Chapter 5

Preparing and Using a Statement of Cash Flows

- What Is a Statement of Cash Flows?
- Cash and Cash Equivalents
- The Statement of Cash Flows Illustrated

After analyzing the Balance Sheet and the Income Statement for Solana Beach Bicycle Company, Samantha had a clear understanding of what her business owned and what she owed, as well as what its "bottom line" is for the year. Although things are looking good so far, Sam has a nagging concern, which she raises at a meeting with her business advisor: "I have read that many small businesses go bankrupt, not because they don't have a great product or a great service, but because they run out of cash. Is that right?"

Well, Sam is right. As we discussed in chapter 4, making a profit, or having a large amount in Retained Earnings, does not equal having cash. And if there is no cash, there is no way to pay the salaries, pay the IRS, or pay any other bills for that matter. In this chapter we will discuss the Statement of Cash Flows and the financial statement, which will help Sam in her quest to stay on top of the cash flow in her business.

What Is a Statement of Cash Flows?

For a company's financial statement to be in accordance with Generally Accepted Accounting Principles (GAAP), the Statement of Cash Flows must be included as one of the four required financial statements. Do you remember the other three? They are the Balance Sheet, the Income Statement, and Statement of Retained Earnings.

The Statement of Cash Flows shows the flow of cash within the business—where the cash came from and how it was spent during the period of reporting (which is generally a month, a quarter, or a year). It also shows the cash flows of the company, divided into categories according to three major activities: operating, investing, and financing. This is helpful to statement users, business owners, investors, and creditors because it indicates the type of transaction that gave rise to each one of the cash flows.

Additionally, the Statement of Cash Flows differs from the Balance Sheet and Income Statement in two key ways. The Balance Sheet shows the financial status of a company at the end of the reporting period (a snapshot), but both the Income Statement and the Statement of Cash Flows show the flow of activity during the reporting period (a short movie compared to the snapshot that is the Balance Sheet). The second difference is that the Income Statement reports this activity on the accrual basis, and the Statement of Cash Flows reports it on the cash basis. Remember from chapter 4, that under the cash basis of accounting, Revenue is not reported until cash is received, and Expenses are not reported until cash is disbursed.

What Is the Purpose of the Statement?

Like the other required financial statements you have learned about—the Balance Sheet and the Income Statement—the Statement of Cash Flows enables users to make decisions about the company. The Statement of Cash Flows is more like the Income Statement than the Balance Sheet in that it is a change statement. It shows the transactions that caused cash levels to change from the beginning of the period to the end. As was mentioned earlier, a company can make a profit or earn a large amount of Revenue but not have enough cash to pay its bills. The Revenue, thus the Net Income, may have been generated (wholly or in part) by promises to pay in the future (Accounts Receivable), so it is critically important to review both the "bottom line" as well as the company's position in cash to really forecast its future.

There are several ways in which you might use a Statement of Cash Flows in your own life. Will you have sufficient cash at the end of the month to purchase additional Inventory? Will you have the cash flow in the future to buy the new equipment you'll need to handle all the growth you're experiencing? Will you have the cash necessary to purchase a new building for the planned expansion? (See Appendix B for a real-life example of a Financial Statement from Station Casinos, Inc.)

Cash and Cash Equivalents

In business the term "cash" has a broader meaning than the amount of cash in the bank at the end of the year. It is also defined as liquid short-term investments; liquid investments are those that can quickly be converted into cash within a very short period of time, usually by cashing them in (in the case of certificates of deposit, for example) or by selling them. For this reason, they are also referred to as cash equivalents. (See Figure 5.1 for examples.) Therefore, whenever the term "cash" is used in this chapter it refers to cash and all cash equivalents.

Figure 5.1: EXAMPLES OF CASH EQUIVALENTS

- Cash in the bank
- Commercial paper (a form of short-term loan)
- Any investment that has a maturity date of less than three months
- Certificates of deposit
- Money market accounts
- U.S. Government treasury bills

The Statement of Cash Flows Illustrated

By looking at the Balance Sheet in chapter 3, Figure 3.2, you can see how much cash the Solana Beach Bicycle Company has at the end of the 2006—$17,385. By reviewing the Statement of Cash Flows in Figure 5.2, we can see where the cash came from and where it went during 2006.

Figure 5.2: SOLANA BEACH BICYCLE COMPANY
Statement of Cash Flows
Year Ended December 31, 2006

Note: Parentheses indicate decreases in cash

Cash Flow from Operating Activities:		
Net Income	$10,385	
Increase in Accounts Receivable	(9,000)	
Increase in Inventory	(23,000)	
Increase in Prepaid Insurance	(1,000)	
Increase in Accounts Payable	3,000	
Total Cash Flow from Operations		($19,615)
Cash Flow from Investing Activities:		
Purchase of Truck	($8,000)	
Purchase of Building	(25,000)	
Purchase of Land	(10,000)	
Total Cash Flow from Investing Activities		($43,000)
Cash Flow from Financing Activities:		
Borrowing for the Mortgage	$20,000	
Owner's Investment	60,000	
Total Cash Flow from Financing Activities		$80,000
Net Increase in Cash and Cash Equivalents		$17,385

(Notice that this is the same number for ending cash on the Balance Sheet in Figure 3.2, since there was no beginning balance in cash, $0 + this change = $17,385)

Now let's examine each of the statement's sections closely.

Operating Activities

As was mentioned earlier, the Statement of Cash Flows reports cash flow related to three areas—operating activities, financial activities, and investment activities. This is because a list of cash flows means more to business owners, investors, and creditors as they analyze the business if they can determine the type of transaction that gave rise to each one of the cash flows.

The operations section of the cash flow statement shows how much cash was generated from operations; that is, the day-to-day running of the business. In the case of Solana Beach Bicycle Company, the cash generated from operations would include the money brought in due to bicycle sales and repairs. This statement always begins with Net Income, the figure calculated on the Income Statement (Revenue minus Expenses). Then the items from operations that cause cash to increase or decrease are added and subtracted.

Since not all of the bicycle company's sales (Revenue) were cash customers, you must subtract the sales on credit (Accounts Receivable) from Net Income to determine the amount of cash generated from these sales. We know from the Income Statement in Figure 4.1 that $35,500 in Revenue from sales was generated in 2006. In Figure 5.2 we can see that Accounts Receivable has increased from a beginning balance (the amount of money the bike shop had at the beginning of the year) of $0 to an ending balance of $9,000. This is the net increase in Accounts Receivable, the receivable minus the allowance for doubtful accounts. This means that of all the sales for the year ($35,500), cash has not been received for $9,000 of that total.

Inventory also has increased from a beginning balance of $0 to $23,000 at the end of the year. This change indicates an increase in one Asset, Inventory, and a decrease in cash because cash was used to purchase that Inventory. Because the Inventory purchase used cash (later you will adjust for the portion that was purchased on account), you must subtract the increase in Inventory in order to determine the cash generated from operations. The reduction to Net Income in our example is $23,000.

Prepaid Insurance represents the cash purchase of insurance that is going to be used in the future. In this example, Solana Beach Bicycle Company has paid $1,500 in cash for this Asset. Since this policy is for three years, at the end of 2006, one-third of the Asset has been used up. The remaining Asset of Prepaid Insurance covers the next two years. The $500 that represents the insurance coverage for 2006, is shown on the Income Statement as an operating Expense, and correspondingly has reduced the Asset Prepaid Insurance. The remaining balance in the Prepaid Insurance account of $1,000 represents an outflow of cash that is not included on the Income Statement. For this reason it needs to be subtracted from Net Income in the operating activities section.

(You may be confused as to why in the case of Inventory, the entire amount of the Asset was deducted in the cash flow statement, but in the case of insurance, only a portion was subtracted. The difference between Inventory and this insurance is the fact that the Inventory was all sold and needed to be adjusted for the full amount. With the insurance only one-third has been used up, and thus only one-third needs to be adjusted in the statement.)

The balance in the Accounts Payable account has increased from the beginning of the year when it was $0 to an ending balance of $3,000. This account represents the purchase of Inventory (bicycles) on account. Towards the top of the statement, we subtracted $23,000 from Net Income for the purchase of Inventory, but since only $20,000 of that was paid with cash and the remaining $3,000 is still owed to the creditor (what we call Accounts Payable), we add that $3,000 back in. In our example this is the reason for the $3,000 adjustment.

When all of these adjustments are made to Net Income, the total represents the cash flow from operations. In this example, there is a negative cash flow from operations of $19,615. What it means in the case of the bicycle company (as can been seen in Figure 5.2) is that instead of receiving all cash for its sales, the Solana Beach Bicycle Company allowed some people to pay later ($9,000 in Accounts Receivable). In addition, Sam took some of the money ($23,000) that came in to buy more Inventory and also purchased insurance, which further reduced the cash balance but did not reduce Net Income. Finally, $3,000 was borrowed in the form of an Accounts Payable that allowed the company to buy part of the Inventory without reducing the cash balance. This transaction does not affect Net Income. It is important to note that having a negative cash flow is not necessarily a bad thing; in this case it is acceptable because the company is expecting to receive cash within a relatively short period from Accounts Receivable. If, however, the company were to operate at a negative cash flow for an extended period, it could put its levels of available cash and its ability to settle its own debts in jeopardy.

Investing Activities

Any time a company makes a purchase of property, plant, or equipment, this addition is treated as an investment in the organization. This investment represents a cash flow from the company. Even though the entire purchase may not have been with cash, but with some borrowed money, the entire purchase is shown as a cash flow in the investing section of the cash flow statement, and any borrowing of money is shown separately in the financing section.

In Figure 5.2 we can see that the Solana Beach Bicycle Company purchased three Long-Term Assets during the year 2006. The land for $10,000,

the building for $25,000, and the truck for $8,000 are all shown as negative cash flows in the investing activities section of the cash flow statement. The total of these three purchases represents a negative cash flow from investing activities of $43,000.

Financing Activities

The section called financing activities represents the cash that has come into or out of the company for the purpose of financing all of the other activities of the business. This could include Retained Earnings and money brought in by stock issued by the company, or as we can see in Figure 5.2 the $60,000 that Samantha invested into the business on the first day. (Remember that Sam's personal money is accounted for separately from the company's money. If she invests personal funds in the business, while this is a decrease in her personal cash funds, it is an increase in funds for the business.) Because this investment was in cash it is shown as an increase in the cash flow from financing activities. In addition to this investment by Sam, a fifteen-year loan was negotiated in order to purchase the land and the building. This loan for $20,000 is also shown as an inflow of cash to the business and thus an increase in cash flow from financing activities.

The total of these two items, $80,000, represents the total cash flow into the company from financing activities during the year 2006.

The total of the three cash flows—from operations, from investing, and from financing—represents the total increase or decrease in cash and cash equivalents for the business during the year being reported (in this example, an increase of $17,385). Notice that this total represents the change in cash from the beginning of the year to the end of the year. In our example, cash at the beginning of the year was $0, and at the end was $17,385, a net increase.

In this chapter you have learned how to prepare the Statement of Cash Flows. In chapter 6 you will learn about the double-entry system of accounting and how transactions are recorded in the accounting books.

GLOSSARY

Statement of Cash Flows: One of the four required financial statements. This statement shows where the cash came from and how it was spent during the period of reporting.

Cash: Includes currency and coins, balances in checking accounts as well as any item that is acceptable into these checking accounts, such as checks and money orders.

Cash Equivalents: The cash held by a business as well as the liquid short-term investments that can quickly be converted into cash within a very short period of time.

Operating Activities: One of the three categories of business activity represented on the Cash Flow Statement. This section of the statement shows how much cash was generated from operations; that is, the day-to-day running of the business. In the case of Solana Beach Bicycle, this would include cash generated from bicycle sales and repairs.

Investing Activities: One of the three categories of business activity represented on the Cash Flow Statement. This section of the statement shows those purchases of property, plant, or equipment. These items are treated as an investment in the organization and represent a cash flow out of the company.

Financing Activities: One of the three categories of business activity represented on the Cash Flow Statement. This section of the statement represents the cash that has come into or out of the company for the purpose of financing all of the other activities. In the case of Solana Beach Bicycle Company this includes the money borrowed on the mortgage and the money invested in the business by Sam.