

Cash Flow Statements: How to Prepare and Read One

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Part of the Series
Guide to Accounting



To assess a company's financial health, you have to understand its cash flow statement. It reveals how cash moves through a business, including operations, investments, and financing activities. The cash flow statement highlights liquidity, showing whether a company can generate enough cash to sustain itself, invest in growth and meet its financial obligations.

Whether you're an investor, business owner, or analyst, learning how to prepare, read, and analyze a cash flow statement will help you identify trends, spot red flags, and make informed financial decisions with confidence.

KEY TAKEAWAYS

- Cash flow statements are essential to understanding a company's financial health.
- They consist of three main sections: operating, investing, and financing activities.
- There are two methods for preparing cash flow statements: direct and indirect.
- Analyzing cash flow statements helps identify financial trends and potential problems.



FY Ended 31 Dec 2017
All figures in USD

Cash Flow From Operations	
Net Earnings	2,000,000
Additions to Cash	
Depreciations	10,000
Decrease in Accounts Receivable	15,000
Increase in Accounts Payable	15,000
Income Taxes Payable	2,000
From Cash	
Change in Inventory	(30,000)
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

Credit: Investopedia / Matthew Collins

Understanding Cash Flow Statements

The cash flow statement is a part of a company's financial statement that tracks its actual cash movements, providing a clear picture of liquidity and its financial lifeblood. Unlike the [income statement](#), which records revenues and expenses based on [accrual accounting](#), the cash flow statement focuses on actual cash inflows and outflows, helping stakeholders assess a company's ability to sustain operations, invest in growth, and manage obligations.

It complements the [balance sheet](#) by explaining changes in cash balances and reconciling non-cash transactions from the income statement to reveal how much profit actually converts into cash. By analyzing these activities, investors can identify trends, detect potential cash flow issues, and make informed financial decisions. ^[1]

Components of a Cash Flow Statement

The cash flow statement has three main sections: operating activities, investing activities and financing activities. Each segment provides a detailed breakdown of how cash is generated and used within a company over the stated period.

Operating Activities

This section of the cash flow statement shows how cash flows from a company's core business operations, and whether the company can sustain itself without external financing. Cash inflows come from revenue, interest, and dividends.

Positive operating cash flow means a business is generating enough cash to cover expenses, whereas negative cash flow may signal inefficiencies in [working capital](#).^[1]

Investing Activities

The investing activities section of the cash flow statement tracks cash movements related to long-term investments that affect a company's growth. In this section, cash inflows come from selling assets, divesting subsidiaries, or collecting payments on loans. Cash outflows include [capital expenditures](#) (capex), investments in securities, and business acquisitions.

High capex can indicate expansion, but excessive spending without strong operating cash flow may strain liquidity. Conversely, frequent asset sales to generate cash might warn of financial distress.^[1]

Financing Activities

This segment shows how a company raises and repays capital through debt and equity financing. In this segment, cash inflows come from issuing stock or borrowing, while cash outflows include loan repayments, dividend payments, and stock buybacks. Raising cash through financing can support expansion, but excessive debt without revenue growth may pose risks. On the other hand, consistent dividends and stock buybacks signal financial strength and a commitment to shareholder value.

Preparing a Cash Flow Statement

Creating a cash flow statement involves gathering relevant financial data, choosing a preparing method, and categorizing cash flows into operating, investing and financing activities. The general steps are as follows:

- **Step 1. Collect financial data:** Collect the necessary data. This includes net income and non-cash expenses from the income statement, changes in assets and liabilities from the balance sheet, and bank statements to track the movement of cash.
- **Step 2. Choose a preparation method:** There are two methods to prepare a cash flow statement—direct and indirect.
- **Step 3. Calculate cash flow from operating activities:** If using the indirect method, begin with net income, add back non-cash expenses, and adjust for changes to working capital. If using the direct method, record actual cash inflows and outflows from customers, suppliers, and operating expenses.
- **Step 4. Calculate cash flow from investing activities:** Next, identify any cash spent on capex from long-term assets. Additionally, record cash inflows from asset sales, divestitures, or loan collections from outflows for acquisitions or new investments.
- **Step 5. Calculate cash flow from financing activities:** Include cash inflows from issuing stocks or borrowing funds. Deduct cash outflows from debt repayments, dividend distributions, and stock buybacks.

that the ending cash balance matches the balance sheet's cash account.

- **Step 7. Review and analyze:** Look for negative cash flow trends that may indicate financial distress. Assess if operating cash flow is sufficient to cover investments and financing obligations. Identify unusual or inconsistent cash movements that may require further investigation.

Direct and Indirect Method

As mentioned previously there are two ways to build a cash flow statement: the direct method and the indirect method. Both methods yield the same net cash flow but they differ in presentation and the information required.

The direct method presents actual cash receipts and payments from operating activities. Instead of starting with net income, it lists cash inflows and outflows to core business operations. Alternatively, the indirect method starts with net income from the income statement and adjusts it for non-cash items and changes in working capital to arrive at cash flow from operations. ^[1]

Differences Between the Direct and Indirect Method

Direct Method

- **Approach:** Lists actual cash transactions from operating activities
- **Transparency:** Provides clearer visibility of cash movements
- **Use of Accrual Accounting Adjustments:** Not required
- **Ease of Preparation:** More complex, requires detailed cash tracking
- **Regulatory Preference:** Preferred under International Financial Reporting Standards (IFRS) but rarely used
- **When Generally Used:** Cash-heavy industries and when IFRS compliance is required

Indirect Method

- **Approach:** Starts with net income and adjusts for non-cash items
- **Transparency:** Less transparent but easier to prepare
- **Use of Accrual Accounting Adjustments:** Required
- **Ease of Preparation:** Easier, uses existing financial statements
- **Regulatory Preference:** Accepted by IFRS and GAAP, widely used by companies
- **When Generally Used:** Used by most companies, especially large corporations as it aligns with accrual-based financial reporting

can assess whether a company is generating enough cash from its core business, with positive operating cash flow indicating financial strength and negative signaling potential distress.

Additionally, investing cash flow shows how a company allocates funds for growth. High capex often indicates expansion, while frequent asset sales may indicate liquidity concerns. Moreover, financing cash flow reveals how a company raises and repays capital, with excessive debt issuance posing risks but steady dividend payments suggesting financial stability.

A strong company typically has positive operating cash flow, strategic investments, and balanced financing activities. On the other hand, cash burn, heavy reliance on debt, or frequent asset sales could indicate trouble.

Common Indicators and Red Flags

Strong indicators of financial stability include:

- Consistently positive operating cash flow
- Strategic capex
- Balanced financing activities, such as debt repayments and shareholder returns

Red flags include:

- Declining or negative operating cash flow
- Excessive reliance on external financing
- Frequent asset sales for liquidity
- High cash burn rate

Generally, a company with strong free cash flow and sustainable debt management is in good financial standing, while persistent negative trends in cash flow indicate distress.

Example of a Cash Flow Statement

FY Ended 31 Dec 2023		
All Figures in USD		
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		<u>2,012,000</u>
Cash Flow From Investing		
Equipment		(500,000)
Cash Flow From Financing		
Notes Payable		10,000
Cash Flow for FY Ended 31 Dec 2023		<u>1,522,000</u>

Credit: Investopedia / Sabrina Jiang

The image above shows the cash flow statement for company XYZ. The analysis of cash flow activities is as follows:

Operating Activities

Net Earnings = \$2,000,000

Depreciation = \$10,000

Change in Inventory = -\$30,000

Changes in Working Capital = Decrease in Accounts Receivable + Increase in Accounts Payable + Increase in Taxes Payable = \$15,000 + \$15,000 + \$2,000 = \$32,000

Net Cash Flow from Operating Activities = \$2,000,000 + \$10,000 + \$32,000 - \$30,000 = \$2,012,000

Investing Activities

Proceeds from Equipment Purchase = -\$500,000

Financing Activities

Capital Raising: Notes Payable = \$10,000

= \$2,012,000 - \$500,000 + \$10,000 = \$1,522,000

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Therefore, the net cash flow for the fiscal year in this example was \$1,522,000.
Guide to Accounting

The Bottom Line
Accounting Explained With Brief History and Modern Job Requirements
Altogether, a well prepared cash flow statement can greatly assist in analyzing a company's financial health, ensuring that cash is being managed effectively, and identifying potential risks or opportunities. By scrutinizing the operating, investing, and financing cash flows, businesses can make informed decisions, investors can assess sustainability, and analysts can detect trends that might affect long-term performance.

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