Cash is King - How to Stick Handle Cash and Win the Game

Cash Flow for the Business Owner

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A "Success:Failure" Publication of Scott and Associates for Potential New Business Owners

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CHAPTER 1 WHO WE ARE

Scott and Associates is a consulting group comprised primarily of W. Stewart Scott as the owner and Senior Consultant, and W James (Jim) Dixon, as Senior Associate Consultant. We also have a group of ancillary associates with expertise in varying subject areas that we can draw upon when required to provide the best service to our clients. The group works closely as a team to ensure that our clients receive the best possible expertise available.

We are a full service consulting group providing consultation in a number of areas, but are known for our approach to business start-ups and assisting owners through those very important initial steps. Over the years, we have developed a specialty in providing consulting services to Aboriginal entrepreneurs and are approved consultants for SaskMétis Economic Development Corporation and its Métis Assistance Program, and the Clarence Campeau Development Fund.

We are also approved consultants for the Farm Business Development Initiative through the Government of Saskatchewan.

Biographies of our Senior Consultants are appended below.

W. Stewart Scott B.A., B.Ed., M.Phil.

Stewart has an extensive and successful background in Corporate Management, Entrepreneurial Business, Franchising, and in Economic Development.

His 45+ years of professional experience and consulting assignments include Teaching, Bank Management, Senior Management (C.O.O and C.E.O) positions in Retail and Manufacturing, Franchise Operations and Franchisee Relations, Financial Planning, Business Consulting and owning his own start-up companies.

Easy to talk to and with a sense of humour, he is adept at understanding a business start-up and the issues his clients are dealing with.

His financial background enhances his ability to translate operations into financial statements.

In our commitment to ongoing education, Stewart is currently completing his Certified Business Consultant (CBC) designation through the Business Consulting Group, an 18,500 worldwide member program recognized in over 80 countries.

W. James Dixon B.G.S., M.B.A., Ec.D (Fellow)

Jim is a results-oriented business professional with 20+ years of experience in business ownership and management in both independent and franchised operations.

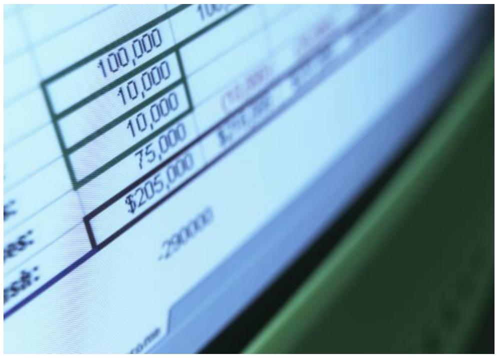
He has a strong understanding of business start-up and preparing and analysing financial statements. He has an extensive background in Entrepreneurial, Business and Economic Development.

With a passion for life-long learning, and open to challenges, Jim recently achieved his Executive MBA (Management Consulting) at Royal Roads University.

In our commitment to ongoing education, Jim is currently completing his Certified Management Consultant (CMC) designation through the Canadian Association of Management Consultants, and his Project Management Professional (PMP) certification.

CHAPTER 2

INTRODUCTION



So, you are writing your business plan and as part of your financial plan you have to ***complete a first year, month by month, cash flow analysis.***

Cash Flow analysis? Didn't I already do a profit / Loss Statement (aka Income Statement) and it looks as though I can make money?

So, what's the difference between the two? How does Cash Flow differ from my Budget?

Kelly Costello started her business Puppy Cake and in 2007 took it to the hit TV show "Shark Tank". The sharks didn't offer her a deal because they felt she needed more sales experience and more products, which she's working to rectify, but neither of those issues are what Costello says she wished she knew before embarking on this business venture. Her comment, "I wish I knew how to manage cash flow".

The following flip book will answer these questions and show how 90% of start-up (and existing businesses) fail because of cash flow management (or to be correct, mismanagement).

This is one of our Success: Failure series of e-books in flip page format, addressing various topics of concern to new business owners, or those interested in starting their own business and are doing their due diligence for their business and financing plan.

It will also be of value to existing business operators who want to develop a better understanding of cash flow management. Remember, just because you have been in business a few years doesn’t mean you understand everything you are doing, or not doing!

It is our intention that, through these quick treatises, you, as a new business owner, can avoid some of the standard pitfalls that jeopardize so many neophyte ventures.

Cash Flow Management is critical to all businesses, but particularly to new businesses just starting up.

This book is not a definitive treatise on cash flow management, but will provide you with a guide to keep your cash flow in line and perhaps save you a lot of grief and many sleepless nights worrying about your cash flow, or lack thereof.

Some years ago, when I was Vice President for the Canadian Operation of a US based Franchise System, I was having a conversation with a member of the board of Directors on the Canadian Start up, and the topic inevitably turned to cash flow.

I casually mentioned that cash flow management was like hockey. Cash was the puck. You only had one puck and your job was to get it to the goal without someone else taking it away.

That’s our intent in this book. How to make sure you stay in control of the puck, and don’t get blindsided by the other player taking away your puck. In other words, how to control your cash flow and the game.

CHAPTER 3 BUDGET VS CASH FLOW?

I was teaching a course at one of our community colleges a number of years ago, and as part of my introduction I asked the students the following question "How many of you know the difference between a budget and cash flow?"

There was silence until one young fellow said "Aren't they the same?" An older student piped up from the back of the class, "You would know the difference if you've ever had to run a business!"

The more experienced student had obviously seen the damage that cash flow can do if improperly handled.

So, let's look at this basic difference, and see how they do differ.

BUDGET

Everyone is familiar with a budget. That's where you decide on how much money you have coming in each month and where it should be spent. The banks are always asking you to do a budget. Financial planners recommend that you have a budget. Even the so called financial "experts" on TV refer to your budget.

What they don't tell you is that a budget is only your best guess as to what is going to or will happen and can be changed to suit various circumstances. The budget you prepared yesterday is no use if your income is reduced by 50% by ill health or a change in job circumstances.

In business, you forecast how much income you have coming in and how much you need for your fixed costs and how much you need for your variable costs. (Best guess).

Actually, these are only estimates and will change all the time. That's why it's important to compare budgets with actuals in order to develop more accurate projections down the road.

On a simpler basis let's look at a standard family budget that we can all understand. The Jones's are a normal family with 2 children (not 2.1)

Jones Family Monthly Budget		
Net Income		
Father	$ 2,500.00	
Mother	$ 1,250.00	
Total Net Income		$ 3,750.00
Expenses		
Mortgage	$ 1,250.00	
Taxes	$ 200.00	
Food	$ 575.00	
Gas/Oil	$ 250.00	
Clothing	$ 100.00	
Cosmetics	$ 50.00	
Newspapers / Books	$ 50.00	
Telephone	$ 45.00	
Cable/Satellite	$ 145.00	
Cel Phones	$ 100.00	
Utilities	$ 366.00	
Vacations	$ 400.00	
Gifts	$ 50.00	
Savings	$ 169.00	
Total Expenses		$ 3,750.00
Net Funds Available		$ -

First of all, we'll not quibble about where this family spends its money. We'll also not quibble about using Net family Income instead of gross and including items such as CPP, EI, Income

Taxes, company pension etc. as expenses (the proper way to do it).

Looking at the budget, it appears that the family has adequate income on a monthly basis to cover all of its expenses. A budget though, is just a budget or an estimate. There are some basic fixed expenses such as the mortgage, taxes, utilities (If on an equal payment plan), but most are variable. That is, they fluctuate with use. For example, the cost of gas and oil will fluctuate with the mileage driven and the price of gas.

Discretionary expenses are those that we choose to spend money on that are not necessary (at least from a fiscal perspective). Discretionary expenses such as cosmetics, clothing, vacations, gifts etc. are areas that can be manipulated, and unfortunately, can be where most abuse happens.

Think about how we budget for gifts. That $50 a month or $600 for the year can soon be eaten up with birthday gifts and then Christmas rolls around and Whoops, the budget is blown, but we put it on our credit cards.

Note that there is no budget for credit cards.

CASH FLOW

A budget is how you are going to allocate your income. Unfortunately, we don't actually set aside the $50 a month for gifts and when we need to buy birthday or Christmas gifts we have to take it out of that month's income or put it on our credit cards. That is Cash Flow.

The same thing happens with business. We prepare a budget (Statement of Income and Expenses) that shows we bring in a certain amount of income and incur a certain amount of expense with the balance remaining as our profit. Unfortunately, this doesn't show us the **TIMING** of income received and the **TIMING** of our expenses, and sometimes this is where we get into trouble.

Many business owners, when developing a monthly budget for themselves or their bank, often start out by deciding on an annual sales volume they believe they can attain in the year. They then allocate yearly expenses they feel are appropriate and list them against the income. The difference they believe, is their profit. We'll show you later that this is not necessarily the case.

For their monthly budget, they divide the annual figures equally by twelve. This is really an attempt at a budget, but we need to go further than this. When you actually receive the income and spend the expenses is really your cash flow, or flow of cash in and cash out.

For example, it is rare for any business to have equal sales per month. There are usually peaks and valleys of sales and expenses. Even a small business has to account for seasonal variations. The pizza industry traditionally has a slow sales periods in the summer. Retail businesses may peak at Christmas. Candy stores may peak between Valentine's Day and Easter. Your annual insurance premium may become due during one of your sales valleys. Your fixed costs are always there (rent, basic staffing etc) even during the valleys. We will look at how these affect your cash flow later.

CHAPTER 4 CASH FLOW – TIMING

PLAN YOUR CASH FLOW

In a business plan, you will prepare a monthly cash flow projection for at least the first year. This will warn you as to cash flow peaks and those times when you have less cash coming in than you need to pay out.

Projections will provide you with warnings as to when you need to arrange for additional cash or to reduce expenses. Many larger companies have fallen victim to the lack of cash flow projections. They are profitable, but fail to plan for the large quarterly expense that is required without matching it up with additional income generation.

The projections need to accommodate the slower times of the year when you still have certain fixed costs (rent, staff etc), but have less income being generated. Operating lines of credit become important at this time to help manage cash flow pressures. Availability of credit when needed is an important aspect of cash flow management.

BOOK BALANCE VS BANK BALANCE

Another basic mistake that many new business owners fail to recognize is the difference between your book balance and your bank balance.

In the early years of franchising, I remember a new franchisee who fancied himself as a businessman, got into serious cash flow difficulties as a result of forgetting (or not knowing) this fundamental concept.

The franchisor had negotiated 30 days payment terms with suppliers and the franchisee was able to deposit all of his cash sales into his bank account with only having to pay for fixed expenses such as rent, staffing etc.

When he checked his bank balance, he believed that the extra $50,000 in there was profit and proceeded to take a vacation to Las Vegas. Needless to say, he came back a week later and the $50,000 was no longer there.

Let's forget about the fact that a new business owner took a week's vacation leaving only a manager in charge of his operation, and concentrate on where he went wrong from a cash flow perspective.

If he had a bookkeeper keep a daily tab on his invoices coming in, on an accrual basis, he would have known that he didn't really have an extra $50,000 available. His "book balance" would have taken into account the cost of product that he still hadn't paid for, whereas his bank balance would show the additional income from his sales.

BOOKKEEPER

Many new business owners try to be "all things to all people", performing many of the tasks required in running the business themselves. To let go of certain tasks is not easy and many new owners feel that they can't afford to hire accomplished people to allow the owners to do what they do best. (Sales, administration, operations, or wherever their talents lie.)

An important lesson can be taken from the owner who was trying to do all the ordering, merchandising, floor mopping, and bookkeeping when first open. Well, all the key things got done, to keep the store stocked and presentable to generate needed sales, except the monthly invoicing and preparation of financial statements. Three month later, hiring a bookkeeper to spend a day a month doing all the required posting and statement preparation seemed like a great idea! His banker liked that too!

We strongly recommend that if you, as owner, do not have the time or expertise, then hire a bookkeeper to manage your books on a regular basis, and make sure they provide financial reports to you in a timely fashion.

Many of today's sophisticated franchise systems have POS (Point of Sales) systems that feed into the electronic accounting system and tell both the franchisee and franchisor exactly where they are in a real time basis. As a result, the work required by a bookkeeper is less and the cost is correspondingly lower.

Even if you are a small one person start up, review your skills and hire appropriate help in areas that you are weak. Invest in an accounting system such as QuickBooks or Simply Accounting. These software programs are becoming more user friendly, have an inexpensive basic system, and in many cases require only a rudimentary knowledge, if at all, of accounting. If you are concerned, then **as part of your due diligence**, take a basic course on the software you have chosen. You can't afford not to.

However, make sure you regularly review your financial statements and monitor your cash flow against your projections.

ACCOUNTS PAYABLE

As a business owner, when you purchase a product for resale or for use in your business, you have a certain time in which to pay for it.

If you pay for it right away, say for office supplies, you have no payables. However, if you charge those supplies to your credit card, it becomes a payable that is paid when you receive your statement. (Hopefully).

If you set up terms with your suppliers, your invoice becomes a payable when you receive it (in an accrual based accounting system). Your Accounts Payable is increased by this amount and is reduced only when you make the payment. Until you make the payment, you owe this money.

This can sometimes work in your favour, if you receive payment from your client **before** you have to pay for the invoice.

However, many businesses will not extend credit to a new business, because they have lost income when a new business goes "out of business" leaving them with a debt that they can't or are unable to collect. In this case the supplier has a DWO or a debt written off.

If a supplier sees that you are slow in paying (often known as "leaning on the trade"), they may cut off your credit and your credit rating may be impacted making it more expensive, or impossible to get additional credit. Additionally, if not paid on time your supplier if he has still extended you credit, will charge you interest on past due accounts.

ACCOUNTS RECEIVABLE

In the same way that our franchisee earlier got into trouble by not watching his Accounts Payable, one significant area contributing to negative cash flow is failing to take into account receivables.

Basically, receivables represent that cash that you have not received even though you have performed the service or made the product sale. This is usually because you have extended terms to your clients as a normal course of business.

In retail, you make a sale and you get paid right away through cash, cheque, debit card or credit card. You have no receivables.

However, in many businesses it is the norm to extend certain payment terms to a client. These may be 10 days, 15 days, or 30 days, which means that you do not receive payment until that time period has passed.

In addition, many of your clients may send you a cheque on the due date, but you don't receive it until several days later. Now you don't get paid for 15, 20, or 35 days after you have provided the product or service.

Some of your clients may have their own terms and pay you only within their internal payment cycles which can stretch you out sometimes to 60 days or longer. Large companies and certain government institutions often follow this approach.

You have to decide whether the (presumably) large sales generated by these companies are worth the fact that you may not get paid for greater than 60 days, before you accept the business.

IMPACT OF RECEIVABLES ON CASH FLOW

Although this is usually reviewed in larger companies, it can, depending on your type of business, have a significant impact on a small business.

Let's look at the following example.

The business is an excavating company that provides excavating services (trenching, basement excavations etc) to both residential and commercial developers.

The company currently has five contracts with major developers all of whom dictate their own terms. The contract prices are lucrative and the owner is prepared to accept the longer receivable terms. His bookkeeper invoices the developers once a month at the end of the month.

Company	Terms	Monthly Contract $
Developer A	30 days	$15,000
Developer B	35 days	$17,500
Developer C	15 days	$10,000
Developer D	45 days	$25,000
Developer E	75 days	$20,000
Total		**$87,500**

The above table shows the value in $ of the monthly contracts and the terms accorded to each client.

Let's look at how the income is received from Developer A.

	May	June
Developer A		
Invoiced	$ 15,000.00	
Cash Received		$ 15,000.00

Work is performed in early May and the bookkeeper invoices the Developer at the end of the month as is her (his) usual procedure. Payment is received 30 days later which is now June 30th.

The business owner has had to pay labour, fuel, administration etc for 60 days without receiving payment.

If we now look at all of the Developers to see how the cash flow changes we see the following:

	May	June	July	August
Developer A				
Invoiced	$ 15,000.00			
Cash Received		**$ 15,000.00**		
Developer B				
Invoiced	$ 17,500.00			
Cash Received			**$ 17,500.00**	
Developer C				
Invoiced	$ 10,000.00			
Cash Received		**$ 10,000.00**		
Developer D				
Invoiced	$ 25,000.00			
Cash Received			**$ 25,000.00**	
Developer E				
Invoiced	$ 20,000.00			
Cash Received				**$ 20,000.00**
Totals	$ 87,500.00	$ 25,000.00	$ 42,500.00	$ 20,000.00
		29%	49%	23%

In May, the bookkeeper invoices $87,500 for work performed during the month of May. In June $25,000 is received according to the terms, or 29% of the outstanding bills. In July, a further

$42,500 is received, or 49% of the original billing, and in July, the balance of $20,000 is received or 23%[1] of the original billing.

Therefore, by the end of August, all outstanding receivables from May are paid.

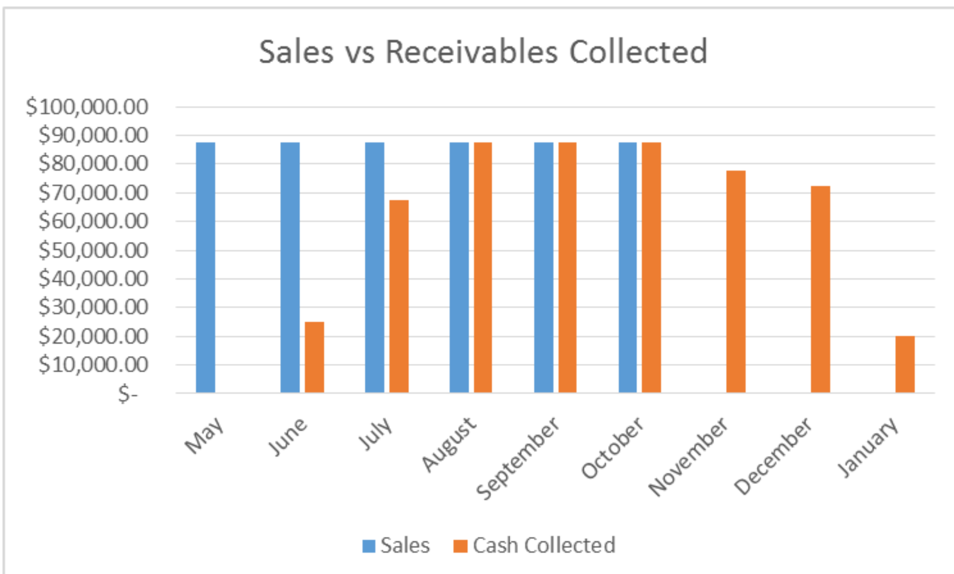
In June, the bookkeeper again invoices the developers and a similar result is found. If we look at the next five months, we see that it takes that long before the company is receiving the full amount of billings as cash flow before it ceases its seasonal workflow.

	May		June		July		August	
Developer A	**Invoiced**	**Collected**	**Invoiced**	**Collected**	**Invoiced**	**Collected**	**Invoiced**	**Collected**
Invoiced	$ 15,000.00		$ 15,000.00		$ 15,000.00		$ 15,000.00	
Cash Received				**$ 15,000.00**		$ 15,000.00		$ 15,000.00
Developer B								
Invoiced	$ 17,500.00		$ 17,500.00		$ 17,500.00		$ 17,500.00	
Cash Received						**$ 17,500.00**		$ 17,500.00
Developer C								
Invoiced	$ 10,000.00		$ 10,000.00		$ 10,000.00		$ 10,000.00	
Cash Received				**$ 10,000.00**		$ 10,000.00		$ 10,000.00
Developer D								
Invoiced	$ 25,000.00		$ 25,000.00		$ 25,000.00		$ 25,000.00	
Cash Received						**$ 25,000.00**		$ 25,000.00
Developer E								
Invoiced	$ 20,000.00		$ 20,000.00		$ 20,000.00		$ 20,000.00	
Cash Received								**$ 20,000.00**
Totals	**$ 87,500.00**	**$ -**	**$ 87,500.00**	**$ 25,000.00**	**$ 87,500.00**	**$ 67,500.00**	**$ 87,500.00**	**$ 87,500.00**
				29%		77%		100%

If we look further, we see that the company does not do any further work in the winter months and the last billing is in October. Receivables from previous month's billings continue to be received until January of the next year. If the company's year-end is December 31st, it would have to show an outstanding receivables figure on its balance sheet of $20,000

[1] Difference due to rounding

September		October		November		December		January		TOTALS	
Invoiced	Collected	Invoiced	Collected	Invoiced	Collected	Invoiced	Collected	Invoiced	Collected	Invoiced	Collected
$15,000.00	$15,000.00	$15,000.00	$ 15,000.00	$ -	$15,000.00	$ -		$ -		$ 90,000.00	$ 90,000.00
$17,500.00	$17,500.00	$17,500.00	$ 17,500.00	$ -	$17,500.00	$ -	$17,500.00	$ -		$ 105,000.00	$ 105,000.00
$10,000.00	$10,000.00	$10,000.00	$ 10,000.00	$ -		$ -	$10,000.00	$ -		$ 60,000.00	$ 60,000.00
$25,000.00	$25,000.00	$25,000.00	$ 25,000.00	$ -	$25,000.00	$ -	$25,000.00	$ -		$ 150,000.00	$ 150,000.00
$20,000.00	$20,000.00	$20,000.00	$ 20,000.00	$ -	$20,000.00	$ -	$20,000.00	$ -	$20,000.00	$ 120,000.00	$ 120,000.00
$87,500.00	**$87,500.00**	**$87,500.00**	**$ 87,500.00**	**$ -**	**$77,500.00**	**$ -**	**$72,500.00**	**$ -**	**$20,000.00**	**$ 525,000.00**	**$ 525,000.00**
	100%		100%		89%		83%		23%		100%



However, from a cash flow perspective, it continues to receive payments for three months after it ceases work for the year.

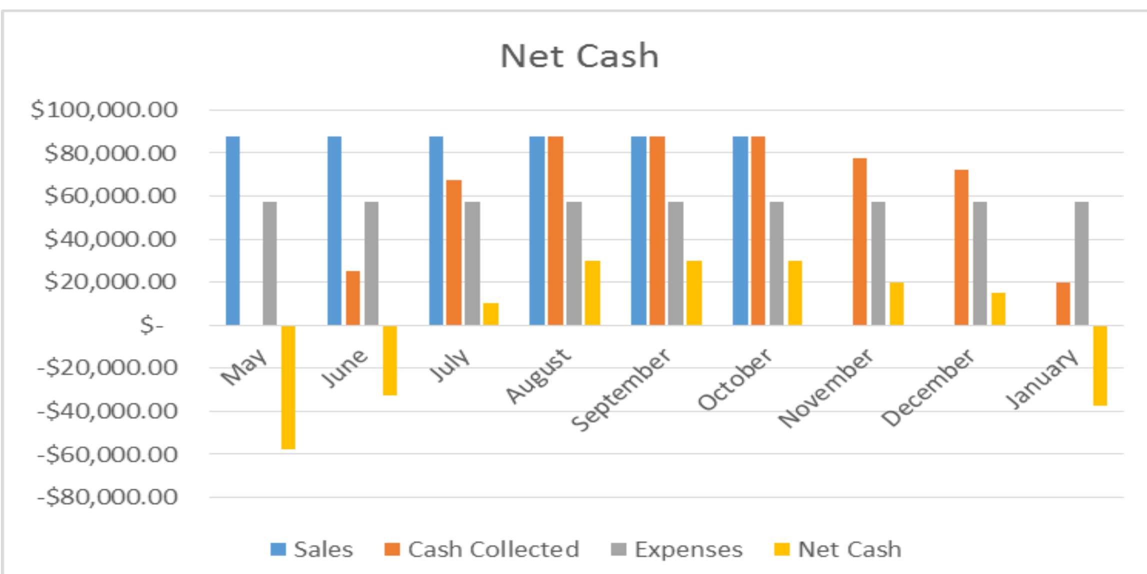
IMPACT OF EXPENSES ON CASH FLOW

In the real world, this company would also have expenses relating to the operation of its business. If we assume that the company requires $57,500 in cash a month for its expenses, then the net monthly cash flow (Cash Collected – Cash Expenses) is shown in Table x below.

	May	June	July	August	September	October	November	December	January	Totals
Sales	$ 87,500.00	$ 87,500.00	$ 87,500.00	$ 87,500.00	$ 87,500.00	$87,500.00				$525,000.00
Cash Collected	$ -	$ 25,000.00	$ 67,500.00	$ 87,500.00	$ 87,500.00	$87,500.00	$77,500.00	$72,500.00	$20,000.00	$525,000.00
Expenses	$ 57,500.00	$ 57,500.00	$ 57,500.00	$ 57,500.00	$ 57,500.00	$57,500.00	$57,500.00	$57,500.00	$57,500.00	$517,500.00
Net Cash	-$ 57,500.00	-$ 32,500.00	$ 10,000.00	$ 30,000.00	$ 30,000.00	$30,000.00	$20,000.00	$15,000.00	-$37,500.00	$ 7,500.00

The net cash flow position where there is a monthly negative cash flow can easily be seen in the figure below. May, June, and January show negative values which require a cash injection from somewhere.

If this company were an ongoing operation, it would have receivables from prior to May to cover the early negative cash



flows. However, if this were a new business, additional Cash would be required at start up (called Working Capital) to cover the early cash losses. The company would have to inject at least $57,500 in working capital on start up to break even.

This exercise shows the benefit of a cash flow projection. The company shows a net <u>positive</u> cash flow over the full year period of $7,500; however, without reviewing the projections and injecting the initial working capital it would never have got off the ground.

A complete year forecast would have to be done since even if the company resumed operation in February, it would have the same receivables lag before cash flow was again 100% of sales.

The company would have several decisions to make which we will review later in how to deal with cash flow.

THE INCOME STATEMENT AND CASH FLOW

Your bank and most people reviewing your financial statements often look at your balance sheet and your Income Statement without taking into account your cash flow.

For example, if we look at a standard Income Statement we see something like the figure below:

The restaurant had a net operating income of $36,346 on $1,035,000 in sales. After Tax Income is shown as $31,622. However, this does not show the true cash situation of the restaurant for the year. There are two variables that need to be reviewed.

<u>Debt Service</u>

Although the interest component of the company's debt is included in the expenses, the Principle portion is always paid out of profits, and financial institutions need to know that there is sufficient cash available to repay that portion of its loans.

Depreciation and Amortization

Depreciation is a $ figure that represents an annual approximation as to the reduction in value of the assets over their useful life. Rather than expensing the total cost of equipment (and leaseholds in this case) in the first year, GAAP allows us to apportion a percentage of the initial value plus any additions over the life of the equipment or leaseholds. Capital costs are classified under certain categories and a fixed percentage of the value is allowed to be added to the operating expenses each year until the residual value is $0.[2]

[2] You are allowed only half of the calculated depreciation in the first year of acquisition. This is known as the half year rule. The proportion of allowance can either be taken as a straight line percentage of the original cost, or a fixed percentage on the declining balance.

Sample Restaurant - Full Service			
PROJECTED STATEMENT OF INCOME AND RETAINED EARNINGS for the year ending December 31st 2015			
REVENUE		**2015**	**%**
Sales - Food	$	785,000.00	75.85%
Sales - Liquor	$	250,000.00	24.15%
TOTAL REVENUE	$	1,035,000.00	100.00%
Cost of Goods Sold			
Beer, Wine & Liquor	$	87,879.84	8.49%
Food	$	282,367.78	27.28%
TOTAL COST OF GOODS SOLD	$	370,247.62	35.77%
GROSS MARGIN	$	664,752.38	64.23%
EXPENSES			
Accounting & Business Support	$	9,076.87	0.88%
Advertising	$	16,263.71	1.57%
Bank Charges & Credit Card Charges	$	14,490.00	1.40%
Insurance	$	3,820.20	0.37%
Interest Expense	$	32,443.00	3.13%
Office Supplies	$	4,991.52	0.48%
Restaurant Supplies	$	7,868.72	0.76%
Rent-Basic	$	98,000.00	9.47%
Rent-Additional	$	26,804.64	2.59%
Repair & Maintenance	$	10,729.37	1.04%
Taxes (Business or Property)	$	-	
Telephone	$	4,943.32	0.48%
Utilities	$	25,875.00	2.50%
Vehicle Expense & Travel	$	2,938.67	0.28%
Wages & Benefits (employees)	$	237,325.50	22.93%
Management (Owner's) Wage	$	65,000.00	6.28%
Depreciation	$	67,835.00	6.55%
TOTAL EXPENSES	$	628,405.52	60.72%
NET OPERATING INCOME	$	36,346.86	3.51%
INCOME TAX (13%)	$	4,725.09	0.46%
NET INCOME AFTER TAX	**$**	**31,621.77**	**3.06%**
OPENING: RETAINED EARNINGS	$	127,875.00	
ADD: NET INCOME	$	31,621.77	
CLOSING: RETAINED EARNINGS	$	159,496.77	

These two factors impact the actual cash available from the operation as follows:

Since Depreciation is a Non-Cash item, (It didn't cost any cash during this period) it must be added back to the after tax operating cash flow.

Since the debt (P) must be serviced from the operation, it must be deducted from the cash flow.

Net Cash Flow Analysis		
NET INCOME AFTER TAX	**$**	**31,621.77**
Add back Depreciation	$	67,835.00
Less Debt Service (P)	$	56,793.00
Net Cash Flow	**$**	**42,663.77**

As can be seen in the table above, if we perform the above calculations, our cash flow changes from $31,621 to $42,664, a 35% increase in available cash.

Owners should always make sure they review this analysis for their operation. I remember an owner whose Income Statement showed a loss each year, but didn't believe it because he always had money left in the bank at the end of the year. He believed his accountant wasn't telling him the truth and fired him.

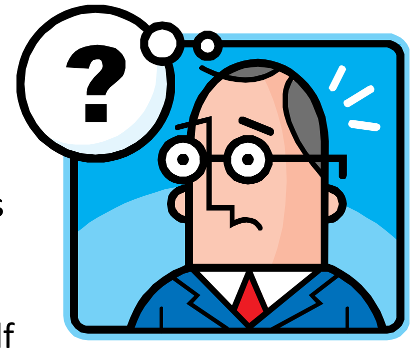
What else can we take away from this discussion?

PROFITS ARE NOT CASH!

Profits Don't Equal Cash!

CHAPTER 5 PLAN YOUR CASH FLOW

GUESSWORK



Smart cash flow management starts with financial projections. They're an early warning system that helps you anticipate cash flow peaks and valleys for the coming year.

By doing projections, you give yourself plenty of time to plan the best ways to handle cash flow dips. These might include seeking additional financing, changing the timing of discretionary outlays, cutting expenses, ensuring an adequate cash reserve, or asking suppliers and bankers for some breathing room. It helps ensure you are on good terms with your banker.

Your projections also allow you to create a performance dashboard, letting you see how you're doing throughout the year by comparing your projections against actual income and outlays.

COMPARE CASH FLOW TO PROJECTIONS

Good companies prepare an annual cash flow projection for the next fiscal year. Exceptional companies compare the actual cash flow with the projections on a regular basis. Ideally, you should compare cash flow projections at least monthly, and at each quarter re-evaluate the next quarter cash flows and re calculate if needed.

It also gives you the chance to see what areas are having the most impact on your cash flow and to make any adjustments to your operations to combat these issues. Your cash flow statements are fluid documents that change regularly.

STEPS TO MAKING FINANCIAL PROJECTIONS

This is as important in an ongoing operation as it is in a start-up venture and is indispensable in your business plan.

In any business plan we prepare, we produce the following at a minimum:

1. First Year Monthly Cash Flow analysis
2. Three Year Statement of Income and Retained Earnings
3. Three Year balance Sheet
4. Three Year Annual Statement of Net Cash Flows
5. Three to Five Year Historic Financial Statement Analysis (Income Statement and Balance Sheet as available)

In some cases, a five year financial plan may be required. Today it is very easy to create or access cash flow templates free that will make it much easier to get started. Examples of great resources are JaxWorks (http://www.jaxworks.com/) – a little more in depth, Squareone (\http://www.squareonesask.ca/core-services) and Vertex42.com (http://www.vertex42.com/about.html). Your own personalized financial planning documents are then easier to create.

So, how does one go about starting to put together the financial projections often called the Financial Plan?

PLAN THE UPCOMING YEAR

Start Up Expenses	
Capital Equipment	
Oven	$ 5,000.00
W/I Freezer	$ 6,500.00
W/I Refrigerator	$ 4,500.00
Triple Sink	$ 1,500.00
Computer	$ 1,000.00
Cash Register	$ 2,500.00
Smallwares	$ 2,000.00
GST	$ 1,150.00
Total Capital Expenses	$ 24,150.00
Other	
Opening Inventory	$ 4,500.00
Legal and Accounting	$ 2,500.00
Business Plan	$ 3,500.00
Advertising	
Brochures	$ 350.00
Newspaper	$ 250.00
Radio	$ 1,500.00
Flyers	$ 1,000.00
Promotion	$ 2,500.00
Insurance	$ 5,000.00
Office Supplies	$ 750.00
Rent	$ 2,000.00
Total Other	$ 23,850.00
Total Start up Costs	$ 48,000.00

It is important to ascertain what you want to accomplish over the next twelve months. Write down any large capital expenditures you will need during that time. If this is a start-up such as a retail operation, you will have costs for equipment and leasehold improvements minus negotiated tenant improvements (TI[3]). This often forms the basis of your term loan request to the lenders, and should be as accurate as possible.

Also list all expenses that you may incur before opening your business (that is, before generating any income).

This plan will form the basis for your business plan or your strategic plan.

Hint:

Make your equipment list and cost it out at one or two suppliers through quotes. Specific quotes carry more weight with the lenders than your best guess. Use the quotes as support for your request for term

[3] See the Leasing Guide for New Businesses available in this series.

financing. Attach the quotes to your business plan in your Appendices.

Sources of Cash	
Own Cash Equity	$ 16,000.00
Bank Financing	$ 17,000.00
Other Financing (Family)	$ 15,000.00
Total Cash Available	$ 48,000.00

Next list your sources of financing. Where are you going to get the funds you need for the start up. Your own investment (called Owner's Equity) plus potential family or bank financing.

MAKE YOUR PROJECTIONS

The simplest way to make your projections is to use an Excel spreadsheet. There are many samples available online at no charge or at a reasonable cost. These templates should be changed to make sure they represent your specific business. Your accounting software may also have the ability to prepare projections.

If you are an ongoing business, then you have an operational history to draw upon. If you are a start-up, you have to make the best judgment you can on these financials. For general guidelines you may want to review industry benchmarks specific to your business sector that are available through StatsCanada. A word of caution as these figures may not be entirely appropriate to your situation.

Be as realistic as you can. It is natural to want to show a rosy picture for our new business, after all it is our idea and something we believe in. However, sometimes a guess can totally skew your projections and potentially sabotage your fledgling business.

One of the major complaints from lenders regarding business plans is that sales or revenue is often overstated which leads to inaccurate cash flow scenarios. We used to prepare three scenarios (Optimistic, Realistic, or Pessimistic) but now just prepare a well-documented realistic set of projections that tend to be a little on the conservative side. You may, however, want to prepare the three scenarios as part of your "What if" analyses.

You should look at preparing three documents:

1. First Year Monthly Cash Flow projections that show all sources of cash input and all anticipated purchases.
2. Projected Income Statement – sometimes called a Profit and Loss Statement
3. A projected balance sheet

Your business plan should include an additional two years of Income Statements and Balance Sheets if you are looking for financing.

FIRST YEAR MONTHLY CASH FLOW FORECAST

Make sure you focus on only cash items.

Depreciation, as we discussed earlier, is a non cash item and therefore should **NOT** be included in your cash flow forecast.

The figure below shows a sample opening cash flow for a proposed restaurant. It outlines in light green the cash input from owner's equity ($16,000) plus two loans ($17,000 and $15,000) being made by family that need to be repaid for a total cash inflow of $48,000. (See Start Up Expenses above).

REVENUE:	OPENING
Food Sales	
Wine and Liquor Sales	
TOTAL REVENUE	
CASH INFLOW	
Cash From Revenues	
Receivables	
Equity	$ 16,000
Loan 1	$ 17,000
Loan 2	$ 15,000
Loan 3	$ -
TOTAL CASH INFLOW	$ 48,000
CASH OUTFLOW	
Capital Assets Purchases	$ -
vehicle	$ -
equipment	$ 23,000
GST	$ 1,150
Cost of Goods Sold Food Sales	$ -
Wine & Liquor Sales	$ -
Food and Wine Opening Inventory	$ 4,500
Accounting & Business Support	$ 2,500
Advertising	$ 5,600
Bank Charges & Credit Card Charges	$ -
Business Plan	$ 3,500
Loan Fee & Life Insurance	$ -
Insurance	$ 5,000
Interest Expense	$ -
Term Debt (principal only)	$ -
Office Supplies	$ 750
Rent	$ 2,000
Repair & Maintenance	$ -
Taxes (Business or Property)	$ -
Telephone	$ -
Utilities	$ -
Vehicle Expense & Travel	$ -
Wages & Benefits (employees)	$ -
Management (Owner's) Wage	$ -
Income Tax	$ -
TOTAL CASH OUTFLOW	$ 48,000
SUMMARY	
Total Cash Inflow	$ 48,000
Plus: Previous Month's Cash Flow	$ -
Total Cash Available	$ 48,000
Less: Current Month Cash Outflow	$ 48,000
CLOSING CASH BALANCE	$ -

The blue section represents the cash outflow, or what needs to be purchased **before the business becomes operational.** This includes capital purchases plus some expenses such as food and product purchases, preopening advertising, insurance, rent etc. that need to be incurred **before the operation begins**. You will note that we have included GST on the equipment. Although this will likely be reimbursed when the company submits its first GST return, it is an actual cash outlay prior to opening.

These expenses total $48,000 so it appears that the business has sufficient cash to begin operations. However, we need to take into account the cash flow that now occurs when the business becomes operational.

The dark green area in the full cash flow analysis on Page 38 represents revenue from operations. Since it is a retail operation, there are no receivables to worry about.

The light green area shows the cash inflows from operations which are the actual sales.

Again, do NOT to take your annual sales projections for the year and divide by twelve. Most businesses have slower times than others and if you do NOT take into account the slower sales months your Cash Flow projections will be incorrect leading to potential problems!

The light blue area contains all of the cash operating expenses of the company on a monthly basis. You will notice that, unlike an Income statement, there is no provision for depreciation. You will also notice that there is an additional line for Debt Service (P) in addition to the monthly Interest (I). It is our practice to take the actual monthly component for both P and I and input it into the cash flow whereas, it is tempting to just take the annual figures and divide by twelve. Since the combination of monthly P plus I will always remain the same (your total monthly payment) you may not want to go to the trouble and just use 1/12 of you annual payments.

Again, if you know what your CGS % (Cost of Goods Sold as a percentage of sales) is for your sales category, make sure that this is reflected in your monthly costs fluctuating with your sales.

The light yellow area represents the Monthly Cash Flow Summary that basically takes your previous month's bank balance adds the cash input and deducts the cash outlays leaving the closing cash balance or you monthly closing bank balance.

PreOpening and Monthly Operating Cash Flow

REVENUE:	OPENING	1	2	3	4	5	6	7	8	9	10	11	12	TOTALS
Food Sales		$ 7,500	$ 8,000	$ 9,000	$ 10,000	$ 13,000	$ 17,500	$ 20,000	$ 18,000	$ 15,000	$ 12,000	$ 18,000	$ 1,000	$ 149,000
Wine and Liquor Sales		$ 3,500	$ 3,760	$ 4,230	$ 4,700	$ 6,110	$ 8,225	$ 9,400	$ 8,460	$ 7,050	$ 5,640	$ 8,460	$ 470	$ 70,005
TOTAL REVENUE		$ 11,000	$ 11,760	$ 13,230	$ 14,700	$ 19,110	$ 25,725	$ 29,400	$ 26,460	$ 22,050	$ 17,640	$ 26,460	$ 1,470	$ 219,005
CASH INFLOW														
Cash From Revenues		$ 11,000	$ 11,760	$ 13,230	$ 14,700	$ 19,110	$ 25,725	$ 29,400	$ 26,460	$ 22,050	$ 17,640	$ 26,460	$ 1,470	$ 219,005
Receivables		$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Equity	$ 16,000	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Loan 1	$ 17,000	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Loan 2	$ 15,000	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Loan 3	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
TOTAL CASH INFLOW	$ 48,000	$ 11,000	$ 11,760	$ 13,230	$ 14,700	$ 19,110	$ 25,725	$ 29,400	$ 26,460	$ 22,050	$ 17,640	$ 26,460	$ 1,470	$ 219,005
CASH OUTFLOW														
Capital Assets Purchases	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
vehicle	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
equipment	$ 23,000	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
GST	$ 1,150	$ -	$ -	$ -	-$ 1,150	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	-$ 1,150
Cost of Goods Sold — Food Sales	$ -	$ 2,250	$ 2,400	$ 2,700	$ 3,000	$ 3,900	$ 5,250	$ 6,000	$ 5,400	$ 4,500	$ 3,600	$ 5,400	$ 300	$ 44,700
Wine & Liquor Sales	$ -	$ 1,400	$ 1,504	$ 1,692	$ 1,880	$ 2,444	$ 3,290	$ 3,760	$ 3,384	$ 2,820	$ 2,256	$ 3,384	$ 188	$ 28,002
Food and Wine Opening Inventory	$ 4,500	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Accounting & Business Support	$ 2,500	$ 100	$ 100	$ 100	$ 100	$ 100	$ 100	$ 100	$ 100	$ 100	$ 100	$ 100	$ 100	$ 1,200
Advertising	$ 5,600	$ 1,000	$ 1,000	$ 1,000	$ 1,000	$ 1,000	$ 200	$ 200	$ 200	$ 200	$ 200	$ 200	$ 200	$ 6,400
Bank Charges & Credit Card Charges	$ -	$ 275	$ 294	$ 331	$ 368	$ 478	$ 643	$ 735	$ 662	$ 551	$ 441	$ 662	$ 37	$ 5,475
Business Plan	$ 3,500	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Loan Fee & Life Insurance	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Insurance	$ 5,000	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Interest Expense	$ -	$ 113	$ 112	$ 110	$ 109	$ 107	$ 106	$ 104	$ 102	$ 101	$ 99	$ 97	$ 96	$ 1,256
Term Debt (principal only)	$ -	$ 231	$ 233	$ 234	$ 236	$ 238	$ 239	$ 241	$ 242	$ 244	$ 246	$ 247	$ 249	$ 2,880
Office Supplies	$ 750	$ 75	$ 75	$ 75	$ 75	$ 75	$ 75	$ 75	$ 75	$ 75	$ 75	$ 75	$ 75	$ 900
Rent	$ 2,000	$ 2,000	$ 2,000	$ 2,000	$ 2,000	$ 2,000	$ 2,000	$ 2,000	$ 2,000	$ 2,000	$ 2,000	$ 2,000	$ 2,000	$ 24,000
Repair & Maintenance	$ -	$ 100	$ 100	$ 100	$ 100	$ 100	$ 100	$ 100	$ 100	$ 100	$ 100	$ 100	$ 100	$ 1,200
Taxes (Business or Property)	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Telephone	$ -	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 125	$ 1,500
Utilities	$ -	$ 1,200	$ 1,200	$ 1,200	$ 1,200	$ 1,200	$ 1,200	$ 1,200	$ 1,200	$ 1,200	$ 1,200	$ 1,200	$ 1,200	$ 14,400
Vehicle Expense & Travel	$ -	$ 200	$ 200	$ 200	$ 200	$ 200	$ 200	$ 200	$ 200	$ 200	$ 200	$ 200	$ 200	$ 2,400
Wages & Benefits (employees)	$ -	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 2,500	$ 30,000
Management (Owner's) Wage	$ -	$ 3,000	$ 3,000	$ 3,000	$ 3,000	$ 3,000	$ 3,000	$ 3,000	$ 3,000	$ 3,000	$ 3,000	$ 3,000	$ 3,000	$ 36,000
Income Tax	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
TOTAL CASH OUTFLOW	$ 48,000	$ 14,570	$ 14,843	$ 15,367	$ 14,742	$ 17,466	$ 19,028	$ 20,340	$ 19,290	$ 17,716	$ 16,142	$ 19,290	$ 10,369	$ 199,164
SUMMARY														
Total Cash Inflow	$ 48,000	$ 11,000	$ 11,760	$ 13,230	$ 14,700	$ 19,110	$ 25,725	$ 29,400	$ 26,460	$ 22,050	$ 17,640	$ 26,460	$ 1,470	$ 219,005
Plus: Previous Month's Cash Flow	$ -	$ -	-$ 3,570	-$ 6,652	-$ 8,790	-$ 8,832	-$ 7,188	-$ 491	$ 8,569	$ 15,739	$ 20,073	$ 21,571	$ 28,741	$ -
Total Cash Available	$ 48,000	$ 11,000	$ 8,190	$ 6,578	$ 5,910	$ 10,278	$ 18,537	$ 28,909	$ 35,029	$ 37,789	$ 37,713	$ 48,031	$ 30,211	$ 219,005
Less: Current Month Cash Outflow	$ 48,000	$ 14,570	$ 14,843	$ 15,367	$ 14,742	$ 17,466	$ 19,028	$ 20,340	$ 19,290	$ 17,716	$ 16,142	$ 19,290	$ 10,369	$ 199,164
CLOSING CASH BALANCE	$ -	-$ 3,570	-$ 6,652	-$ 8,790	-$ 8,832	-$ 7,188	-$ 491	$ 8,569	$ 15,739	$ 20,073	$ 21,571	$ 28,741	$ 19,841	$ 19,841

It can easily be seen that although the owner believed that there was sufficient cash to open the business, the cash flow forecasts show a negative cash flow for the first six months. The largest cash deficit occurs in the fourth month at ($8,832).

Assuming that matters work out as forecast, in order to ensure that there is no cash issue, the owner has to find at least $9,000 in additional working capital. This can be from their own resources or additional loans. If loans are taken, the additional debt service would have to be included in the cash flow.

Once you see these initial projections, it is much better to show these to the bank at the time that you are seeking the original loan to support a larger loan. The lender will be much more sympathetic at this time than for you to go back to them after each month requesting an overdraft increase to cover your cash losses.

THINK STRATEGICALLY

This cash flow forecast is a tool that you can use to answer changes in strategy. If you are running a company that has accounts receivable, you can see what changes to your cash flow will occur if you accelerate your payment terms with your customers.

- In the earlier receivables analysis, what would happen if all of the developers paid on 30 day terms or you billed them weekly?
- Would you lose some clients?
- If you did would the loss of business be less of a cash impact than accelerating your collections?
- Could a portion of that business be replaced with clients paying on the accelerated terms?

- What if you offered a discount for early payment?

All of these can be answered in your cash flow forecasts, and the results may surprise you.

CASH RESERVES

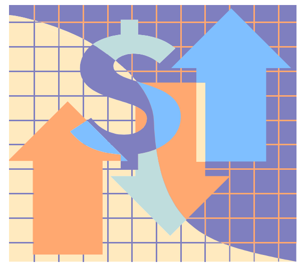
This may be more difficult in a start-up where we traditionally have a need for all of our available cash, however, if possible set a cash reserve target that you feel comfortable with. Similar to our personal circumstances where it may be financially prudent to have three months living expenses saved and available, many businesses like to have a 90 day cash reserve to cover operations. This could be cash available in the bank account or an available line of credit.

Keep in mind that if you hold too much cash in reserve, you may lose out on potential assets that could be invested in your business to generate increased sales.

CHAPTER 6 PITFALLS TO AVOID

Most of the pitfalls that companies encounter seem self-evident. Nevertheless, new business owners should make note of the following and recognize the issue before it becomes unmanageable.

INSUFFICIENT REVENUE



This seems an obvious issue. Are your revenues high enough to cover your expenses and provide you with your desired profit? Perhaps you have just launched a new product line or are in the start-up phase of your new business.

You must be realistic about how long it will take for revenues to catch up to or overtake costs. No one likes to endure losses, but the reality is that many new and existing businesses will take time to get into the black.

How to handle this? If it is not possible to reduce costs, then a source of financing must be found to cover off the negative cash flow as we saw above. Savings, family, friends, angel investors, financial institutions all may play a role in providing the necessary dollars.

Going to a bank when you are in a loss position, is not the strongest case for financing approval. If you had produced an initial cash flow projection identifying times where you would be in a negative cash flow position, you would have a better chance of securing financing than to go “cap in hand” at crunch time.

Any potential source of additional financing is not going to be sympathetic if you are paying yourself an excessive wage or draw. Even banks understand that you need a certain income to pay for your daily personal expenses. They will often ask for a budget to gauge what you really need and to see how serious you are in building your business. You may very well believe that you are worth the same $100,000 you received in income from your previous job, but if your fledgling company can't afford to pay you that, then make sure you take only what you require on a daily basis until your revenues can cover the added costs.

INAPPROPRIATE PRICING

Did you conduct a product or service costing analysis before you set your product or service price? Many entrepreneurs really don't know for sure.

Typically, you base your price on what your competitors are charging, but this could be a serious mistake. It's important to know all your costs and your desired return on capital, and to take these into account when you set your prices. It isn't necessarily bad for your prices to be higher than those of your competitors. In fact, this is perfectly appropriate if your strategy is based on differentiation—offering a unique or specialized product or a strong value proposition.

Make sure that your marketing plan clearly shows this differentiation or value proposition, and, more importantly, make sure that this is communicated to you clients, particularly on a start-up or new market penetration.

A growing number of businesses use estimating software to take the guesswork out of making job bids that better reflect their costs. The software takes into account overhead costs, the price of material and other expenses as well as your targeted profit margin, ensuring that every job is profitable.

INEFFICIENCY

Are you being as efficient as you can be? This question is especially important if you are using a low-price strategy to gain competitive advantage.

It's important to look at each of your costs—such as labour, material and overhead—and benchmark them against norms in your industry. If your costs are above average, it means you're not as efficient as your competitors and action is required. For industry benchmark data, consult Industry Canada's SME Benchmarking Tool (www.sme.ic.gc.ca).[4]

To improve efficiency, it's also worth exploring information technology tools. They can offer user-friendly and affordable ways to improve productivity across your business, including inventory control, operations, accounting, human resources management, customer relationships, and lean management continuous improvement initiatives.

LOW MARGINS

Do you know the profit margin for each of your products and services? Analyzing each one separately can be an eye opener and may reveal problems that you hadn't noticed. Products that aren't doing well may be dragging down your bottom line and cash flow, as well as diverting management focus from higher margin products. Products that are selling well may be low

[4] Although lenders tend to refer to these benchmarks, use them sparingly as they are sometimes out of date particularly in an economic sector that is moving fast through technological innovations. They are also taken from corporate income tax returns and are only as valid as the return.

margin products that are not contributing to cover your fixed costs.

Again, relatively inexpensive software is available, particularly in the restaurant sector that tracks the cost of producing each of your meals. In addition, it also ties into you POS system and analyzes each product sales compared to its cost. It will show you graphically whether your best-selling meal may also be the least profitable. It allows you to make better business decisions as to how to manipulate your product mix.

GROSS PROFIT MARGIN

In a retail environment, the Gross Profit Margin (GPM) is the difference between your product sales and the cost of the product you sold. It is sometimes identified in dollars, but is usually referred to as a percentage of sales.

In our restaurant Income Statement above the revenue was split into Food and Liquor (Beer, wine, liquor). Similarly, the costs of these items followed the same format. This allowed the owner to monitor separate costs for control purposes. According to the industry and the SME Benchmarks, each style of restaurant (fast food, full service, take out etc) will have a specific range of GPM that should be attainable. If you are not reaching these goals then you need to review your costs, pricing, and operations.

Costs and Pricing are simple enough, but this may also highlight other issues such as theft, sweetheart dealing (staff giving away product to friends or family), not checking product received against invoices, and not conducting regular inventories.

From the GPM, our operational expenses are deducted. It can easily be seen that a drop of 5% in GPM, in this case, reduces our net operating income from $36,347 to $3,109! This is why the GPM is so critical in a retail environment.

FROM TOP OR BOTTOM

You may occasionally hear someone state that their GPM is from top. **A 50% GPM from top is the same as a 100% profit margin from bottom, so be sure you are comparing apples with apples.** Profit margins from bottom are usually found in a manufacturing environment where product costs are a function of the manufacturing and distribution process.

<u>Example:</u>

From Top is based on a percentage of Sales

Sales	$1,000
Cost of Goods	$500
Gross Profit	$500

Margin **= 50%** (Profit / Sales: $500/$1,000)

From Bottom is based on a percentage of Costs

Sales	$1,000
Cost of Goods	$500
Gross Profit	$500

Margin **= 100%** (Profit / Costs: $500/$500)

CHAPTER 7 MONITOR YOUR PROGRESS

It is critical to monitor your cash flow on a regular basis to maintain the financial pulse of your business, but it doesn't have to be complicated.

Simply take your initial monthly cash flow projections and insert the actual cash each month. If you do this monthly it is fairly easy. If you wait, then it becomes more daunting. You can take your original spreadsheet and insert a second column for each month to input your data.

Some Accounting software programs offer a dashboard as part of their cash flow management process.

Although we recommend at least monthly monitoring, if your business has large cash fluctuations you may want to review it weekly.

HOW TO MONITOR CASH FLOW

Even if you monitor your cash flow on a monthly basis by reviewing your actuals against forecast, it is a good idea to take a more in depth look at the numbers. There are a number of accounting ratios that you can easily review if you are using an accounting program. They are not just something that your accountant or banker looks at, but provide you with information that allows you to make some management decisions to benefit your company.

CASH CONVERSION CYCLE

Your cash conversion cycle equals your *average collection period* (how many days it takes your customers to pay you) plus *days inventory outstanding* (how long it takes, on average, to sell your inventory) minus *average days payable* (how long it takes you to pay your bills).

The lower the number, the better. It means you have more cash on hand to generate additional returns and/or reduce your line of credit. Tracking this metric over time will help you identify sources of cash flow problems and measure your progress in improving your cash flow management.

INVENTORY TURNOVER

This metric is the number of times your business sells its inventory per year. It is closely related to days inventory outstanding. The faster your inventory turns, the better.

For example, you may have products on your shelf that are high priced, high margin items but take six months to sell. That same shelf space may be able to hold ten times as many items at a lower profit margin which all sell within a week. By doing a calculation, you may find that you are better off to stock the lower cost item since it doesn't sit on your inventory very long plus you get a sales return much faster.

CASH ON HAND

We have earlier reviewed setting up a cash contingency target. It is now important to monitor how much cash you have on hand and check it against the target you set when you did your cash flow projections.

If cash falls below this target, you need to check and see what is happening, and take contingency measures as soon as possible. Some companies with large cash fluctuations monitor this daily.

CHAPTER 8 SOLVING CASH FLOW ISSUES

You have been monitoring your actual cash flow against your forecast and you identify some issues that you would like to correct. How you do it often depends on what type of issues you have revealed.

Here are some tips to help you solve some cash flow issues.

GENERAL

You wish to expand your business by purchasing some new equipment and have the cash on hand. Avoid the temptation to pay for capital purchases out of everyday cash. Although you are doing well now, should the business climate in your economic sector change, you may need that cash. Instead consider a term loan for the purchase, or from a line of credit.

With cash tied up in long term assets, you may be squeezed for cash for operations. If you approach a bank at that time, it may not look favourably on a company that used cash flow to finance long term assets.

Also, if you have cash tied up in long term assets, it hampers your ability to take advantage of opportunities that may arise out of the blue.

BEFORE YOU GET YOUR LOAN

If you are looking to purchase capital assets the conventional wisdom is to match the source of cash to the type of expenditure.

Use of everyday cash is generally fine for expenditures such as payroll, office supplies and inventory, and other recurring expenses. However, when purchasing long term assets, you should look to matching the financing against the asset's expected lifespan. You can get the most flexibility for your various spending requirements by arranging for a mix of term loans, a line of credit and overdraft protection—each matched to an appropriately aged underlying asset or purpose.

ASSET PURCHASES

For example, when applying for a loan to finance leasehold improvements, the lender will want to see your signed lease. If you only have a three year lease, the lender will be unlikely to give you a five year loan.

Similarly, loans for capital purchases such as restaurant equipment will usually be for a five year period or less. The lender is balancing risk (whether you will be in business long enough to repay the loan) with security (restaurant equipment depreciates rapidly and many lenders consider that at best they can recoup 10 cents on the dollar loaned.)

CASH FLOW PROTECTION

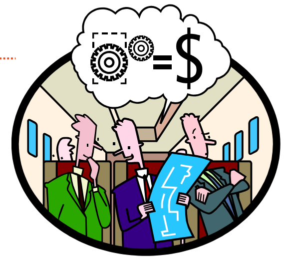
If purchasing a capital asset will dip into your cash reserve, then consider taking the term loan or line of credit to preserve your cash. Again, this keeps you in a better position should the economy change (and historically it will at some point).

FINANCING TIPS TO BOOST CASH FLOW[5]

We acknowledge the contribution of BDC (Business Development Corporation) for input on this section of financing.

[5] Taken from Master Your Cash Flow BDC

PLAN AHEAD



Work out upcoming financing needs when preparing your financial projections. You can then approach your bank ahead of time and arrange the best possible terms.

Having your projections in hand will help you show your bankers that you're a good manager. The plan should spell out what you will use the money for, when you will need it and how you will repay it.

COMPARE LOAN TERMS

When considering a loan, don't look only at the interest rate. The terms can be just as important. Can you defer principal repayments for an initial period? How much security does the bank need? How long is the amortization period? Flexible terms can free up more cash.

Talk to a variety of lenders, sometimes your local credit union is more flexible on terms or security.

Don't forget your local Small Business Loans Association (SBLA). They currently can provide up to $20,000 in term financing at flexible rates or check with your local Community Futures Development Corporation.

TALK TO SUPPLIERS

Consider asking suppliers to finance a purchase. Many are willing to offer the equivalent of a loan (by accepting deferred payments, for example) if it means a sale. It's a win-win for the supplier and for you.

RETIRE HIGH INTEREST DEBT

Work with your banker to identify any high-interest debt that you can retire or reduce.

ACCELERATE YOUR PAYMENTS

Collecting your accounts receivable more quickly is one of the best ways to improve your company's cash flow.

Collecting faster can also boost your bottom line. Let's say you reduce your *average collection period* (the number of days it takes clients to pay you) from 45 days to 30. If you have $1 million in annual sales, that difference means 15 days more cash in your pocket by year's end—or $41,000.

That $41,000, in turn, means $2,500 in annual savings in carrying charges on your line of credit (assuming 6% interest). Alternatively, you could use the extra cash to create additional investment returns—$3,700 more each year, if your business earns 9% annually.

HOW DO I COLLECT BILLS FASTER

INVOICE FASTER

The faster you invoice, the faster you'll get paid. Be sure to send invoices as soon as you ship or complete a job, preferably by email. If you're working on a large job, consider negotiating upfront and/ or milestone payments.

Technology can help you collect faster. Some types of accounting software let you send an electronic invoice that includes a link taking your clients to a digital portal where they can pay bills online.

Many businesses use mobile technology to speed up collections even more. If you're on a service call, you can use a smartphone to log into a mobile billing service and enter the transaction details and your customer's credit card information on the spot.

Apart from being faster than creating invoices manually, using technology cuts mailing and paper costs. It can also reduce the risk of NSF cheques and the time employees spend generating bills.

In our receivables analysis above, we saw the impact that slower collection of receivables had on cash flow, and how just invoicing twice a month changed the cash flow.

OFFER DISCOUNTS TO FASTER PAYERS

Consider offering a small discount for quick payment (e.g., within 10 days). This is often called 1/10 net 30—meaning a customer gets a 1% discount for paying within 10 days; otherwise, the bill is due in 30 days. (Some businesses go as high as a 2% discount.) But these discounts are costly and should be used only if you need to get cash in the door quickly. See page 60 and 61.

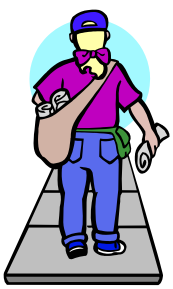
GET TOUGH ON DEADBEATS

One in four entrepreneurs say waiting for late-paying customers is the worst part of being a small business owner, according to a 2011 survey for Intuit. The same proportion of entrepreneurs say they spend three to five hours each week invoicing and chasing overdue payments.

One way to encourage your customers to pay on time is to charge late fees. Just be sure to mention the penalty interest you charge on invoices and then follow up with late payers. As well, when customers who have been laggards on previous orders come back, you can ask for partial or full payment up front.

You may want to have a policy that new customers pay upfront for the first two or three orders until they have established themselves, then offer them your normal credit terms.

Consider using an automated billing system that sends out regular reminders to late payers. When collecting bills, the rule of thumb is that the squeaky wheel gets the grease. Be firm and stay in regular contact with late customers, while maintaining a professional tone.



You need to be able to balance customer relations with collection practices, but in the long run, you need to get paid and on time. A corporate executive friend of mine used to drum this into his son for his paper route

"A sale isn't a sale until it's paid for".

The son collected every dollar owed to him and went on to become a very successful corporate executive in his own right.

CONSIDER FIRING LAGGARDS

Think about dumping your worst customers—chronic late payers, those who complain excessively or those who return a lot of merchandise. Companies often put up with such clients because they're afraid of losing business. But bad customers cost you money by draining employee attention and company resources.

Getting rid of bad customers can free you and your staff to give more attention to better customers and pursue new business.

Instead of telling customers outright that you don't want their business, you could increase your prices to them. They may balk at paying more and take their business elsewhere. On the other hand, if they do agree to pay more, the additional revenue should compensate for the extra effort they require.

Remember, they may be having their own cash flow problems and if they close down, you will end up with a Bad Debt.

ELECTRONIC BANKING

Consider dealing with a financial institution that allows electronic deposits to your account. If you can arrange this you may still have to get your staff to overcome their fear of lack of control over the receivables. Usually they will buy in when they see the results.

On line payments can go through at least seven days faster than conventional ones due to saved processing and mailing time. Also, there are fewer follow up phone calls chasing outstanding invoices. If a customer usually pays on the 15th of the month, and it is the 16th with no payment, you can follow up right away.

CONTROL CASH OUTLAYS

The converse of the Cash cycle is also true; if you hold on to cash longer, it is just as good as getting paid earlier.

You may want to be a good customer, but don't pay until the invoice is due. Pay your bills on time and don't try to stretch anyone out or lean on the trade.

Another option is to take advantage of early payment discounts which is discussed in detail on page 60.

CREDIT CARDS

Consider using a corporate credit card to get a little more time to pay some bills. Most cards don't charge interest if you pay within the grace period.

Most credit cards have relatively high interest rates (although some new corporate credit cards have rates as low as 6%) so make sure you monitor the account so as not to drive up another debt. Many business owners use their credit cards to build air mile points, but remember this is a taxable item and may offset any benefits.

CONTROL EXPENSES

Expenses are generally categorized as fixed or variable, and maintaining control over expenses is an essential part of maximizing cash flow and profits for your business.

FIXED COSTS

Most business owners seem to gloss over fixed costs because they are, well…fixed. They also often reflect longstanding relationships with suppliers.

Besides asking for better terms from your suppliers, periodically test the market to see whether you can get a better deal from competing companies. It is also wise not to have all your eggs in one basket in case a key supplier goes out of business or becomes hard to deal with.

It's good practice to get two or three quotes regularly, by putting out a request for proposal (RFP) or using a less formal method. It’s important to watch your costs and be seen to be watching your costs.

Be careful that you are comparing apples with apples when reviewing competing offers. Particularly watch your insurance costs. It is quite easy for a broker to come in with a lower cost than you are currently paying, but make sure you are receiving exactly what you were originally insured for. If not, have the new broker explain why you don’t need what you had. Also check with your existing broker to review what you are being offered.

If you have been satisfied with your existing broker’s service, you also need to ensure that you are getting the service you require from your new broker. There’s nothing worse than having a claim and you can’t get support from your broker.

Sometimes service has a value.

Some insurance companies will allow you to pay monthly with a slight premium, but many commercial policies call for full payment in advance.

VARIABLE COSTS

Variable costs by definition and their nature vary. Historic percentages will indicate approximately what percentage of sales your variable costs will incur. If you see these going out of line you must step in to investigate.

For example, fuel costs will vary with the time the truck is used, the distance travelled and the cost of fuel. If truck use is down along with mileage travelled and fuel prices have not increased but your fuel costs have increased as a percentage of trucking, then you need to find out what the issue is. It may be as simple as maintenance, but it may indicate other issues that need to be addressed.

If you do not already charge for shipping, you may have to in order to help offset rising transportation costs. Many companies charge for shipping and customers most often accept this as a cost of doing business.

OFFER TO PAY MORE

In some cases, you also may find it worthwhile to offer to pay your suppliers slightly more (e.g., 1%) if they let you stretch payments by, for example, letting you pay in 60 days, instead of 30. Your suppliers win by earning more, while you can use the extra cash to reduce your use of your line of credit and/or generate more sales.

TAKE ADVANTAGE OF DISCOUNTS

Conversely, some suppliers offer a discount to customers willing to pay quickly. These discounts can produce surprisingly large returns on your capital. ***For example, you could earn what works out to be a 37% annual effective interest rate if you receive a 2% discount for paying an invoice within 10 days, rather than paying the full amount in 30 days (2% 10 Net 30).***

Wait a minute, you say, how can that be? By paying 20 days earlier, I can earn 37%? I'm from the prairies, show me how that works.

For the first step, unfortunately, we need to do a little math. The good news is that it isn't complicated. The formula is:

Effective Interest Rate = discount %/ (100-discount %) x 360[6]*/ (FT-DP)*

Where:

FT = the full Term allowed for payment in days

DP = the discount period allowed for payment in days

For Example:

Scott and Associates is going to pay an invoice with terms of 2/10 net 30. Inserting this into the formula, we get:

Effective Interest rate = 2 / (100 – 2) x 360 / (30 – 10)

= 2 / 98 x 360 / 20

= 36.7

Thus, taking the discount is equivalent to earning almost 37% a year on your money. That sounds high, but it makes sense when you look at the details. You're getting a 2-percent discount, but that saving is spread over just 20 days, the difference between the regular due date and the discount period. Had the terms been 2/10, net 60, that same 2-percent discount would have been spread over 50 days (60 less 10) and the effective interest rate on an annual basis would be about 15%.

To give you an idea of how the numbers work for various combinations, please check the table below:

* Remember that column 2 is the number of days between the last day of the discount and the final date of the invoice. E.g. 2%10 net 30 is 20 days (30-10) in column 2.

[6] The convention is to use 360 rather than 365, but the actual difference is small. Using 365 our effective rate is 37.2 rather than 36.7

Percent discount %	Full Term Less Discount Period *	Effective Interest Rate
1	15	24.2
1	20	18.2
1	25	14.5
1	30	12.1
1	50	7.3
2	15	49.0
2	20	36.7
2	25	29.4
2	30	24.5
2	50	14.7
½	20	9.0

CAUTION Don't use only this factor when deciding how to pay your bills. You should also consider;

- Cost of Capital
- Use for Money
- Margins
- Short Term Needs
- Cheaters

This may seem complicated but it's not really. If you feel uncomfortable with this, discuss it with your accountant.

Bear in mind that if you are the seller, you are on the other side of the coin, and are giving your customers an effective 37% annual interest rate on your money. Many customers will take the discount and pay later than the terms (Cheaters).

It is therefore, not usual to find such generous terms today, but if you do, or terms in the table above, you can take advantage of them if it makes sense.

INVEST IN TECHNOLOGY

Explore technology that may help your business improve efficiency, increase productivity or reduce costs. For example, many companies are now using cloud computing systems rather than in-house systems that can be relatively expensive to buy and maintain.

Be careful to balance the relative security of each system before committing to any major changes.

STAFF INCENTIVES

Make people accountable for costs and establish appropriate rewards for employees who find ways to reduce expenses. This helps to create a zero-waste culture within your organization. It also helps motivate staff members charged with reducing expenses to stay on task and be creative. Creating a culture of continuous improvement will benefit your bottom line ultimately.

For example, food costs are a significant cost in a restaurant. By making the chef or back of the house manager accountable for maintaining specific food costs and food quality, a considerable saving may be attained. A portion of this saving can be allocated to that person or to that team.

INVENTORY MANAGEMENT AND CONTROL

Holding too much inventory can take a large bite out of cash flow. At the same time you don't want to keep so little inventory that you run out of products to sell or you can't deliver on time. Maintaining this balance is called ***Inventory Optimization.***

INVENTORY OPTIMIZATION

Below are some tips on decreasing your ***days inventory outstanding*** (average time products stay in inventory) and improve inventory turnover while minimizing negative impact on sales.

COORDINATE DIFFERENT TYPES OF INVENTORY

Businesses often manage different types of inventory in separate departments. Coordinating the various types of inventory (raw materials, work in progress, finished goods etc) can improve inventory optimization.

PLAN FOR CHANGES IN DEMAND AND VOLATILITY

If your company has seasonal highs and lows in demand, you probably try to optimize inventory levels to meet your demand cycle. However, don't forget that the demand cycle can affect not only the volume of orders but also their volatility.

For example, a restaurant may have a huge range of $100,000 to $300,000 in monthly sales during its summer high season, but a much smaller variation of $50,000 to $60,000 in the slow season. Inventory levels should take into account cycles in both demand and volatility—for example, you may want to increase buffer stock when volatility is higher.

OPTIMIZE FOR DIFFERENT CUSTOMERS

Your customers may have different expectations in terms of service levels and lead times. Weigh all of these factors when setting inventory levels. You should be up front with customers about how you manage inventory and your lead-time requirements to meet their orders.

Ideally if you can order inventory as it is needed, this results in the most efficient operation and use of your cash resources (often called JIT ordering or "Just in Time" ordering). Your supplier support and reliability is critical here.

STRONG SUPPLIER RELATIONSHIPS

The goal is to work with companies you can rely on to deliver on time and go the extra mile to meet a tight schedule.

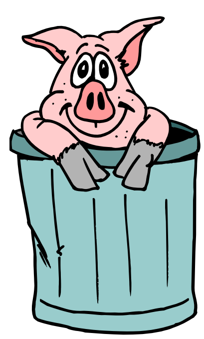
Marketing buzzwords now call this "partnering" indicating a stronger relationship than merely customer and supplier.

CONSIDER TECHNOLOGY

Consider purchasing inventory management software. Although there may be a steep learning curve, these have tools that allow you to forecast demand, compress your order-to-delivery cycle, and optimize buffer stock levels.

DUMP LOSING PRODUCTS

Speed up inventory turnover by analyzing each product line and getting rid of products that either lose money or have a low inventory turnover time.



CREATING AND DELIVERING CUSTOMER VALUE

Creating and delivering customer value involves many things, not the least being proper cash flow management, which ultimately results in lower operating costs to you and in return greater value in pricing to your customer. By providing your products and services at competitive prices, this benefits your customer and contributes to increased sales and profitability, making it much easier to stickhandle your cash to prosperity.

CHAPTER 9

CONCLUSION

As stated in the introduction, it was not our purpose to give you an accountant's guide to cash flow, but to give you some general points and particularly to point out areas where you can make positive changes to your business by changing your cash flow.

Much of what is written seems to be for businesses with larger or more volatile cash flow, but the concepts are the same for all businesses large or small.

We hope we have been able to address salient points of cash flow for all businesses and to instill in you, the business owner, a healthy respect for cash and its management.

This is one of our e-books on various issues that a new or potential business owner may have to address in setting up his or her new business.

If you found it interesting and would like to know more, please contact us at

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