

## 14.2: Differentiate between Operating, Investing, and Financing Activities

The statement of cash flows presents sources and uses of cash in three distinct categories: *cash flows from operating activities*, *cash flows from investing activities*, and *cash flows from financing activities*. Financial statement users are able to assess a company's strategy and ability to generate a profit and stay in business by assessing how much a company relies on operating, investing, and financing activities to produce its cash flows.

### THINK IT THROUGH

#### Classification of Cash Flows Makes a Difference

Assume you are the chief financial officer of T-Shirt Pros, a small business that makes custom-printed T-shirts. While reviewing the financial statements that were prepared by company accountants, you discover an error. During this period, the company had purchased a warehouse building, in exchange for a \$200,000 note payable. The company's policy is to report noncash investing and financing activities in a separate statement, after the presentation of the statement of cash flows. This noncash investing and financing transaction was inadvertently included in both the financing section as a source of cash, and the investing section as a use of cash.

T-Shirt Pros' statement of cash flows, as it was prepared by the company accountants, reported the following for the period, and had no other capital expenditures.

Cash flows from operating activities	\$195,000
Cash flows from investing activities	(120,000)
Cash flows from financing activities	120,000
Total net cash flows	195,000

Because of the misplacement of the transaction, the calculation of free cash flow by outside analysts could be affected significantly. Free cash flow is calculated as cash flow from operating activities, reduced by capital expenditures, the value for which is normally obtained from the investing section of the statement of cash flows. As their manager, would you treat the accountants' error as a harmless misclassification, or as a major blunder on their part? Explain.

#### Cash Flows from Operating Activities

Cash flows from **operating activities** arise from the activities a business uses to produce net income. For example, operating cash flows include cash sources from sales and cash used to purchase inventory and to pay for operating expenses such as salaries and utilities. Operating cash flows also include cash flows from interest and dividend revenue interest expense, and income tax.

#### Cash Flows from Investing Activities

Cash flows from **investing activities** are cash business transactions related to a business' investments in long-term assets. They can usually be identified from changes in the Fixed Assets section of the long-term assets section of the balance sheet. Some examples of investing cash flows are payments for the purchase of land, buildings, equipment, and other investment assets and cash receipts from the sale of land, buildings, equipment, and other investment assets.

#### Cash Flows from Financing Activities

Cash flows from **financing activities** are cash transactions related to the business raising money from debt or stock, or repaying that debt. They can be identified from changes in long-term liabilities and equity. Examples of financing cash flows include cash proceeds from issuance of debt instruments such as notes or bonds payable, cash proceeds from issuance of capital stock, cash payments for dividend distributions, principal repayment or redemption of notes or bonds payable, or purchase of treasury stock. Cash flows related to changes in equity can be identified on the Statement of Stockholder's Equity, and cash flows related to long-term liabilities can be identified by changes in long-term liabilities on the balance sheet.

## CONCEPTS IN PRACTICE

### Can a Negative Be Positive?

Investors do not always take a negative cash flow as a negative. For example, assume in 2018 **Amazon** showed a loss of \$124 billion and a net cash outflow of \$262 billion from investing activities. Yet during the same year, **Amazon** was able to raise a net \$254 billion through financing. Why would investors and lenders be willing to place money with **Amazon**? For one thing, despite having a net loss, **Amazon** produced \$31 billion cash from operating activities. Much of this was through delaying payment on inventories. **Amazon**'s accounts payable increased by \$78 billion, while its inventory increased by \$20 billion.

Another reason lenders and investors were willing to fund **Amazon** is that investing payments are often signs of a company growing. Assume that in 2018 **Amazon** paid almost \$50 billion to purchase fixed assets and to acquire other businesses; this is a signal of a company that is growing. Lenders and investors interpreted **Amazon**'s cash flows as evidence that **Amazon** would be able to produce positive net income in the future. In fact, **Amazon** had net income of \$19 billion in 2017. Furthermore, **Amazon** is still showing growth through its statement of cash flows; it spent about \$26 billion in fixed equipment and acquisitions.

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