9. Cash Flows and the Cash Flow Statement

Accounting is based upon accrual concepts that report revenues as earned and expenses as incurred, rather than when received and paid. Accrual information is perhaps the best indicator of business success or failure. However, one cannot ignore the importance of cash flows. For example, a rapidly growing successful business can be profitable and still experience cash flow difficulties in trying to keep up with the need for expanded facilities and inventory. On the other hand, a business may appear profitable on an accrual basis, but may be experiencing delays in collecting receivables, and this can impose severe liquidity constraints. Or, a business may be paying generous dividends, but only because cash is being produced from the disposal of core assets. Sophisticated analysis of the balance sheet and income statement will often reveal such issues.

9.1 The Statement of Cash Flows

Rather than depending upon sophisticated financial statement users to do their own detailed cash flow analysis, the accounting profession has seen fit to require another financial statement that clearly highlights the cash flows of a business entity. This required financial statement is appropriately named the Statement of Cash Flows. The Statement of Cash Flows can be seen as an outgrowth of the FASB's conceptual framework. In the previous chapter, it was pointed out that the FASB cited one objective of financial reporting as follows: Information should be helpful in assessing the amounts, timing, and uncertainty of an organization's cash inflows and outflows. The applicable rules require that the statement of cash flows provide three broad categories that reveal information about operating activities, investing activities, and financing activities. In addition, businesses are required to reveal significant noncash investing/financing transactions.

9.2 Cash and Cash Equivalents

In preparing the statement of cash flows, companies broadly define "cash" to consist of cash and items that are equivalent to cash. As a general rule, cash equivalents are short-term, highly liquid investments that mature in 90 days or less.