it had a positive or favorable effect on the corporation's cash balance

A *negative amount* on the SCF means:

- *a cash outflow*
- cash was used
- it was not good for the corporation's cash
- it had a negative or unfavorable effect on the corporation's cash balance

How a Positive Amount is Determined

If a balance sheet *asset* (other than cash) *has decreased* it usually means that *cash was provided*. Therefore, the SCF will report the amount of the asset's decrease as a *positive amount*. For instance, if the asset Accounts Receivable has decreased by $2,000, the SCF will report this as a positive $2,000 since decreasing Accounts Receivable is good for the corporation's cash, there was a cash inflow, and it had a positive or favorable effect on the corporation's cash balance.

When a balance sheet *liability* has *increased*, it will mean that *cash was provided*. This means the amount of the increase will be shown on the SCF as a *positive amount*. For example, if Notes Payable has increased by $10,000 it will be reported on the SCF as a positive $10,000 since the increase in Notes Payable means there was a cash inflow, cash was provided, and this had a positive or favorable effect on the cash balance.

When a *stockholders' equity account* has *increased*, it will mean that *cash was provided*. Thus, the amount of the increase in stockholders' equity will be reported on the SCF as a *positive amount*. For instance, if Common Stock has increased by $40,000, it will be reported on the SCF as a positive $40,000. It is positive since the increase in Common Stock means there was a cash inflow, cash was provided, and this had a positive or favorable effect on the cash balance.

How a Negative Amount is Determined

If the *asset* Inventory has *increased*, the SCF will report this as a *negative amount*. The reasoning is that increasing Inventory likely meant a cash outflow, cash was used, and/or it was not good for the corporation's cash balance.

When a *liability* has *decreased*, it is also assumed that *cash was used* and it is presented on the SCF as a *negative amount*. For example, if Accounts Payable has decreased by $3,000, the amount will be reported on the SCF as (3,000). It is reported as a negative amount since reducing Accounts Payable meant there was a cash outflow, cash was used, and this had a negative or unfavorable effect on the corporation's cash balance.

When a *stockholders' equity* account is *decreased*, it is assumed that *cash was used*. As a result, the amount of the decrease will appear on the SCF as a negative amount. For example, if Retained Earnings is decreased, it could be the result of declaring and paying a cash dividend. The payment of a cash dividend is reported on the SCF as a negative amount since the decrease in Retained Earnings means there was a cash outflow, cash was used, and it had a negative or unfavorable effect on the corporation's cash balance.

Indirect Method of Preparing SCF

The indirect method of preparing the statement of cash flows is used by nearly all large corporations. (The alternative is the direct method, which is actually preferred by the Financial Accounting Standards Board or FASB.)

Under the indirect method the first section of the SCF (which is the cash flows from operating activities) begins with the corporation's net income. Since the income statement reports revenues and expenses using the accrual method of accounting, the net income will have to be adjusted to cash amounts.

A common adjustment involves depreciation expense. The reason is the depreciation expense had reduced the amount of net income, but depreciation did not require the use of cash. There will be additional adjustments to net income reporting in the operating activities section for the changes in the current assets and current liabilities.

Cash Flows from Operating Activities

The *cash flows from operating activities* is the heading of the first section of the cash flow statement. Under the indirect method, this section begins with a corporation's net income and is then adjusted from the accrual accounting amounts to the cash amounts. For example, there will be a positive adjustment to net income for the depreciation expense taken on the income statement since it did not use cash. If Accounts Receivable increased, it indicates that the corporation did not collect cash for all of the Sales reported on the income statement. As a result, there will be a subtraction or negative adjustment to the net income for the amount of the increase in Accounts Receivable. There will be adjustments for most of the changes in current asset and current liability accounts, including inventory, prepaid expenses, accounts payable, deferred revenues, etc. (However, the change in a company's short-term borrowings is reported under *cash flows from financing activities*.)

Ideally, the *net amount of cash flows from operating activities* will be greater than the net income. If this is not the case, I suggest a close review of the negative adjustments within this section of the SCF. For instance, an increase in Accounts Receivable may indicate that customers are unable to pay the amounts they owe. An increase in Inventory may indicate sales have slowed unexpectedly.

Cash Flows from Investing Activities

The *cash flows from investing activities* is the second section of the SCF. This section reports the amounts pertaining to the purchase and sale of a corporation's *noncurrent (or long-term) assets*. For example, capital expenditures (amounts spent for property, plant and equipment used in the business) and the purchase of long-term investments are uses of cash and therefore will be reported as negative amounts. The proceeds from the sale of property, plant and equipment and the sale of a long-term investment will *provide cash* and are therefore reported as *positive amounts*.

Cash Flows from Financing Activities

The third section of SCF is the *cash flows from financing activities*. The amounts reported in this section involve the increases and decreases in noncurrent liabilities, stockholders' equity, and short-term loans. For example, if the corporation issues common stock or bonds, the amount received will be reported as a positive amount since this *provides* cash, which is positive for the corporation's cash balance. If the corporation pays off some of its debt or pays a cash dividend to stockholders, those amounts will be listed as negative amounts, since cash was *used* and that has a negative effect on the corporation's cash balance.

Total of Three Sections = Change in Cash and Cash Equivalents

After the three sections, the SCF will show the grand total of the three sections. The grand total is followed by a reconciliation with the *change* in the corporation's cash and cash equivalents.

Supplemental Information

In addition to the amounts reported in the three sections of the face of the cash flow statement, the statement must also disclose *supplemental* or *supplementary information*. One example is the acquisition of an asset in exchange for shares of stock. In this example, no cash was involved, but the transaction did involve a significant investing activity and a significant financing activity. Two other required disclosures are the amount of interest *paid* and the amount of income taxes *paid*.