Cash Flow Primer

Cash flow is an accounting term that is simply a monthly summary of income and expenses – usually done on an EXCEL spreadsheet. Both business and personal finances can be tracked with cash flow. This tool can be used to track the prior 12 months of income and expenses and to project 12-24 months into the future. Cash flow can (and should) be used to track both personal and business income and expenses and is required to obtain a loan. It helps reduce financial surprises!

Cash flow is more important than profit; businesses fail and individuals go bankrupt because they run out of cash and simply can't pay the bills. Cash flow is a budgeting tool that can be used to remind us of annual expenses and seasonal fluctuations in expenses. For example, taxes are due once a year; insurances twice a year. Income may be the same every month if you have a job. However, if you work on a commission or in a seasonal industry, like agriculture or tourism, your income may vary from month to month. The example below is my personal budget in a cash flow format showing the categories of income and expense that I update on a monthly basis.

Income	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sept	Oct	Nov	Dec
day trading												
salary												
book / conferences												
horses												
investments												
Total Inc												
Expenses												
car loan												
house loan												
credit card												
house insurance												
health insurance												
car insurance												
food and sundries												
eating out												
property tax												
Income tax												
utilities / phone												
Clothing												
horse / ranch												
legal/accounting												
Giving												
vacation/conferences												
Total exp												
Cash Flow (Inc - Exp)												

What is the Most Important Asset in Your Business?

Many business owners would respond with answers such as customers, our service, products, employees or stakeholders. These are all very important but what is it in your business that is like blood to the human body? What is the asset, just like your blood, that once it is gone, so is the business life?

The most vital and important asset in your business is CASH FLOW. My experience working with thousands of business owners for almost four decades is when the term cash flow is mentioned, like that of other 'financial terms,' many business owners turn or point to their accountant, CPA or bookkeeper as the one responsible and not themselves.

Working with and relying upon your accountant/CPA/bookkeeper is an asset; leaning too hard on one can be a flaw. Business owners have a tendency to rely heavily on their financial aids when it comes to tracking their company's critical numbers. As the owner of your business, you cannot afford to abdicate the responsibility for the financial health (cash flow) of your company to others, even though they have the education and training that is required to monitor the health and you might not. As the owner, the most important asset in the company – cash flow - rests ultimately with you and you alone. If you're someone who is a bit intimidated by accounting and all the jargon that goes with it, you are not alone. Stay with me - I wrote this guide with you in mind.

The simple truth is that you don't need an accounting degree, MBA or an in-depth understanding of double-entry accounting to know and understand cash flow and how this knowledge affects the health and risk management (intelligence) of your business and deserves your keen attention. I want to help you get over your fears, lack of knowledge and misunderstandings about cash flow.

As we get started, let's do a review of the basic financial documents that track the flow of money within your company. Most critical numbers live on these documents.

Balance Sheet: This is a cumulative document that lists your company's assets and liabilities, among other numbers, from the time your started your business. Reviewing your balance sheet gives you a quick handle on the financial strength and capabilities of your business.

Income Statement: Also known as the profit and loss statement, or P&L, or statement of operations, this document lists your company's income (revenues or sales), minus your company's expenses, and it shows you the profit or loss over a specific period of time.

Cash Flow Statement: A cash flow statement helps you stay on top of how much money came and went through the business for any period of time. This document is critical because it helps you understand why, even if your company appears to be turning a profit, you don't have much money in the bank. It points out the sum total or result of all the decisions you and your team made in the business for the time period of the statement.

For this discussion it is important to understand the term *net income* or *net profit*, also referred to as *net earnings*, current earnings or the bottom line. This number is critical in that it reveals how much money is left after *accounting* for business operations. The key word to recognize and acknowledge is *accounting*. **There is a difference between net income and cash flow** and business owners need to know, understand and be able to apply the differences in their decision making.

Net income is really an accounting term while cash flow is a very practical, common sense, where-the-rubber-hits-the-road business term. The key difference between profit and cash flow for business owners to know, understand, recognize and apply to their decision making is timing differences. Based on generally accepted accounting principles (GAAP), profit does not factor into timing differences.

What do I mean by timing differences and why are they important to a business owner and the running and managing of their business? Timing differences occur when you record income or an expense in accounting terms and when you actually receive or pay out cash. The key to running and managing your business (what keeps your business alive – like blood in your body) is CASH. So what are some examples of timing differences?

- You make a sale and record a receivable but receive the cash (collect on the receivable) 90 days after closing the sale. Income has been recorded, yet cash has not been received or banked.

- You purchase materials for a specific order on account, sell the product and record the expense but pay the account payable 45 days after the sale. You record an expense yet pay out the cash 45 days later.

- You purchase inventory as part of a “special” deal and pay for it COD at a much reduced price yet you sell the inventory over the next 36 months. You pay out cash immediately but receive cash back from the sale over 36 months.

Major timing differences and cash flow fluctuations occur around transactions involving: sales and the resultant accounts receivable collection from those sales, inventory purchases and payment on those purchases and accruals. Several other decisions you make that affect cash flow and need to be factored into your planning and thinking are investments in capital (fixed) assets and borrowing money.

Key to your business' success is your cash flow management philosophy or mindset. Cash is essential for achieving the profit potential of your business. A dollar held in the form of accounts receivable or inventory cannot be reinvested profitably until you convert it back into cash. Receivable and inventory are necessary parts of the cash flow cycle, but cash makes the cycle revolve. Your cash flow management effort should seek the most rapid conversion into cash of your receivables and inventory. It is important to know and apply the fact that neither a rising sales volume nor a profitable operation spontaneously produces a positive cash flow.

What do you use to help manage your business? What tools, from a financial point of view, besides your bank account, do you use to help make daily, weekly, monthly and annual decisions affecting the growth and viability of your business?

Many would say financial statements (balance sheet and income statement). How often do you have financial statements prepared? Do you receive them frequently enough so the material is relevant to helping you make business decisions now? What in the financial statements do you look at or use to guide you? Does your CPA, accountant, bookkeeper or internal accounting system give you a cash flow statement with the balance sheet and income statement?

Financial statements provide great value, if used properly. The primary fact about financial statements is they are *backward looking.* When driving your car, do you look through the rear view mirror the bulk of the time while trying to go forward? Certainly not! You look through the front windshield in order to drive forward. What tool do you have in your financial tool box to give you the ability to see down the road a good distance?

The tool to be used consistently = is cash flow projections! This tool is the only one to give you the forward visibility you need to know what is happening with your cash flow.

The foundational principle to your business is, after the fact that God is the real owner and you are just a steward of the business, CASH IS KING. If cash runs out everything you're working for is down the toilet. If the business is important – then CASH has got to be important.

Over the years I would ask business owners, "How do you use or why do you get financial statements and cash flow projections." They would always answer, "To give to my banker/lender." I hope that would not be your answer! With this article I hope to help you form a new mindset or philosophy about cash flow projections and their value to you as a business owner.

If I were to ask you the question, "What is your cash balance now?" Could you give me an answer? Or how about if I were to ask, "What will your cash balance be six months from now?" The key to answering both of these extremely important questions is: do you have the mechanism, things, tools, systems, processes in place to give yourself the answers?

What do I mean by that? First, are you keeping the books current and accurate? Second, do you have cash flow projections that go out at least six months and are you adjusting them monthly by adding in actual numbers to the template and keeping a rolling projection, adjusting for what has just happened in your business, industry, local and national economy?

These forward-rolling, monthly-adjusted cash flow projections allow you the best visibility you can possibly have for your business. They allow you *to act* rather than *react* to factors and opportunities in your business.

What do you have or use to head off potential disasters in your business? What do you have or use to adequately gauge if you have the cash flow or wherewithal to take advantage of potential opportunities?

Cash flow projections are like an early warning system for your business. The US government spends billions annually on early warning systems of varying kinds – to protect citizens' borders, electrical power, water supplies, airways, and waterways, to name a few. What early warning system for cash flow – your most vital asset of your business – do you have and use consistently?

In your business, there are vital signs that must be monitored daily - the primary one being cash flow. Look at cash flow projections that are updated and adjusted monthly and viewed almost daily as taking the heart rate and blood pressure of your business. Physically checking someone's heart rate and blood pressure will give much different and more accurate information than just asking them if they are okay or how are they doing.

As humans we are all capable of irrational behavior, thinking or actions from time to time. One force or pull that might cause irrational actions and thinking is:

> <u>Loss aversion</u> – ones tendency to go to great lengths to avoid possible losses. In early 2009, several business owners/borrowers I had loans to and who had in 2007 and early 2008 hundreds of thousands of dollars in liquidity in their businesses thought their cash flow was safe even if there was a dip in

their industry, the local, regional or national economies. In late 2007 and all during 2008 these business owners experienced a severe drop off in sales, not just a dip. They exhausted **all** liquidity or cash reserves thinking, hoping, expecting, praying that things would get better. Though they were highly seasoned veterans of 30 plus years in their industry and businesses, they didn't believe in or practice the use of cash flow projections and adjusting these projections monthly as they experienced new and difference realities in their business and industry. Each sheepishly admitted, "I just knew the economy would improve or turn around tomorrow or I'd get a contract so I wouldn't have to face you." As humans we associate with the pain of a potential loss more vividly than we do with the joy of experiencing a gain. The key is understanding how our aversion to loss plays out in our decision making. Pre-occupied with resuming a schedule or recovering losses, we blindly focus on getting back to even and become oblivious to the risks we take. We ignore signs, put on blinders and proceed with a singular purpose to recover as much of the loss as possible – many times risking everything. I believe that these business owners might have averted most of their losses had they properly been projecting their cash flow.

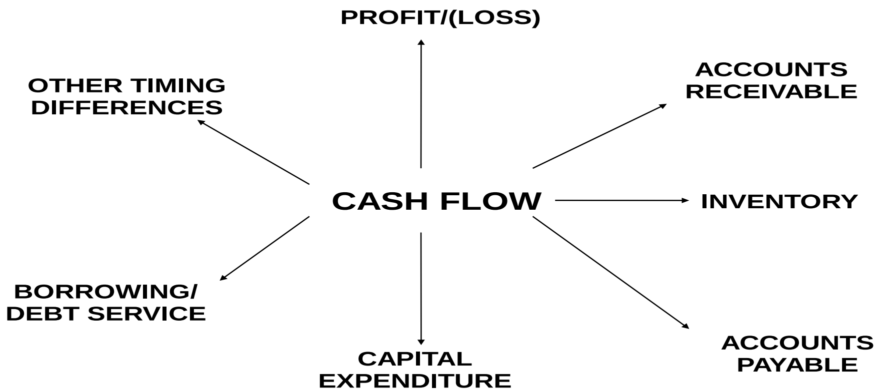
Benefits of establishing the habit and discipline of cash flow management via projections and updating the projections monthly with actual history are:

- Gives you forward visibility
- Gives you the ability to act rather than react to circumstances that you encounter
- Daily use and review provides the vital signs of health of your business rather than just assuming it is healthy
- Gives you greater insights into your business you might not have known or seen
- Provides an early warning system for potential problems
- Increases profitability
- Reduces the stress of managing the day to day affairs of your business
- Gives you greater control, confidence and therefore peace of mind
- You know the true cash position of your business at all times
- Gives you the opportunity to concentrate on other areas
- Reduces the chance of failure
- Enhance the perception lenders will have of you
- Improves your return on investment (ROI)
- Frees you to be alert for opportunities to expand
- Creates greater value and increases wealth of your business

Cash can come from three major sources for your business:

- From the operations of the business (sale of goods or services)
- Borrowing money or equity from the owners
- Sale of assets (asset conversion)

Like a private investigator you need to analyze what impacts or changes in your cash position you must make to get and maintain control of your cash,



Two basic principles of cash flow management are:

- Keep money moving to make more money; money at rest (tied up in accounts receivable, inventory and capital expenditures that aren't producing something) incurs opportunity costs.

- Money makes the most money when it turns over fast; this is the principle of turnover.

Key to understanding and applying these principles is the ***cash conversion cycle***. Here's the basic story: a business firm starts out with cash. That cash is used to purchase inventory. Next, the inventory is sold or a professional service is delivered. Usually the business gets little or no cash at the time of sale because the buyer typically acquires the goods or service on credit. The seller exchanges inventory or professional activity for accounts receivable. Sometime in the future, hopefully sooner rather than later, the firm collects the accounts receivable and then has cash again.

Inventory and receivables must be financed (paid for) either with the business' own cash on hand or by borrowed money, which can be costly. The object is to reduce the cycle – shorten the time, as much as you can, between paying out cash and getting cash back. Use and evaluation of the cycle answers the question, "How long does it take to get the money back into the bank?"

A visual explanation of the cash conversion cycle looks like this:

	Days outstanding	**Amount outstanding**
Receivables	30 days sales	$100,000
Inventory	60 days sales	200,000
Trading cycle	90 days	$300,000
Acct's payable	15 days sales	50,000
Cash cycle	75 days	$250,000

The cash conversion cycle can simply and easily be used by setting up an excel spread sheet like the following. Using this tool the business owner can see and understand the average length of time of the business' operating cycle, determine what the cycle, time wise, would be if the business did a more efficient job of reducing the collection period of their receivables or shorten the time inventory was in the warehouse – thus freeing up cash. Many times business owners see their businesses growing and know they are making money but are always short of cash. This tool helps show them were their cash is hiding. I use this tool frequently to help determine the gap (short fall) in a business' working capital and as a guide to the amount of a possible revolving line of credit.

	2007	**2008**	**2009**	**2010**
Sales per day	1,043	1,038	965	1,370
Working Capital on hand	32,636	31,022	47,859	60,000
Days Sales in Receivable	45	48	57	63
Days Sales in Inventory	116	96	118	64
Days in Trading Cycle	161	144	175	127
Days Sales in Payable	29	36	40	47
Days Sales of Working Capital required	132	108	135	80
Working Capital in Days on hand	31	30	50	44
Excess or (Deficit) in days	-101	-78	-85	-36
Surplus or (Deficit) in Dollars	-105,040	-81,082	-82,416	-49,600

The most valuable tool to use for your cash flow management is a cash flow projection template similar to the partial one below:

	Pre-Startup EST	Jan-10	Feb-10	Mar-10	Apr-10	May-10
Cash on Hand (beginning of month)		0	0	0	0	0
CASH RECEIPTS						
Cash Sales						
Collections fm CR accounts						
Loan/ other cash inj.						
TOTAL CASH RECEIPTS	0	0	0	0	0	0
Total Cash Available (before cash out)	0	0	0	0	0	0
CASH PAID OUT						
Purchases (merchandise)						
Purchases (specify)						
Purchases (specify)						
Gross wages (exact withdrawal)						
Payroll expenses (taxes, etc.)						
Outside services						
Supplies (office & oper.)						
Repairs & maintenance						
Advertising						
Car, delivery & travel						
Accounting & legal						
Rent						
Telephone						
Utilities						
Insurance						
Taxes (real estate, etc.)						
Interest						
Other expenses (specify)						
Other (specify)						
Other (specify)						
Miscellaneous						
SUBTOTAL	0	0	0	0	0	0
Loan principal payment						
Capital purchase (specify)						
Other startup costs						
Reserve and/or Escrow						
Owners' Withdrawal						
TOTAL CASH PAID OUT	0	0	0	0	0	0
Cash Position (end of month)	0	0	0	0	0	0

I believe it is important to make cash flow projections an active, live tool that is used daily to aid in making business decisions. The template should be updated and adjusted no less than monthly to have good visibility of the future.

My friend and author, Philip Campbell, has written an easy to understand book, "Never Run Out of Cash" explaining 10 cash flow rules you can't afford to ignore. Through his website www.neverrunoutofcash.com you can get his book and he also has a very good cash flow projection template (a little more detailed than the one above) that he offers for free. Follow this link to Philip's site where he also provides an excellent one hour web video on cash flow that explains how to effectively use the template and offers tips on cash flow intelligence.
www.neverrunoutofcash.com/cashflowintro.htm

Another aspect of cash flow management that many business owners fail to consider or include in their tools is personal cash flow projections and management. It has been my experience that when personal cash flow is out of sorts the business' cash flow is already showing signs of stress or soon will. Business cash flow and the personal cash flow of the owner go hand in hand. Discipline of following both is a must. The same cash flow template that is used for the business can easily be used for personal use with minor modifications.

Like mentioned above, getting your personal finances and cash flow in line goes along with that of the business. I believe from God's perspective, this is stewardship. For many the word stewardship brings up visions of church budgets and building campaigns. Stewardship comes from a Greek word, is an economic term and is, in fact, the origin of our word *economy*, which has to do with household economy.

Leadership boils down to stewardship – taking initiative and responsibility for all God has entrusted you to care for. Leadership, for the business owner, from a Biblical perspective is not about a position of authority or having a commanding personality or presence or getting one's way. According to God, leadership is more about choices you make. It's about believing what He says and taking action on those principles to bring about results His way.

As Kingdom citizens, faithful stewards (business owners/kings) of God's businesses, go first, take the lead, in being the steward of God's business to bring about a good return.

In the parable of the Minas (Luke 19: 11-27), a nobleman, representing Christ, distributes, prior to leaving the country, to each of his servants a mina (money of about three months salary) and instructs each servant to "do business until I come" back. In this parable, God is demonstrating His desire for each of us to be involved in His business but also to be fruitful, to bring about a good return.

God wants you to be fruitful in the business in which you steward for Him. When you follow His word and seek His understanding and wisdom you will have a much greater chance of being fruitful and experiencing an abundant life. I know that cash flow projections (proper planning, counting the cost, keeping track of what belongs to others, and being forward looking) are part of God's way of doing business.

May your Cash Flow!

Note:

This article was written by Larry Tyler. You can read his interview here. If you need help with cash flow, Larry or your accountant can make it happen.