CASH FLOW STATEMENTS:

The purpose of a cash flow statement is to provide a detailed picture of what happened to a business's cash during a specified period, known as the accounting period. It demonstrates an organization's ability to operate in the short and long term, based on how much cash is flowing into and out of the business.

The cash flow statement is typically broken into three sections:

- **Operating activities**
- **Investing activities**
- **Financing activities**

Operating activities detail cash flow that's generated once the company delivers its regular goods or services, and includes both revenue and expenses. Investing activities include cash flow from purchasing or selling assets—think physical property, such as real estate or vehicles, and non-physical property, like patents—using free cash, not debt. Financing activities detail cash flow from both debt and equity financing.

Based on the cash flow statement, you can see how much cash different types of activities generate, then make business decisions based on your analysis of financial statements.

Ideally, a company's cash from operating income should routinely exceed its net income, because a positive cash flow speaks to a company's ability to remain solvent and grow its operations.

It's important to note that cash flow is different from profit, which is why a cash flow statement is often interpreted together with other financial documents, such as a balance sheet and income statement.

HOW CASH FLOW IS CALCULATED:

Now that you understand what comprises a cash flow statement and why it's important for financial analysis, here's a look at two common methods used to calculate and prepare the operating activities section of cash flow statements.

Cash Flow Statement Direct Method:

The first method used to calculate the operation section is called the direct method, which is based on the transactional information that impacted cash during the period. To calculate the operation section using the direct method, take all cash collections from operating activities, and subtract all of the cash disbursements from the operating activities.

Cash Flow Statement Indirect Method:

The second way to prepare the operating section of the statement of cash flows is called the indirect method. This method depends on the accrual accounting method in which the accountant records revenues and expenses at times other than when cash was paid or received—meaning that these accrual entries and adjustments cause the cash flow from operating activities to differ from net income.

Instead of organizing transactional data like the direct method, the accountant starts with the net income number found from the income statement and makes adjustments to undo the impact of the accruals that were made during the period.

Essentially, the accountant will convert net income to actual cash flow by de-accruing it through a process of identifying any non-cash expenses for the period from the income statement. The most common and consistent of these are depreciation, the reduction in the value of an asset over time, and amortization, the spreading of payments over multiple periods.

HOW TO INTERPRET A CASH FLOW STATEMENT:

Whenever you review any financial statement, you should consider it from a business perspective. Financial documents are designed to provide insight into the financial health and status of an organization.

For example, cash flow statements can reveal what phase a business is in: whether it's a rapidly growing startup or a mature and profitable company. It can also reveal whether a company is going through transition or in a state of decline.

Using this information, an investor might decide that a company with uneven cash flow is too risky to invest in; or they might decide that a company with positive cash flow is primed for growth. Similarly, a department head might look at a cash flow statement to understand how their particular department is contributing to the health and wellbeing of the company and use that insight to adjust their department's activities. Cash flow might also impact internal decisions, such as budgeting, or the decision to hire (or fire) employees.

Cash flow is typically depicted as being positive (the business is taking in more cash than it's expending) or negative (the business is spending more cash than it's receiving).

Positive Cash Flow:

Positive cash flow indicates that a company has more money flowing into the business than out of it over a specified period. This is an ideal situation to be in because having an excess of cash allows the company to reinvest in itself and its shareholders, settle debt payments, and find new ways to grow the business.

Positive cash flow does not necessarily translate to profit, however. Your business can be profitable without being cash flow-positive, and you can have positive cash flow without actually making a profit.

Negative Cash Flow:

Having negative cash flow means your cash outflow is higher than your cash inflow during a period, but it doesn't necessarily mean profit is lost. Instead, negative cash flow may be caused by expenditure and income mismatch, which should be addressed as soon as possible.

Negative cash flow may also be caused by a company's decision to expand the business and invest in future growth, so it's important to analyze changes in cash flow from one period to another, which can indicate how a company is performing overall.

CASH FLOW STATEMENT EXAMPLE:

COMPANY A
STATEMENT OF CASH FLOWS

Year Ended September 28, 2019 (In millions)

CASH AND CASH EQUIVALENTS, BEGINNING OF THE YEAR	$ 10,746
OPERATING ACTIVITIES:	
NET INCOME	37,037
ADJUSTMENTS TO RECONCILE NET INCOME TO CASH GENERATED BY OPERATING ACTIVITIES:	
DEPRECIATION AND AMORTIZATION	6,757
DEFERRED INCOME TAX EXPENSE	1,141
OTHER	2,253
CHANGES IN OPERATING ASSETS AND LIABILITIES:	
ACCOUNTS RECEIVABLE, NET	(2,172)
INVENTORIES	(973)
VENDOR NON-TRADE RECEIVABLES	223
OTHER CURRENT AND NON-CURRENT ASSETS	1,080
ACCOUNTS PAYABLE	2,340
DEFERRED REVENUE	1,459
OTHER CURRENT AND NON-CURRENT LIABILITIES	4,521
CASH GENERATED BY OPERATING ACTIVITIES	53,666
INVESTING ACTIVITIES:	
PURCHASES OF MARKETABLE SECURITIES	(148,489)
PROCEEDS FROM MATURITIES OF MARKETABLE SECURITIES	20,317
PROCEEDS FROM SALES OF MARKETABLE SECURITIES	104,130
PAYMENTS MADE IN CONNECTION WITH BUSINESS ACQUISITIONS, NET OF CASH ACQUIRED	(496)
PAYMENTS FOR ACQUISITION OF PROPERTY, PLANT, AND EQUIPMENT	(8,165)
PAYMENTS FOR ACQUISITION OF INTANGIBLE ASSETS	(911)
OTHER	(160)
CASH USED IN INVESTING ACTIVITIES	(33,774)
FINANCING ACTIVITIES:	
DIVIDENDS AND DIVIDEND EQUIVALENT RIGHTS PAID	(10,564)
REPURCHASE OF COMMON STOCK	(22,860)
PROCEEDS FROM ISSUANCE OF LONG-TERM DEBT, NET	16,896
OTHER	149
CASH USED IN FINANCING ACTIVITIES	(16,379)
INCREASE/(DECREASE) IN CASH AND CASH EQUIVALENTS	3,513
CASH AND CASH EQUIVALENTS, END OF YEAR	**$ 14,259**

Operating Section

Investing Section

Financing Section

Harvard Business School Online

This cash flow statement shows Company A started the year with approximately $10.75 billion in cash and equivalents.

Cash flow is broken out into cash flow from operating activities, investing activities, and financing activities. The business brought in $53.66 billion through its regular operating activities. Meanwhile, it spent approximately $33.77 billion in investment activities, and a further $16.3 billion in financing activities, for a total cash outflow of $50.1 billion.

The result is the business ended the year with a positive cash flow of $3.5 billion, and total cash of $14.26 billion.

THE IMPORTANCE OF CASH FLOW:

Cash flow statements are one of the most critical financial documents that an organization prepares, offering valuable insight into the health of the business. By learning how to read a cash flow statement and other financial documents, you can acquire the financial accounting skills needed to make smarter business and investment decisions, regardless of your position.

CASH FLOW STATEMENT:(Alternative Version)

Cash and cash equivalents, beginning of the year: $10,746

OPERATING ACTIVITIES:

ACTIVITY	AMOUNT
NET INCOME	37,037
ADJUSTMENTS TO RECONCILE NET INCOME TO CASH GENERATED BY OPERATING ACTIVITIES:	
DEPRECIATION AND AMORTIZATION	6,757
DEFERRED INCOME TAX EXPENSE	1,141
OTHER	2,253
CHANGES IN OPERATING ASSETS AND LIABILITIES:	
ACCOUNTS RECEIVABLE, NET	(2,172)
INVENTORIES	(973)
VENDOR NON-TRADE RECEIVABLES	223
OTHER CURRENT AND NON-CURRENT ASSETS	1,080
ACCOUNTS PAYABLE	2,340
DEFERRED REVENUE	1,459
OTHER CURRENT AND NON-CURRENT LIABILITIES	4,521
CASH GENERATED BY OPERATING ACTIVITIES	53,666

INVESTING ACTIVITIES:

ACTIVITY	AMOUNT
PURCHASES OF MARKETABLE SECURITIES	(148,489)
PROCEEDS FROM MATURITIES OF MARKETABLE SECURITIES	20,317
PROCEEDS FROM SALES OF MARKETABLE SECURITIES	104,130
PAYMENTSMADE IN CONNECTION WITH BUSINESS ACQUISITIONS, NET OF CASH ACQUIRED	(496)
PAYMENTS FOR ACQUISITION OF INTANGIBLE ASSETS	(911)
OTHER	(160)
CASH USED IN INVESTING ACTIVITIES	(33,774)

<u>FINANCING ACTIVITIES:</u>

ACTIVITY	AMOUNT
DIVIDENDS AND DIVIDEND EQUIVALENT RIGHTS PAID	(10,564)
REPURCHASE OF COMMON STOCK	(22,860)
PROCEEDS FROM ISSUANCE OF LONG-TERM DEBT, NET	16,896
OTHER	149
CASH USED IN FINANCING ACTIVITIES	(16,379)

Increase / Decrease in Cash and Cash Equivalents: 3,513

Cash and Cash Equivalents, End of Year: <u>$14,259</u>