xendoo

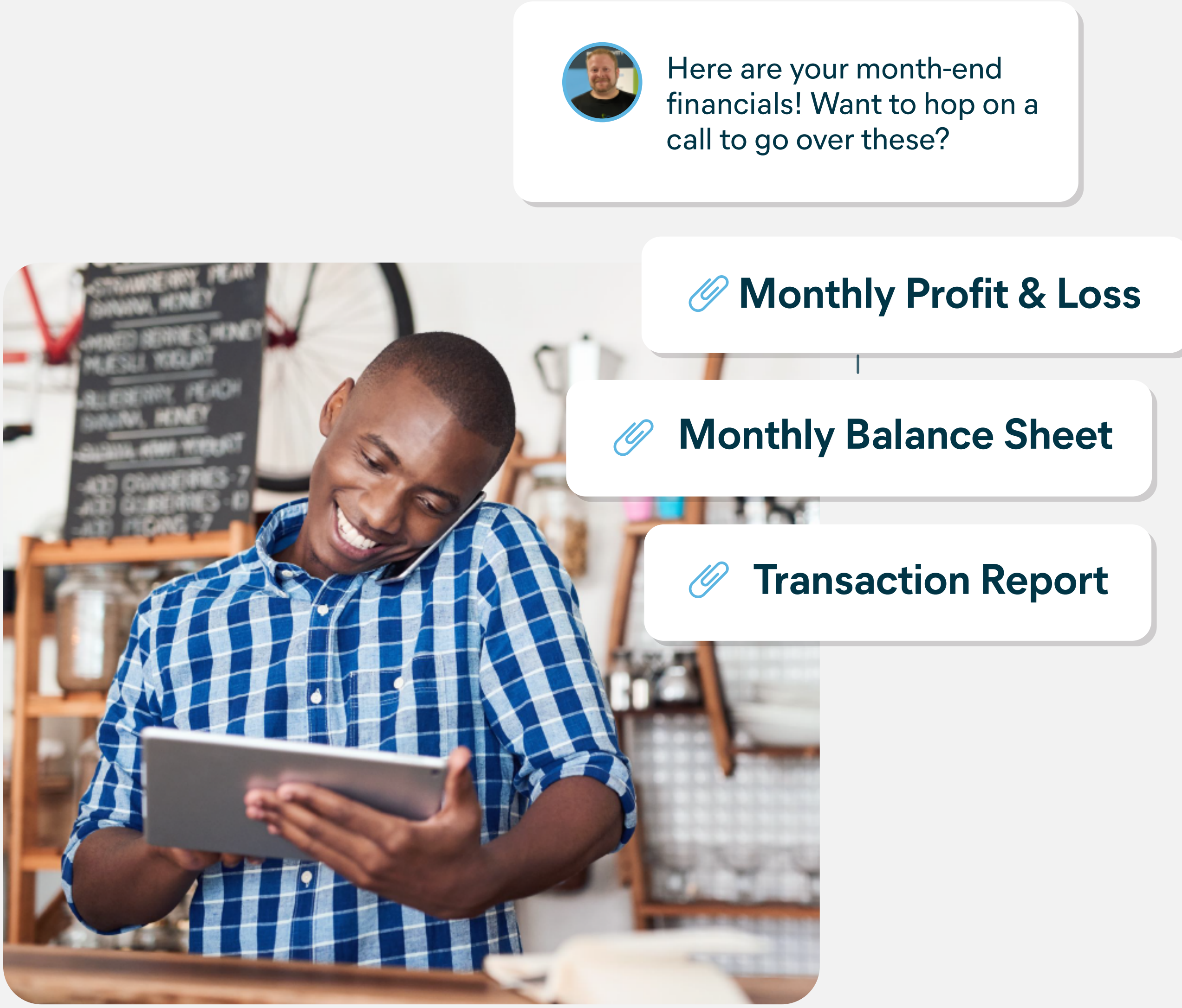
PLANNING FOR SUCCESS:

A GUIDE TO CASH FLOW

The Value of Cash Flow

Running a business means more than just making money. It comes with costs - vendor payments, office space, and payroll expenses are just a few. As a business generates profit, the owner must be mindful of the timing of their payments so that they do not run out of cash. This is where cash flow comes in.

Healthy cash flow is vital, but monitoring it can be tedious and complex, leaving room for error. Business owners already juggle countless responsibilities, such as closing sales, building and managing their team, networking and marketing, and even bookkeeping - all while trying to enjoy a fun and fulfilling personal life.



You Are Not Alone

Cash flow management may feel like a hurdle, but it is one you can leap. In this guide, we will walk you through your Cash Flow Statement, and how to create a cash flow forecast to plan for long-term success!

What is Cash Flow?

Cash flow is described as the lifeblood of a business. In technical terms, cash flow represents the money that comes into (inflows) and out of (outflows) your business. Positive cash flow means there is more money coming in than going out, while negative cash flow means that there is more money going out than coming in.

Think about a water tank: water flows in at the top and flows out at the bottom. More water must flow in than flow out in order to keep the tank full.

Be aware that **profitability does not necessarily indicate positive cash flow.** A business could make an impressive yearly profit, but have no money in the bank. According to a U.S. Bank study, 82% of businesses that fail are actually profitable, but do not have visibility into their cash flow. This could occur due to a number of reasons, including, but not limited to:

- **Bills** (outflows) could be due before invoices (inflows) are received.
- **Past-due customer invoices.** According to the 2021 QuickBooks Payment and Cash Flow Survey, 27% of business owners express that not getting paid according to the agreed-upon was a primary contributor to their cash flow problems.
- **Lack of visibility into business financials** (usually due to late reporting or not having bookkeeping up to date).
- **Having cash tied up in idle inventory**

Cash flow is all about timing. This understanding reveals solutions concerning payments, costs, and business spending. In order to determine your monthly cash flow, and how you can make improvements going forward, it is crucial to review your Cash Flow Statement on a monthly basis.

Get to Know Your Cash Flow Statement

The Cash Flow Statement summarizes the amount of cash that flows into and out of a company over a specific period of time. It is broken down into three sections: cash flow from operating, investing, and financing activities.

Cash Flow from Operating Activities

The first section of the Cash Flow Statement covers cash flow from operating activities. This refers to the amount of money a business earns from ongoing business activities, such as selling your products and services, and the cost of selling those goods and services, along with operating expenses.

Cash Flow from Investing Activities

Cash flow from investing activities includes any inflows or outflows from investment-related activities, such as the purchase of long-term assets like buildings, land, and equipment.

In some cases, investing activities can cause more cash to flow out than in. For example, if you are making major investments for your business, you may see consistently negative cash flow under your investing activities.

Cash Flow from Financing Activities

Cash flow from financing activities refers to the cash that is provided by or repaid to debt holders or equity holders. Examples of financing activities include (but are not limited to) the usage of a credit card or loan to fund the business (inflows), as well as credit card, loan, and dividend payments (outflows).

Below is an example of a Cash Flow Statement:

Cash Flow Statement For the year ended December 31, 2021	
Cash Flow from Operations	
Cash receipts from customers	86,772
Cash paid for inventory	(7,400)
Cash paid for wages	(53,000)
Net Cash Flow from Operations	**26,372**
Cash Flow from Investing	
Cash receipts from sale of property and equipment	13,500
Cash paid for purchase of equipment	(17,500)
Net Cash Flow from Investing	**(4,000)**
Cash Flow from Financing	
Cash paid for loan repayment	(5,000)
Net Cash Flow from Investing	**(5,000)**
Net Increase in Cash	**17,372**

Cash Flow and Debt

Cash flow-savvy business owners know when to strategically take on debt to finance their business. Understanding *your* debt levels enables *you* to make wise decisions about your finances, acquire loans, and pay off your debts through cash flow.

A reasonable amount of debt can benefit a business, as it delivers immediate cash flow. For example, a loan could provide the cash needed to open a new location. However, you must be mindful of how you intend to pay off your debt. Will you have the cash you need, when you need it, in order to make your payments? Before you make your next move, examine your Debt to Equity and Debt to Asset Ratios.

The Debt Ratios

The Debt to Equity Ratio is a measure of the degree to which a company is financing its operations through debt versus its own funds. The Debt to Asset Ratio indicates the percentage of assets that are being financed with debt. These ratios determine the amount of debt in a business, and the ability to repay that debt.

Investors and creditors tend to favor companies with lower Debt to Equity Ratios because it means that they are not relying heavily on debt to finance their operations, and will likely be able to pay back loans efficiently through healthy cash flow. A higher ratio is considered risky, because the business has more liabilities than it does assets, so strategic debt management is key to acquiring funding.

How you choose to finance your business can affect your ability to acquire loans, and pay them off. Healthy cash flow is crucial to meet your current financial obligations and prove that you are able to take on more debt if needed.

Net Profit Margin

When deciding whether to accept a loan, consider the interest rate in relation to your Net Profit Margin. The Net Profit Margin is a financial ratio that determines the amount of Net Profit a business makes per dollar of revenue gained. Creditors and investors use it to assess the ability of a business to pay back loans, based on the profitability of the business. For business owners, it serves as a gauge for what interest rate they can safely take on. If the interest rate of a loan hinders the ability to maintain healthy cash flow and negatively affects Net Income, it may be best to explore less expensive options.

To illustrate, here is an example:

A business owner has a Net Income of $1,000,000 and a 20% Net Profit Margin. This means that for every dollar generated in revenue, the business keeps $0.20 as profit - $200,000 total.

They are offered a one-year loan of $200,000, with an interest rate of 20% (or $40,000). In total, they will owe $240,000.

Should the business owner take this loan? It depends on how quickly the business intends to scale.

If the loan is intended to help produce dramatic results, such as doubling Net Income year over year, the accelerated growth and increased cash flow will enable the business to pay back the loan quickly and efficiently.

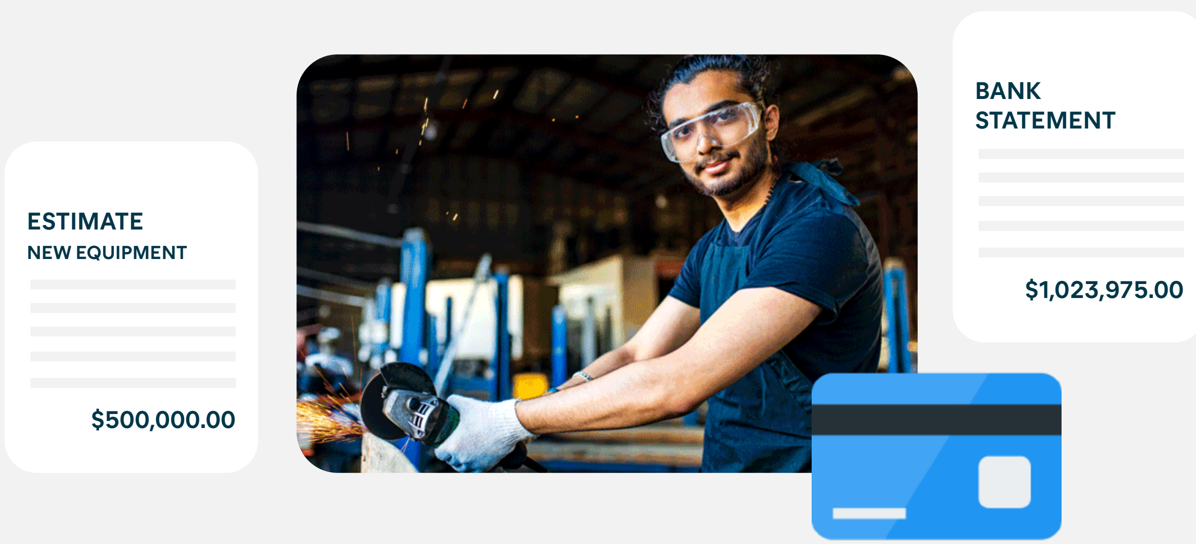
On the other hand, if the business does not intend to use the loan to scale rapidly, it may be worthwhile to find one with a lower interest rate, so payments can be made efficiently with Net Income, the Net Profit Margin and cash flow remaining stable.

Disclaimer: The example above is not intended to serve as financial advice for any specific business. Its purpose is to illustrate how loan interest rates can affect the choices business owners make based on their Net Profit Margin and cash flow. Speak to your accountant to discuss your specific situation regarding accepting loans for your business.

How Will You Use Your Cash?

The Cash Flow Statement helps you plan how you will use your cash. By examining how and when cash flows into and out of your business, you can determine that you have the cash you need to make crucial financial decisions.

To illustrate, let's take a look at an example:



You have **$1,000,000** in the bank and need to purchase **$500,000** worth of equipment. **You can either pay the entire amount in cash or finance it through a loan.**

Paying the entire amount up front may not allow for enough capital to continue operating. Although you will have money left after the purchase, there are still other expenses that need to be covered, such as bills, insurance, and payroll. With $500,000 now out of your account, you may not have what you need to cover those expenses and could run out of cash.

On the other hand, if your budget confirms that $500,000 is enough to continue operating and maintain healthy cash flow, it may be best to pay up front and avoid taking on debt.

If your financials indicate that you need to obtain a loan, payments can be factored into your budget and scheduled over a period of time. Even though a sizable purchase was made, you will still have the cash needed for operations.

In this scenario, you thought about how you spend money, when money comes in, and if the cash on hand would be enough to keep the business operating. With all of those factors in mind, you considered which option would be best for future cash flow management.

Predicting cash flow is a common practice that provides insight into your cash needs, to ensure that you will have the cash you need to cover expenses and keep operating as your business grows. It also paints a picture of how your cash position may change over time. By examining your previous Cash Flow Statements, you can use the past to predict the future.

How to Create a Cash Flow Forecast

Business growth comes with investments. As you grow your business, you will likely have to increase your inventory, hire new team members, and rent a larger work space. In order to effectively strategize your cash usage for the future, you can create a cash flow forecast.

1 Decide How Far Out You Want to Plan

To begin, decide how far out you want to plan. A cash flow forecast can cover a few weeks or a year ahead, depending on the amount of financial data you have and your insights about future needs.

Well-established businesses will have years of financial data that can be used to create accurate, long-term cash flow forecasts. Newer businesses may not have as much data, so the further out they go, the less accurate their predictions will be. The goal is to plan as far as you need to make impactful business decisions.

Regardless of how much data you have, cash flow forecasts can change over time. As your business grows, you can make more accurate predictions and update your forecast as needed.

2 Know Your Inflows and Outflows

Many rely on a calendar to keep track of their cash inflows and outflows. While the visualization can be helpful, there is a time-saving alternative: a dedicated **online bookkeeper**.

Online bookkeepers utilize **cloud-based accounting software** such as Xero or QuickBooks Online to keep your financials up to date. As they record your expenses, they can determine what your usual cash inflows and outflows are. All the information is consolidated in your monthly Profit & Loss Statement and Balance Sheet, which is generated through your accounting software.

Well-established businesses will have years of financial data that can be used to create accurate, long-term cash flow forecasts. Newer businesses may not have as much data, so the further out they go, the less accurate their predictions will be. The goal is to plan as far as you need to make impactful business decisions.

Regardless of how much data you have, cash flow forecasts can change over time. As your business grows, you can make more accurate predictions and update your forecast as needed.

Examples of cash inflows and outflows include, but are not limited to:

Cash Inflows

- Accounts Receivable (future cash inflows)
- Revenue (customer payments, etc.)
- Loans
- Equity
- Supplier Refunds

Cash Outflows

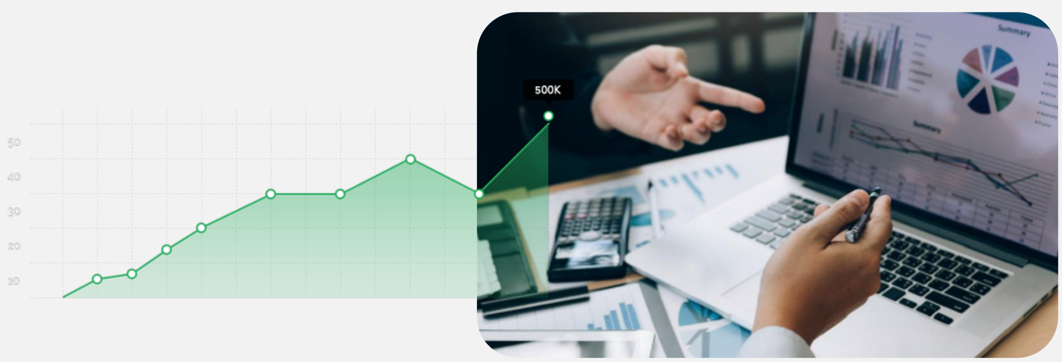
- Accounts Payable (future cash outflows)
- Operating Expenses (rent, insurance, payroll, etc.)
- Cost of Goods Sold (COGS)
- Inventory Purchases
- Loan and Credit Card Payments
- Purchase of Property and Equipment
- Owner's Draw
- Supplier Payments
- Cost of Labor (employee wages, benefits, and payroll taxes)

Knowing your cash inflows and outflows will provide you with insight into business spending, and help you determine where you can cut costs if needed.

3 Make Your Estimates

To estimate your cash flow for each month, start with the opening bank balance, meaning the cash you currently have on hand. Then, add all your projected cash inflows, and subtract the projected cash outflows. The result is the amount of money you will have at the end of each period, called the Closing Cash Balance. This also serves as your next period's opening balance.

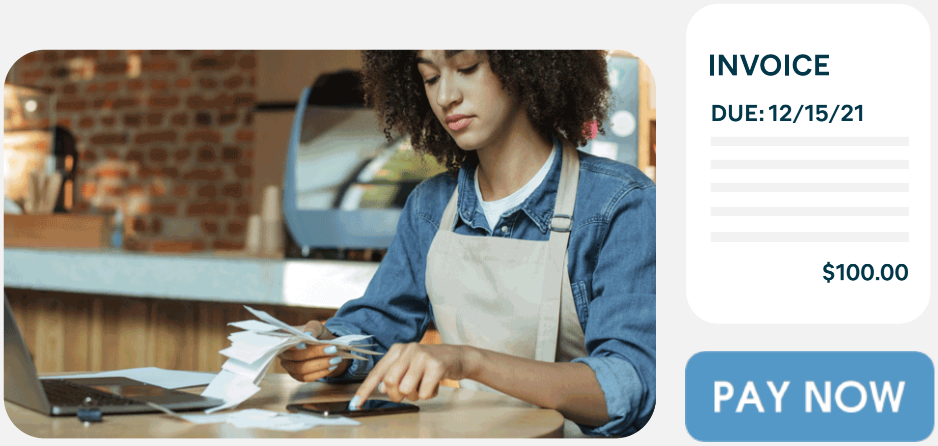
Repeat this process until you reach the end of your forecast period. These estimates will show you whether you can expect to have the cash you need to make financial decisions, such as expanding your inventory, or opening a new location!



4 Compare Your Results

As you move forward, review your cash flow forecast from month to month and compare your results. Is your cash flow meeting your expectations, or are you seeing negative results? What steps can be taken to change that?

To illustrate, let’s take a look at an example:



You have a supplier bill of $100 due on the 15th of each month. A customer will send in a recurring $200 payment, but it is not scheduled to be received until the 30th.

You can prevent negative cash flow by:

- Negotiating a later payment date with your supplier
- Incentivizing your customer to make their payment sooner by offering an early payment discount

Either way, you will receive the cash in time to cover the bill.

Knowing your cash flow enables you to improve the timing of payments, identify solutions for costs and savings, and make data-driven decisions that will affect the future of your business.

More Money, Less Problems

Xendoo Online Bookkeeping and Accounting is here for you. Enjoy peace of mind knowing your books are up to date and organized. Each month, you will receive detailed reports giving you actionable insights to help you manage your cash flow and grow your business.

We would love to partner with you as your **online bookkeeping** team. **Schedule a consultation with one of our accountants today to get started!**

xendoo

PLANNING FOR SUCCESS:

A GUIDE TO CASH FLOW

© Xendoo Inc. All Rights Reserved