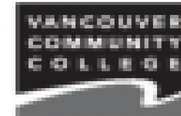

Statement of Cash Flows

The Statement of Cash Flows (or cash flow statement) is one of the main financial statements used by investors. It shows the cash generated and used during a specific time period. Ideally a company should generate positive cash flows; this will make it more likely to find investors for the future. The positive or negative net cash flow identified at the end of the statement of cash flows is equal to the total change in the cash account balance.

The cash flow statement reports the cash inflows and outflow in three categories:

1. Operating activities – reports the accrual net income and adjusts it for changes in current asset and current liability accounts
2. Investing activities – Reports the purchase and sale of fixed assets, marketable securities, and any other investment accounts
3. Financing activities – reports the changes to ownership equity and payment or borrowing of long-term liabilities

The cash flow statement can be prepared using the indirect method where differences in the balance sheet accounts for two time periods are compared. The first step is to determine if the changes in each account represent an increase or decrease of cash. An increase of cash (also called an "inflow" or "source of cash") is added when converting accrual net income to cash net income. A decrease of cash (also called an "outflow" or "use of cash") is subtracted when converting accrual net income to cash net income.

For instance, if accounts receivable increased from one period to the next, then revenue would also have increased. The revenue would overstate the amount of cash received and the net income would be higher than it would be in cash basis accounting. To adjust the income, the increase in A/R represents a decrease to net income. It is an outflow of cash. This is true for any other asset account – an increase in an asset account corresponds to an outflow of cash; a decrease corresponds to an inflow of cash.

If a liability increased, (for example, A/P), that means we are borrowing cash to finance a purchase or pay expenses. The actual expenses or purchases paid in cash are less than the total reported accrual operating expenses; this means the accrual net income is lower than it would be in cash basis accounting. The increase in a current liability is a source of cash (inflow), and added to net income when converting to the cash basis.

There are some items that are only ever an inflow or outflow of cash: depreciation expense, capital gain/loss, dividends, and net income/loss. Dividends are paid out, so they represent an outflow of cash. Net income is an inflow of cash into the business. Capital gains and losses occur from the sale of long-term assets. If there is a capital gain it would increase the net income, but not the cash, so to adjust to the cash basis, we would treat it as an outflow of cash (and inflow for a capital loss).

The table on the next page summarizes changes in accounts and whether they are inflows or outflows of cash.

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