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Cash Flow FOR DUMMIES®

Learn to:

- Grasp the basic principles of cash flow management
- Secure business with positive and consistent cash flow
- Bring financial security to your company
- Distinguish profit and cash flow from profit

Tage C. Tracy
Principal owner of TMK & Associates

John A. Tracy
Author of Accounting For Dummies

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by Tage C. Tracy and John A. Tracy

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About the Authors

Tage C. Tracy (Poway, California) is the principal owner of TMK & Associates, an accounting, financial, and strategic business-planning consulting firm focused on supporting small- to medium-sized businesses since 1993. Tage received his baccalaureate in accounting in 1985 from the University of Colorado at Boulder with honors. Tage began his career with Coopers & Lybrand (now merged into PricewaterhouseCoopers). More recently, Tage coauthored with his father, John, *How to Manage Profit and Cash Flow* and *Small Business Financial Management Kit For Dummies*.

John A. Tracy (Boulder, Colorado) is professor of accounting, emeritus, at the University of Colorado in Boulder. Before his 35-year tenure at Boulder, he was on the business faculty for four years at the University of California at Berkeley. He served as staff accountant at Ernst & Young and is the author of several books on accounting and finance, including *Accounting For Dummies, Accounting Workbook For Dummies, The Fast Forward MBA in Finance,* and *How to Read a Financial Report.* He has coauthored two books with his son Tage, *How to Manage Profit and Cash Flow* and *Small Business Financial Management Kit For Dummies.* Dr. Tracy received his BSC degree from Creighton University and earned his MBA and PhD degrees from the University of Wisconsin. He is a CPA (inactive) in Colorado.

Dedication

We would like to dedicate this book to the backbone of the U.S. economy, namely the tens of thousands of business owners, managers, and entrepreneurs that battle every day to make their companies succeed. Remember that while the deck at times may seem stacked against you during these trying economic times, your spirit cannot be deterred. Our simple hope is that for those of you experiencing cash flow problems or just simply looking to understand cash flows a little better, this book can help ease your pain and offer additional insight on how to improve and manage your business interests.

We also want to mention who this book is not dedicated to: the politicians in Washington and across the U.S. and the banksters that have lost sight of what it means to create, launch, build, and operate a business. Simply put, these parties have spent too much time managing other people's hard-earned money and not enough time creating real value, wealth, and opportunity. Think of the Grinch from the wonderful story by Dr. Seuss, *How the Grinch Stole Christmas.* The Grinch attempted to "steal" Christmas by taking all of the trees, presents, decorations, and whatever else was available from Whoville. Yet Christmas still came, and it was then that the Grinch realized that "Maybe, just maybe, Christmas meant a little bit more." When the politicians and banksters finally realize that maybe, just maybe, owning a business and risking everything one has to pursue a dream means just a little bit more, the unparalleled historical disconnect between the twin Ws (Washington and Wall Street) and Main Street America will begin to evaporate, allowing for real growth to resume.

From Tage Tracy: I would like to dedicate this book to my old man and coauthor (or as I refer to him, TOP, or The Old Pro). About seven years ago, my dad, in a manner reminiscent of Vito Corleone of *The Godfather,* made me an offer I couldn't refuse: Take over the family business or else. (Thank goodness we didn't own a horse, but I was concerned about our cat from time to time). In this case, the family business involved carrying on his remarkable and deeply insightful legacy of being able to translate even the most complex and difficult accounting and financial concepts into easy-to-comprehend layman's terms. As for the "else," well let's just say that the old man has threatened to ditch me from his will more than once (a running joke in our family). I am forever grateful for the opportunity to write with and learn from TOP.

Acknowledgments

We are deeply grateful to everyone at John Wiley & Sons, Inc., who helped produce this book. Their professionalism and courtesy were much appreciated. First, we thank Stacy Kennedy, the acquisitions editor. She helped us develop the concept for the book. We appreciate her encouragement. Our editors, Tim Gallan and Caitie Copple, were exceptional. It was a pleasure working with them. We owe them a debt that we cannot repay. So a simple but heartfelt “thank you” will have to do. Every author should have such superb editors.

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Contents at a Glance

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Introduction

Cash Flow For Dummies explains how cash flows in the business setting. In broad terms, *cash flow* refers to generating or producing cash (cash inflows) and using or consuming cash (cash outflows). As such, maybe the simplest way to view cash flows are to consider them the blood of the business, and you must keep that blood circulating at all times in order avoid failure or death. So the first rule is that you can't run out of cash, no more than you can run out of blood, and although you might be able to go on cash flow life support for a short time, the outcome of this strategy is almost always extremely painful. In addition to explaining the basics of cash flow, this book then tackles numerous issues on how to improve cash flow and manage this invaluable resource more efficiently. Continuing the analogy of cash flow being the blood of the business, we assist you in keeping your arteries free and clear of any potential blockages to ensure that your blood flows freely and that your business's health is protected at all times.

In large business organizations, cash-flow duties are delegated to finance professionals. In small businesses, and even in many midsize businesses, managers and owners have to take a more direct role in cash-flow affairs, and this area of business management isn't always easy to navigate. That's why we're here to help.

Cash flow is both clear and opaque. Borrowing money from a bank is an obvious source of cash. But when should you borrow money, what payment terms should you negotiate, and what are the risks of debt? Our book provides practical answers for the fundamental cash-flow questions facing every business. We explain the crucial difference between recording a profit, which is an accounting measure, and generating cash flow from that profit. Many business managers confuse profit and cash flow, which can have serious consequences. With this book at hand, you'll be prepared to handle cash flow in an efficient and profitable way.

About This Book

Cash Flow For Dummies aims to help managers and owners of small and midsize business who have direct involvement in the cash flows of their business. We also provide very useful information for business lenders and investors. Although business finance professionals may find fresh insights in this book, this book sticks to essentials, and we don't delve into technical areas.

Business managers are very busy people; they have to carefully budget their time. Small business owners/managers are especially busy people; they have little time to spare. We promise not to waste your time with this book. In every chapter, we cut to the chase and avoid detours. We restrict our discussions to fundamentals — topics you must know to handle the cash-flow affairs of your business.

This book is not like a mystery novel; you can read the chapters in any order. You may have more interest in one chapter than others, so you can begin with the chapters that have highest priority to you. Where a topic overlaps with a topic in another chapter, we provide a cross-reference.

By all means, use the book as a reference manual. Put it on your desk and refer to it as the need arises. It's your book, so you can mark topics with comments in the margins or place sticky notes on pages you refer to often. This book isn't a college textbook. You don't have to memorize things for exams. The only test is whether you improve your skills for managing the cash flow of your business.

Conventions Used in This Book

Throughout this book we use examples to explain cash flow, most of which are illustrated with financial statements or elements of financial statements. We make the examples as true to life as we can without getting bogged down in too many details. Our examples are hypothetical, but they come from the real world of business.

As you may know, financial statements are based on standardized accounting methods and terminology. It's been said many times that accounting is the language of business. You may not be entirely comfortable with financial statements and the methods and jargon of accountants. We understand your predicament. Throughout the book we take care to use plain English in explaining financial statements and accounting methods.

In this book, we distinguish between the internal accountant, who is an employee of your business, and the outside, independent accounting professional who advises you from time to time. A small business employs an accountant who is in charge of its accounting system. The employee's job title may be controller, in-charge accountant, or office manager. In this book, the term *accountant* refers to the person on your payroll. We refer to your independent professional accountant as a *CPA* (certified public accountant).

As for formatting conventions, we use *italic* to introduce new terms that are defined. We also use italic to reference information listed in figures.

What You're Not to Read

We occasionally go off on tangents or offer anecdotes in gray boxes called *sidebars.* These sidebars offer interesting but nonessential information, so you can skip them if you like.

Not every topic may have you sitting on the edge of your seat. For example, you may already have a good grasp on the three primary financial statements of a business — the income statement, the balance sheet, and the statement of cash flows. If so, you may not be terribly interested in Chapter 3, which introduces these three financial statements. (But be sure that you understand the statement of cash flows!) You can skip over topics that aren't immediately relevant or urgent; you won't hurt our feelings.

We suspect that a few topics in the book are more detailed than you're interested in. For example, you may find that the details of the technique discussed in Chapter 6 for analyzing cash flow from profit is not practical for your business because it deviates from the standard methods of accountants. You may simply skim over the technique, and reconsider it at a later time.

Foolish Assumptions

In writing this book, we've done our best to put ourselves in your shoes as a manager of a small or midsize business who has responsibilities for cash flow. Of course, we don't know you personally. But we have a good composite profile of you based on our experience in consulting with small business managers and explaining cash-flow issues to business managers who have a limited background in financial matters.

Perhaps you've attended a short course in finance for the nonfinance manager, which would give you a leg up for reading this book. We should mention that many of these short courses focus mainly on financial statement analysis and don't explore the broader range of cash-flow management issues that owners and managers of smaller-size businesses have to deal with.

However, we take nothing for granted and start our discussions at ground zero. We present the material from the foundation up. The more you already know about the topics, the quicker you can move through the discussion. Whether you're a neophyte or veteran, you can discover useful insights and knowledge in this book. If nothing else, the book is a checklist of the things you ought to know for managing the cash flow of your business.

How This Book Is Organized

This book is divided into parts, and each part is divided into chapters. The following sections describe what you find in each part.

Part I: Fitting Cash Flow into the Big Picture of Running a Business

Part I explains the crucial importance of managing cash flow to avoid running out of cash and to keep your business financially viable. The continued existence of a business depends on a healthy rhythm of cash flow. Cash flow from making profit is the starting point. The first two chapters explain the important difference between accrual-basis accounting that's used in recording revenue and expenses and the cash flows of revenue and expenses. Also, the three basic financials statements of a business are reviewed with special emphasis on the statement of cash flows.

Part II: Using Financial Statements to Assess Cash Health

Part II offers chapters that take you on a walk through the balance sheet from the cash-flow point of view. As you probably know, this financial statement summarizes the assets, liabilities, and owners' equity of the business. The cash-flow aspects of assets and liabilities are typically overlooked or not understood well. Business managers need to astutely understand the cash-flow aspects of every asset and liability. Also, we take the particular assets and liabilities from the balance sheet that affect cash flow from profit and use them to build a technique for analyzing the difference between cash flow and bottom-line profit in the income (profit and loss) statement.

Part III: Getting Intimate with Your Company's Cash Flow Needs

To begin this part of the book, we explain the importance of developing a viable and realistic business plan, one that lays the foundation for the business and that serves as the key document in raising capital to start and grow a business. A business has to demonstrate clear thinking when it comes to raising cash from lenders and investors, and its clearheaded thinking must show through in its business plan. This part of our book takes a hard but realistic look at the two basic sources of business capital: debt and equity.

Part IV: Managing Your Business with Cash Flow in Mind

Part IV gets down to the nuts and bolts of managing cash flows. The first two chapters explain the day-to-day management details of keeping cash flowing and preventing cash losses from embezzlement and fraud. The last two chapters explain how to squeeze more cash flow from the two basic cycles of business: the selling cycle and the disbursement cycle. Managers often overlook the potential cash-flow benefits from paying more attention to the cash-related aspects of these two basic operating cycles.

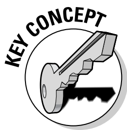
Part V: The Part of Tens

The Part of Tens is a staple in every *For Dummies* book. These chapters offer pithy lists of advice related to the main points of the chapters. One chapter summarizes ten cash-flow management rules for the small business (that apply to larger businesses as well, we should mention). The final chapter in this part of the book tells ten tales of cash-flow woes.

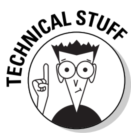
Icons Used in This Book

Throughout this book, you see some little pictures in the margins. These icons highlight the following types of information:

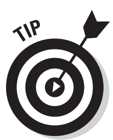
This icon asks you to keep in mind an important point that is central in the explanation of the topic at hand.



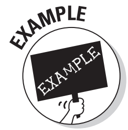
This icon serves as a bookmark tagging an extremely significant concept.



As you may surmise, this icon serves as a “yellow light” that the going gets a little heavier here. You may have to slow down and read this stuff more carefully and ponder it more than usual. However, this information isn’t critical to understanding the basic concept.



This icon highlights, well, *tips* for understanding, analyzing, and managing cash flow. These pointers and advisories are worth highlighting with a yellow marker so you don’t forget them. On second thought, this icon saves you the cost of buying a highlighter pen.



When you see this icon, we're presenting a real-world example of whatever concept or point we happen to be discussing.

This icon calls out terminology that is frequently used in the accounting and finance world.

This sign warns you about speed bumps and potholes on the cash-flow highway. Taking special note of this material can steer you around a financial road hazard and keep you from blowing a fiscal tire. You can save yourself a lot of trouble by paying attention to these warning signs.

Where to Go from Here

Many small business managers and owners are confused (or if not confused, then not entirely sure) about earning profit on the one hand and squeezing out cash flow from profit on the other hand. For that matter, many managers of larger businesses are confused about profit and cash flow. If you are in this state of mind, you should start with Chapter 1, where we distinguish between revenue and expenses that you see in a profit report and the cash flows of revenue and expenses. Chapter 2 is the logical next step, which explains why accrual accounting is necessary for measuring revenue and expenses.

You may need to review business financial statements. If so, then by all means read Chapter 3. You can start with that chapter, but you'll probably get more use out of it after you have absorbed the captivating topics in Chapters 1 and 2. You may already have a solid understanding of accrual accounting (be certain that you do) and you may already have a good understanding of the balance sheet and income statement of businesses. In this case, you may want to charge directly ahead to Chapter 4, which explains the statement of cash flows.

After Part I, you can take a more cafeteria-style approach and read the chapters in Parts II, III, and IV as you prefer. One or more chapters may have particular interest to you, such as Chapter 14, on the "ground rules" for using debt, or Chapter 8, on creating a business plan with cash flow foremost in mind. Feel free to jump around. However, we recommend saving the chapters in Part V for dessert, after enjoying a full meal of other chapters.

Part I

Fitting Cash Flow into the Big Picture of Running a Business

The 5th Wave By Rich Tennant

"This ledger certainly paints a picture of the company. Edvard Munch's 'The Scream' comes to mind."

In this part . . .

We begin with the first rule of business — you can't run out of cash. Business managers and owners need to understand cash flow. The logical place to start is cash flow from making profit. When you read about revenue and expenses in an income statement (also known as a *profit and loss report*), you aren't reading cash-flow numbers. The cash flows of revenue and expenses are different, and you'd better know why.

Business managers and owners need to know how to read their three basic financial statements from the cash-flow point of view, and that includes having a sure grip on the statement of cash flows and how it connects with the balance sheet and income statement. Ignoring cash flow is not an option in managing a business — unless you have more cash than you know what to do with. Many businesses operate with a razor-thin cash balance, so understanding cash flow should be a top priority.

Chapter 1

Getting in Sync with the Rhythm of Cash

In This Chapter

- Defining the number one business rule: Don't run out of cash
- Reviewing how revenue and expenses are tracked
- Differentiating profit and cash flow: Kissing cousins but not identical twins
- Sorting out basic types of cash flows

In running a business, you have to follow many rules, but one rule stands above the others: *Don't run out of cash.* As obvious as you may think this rule is, the importance and difficulty of maintaining an adequate cash balance are generally taken for granted in business management books and articles. Many business managers ignore cash until a serious problem pops up. They assume that cash will take care of itself, as if cash could be put on automatic pilot. Nothing is farther from the truth. If you don't pay attention to cash, you may be in for a nasty surprise.

To control cash, you must control cash inflows and cash outflows. To do that, you need cash-flow information, and you need to know how well your current cash balance stacks up against the short-term demands on cash. Managers depend on regular accounting reports for financial information; in particular, their monthly income statement (also called the *profit and loss,* or *P&L, report*). However, the income statement doesn't provide the cash-flow information you need.

You must turn to another financial statement for cash-flow information, appropriately called the *statement of cash flows.* But here is where things get rather befuddling for the business manager. The cash-flow statement lists adjustments to profit to arrive at the cash flow from making profit. It assumes that the reader has a good basic understanding of profit accounting and, therefore, knows why adjustments are necessary to find cash flow. But in our experience, business managers do not fully understand how their accountants measure profit, which makes understanding cash flow and why it's higher or lower than profit very difficult.

This chapter starts by pointing out the catastrophic consequences of running out of cash. Next, we offer a brief review of profit accounting and the assets and liabilities that are used in recording revenue and expenses. Changes in these assets and liabilities are the reasons why cash flow differs from profit. Then the chapter takes the first steps in explaining the cash-flow aspects of making profit and why cash flow is invariably higher or lower than the bottom-line profit or loss number in the income statement. We also explain the cash-flow side of business transactions and the basic classes of cash flows.

Not Letting the Well Run Dry

One morning you arrive at your business. As usual, you're the first person to arrive. But none of your employees come to work. Not one. Who will open the doors for customers? Who will sell your products? Who will start tapping on the computers? This scenario may seem like a nightmare, but it's not the worst thing that can happen to a business.

Here's the real fiasco you should worry about: One day your accountant rushes into your office and tells you that the business's bank account balance is zero. You have $50 in petty cash and a small amount of currency in the cash registers. But that's it. Your checking account is empty. You can't cut any checks to your vendors, who will cut off your credit if not paid on time. You have a sizable payroll to meet in two days. If not paid, your employees will quit. And your bank is sure to notice that your checking account balance is zip and may consider shutting down your credit line. It's not a pretty picture, is it?

WARNING!

A zero cash balance puts you on the edge of a cliff. One false step and you can fall off and be unable to recover. When your suppliers, employees, and sources of capital find out about your cash problems — and they will — your credibility drops to zero. The businesses and various people you deal with depend on your ability to continue as a going business that they can rely on in the future. Running out of cash would pull the rug out from under the reputation of your business that you worked so hard to build up over the years. You could lose your business to creditors or have to declare bankruptcy.

Running out of cash is an extreme, worst-case scenario, although it's a threat many businesses face. The purpose of mentioning it here is to emphasize its disaster potential for a business. Running out of cash is not just a life-changing event for a business; it can be a life-*ending* event. Business managers should never let their guard down regarding cash and cash flows.