# The Statement of Cash Flows

*by Sophia*

WHAT'S COVERED

In this lesson, you will learn about the impact of operational, investment, and financing activities on an organization's cash flow. Specifically, this lesson will cover:

## 1. The Statement of Cash Flow

The statement of cash flows is a financial statement that reports cash receipts and cash payments for a specific period, providing information about the business and cash.

It generally covers one year or less, similar to the income statement, and it tells us how the business used cash—meaning the cash payments that were made—as well as how the business generated cash or cash receipts.

The statement of cash flows is categorized by type of activity and cash performance is outlined in three main business areas:

- *Operating*: Activities found on the income statement.
- *Investing*: Sale or purchase of long-term assets, loaning money, and collecting principal of monies loaned.
- *Financing*: Cash from financing and cash paid to owners.

We get information from the balance sheet, both the current year balance sheet as well as last year's balance sheet, to create the statement of cash flows. We also get information from our income statement, and lastly, we get transaction-specific information for our cash transactions.

| XYZ co. Ltd. Cash Flow Statement (all numbers in millions of Rs.) | | | |
|---|---|---|---|
| *Period ending* | *03/31/2010* | *03/31/2009* | *03/31/2008* |
| **Net income** | **21,538** | **24,589** | **17,046** |
| **Operating activities, cash flows provided by or used in:** | | | |
| Depreciation and amortization | 2,790 | 2,592 | 2,747 |
| Adjustments to net income | 4,617 | 621 | 2,910 |
| Decrease (increase) in accounts receivable | 12,503 | 17,236 | -- |
| Increase (decrease) in liabilities (A/P, taxes payable) | 131,622 | 19,822 | 37,856 |
| Decrease (increase) in inventories | -- | -- | -- |
| Increase (decrease) in other operating activities | (173,057) | (33,061) | (62,963) |
| **Net cash flow from operating activities** | 13 | 31,799 | (2,404) |
| **Investing activities, cash flows provided by or used in:** | | | |
| Capital expenditures | (4,035) | (3,724) | (3,011) |
| Investments | (201,777) | (71,710) | (75,649) |
| Other cash flows from investing activities | 1,606 | 17,009 | (571) |
| **Net cash flows from investing activities** | (204,206) | (58,425) | (79,231) |
| **Financing activities, cash flows provided by or used in:** | | | |
| Dividends paid | (9,826) | (9,188) | (8,375) |
| Sale (repurchase) of stock | (5,327) | (12,090) | 133 |
| Increase (decrease) in debt | 101,122 | 26,651 | 21,204 |
| Other cash flows from financing activities | 120,461 | 27,910 | 70,349 |
| **Net cash flows from financing activities** | 206,430 | 33,283 | 83,311 |
| Effect of exchange rate changes | 645 | (1,840) | 731 |
| **Net increase (decrease) in cash and cash equivalents** | 2,882 | 4,817 | 2,407 |

## 2. Cash Flow from Operations

**Cash flows** from operations, as the name implies, showcases the cash generated as a result of the day-to-day operations of the business. This is derived from the revenues minus any appropriate costs. Simply put, it is the result of accounting for cash paid out and the cash generated from clients.

Cash flows from operating activities can be calculated and disclosed on the cash flow statement using the direct or indirect method. The direct method shows the cash inflows and outflows affecting all current asset and liability accounts, which largely make up most of the current operations of the entity. Those preparers that use the direct method must also provide operating cash flows under the indirect method.

The indirect method is a reconciliation of the period's net income to arrive at cash flows from operations; changes in current asset and liability accounts are added or subtracted from net income based on whether the change increased or decreased cash.

The indirect method must be disclosed in the cash flow statement to comply with U.S. accounting standards, or **GAAP**. The major accounting standards system used outside of the United States is the International Financial Reporting Standards, or **IFRS**. One major difference between GAAP and IFRS is how interest paid is categorized.

| Cash Flow Statement: GAAP vs. IFRS | | |
|---|---|---|
| | **GAAP** | **IFRS** |
| **Interest Received** | Operating | Operating or Investing |

| | | |
|---|---|---|
| **Dividends Received** | Operating | Operating or Investing |
| **Interest Paid** | Operating | Financing or Operating |
| **Dividends Paid** | Financing | Financing or Operating |
| **Income Taxes** | Operating | Operating unless specifically associated with financing or investing activity |

One major difference between GAAP and IFRS is how interest paid is categorized. Under GAAP, a loan payment would have to be broken down into two parts: the payment on principal (financing) and the payment of interest (operating). Under IFRS, it is possible to categorize both as financing cash flows.

All of the major operating cash flows, however, are classified the same way under GAAP and IFRS. The most noticeable cash inflow is cash paid by customers. Cash from customers is not necessarily the same as revenue, though. For example, if a company makes all of its sales by extending credit to customers, it will have generated revenues but not cash flows from customers. It is only when the company collects cash from customers that it has a cash flow.

Significant cash outflows are salaries paid to employees and purchases of supplies. Just as with sales, salaries and the purchase of supplies may appear on the income statement before appearing on the cash flow statement. Operating cash flows, like financing and investing cash flows, are only accrued when cash actually changes hands, not when the deal is made.

TERMS TO KNOW

**Cash Flow**

The sum of cash revenues and expenditures over a period of time.

**IFRS**

International Financial Reporting Standards; the major accounting standards system used outside of the United States.

**GAAP**

Generally Accepted Accounting Principles; refers to the standard framework of guidelines, conventions, and rules accountants are expected to follow in recording, summarizing, and preparing financial statements in any given jurisdiction.

# 3. Cash Flow from Investing

One of the components of the cash flow statement is the cash flow from investing. An **investing activity** is anything that has to do with changes in non-current assets — including property and equipment, and investment of cash into shares of stock, foreign currency, or government bonds — and return on investment — including dividends from investment in other entities and gains from sale of non-current assets. These activities are represented in the investing income part of the income statement.

It is important to note that investing activity does not concern cash from outside investors, such as bondholders or shareholders. For example, a company may decide to pay out a dividend. A dividend is often thought of as a payment to those who invested in the company by buying its stock. However, this cash flow is not representative of an investing activity on the part of the company. The investing activity was undertaken by the shareholder. Therefore, paying out a dividend is a financing activity.

Some examples of investment activity from the company's perspective would include:

- Cash outflow from the purchase of an asset (land, building, equipment, etc.)
- Cash inflow from the sale of an asset
- Cash outflow from the acquisition of another company
- Cash inflow resulting from a **merger**
- Cash inflow resulting from dividends paid on stock owned in another company

It is important to remember that, as with all cash flows, an investing activity only appears on the cash flow statement if there is an immediate exchange of cash. Therefore, extending credit to a customer (accounts receivable) is an investing activity, but it only appears on the cash flow statement when the customer pays off their debt.

TERMS TO KNOW

**Investing Activities**
Actions where money is put into something with the expectation of gain, usually over a longer term.

**Merger**
The legal union of two or more corporations into a single entity, typically assets and liabilities being assumed by the buying party.

---

# 4. Cash Flow from Financing

One of the three main components of the cash flow statement is cash flow from **financing**. In this context, financing concerns the borrowing, repaying, or raising of money. This could be from the issuance of shares, buying back shares, paying dividends, or borrowing cash. **Financing activities** can be seen in changes in non-current liabilities and in changes in equity in the change-in-equity statement.

On the liability side, a company may take out a loan. Everything concerning the loan is a financing activity. Receiving the money is a positive cash flow because cash is flowing into the company, while each individual payment is a negative cash flow.

However, when a company makes a loan (by extending credit to a customer, for example), it is not partaking in a financing activity. Extending credit is an investing activity, so all cash flows related to that loan fall under cash flows from investing activities, not financing activities.

As is the case with operating and investing activities, not all financing activities impact the cash flow statement — only those that involve the exchange of cash do. For example, a company may issue a discount which is a financing expense. However, because no cash changes hands, the discount does not appear on the cash flow statement.

Overall, positive cash flow could mean a company has just raised cash via a stock issuance or the company borrowed money to pay its obligations, therefore avoiding late payments or even bankruptcy. Regardless, the cash flow statement is an important part of analyzing a company's financial health, but is not the whole story.

TERMS TO KNOW

**Financing**

A transaction that provides funds for a business.

**Financing Activities**

Actions where money is flowing between the company and investors in the company, such as banks and shareholders.

# 5. Interpreting Overall Cash Flow

When using financial accounting, the statement of cash flows indicates how the changes in other statements, balance sheet and income statement, affect the cash position of the organization. This statement provides insight into the level of cash going both in and out of the organization during the accounting period.

The cash flow is widely believed to be the most important of the three financial statements because it is useful in determining whether a company will be able to pay its bills and make the necessary investments. A company may look really great based on the balance sheet and income statement, but if it doesn't have enough cash to pay its suppliers, creditors, and employees, it will go out of business. A positive cash flow means that more cash is coming into the company than going out, and a negative cash flow means the opposite.

Having positive and large cash flow is a good sign for any business, though it does not by itself mean the business will be successful.

When preparing the cash flow statement, one must analyze the balance sheet and income statement for the coinciding period. If the accrual basis of accounting is being utilized, accounts must be examined for their cash components. Analysts must focus on changes in account balances on the balance sheet.

General rules for this process are as follows:

- Transactions that result in an increase in assets will always result in a decrease in cash flow.
- Transactions that result in a decrease in assets will always result in an increase in cash flow.
- Transactions that result in an increase in liabilities will always result in an increase in cash flow.
- Transactions that result in a decrease in liabilities will always result in a decrease in cash flow

An analyst looking at the cash flow statement will first care about whether the company has a net positive cash flow. Having a positive cash flow is important because it means that the company has at least some liquidity and may be solvent.
Regardless of whether the net cash flow is positive or negative, an analyst will want to know where the cash is coming from or going to. The three types of cash flows (operating, investing, and financing) will all be broken down into their various components and then summed. The company may have a positive cash flow from operations, but a negative cash flow from investing and financing. This sheds important insight into how the company is making or losing money.

The analyst will continue breaking down the cash flow statement in this manner, diving deeper and deeper into the specific factors that affect the cash flow. For example, cash flows from operating activities provide feedback on a company's ability to generate income from internal sources. Thus, these cash flows are essential to helping analysts assess the company's ability to meet ongoing funding requirements, contribute to long-term projects and pay a dividend.

Analysis of cash flow from investing activities focuses on ratios when assessing a company's ability to meet future expansion requirements. One such ratio is that for capital acquisitions: Capital Acquisitions Ratio = cash flow from operating activities / cash paid for property, plant and equipment.

This sphere of cash flows also can be used to assess how much cash is available after meeting direct shareholder obligations and capital expenditures necessary to maintain existing capacity.

**Free cash flow** can be derived by evaluating how much of an organization's cash is available for distribution to other accounts within the organization. This is helpful when evaluating the level of cash that can be allocated without adversely impacting the daily operation of the organization.

The free cash flow takes into account the consumption of capital goods and the increases required in working capital. For example, in a growing company with a 30-day collection period for receivables, a 30-day payment period for purchases, and a weekly payroll, it will require more and more working capital to finance its operations because of the time lag for receivables, even though the total profits have increased.

Most importantly, this metric evaluates the ability of the organization to pay out dividends and grow without disrupting its ability to operate. It is important to keep in mind that it is possible to have a profitable business and negative free cash flow. This underscores the importance of calculating this metric in order to inform decision making.

TERM TO KNOW

**Free Cash Flow**
Net income plus depreciation and amortization, less changes in working capital, less capital expenditure.

## SUMMARY

In this lesson, you learned how companies account for the movement of cash in **the Statement of Cash Flows**. **Cash flow from operations** includes inflows and outflows resulting from day-to-day operations of the business. **Cash flow from investing** includes the flow of money relating to non-current assets, such as property, equipment, investment vehicles like government bonds, and business mergers. **Cash flow from financing** includes transactions related to the borrowing, repaying, or raising of money. **Interpreting overall cash flow** gives insight into a company's activities and financial strength, but should be viewed alongside balance sheets and income statements for a more complete picture.

Best of luck in your learning!



## TERMS TO KNOW

**Cash Flow**
The sum of cash revenues and expenditures over a period of time.

**Financing**
A transaction that provides funds for a business.

**Financing Activities**
Actions where money is flowing between the company and investors in the company, such as banks and shareholders.

**Free Cash Flow**
Net income plus depreciation and amortization, less changes in working capital, less capital expenditure.

**GAAP**
Generally Accepted Accounting Principles; refers to the standard framework of guidelines, conventions, and rules accountants are expected to follow in recording, summarizing, and preparing financial statements in any given jurisdiction.

**IFRS**
International Financial Reporting Standards; the major accounting standards system used outside of the United States.

**Investing Activities**
Actions where money is put into something with the expectation of gain, usually over a longer term.

**Merger**
The legal union of two or more corporations into a single entity, typically assets and liabilities being assumed by the buying party.