How to Prepare a Cash Flow Statement

Peoples Bank Business Resource Center
Business Builder 4

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A cash flow statement is important to your business because it can be used to assess the timing, amount and predictability of future cash flows and it can be the basis for budgeting. A cash flow statement can answer the questions, "Where did the money come from?" "Where did it go?"

WHAT TO EXPECT

This Business Builder will introduce you to the cash flow statement and its importance for financial management. Through the use of a worksheet, the Business Builder will guide you through the construction of a cash flow statement for your business. The cash flow statement is a complex financial statement and by necessity, this Business Builder contains information on sophisticated accounting topics.

WHAT YOU SHOULD KNOW BEFORE GETTING STARTED

What is a Cash Flow Statement?

For your business, the cash flow statement may be the most important financial statement you prepare. It traces the flow of funds (or working capital) into and out of your business during an accounting period. For a small business, a cash flow statement should probably be prepared as frequently as possible. This means either monthly or quarterly. An annual statement is a must for any business.

A cash flow statement can be used to assess the timing, amount and predictability of future cash flows and it can be used as the basis for budgeting. You can use a cash flow statement to answer the questions, "Where did the money come from?" "Where did it go?" A loan officer will use cash-flow analysis techniques to evaluate the firm's ability to generate cash to repay a loan. A cash flow statement is also a key to understanding the investment and financing philosophy of a borrower. It will be used by your banker to answer the question, "Does this company have enough cash to make payments on a loan?"

The cash flow statement became a requirement for publicly traded companies in 1987. There are various rules governing how information is reported on cash flow statements, as determined by generally accepted accounting principles (GAAP). While your business may not be a public company, a cash flow statement is still important to measure and track the flow of cash into and out of your business.

This Business Builder will show you how to adjust net income to compute cash flow.

Watch Out For ... Cash flow is not the same as net income. Cash flow will not match the amount of net income shown on your profit and loss (P & L) statement. This is because net income includes noncash items, such as depreciation, and also because net sales are sales not cash payments.

In the accounting, banking and business communities there has been much debate as to the best method to report cash flow information. Accounting experts recommend using three categories to organize cash flow data: **operating activities, investing activities, and financing activities**. However, there are two possible approaches to reporting cash flow from operating activities: **the direct method and the indirect method**. Since 1987, the Financial Accounting Standards Board – the rule makers of the accounting community – have encouraged the use of the direct method. However, most companies continue to report operating cash flow by the indirect method.

This Business Builder will introduce you to both. You will need to make a decision as to which method you will use. However, under the direct method, it is necessary to reconcile net income reported on the P & L statement to net cash flow from operations on the cash flow statement. (This is the same as using the indirect method to compute cash flow from operating activities.) It may seem like a Catch-22 situation – you can choose either method, but if you choose the direct method, you must also compile operating activities according to the indirect method. **(But, if you choose the indirect method, you DO NOT have to also compile cash flows according to the direct method.)**

The method of least work, would be to just use the indirect method. However, it's suggested that you work through both methods and choose the one that gives you the best information on which to base management decisions.

Also, you may want to consider that the direct method of reporting cash flow from operations is the method recommended by small business loan officers. It is considered to be a more useful rendering of a company's use of cash. Cash, of course, is what will repay a loan.

Note ... This Business Builder assumes that a reliable accounting system is in place in your business and that information typically recorded by small businesses is accessible to you. This Business Builder assumes that a balance sheet and P & L statement (or income statement) has been prepared for your business for the same time period as the cash flow statement you will be preparing. The three statements work together to give you and others a clear picture of your business. This Business Builder will explain what data is necessary to create a statement of cash flows for your business.

You may want to consider the following questions before you start:

Do I have a record of what was paid to suppliers and employees during the time period being examined?

☐YES ☐NO

Do I have a system to record sales or other revenues that flow into the business?

☐YES ☐NO

Do I have an income statement and a balance sheet for the same period for which I am constructing the cash flow statement?

☐YES ☐NO

An Overview

There are three sections to a cash flow statement, **operating activities, investing activities** and **financing activities**. Together, the three sections of the cash flow statement work together to show the net change in cash for the period. Here is what a completed cash flow statement looks like. It is compiled according to the indirect method.

Cash Flow Statement
ABC Company
For the year ended 20___

Cash Flow From Operations	
Net Income*	$ 200
Additions (Sources of cash)	
Depreciation	$ 100
Increase in accounts payable	$ 30
Increases in accrued income taxes	$ 10
Subtractions (Uses of cash)	
Increase in Accounts Receivable	$ -150
Increase in Inventory	$ -25
Net cash flow from operations	$ 165
Cash Flows from Investing Activities	
Equipment	$ -400
Cash Flows Associated with Financing	
Activities Notes payable	$ 30
Net change in Cash	$ -205

***Net income is taken from the income statement.**

The cash flow statement for the ABC Company shows that there was a $205 cash shortfall in 20XX. As can be seen from the cash flow statement, the cash drain is primarily from the investment of $400 in equipment. The statement also shows that the cash flow from operations activity was a positive $165.

HOW TO PREPARE A CASH FLOW STATEMENT

This Business Builder will concentrate on each of the three sections of a cash flow statement individually.

- Operating Activities
- Investing Activities
- Financing Activities

Operating Activities

Cash flow from operating activities is probably the most complex section because there are two methods of computing it. The direct method will be introduced first. However, the direct method is NOT the most widely used method to calculate the cash flow from operating activities. Many companies use the Indirect Method. The choice of method does not change the amount of cash flow reported from operating activities. The direct and indirect methods are just two routes to the same destination. No matter which method you select, the philosophy behind what constitutes cash flow from operating activities is the same:

> Cash flow from operating activities is any cash transaction related to the company's ongoing business, that is the business activities that are responsible for most of the profits. Operating activities usually involve producing and delivering goods and providing services. Cash flow from operations is the healthiest means of generating cash. Over time, cash from operations will show the extent to which day-to-day operating activities have generated more cash than has been used.

Note ... A cash flow statement is concerned only with cash and cash equivalents. This includes cash on hand, cash in the bank, and any cash invested in what is defined as short-term, highly liquid financial instruments. Generally, only instruments with original maturities of three months or less qualify as cash equivalents. Accepted cash equivalents include treasury bills, commercial paper, and money market funds.

Cash Flow from Operating Activities – The direct method following is the underlying formula for the direct method of computing the operating activities section of a cash flow statement:

Cash Received from Sales of Goods and Services
- Cash Paid for Operating Goods and Services

Cash Flow from Operating Activities

The operating activities section of a cash-flow statement reports the information listed below. These are the line items that you will need to fill in to complete a cash flow statement.

Cash Flow from Operating Activities:

(+) Cash received from customers

(+) Other operating cash receipts (if any)

(-) Cash paid to suppliers (including suppliers of inventory, insurance, advertising, etc.)

(-) Cash paid to employees

(-) Interest paid

(-) Income taxes paid

(-) Other operating payments, if any

(=) Total Net Cash Provided (Used) by Operating Activities

As you can see, any use of cash (such as payments to suppliers or employees) is subtracted and any source of cash (such as cash sales) is added to compute total net cash from operating activities. Here is an example of how a small business' cash flow from operating activities using the direct method might look:

XYZ Company
Cash Flow from Operating Activities:
Direct Method

Sources of cash (additions):	
Cash received from customers	$ 10,000
Dividends received	$ 700
Cash provided by operating activities	$ 10,700
Uses of cash (subtractions):	
Cash paid for inventory	$ 3,000
Cash paid for insurance	$ 1,500
Cash paid for selling expenses	$ 1,500
Interest paid	$ 300
Taxes paid	$ 1,450
Net Cash from Operating Activities	$ 2,950

While it seems simple enough, there are various reasons that many companies do not opt for this format. One reason may be the number of calculations necessary to compute some of the categories, such as cash received from customers. While computerized accounting systems could make this relatively easy, a small business with many small cash sales and a manual accounting system might find it harder to determine total cash received.

To compile a statement of cash flows from operations using the direct method, an in-depth knowledge of the business and its accounting methods is required. That is, the preparer needs to be thoroughly familiar with the manner in which sales are recorded and expenses are incurred and paid. As a small business owner, this might be information that you are very comfortable assembling. If this is the case, then prepare the statement of cash flows for your business by using the direct method.

Tip ... One option that might make the calculation of cash received from customers easier is to estimate it based on changes in some balance sheet accounts: Take accounts receivable at the beginning of the year, add to it sales for the period, and then subtract accounts receivable at the end of the year to compute how much in cash was collected.

As noted earlier, even if the direct method is used, net income is such an important accounting concept that an additional statement reconciling the net income shown on the profit and loss statement with cash flow from operating activities must be prepared. What this means is that according to generally accepted accounting principles, if you prepare cash flow from operating activities using the direct method, you must also prepare it by the indirect method on a supplemental statement. (While it may strike you as twice as much work, information on the direct method is presented in this Business Builder because it is the method preferred by bankers and accountants.)

We will continue working through the preparation of a cash flow statement using the direct method. Then an explanation of the indirect method will be given. This Business Builder assumes that you will be working through both methods in order to choose which method will work best for you. Information on financing and investing activities included in the description of the direct method is important for both types of cash flow statements.

Investing Activities

Cash flow from investing activities is the second part of both types of cash flow statements. Investing activities are the changes to your cash position owing to the buying or selling of noncurrent assets. This includes selling and replacing equipment that wears out or acquiring a new building or land so that your company can grow.

Investing activities can also include the purchase or sale of stock, bonds, and securities. Lending money and receiving loan payments are also considered investing activities. For a small business, the investing activities section of a cash flow statement usually reports the following information:

Cash Flows from Investing Activities:

(+) Proceeds from sale of assets

(-) Purchases of property and equipment

(=) Total Net Cash Provided (Used) by investing activities

For a given period, you may not have much in the way of investing activities. But over time, it is an important consideration for assessing how you have chosen to use the cash generated by your business.

Financing Activities

Financing activities on a cash flow statement reflect borrowing money and repaying money, issuing stock, and paying dividends. The financing activities section of the cash flow statement can be reduced to the following formula:

Cash received from issues of debt and capital stock
- Cash pd for divid. and reacquisition of debt & cap. stock

= Cash flow from financing activities

For a small business, the financing activities section of a cash flow statement usually reports the following information:

(+) Net borrowing under line of credit agreement

(+) Proceeds from new borrowings

(-) Repayment of loans

(-) Principal payments under capital lease obligations

(-) Dividends/distributions/withdrawals paid

(+) Proceeds from issuance of stock

(+) Partner/owner capital contributions

(=) Total Net Cash Provided (Used) by financing activities

As you can see, this section of the cash flow statement is registering inflows of cash from loans received and loans repaid, and other cash inflows from outsiders and owners. If you have paid dividends or taken money from the business, it should be reported here.

CASH FLOW FROM OPERATING ACTIVITIES — INDIRECT METHOD

The indirect method of computing cash flow from operating activities starts with net income (from the income statement or P & L statement). Then net income is adjusted to take into account changes during the period as shown on the balance sheet. Adjustments are made for changes in the following accounts: depreciation and amortization, accounts receivable, inventory, accounts payable, accrued wages payable, prepaid insurance, and income taxes payable. For a very small business, all of the accounts may not apply.

Here is what cash flow from operating activities using the indirect method looks like. Note that this statement is for the same firm and time period as the example illustrating the direct method. The amount of cash flow from operations is the same, the only difference is the method used to report it.

XYZ Company
Cash Flow from Operating Activities
Indirect Method

Net income	$ 3,000
Adjustments:	
Depreciation and amortization	$ 1,500
Deferred taxes	$ 150
Decrease in accounts receivable	$ 2,000
Increase in inventories	$ -4,000
Increase in accounts payable	$ 1,150
Increase in accrued interest receivable	$ -350
Increase in accrued interest payable	$ 100
Gain on sale of property	$ -600
Net cash flow from operating activities	$ 2,950

SOURCES AND USES OF FUNDS

To identify what adjustments are necessary, a Sources and Uses of Funds statement is constructed based on the company's ledger accounts. Changes in the accounts (that is, increases or decreases) are organized as to whether cash came into the firm (a SOURCE of cash) or cash left the firm (a USE of cash). Here is what a typical Sources and Uses of Funds statement might look like for a small business:

ABC Company
Sources and Uses of Funds during 20___

Account	12/31/__	12/31/__	Source	Use	Type of Activity
Cash	50	55	5		Oper.
Accounts Receivable	350	200	150		Oper.
Inventories	300	275	25		Oper.
Equipment	1400	1000		400	Invest.
Depreciation	500	400		100	Oper.
Accounts Payable	60	30		30	Oper.
Notes payable	100	70		30	Financ.
Accrued Wages	10			10	Oper.
Accrued Taxes	50	40		10	Oper.
Totals	2820	2080	180	570	

Activities are classified as operating, investing, or financing activities. Each ledger account is analyzed to see if a change affecting cash occurred. If it did, then the amount of the change is noted. Once a Sources and Uses of Funds table is completed, each balance sheet change should be classified as to whether it is an operating, financing, or investing activity (as shown in the column on the far right). Then the information can be recorded to the cash flow statement.

For most small businesses, changes to depreciation, accounts receivable, inventory, and income taxes will be analyzed and reflected on the cash flow statement. Here are the reasons why:

- **Depreciation and Amortization**

  Any depreciation and amortization amounts shown on the P & L statement are added to net income. This is because a depreciation or amortization allowance has no cash component. It is simply an allocation of the cost of an asset (a real asset in the case of depreciation or an intangible asset in the case of amortization) to an expense account. The only time cash will enter into the transaction is when the asset is sold.

  When using the indirect method to compute the cash flows from operating activities, any depreciation or amortization expense must be added back to income because it was deducted as an expense when net income was computed. (Amortization, as used here, is the write-off as an expense of the costs incurred to acquire an intangible asset, such as a patent or copyright.)

- **Accounts Receivable**

  If accounts receivable decreased during the time period, this means that customers have paid off some accounts, (that is, the company received cash payments) and so, net income should be increased by the amount accounts receivable decreased during the period. Conversely, if accounts receivables increased during the period, net income will be reduced. This adjustment shows that net income overstates cash because it includes both cash sales and sales on account.

- **Inventory**

  If inventory increased during the period, this means the company either used cash to purchase the inventory, in which case net income would be decreased or, if the inventory was purchased on account, then accounts payable will have increased. As such positive changes in inventory will be deducted from net income.

- **Income Tax**

  Adjustments for increases in income tax expense are subtracted from net income because, most often, income taxes will not be paid until a few months after the beginning of the next year. While income taxes have been deducted from net income on the P & L statement, they actually are a future expense and do not reflect a reduction in cash. So, they are added back to net income.

On the worksheet you will use to construct cash flow from operating activities using the indirect method, cash activities are organized as to whether they represent additions or subtractions to cash. At this stage, it is more important that you understand the basic philosophy behind the changes rather than memorize how it works. If in doubt, follow these rules.

Shortcuts for entering changes in Assets and Liabilities Accounts on the Cash Flow Statement:

- **Accounts Receivable**

  If there is an increase in accounts receivable, the amount of the change should be deducted from net income. If there is a decrease in accounts receivable, the amount of the change is added to net income.

- **Inventory**

  If there is an increase in inventory, the amount of the change is deducted from net income. If there is a decrease in inventory, the amount of the change is added to net income.

- **Accounts Payable**

  If there is an increase in accounts payable, the amount of the change is added to net income. If there is a decrease in accounts payable, the amount of the change is subtracted from net income.

- **Accrued Wages Payable**

  If there is a decrease in accrued wages payable, the amount of the change is deducted from net income. If there is an increase in accrued wages payable, the amount of the change is added to net income.

- **Prepaid Insurance**

  If there is a decrease in prepaid insurance, the amount of the change is added to net income. If there is an increase in prepaid insurance, the amount of the change is subtracted from net income.

- **Income Taxes Payable**

  If there is an increase in income taxes payable, the amount of the change is added to net income. If there is a decrease in income taxes payable, the amount of the change is subtracted from net income.

Once these adjustments are made, you can compute the cash flow from operating activities using the indirect method.

Tip … Changes to cash, accounts receivable, inventory, depreciation and amortization, and accounts payable will most likely be operating activities. Cash changes due to equipment or asset purchases will be investing activities. And changes due to paying down debt or loan payments and payments of dividends will be financing activities.

HOW TO ANALYZE A CASH FLOW STATEMENT

Use the Sources and Uses of Funds Worksheet to complete the indirect method cash flow worksheet for your business. Group transactions according to operating, investing, and financing activities.

Enter Your Company Name Here:___________________
Sources and Uses of Funds during 20___

Account	12/31/___	12/31/___	Source	Use	Type of Activity
Cash					
Accounts Receivable					
Inventories					
Equipment					
Depreciation					
Accounts Payable					
Notes payable					
Accrued Wages					
Accrued Taxes					
Totals					

Once you have constructed a cash flow statement, you will be much closer to understanding the financial position of your company. While a balance sheet and income statement are tools for management, without a cash flow statement they are limited barometers and may even be misleading.

Operating Activities

The cash flow statement will tell you where money came from and how it was used. When analyzing cash flow, the first place to look is the cash flow from operating activities. It tells you whether the firm generated cash or whether it needs a cash infusion.

A few periods of negative cash from operating activities is not by itself a reason for alarm if it is based on plans for company growth or due to a planned increase in receivables or inventories. However, if a negative cash flow from operating activities is a surprise to managers and owners, it may be undesirable. Over time, if uncorrected, it can foretell business failure. Managers and owners should pay particular attention to increases in accounts receivable. The cash flow statement gives the true picture of the account. A large increase in accounts receivables may warrant new billing or collection procedures.

Investing Activities

The cash flow statement puts investing activities into perspective. At one glance, you can see whether or not a surplus in operations is being used to "grow" the company. A lack of investing activities, that is few purchases of new equipment or other assets, may indicate stagnant growth or a diversion of funds away from the company.

Financing Activities

The financing activities section of the cash flow statement will show repayments of debt, borrowing of funds, as well as injections of capital and the payment of dividends. As a company expands, this area of the cash flow statement will become increasingly important. It will tell outsiders how the company has grown and the financial strategies of management.

Together, the three sections of the cash flow statement show the net change in cash during the period being examined. A comparison between past periods will give owners and managers a good idea of the trend of their business. Positive trends in cash flow may encourage owners to consider long-term financing as an aid to growth and increase their comfort level concerning the company's ability to generate cash for repayment. Strong cash flow will also make it easier to acquire financing and to negotiate with lenders from a position of strength. Preparation of a cash flow statement is the first step toward financial management for long-term success. Prepared on a regular basis, it is a powerful tool for growth and long-term success.

CHECKLIST

Operating Activities

___ When you prepared the operating activities portion of the cash flow statement by the direct method, did you also prepare it by the indirect method to reconcile net income to cash flow from operating activities?

___ Has net income been adjusted for changes in accounts receivable, inventory, accounts payable, wages payable, and income taxes?

Investing Activities

___ Is every cash transaction to purchase equipment or other assets represented?

___ If any loans were made by the company, are they reflected here?

Financing Activities

___ Are all loan payments reported?

___ Have all cash dividends been reported?

___ Are there any unreported cash inflows from owners or investors?

Cash Flow Analysis

___ What is the trend in cash flow from operating activities for your company?

___ Is there a reason for any large increase in accounts receivable?

___ How do you expect the financing activities of your company to change in the next year and the next two years?

RESOURCES

Books

Analysis and Use of Financial Statements, 2nd ed. by Gerald I. White, Ashwinpaul C. Sondhi, and Dov Fried. (John Wiley & Sons, 1997).

Fundamentals of Financial Management, 11th ed. by James C. Van Horne and John Martin Wachowicz. (Prentice Hall, 2001).

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