

# Chapter 1

## Getting in Sync with the Rhythm of Cash

### *In This Chapter*

- ▶ Defining the number one business rule: Don't run out of cash
- ▶ Reviewing how revenue and expenses are tracked
- ▶ Differentiating profit and cash flow: Kissing cousins but not identical twins
- ▶ Sorting out basic types of cash flows

**I**n running a business, you have to follow many rules, but one rule stands above the others: *Don't run out of cash*. As obvious as you may think this rule is, the importance and difficulty of maintaining an adequate cash balance are generally taken for granted in business management books and articles. Many business managers ignore cash until a serious problem pops up. They assume that cash will take care of itself, as if cash could be put on automatic pilot. Nothing is farther from the truth. If you don't pay attention to cash, you may be in for a nasty surprise.

To control cash, you must control cash inflows and cash outflows. To do that, you need cash-flow information, and you need to know how well your current cash balance stacks up against the short-term demands on cash. Managers depend on regular accounting reports for financial information; in particular, their monthly income statement (also called the *profit and loss*, or *P&L, report*). However, the income statement doesn't provide the cash-flow information you need.

You must turn to another financial statement for cash-flow information, appropriately called the *statement of cash flows*. But here is where things get rather befuddling for the business manager. The cash-flow statement lists adjustments to profit to arrive at the cash flow from making profit. It assumes that the reader has a good basic understanding of profit accounting and, therefore, knows why adjustments are necessary to find cash flow. But in our experience, business managers do not fully understand how their accountants measure profit, which makes understanding cash flow and why it's higher or lower than profit very difficult.

This chapter starts by pointing out the catastrophic consequences of running out of cash. Next, we offer a brief review of profit accounting and the assets and liabilities that are used in recording revenue and expenses. Changes in these assets and liabilities are the reasons why cash flow differs from profit. Then the chapter takes the first steps in explaining the cash-flow aspects of making profit and why cash flow is invariably higher or lower than the bottom-line profit or loss number in the income statement. We also explain the cash-flow side of business transactions and the basic classes of cash flows.

## *Not Letting the Well Run Dry*

One morning you arrive at your business. As usual, you're the first person to arrive. But none of your employees come to work. Not one. Who will open the doors for customers? Who will sell your products? Who will start tapping on the computers? This scenario may seem like a nightmare, but it's not the worst thing that can happen to a business.

Here's the real fiasco you should worry about: One day your accountant rushes into your office and tells you that the business's bank account balance is zero. You have \$50 in petty cash and a small amount of currency in the cash registers. But that's it. Your checking account is empty. You can't cut any checks to your vendors, who will cut off your credit if not paid on time. You have a sizable payroll to meet in two days. If not paid, your employees will quit. And your bank is sure to notice that your checking account balance is zip and may consider shutting down your credit line. It's not a pretty picture, is it?



A zero cash balance puts you on the edge of a cliff. One false step and you can fall off and be unable to recover. When your suppliers, employees, and sources of capital find out about your cash problems — and they will — your credibility drops to zero. The businesses and various people you deal with depend on your ability to continue as a going business that they can rely on in the future. Running out of cash would pull the rug out from under the reputation of your business that you worked so hard to build up over the years. You could lose your business to creditors or have to declare bankruptcy.

Running out of cash is an extreme, worst-case scenario, although it's a threat many businesses face. The purpose of mentioning it here is to emphasize its disaster potential for a business. Running out of cash is not just a life-changing event for a business; it can be a life-*ending* event. Business managers should never let their guard down regarding cash and cash flows.

Surprisingly, many business managers, small-business owners/managers in particular, do not take an aggressive, proactive approach toward controlling cash. Instead of learning cash-flow fundamentals and techniques of controlling cash flows, they retreat into a passive mode. But very few businesses have the luxury of sitting on hoards of cash such that they really don't have to worry about the cash balance period to period. Many businesses operate on a razor-thin cash balance.

## Outlining Profit Accounting Basics



The best way to avoid cash-flow problems and to generate a stream of cash flow is to earn profit. Measuring profit (or loss) is the job of your accountant. Each period your accountant prepares an income statement that summarizes revenue and expenses and profit (or loss) for the period. To understand cash flow emanating from profit, you need to understand how your accountant records revenue and expenses. Otherwise you'll be confused about why your cash flow from profit during the period is different from your profit for the period. You don't have to delve into the technical aspects of revenue and expense accounting — just understand the basics. This section gives you the brief overview you need to go forward with managing cash flow.

We're optimistic that you know that profit is the excess of revenue over expenses (and loss is the excess of expenses over revenue). We mention it simply to stress that *profit* accounting really refers to *revenue and expense* accounting. Profit (or loss) is just the residual number left over after recording revenue and expenses for the period.

The brief discussion of revenue and expense accounting in this section is no more than dipping our toes in the water. Profit accounting involves much, much more than this very brief introduction covers. We go into more details later in this chapter in and future chapters. For a more extensive explanation of accounting methods and problems, see *Accounting For Dummies*, 4th Edition, by John A. Tracy (John Wiley & Sons, Inc.).

### Reviewing revenue accounting

When a sale is made for “cash on the barrelhead,” to use an old expression, cash increases and the accountant increases the sales revenue account the same amount. At the retail level, most sales are for cash; currency and

coins are received by the business, or a credit or debit card is accepted that almost immediately increases the cash account of the business. In contrast, many businesses sell on credit, especially to other businesses. No money is collected from the customer until a month or so after the sale. In those cases, the accountant records the sale immediately by increasing an asset account called *accounts receivable* and increases sales revenue the same amount. When the customer pays later, cash is increased and the accounts receivable asset is decreased. Notice the time lag between the two events — point one when the sale is recorded and point two when the cash is received.

Revenue accounting can be much more complicated than recording simple cash and credit sales. For example, some businesses collect cash from customers before delivering the product or service, such as newspapers that collect subscriptions in advance before delivering the papers, and insurance companies that collect premiums before the insurance period coverage begins. But in any case, recording revenue is coupled with a corresponding increase in an asset or, in some cases, a decrease in a liability.

## *Examining expense accounting*

A business records many expenses by decreasing cash and increasing an expense account, such as paying the monthly utility bill for gas and electricity. This transaction is straightforward enough: Cash decreases and an expense account increases the same amount. But many expenses are more complicated. Perhaps an expense is recorded before cash is actually paid out, or it may be recorded sometime after cash has been paid out.



Recording an expense is coupled with a corresponding decrease in an asset or an increase in a liability. For example, a business receives a bill from its lawyer for work already done. The appropriate expense account (legal fees) is increased, and a liability account called *accounts payable* is increased. When the bill is paid later, cash is decreased and the accounts payable liability is decreased.

When a business buys products that it will sell later to its customers, it increases an asset account called *inventory*. Suppose the purchase is on credit from the vendor. The inventory asset account is increased, and the accounts payable liability account is increased. When the goods are sold — but not until then — the inventory asset account is decreased for the cost of products sold and the expense account cost of goods sold is increased the same amount.

Usually a business pays its vendor before it sells the products to its customers. However, in some cases a business may sell products to its customers before it pays the supplier of the products.

Here's another example of an important expense: Suppose a business bought a delivery truck three years ago and paid for it then. The cost of the truck is recorded as an increase in an asset account. Then each year the truck is used, a fraction of the total cost of the truck is recorded to expense, which amount is recorded as a decrease in the asset account. That portion of the original cost charged to expense in the year is called *depreciation expense*, and we discuss its cash-flow aspects in the later section "Depreciation expense."

## *Contrasting cash- and accrual-basis accounting*

For most businesses, profit accounting (recording revenue and expenses) involves much more than just recording cash inflows and cash outflows. Recording only cash inflows and outflows is not acceptable for most businesses and, in fact, would be seriously misleading. That type of accounting, called *cash-basis accounting*, doesn't fit how most businesses carry on their profit-making activities or how businesses raise and invest capital.



Under cash-basis accounting, revenue and expenses are recorded when the cash flow happens. Revenue is recorded when cash is received, and expenses are recorded when cash payments are made — not before and not after. Some small businesses that tend to operate through straightforward transactions get by with cash-basis accounting. Federal income-tax law allows cash-basis accounting for businesses that meet certain conditions. Generally, cash-basis accounting is acceptable only for relatively small businesses that don't buy or sell on credit and that don't make investments in operating assets.

Most businesses of any size and complexity buy and/or sell on credit and make sizable investments in long-term operating assets (buildings, machinery, and the like). For these businesses, cash-basis accounting is woefully inadequate. Instead, they use accrual-basis accounting. (How well they use it is another matter.) Fundamentally, *accrual-basis accounting* means that several assets other than cash and several liabilities are used in recording revenue and expenses.



*Accrual* is not a particularly good descriptive term. In accounting jargon, it doesn't mean accumulation, accretion, growth, or enlargement. In the field of accounting, the term *accrual* refers to recording revenue and expenses (as well as the resultant increases and decreases in assets and liabilities) at the time that economic exchanges and business transactions take place. The cash flows of many transactions occur before or after the transaction — perhaps a few days, maybe a month, or even years before or after recording revenue and expenses. Accrual-basis accounting is on one timetable; cash flows are on another timetable.

## Seeing Why Profit and Cash Flow Are Different Bottom Lines

You often hear that a business “made money,” meaning that it earned a profit. But earning a profit does not mean that the business’s cash balance went up the same amount. In fact, earning profit can sometimes cause the cash balance to decrease. To keep the business healthy, managers need to differentiate the two numbers and understand the importance of each.



The income statement of a business (a key accounting report also called the *P&L report*, *earnings statement*, *statement of operations*, and other titles) summarizes the revenue and expenses of a business for a period of time. The last line of the statement is the profit or loss for the period. The cash increase (or decrease) from making the profit is a different matter. Many business managers mistakenly assume that profit reported in this statement means the cash balance increases the same amount — a potentially dangerous misperception.

In this section, we discuss what information you can glean from the income statement, what info you can’t, and why you need to keep an eye on more than one bottom line.

### Considering what the income statement doesn’t say about cash flow

Figure 1-1 presents the most recent annual income statement of your friendly hardware store. We keep the number of lines in this income statement example to a minimum, to focus attention on fundamentals. Also, the dollar amounts are rounded off. (Following common practice, numbers in parentheses mean a decrease by that amount; numbers not in parentheses mean an increase.) The figures for revenue and expenses are in accordance with generally accepted accounting standards, and you can assume that they’re free of fraud or deliberate distortion.

The business sells a wide variety of products to retail customers who pay cash or use credit and debit cards, which the business converts into cash almost immediately. The hardware store also sells to other businesses. Its basic business model is to mark up the costs of products (called “goods”) it buys to earn enough total gross margin to cover its operating, depreciation, and interest expenses, and to provide profit. As you see in Figure 1-1, the business earned \$600,000 bottom-line profit for the year just ended, which equals sales revenue minus all expenses. As an aside, you may notice that profit equals 5 percent of sales revenue ( $\$600,000 \text{ profit} / \$12,000,000 \text{ sales revenue} = 5\%$ ), which means that expenses are 95 percent of sales revenue.

### **Income Statement for Year Just Ended**

*Dollar amounts in thousands*

Sales Revenue	\$12,000
Cost of Goods Sold Expense	(\$7,500)
Gross Margin	\$4,500
Operating Expenses	(\$3,400)
Depreciation Expense	(\$200)
Operating Earnings	\$900
Interest Expense	(\$300)
Net Income	\$600

**Figure 1-1:**  
Example  
income  
statement.

The income statement by itself doesn't report how much of sales revenue was collected in cash during the year. Consider the \$12 million sales revenue amount, for instance. This accrual-basis accounting amount may be relatively close to the actual cash inflow from sales during the year — but then again, it may not be. Most of the total annual sales revenue probably has been collected in cash through the end of the year, but some of it probably hasn't been collected in cash yet at that time. In this case, cash flow from sales would be less than sales revenue. (We explain cash flow from revenue in the next section, "Exploring cash flow from profit.")

Likewise, the income statement by itself does not report how much of each expense was paid in cash during the year. You don't see in the income statement the impact of expenses on the particular assets and liabilities used to record the expenses. The amount of an expense may be relatively close to the actual cash outflow for the expense — but maybe not. One expense in particular is important to understand in this regard because it is a noncash expense: *depreciation*. Depreciation recorded on the income statement involves no cash outlay at any point. In contrast, other expenses are intertwined with cash. (We also explain cash flow for expenses in the next section.)

The actual cash flows of revenue and expenses differ from the accrual-basis amounts reported in the income statement for most businesses. Therefore, the bottom-line profit number does not indicate the increase in cash from making profit. Cash flow can be about the same, or can be considerably lower or higher than profit.

## ***Exploring cash flow from profit***

Figure 1-2 presents a summary of the cash flows for sales revenue and expenses that are reported in the income statement (refer to Figure 1-1).

Your accountant can prepare this summary in the process of compiling the financial statements of the business at the end of the period.

## Revenue and Expense Cash Flows for Year

*Dollar amounts in thousands*

<b>Figure 1-2:</b> Summary of revenue and expense cash flows.	Sales Revenue	\$11,750
	Cost of Goods Sold Expense	(\$7,800)
	Operating Expenses	(\$3,250)
	Depreciation Expense	\$0
	Interest Expense	(\$300)
	Net Increase in Cash	<u><u>\$400</u></u>

The cash flows of revenue and most expenses in Figure 1-2 are different from the accrual-basis numbers in the income statement (in Figure 1-1). The income statement reports the correct profit for the period, \$600,000 in the example. The cash-flows summary shows actual cash flows of revenue and expenses, and it turns out that net cash flow for the year is \$400,000, which is \$200,000 lower than profit for the year. This discrepancy isn't unusual and doesn't in any way imply that profit has not been accounted for correctly.

Here's a quick summary of the differences between the income statement amounts and the cash flows of revenue and expenses in thousands.

Sales	(\$250)
Goods sold	(\$300)
Operations	\$150
Depreciation	\$200
Interest	\$0
Total cash flow	(\$200)

A negative number (shown in parentheses) means that cash inflow from revenue is lower than the accrual-basis number in the income statement, or that cash outflow for an expense is higher than the number in the income statement. A positive number (without parentheses) means that cash inflow from revenue is higher than the accrual-basis number in the income statement, or that cash outflow for an expense is lower than the number in the income statement.

Because these numbers are different, business managers need to keep an eye on both cash flows and accrual-basis revenue and expenses. You could say that the business manager needs bifocals — one level for focusing on cash



flow and one level for profit — because cash flow can get out of control even when profit performance is acceptable. For example, a business may allow its uncollected receivables from credit sales to balloon way out of proportion to the growth in sales. Or a business may overstock its inventory of products, resulting in slow-moving products (that take too long to sell). Business survival depends both on making profit and controlling the cash flow outcomes of making profit. Like riding a bicycle, a business needs to keep both the cash-flow wheel and the profit wheel turning.

In the following sections, we offer brief explanations for each of the cash-flow amounts in Figure 1-2, explaining why the cash-flow amount differs from the income statement amount.

### ***Cash inflow from sales***

The reason cash inflow from sales revenue is \$250,000 less than sales revenue for the year is that the company's accounts receivable balance increased \$250,000 during the year. The balance in this asset account is the total of uncollected credit sales. The sales were recorded in sales revenue but were not collected in cash by the end of the year. In short, the business made \$250,000 in credit sales that it has not yet collected. This amount counts toward profit but won't turn into cash inflow until the customers pay for their purchases next year.

### ***Cash outflow for products***

The reason cash outflow for products is \$300,000 more than cost of goods sold expense for the year is that the business increased its inventory of products (goods) being held for sale. The inventory asset account holds the cost of products purchased or manufactured until the goods are sold, at which time the business decreases the asset account and records the cost of the items sold. The \$300,000 inventory increase was paid for during the year, but the cost of these goods will not be charged to expense until next year when the products are sold.

### ***Cash outflow for operations***

Cash outflow for operations is \$150,000 less than the amount of operating expenses for the year because the business increased its payables for these costs \$150,000 during the year. Many operating costs are not paid for immediately. The expenses are recorded when the obligation to pay becomes fixed on the business (when the business incurs the liability to pay the expense). The expenses are not paid until four to six weeks later. For example, a business records advertising expense as soon as the ads are run in the local newspaper, even though the newspaper will not be paid until weeks later.

The obligations for these expenses are recorded in liability accounts. During the year, the balances in these liability accounts increased \$150,000. The business will not pay these liabilities until next year.



### ***Depreciation expense***

Depreciation expense is a prime example of accrual-basis accounting — of recording an expense in the period benefited rather than when cash is paid out. The assets being depreciated were bought and paid for sometime in the past. These assets last many years. Thus, the cost of a long-lived asset is recorded as an investment. No expense is recorded until the business starts using the asset in its operations. The costs of these long-term or *fixed* assets are allocated over the years the assets are used. The business doesn't make a second cash payment when recording depreciation expense. Depreciation is not a cash outlay in the period the expense is recorded.

Depreciation accounting methods get rather involved, and this chapter isn't the place to go into a lengthy discussion on depreciation accounting. The main point is that a fraction of the cost of a long-lived operating asset — such as a delivery truck, a building, or a computer — is recorded as a decrease in the asset account and the amount is charged to depreciation expense. The business doesn't write a check for depreciation; no cash is involved in recording depreciation expense. Depreciation is a real expense because the long-term operating assets wear out and lose their economic usefulness. Eventually these assets are traded in, sold, or sent to the junkyard.

From the cash-flow point of view, depreciation is a zero outlay expense. In recording depreciation, the recorded cost value of the asset is decreased and the amount is charged to depreciation expense. Depreciation expense is deducted from revenue like other expenses to determine profit. But from the cash-flow point of view, there is nothing to deduct. So in Figure 1-2, the cash outflow for depreciation is zero.



Don't simply add back depreciation expense to bottom-line profit and call this amount cash flow. This practice may appear to be a convenient shortcut to finding cash flow, but it isn't. In this example, cash flow would be \$800,000 because \$600,000 net income + \$200,000 depreciation expense = \$800,000. In fact, cash flow from profit for the year is only \$400,000 because of the other factors that determine cash flow (refer to Figure 1-2). You should consider all the factors that impact cash flow from profit.

### ***Interest expense***

The cash outlay for interest in the example in Figure 1-2 is exactly equal to the interest expense for the year. No difference between the two amounts means that the business paid the exact interest that was owed on its debt during the year. Interest is one of the few expenses for which cash payments often are equal to (or very nearly equal to) the amount of expense that is recorded in the year. On the other hand, if the business had not paid all its interest that had accumulated during the period, it would record the unpaid amount in a liability account in order to pick up the full amount of interest expense for the year and to recognize its obligation to pay the additional unpaid amount of interest.



## Depreciation expense versus losses from nonrecurring write-downs of assets

Depreciation expense is based on a predetermined, systematic method. When a depreciable asset is bought or constructed, its cost is recorded in an asset account. The accountant estimates its future useful life to the business and chooses a method to allocate the cost to each year of expected use. Depreciation is not a cash outlay in the year in which depreciation expense is recorded. The cash outlay occurred in its entirety when the asset was acquired.

In contrast, a business may have to record an unexpected write-down in the recorded

value of an asset. The write-down was not predetermined and is not factored according to any systematic plan. For example, a business may suffer irreparable damage to its building from an earthquake. Assuming that insurance doesn't cover this risk, the business records an entry to reduce the recorded value of the asset to zero and records a loss of equal amount. The loss is reported as an extraordinary item in the income statement. The loss reduces the profit of the business, of course, but it doesn't involve cash outlay. Like depreciation, recording the loss does not decrease the cash balance of the business.

## Identifying and Reporting Basic Types of Cash Activities

Until a generation ago, explicit cash-flow information was not included in the external financial reports of businesses. Sophisticated financial statement users could do cash-flow analysis, but it was a burdensome and time-consuming process. Under pressure from financial analysts and others, the rule-making body of the accounting profession decided that henceforth a *statement of cash flows* should be included in external financial reports to supplement the income statement and balance sheet.

Cash-flow information is useful to users of financial reports, who are primarily business managers, investors, and creditors. Both public and private companies are required to include a statement of cash flows in their external financial reports. By law, publicly owned corporations must make their financial reports available to the public at large. Private companies, on the other hand, generally limit circulation of their financial reports to their investors and lenders. They treat their financial reports as confidential. Internally, businesses can report information however they want, but in general, internal accounting reports look a lot like the external financial statements of the business.

For external financial reporting, accountants divide cash flows into three groupings or types, which we discuss in the following sections. In fact, these three classes constitute the three parts of the statement of cash flows, as we explain further in Chapter 4.

## *Cash flow from investing activities*

One group of cash flows contains the investing and “disinvesting” activities of the business during the year. As you would think, *investing* refers to the expenditure of cash for investments in different assets. Most years (except in severe downturns), businesses make new investments to replace and expand *long-term operating assets*, such as buildings, building improvements, land, machinery, manufacturing equipment, vehicles, and information-processing equipment. These cash outlays are referred to as *capital expenditures*. The term *capital* is used to stress the long-term commitment of these investments in assets that will be used in the operations of the business.

Companies also invest in intangible assets, such as patents and trademarks. A business may buy all the ownership shares or a controlling interest of another business and pay for a goodwill asset. A business may invest in marketable securities, either short term or long term. Or a business may invest in ownership instruments that are not readily marketable. We suppose a business could even invest in pork-belly futures contracts if it wanted to (and meat processors do). The law allows a business to invest in almost anything (that’s legal).



During the year, the business may sell or otherwise dispose of some of its investments. The cash inflows from these disinvestments are included in the investment category. So the category includes both cash outflows and cash inflows. The buying and selling of marketable securities can be a major source of income for a business. In contrast, long-term tangible and intangible assets that are used in the operations of a business are not sold off very often, except when the assets reach the end of their useful lives or when the business has to downsize its scale of operations.

## *Cash flow from financing activities*

The term *financing* refers to securing capital and returning capital to its sources. We discuss capital sources in Chapters 10 and 11. Basically, the two sources of capital to a business are equity and debt. *Equity* refers to ownership capital invested in a business. For example, a business corporation issues shares of capital stock to individuals willing to put their money in the business. The business may or may not be able to pay its shareowners for the use of their money, depending on whether it makes a profit and whether it generates enough cash flow from profit to make a cash distribution. Equity

can be simple (just one class of ownership shares) or incredibly complex, and it depends on the legal organization of the business. (We discuss equity sources in Chapter 10.)

*Debt* refers to money borrowed from banks and other business lenders, and even credit cards used by the business. Businesses pay interest for the use of the debt capital. The debt is either paid back or renewed on the maturity date of the loan. The business signs a note payable or a similar legal instrument to the lender. (Chapter 11 explores debt in more detail.)



Interest paid on debt capital is reported as an expense in the income statement, so the bottom-line profit is after interest expense is deducted. In contrast, a cash distribution from profit that is paid to shareowners for the use of their equity capital is not treated as an expense. (Cash distributions from profit by corporations are called *dividends*.) Bottom-line net income is calculated before making distributions to shareowners. The amount of cash distributions from profit to shareowners is included in the financing category of cash flows.

## ***Cash flow from operating (profit-making) activities***

The third class of cash flow is the profit-making activities of the business. Investing and financing activities constitute only a small fraction of the total activities of a business during the year. Over 95 percent, maybe 99 percent, of the action in a business has to do with *operating activities*: making sales, acquiring products for sale, hiring employees, and all the other things that are done to make a profit.

The cash flows of the operating activities during the year can be reported the same way as the summary of cash flows shown in Figure 1-2. In fact, the authoritative rule-making body of the accounting profession prefers this method of reporting the cash flows. However, an alternative method of reporting operating cash flows is permitted, which has become the most popular method. Instead of directly reporting the cash flows of revenue and expenses, the alternative method starts with bottom-line net income and then lists several adjustments to net income in order to work down to the amount of cash flow from profit. (Chapter 4 goes into more detail.) Both ways of presenting cash flow from operating activities report the same cash flow figure; the difference is how you get there.

## ***Putting cash-flow activities together***

The change in cash during the period is the sum of the changes in the three types of cash flow:

- ✓ Cash from investing activities
- ✓ Cash from financing activities
- ✓ Cash from operating activities

For most businesses, investing activities result in a decrease in cash, which is caused by expenditures for new machinery, equipment, buildings, and other long-term operating assets. The old assets disposed of during the year don't produce much cash inflow. Financing activities can have either positive or negative cash impact, depending on whether the business raised new debt and equity capital during the period or reduced its debt and equity capital. Also, it depends on the size of cash dividends paid to shareowners from profit for the year. Ominously, all three activities can be negative, which would probably indicate serious cash-flow problems.

We end this section with a pop quiz to wrap things up: Suppose the net cash result from the investing activities of a business during the year is a \$500,000 decrease in cash. Purely by coincidence, the net cash result from its financing activities is \$500,000 increase in cash. Therefore, the net effect on cash of these two classes of cash-flow activities is exactly zero for the year (not too likely, of course). Yet the company's cash balance increased \$200,000 during the year. Is this cash increase due solely to its cash flow from operating activities for the year?

The answer is yes. In addition to cash flow from investing and financing activities, the only other source of cash to a business is from its operating (profit-making) activities. Therefore, the \$200,000 cash increase must be the cash flow from profit. The other two sources and uses of cash are a wash; the increase in one offsets the decrease in the other.

What was the company's profit for the year? Well, you can't tell from the cash-flow figure. Profit could be much more, about the same, or less than the \$200,000 cash-flow amount. In fact, the business may have recorded a loss for the year (and still have \$200,000 positive cash flow from operating activities). You have to look at the company's income statement for the year, which is based on accrual-basis accounting, to find the profit or loss for the period.