Question 1: Why is depreciation expense a source of cash?

Depreciation is a non-cash expense that provides a source of free cash flow, but does not involve any actual cash. Rather, it is a way to recognize in the current period the disbursement of cash that took place in a prior period for assets that are used over time. It is included on income statements as an expense for accounting purposes.

The matching principle of accounting dictates that the item is not expensed until and unless it is used in operations or expended in some other fashion. In accordance with the matching principle, assets are recognized as being "used up" (i.e., "expensed" or, in a non-profit, "expended") in the period in which, as far as can be determined, they are "used up." This recognition is called "depreciation." By means of depreciation, the cash that went out of the company in some earlier accounting period is recognized as going out of the company in the current period.

Although the initial purchase is a cash flow, the subsequent allocation of part of the cost as a period expense involves only an accounting entry. Because depreciation is an expense but has no associated cash flow, it is sometimes described as being "added back" to arrive at cash flow for the firm. This gives the impression that depreciation is somehow a source of cash flow. The "adding back," however, is simply a recognition that no cash flow occurred.

Depreciation expense "frees up" cash instead of physically generating it, and is therefore considered a source of cash. Such "freed up" working capital does not result in one dollar more or less in the cash account. What depreciation expense does, however, is legitimize the use of that cash for working capital purposes by changing (reclassifying) the cash "tied up" in long-term assets by expensing the long-term asset and freeing up the expensed amount for other purposes.

Question 2: Why is an increase in the receivable level considered a use of cash and not a source?

When money is tied-up in future commitments, the amount of cash available for working capital is reduced. In effect, the cash which could be used to generate additional income for the company has been expended to produce and deliver goods, while the compensation has not yet been realized, resulting in negative cash flow.

The relationship between the accounting equation and accounts receivable is that accounts receivable is a current asset, and receivables represent cash expended ("used up") by the company, but not yet recouped. An "accounts receivable" does the same thing for the sale of an item that depreciation does for its use. That is, the cash was recognized as "coming into" the company at the time of sale (when an accrual basis is used for accounting), even though the actual cash did not "come into" the company until a later period when the invoice was paid.

"Accounts receivable" is a recognition by the company on the balance sheet that the cash has not yet been received - although the receipt has already been recognized on the income statement. Again, this is a recognition of the difference between income statement-type accounts and balance sheet-type accounts. Similar to the way that a depreciation expense on the income statement does not affect current asset accounts on the balance sheet, the receipt of accounts receivable does not affect the revenue accounts on the income statement.

Question 3: Why is the decrease in inventory considered a source of cash?

Whether decreasing inventory due to sales or through asset-based borrowing, liquidity from the current asset portion of the balance sheet can result in an immediate source of cash available for working capital, investment, debt reduction or other purposes. On the balance

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sheet, inventory is a current asset, much like money in the bank, so all tangible goods are considered "sources" of potential cash when "withdrawn" or decreased from inventory and sold.