What is a Cash Flow Statement (CFS)?

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- It is one of the two key financial documents you need to assess your financial situation (the other document is a Personal Financial Statement)
- Measures all the cash that enters your household (inflow) and all the cash that leaves it (outflow) over a specific period.
- Is often referred to as a budget. However, the term “budget” is frequently associated with “cutting back” and has a negative connotation. As we wish to remove judgment from the analysis, the term Cash Flow is more appropriate.

What is the purpose of a Cash Flow Statement (CFS)?

- **Purpose:** The primary goal of preparing a CFS is to determine if your household will be "cash-positive" (more money coming in than going out) or "cash-negative" (more money going out than coming in) at the end of the designated period.
- **Impact on Net Worth:**
  - If your household is cash-negative, you need to find a way to bridge the gap. Generally, individuals deplete their savings account or increase their credit card debt to cover the shortfall, both of which decrease the person’s net worth.
  - If your household is cash-positive, it presents opportunities to strategically invest the excess funds, helping you work towards personal goals and increase your net worth.
- **Recommended Period:**
  - A CFS should always be prepared **annually**. Looking at the total year is crucial because many income items or expenses occur only once a year, and it's easy to overlook them if the statement is prepared monthly.
  - This means all items must be "annualized"—for example, weekly income multiplied by 52 or monthly payments multiplied by 12.

Why People Resist Preparing a CFS

It's common for individuals to resist preparing a cash flow statement, often out of fear.

- **Addressing Fears:** People hesitate to commit their financial situation to writing because it makes the situation feel "more real," and they fear facing the facts.
- **Intuition vs. Facts:** The common thought is, "Well, I have it more or less in my head". However, what we hold in our minds is often based on intuition, which can differ significantly from the actual facts. Preparing a CFS helps you move away

from intuition and gather factual data, which can then be used to make informed decisions and implement changes.
- **Measurement is Feedback, Not Judgment:** As James Clear states, "The trick is to realize that measuring is not a judgment about who you are; it's just feedback on where you are." Measuring helps you discover, understand, and get to know yourself better financially. It enables you to focus on what truly matters and disregard what doesn't.

What are the Steps to Preparing a Cash Flow Statement?

Preparing a CFS requires writing it down; it cannot simply remain "in your head."

Step 1: Start with a Rough Estimate of the Prior Year.

- **Tip:** Use Form 3.01 for guidance. The form lists over 90 categories developed from the Divorce Court system, which can help you recall typical expenses you might overlook.
- Eliminate any categories that do not apply to you. Try to narrow down the list to 25-35 categories, consolidating items to suit your household.
- Enter a rough estimate of your cash inflow and outflow **for the prior year**. This initial run-through should take no more than 20 minutes. This allows you to verify the accuracy of your projections later.

Step 2: Refine the Estimate Using Bank and Credit Card Statements and Tax Returns.

- This step provides the most accurate measurement. Download all bank and credit card transactions into an Excel file.
- Assign a category number or name to each transaction.
- Sort and subtotal transactions by category.
- Enter the category subtotals into your adjusted 3.01 form spreadsheet. Taking the time to code each transaction will be a significant help to organize your records for tax filing.

Step 3: Forecast for the Current Year.

- Once you have an accurate picture of the prior year's cash flow, it's time to forecast the current year's cash flow.
- Interestingly, most people's outflows don't change significantly year to year. The most significant changes often occur in cash inflows, such as those resulting from job loss or changes in employment.
- **Tip:** Doing this exercise annually will make it progressively easier over time.

What are Common Cash Flow Statement Categories?

While Form 3.01 has over 90 cash inflow or outflow categories, for ongoing practical use, it's better to consolidate them to 25-35 categories. Below are suggestions.

Cash Sources

1. W-2 earnings
2. Interest and Dividends on Investments
3. 401K or IRA Distributions (Note: NOT growth in the account itself)
4. Rental Property Income
5. Business Related Income
6. One-time events: i.e., Sale of Assets, Insurance proceeds, Gifts or "loans from family and friends," and an Inheritance

Cash Uses

7. **Housing with Maintenance Costs**: Rent, mortgage, real estate taxes, utilities, cable/internet, phone landlines, interior and exterior maintenance, housekeeping, housing insurance policies.
8. **Food and Sundry essentials used at home:** Includes sundry cleaning and household items, as well as drugs (can include restaurant meals, but best to list meals eaten outside as discretionary).
9. **Transportation:** Public transportation, car payments, car insurance, tolls, and 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. Include Child Care garnishments from wages.
12. **Medical costs:** Medical insurance premiums, prescription drugs, and copays for doctors and hospitals.
13. **Insurance (other than housing and medical):** Life insurance, umbrella policies.
14. **Taxes:** Withholding, estimated payments, and taxes paid at the time of filing.
15. **Debt Repayment:** Payments towards prior year balances and interest payments. (Current year expenses should be listed in their proper category.)
16. **Savings:** Contributions to retirement plans or taxable investment accounts.
17. **One-time expenses:** Special non-recurring events, significant capital improvements, down payments for major asset purchases (e.g., house).
18. **Business-related expenses or professional fees:** Including legal and accounting assistance.

What are the Common Challenges in Preparing a CFS?

Certain situations present unique challenges in preparing an accurate CFS.

- **Salaried Employees:** Report your **GROSS INCOME** as the cash inflow. Then, list deductions for taxes, medical insurance, retirement plan contributions, and any other deductions as separate cash outflows. It's important to know the cost of each deduction, which is why listing gross income is crucial.

- **Households with More Than One Person:** Use separate columns to track cash inflow and outflow per person, then add the two together to get a total. Form 3.01, for instance, has two columns for this reason. This helps both parties understand the complete financial picture and the consequences of any changes to one person's contribution.

- **Business Owners:** You need to decide how to account for business income and expenses.

    - **Method 1: Separate Column on Same Form:** Use the same CFS form, but enter business-related items in a separate column. This is particularly helpful for start-ups with minimal income but numerous expenses, as it simplifies the calculation of the business's net income effect..
    - **Method 2: Separate Records:** Established businesses may keep their records entirely separate, recording only the cash the owner takes from the company on the owner's cash flow statement (CFS).

What is the difference between a Cash Flow Statement and a Personal Financial Statement?

It's important to distinguish between a Cash Flow Statement and a Personal Financial Statement (PFS).

- **Cash Flow Statement (CFS):** Measures cash movement **in and out of a household over time**.
- **Personal Financial Statement (PFS):** Is a snapshot done **at a specific point in time** (e.g., December 31st). It lists everything you own that can be converted to cash (ASSETS) and everything you owe (LIABILITIES). The difference between your assets and liabilities is your **Net Worth**. (Handout 4.00 discusses the Personal Financial Statement in detail.)

Here's an illustrative table highlighting the differences:

Category	Cash Flow Statement	Personal Financial Statement
Rent If your rent is $1,000 monthly, and by 12/31, all rent was paid:	**On the CFS under Cash Outflow for Rent $12,000**	**On the PFS, there would be no entry.** **.**
Rent If your rent is $1,000 per month, and on 12/31, you owed two months' rent.	**On the CFS** **under cash outflow,** **enter Rent = $12,000**	**On the PFS** **under Liabilities** **enter Accounts Payable, $2,000**
Savings Account If you earned $500 in interest income during the year and had a balance of $5,500 in your savings account as of 12/31.	**On the CFS** **under cash inflow,** **enter Interest Income = $500**	**On the PFS** **under Assets** **enter Cash Savings = $5,500**
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:	**On the CFS** **under cash outflow,** **enter Retirement savings = $5,200** (The employer's contribution would NOT be listed as it is not coming from household funds)	**On the PRS** **under Assets** **enter Retirement Account = $22,000** (It is accepted practice to include the total value of the account, including an employer's match.)

How does the Cash Flow Statement Tie into the Personal Financial Statement?

The CFS directly impacts your PFS and, consequently, your Net Worth.

- If you have a **negative cash flow**, your Net Worth will likely decrease in the coming period. This typically happens by depleting savings, selling assets, or increasing credit card debt (liabilities).

- If you have a **positive cash flow**, your Net Worth will increase in the coming period. This usually appears as an increase in assets, such as savings, investments, or retirement accounts.

What Happens in Retirement with a CFS?

In retirement, a person's Cash Flow Statement undergoes a significant transformation.

- The primary change is the disappearance of work income as a source of cash. This is often partially replaced by social security payments and drawing on savings.
- This shift generally results in a decrease in Net Worth. However, if this change is anticipated and planned for, individuals can enjoy a comfortable and worry-free retirement.

Conclusion & Key Takeaways

Preparing a cash flow statement may seem daunting at first, but it is an incredibly valuable exercise for understanding and managing your finances.

- **Measure to Understand:** Remember, measurement is feedback, not judgment. It provides you with factual insights into your financial habits, allowing you to move beyond intuition.
- **Empowerment:** By understanding your cash flow, you gain the power to make informed decisions, identify areas for improvement, and strategically work towards your financial goals.
- **Proactive Planning:** Regularly reviewing your CFS allows for proactive adjustments, helping you avoid negative cash flow situations and build wealth over time.

Supporting Resources

- **FORM 3.01 Cash Flow Statement:** This comprehensive form is an excellent tool to guide you through detailing your household's cash inflows and outflows.
- **Handout 4.00 Personal Financial Statement (PFS):** To learn how to prepare the other critical document - a PFS - refer to this handout, which explains assets, liabilities, and net worth.
- **James Clear on Focus:** The valuable perspective on measurement as feedback, not judgment, is inspired by James Clear's insights on focus. (You can find more of his work at https://jamesclear.com/focus).