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Need and Calculation of Cash Flow Statement

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➢ Abstract

This study has been undertaken to investigate the determinants of Need of cash flow, Importance of cash flow, How to calculate Cash Flow and Calculation Methods of cash flow statement. A cash flow statement tells you how much cash is entering and leaving your business in a given period. Along with balance sheets and income statements, it's one of the three most important financial statements for managing your small business accounting and making sure you have enough cash to keep operating.

➢ Keyword –

Cash Flow, assets, liabilities, and equity

➢ Introduction

A cash flow statement is a regular financial statement telling you how much cash you have on hand for a specific period. While income statements are excellent for showing you how much money you've spent and earned, they don't necessarily tell you how much cash you have on hand for a specific period of time.

If you use accrual basis accounting, income and expenses are recorded when they are earned or incurred-not when the money actually leaves or enters your bank accounts. (The cash accounting method only records money once you have it on hand. Learn more about the cash vs. accrual basis systems of accounting.)

So, even if you see income reported on your income statement, you may not have the cash from that income on hand. The cash flow statement makes adjustments to the information recorded on your income statement, so you see your net cash flow the precise amount of cash you have on hand for that time period.

For example, depreciation is recorded as a monthly expense. However, you've already paid cash for the asset you're depreciating; you record it on a monthly basis in order to see how much it costs you to have the asset each month over the course of its useful life. But cash isn't literally leaving your bank account every month. The cash flow statement takes that monthly expense and reverses it so you see how much cash you have on hand in reality, not how much you've spent in theory.

➢ Need of cash flow statements

So long as you use accrual accounting, cash flow statements are an essential part of financial analysis for three reasons:

1. They show your liquidity: - That means you know exactly how much operating cash flow you have in case you need to use it. So you know what you can afford, and what you can't.

2. **They show you changes in assets, liabilities, and equity:-** in the forms of cash outflows, cash inflows, and cash being held. Those three categories are the core of your business accounting. Together, they form the accounting equation that lets you measure your performance.

3. They let you predict future cash flows:- You can use cash flow statements to create cash flow projections, so you can plan for how much liquidity your business will have in the future. That's important for making long-term business plans.

On top of that, if you plan on securing a loan or line of credit, you'll need up-to-date cash flow statements to apply.

➢ Negative cash flow vs. positive cash flow

When your cash flow statement shows a negative number at the bottom, that means you lost cash during the accounting period—you have negative cash flow. It's important to remember that long-term, negative cash flow isn't always a bad thing. For example, early stage businesses need to track their burn rate as they try to become profitable.

When you have a positive number at the bottom of your statement, you've got positive cash flow for the month. Keep in mind, positive cash flow isn't always a good thing in the long term. While it gives you more liquidity now, there are negative reasons you may have that money—for instance, by taking on a large loan to bail out your failing business. Positive cash flow isn't always positive overall.

➢ Where do cash flow statements come from?

If you do your own bookkeeping in Excel, you can calculate cash flow statements each month based on the information on your income statements and balance sheets. If you use accounting software, it can create cash flow statements based on the information you've already entered in the general ledger.

Keep in mind, with both those methods, your cash flow statement is only accurate so long as the rest of your bookkeeping is accurate too. The most surefire way to know how much working capital you have is to hire a bookkeeper. They'll make sure everything adds up, so your cash flow statement always gives you an accurate picture of your company's financial health.

➢ Statements of cash flow using the direct and indirect methods

In order to figure out your company's cash flow, you can take one of two routes: The direct method, and the indirect method. While generally accepted accounting principles approve both, the indirect method is typically preferred by small businesses.

➢ The direct method of calculating cash flow

Using the direct method, you keep a record of cash as it enters and leaves your business, and then use that information at the end of the month to prepare a statement of cash flow.

The direct method takes more legwork and organization than the indirect method you need to produce and track cash receipts for every cash transaction. For that reason, smaller businesses typically prefer the indirect method.

Also worth mentioning: Even if you record cash flows in real time with the direct method, you'll also need to use the indirect method to reconcile your statement of cash flows with your income statement. So, you can usually expect the direct method to take longer than the indirect method.

➢ The indirect method of calculating cash flow

With the indirect method, you look at the transactions recorded on your income statement and then reverse some of them in order to see your working capital. You're selectively backtracking your income statement in order to eliminate transactions that don't show the movement of cash.

Since it's simpler than the direct method, many small businesses prefer this approach. Also, when using the indirect method, you do not have to go back and reconcile your statements with the direct method.

In our examples below, we'll use the indirect method of calculating cash flow.

You use information from your income statement and your balance sheet to create your cash flow statement. The income statement lets you know how money entered and left your business, while the balance sheet shows how those transactions affect different accounts like accounts receivable, inventory, and accounts payable.

So, the process of producing financial statements for your business goes:

Income Statement + Balance Sheet = Cash Flow Statement

➢ **Example of a cash flow statement**

Cash Flow Statement

Month Ending January31 2021

Cash Flow from Operations	
Net income	Rs. 60,000
Additions to Cash	
Depreciation	Rs. 20,000
Increase in Accounts Payable	Rs. 10,000
Subtractions from Cash	
Increase in Accounts Receivable	(Rs. 20,000)
Increase in inventory	(Rs. 30,000)
Net Cash from Operations	Rs. 40,000
Cash Flow from Investing	
Purchase of equipment	(Rs. 5,000)
Cash Flow from Financing	
Notes payable	Rs. 7,500
Cash Flow for Month Ended December 31,2020	**Rs. 42,500**

Now that we've got a sense of what a statement of cash flows does and, broadly, how it's created, let's check out an example.

There's a fair amount to unpack here. But here's what you need to know to get a rough idea of what this cash flow statement is doing.

• **Bracket amounts** decrease cash. For instance, when we see (Rs.30,000) next to "Increase in inventory," it means inventory increased by Rs.30,000 on the balance sheet. We bought Rs.30,000 worth of inventory, so our cash balance decreased by that amount.

• **Without Bracket amounts** increase cash. For example, when we see Rs.20,000 next to "Depreciation," that Rs.20,000 is an expense on the income statement, but depreciation doesn't actually decrease cash. So we add it back to net income.

You'll also notice that the statement of cash flows is broken down into three sections—Cash Flow from Operating Activities, Cash Flow from Investing Activities, and Cash Flow from Financing Activities. Let's look at what each section of the cash flow statement does.

➢ **The three sections of a cash flow statement**

These three activities sections of the statement of cash flows designate the different ways cash can enter and leave your business.

• **Cash Flow from Operating Activities** is cash earned or spent in the course of regular business activity the main way your business makes money, by selling products or services.

• **Cash Flow from Investing Activities** is cash earned or spent from investments your company makes, such as purchasing equipment or investing in other companies.

• **Cash Flow from Financing Activities** is cash earned or spent in the course of financing your company with loans, lines of credit, or owner's equity.

Using the cash flow statement example above, here's a more detailed look at what each section does, and what it means for your business.

➢ **Cash Flow from Operating Activities**

For most small businesses, Operating Activities will include most of your cash flow. That's because operating activities are what you do to get revenue. If you run a pizza shop, it's the cash you spend on ingredients and labor, and the

cash you earn from selling pies. If you're a registered massage therapist, Operating Activities is where you see your earned cash from giving massages, and the cash you spend on rent and utilities.

Cash Flow from Operating Activities in our example

Taking another look at this section, let's break it down line by line.

Net income is the total income, after expenses, for the month. We get this from the income statement.

Depreciation is recorded as a Rs.20,000 expense on the income statement. Here, it's listed as income. Since no cash actually left our hands, we're adding that Rs.20,000 back to cash on hand.

Increase in Accounts Payable is recorded as a Rs.10,000 expense on the income statement. That's money we owe in this case, let's say it's paying contractors to build a new goat pen. Since we owe the money, but haven't actually paid it, we add that amount back to the cash on hand.

Increase in Accounts Receivable is recorded as a Rs.20,000 growth in accounts receivable on the income statement. That's money we've charged clients—but we haven't actually been paid yet. Even though the money we've charged is an asset, it isn't cold hard cash. So we deduct that Rs.20,000 from cash on hand.

Increase in Inventory is recorded as a Rs.30,000 growth in inventory on the balance sheet. That means we've paid Rs.30,000 cash to get Rs.30,000 worth of inventory. Inventory is an asset, but it isn't cash—we can't spend it. So we deduct the Rs.30,000 from cash on hand.

Net Cash from Operating Activities, after we've made all the changes above, comes out to Rs.40,000.

Meaning, even though our business earned Rs.60,000 in October (as reported on our income statement), we only actually received Rs.40,000 in cash from operating activities.

➢ **Cash Flow from Investing Activities**

This section covers investments your company has made—by purchasing equipment, real estate, land, or easily liquidated financial products referred to as "cash equivalents." When you spend cash on an investment, that cash gets converted to an asset of equal value.

If you buy a Rs.10,000 mower for your landscaping company, you lose Rs.10,000 cash and get a Rs.10,000 mower. If you buy a Rs.140,000 retail space, you lose Rs.140,000 cash and get a Rs.140,000 retail space.

Under Cash Flow from Investing Activities, we reverse those investments, removing the cash on hand. They have cash value, but they aren't the same as cash—and the only asset we're interested in, in this context, is currency.

For small businesses, Cash Flow from Investing Activities usually won't make up the majority of cash flow for your company. But it still needs to be reconciled, since it affects your working capital.

Cash Flow from Investing Activities in our example

Purchase of Equipment is recorded as a new Rs.5,000 asset on our income statement. It's an asset, not cash so, with (Rs.5,000) on the cash flow statement, we deduct Rs.5,000 from cash on hand.

➢ **Cash Flow from Financing Activities**

This section covers revenue earned or assets spent on Financing Activities. When you pay off part of your loan or line of credit, money leaves your bank accounts. When you tap your line of credit, get a loan, or bring on a new investor, you receive cash in your accounts.

Cash Flow from Financing Activities in our example

Notes payable is recorded as a Rs.7,500 liability on the balance sheet. Since we received proceeds from the loan, we record it as a Rs.7,500 increase to cash on hand.

➢ **Cash flow for the month**

At the bottom of our cash flow statement, we see our total cash flow for the month: Rs.42,500. Even though our net income listed at the top of the cash flow statement (and taken from our income statement) was Rs.60,000, we only received Rs.42,500. That's Rs.42,500 we can spend right now, if need be. If we only looked at our net income, we might believe we had Rs.60,000 cash on hand. In that case, we wouldn't truly know what we had to work with—and we'd run the risk of overspending, budgeting incorrectly, or misrepresenting our liquidity to loan officers or business partners.

➢ **How to track cash flow using the indirect method**

Four simple rules to remember as you create your cash flow statement:

1. Transactions that show an increase in assets result in a decrease in cash flow.
2. Transactions that show a decrease in assets result in an increase in cash flow.

3. Transactions that show an increase in liabilities result in an increase in cash flow.
4. Transactions that show a decrease in liabilities result in a decrease in cash flow.

But if you'd like to get a clearer idea of how it all works, this quick example should help.

- **Creating a cash flow statement from your income statement and balance sheet**

Let's say we're creating a cash flow statement Stand for July 2019.

Our income statement looks like this:

Anand Store's

Income Statement

For the Month Ending July 31, 2019

Sales Revenue	Rs. 10,000
Cost of Goods Sold (COGS)	Rs. 3,000
Gross Profit	Rs. 7,000
General Expenses	Rs. 3,000
Rent	Rs. 2,500
Depreciation	Rs. 500
Utilities	Rs. 500
Operating Earnings (EBIT)	Rs. 4,000
Net Profit	**Rs. 3500**

- **And our balance sheet looks like this:**

Anand Store's

Balance Sheet

As of July 31, 2019

ASSETS	
Cash in Bank Accounts	Rs. 6,000
Accounts Receivable	Rs. 4,000
Equipment	Rs. 5,000
Accumulated Depreciation	Rs. 500
Raw materials	Rs. 1,000
Total assets	Rs. 15,500
LIABILITIES	
Accounts payable	Rs. 5,500
Total liabilities	Rs. 5,500
OWNER'S EQUITY	
Retained earnings	Rs. 10,000
Total equity	Rs. 10,000

Remember the four rules for converting information from an income statement to a cash flow statement? Let's use them to create our cash flow statement.

Anand Store's

Cash Flow Statement

For the Month Ending July 31, 2019

Cash, Beginning of Period	Rs. 5,500
Cash Flow from Operating Activities	
Net Income	Rs. 3,500
Additions to Cash	
Depreciation	Rs. 500
Increase in Accounts Payable	Rs. 5,500
Subtractions from Cash	
Increase in Accounts Receivable	(Rs. 4,000)
Net cash from Operating Activities	Rs. 5,500
Cash Flow from Investing Activities	
Purchase of Equipment	(Rs. 5,000)
Cash Flow from Financing Activities	
n/a	
Cash Flow for Month Ending Juy 31 , 2019	Rs. 500
Cash, End of Period	Rs. 6,000

Our net income for the month on the income statement is Rs.3,500 that stays the same, since it's a total amount, not a specific account.

Additions to Cash

Depreciation is included in expenses for the month, but it didn't actually impact cash, so we add that back to cash.

Accounts payable increased by Rs.5,500. That's a liability on the balance sheet, but the cash wasn't actually paid out for those expenses, so we add them back to cash as well.

Decreases to Cash

Accounts receivable increased by Rs.4,000. That's an asset recorded on the balance sheet, but we didn't actually receive the cash, so we remove it from cash on hand.

Our net cash flow from operating activities adds up to Rs.5,500.

Cash Flow from Investing Activities

Anand purchased Rs.5,000 of equipment during this accounting period, so he spent Rs.5,000 of cash on investing activities.

Cash Flow from Financing Activities

Anand didn't invest any additional money in the business, take out a new loan, or make cash payments towards any existing debt during this accounting period, so there are no cash flows from financing activities.

Cash Flow for Month Ending July 31, 2019 is Rs.500, once we crunch all the numbers. Anand started the accounting period with Rs.5,500 in cash. After accounting for all of the additions and subtractions to cash, he has Rs.6,000 at the end of the period.

Cash flow statements are powerful financial reports, so long as they're used in tandem with income statements and balance sheets. See how all three financial statements work together.

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