Inventory and expenses

Inventory is usually the largest current asset of a business that sells products. If the inventory account is greater at the end of the period than at the start of the reporting period, the amount the business actually paid in cash for that inventory is more than what the business recorded as its cost of good sold expense. When that occurs, the accountant deducts the inventory increase from net income for determining cash flow from profit.

the prepaid expenses asset account works in much the same way as the change in inventory and accounts receivable accounts. However, changes in prepaid expenses are usually much smaller than changes in those other two asset accounts.

The beginning balance of prepaid expenses is charged to expense in the current year, but the cash was actually paid out last year. this period, the business pays cash for next period's prepaid expenses, which affects this period's cash flow, but doesn't affect net income until the next period. Simple, right?

As a business grows, it needs to increase its prepaid expenses for such things as fire insurance premiums, which have to be paid in advance of the insurance coverage, and its stocks of office supplies. Increases in accounts receivable, inventory and prepaid expenses are the cash flow price a business has to pay for growth. Rarely do you find a business that can increase its sales revenue without increasing these assets.

The lagging behind effect of cash flow is the price of business growth. Managers and investors need to understand that increasing sales without increasing accounts receivable isn't a realistic scenario for growth. In the real business world, you generally can't enjoy growth in revenue without incurring additional expenses.