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EXPLANATION of...

## Cash Flow Statement



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## Understanding The Changes In Cash

We often enhance our comprehension of a topic when we have to think through solutions to problems, so to help you really understand the cash flow statement, we've put together some questions for you to answer. As you formulate your response you will be learning to think about cash flows the way an accountant does.

1.	When Mary Smith invests her personal money into her new company, what will happen to her company's <b>Cash</b> account?	<a href="#">Answer</a>
2.	When a company purchases inventory (merchandise purchased in order to be resold) what will happen to its <b>Cash</b> account?	<a href="#">Answer</a>
3.	What happens to the company's <b>Cash</b> account if it borrows money from the bank by signing a note payable?	<a href="#">Answer</a>
4.	What happens to a company's <b>Cash</b> account if it declares a dividend on its shares of stock?	<a href="#">Answer</a>
5.	What is the effect on its <b>Cash</b> account when a company pays some of its <b>Accounts Payable</b> ?	<a href="#">Answer</a>
6.	What is the effect on its <b>Cash</b> account when a company prepays a 6-month insurance premium?	<a href="#">Answer</a>

7.	What is the effect on its <b>Cash</b> account when a company sells merchandise, but allows the customer to pay in 30 days?	<b>Answer</b>
8.	What is the effect on its <b>Cash</b> account when a company receives payment from one of its customers 30 days after the sale was recorded?	<b>Answer</b>
9.	If a company's <b>Accounts Payable</b> account decreased, what is the likely effect this will have on <b>Cash</b> ?	<b>Answer</b>
10.	If the asset account <b>Prepaid Insurance</b> increased, what is the likely effect on <b>Cash</b> ?	<b>Answer</b>
11.	If the asset account <b>Land</b> increased, what's the likely effect on <b>Cash</b> ?	<b>Answer</b>
12.	If the asset account <b>Land</b> decreased, what's the likely effect on <b>Cash</b> ?	<b>Answer</b>
13.	If the liability account <b>Bonds Payable</b> increases, what is the likely effect on <b>Cash</b> ?	<b>Answer</b>
14.	If the liability account <b>Bonds Payable</b> decreases, what is the likely effect on <b>Cash</b> ?	<b>Answer</b>

Much of what you learned in the practice questions above is common sense. For example, when you use cash to buy a book, you now own the book (you've increased your "assets") but you also have less money (you've decreased your cash). Based on what you learned, you can make the following general assumptions:

- When an asset (other than cash) increases, the **Cash** account *decreases*.
- When an asset (other than cash) decreases, the **Cash** account *increases*.
- When a liability increases, the **Cash** account *increases*.
- When a liability decreases, the **Cash** account *decreases*.
- When owner's equity increases, the **Cash** account *increases*.
- When owner's equity decreases, the **Cash** account *decreases*.



### Here's a Tip

For a change in assets (other than cash)--the change in the **Cash** account is in the *opposite* direction.

For a change in liabilities and owner's equity--the change in the **Cash** account is in the *same* direction.

## Format of the Statement of Cash Flows

The statement of cash flows has four distinct sections:

1. Cash involving **operating activities**
2. Cash involving **investing activities**
3. Cash involving **financing activities**

#### 4. Supplemental information.

Assuming that the cash flow statement is being prepared using the **indirect method** (the method used by most companies) the *differences*

in a company's balance sheet accounts will provide much of the needed information. For example, if the statement of cash flows is for the year 2006, the balance sheet accounts at December 31, 2006 will be compared to the balance sheet accounts at December 31, 2005. The changes--or differences--in these account balances will likely be entered in one of the sections of the statement of cash flows.

Shown below is each of the four sections of the statement of cash flows, followed by a list of those balance sheet accounts which affect it.

## 1. Cash Provided From or Used By Operating Activities

This section of the cash flow statement reports the company's net income and then converts it from the accrual basis to the cash basis by using the *changes* in the balances of *current asset* and *current liability* accounts, such as:

- Accounts Receivable
- Inventory
- Supplies
- Prepaid Insurance
- Other Current Assets
- Notes Payable (generally due within one year)
- Accounts Payable
- Wages Payable
- Payroll Taxes Payable
- Interest Payable
- Income Taxes Payable
- Unearned Revenues
- Other Current Liabilities

In addition to using the changes in current assets and current liabilities, depreciation and the gains/losses on the sale of long-term assets are removed so that the income statement net income is converted from the accrual basis to cash.

## 2. Cash Provided From or Used By Investing Activities

This section of the cash flow statement reports *changes* in the balances of *long-term asset* accounts, such as:

- Long-term Investments
- Land
- Buildings
- Equipment
- Furniture & Fixtures
- Vehicles

In short, investing activities involve the purchase and/or sale of long-term investments and property, plant, and equipment.

## 3. Cash Provided From or Used By Financing Activities

This section of the cash flow statement reports *changes* in balances of the *long-term liability* and *stockholders' equity* accounts, such as:

**Notes Payable** (generally due after one year)  
**Bonds Payable**  
**Deferred Income Taxes**  
**Preferred Stock**  
**Paid-in Capital in Excess of Par-Preferred Stock**  
**Common Stock**  
**Paid-in Capital in Excess of Par-Common Stock**  
**Paid-in Capital from Treasury Stock**  
**Retained Earnings**  
**Treasury Stock**

In short, financing activities involve the issuance and/or the repurchase of a company's own bonds or stock. Dividend payments are also reported in this section.

#### 4. Supplemental Information

This section of the cash flow statement discloses the amount of interest and income taxes paid. Also reported are significant exchanges not involving cash. For example, the exchange of company stock for company bonds would be reported in this section.

#### Where To Enter The Balance Sheet Changes

Take a look at the summary below--it shows where the changes in balance sheet accounts should be entered on your statement of cash flows:

<u>A change in this balance sheet category</u>	<u>...is reported in this section of the cash flow statement</u>
Current Assets*	Operating Activities
Current Liabilities	Operating Activities
Long-term Assets	Investing Activities
Long-term Liabilities	Financing Activities
Stockholders' Equity	Financing Activities
*This refers to current assets other than <b>Cash</b> .	

#### Adjustments Within The Operating Activities Section

When we use the **indirect method**

to prepare a statement of cash flows we begin with the net income figure from the company's income statement as our starting point. We then make adjustments to that figure to arrive at the cash amount.

If all of a company's revenues were cash sales (no credit sales), and if the company paid out cash for all of its expenses, then net income would equal the cash from operating activities. However, since some of the revenues and expenses on the income statement were not cash transactions, we must include depreciation, gain or losses on sales of assets, and the changes in current assets and current liabilities. These adjustments will be illustrated in the hypothetical story presented in Part 3.



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