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Cash: Lifeblood of the Business

Source: Entrepreneurial Small Business, Katz & Green, 2e
McGraw-Hill/Irwin

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Importance of Money

- What is money, and why is it so important?
- **Money:** cash, cash equivalents, profits, and banking
- **Differences are important**
 - Represents the lifeblood of the business, and knowing how to use it can make the difference between boom and bankruptcy

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Money In / Money Out

- Almost 2/3 of all small businesses experience money problems
 - 1/5 of small business managers reported that cash flow is a **continuing problem**
- Three primary causes of **cash flow problems**:
 - Difficulty collecting money due
 - Seasonal variation in sales
 - Unexpected decreases in sales

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Percentage of Small Businesses that Experience Cash Shortages

Frequency	1-9 employees	10-19 employees	20-249 employees
Never	~35%	~30%	~25%
Occasional	~30%	~25%	~20%
Common	~15%	~10%	~5%
Continuing	~10%	~5%	~2%

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The Cash-to-Cash Cycle

```

    graph TD
      CASH((CASH)) --> PURCHASES[PURCHASES]
      PURCHASES --> PAYABLES[PAYABLES TO VENDORS]
      PAYABLES --> Labor[Labor]
      PAYABLES --> Materials[Materials]
      PAYABLES --> Overhead[Overhead]
      Labor --> PRODUCT[PRODUCT OR SERVICE]
      Materials --> PRODUCT
      Overhead --> PRODUCT
      PRODUCT --> SALES[SALES]
      SALES --> RECEIVABLES[RECEIVABLES FROM CUSTOMERS]
      RECEIVABLES --> CASH
    
```

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- The **cash-to-cash cycle** of a pushcart vendor is only a few hours; construction projects may take years to complete
- Many small businesses experience difficulty because:
 - The mismatch in time between **receiving and spending cash**
 - Mismatch in time between **size of payments received and size of payments to be made**

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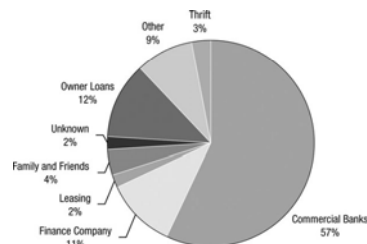
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- **Company book balance includes:**
 - Records of all inflows of cash
 - Cash from sales
 - Receipts on receivables
 - Checks received from customers
 - Deposits made directly to the bank through electronic transfers
 - Records of all outflows of cash
 - Checks written to pay for wages, salaries, inventory, services, taxes, and so on

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Sources of Credit and Debt for Small Businesses



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- **Bank ledger balance:** bank's accounting system for all recognized transactions that affect the account
 - Balance may vary because of delays in collecting deposits and delays in making cash transfers
- **Bank available balance:** actual cash value of the account

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- **Overdraft:** a negative balance in a depositor's bank account
- **Float:** describes the delay in movement of money among depositors and banks
 - **Two primary causes:**
 - Delays in transferring money due to internal procedures (**availability float**)
 - Delays in delivering checks (**processing float**)

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- **Reconciling bank balances with company book balances**
 - key is knowing how much cash is available to you at the moment
- Process of reconciling bank balance and book balances is quite simple

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- **Two reasons why balances differ:**
 - Bank knows information about your account that you cannot know until the bank tells you
 - You know information about your account that the bank cannot know, because relevant transactions have not yet reached the bank

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- **Two-step reconciliation process:**
 - Add (subtract) to the bank balance those things that you know about your account that the bank does not know
 - Add (subtract) to your book balance those things that the bank knows

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- **Reconciliation serves four purposes:**
 - Estimate the bank's available balance for the purpose of managing your cash flows
 - Identifies any mistakes that were made by either the bank or by your own bookkeeper
 - Checks the accuracy of both the bank and business records
 - Lets you know about items on the bank statement that would not otherwise be included in the business's accounting records

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- **Forecasting sales receipts:** sales forecast is the cash receipts forecast
- Businesses whose customers make heavy use of their **credit cards** can face serious **cash drains**
- Many businesses have either relatively few large sales events or highly seasonal sales that complicate forecasting

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- If you provide credit to your customers, you will always **wait some period of time** for some of your money
 - You will also have some customers who **never** pay
 - You never know exactly when you will **collect cash**
 - **Reasonable estimate** of their amount and timing can be made

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- **Forecasting cash disbursements:**
 - Estimates of expenses
 - Knowledge of your business's payment patterns
 - Predict how much and when cash should be paid out
 - Need to know how much money we will have on the first day of the year to put together a cash budget for the first quarter

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- **Pro forma balance sheet:**
 - Final step is to put everything together to create a complete set of pro forma financial statements that you can use for raising money, for evaluating your operations, and for managing your business
 - **Comprehensive budgets:** referred to as master budgets

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Example

Managing Your Cash Flow

- Cash-flow forecast will help you predict the amount of money that will be coming into and flowing out of your business
- Take these steps to ensure your new business will maintain its positive cash flow
 - Know what to expect
 - Predict and plan for the slow times
 - Make projections for the future

<http://www.entrepreneur.com/magazine/bsstartups/2002/august/54176.html>

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Preventing Cash Flow Problems

- Best prevention is **attention and understanding** your business's operations
 - Maintain an accurate forecast of cash needs
- Techniques to **increase cash flows**
 - Taking deposits and progress payments
 - Offering discounts for prompt payments
 - Asking for your money
 - Taking on noncore paying projects
 - Factoring receivables

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Techniques to decrease cash outflows:

- Two factors of cash outflows that must be controlled:
 - The amount of cash being paid out
 - The timing of cash being paid out
- **Waste** also affects cash outflow

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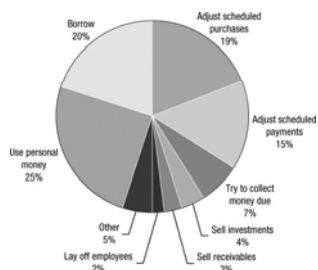
Several strategies that will provide savings in cash outflows:

- Trade discounts
- Non-cash employee incentives
- Use of temporary agencies
- Consignment
- Barter
- Control of the timing of paying out cash
- Timing of purchases
- Negotiation of terms with suppliers

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Controlling Cash Shortages



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Summary

- Managing cash flows is the most important and most difficult task faced by owners and managers of small businesses
- Revenue and expenses are used to predict the amounts and timings of cash outflows primarily through the budgeting process
- Reconcile both the bank balance for items that you know about but are unknown to the bank, and then include those items that are reported by the bank, such as their fees

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