Cash flow is the lifeblood of every business. Having too little of it hampers your ability to pay your suppliers or employees on time, and having too much indicates that you could afford making an investment in extra inventory, additional machinery, or a much-needed store renovation. In a previous article on here, we provided an introduction on monitoring monthly cash flow. Now, let’s build on that foundation by diving deeper into how to correctly perform a cash flow analysis in order to make more informed decisions on the operating, investing, and financing activities of your small business.

Preparing Your Cash Flow Statement

In order to perform a cash flow analysis, you’ll first need to prepare your cash flow statement. A cash flow statement allows you to track the amount of cash your business has coming in, and how much it has going out—or simply put, the amount of money you’ll have available—in a given period of time.

To save you time, we whipped up a ready-to-use cash flow analysis template on Excel that you can use (here). On line 29 of this spreadsheet, you’ll find a cash flow statement that looks like this:

29  Cash Flow Analysis
30 Net Profit (Loss)       $9,460.00
31 Plus Depreciation Expense $350.00
32 Cash from Operations    $9,810.00
33 Plus Initial Cash       $10,000.00
34 Less Principal Payment* $800.00
35 Cash After Princ. Payment $19,010.00
36 Plus Loan Advance**     -
37 Less Loan Payment***    -
38 Plus Misc. Cash Inflow**** -
39 Minus Misc. Cash Outflow -
40 Ending Cash Flow        $19,010.00

* Principal portion of term loan payment.
** Advance from line of credit to cover cash shortfall.
*** Repayment of loan in excess of needs.
**** Examples: sale of equipment, additional capital invested.
Examples: purchase of equipment, withdrawal from owner.

We will reference this example as we explain how to do a cash flow analysis.

Cash Flow Statement: What Should You Include?

The cash flow statement consists of three main sections: operating activities, investing activities and financing activities.

Lines 31-32: Cash Flows from Operating Activities

These are cash inflows and outflows directly related to your core business operations. In our initial budgeting model, we only added back depreciation to the net profit or loss from operations.

To properly keep track of cash on hand—and perform an accurate cash flow analysis—we would need to get more granular and account for changes in accounts payable, accounts receivable, inventory, and tax payment. Depending on the nature of your business, you may keep accounts receivable and payable from not only customers, but from suppliers as well.

Our cash flow analysis template assumed an all-cash business, so you would need to make the following adjustments related to operating activities. This process of reconciling net income with net cash flow from operating activities is known as the indirect method.

<table>
<thead>
<tr>
<th>Cash Inflows</th>
<th>Cash Outflows</th>
</tr>
</thead>
<tbody>
<tr>
<td>+ Depreciation</td>
<td>- Increase in Accounts Receivable</td>
</tr>
<tr>
<td>+ Decrease in Accounts Receivable</td>
<td>- Increase in Inventory</td>
</tr>
<tr>
<td>+ Decrease in Inventory</td>
<td>- Decrease in Accounts Payable</td>
</tr>
<tr>
<td>+ Increase in Accounts Payable</td>
<td>- Increase in Prepaid Expenses</td>
</tr>
<tr>
<td>+ Decrease in Prepaid Expenses</td>
<td>- Decrease in Taxes Payable</td>
</tr>
<tr>
<td>+ Increase in Taxes Payable</td>
<td></td>
</tr>
</tbody>
</table>

Depending on the unique situation of your small business, insert additional rows as needed between lines 31 and 32 to account for cash inflows or outflows from operating activities.

Lines 34-37: Cash Flows from Financing Activities

Financing activities affect your cash balance. When you raise capital, such as taking out a
term loan or withdrawing money from a line of working capital, you increase your available cash. On the other hand, when you pay back your lenders, you decrease your available cash.

Notice on line 34 that we only deduct the principal portion of term loan payment. This is due to the fact that an interest expense would already be included in your operating expenses. Lucky you! You won’t need to do any adjustments to your cash flow analysis template.

**Lines 38-39: Cash Flows from Investing Activities**

When you sell equipment that wears out or acquire real estate to expand retail space, your cash flow is affected. These are considered to be investing activities. Since there might not be any investing activities for a long time, our cash flow analysis template labels lines 38 and 39 as miscellaneous cash inflow and outflow, respectively. Additionally, we account for infusions or withdrawals of capital by the owner(s) in these lines.

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**How to Do a Cash Flow Analysis**

Now that you know the necessary steps to prepare a cash flow statement, let’s discuss strategies to improve your cash flow management, and interpret key numbers as well as their effects on your business decisions.

**Line 32: Cash Flow from Operations**

**Aim for a positive cash flow from operations.** Unless you’re the owner of a non-profit, your main business objective is to make a profit. As long as there is an intentional plan to increase accounts receivable or inventories, a few periods of low, or even negative, cash flow from operations isn’t necessarily a red flag.

Still, to be a sustainable venture, your business needs to maintain a positive cash flow from operations, and ideally increase this balance every quarter (or year at minimum). Too many
consecutive periods of negative cash flow from operations could spell trouble for your small business.

**Keep tabs on your accounts receivable.** If your accounts receivable keeps increasing period after period, make sure to have appropriate billing and collection procedures in place. Sales on credit may look fine on paper, but can create a major cash crunch when clients don’t pay on time or at all!

Monitor how long clients take to pay you back. Some commercial lenders allow you to use your accounts receivable under 60 to 90 days as collateral for asset-based lending. It’s important to have accurate records because lenders generally loans against 70% to 80% of eligible accounts receivable.

**Line 36: Loan Advance**

**Plan ahead for cash crunches.** If adding cash from operations (line 32) to initial cash (line 33) leads to a negative balance, it might be a sign to start thinking about securing some kind of loan to bridge those crunches. If you’re thinking that you could just come up with the difference by having a one-time sale, remember that the more that you discount your product or service, the more that you would have to sell to your client. Additionally, you most likely will need to purchase additional inventory prior to selling that inventory—and where’s that upfront money going to come from?

**Decide on an appropriate form of financing.** Budgeting for potential loan advances ahead of time allows you to estimate your target number when shopping around for financing. It also gets you ready to provide documentation—including cash flow and income statements—to those potential lenders. Depending on the reason why a loan advance is needed, you may opt for a working capital or term loan. For example, if you expect to cover the shortfall in just a few weeks, then you may be better served by a working capital loan. On the other hand, if you’re experiencing a shortfall due to needed renovation, temporary hiring, and inventory buildup to meet seasonal demand, then a term loan may be a more suitable option.

**Beware of maxing out loan advances too fast.** Securing a loan that is maxed out in just a few consecutive periods may be holding back the growth potential of your small business. If that’s the case, consider requesting an increase on your existing line of credit or refinancing your loan for one with a higher credit limit. The point isn’t that you will max out that new line of credit but instead that you will set a reserve in place in case of an emergency.
Line 37: Loan Payment

Develop a strong history of payment to lenders. Money talks. By having records that you can consistently pay back to your lenders, you’ll have ammunition to back up your request for a loan with a higher limit in the future. Set a target repayment period and stick to it as much as you can throughout the year.

Line 38: Miscellaneous Cash Inflow

Understand your local market. Whether you had an entire semester to sell an old frying machine or just one day to get rid of a forklift, keep a pulse on market trends for your business equipment. Having more accurate pricing estimates allows you to better negotiate the next time that you have to sell or barter business equipment.

Line 40: Ending Cash Flow

Surplus isn’t always the best. While it’s great to see a positive balance on your ending cash flow, having a balance that is aggressively growing, combined with a lack of investing activities (line 39), can be a sign that surplus in operations isn’t used to grow your small business. You need money to make money; so fuel your businesses with smart purchases of equipment or other assets when your cash flow allows you to comfortably do so.

Cash flow analysis empowers you to make necessary corrections and take proactive steps to maintain a sustainable operation. By adjusting your net income with key cash inflows and outflows, you get a clearer picture of how much cash is actually generated by core operations, a better sense of your financing needs, and a snapshot of the growth potential of your small business.