Statement of Cash Flows

The Statement of Cash Flows (SCF), also known as the cash flow statement, is a vital financial document that provides a detailed picture of a company's cash inflows and outflows over a specific accounting period. It is one of the three main financial statements required in standard financial reporting, alongside the income statement and balance sheet, and is crucial for understanding a company's financial health and liquidity.

Authoritative Guidance

The primary authoritative guidance for the Statement of Cash Flows in the U.S. is **FASB Accounting Standards Codification (ASC) 230**. This guidance aims to provide relevant information about an entity's cash receipts and payments during a period, helping investors, creditors, and other stakeholders assess the entity's ability to generate positive future net cash flows, meet its obligations, pay dividends, and understand the effects of both cash and noncash investing and financing transactions on its financial position.

Core Concepts: Sections of the Statement of Cash Flows

The cash flow statement is divided into three main sections: **operating activities, investing activities, and financing activities**. These sections collectively illustrate where a company's cash originates, how it is spent, and the resulting net change in cash during the reporting period.

1. **Cash Flow From Operating Activities (CFO)**
   - **Definition:** Operating cash flow is the money a company generates from its **core day-to-day operations**, such as selling products or providing services. It represents the cash generated from the ongoing, primary business activities and is typically the first section presented on a company's cash flow statement. CFO focuses solely on the core business and does not include long-term capital expenditures or investment revenue and expense. A **positive (and increasing) cash flow from operating activities** indicates that the company's core business activities are thriving and serves as an additional measure of profitability potential, complementing traditional metrics like net income.
   - **Methods of Presentation:** There are two methods for depicting cash from operating activities on a cash flow statement: the **indirect method** and the **direct method**.
     - **Indirect Method:** This method begins with **net income** from the income statement and then adjusts it by adding back noncash items (such as depreciation and amortization) and accounting for changes in working capital accounts (like accounts receivable, inventory, and payables) to arrive at a cash-basis figure. It is the dominant method used by most companies due to its simplicity in preparation using information from the income statement and balance sheet, which typically follow the accrual method of accounting.
     - **Direct Method:** This method tracks and presents all transactions in a period on a cash basis, using **actual cash inflows and outflows** from

operating activities. Examples of items reported under the direct method include cash collected from customers, cash paid to vendors and suppliers, salaries paid out to employees, interest income and dividends received, and income tax paid and interest paid. While the Financial Accounting Standards Board (FASB) recommends the direct method as it offers a clearer picture of cash flows in and out of a business, it also requires companies using this method to disclose a reconciliation of net income to operating cash flow, similar to the indirect method, which can make it less popular among companies. Regardless of the method used, the net cash flows from operating activities will be the same.

2. **Cash Flow From Investing Activities (CFI)**
   - **Definition:** Cash flow from investing activities reports how much cash has been **generated or spent from investment-related activities**. These activities generally involve the acquisition and disposal of noncurrent (long-term) assets, such as property, plant, and equipment, and investments in the securities of other companies. Investment activities may generate income or ensure the long-term health or performance of the company.
   - **Examples:** Common investing activities include:
     - **Purchases of property, plant, and equipment (capital expenditures)**.
     - **Proceeds from the sale of property, plant, and equipment**.
     - **Purchase and sale of long-term investments in securities**.
     - **Making and collecting loans to others**.
3. **Cash Flow From Financing Activities (CFF)**
   - **Definition:** Cash flow from financing activities details the **net cash flows involved in funding a company's operations**, encompassing both debt and equity financing. It reports cash inflows and outflows related to external sources of financing, such as owners and creditors. This section highlights how management has chosen to fund its growth, which is crucial for evaluating a business's capital structure and growth potential.
   - **Examples:** Common financing activities include:
     - **Proceeds from issuing equity instruments (e.g., common stock)**.
     - **Proceeds from issuing bonds, mortgages, and notes (long-term debt)**.
     - **Repayment of principal to creditors (excluding interest, which is an operating activity)**.
     - **Repurchasing stock (treasury stock) from owners**.
     - **Payment of dividends to owners**.
     - **Capital/finance lease payments**.

Complete Walkthrough of the Indirect Method for Cash Flow From Operating Activities (CFO)

The indirect method is the most commonly used approach for preparing the operating activities section of the cash flow statement. It starts with net income and adjusts for items that affected net income but did not involve cash, or that involved cash but are classified as investing or financing activities.

Here’s a step-by-step walkthrough of the indirect method:

1. **Start with Net Income (or Profit for the Year):** This figure is taken directly from the company's income statement. The reconciliation of net income to net cash flow from operating activities is required regardless of whether the direct or indirect method is used.
    - **Insight:** Net income is based on the accrual method of accounting, which recognizes revenues when earned and expenses when incurred, regardless of when cash is exchanged. The purpose of these adjustments is to convert this accrual-basis net income into a cash-basis figure.
2. **Add Back Noncash Expenses:**
    - **Depreciation, Depletion, and Amortization:** These are common noncash expenses that reduce net income but do not involve any cash outflow. Therefore, they are added back to net income to reflect the true cash generated by operations.
    - **Losses and Deduct Gains:** Gains on the sale of assets (e.g., property, plant, and equipment) are subtracted from net income, while losses are added back. This is because the actual cash proceeds from the sale of such assets are classified under investing activities, and adding/subtracting the gain/loss prevents double-counting or misrepresenting the cash flow from operations.
3. **Adjust for Changes in Operating Current Assets and Liabilities:** These adjustments account for the differences between accrual accounting and cash accounting for operating items.
    - **Current Assets:**
        - **Decrease in Accounts Receivable:** When accounts receivable decreases, it means the company collected more cash from customers than it recognized as revenue during the period. This is a **cash inflow**, so it is **added** to net income.
        - **Increase in Accounts Receivable:** An increase implies that the company recognized more revenue on credit than it collected in cash, representing a **cash outflow** (or a use of cash). It is, therefore, **subtracted** from net income.
        - **Decrease in Inventory:** A decrease indicates that more inventory was sold (leading to cost of goods sold) than was purchased with cash. This implies an **inflow** of cash, so it is **added** to net income.
        - **Increase in Inventory:** An increase means the company spent cash on purchasing more inventory than it sold, representing a **cash outflow**. It is, therefore, **subtracted** from net income.
        - **Decrease in Prepaid Expenses:** A decrease means expenses that were previously paid in cash are now being recognized (expensed). This effectively "frees up" cash from a prior period, so it is **added** to net income.
        - **Increase in Prepaid Expenses:** An increase means cash was paid for future expenses, which is a **cash outflow**. It is, therefore, **subtracted** from net income.
    - **Current Liabilities:**

    - **Decrease in Accounts Payable:** A decrease indicates the company paid out more cash to suppliers than it incurred in expenses. This is a **cash outflow**, so it is **subtracted** from net income.
    - **Increase in Accounts Payable:** An increase means the company incurred more expenses than it paid out in cash, representing a **cash inflow** (effectively postponing cash outflow). It is, therefore, **added** to net income.
    - **Decrease in Accrued Expenses (Accrued Liabilities):** A decrease means the company paid out more cash for expenses than it incurred. This is a **cash outflow**, so it is **subtracted** from net income.
    - **Increase in Accrued Expenses:** An increase means the company incurred more expenses than it paid out, representing a **cash inflow**. It is, therefore, **added** to net income.

By performing these adjustments, the indirect method converts net income to the actual cash generated or used by the company's operating activities. This net figure is then reported as "Net cash provided by (used in) operating activities".

Noncash Investing and Financing Activities Disclosures

While the main sections of the Statement of Cash Flows report only cash receipts and payments, some significant investing and financing activities do not involve the exchange of cash but still affect a company's recognized assets or liabilities. These are known as **noncash investing and financing activities**, and they **must be disclosed separately** from the main body of the cash flow statement.

These disclosures are important because they provide a complete understanding of an entity's investing and financing transactions, even if no cash was exchanged in the period. The disclosures can be presented in a **narrative form or summarized in a schedule** either on the face of the statement of cash flows or in the notes to the financial statements, clearly linking the cash and noncash aspects of related transactions.

Examples of noncash investing and financing activities that require disclosure include:

- **Acquisition of assets by assuming liabilities:** For instance, purchasing property, plant, and equipment by incurring a direct liability to the seller (e.g., a mortgage or note payable) rather than paying cash.
- **Acquisition of assets by issuing equity securities:** Such as acquiring another company's common stock in exchange for issuing shares of the acquiring company's stock.
- **Issuance of shares in exchange for goods or services:** For example, granting share-based payment awards in exchange for employee services.
- **Debt extinguishment through the issuance of equity securities:** When debt is settled by issuing common shares or other equity securities instead of making a cash payment.
- **Conversion of debt to equity:** Such as converting convertible bonds into common or preferred stock.

- **Noncash effects of a business combination:** Including any noncash consideration transferred and the total effects on the acquirer's assets and liabilities.
- **Forgiveness of a loan:** Such as the forgiveness of a government grant (e.g., a PPP loan) accounted for as debt, which is disclosed as a noncash financing activity.

If a transaction includes both cash and noncash components, only the cash portion is reported in the statement of cash flows, while the noncash component is separately disclosed. The SEC Chief Accountant emphasizes that these disclosures are critical for investors to understand how noncash activities affect recognized assets or liabilities.