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The Flow of Funds Into and Out of Business

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Abstract

"Cash is important!" A company cannot operate without cash. Cash means the money a company has in the office and bank. This is the money a company uses to pay near term obligations such as bills, weekly payroll etc. Without meeting the day-to-day obligations of business, even a company with great long-term prospects will be bankrupt. The management of Cash Flow is essential for a company's success. This paper will present how to do Cash Flow Statement and how to budget for Cash Flow.

Key words: *funds, cash flow, business, banking, financing*

What is a Cash Flow Statement?

The Cash Flow Statement traces the flow of funds (money) into and out of business over a period of time. Cash Flow is not net income. Companies with a positive net income have a negative Cash Flow while poor performing companies have a positive Cash Flow. How a company obtains cash and how it uses the cash are measured through the use of a Cash Flow Statement. Put it simply, a Cash Flow statement is used to answer the questions, "Where did the money come from?" and "Where did it go?"

As stated above, Cash Flow is not the same as net income. Cash Flow includes net income along with adjustments for non-cash items such as depreciation and receivables. Net income will vary from Cash Flow because net income is based on sales and not on cash payments. Sometimes the difference between what is sold and immediately paid for in cash may be substantial.

A Cash Flow Statement is concerned only with cash and cash equivalents, which include cash on hand, in the bank, and any cash invested in what is defined as short-term, highly liquid financial instruments (Certificates of Deposit with a near-term maturity). Generally, only instruments with original maturity of three months or less are qualified as cash equivalents. As such, Cash Flow will not match the amount of net income shown on your income statement.

Cash Flow Statement can be a very effective financial management tool. Some people even believe that the Cash Flow Statement could be the most important financial statement that is prepared.

Cash Flow Statements are usually prepared monthly, quarterly or annually. Cash Flow Statement is prepared after the Income Statement and the Balance Sheet are completed because it needs information from each of these statements. Cash Flow works together with the Balance Sheet and the Income Statement to give a clear picture of a company. A Cash Flow Statement can be used to assess the timing, amount and predictability of future Cash Flows and as the basis for budgeting.

The Cash Flow of a company is of outmost importance to a company looking for financing. Banks will look at a company’s Cash Flow to answer the following question: "Has this company enough cash to make payments on a loan?" My statement that ‘Cash is important’ sounds real because only cash can repay a loan. In fact, banks will use their own format for accessing a company’s Cash Flow.

In the accounting, banking and business communities, there have been many debates 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 and indirect method.

The direct method is encouraged by one of the leading accounting standard organizations. However, most American companies continue to report operating Cash Flow by the indirect method. This chapter will introduce both and will list the benefits for using each type of Cash Flow Statement.

The Cash Flow Statement contains three sections: Operating Activities, Investing Activities and Financing Activities. The difference between direct and indirect methods focuses on how each method treats the operating activities of the company. The direct method will be reviewed first. However, the direct method is not the most widely used method to calculate the Cash Flow from operating activities.

The choice of method does not change the amount of Cash Flow reported from operating activities. Direct and indirect methods are just two routes for the same destination. No matter which method is selected, the idea behind what constitutes Cash Flow from operating activities is the same.

Operating Activities

Cash Flow from operating activities is any cash transaction related to the company's ongoing business that is the business activities 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 excess cash.

The Direct Method for Operating Activities

Cash Flow from operating activities is obtained as described below:

+ 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 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

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:

"X" 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
Cash used for operating activities		$ 7,750
Net Cash from Operating Activities	**$ 2,950**	

While it seems simple enough, there are various reasons many companies do not use this format. One reason may be the number of calculations necessary to compute some of the categories, such as the cash received from customers. Even in the United States where computerized accounting systems are common, small businesses with many small cash sales might find it hard to determine total cash received.

To compile a statement of Cash Flows from operations using the direct method, in-depth knowledge of the business and its accounting methods is required. It needs to be thoroughly familiar with the manner in which sales are recorded and expenses incurred and paid. A small business owner might be comfortable assembling this information as it usually is involved in the day-to-day operations. If so, the direct method should be used.

One drawback to using the direct method is that a supplemental chart illustrating the indirect method is usually provided along with the direct method. Net income is such an important accounting concept that this additional statement reconciling the net income shown on the income statement with Cash Flow from operating activities must be prepared.

This extra amount of work should not discourage the use of the direct method of accounting for Cash Flow from operations since valuable information can be gathered from both types.

Before we review the indirect method, here is a Cash Flow 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 its sales for the period, and then subtract accounts receivable at the end of the year to compute how much it was collected in cash.

Cash Flow from Operating Activities - Indirect Method

Both methods of determining Cash Flow from operations should be used in order to choose which method suits the company better. The indirect method of computing Cash Flow from operating activities starts with net income (from the income statement).

The 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, VAT payable, and income taxes payable.

Here is what Cash Flow from operating activities using the indirect method looks like. Note that this statement is for the same company and period of time 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.

“X” Company

Cash Flow from operating activities:

<u>Indirect method</u>:

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
Loss on sale of property	<u>($ 600)</u>	
Net Cash Flow from operating activities		**$ 2,950**

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 caused by the buying or selling of non-current assets. This includes selling and replacing equipment that wears out, or acquiring a new building or land for your company to grow.

For an SME, the investing activities section of a Cash Flow statement usually reports the following information:

Cash Flows from Investing Activities:

(+) Proceeds from sale of assets
<u>(-) Purchases of property and equipment</u>

(=) Total Net Cash provided (used) by investing activities

Financing Activities

Financing activities on a Cash Flow Statement reflect borrowing money, 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 paid for dividends and re-acquisitions of debt and capital stock
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= 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
<u>(+) Partner/owner capital contributions</u>

= 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 other cash inflows from outsiders and owners. If a company paid dividends, repaid loans, or otherwise took money from business, it should be reported here.

Summary Example

Together, the three sections of the Cash Flow statement show the net change in cash for a given period. Here is what a complete Cash Flow statement looks like. It is compiled according to the indirect method.

Cash Flow Statement

"Y" Company
For the year ended 2007

Cash Flow from Operating Activities			
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		<u>$ (25)</u>	
Net Cash Flow from operations	$ 165		
Cash Flows from Investing Activities			
Purchase of Equipment		$ (400)	
Cash Flows associated with Financing Activities			
Notes payable			<u>$ 30</u>
Net change in Cash			$ (205)

*Net income is taken from the Income Statement.

The Cash Flow statement for the "Y" company shows that there was a $205 cash shortfall in 2007. As it 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 operating activity was a positive $165. Please note that this company had a net income of $200 and a negative Cash Flow of ($205).

Depreciation and Amortization

Any depreciation and amortization amounts shown on the income statement are added to net income for Cash Flow purposes. This is because a depreciation or amortization allowance has no cash component but it decreases our net income (net cash) for income statement purposes. Depreciation and amortization are simply non-cash allocations of the asset's costs (a real asset in the case of depreciation or intangible asset in the case of amortization) to an expense account that distorts and reduces net income (net cash). The only time cash will enter into transaction is when the asset is sold. Thus, when using the indirect method to compute the Cash Flows from operating activities, any depreciation or amortization expense must be added back to net income.

Accounts Receivable

If accounts receivable decrease during the time period, this means customers have paid off some accounts, (the company received cash payments) and so, net income should be increased by the accounts amount receivable decreased during the period. Conversely, if accounts receivable increase 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, the company either used cash to purchase the inventory, which is a direct decrease in cash account, or purchased the inventory on credit which is an increase in accounts payable. A decrease in the company's cash account is a direct reduction of net income (net cash), an increase in accounts payable makes available more net income (net cash) which is then used to purchase inventory, that is another decrease in net income (net cash). 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 on the income statement although, 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 income statement, they actually are a future expense and do not reflect a reduction in cash. As such, they are added back to net income for Cash Flow purposes.

Types of Activities

Generally speaking changes to cash, accounts receivable, inventory, depreciation and amortization, and accounts payable will be operating activities. Cash changes due to equipment or asset purchases will be investing activities, while changes due to paying down debt or loan payments and payments of dividends will be financing activities.

How to Analyze a Cash Flow Statement

Once a Cash Flow Statement has been constructed, the company will be much closer to understanding its financial position. 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 a company where its 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 company generated cash or needs a cash infusion.

A few periods of negative cash from operating activities do not represent a reason for alarm if they are based on plans for company growth or they are due to 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 account receivable. The Cash Flow Statement gives the true picture of the account. A large increase of account receivables may warrant new billing or collection procedures.

Investing Activities

The Cash Flow Statement puts investing activities into perspective. At one glance, a company can see whether a surplus in operations is being used to "grow" the company or not. 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 payment of dividends. As a company expands, this area will become increasingly important. It will tell outsiders how the company has grown and it will also reveal 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 long-term success. Prepared on a regular basis, it is a powerful tool for growth.

Understanding Cash Flow and being able to estimate the shortages is the hallmark of a good financial manager.

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Intrarea şi ieşirea fondurilor în afaceri

Rezumat

“Banii lichizi sunt importanţi!” O companie nu poate opera fără bani lichizi. Banii în numerar reprezintă banii pe care o companie îi are în birou sau în bancă. Aceştia sunt banii cu care o companie îşi plăteşte obligaţiile trimestriale, cum ar fi nota de plată a Romtelecom-ului, impozitul bazat pe totalul angajaţilor ce figurează pe statul de plată etc. Fără a acoperi obligaţiile zilnice ale unei afaceri, chiar şi o companie cu perspective pe termen lung va fi falimentară. Administrarea fluxului monetar este esenţială pentru succesul unei companii. Acest articol prezintă modul în care se pot pune în aplicare cele două tipuri de declaraţii ale fluxului monetar după modelul american şi cum se poate trece în buget fluxul monetar.