3.00 How to prepare a CASH FLOW Statement AKA BUDGET, and why having one is critical

Step one in creating wealth is to measure your starting point by preparing two documents:

- A Cash Flow Statement, often called a Budget
- A Personal Financial Statement

This Handout 3.00 discusses the Cash Flow Statement.
Handout 4.00 discusses the Personal Financial Statement.

1. What is a Cash Flow Statement (CFS)?

A cash flow statement lists all the cash that flows into a household and all that flows out over a given period.

2. What is the recommended "Period" and why?

A CFS should always be prepared on an ANNUAL basis because many items only occur once a year, and it is easy to forget if the CFS is done monthly.

This means that all items must be "annualized," so if you receive something weekly, it must be multiplied by 52; if you pay something monthly, it must be multiplied by 12, etc.

3. What is the purpose of the Cash Flow Statement?

The primary purpose is to determine if the household will be cash-positive or cash-negative at the end of the period.

- If the household is cash-negative, increasing credit card debt is the primary method to close the gap. This creates a decrease in net worth.
- If the household is cash-positive, there are opportunities to strategically invest the excess to get closer to personal goals and increase net worth/

Additionally, a household may want to identify:

- What percentage does each person contribute towards cash inflow and outflow? *This is particularly important in case of a divorce.*
- How much does a cash source contribute towards the total cash inflow, measured as a percent?
- How much does each expense contribute towards total outflow measured as a percent?

4. What stops individuals from preparing a Cash Flow Statement?

In my years of teaching, I have been surprised by clients' resistance to preparing a cash flow statement. It is not that they don't think it is valuable, but instead, they are scared to commit their financial situation to writing, almost as though by putting it on paper, the situation becomes more real.

When I challenge people to do the exercise, my typical response is, "Well, I have it more-or-less in my head." But what we have in our mind is often our intuition, which can differ from the facts. Preparing the Cash Flow Statement helps us move away from intuition and gather factual data. Then, we can use those facts to make changes if we choose.

If you are stuck in that fearful place, remember that measurement is NOT a judgment.

A client forwarded me the below quote, which I believe sums it up:

> Unfortunately, we often avoid measuring because we fear what the numbers will tell us about ourselves. The trick is to realize that measuring is **not a judgment** about who you are; it's just feedback on where you are.
>
> Measure to discover, to find out, to understand. Measure to get to know yourself better. Measure to see if you're spending time on the things that are important to you. Measure because it will help you focus on the things that matter and ignore those that don't.

SOURCE: James Clear – on Focus https://jamesclear.com/focus.

5. **Steps to preparing a Cash Flow Statement (CFS).**

- **A CFS must be done in writing –** it cannot be in your head.

- **Use a budget form as guidance, and if possible, prepare with Excel**

It is best to use a form that lists typical household cash sources and uses them as it reminds people of items they might have overlooked.

Form 3.01 has been developed from the Divorce Court system, whereby the Court needs to assess a household's finances. It has over 90 categories and is a helpful first step as it will jog your memory about typical expenses.

- **Start with a rough estimate of the prior year.**

The CFS statement should be made for the first time using rough estimates; the run-through should take at most 20 minutes. It is suggested that the CFS be prepared based on the PRIOR full year, i.e., if it is 2024, prepare the CFS for 2023. This allows you to verify if your projections were accurate.

- **Refine the estimate using bank and credit card statements and tax returns.**
    - Download all bank and credit card transactions into an Excel file,
    - Assign a category number or name to each transaction,
    - Sort and total by category.
    - Enter the total on the spreadsheet.

This technique is time-consuming but gives the most accurate measurement and helps get records in shape for tax filing.

- ## Forecast for the current year

It is time to forecast forward after you have an accurate picture of the prior year.

Interestingly, most people's outflows do not change significantly from year to year. The significant changes tend to be on cash inflows, for example, if a person loses their job or changes employment. If you do this exercise on an annual basis, it will become easier.

6. What are common CFS categories?

While form 3.01 lists over 90 categories, on an ongoing basis, it is more practical to consolidate so that there are no more than 25 categories. Here are some typical groupings:

Cash Sources

1. W-2 earnings
2. Interest and Dividends on Investments
3. 401K or IRA Distributions (NOT GROWTH IN THE ACCOUNT)
4. Rental Property Income
5. Business Related Income
6. One-time events
   - *Sale of Assets*
   - *Insurance proceeds*
   - *Gifts or "loans from family and friends."*
   - *Inheritance*

Cash Uses

7. **Housing with Maintenance Costs** –rent, mortgage, real estate taxes, utilities, cable/internet, phone landlines, maintenance interior and exterior, housekeeping, and housing insurance policies.
8. **Food at home** includes sundry cleaning & household items, drugs (can include restaurants, but it is best to list meals eaten outside of the home as discretionary)
9. **Transportation** -public transportation, car payments, car insurance, tolls, car maintenance.
10. **Discretionary** - clothing, entertainment, cell phone, sports, gifts, vacations, restaurants, subscriptions, charitable contributions.
11. **Children or other Dependents** - childcare, education, children's clothing, school lunch, trips, books, sports programs, camps.
12. **Medical costs,** including medical insurance premiums, drugs, and doctor/hospital copay.
13. **Insurance** - other than housing and medical – i.e., life insurance, umbrella policies)
14. **Taxes** - withholding, estimated, paid at the time of filing

15. **Debt Repayment** would cover payments towards prior year balances and interest payments. Current year expenses should be listed in the proper category.
16. **Savings**, including contributions to retirement plans
17. **One-time expenses –** special non-recurring events, significant capital improvements, downpayments for major asset purchases (i.e. house)
18. **Business-related expenses or professional fees,** including legal and accounting assistance.

7. What are typical challenges that occur in preparing a CFS?

Salaried employees should report their GROSS INCOME as the cash inflow and then enter the deductions for taxes, medical insurance, retirement plan contributions, and any other deductions as a cash outflow. It is important not to list only the net income because you should know the cost of each deduction.

Households with more than one person should separate the cash inflow and outflow per person – that is one of the reasons Form 3.01 has two columns. Both parties must see the big picture and understand the consequences if one person loses their income.

Business Owners should decide how they want to account for business income and expenses. One method is to use the same form but enter business-related items in a separate column. This is particularly helpful for start-ups with minimal income but several expenses. A separate column makes it easier to calculate the net effect of starting the business. Established businesses might keep their records separate and only record the cash the owner can take from the company on the owner's CFS.

8. How does a Cash Flow Statement differ from a Personal Financial Statement?

As stated above, a Cash Flow Statement measures cash movement in and out of a household over time. A personal financial statement is done at a point in time, often December 31st. It lists everything you have that can be turned into cash (ASSET) and everything you owe as of that moment (LIABILITY). The difference between the two is your Net Worth. For Example:

	Cash Flow Statement	Personal Financial Statement
Rent – if your rent is $1,000 monthly and by 12/31 all rent was paid	$12,000 cash outflow rent	No entry
Rent – if your rent is $1,000 monthly and on12/31 you owed two months' rent.	$12,000 cash outflow rent	$2,000 as a LIABILITY - accounts payable

Savings Account – if you earned $500 in interest income during the year and on 12/31 had a balance of $5,500	$ 500 cash source interest income	$5,500 as an ASSET - cash savings account
Retirement Account if you were contributing $100 per week to your 401K, and your employer matched it with $50 weekly, and at the end of the year the account value including prior year contributions was $22,000	$ 5200 cash outflow – retirement savings *The employer's contribution would NOT be listed as it is not coming from household funds*	$22,000 as an ASSET – Retirement Account. *It is accepted practice to include the total value of the account including an employer's match.*

9. How does the CFS tie into the Personal Financial Statement?

If a person has a negative cash flow, their Net Worth will decrease in the coming period. Americans typically bridge the gap by increasing credit card debt (liabilities), depleting savings, or selling assets.

If a person has a positive cash flow, their Net Worth will increase in the coming period. This usually shows up as an increase in Assets, whether a savings, investment, or retirement account.

10. What happens in retirement with a CFS?

In retirement, the most significant change is that a person's work income disappears as a Cash Source, and often, it is partially replaced by receipt of social security and drawing on savings.

This will result in a decrease in Net Worth. However, if this is anticipated and planned, a person can have a comfortable, worry-free retirement.

REFERENCE
FORM 3.01 Budget - Cash Flow Statement