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Most small businesses raise their funding from a variety of sources. Perhaps the owner’s personal funds, with a mix of loans from family, friends and the bank.

Whatever the mix, you’ve got to make sure you start your business with the right money.

In other words, you don’t want to borrow excessively when you’ve plenty of your own money, or be short of cash to run your business effectively.

Understanding cash flow

The simplistic explanation of cash flow is the money flowing in and out of your business.

Profits versus cash

One of the first things to understand is that profits generally don’t automatically equal cash.

Example

Let’s say you’ve made a $30,000 sale
Your operating expenses represent 10% – $3,000
The cost of stock to your business is 50% – $15,000

So that’s $12,000 profit

For the sake of this example, let’s now assume you offer your customers 30 days’ credit. The customer pays a 10% deposit ($3,000) on receipt of the goods and will pay the final $27,000 in 30 days. However, you’ve paid for the stock and operating expenses up front.

Example

Funds collected from the customer – $3,000
Stock and operating cost to you – $18,000
Cash flow shortfall – $15,000

You’ve got a cash flow shortfall of $15,000 to carry for the next 30 days. What happens if you make two more sales? On paper you’d have profits of $36,000 (3 x $12,000). You’d also have a cash flow shortfall of $45,000 (3 x $15,000).

In this scenario, if you don’t have access to $45,000, how could you afford to operate? Imagine the angst of turning away another sale because you simply couldn’t afford to carry the debt.

Understanding your operating cycle

It’s fair to say the example above is relatively simplistic, but the point is valid. If you don’t plan your cash flow and understand your operating cycle, you may find yourself in difficulty even though the basics of your business appear sound.

Getting a sense of your operating cycle is relatively straightforward.

First, leave all the other reasons for being in business to one side and look at the end result solely as cash. You can construct a diagram like the one below for your business. You’ll notice the times when cash moves in and out and how part of this cash is reinvested as the operating cycle turns full circle and continues.

In this business cash goes out in three areas. Purchasing raw materials, manufacturing goods from those materials and the cost of retail staff and premises when the goods are sold.

Cash flow planning

Cash flow forecasting is usually done over a 12 month period (matching your business planning year) on a monthly basis. To maintain focus on the bigger picture ensure the forecast has a system for keeping track of the cumulative figures.

You can download a Cash Flow Forecast template at www.thesbhub.com.au
Managing cash flow
Cash flow management isn’t just about the movement of cash in and out of the business. It’s also about ensuring there are sufficient funds to pay wages, suppliers, taxes and expenses when they fall due. It’s important that you forecast for your monthly cash needs on a regular basis, then compare your forecast with the actual results and adjust the forecasts accordingly.

Have a plan
Don’t throw your business plan or your cash flow forecast in the top drawer and forget them. If you regularly check your performance you’ll have a sense of how things are progressing and if you need to make adjustments.

Planning is vital and can turn a potentially damaging situation into an opportunity. Monitor your cash flow closely and make contingency plans to cover the rough patches. It’s important to be aware of changing market conditions so that you can respond to changes.

But if you have cash flow difficulties then there are a number of options to consider.

Option 1 – Shorten the operating cycle
One way to attack cash flow problems is to shorten your operating cycle. Look at the individual components and see which ones can become more efficient. The most obvious is to collect debts sooner. Also examine some other areas:

- reducing the level of excess stock on hand (be careful not to leave yourself short and unable to meet customer demand)
- obtaining stock on a consignment basis, so you don’t pay for it until it’s sold
- reducing the time it takes to manufacture your product, sell your product or provide your service
- reducing costs – which will obviously increase your cash in hand and your overall profits.

Above all, attempt to increase your profits.
While we know this is easier said than done, areas to examine are your price structure, costs and total sales. If you can sell the same products and services at greater profit, you’ll raise the level of funds available. It won’t speed up the collection of these funds but there’ll be more left over once you have collected.

If you’re looking to increase your profits, you should also understand the impact this will have on your sales volume. If you can increase your sales volume this should also positively impact on your cash flow, provided you’ve positively addressed any difficulties in your operating cycle.

Option 2 – Trade debtors
Remember, there’s an opportunity cost to trade debtors. The money tied up with trade debtors belongs to your business. It could be much more productively invested elsewhere and, if you’re operating an overdraft, trade debtors may also cost you interest.

But offering credit may increase your sales volume.
Just be careful how this is done.
- if the average collection period is increasing, then you’ll be increasing your business investment in trade debtors and lengthening your operating cycle.
- if you choose to increase the credit terms, you may have an increase in trade debtors on two fronts. The offer of extended terms will obviously lengthen your average repayment period and it could increase the number of sales. The result could be more people owing you money for longer.

Option 3 – Collecting debt
Be clear about your payment terms up front to ensure there’s no misunderstanding. If the reminder is timely, friendly and in the spirit of a business relationship, it may be more successful in terms of obtaining payment and maintaining the relationship.

Option 4 – Debtor finance
This is where a lender provides cash advances against your outstanding invoices. It generally provides you with greater certainty over your cash flow and the ability to access cash when you need it. This type of finance is only available to certain businesses.

Option 5 – Progress payments
Look at making payments at different stages of your operating cycle. This is particularly effective for contractors providing a service. This works by arranging for a certain level of funds to be paid prior to the job, further funds released during the work and the remainder paid on completion.

When offering credit be aware of the risks and measure the impact of the increased payment terms on your cash flow forecasts.
Option 6 – Ex-factory sales
If you’re a manufacturer, holding a direct from the factory sale can generate immediate cash. But you need to be careful this doesn’t damage your relationship with retailers who currently stock your product.

Option 7 – Leasing
Instead of purchasing equipment you should consider leasing. This can free up substantial amounts of cash, but the additional cost of the finance (e.g. fees and interest) may impact in the longer term on your overall profit margin.

Option 8 – Cash discounts
Some businesses find they can improve cash flow by offering a discount for cash payments in advance. But you may find yourself offering discounts to customers who would have paid on time anyway and in the end you make less profit.

Option 9 – Extend the trading terms with your suppliers
A way to improve your operational cash flow is to take longer to pay your suppliers or, take stock on consignment. If you pay your suppliers cash on delivery, then wait to make a sale and wait a further 30 days to collect from your customers, you’ll clearly have some cash flow issues. If you’re in a liquid position you may be able to negotiate discounts with your own suppliers by paying in advance.

Getting value from your cash reserves
At times you may find yourself in the pleasant situation of having cash coming in more quickly than you’d anticipated. Then you have a number of options:
- re-investing in growth
- paying off a portion of long term debt
- distributing the profits to shareholders and directors investing
- keeping some funds in reserve.

While you have to consider your own personal situation, it often pays off to reinvest in your business when it’s going well. However, it’s best to do so with a plan and you should track your performance to ensure the investment increases profit.

As you consider these options, find out if your increased cash flow is a seasonal or more permanent occurrence.

Making your money work harder is a goal everyone wants to achieve regardless of whether it’s your own income or the cash reserves of your business. There may be many more cost-effective alternatives for managing your reserves.

Let’s look at a hypothetical example. For the sake of this exercise, we’ll assume money invested in your business generates a 20% return. Let’s say the money in your business bank account generates 5% return. You’d be 15% better off investing this money in the business.

<table>
<thead>
<tr>
<th>Using your available cash</th>
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<tbody>
<tr>
<td>Return if cash is invested in your business</td>
</tr>
<tr>
<td>Return if cash is in your business bank account</td>
</tr>
<tr>
<td>Difference between alternatives</td>
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</tbody>
</table>

So how do you gain access to funds when you need them if you have no cash reserves and something goes wrong with your operating cycle?

For some businesses, the answer is an overdraft facility. To take our example further, if your overdraft carries an interest rate of 8% you’ll still be better off using the overdraft to finance business activities than you would by limiting your activities due to a temporary cash flow restraint.

<table>
<thead>
<tr>
<th>Investing cash returns in the business and utilising an overdraft facility:</th>
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<tbody>
<tr>
<td>Interest paid on balance of overdraft</td>
</tr>
<tr>
<td>Return by investing cash in your business</td>
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<tr>
<td>Return to your business</td>
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Do you need finance?
Here are some fundamentals to examine when considering accessing finance for your business.

Fundamental 1: The costs and benefits of financial leverage
Generally, the greater the borrowings the greater the financial leverage. In the right circumstances this can have a positive impact on the return on your own investment. But if sales fall, a business that’s highly leveraged will drop below its breakeven point more quickly than a business with minimal borrowings due to the increased interest payments.

So, there are advantages to understanding the costs and benefits of borrowing. To benefit, the return on the borrowed money should clearly outweigh the cost. Understanding how stable the return will be is also important. If it’s likely to be consistent into the future, then the risk of leveraging the business is lower.
Borrowing too much money, or not enough, could impede business growth and, in the worst case, even be fatal to the business.

Fundamental 2: Borrow money when it is required
Loans have to be repaid and the repayments (including interest) factored into both your future profits and your cash flow. If borrowing money will help you grow your business, increase profits and deliver a greater return on your own equity, then it may be the right strategy. But, in many cases there may be more cost-effective alternatives available.

For example, you may be considering making a major purchase of a fixed asset. After discussions with your accountant or business adviser, you may discover that your business would be better off leasing the equipment. You’ll obviously need to plan for the interest charges and any other fees associated with the lease.

Fundamental 3: Borrow what is required
This isn’t to say you should stifle your business by not having access to necessary funds. But why pay interest on a greater amount than is necessary? Also, if you’ve reached your maximum level of borrowing, you mightn’t have room to move later if you need further finance.

Fundamental 4: Never surrender equity in your business without completely understanding what you’re giving up
Think about your position in 12, 18 or 36 months time if you give up a portion of your business to new investors. What will the new investor/partner bring to the business? Imagine if you find it difficult to work with your new partner or vice versa.

Fundamental 5: Understanding the needs of your business
Borrowing the right amount is important. Some businesses borrow too much, while others don’t have access to enough funds to seize the opportunities that exist. In the long run, borrowing too much money, or not enough, could impede business growth and, in the worst case, even be fatal to the business.

As you begin to determine the financial needs of your business examine your business plan. If you’ve got a thorough business plan and have conducted an extensive SWOT analysis (strengths, weaknesses, opportunities and threats) you should have a clear understanding of why and if you need finance.

Armed with your business plan, you’re well placed to research rationale for the following questions.
- How much money will the business need?
- How will this money be used?
- How will this finance help the business meet a market demand?
- How will the loan be repaid?
- What will the business look like in the future as a result of this finance?

Your case for finance
Take your business owner hat off for a moment and put your investor hat on. If you were investing in a business you’d want to know a lot about that business. These are some of the areas you’d want to examine:
- the skills and character of the owners and managers
- the history of the business
- the structure of the business
- the market within which the business operates
- the opportunities and threats facing the business
- the existing financial structure
- past financial returns
- profit projection
- the amount of the loan needed
- security offered.

As lenders (e.g. banks) examine the same areas it pays to be prepared. The more preparation you do to help the lender with this analysis, the greater the chance that your application for finance will go smoothly. If you’re not well prepared and can’t demonstrate your rationale for needing finance and how it will be repaid, then things may be tougher. In some cases this can directly impact the terms on which you gain finance.

The good news is, if you’ve done a thorough business plan, most of the items raised above will be covered.

To analyse the level of risk lenders may want to see how the business has developed over the years, how it stands today and how it’s likely to develop in the future. Your previous three years’ financial accounts can demonstrate how the business has performed in the past.

In terms of your current situation and the opportunities for the future, lenders want to know if the business is solvent, profitable and liquid.
- Your balance sheet will demonstrate solvency.
- The profit and loss statement will demonstrate profitability.
- Your cash flow forecast will demonstrate liquidity.
Understanding the accounting framework

Balance sheet – This is a financial snapshot of your business at a particular moment in time. It records the assets that belong to your company – everything from the cash in the bank to stock and equipment – as well as the liabilities, such as long term loans and creditors. The balance sheet is divided into three sections: assets, liabilities and equity.

The balance sheet should balance. That is, when you add the total liabilities to the total equity, the amount should be the same as the total assets.

Assets – These are the items your business owns. This section of the balance sheet is further divided into two sections.

• Current assets – These are assets that will be used within the next 12 months including cash at bank, stock on hand, accounts receivable (money you are owed by others), prepaid expenses and investments you’ve made.

• Non-current assets – These are assets that you’ll hang on to for longer than 12 months. They’re also known as fixed assets. These include land, buildings, plant, equipment and vehicles.

Liabilities – Are what you owe to others. Again, they’re divided into two sections.

• Current liabilities – These are debts that need to be paid back in the next 12 months. They include short term loans (including bank overdrafts), accounts payable (money owed to suppliers), wages owed and taxes payable.

• Non-current liabilities – These are generally long term loans such as a mortgage.

Equity – This section includes the funds committed by the owner or owners plus any retained earnings.

Projected profit and loss statement – This is also known as an income projection statement which will tell you how much money you expect to have made at the end of the year.

It shows the amount of revenue you’ve earned through the sale of goods and services minus your expenses and any taxes paid. The elements you’ll track in the profit and loss statement are:

• total sales
• cost of goods sold
• gross profit
• variable expenses (such as wages and salaries, advertising, office supplies and utilities)
• fixed expenses (such as rent, insurance and loan repayments)
• taxes
• net profit.

It’s best to prepare a projected profit and loss statement on a monthly basis. This will be handy in identifying expenses that could be cut.

The profit and loss statement should also allow you to calculate a very important figure – your business’s gross profit margin. This is calculated by dividing the gross profit figure (sales less the cost of goods sold) by the revenue figure. Gross profit margin reveals the portion of money left over from revenue after accounting for the cost of goods sold.

Your options for finance

If you’ve determined your need for finance there’re a number of options:

• a bank or other lender
• existing owners
• releasing equity to new shareholders
• venture capitalists.

Banks and other lenders

Look for a lender who takes the time to understand your needs and is prepared to work with you to develop the best solution for your particular business.

It’s not the intention of this guide to examine the merits of various loan products available but here’s a brief overview of some things to consider as you investigate the available options.

Option 1 – Short-term finance

Short-term finance is used to maintain cash flow by purchasing assets that will turn over quickly. You’d expect that this borrowing will be self liquidating, meaning the moment the cash is received from the debtor, or the goods are sold, the loan will be repaid in full. Short-term finance includes overdrafts, import finance and business credit cards.

Overdraft – This is an ongoing arrangement where you have access to a set level of funds through your business transaction account. It’s an extremely flexible arrangement because you only draw on the money when you need it and interest is charged daily based on the outstanding balance.

Import finance – If you’re an importer, you may be able to access import finance. This works by the lender paying the supplier on your behalf and you repaying the lender by a set date. This is usually an agreed period after the goods arrive in the country. This gives you the chance to on-sell the goods and maintain your cash flow.

Debtor finance – Debtor finance, as mentioned above, is where a lender provides cash advances against your outstanding invoices.
**Business credit cards** – Business credit cards allow you, and staff in your business, to make purchases for the business on credit. There are set limits and ideally an interest free period of up to 30 days. This allows you to settle the account by direct debit before any interest is charged.

**Option 2 – Long-term finance**

This could be used for the purchase of the business itself, acquiring a new business or acquiring other fixed assets such as plant and equipment.

The type of loan you choose will depend on your individual needs. For example, if you’re a business owner just starting up you may choose to pay interest only in the first few years. Others may want the flexibility of making extra payments but still be able to redraw the additional funds if needed.

The key is to know why you want access to the money and how comfortable you’ll be with the repayment schedule.

**Seeking further funding from existing owners** – In some small businesses this may mean funding from friends and family. At times it can mean using the family home as security. This is clearly not a decision to be taken lightly.

No matter who the existing owners are, if you’re asking for more finance or considering putting more of your own equity into the business, it’s wise to prepare a detailed plan. You wouldn’t expect other people to risk their money without a detailed plan. You shouldn’t risk your own without one. Make sure that everyone involved understands the opportunity and the risk.

**Releasing equity to new owners** – Taking on partners and releasing equity in a business you have built is not easy. Make sure your new partners bring much more than finance to the table.

The skills and business contacts they possess will play a part in the value they bring to the business. Make sure you’re absolutely comfortable in the knowledge that you’ll be able to work with your new partners.

**Venture capital** – This usually suits businesses that are about to embark on relatively quick expansion strategies. Essentially, you surrender a proportion of the ownership of your business in return for funding. The advantage is you won’t be paying interest on a loan. However, when raising venture capital, it’s vital to understand exactly how much of the business you’re surrendering and what level of influence the investors will have on the day-to-day running of the business. It’s best to ensure the investors share your vision. If your plan is to steadily grow the business over ten years but the investors want to make a quick profit and sell in two years, then you’ll probably have an issue in terms of working together in the future.

**Getting help**

The following contacts may provide assistance as you work through your cash flow and, if needed, prepare your case for finance.

**Accountants and bookkeepers**

Various associations have online tools to help you find a member in your area.

- **Australia Institute of Certified Bookkeepers Australia**
  [www.icb.org.au](http://www.icb.org.au)
- **Certified Practicing Accountants Australia**
- **Institute of Chartered Accountants of Australia**
- **Institute of Public Accountants**
  [www.publicaccountants.org.au](http://www.publicaccountants.org.au)

**Government assistance and advice**

The gateway to Federal Government resources is [www.business.gov.au](http://www.business.gov.au)

- **Small business field officers** can provide general advice and mentoring. [www.auisindustry.gov.au](http://www.auisindustry.gov.au)
- **Your local business enterprise centre** provides a range of services to small business. [www.beca.org.au](http://www.beca.org.au)
- **Regional Development Australia** provide a link between small business and government. [www.rda.gov.au](http://www.rda.gov.au)

There is also a range of websites with state or territory specific information.

- **South Australia** - [www.southaustralia.biz](http://www.southaustralia.biz)
- **Western Australia** - [www.smallbusiness.wa.gov.au](http://www.smallbusiness.wa.gov.au)
If you’re starting a new business from scratch, then obviously your task is a little tougher. You may need to provide thorough research to back the assumptions you make about future cash flow and profitability. You may like to read our guide to *Going into business*. 