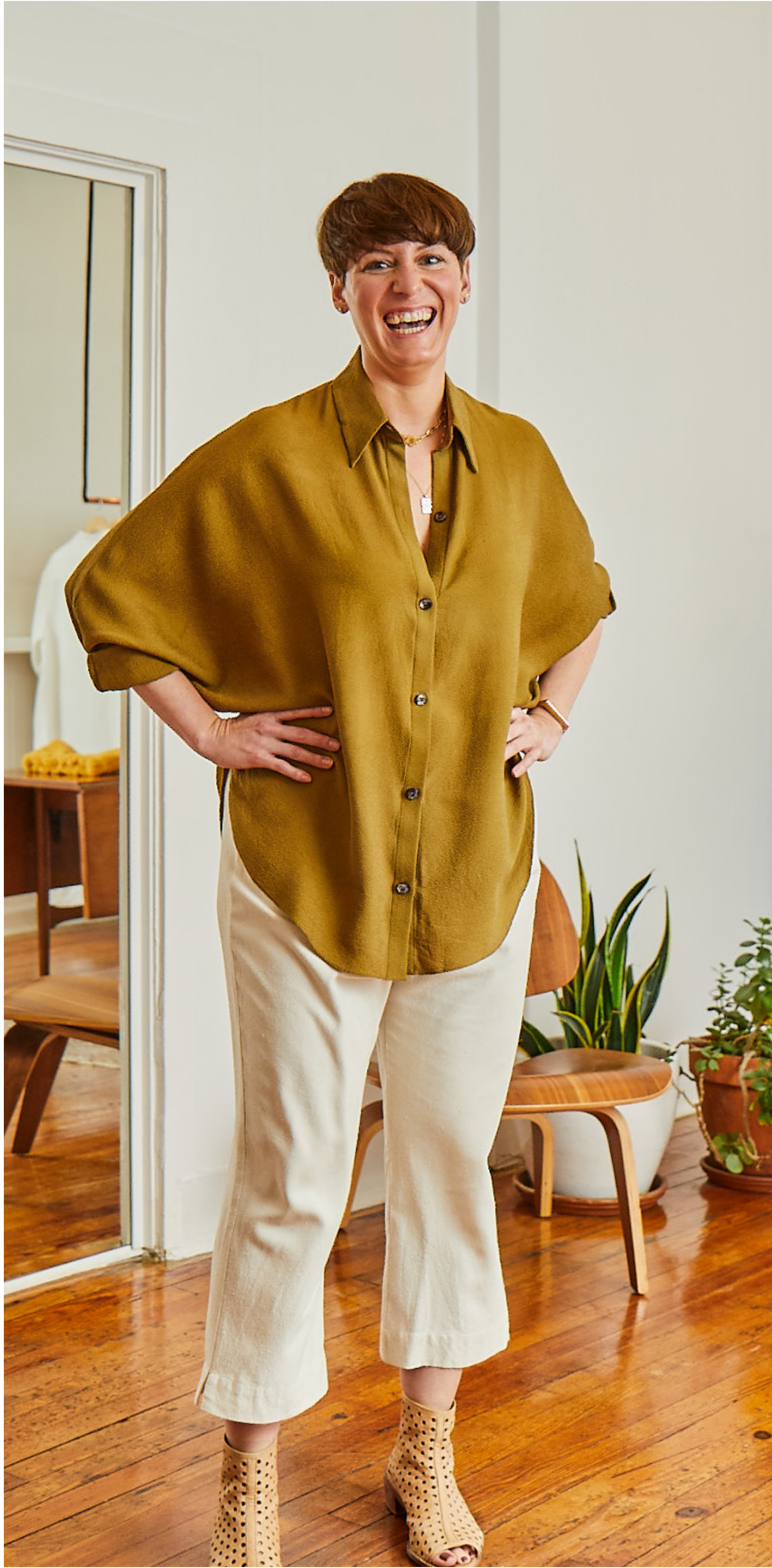
The beginner's guide to cash flow

By Kathryn Pomroy



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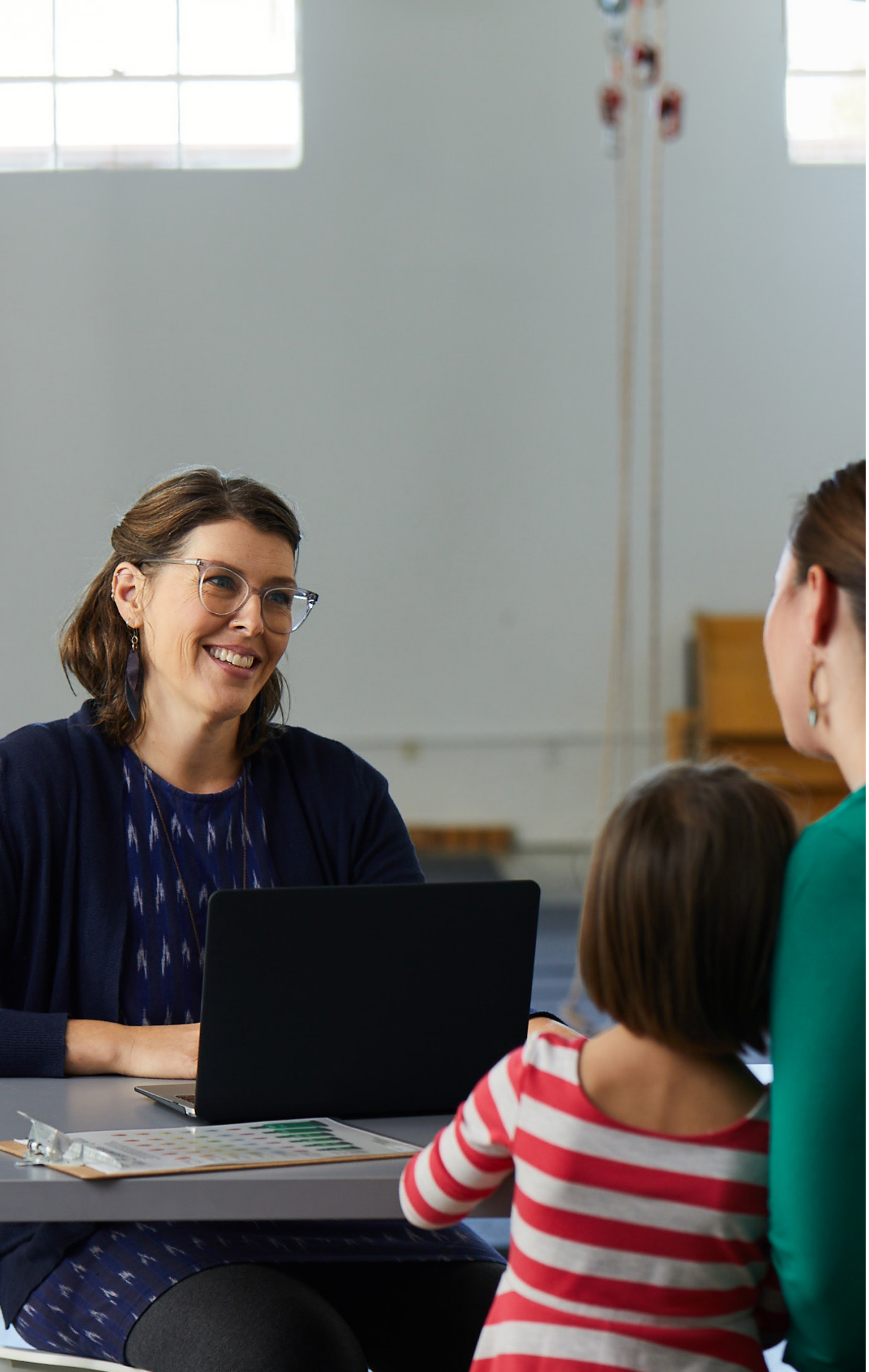
Introduction

Think of cash flow like your car's gas tank. You fill up the tank with gas, and it empties as you drive. The goal, however, is to always have enough gas in your tank so you never run on empty. In the same way, cash flow is the movement of cash in and out of your business and your bank account. Cash inflows are your sources of income, and cash outflows are your business expenses. Naturally, positive cash flow is better than negative cash flow.



Why is cash flow important to your business?

For small business owners, positive cash flow is the goal. You want to generate more money than you're spending. This sounds simple, but plenty of profitable businesses run into cash flow problems. It can be challenging to balance regular business expenses – like salaries, rent, and technology updates – with the sporadic revenue and periods of negative cash flow that can come from seasonal patterns or investments in growth.

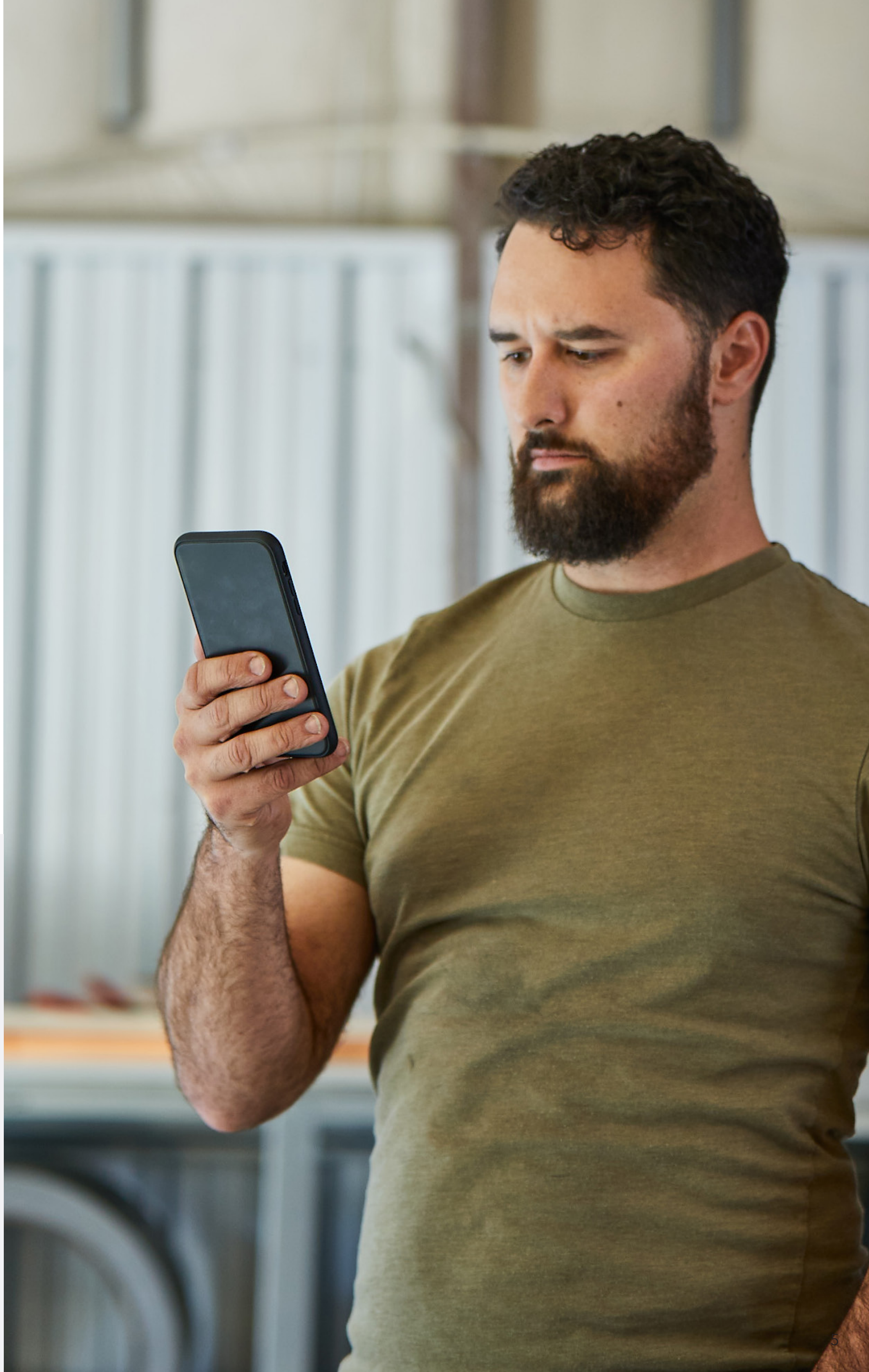
Achieving and maintaining positive cash flow is essential in a small business. In practical terms, understanding where your cash goes every month and how you can get more cash when you need it are the bare necessities to running a successful company.

To grasp the idea of cash flow, let's take a look at a cash flow statement, how to read it, why it's important, and what problems to avoid so you don't find yourself and your business in a tight spot.

What is a cash flow statement?

A cash flow statement – also known as a statement of cash flows – tracks money in and money out of your company. It will show how much cash a company has on hand and provide insight into a company's liquidity. Public companies are required to release cash flow statements each quarter. You can see examples of cash flow statements from Nordstrom, Meta Financial Group, Inc., and Ford on Yahoo! Finance.

A better option for your company may be to download your free cash flow statement template from QuickBooks.



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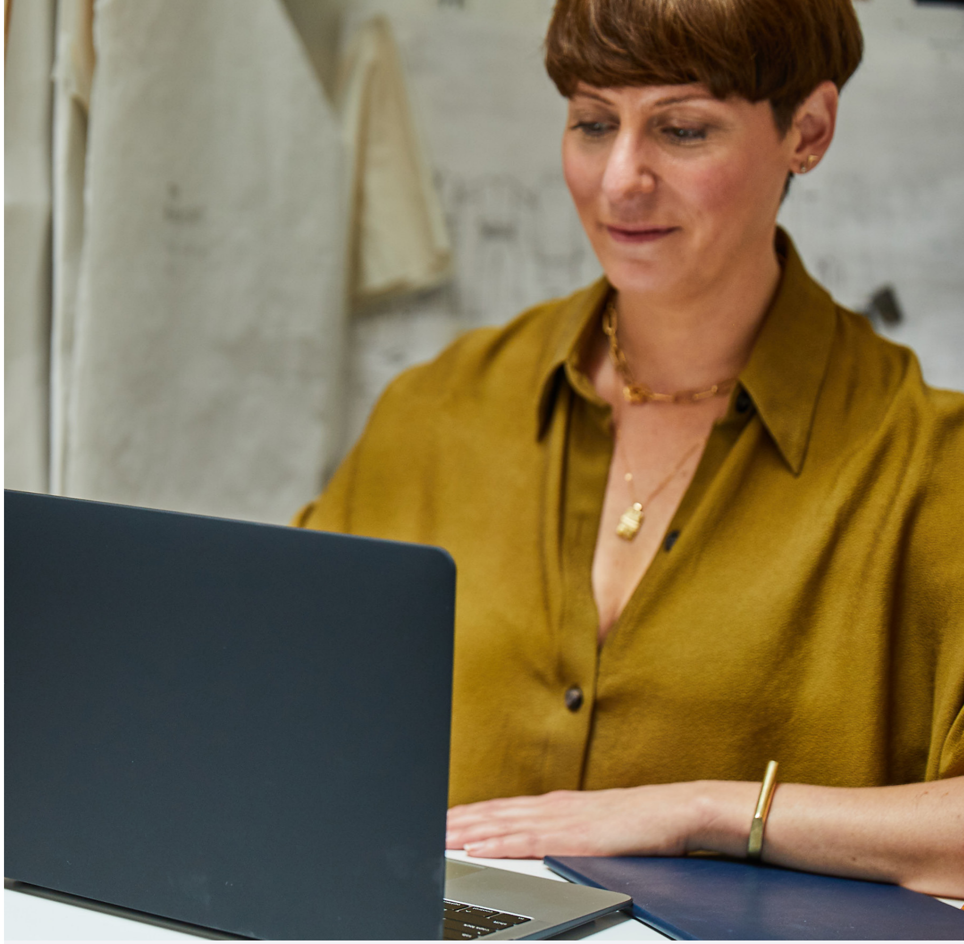
What goes into your cash flow statement

Cash flow statements, along with balance sheets and income statements help provide insights into a company's finances. But business owners aren't always sure how they interconnect.

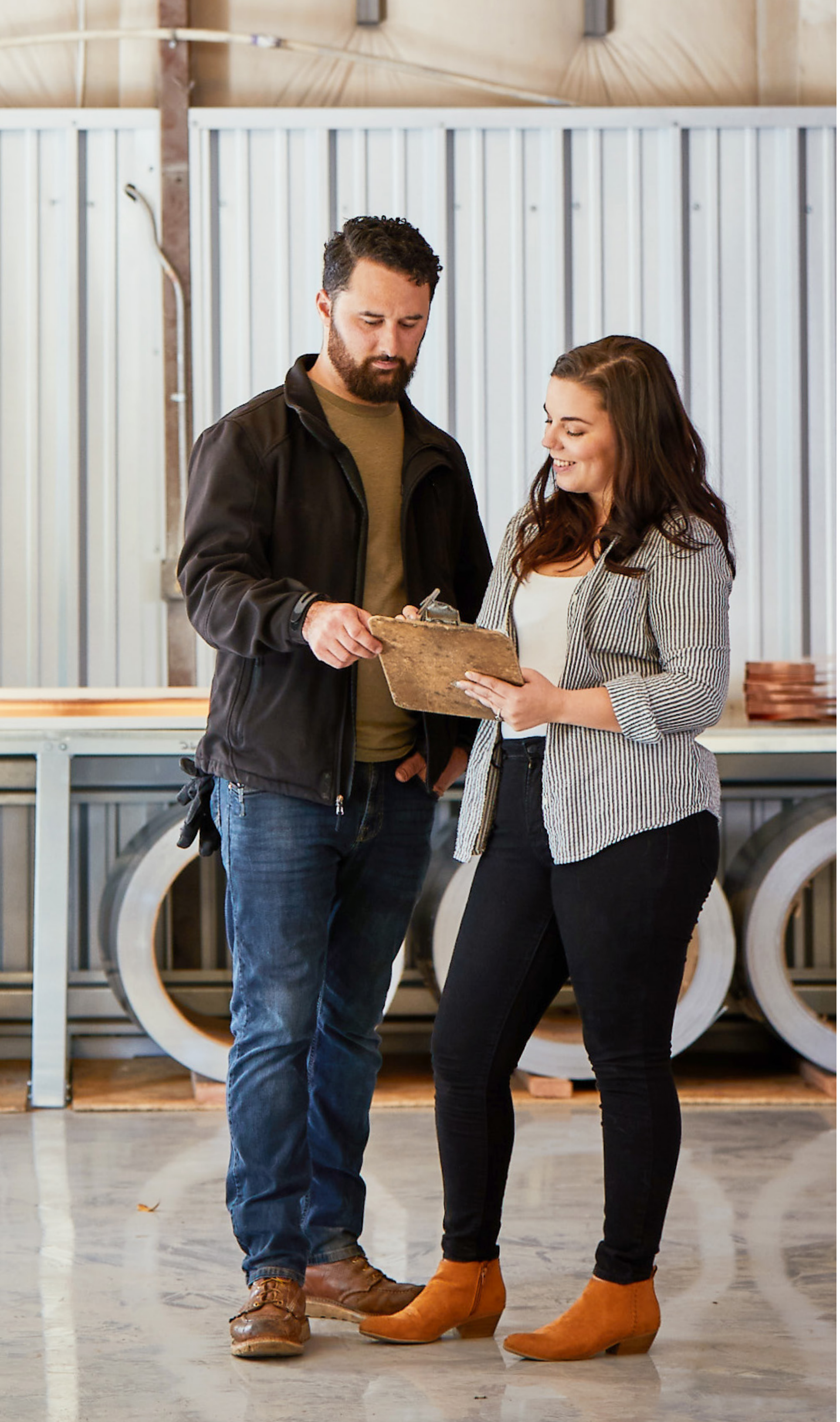
The balance sheet gives you an overall view of a company's finances. It's split into assets, liabilities, and equity. The cash balance from a company's cash flow statement appears on the balance sheet in the asset section.

The income statement shows a company's revenue, expenses, and profit and losses (P&L). It will offer insights into a company's profitability. The bottom line of your income statement is net income. Net income is used to calculate cash flow from operating your business. Also, any non-cash income from the income statement, such as depreciation, and non-cash expenses flow into the cash flow statement and affect net income.

Long story short, each accounting statement is important for understanding your company's performance from all angles. The balance sheet and cash flow statement focus on the financial management of your company in terms of both structure and assets. Whereas, the income statement shows you which core operating activities generate the most income for your company.



Profits and cash flow are both essential aspects of a business. After all, for your business to be prosperous long term, you need to make a profit while also operating with positive cash flow. Keep in mind, however, that profit and cash flow are very different.



Cash inflows and outflows on your cash flow statement

Not understanding cash flow and poor cash flow management are among the leading reasons why businesses fail. That's why understanding the cash inflows and outflows on your cash flow statement is so important if you want to keep your business up and running.

Cash inflow is the money going into your company. It may be from investments and financing or from sales. Cash inflow is the opposite of cash outflow, which is money going out of your business from things like payments to vendor or disbursements. For your company to be considered healthy, your cash inflow must be greater than your cash outflow.

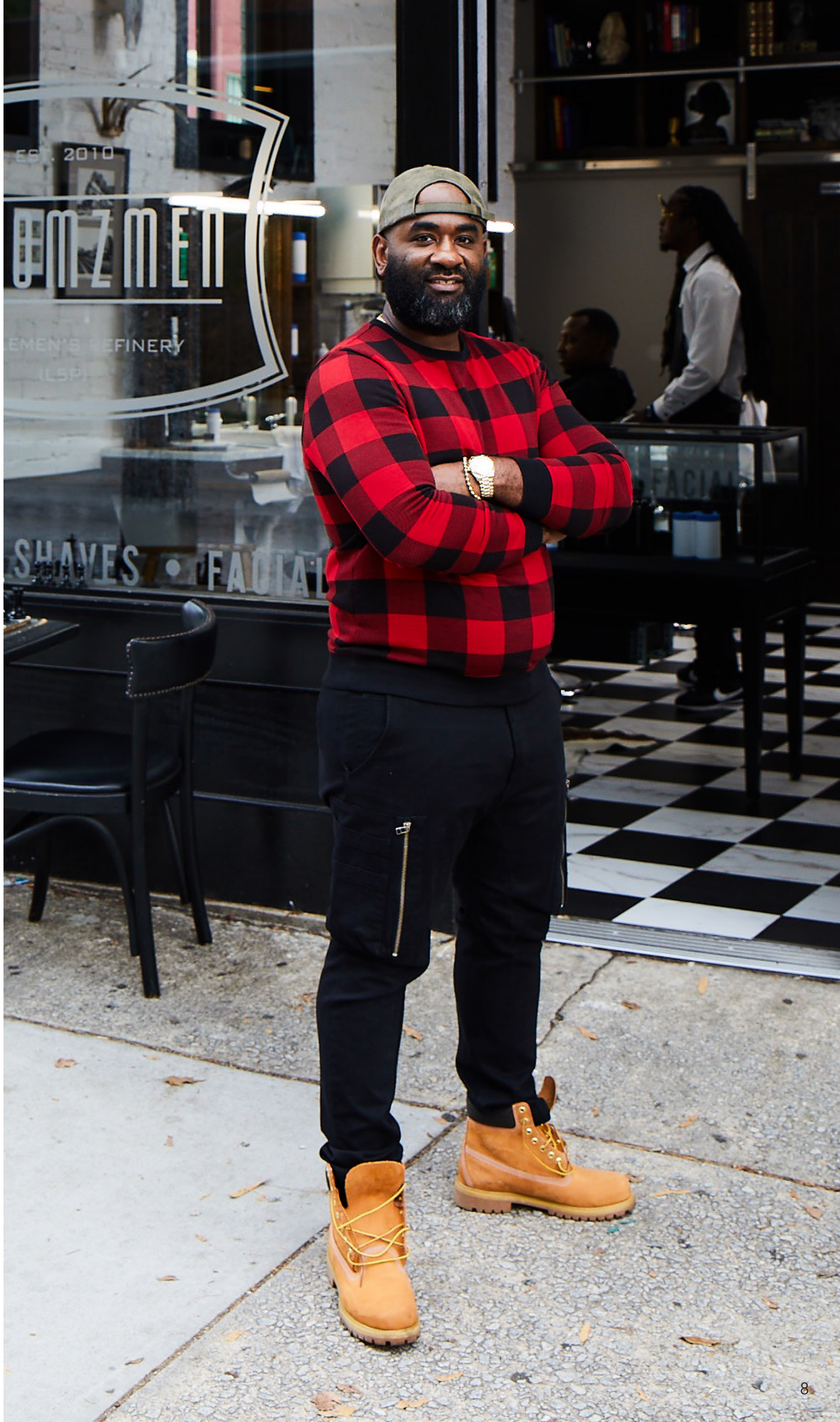
On your cash flow statement, you will find operating activity, investing activity, and financing activity, in that order. Add together the total cash gained from or used by each of the three activities to come up with the overall change in cash for the period. Then add this to the opening cash balance to reach your cash flow statement's bottom line, also known as the closing cash balance.

The difference between cash flow and profit

Although cash flow and profit are related, they're quite different when it comes to accounting. You can see it most clearly when you compare an income statement to a cash flow statement.

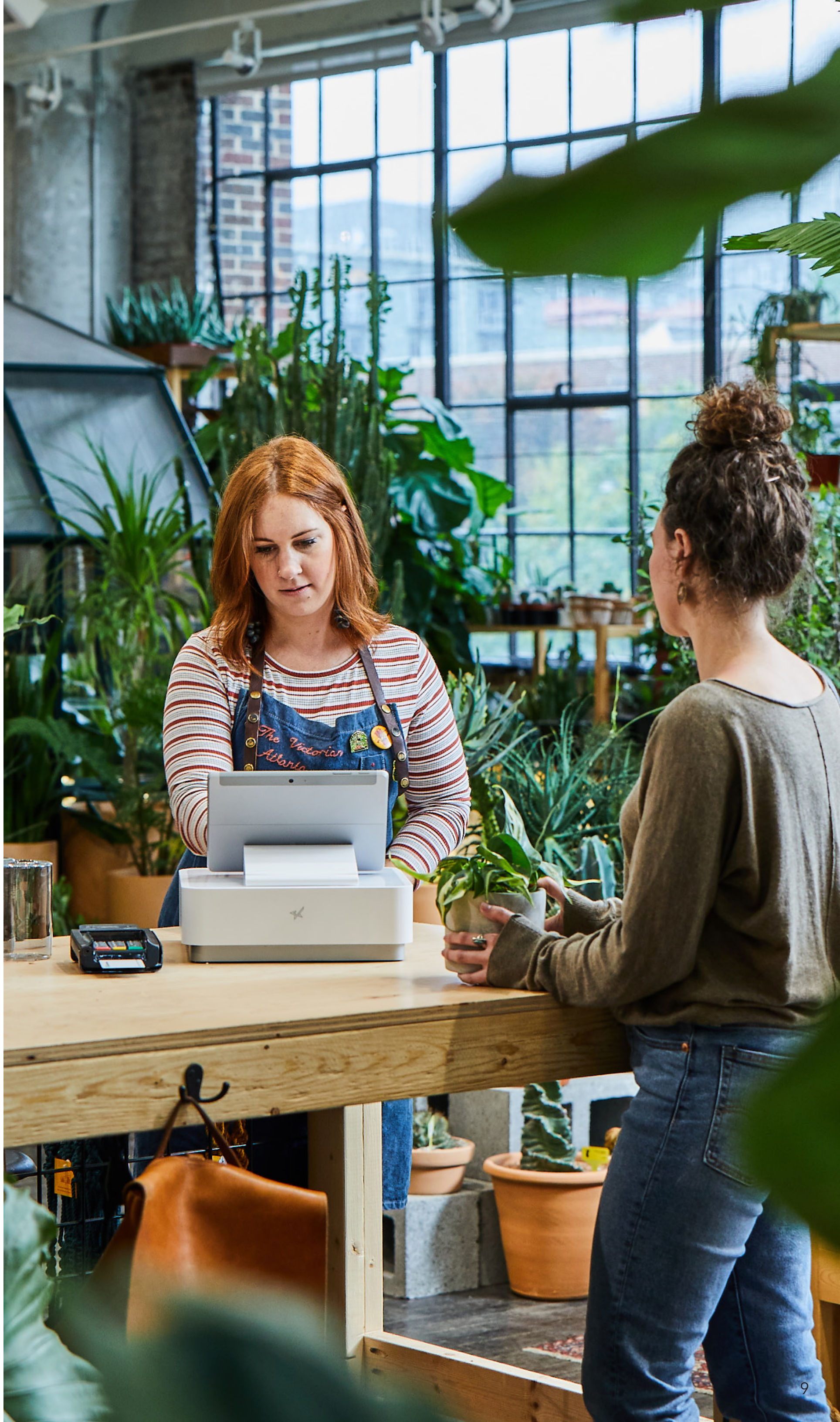
The most significant difference between the two is that the income statement may be based on accrual accounting, whereas the cash flow statement is based on cash basis accounting.

But, even if you don't handle your own financial reporting, it's still important to know how both accrual accounting and cash basis accounting work so you can choose the best reporting method for your business. It's also important to know that as long as your sales are less than $25 million per year, you're free to use either.



Cash basis accounting

Cash basis accounting identifies revenue when it's received and expenses when they're paid. It does not recognize either accounts receivables or accounts payables. Many small businesses use cash basis accounting because it's simpler to maintain. It's easy to see when a transaction has been made or how much cash your business actually has at any given time by looking at your bank balance.

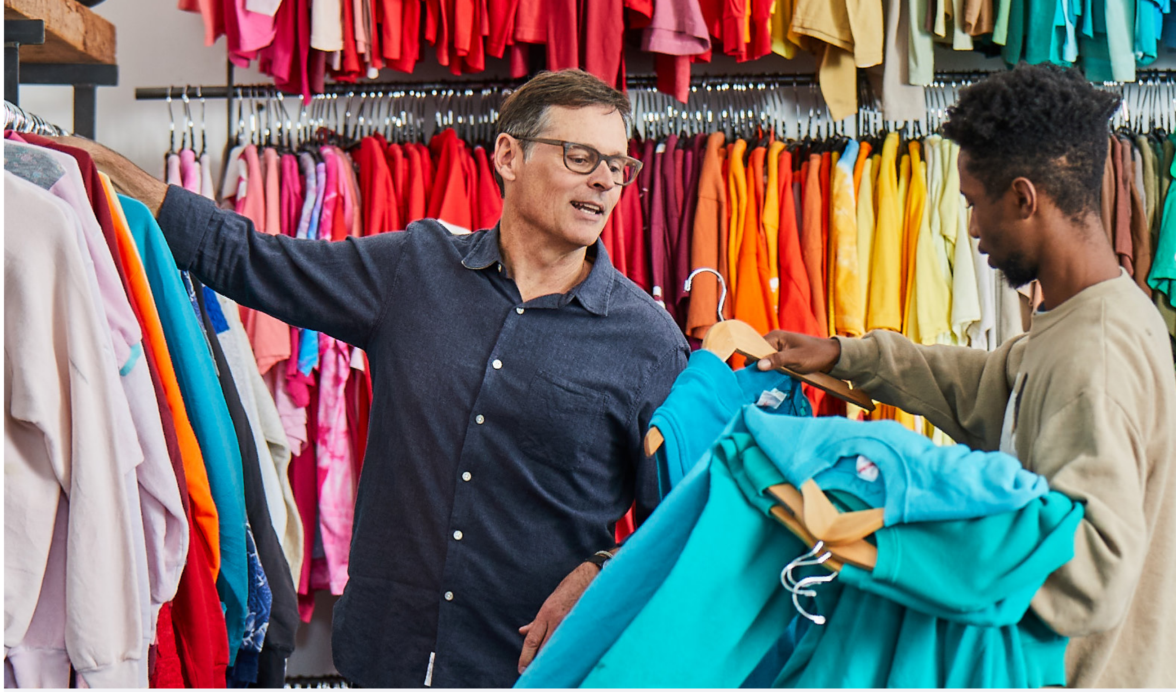


Accrual accounting

Accrual accounting, on the other hand, records revenues and expenses when they are earned, irrespective of when the money is received or paid out.

For example, if you paid $240 up front for a two-year newspaper subscription, your cash flow statement will show a cash outflow of $240 immediately. On the other hand, your income statement will break down the $240 into each individual accounting period, usually monthly or quarterly.

Think of it this way. Let's say you started a company. After one year, you ran into cash flow issues even though your business was profitable. As a small business, you relied on invoices to collect accounts receivables from customers. As anyone who sends invoices knows, customers don't always pay on time. Even though your company was profitable, according to your income statement, you were short on cash.



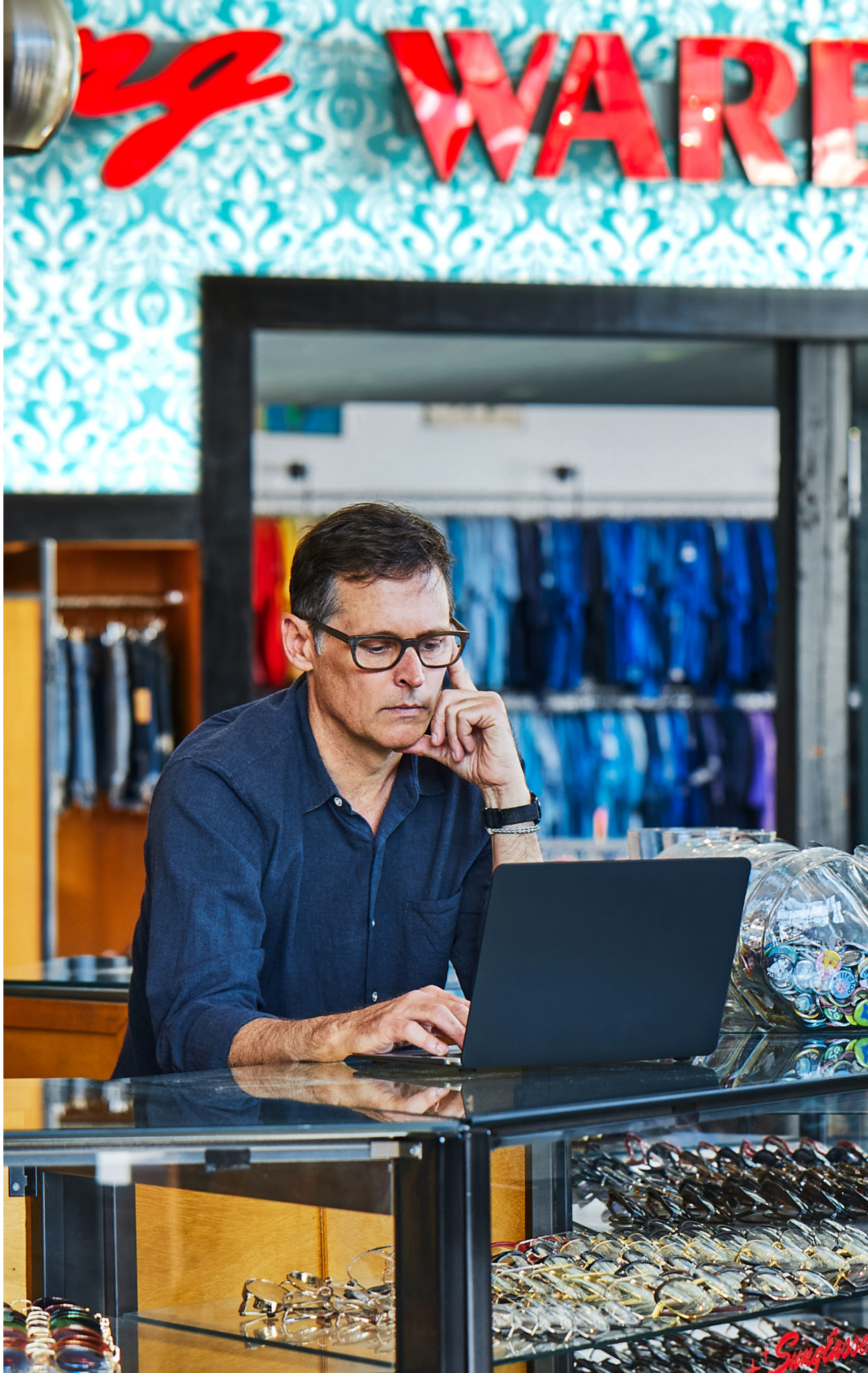
You may have had the best intentions but failed to make payment deadlines simply because you couldn't manage your company's cash outflow or cash inflow. The relationship between cash flow and profit will vary depending on the type of business. You can be profitable but have times of slow or inconsistent cash flow.

In other words, cash flow is the total amount of money moving in and out of a business at a given time. Whereas profit is the amount of money left over after all expenses are subtracted or paid.

How to read a cash flow statement

You can break down a cash flow statement into a simple equation:

Operating activities **+** investing activities **+** financing activities **=** **cash on hand**



The elements of the cash flow equation are:

Operating activities

Also called operating cash flow, operating costs show how much you've spent or made on a daily basis. It's the amount of money your company brings in from any ongoing regular business activities, such as selling products, manufacturing, or providing a service. It is the most accurate assessment of how much money you've generated from your core business.

Investment activities

Also called cash flow from investing activities, asset investments show cash used to buy or sell long-term capital assets for your business. These assets may be equipment, property, machinery, vehicles, furnishings, or investment securities. Over time, you want to see that your business can pay for these investments with income generated from its operations.

Financing activities

Financing is cash received from or paid to lenders, other creditors, and investors (if you have them). For publicly-traded companies, this is where cash flow from the sale of stocks and bonds, payment of dividends, or repayment of debt capital is reported.

This cash flow equation will show you the changes in cash balances from one period to the next so that you can always stay on top of your company's cash flow.

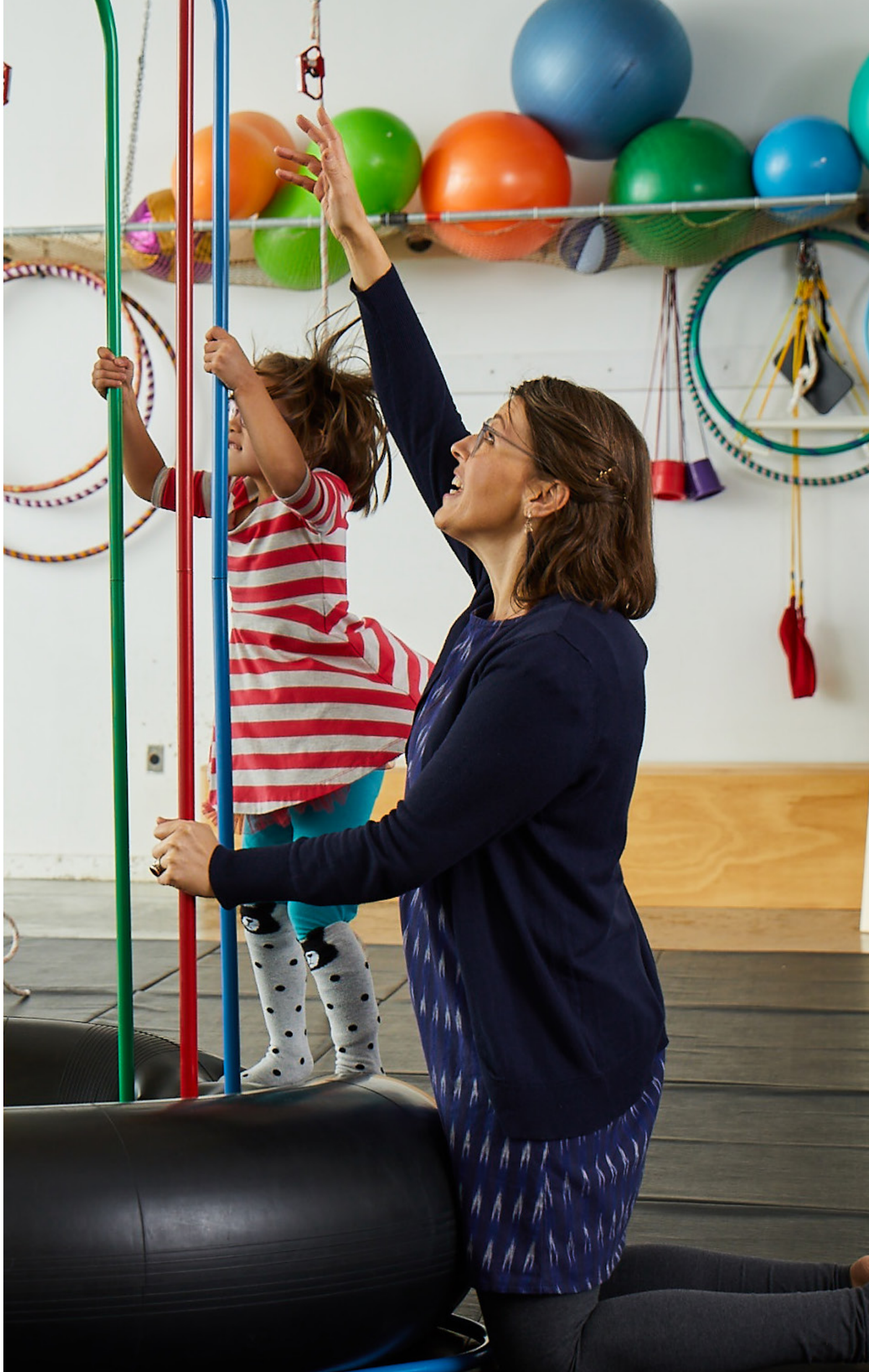
What causes cash flow problems?

Plenty of businesses have folded because they didn't understand the difference between making money and managing cash flow. More often than not, cash flow is a challenge because income is sporadic while expenses are recurring. Although both affect your cash flow, sales aren't a cash flow problem – that's a sales or product problem.

A cash flow problem is when sales are good, but cash is stuck in inventory or accounts receivable, so it's not there when you have to pay for inventory on-hand or rent. The cash is coming, it's just not in the bank yet.

Controlling your accounts receivable is one of the best ways to increase cash flow. And there are plenty of ways to get paid faster. Even so, it's not always easy. Tracking down late payments can cost you time and money that you might not be able to spare.

Obviously, the best way to stop mounting past due receivables is to not let them pile up in the first place. But, even that isn't always possible. Some companies look at business financing options to relieve some of their cash flow burden. That too isn't always a silver bullet.



Cash flow you can bank on

Solving your company's cash flow issues typically comes down to getting all of your accounting in order. Now you understand the importance of your cash flow statement and know what cash flow problems to address in the short-term. You're ready to look at your accounts receivables and review your company's financial statement.

We hope you've decided on no more Excel spreadsheets and no more manual reports. That's because you now know that positive cash flow is part of a comprehensive accounting process that can be automated and accessible.

Nearly every business that graduates from Excel to accounting software like QuickBooks wishes they'd done it sooner. If you want to stay on top of your company's cash flow, get your system in place before problems arise. Your employees, your vendors, and your accountant will thank you.