

Reading a Cash Flow Statement

A cash flow statement, or a statement of cash flows, is one of the key financial statements for a business, along with the income statement and balance sheet. It shows the inflow and outflow of cash in a business during a specific period of time. Understanding how to read and interpret a cash flow statement is crucial for small business owners, as it provides insights into a company's liquidity and overall financial health.

Here is a detailed guide on how to read a cash flow statement:

1. Understand the Three Sections of a Cash Flow Statement

A typical cash flow statement is divided into three sections:

Operating Activities: This section reflects the cash flow from the primary activities of a business, such as receiving cash from customers or paying cash to suppliers and employees. It starts with net income and then adjustments are made for non-cash items (like depreciation) and changes in working capital (like changes in receivables, payables, inventory etc.).

Investing Activities: This section reports the cash flow from the purchase and sale of assets, such as property and equipment (also referred to as capital expenditures), as well as cash flow from investments like acquisition or disposal of businesses or investment securities.

Financing Activities: This section shows the cash flow from all financing activities, such as issuing or repaying debt and equity and paying out dividends.

2. Reading the Cash Flow From Operating Activities

Start with the net income, then add or subtract the following items:

Depreciation and Amortization: These are non-cash expenses that are added back to net income because they don't represent actual cash outflows.

Changes in Working Capital: Increases in assets like accounts receivable or inventory are subtracted from net income, while decreases are added back (and vice versa for liabilities). This is because an increase in assets represents a use of cash, while an increase in liabilities represents a source of cash.

Other Adjustments: There may be other adjustments made to reconcile net income to the cash provided by (or used in) operating activities. These might include deferred tax, gains or losses on the sale of assets, and non-cash expenses like stock-based compensation.

The resulting number represents the cash generated or used in operating activities. Ideally, you want this number to be positive and growing over time, as it indicates that the company's core business operations are generating cash.

3. Reading the Cash Flow From Investing Activities

This section can include a wide range of activities, but the most common are:

Purchases of Property and Equipment (Capital Expenditures): These are typically large purchases that represent an investment in the business. They are listed as a cash outflow.

Sales of Property and Equipment: These represent a cash inflow.

Purchases or Sales of Investments: These can be either a cash inflow or outflow, depending on whether the company is buying or selling investments.

The total cash flow from investing activities can be either positive or negative, depending on the company's strategy. It's important to understand the details of this section to know where the company is investing its cash.

4. Reading the Cash Flow From Financing Activities

Key elements in this section include:

Debt Issued (Borrowings) or Debt Repayment: When a company borrows money, it's a source of cash (positive). When it repays debt, it's a use of cash (negative).

Equity Issued or Repurchased: If the company issues stock, it's a source of cash. If it repurchases its own stock, it's a use of cash.

Dividends Paid: When a company pays dividends to shareholders, it's a use of cash.

Just like with investing activities, the financing activities section can also be either a net source or a net use of cash. It largely depends on the company's financing strategy.

5. Net Increase or Decrease in Cash

After going through the cash flows from operating, investing, and financing activities, you'll come to the "Net Increase/Decrease in Cash and Cash Equivalents" line. This line item represents the total change in the company's cash position over the reporting period.

6. Beginning and Ending Cash

Finally, the cash flow statement will list the beginning and ending cash balances. The ending cash balance is computed by adding the net change in cash to the beginning cash balance.

Understanding the Cash Flow Statement

The cash flow statement provides key insights into the liquidity of a business and its ability to generate cash. Here's what to look for:

Positive Cash Flow from Operating Activities: This is typically a good sign as it indicates the business is generating enough cash from its core operations to sustain itself.

Sustainable Capital Expenditures: Look at cash spent on investment activities. If a company consistently spends more cash on investments than it generates from its operations, it might have to borrow or issue equity to finance these investments, which could be a warning sign.

Borrowing and Repaying Debt: If a company is borrowing money, it's not necessarily a bad sign. It could be using the debt for growth. However, consistently increasing debt levels can be a red flag.

Dividend Payments: If a business pays dividends, it suggests that it is generating enough cash to return some of it to the shareholders.

Remember, one statement doesn't provide the complete picture. It's important to look at trends over multiple periods and compare the cash flow statement with the income statement and balance sheet to get a comprehensive financial health view of the business.

Also, every business is unique, so what works for one small business might not work for another. Therefore, it's essential to understand the context in which the business operates.

Idea Sheets provide quick and actionable suggestions to drive more referrals and sales. Visit www.referralsafe.com/asktra frequently for new additions.