The Art of Financial Literacy: The Importance of Cash Flow

When it comes down to it, how many of us can accurately give a picture of our current financial status?

Most people will answer that question with a current bank balance, but using a current balance to gauge our present financial status is erroneous.

There are three general perspectives on finances: the past (looking at where you have been), the present (exploring where you are) and the future (planning for where you are heading). The only real reason that you would need to know your current balance or "where you are," is to figure out the other two perspectives.

You might say then, "Why is this important?" The simple answer is that since our current financial position reflects one point in time, we need to understand what "cash flow" is.

Cash Flow

Cash flow is the single most important part of any financial perspective. Think of it as a person's financial DNA. It reflects how each person's spending is unique. Cash flow can be both the easiest and the most complicated accounting and financial concept to understand. I know that may sound contradictory, but it's not really. Let's break it down further.

Simple cash flow could be explored through the process of getting a paycheck and paying your bills. Many people can do this very easily.

Where cash flow becomes complicated is when you add variables. For instance: you have a commission-based income and you are planning to retire in a couple of years or you are trying to minimize your tax liability over a period of time. Now the *present picture* determined by simple cash flow is intermingled with your *future* financial goals.

Given that cash flow is each person's unique financial DNA, it is essential in any financial-based discussion. For this reason it is important to be able to determine what your cash flow is.

How do we do that?

Determining Cash Flow

There are two general methods for determining cash flow.

Simple Formula:

Earned income over a period of time

(minus) **Expenses** over the same period of time

(equals) **Remaining cash / slush / emergency fund / maximum investment contributions**

Complex Formula:

Regular income over a period of time

(plus) **Average other income** over the same period of time

(minus) **Normal expenses** over the same period of time

(minus) **Unusual expenses** over the same period of time

(minus) **Savings/purchase plan contributions**

(minus) **Excess tax liability** not covered by withholding

(equals) **Remaining cash / slush / emergency fund / maximum investment contributions**

Take the Challenge

Now at this point you may be saying, "This all seems very simple".

Here is my challenge to you:

- First write down what you ***think*** your monthly expenses are.
- Then go to your bank account(s), take the ***actual*** sum of all of your expenses over a six month period of time.
- Once you have done that, *divide that sum by six*.

Most people will estimate their monthly expenses to be lower than their actual expenses. This is why actual cash flow is so important. Without knowing something "simple" like how much money we spend month to month, how can we reliably make financial decisions?

Know your bottom line - determination of your actual cash flow may inform your future planning.

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