

Cash—a four-letter word that has become a curse for many small businesses. Lack of this valuable asset has driven countless small companies into bankruptcy. Unfortunately, many more firms will become failure statistics because their owners have neglected the principles of cash management, which can spell the difference between success and failure. One small business consultant says that a serious mistake that entrepreneurs make is trying to run their businesses without accurate cash flow projections. “This is like driving along on the freeway at 70 miles per hour with a blindfold on. It’s not a question of whether you are headed for an accident. It’s a question of how serious the accident will be and whether or not you will survive it.”¹

Developing cash forecasts is important for every small business but is essential for new businesses in particular because early sales levels usually do not generate sufficient cash to keep the company afloat. Too often, entrepreneurs launch their companies with insufficient cash to cover their start-up costs and the cash flow gap that results while expenses outstrip revenues. The result is business failure. Controlling the financial aspects of a business with the profit-planning techniques described in the previous chapter is immensely important; however, by themselves, these techniques are insufficient to achieve business success. Entrepreneurs are prone to focus on their companies’ income statements—particularly sales and profits. The balance sheet and the income statement, of course, show an important part of a company’s financial picture, but it is just that: only part of the total picture. It is entirely possible for a business to have a solid balance sheet and to make a profit and still go out of business by *running out of cash*. Even if a company’s revenue exceeds its expenses for a given period, the cash flow from that revenue may not arrive in time to pay the company’s cash expenses. Managing cash effectively requires an entrepreneur to look beyond the “bottom line” and focus on what keeps a company going—cash.

Cash Management

1. Explain the importance of cash management to the success of a small business.

Managing cash flow is a struggle for many business owners. In fact, research by the National Federation of Independent Businesses (NFIB) shows that managing cash flow consistently ranks among the top 10 problems that small business owners face. Surveys by American Express OPEN Small Business Monitor and Visa show similar concerns: Cash flow management ranks as the number one issue facing small business owners. Figure 15.1 shows the most common cash flow challenges that business owners encounter.

Cash management involves forecasting, collecting, disbursing, investing, and planning for the cash a company needs to operate smoothly. For a start-up business, managing cash depends on the accuracy of the financial forecasts that come from a well-developed business model and business plan. These forecasts guide fund-raising for the new venture. For an operating small

Source: CartoonStock.



“I’ll covet this trophy right up to the time I sell it to meet my payroll.”

In recent surveys, at least 50 percent of small business owners report experiencing cash flow problems. The most common challenges they encounter are as follows:

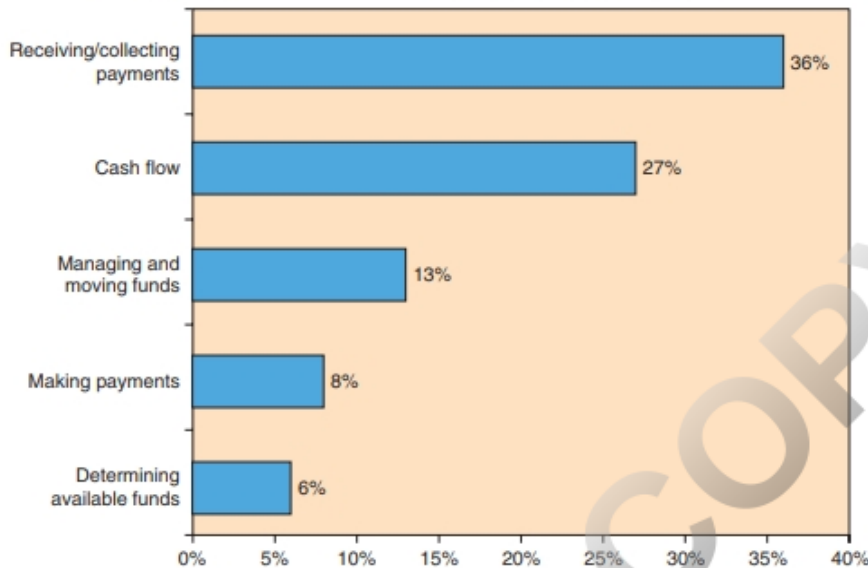


FIGURE 15.1

Cash Flow Challenges

Source: Visa 2012 Small Business Cash Management Survey, September 26, 2012.

business, managing cash is a matter of timing—gaining control over when a company collects cash and when it pays it out. Managing cash is an important task because cash is the most important yet least productive asset that a small business owns. A business must have enough cash to meet its obligations as they come due, or it will eventually experience bankruptcy. The Small Business Administration recommends that business owners have enough cash on hand to cover at least six months of operating expenses, and many experts recommend up to a year's worth during a slow economy. Creditors, employees, and lenders expect to be paid on time no matter how tough the economy may get, and cash is the required medium of exchange to meet these expectations.

Proper cash management permits entrepreneurs to adequately meet the cash demands of their businesses, to avoid retaining unnecessarily large cash balances, and to stretch the profit-generating power of each dollar their companies own. Entrepreneurs must have the discipline to manage cash flow from the business's first day of operation.



ENTREPRENEURIAL PROFILE: Henry Ford: Ford Motor Company Shortly after he launched his new company on June 16, 1903, entrepreneur Henry Ford ran headlong into a cash crisis that nearly wiped out the Ford Motor Company. Start-up expenses (including \$10,000 to the Dodge brothers for engines and other parts and \$640 to the Hartford Rubber Works for 64 tires) quickly soaked up Ford's \$28,000 in start-up capital he and eleven associates invested, and by July 10, the company's cash balance had fallen a mere \$223.65. Another payroll and more parts orders were just around the corner, and the 25-day-old company was already on the brink of a financial collapse. On July 11, an investor saved the day with a \$5,000 contribution. Four days later the Ford Motor Company sold its first car to Dr. E. Pfennig of Chicago, pushing the company's cash balance to \$6,486.44. From this shaky financial beginning grew one of the largest automakers in the world!²

Although cash flow problems afflict companies of all sizes and ages, young businesses are prone to suffering cash shortages because they act like “cash sponges,” soaking up every available dollar and then some. The reason is that their cash-generating “engines” have not had the opportunity to “rev up” to full speed and cannot generate sufficient power to produce the cash necessary to cover rapidly climbing expenses.

Owners of fast-growing businesses also must pay particular attention to cash management because the greatest potential threat to cash flow occurs when a company is experiencing rapid growth. If a company's sales are rising, the owner also must hire more employees, expand plant capacity, develop new products, increase the sales force and customer service staff, build

inventory, and incur other drains on the firm's cash supply. In addition to these cash demands, collections from sales often slip as a company grows, and the result is a cash crisis.

Unfortunately, many small business owners do not engage in cash planning. One study of 2,200 small businesses found that 68 percent performed no cash flow analysis at all!³ The result is that many successful, growing, and profitable businesses fail because they become insolvent; they do not have adequate cash to meet the needs of a growing business with a booming sales volume. The head of the National Federation of Independent Businesses says that many small business owners "wake up one day to find that the price of success is no cash on hand. They don't understand that if they're successful, inventory and receivables will increase faster than profits can fund them."⁴ The resulting cash crisis may force an entrepreneur to lose equity control of the business or, ultimately, declare bankruptcy and close.



ENTREPRENEURIAL PROFILE: Peter Justen: MyBizHomepage After 94 years in business, Cerf Brothers Bag Company, a family-owned business that made duffle, cargo, and storage bags and a line of outdoor gear under the brand names Hideaway Hunting Gear and Camp Inn, fell victim to a cash crisis. In an attempt to lower its costs, the company shifted most of its production from its three manufacturing operations in the United States to factories in Asia. When these vendors accelerated their collection terms, insisting on payment for products when Cerf Brothers placed an order rather than after it was delivered, the company found itself in a cash flow bind. [Our vendors] were asking us to pay for goods three to five months before we would be paid by our customers," says Jerry Michelson, the company's CEO. The company's cash flow evaporated and debt piled up, forcing its owners to declare bankruptcy and sell the once-successful business.⁵

Table 15.1 describes the five key cash management roles every entrepreneur must fill.

The first step in managing cash more effectively is to understand the company's **cash flow cycle**—the time lag between paying suppliers for merchandise and receiving payment from customers (see Figure 15.2). The longer this cash flow cycle, the more likely the business owner is to encounter a cash crisis. Preparing a cash forecast that recognizes this cycle, however, helps avoid a crisis.



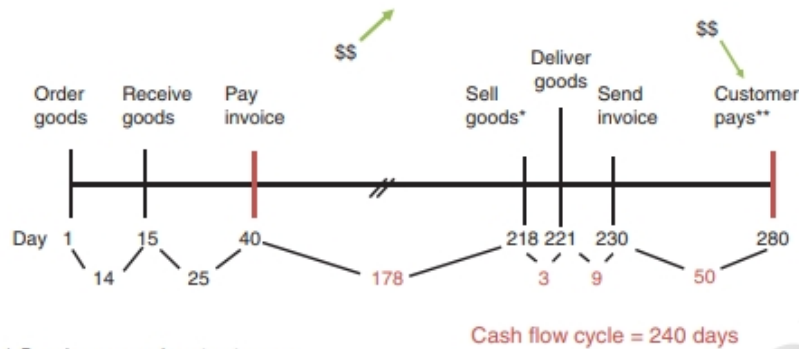
ENTREPRENEURIAL PROFILE: John Fernsell: Ibex Outdoor Clothing John Fernsell recognizes the importance of cash management because of the length of his company's cash flow cycle. Fernsell, a former stockbroker, is the founder of Ibex Outdoor Clothing, a company that makes outdoor clothing from high-quality European wool. Ibex's sales are growing rapidly, but cash is a constant problem because of its lengthy cash flow cycle. Fernsell orders wool from his European suppliers in February and pays for it in June. The wool then goes to garment makers in California,

TABLE 15.1 Five Cash Management Roles of the Entrepreneur

- Role 1: Cash Finder.** This is your first and foremost responsibility. You must make sure that there is enough capital to pay all present (and future) bills. This is not a one-time task; it is an ongoing job.
- Role 2: Cash Planner.** As cash planner, you make sure that your company's cash is used properly and efficiently. You must keep track of its cash, make sure that it is available to pay bills, and plan for its future use. Planning requires you to forecast your company's cash inflows and outflows for the months ahead with the help of a cash budget (discussed later in this chapter).
- Role 3: Cash Distributor.** This role requires you to control the cash needed to pay the company's bills and the priority and the timing of those payments. Forecasting cash disbursements accurately and making sure that the cash is available when payments come due is essential to keeping your business solvent.
- Role 4: Cash Collector.** As cash collector, your job is to make sure that your customers pay their bills on time. Too often, entrepreneurs focus on pumping up sales while neglecting to collect the cash from those sales. Having someone in your company responsible for collecting accounts receivable is essential. Uncollected accounts drain a small company's pool of cash very quickly.
- Role 5: Cash Conserver.** This role requires you to make sure that your company gets maximum value for the dollars it spends. Whether you are buying inventory to resell or computer systems to keep track of what you sell, it is important to get the most for your money. Avoiding unnecessary expenditures is an important part of this task. The goal is to spend cash so that it produces a return for the company.

Source: Based on Bruce J. Blechman, "Quick Change Artist," *Entrepreneur*, January 1994, pp. 18–21.

FIGURE 15.2
The Cash Flow Cycle



* Based on average inventory turnover:

$$\frac{365 \text{ days}}{2.05 \text{ times/year}} = 178 \text{ days}$$

** Based on average collection period:

$$\frac{365 \text{ days}}{7.31 \text{ times/year}} = 50 \text{ days}$$

who ship finished clothing to Ibox in July and August, when Fernsell pays for the finished goods. Ibox ships the clothing to retailers in September and October but does not get paid until November, December, and sometimes January! Ibox's major cash outflows are from June to August, but its cash inflows during those months are virtually nil, making it essential for Fernsell to manage the company's cash balances carefully.⁶

The next step in effective cash management is to begin whittling down the length of the cash flow cycle. Reducing the cycle from 240 days to, say, 180 days would free up incredible amounts of cash that this company could use to finance growth and dramatically reduce its borrowing costs. What steps do you suggest that the owner of the business whose cash flow cycle is illustrated in Figure 15.2 take to reduce the cycle's length?

Cash and Profits Are Not the Same

When analyzing cash flow, entrepreneurs must understand that cash and profits are not the same. Both are important financial concepts for entrepreneurs, but they measure very different aspects of a business. **Profit** (or net income) is the difference between a company's total revenue and its total expenses. It is an accounting concept designed to measure how efficiently a business is operating. On the other hand, cash is the money that is readily available to use in a business. **Cash flow** measures a company's liquidity and its ability to pay its bills and other financial obligations on time by tracking the flow of cash into and out of the business over a period of time. Many factors determine a company's cash flow, including its sales patterns, the timing of its accounts receivable and accounts payable, its inventory turnover rate, its debt repayment schedule, and its schedule of capital expenditures (e.g., fixtures, equipment, facilities expansion, and others).



ENTREPRENEURIAL PROFILE: Anne-Marie Faiola: Bramble Berry Anne-Marie Faiola founded Bramble Berry, a soap-making supply company, in 1998. From the beginning, Faiola grew her company by aggressively introducing new products. However, even though Bramble Berry was showing a profit on its income statement, the business never seemed to have any cash at the end of the month. The problem was that the money that Faiola spent on product development outpaced her ability to earn it back with increased cash flow from sales. Faiola had to use credit cards and drawing on her company's line of credit to fund the gap in cash flow. "If you do that for too many years, you will find yourself heavily in debt—while still being profitable—and wondering why you can't seem to get ahead," says Faiola. Once she recognized that more money was going out than was coming in, Faiola slowed spending on new products for period of time to generate positive cash flow that she could use to pay down her debt. Bramble Berry now offers more than 2,500 products to thousands of customers across the country.⁷

2.

Differentiate between cash and profits.



Anne-Marie Faiola, founder of Bramble Berry.

Source: BrambleBerry Inc.

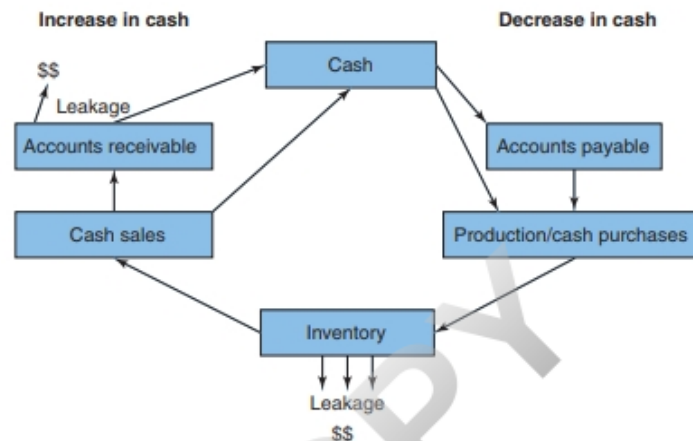
FIGURE 15.3**Cash Flow**

Figure 15.3 shows the flow of cash through a typical small business. Decreases in cash occur when a business purchases, on credit or for cash, goods for inventory or materials for use in production. The company sells the goods either for cash or on credit. When it takes in cash or collects accounts receivable, a company's cash balance increases. Notice that purchases for inventory and production *lead* sales; that is, these bills typically must be paid *before* sales materialize. However, collection of accounts receivable *lags* behind sales; that is, customers who purchase goods on credit may not pay until a month or more later.

As important as earning a profit is, no business owner can pay creditors, employees, and lenders in profits; that requires *cash*! "Cash flow is more important than earnings," says Evan Betzer, founder of a financial services firm.⁸ A company can operate in the short run with a net loss showing on its income statement, but if its cash flow becomes negative, the business is in trouble. It can no longer pay suppliers, meet payroll, pay its taxes, or any other bills. In short, the business is out of business!



In the Entrepreneurial Spotlight

Cash Flow and Pass-Through Entities

Jean Young was excited about the first full year of operations of the company that she and her sister Susan had started just a year and a half ago. The Young sisters had started their fashion and jewelry boutique, Young Fashion, in the summer of 2011 as a limited liability company (LLC). Although the first few months were rather slow, their store picked up business during the holiday season. At the end of 2011, they had sold enough so that they had broken even during their company's first partial year of operation. Not a bad start for a new store!

The momentum they had gained in 2011 carried over into 2012. Like many retailers, they broke even for the first four quarters of the year. Their store's second holiday season was a phenomenal success. When they ran the year-end financial statements for 2012, they showed a profit of a little more than \$80,000. Even better was the fact that they had earned that much profit even after paying themselves very modest salaries throughout the year.

Excited about their success, Jean and Susan decided to use the extra cash they had built up for three things. First, they expanded their company's inventory. With a bit of careful planning, they determined that Young Fashion could easily hold quite a bit more inventory on the floor without making it too crowded.

Second, they bought new racks and display cases to give the store a better look. They had bootstrapped the start-up and had bought a variety of used and even discarded equipment to keep their initial costs down. Now that they had cash on hand, they wanted to replace that equipment with new, more professional-looking displays. Third, because they launched their business right out of college, neither of them had much money to invest. They had to borrow the money from their parents and other family members to cover the start-up costs for Young Fashion. Thus, they used most of the rest of their business's excess cash to pay down that debt to their family. They kept enough cash on hand to cover day-to-day needs.

In early April, they met with the accountant who prepared the tax returns for Young Fashion. "You certainly had a great year," he said. "But, as you know, with that success you are going to owe a bit to Uncle Sam in taxes."

"I am not sure I understand," said Susan with more than a bit of worry. "How much to we owe?"

"The \$80,000 profit will be split between the two of you, so I will issue each of you a K-1 tax form that you will include with your personal tax returns. Each of you owes taxes on an additional \$40,000 above the salaries you earned. At your tax

rate, each of you will probably owe at least another \$10,000 in taxes in a couple of weeks."

"But we don't have any extra cash," said Jean. "We put it all back into the business!"

What Jean and Susan are facing is not an unusual situation for new business owners. Because they set the business up as an LLC, it is treated as a pass-through entity. Therefore, any profit from the business is not taxed at the corporate rate but rather passes directly through to each of the owners based on their shares of ownership.

Jean and Susan had spent excess cash on items that did not increase the business's profits. They bought inventory, which merely exchanged one asset, cash, for another asset, inventory, which does not become an expense until it is sold. They bought equipment, which they will depreciate over time as an expense, but in the short run also trades one asset for another. Finally, they paid down debt, which decreases cash and decreases a liability on the balance sheet. None of these transactions had an impact on the company's income statement. Thus, even though they spent the cash, their business still showed a profit.

Experienced entrepreneurs learn to manage cash more strategically. Many use the 1/3-1/3-1/3 rule of thumb. One-third of cash flow from profits is set aside for the taxes that owners will owe when profits flow through to their personal tax returns. Whereas some business owners build this up throughout the year and then distribute it at tax time, others distribute cash to cover taxes each quarter based on the profits for those three months. At that point, the business has done what it is

responsible for—paying out the cash to cover the tax liability. If any of the owners decide to spend it rather than save it for taxes, that is their responsibility!

Entrepreneurs keep the second third of cash from profits in the business to support growth. They use it to build up inventory, buy equipment, upgrade fixtures, and so forth, or they can simply hold it to build up cash reserves (for that eventual "rainy day").

They use the final third of cash from profits to pay down the principle on any debt that the business owes. If the business has no debt, this final third can be distributed to the owners as dividends. Because the business already has paid taxes on the earnings from which the dividends originate, owners of pass-through entities do not pay taxes on them.

By following this approach to managing cash created by the profits of a business, entrepreneurs should never face the kind of surprise that Jean and Susan did when they met with their accountant.

1. Why is it so important for owners of pass-through entities to pay attention to personal income taxes even if they did not receive dividends or distributions of earnings?
2. If the owners of a pass-through entity are personally responsible for pay the taxes for the profits of their businesses, why is it advisable to choose an LLC or S corporation for a small business?
3. Identify and explain at least three recommendations can you make to Jean and Susan that would help them manage their company's cash flow more effectively.

Preparing a Cash Budget

The need for a reliable cash forecast arises because in every business, the cash flowing in is rarely "in sync" with the cash flowing out. This uneven flow of cash creates periodic cash surpluses and deficits, making it necessary for entrepreneurs to track the flow of cash through their businesses so that they can project realistically the pool of cash that is available throughout the year. Many owners operate their businesses without knowing the pattern of their cash flows, believing that the process is too complex or time consuming. In reality, entrepreneurs simply cannot afford to ignore cash management. They must ensure that an adequate but not excessive supply of cash is on hand to meet their companies' operating needs.

How much cash is enough? What is suitable for one business may be totally inadequate for another, depending on each company's size, sales, collections, expenses, and other factors. Entrepreneurs should prepare a **cash budget**, which is nothing more than a "cash map" showing the

3.

Understand the five steps in creating a cash budget and use them to build a cash budget.



Preparing a Cash Budget.

Source: Rido/Shutterstock.