

What Is a Cash Flow Statement?

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The statement of cash flows or the cash flow statement, as it's commonly referred to, is a financial statement that summarizes the amount of [cash and cash equivalents](#) entering and leaving a company.

The cash flow statement (CFS) measures how well a company manages its cash position, meaning how well the company generates cash to pay its debt obligations and fund its operating expenses. The cash flow statement complements the [balance sheet](#) and [income statement](#) and is a mandatory part of [a company's financial reports](#) since 1987.

In this article, we'll show you how the CFS is structured, and how you can use it when analyzing a company. (Also check out our tutorial, [An Introduction To Fundamental Analysis](#).)

How A Cash Flow Statement Is Utilized

- The CFS allows investors to understand how a company's operations are running, where its money is coming from, and how money is being spent. The CFS is important since it helps investors determine whether a company is on a solid financial footing.
- Creditors, on the other hand, can use the CFS to determine how much cash is available (referred to as liquidity) for the company to fund its operating expenses and pay its debts.

The Structure Of The CFS

The main components of the cash flow statement are:

1. Cash from operating activities,
2. Cash from investing activities,
3. Cash from financing activities,
4. A fourth category, disclosure of noncash activities, is *sometimes* included when prepared under the [generally accepted accounting principles](#), or GAAP.

It's important to note that the CFS is distinct from the income statement and balance sheet because it does not include the amount of future incoming and outgoing cash that has been recorded on *credit*. Therefore, *cash is not* the same as [net income](#), which on the income statement and balance sheet, includes cash sales *and* sales made on credit. (For background reading, see [Analyze Cash Flow The Easy Way](#).)

Operating Activities

The operating activities on the CFS include any sources and uses of cash from business activities. In other words, it reflects how much cash is generated from a company's products or services.

Generally, changes made in cash, [accounts receivable](#), [depreciation](#), [inventory](#), and [accounts payable](#) are reflected in cash from operations. These operating activities might include:

- Receipts from sales of goods and services,
- Interest payments,
- Income tax payments,
- Payments made to suppliers of goods and services used in production,
- Salary and wage payments to employees,
- Rent payments,
- Any other type of operating expenses.

In the case of a trading portfolio or an investment company, receipts from the sale of loans, debt or equity instruments are also included. When preparing a cash flow statement under

the **indirect method**, depreciation, amortization, deferred tax, gains or losses associated with a noncurrent asset, and dividends or revenue received from certain investing activities are also included. However, purchases or sales of **long-term assets** are not included in operating activities.

How Cash Flow Is Calculated

Cash flow is calculated by making certain adjustments to net income by adding or subtracting differences in revenue, expenses and credit transactions (appearing **on the balance sheet** and income statement) resulting from transactions that occur from one period to the next. These adjustments are made because non-cash items are calculated into net income (income statement) and total **assets** and **liabilities** (balance sheet). So, because not all transactions involve actual cash items, many items have to be re-evaluated when calculating **cash flow from operations**.

As a result, there are two methods of calculating cash flow: The direct method and the indirect method.

- The **direct method** adds up all the various types of cash payments and receipts, including cash paid to suppliers, cash receipts from customers and cash paid out in salaries. These figures are calculated by using the beginning and end balances of a variety of a business accounts and examining the net decrease or increase in the accounts.
- With the **indirect method**, cash flow from operating activities is calculated by first taking the net income off of a company's income statement. Because a company's income statement is prepared on an **accrual basis**, **revenue** is only recognized when it is **earned** and not when it is received. Net income is not an accurate representation of net cash flow from operating activities, so it becomes necessary to adjust **earnings before interest and taxes (EBIT)** for items that affect net income, even though no actual cash has yet been received or paid against them. The indirect method also makes adjustments to add back non-operating activities that do not affect a company's

operating cash flow.

For example, depreciation is not really a cash expense; it is an amount that is deducted from the total value of an asset that has previously been accounted for. That is why it is added back into **net sales** for calculating cash flow. The only time income from an asset is accounted for in CFS calculations is when the asset is sold.

Changes in accounts receivable on the balance sheet from one **accounting period** to the next must also be reflected in cash flow. If accounts receivable decreases, this implies that more cash has entered the company from customers paying off their credit accounts – the amount by which AR has decreased is then added to net sales. If accounts receivable increases from one accounting period to the next, the amount of the increase must be deducted from net sales because, although the amounts represented in AR are revenue, they are not cash.

An increase in inventory, on the other hand, signals that a company has spent more money to purchase more **raw materials**. If the inventory was paid with cash, the increase in the value of inventory is deducted from net sales. A decrease in inventory would be added to net sales. If inventory was purchased on credit, an increase in accounts payable would occur on the balance sheet, and the amount of the increase from one year to the other would be added to net sales.

The same logic holds true for taxes payable, salaries payable and **prepaid insurance**. If something has been paid off, then the difference in the value owed from one year to the next has to be subtracted from net income. If there is an amount that is still owed, then any differences will have to be added to net earnings. (For more insight, see **Operating Cash Flow: Better Than Net Income?**).

Investing Activities

Investing activities include any sources and uses of cash from a company's investments. A purchase or sale of an asset, loans made to vendors or received from customers or any

payments related to a merger or acquisition are included in this category. In short, changes in equipment, assets, or investments relate to cash from investing.

Usually, cash changes from investing are a "cash out" item, because cash is used to buy new equipment, buildings, or short-term assets such as [marketable securities](#). However, when a company divests an asset, the transaction is considered "cash in" for calculating cash from investing. For more on how cash flow from investing activities is calculated, please see [Cash Flow From Investing Activities](#).

Financing Activities

Cash from financing activities include the sources of cash from investors or banks, as well as the uses of cash paid to shareholders. Payment of [dividends](#), payments for stock repurchases and the repayment of debt principle (loans) are included in this category.

Changes in cash from financing are "cash in" when capital is raised, and they're "cash out" when dividends are paid. Thus, if a company issues a bond to the public, the company receives cash financing; however, when interest is paid to [bondholders](#), the company is reducing its cash. For more on how cash flow from financing activities is calculated, please see [Cash Flow From Financing Activities](#).

Analyzing An Example Of A CFS

Below is an example of a cash flow statement:

Cash Flow Statement Company XYZ FY Ended 31 Dec 2017 <small>All Figures in USD</small>		
Cash Flow From Operations		
Net Earnings		2,000,000
<i>Additions to Cash</i>		
Depreciations		10,000
Decrease in Accounts Receivable		15,000
Increase in Accounts Payable		15,000
Increase in Taxes Payable		2,000
<i>Subtractions From Cash</i>		
Increase in Inventory		(30,000)
Net Cash From Operations		2,012,000
Cash Flow From Investing		
Equipment		(500,000)
Cash Flow From Financing		
Notes Payable		10,000
Cash Flow for FY Ended 31 Dec 2017		1,522,000

From this CFS, we can see that the cash flow for FY 2017 was \$1,522,000. The bulk of the positive cash flow stems from cash earned from operations, which is a good sign for investors. It means that core operations are generating business and that there is enough money to buy new inventory. The purchasing of new equipment shows that the company has the cash to invest in inventory for growth. Finally, the amount of cash available to the company should ease investors' minds regarding the notes payable, as cash is plentiful to cover that future loan expense.

Of course, not all cash flow statements look this healthy, or exhibit a positive cash flow; but a negative cash flow should not automatically raise a **red flag** without further analysis. Sometimes, a negative cash flow is the result of a company's decision to expand its business at a certain point in time, which would be a good thing for the future. This is why analyzing

changes in cash flow from one period to the next gives the investor a better idea of how the company is performing, and whether or not a company may be on the brink of [bankruptcy](#) or success. (For information on cash flow accounting, see [Cash Flow On Steroids: Why Companies Cheat.](#))

Tying The CFS With The Balance Sheet And Income Statement

As we have already discussed, the cash flow statement is derived from the income statement and the balance sheet. Net earnings from the income statement is the figure from which the information on the CFS is deduced. As for the balance sheet, the net cash flow in the CFS from one year to the next should equal the increase or decrease of cash between the two consecutive balance sheets that apply to the period that the cash flow statement covers. (For example, if you are calculating a cash flow for the year 2017, the balance sheets from the years 2016 and 2017 should be used.)

The Bottom Line

A cash flow statement is a valuable measure of strength, profitability and of the long-term future outlook for a company. The CFS can help determine whether a company has enough liquidity or cash to pay its expenses. A company can use a cash flow statement to predict future cash flow, which helps with matters of budgeting.

For investors, the cash flow statement reflects a company's [financial health](#) since typically the more cash that's available for business operations, the better. However, this is not a hard and fast rule. Sometimes a negative cash flow results from a company's growth strategy in the form of expanding its operations.

By studying the cash flow statement, an investor can get a clear picture of how much cash a company generates and gain a solid understanding of the financial well being of a company.

