

Focus on Finance

Cash Flow...what you may want to know.

Cash flow mismanagement: the #1 reason businesses fail.

Why is cash flow so important? A business has to have it to operate. It's like the air we breathe or the gas we use to fuel our cars. It's easy to take for granted until it is in short supply or gone. Similar to other precious commodities, we tend to overuse it when it is plentiful, and, regret our indulgent consumption after the fact. Cash flow problems can happen to any size organization from a one person start-up to a profitable Fortune 100 company.

What is cash flow? "Cash flow" is a vastly misunderstood phrase, and, rarely used in a practical, systematic way. To add to the confusion, the terms earnings and cash flow are frequently used interchangeably yet they are quite different. Earnings (profit or net income) is an accounting concept created by accounting convention. Cash flow, simply put, is based on the timing between receipts and disbursements of cash.

Why are we looking more closely at cash flow now? The boom of the 1990's encouraged easing credit approval criteria, which helped inspire lavish spending habits. Both of which have become difficult to sustain. The twenty first century continues to offer the abundant, excellent opportunities of the 90's, but, the reins of conducting business are being pulled in slightly. The result is a renewed attitude and appreciation for proper cash flow management. For business owners and creditors alike, cash flow has become a critical focus.

How can something so vital be mishandled so frequently? Cash flow has a passive personality and can be easily overlooked when business is booming, additionally, many companies define cash flow in such broad terms as to render it a useless benchmark. But make no mistake, you can go broke while showing a profit! That's right! With sales going through the roof, your business could be going down the drain.

A small business runs on cash not profits or sales growth. Businesses must have cash for growth and lots of cash for fast growth. You must pay salaries, purchase inventory for resale, meet operating expenses, finance growth and provide stability in downward markets with cash. A company's success is determined by its ability to cash flow, not, increase revenues.

What steps can you take to maximize your cash flow? Safeguarding the use of your capital and maximizing your cash flow management can be enhanced with several steps.

1. *Avoid a distortion of the truth.* There are two basic accounting systems: cash-based and accrual-based. Each method distorts, to a degree, what really goes on in the business. Accrual-based accounting measures the flow of value, not the

flow of cash. Cash-based accounting accomplishes the reverse. Understanding what your accounting method omits or distorts will help you assess the true financial state of your business.

2. *Determine your cash flow cycle.* Most salons and spas have two cycles to define: 1) inventory cycle 2) service cycle. It is important to identify how much inventory must be sold and how many services must be rendered in order to breakeven each month. If sales are falling behind, you'll be able to readily see the problem and design a solution.
3. *Create a budget.* You wouldn't leave for vacation without a predetermined destination, mode of transportation, and adequate money. Your business requires that same kind of thorough planning and execution. We suggest creating a cash flow budget that presents the timing and amount of the expected cash inflow and outflow for a designated time period. The cash flow budget usually contains four major sections:
 - a. Receipts (sales)
 - b. Disbursements (payroll, inventory, insurance, advertising, etc.)
 - c. Cash surplus or deficit (receipts – disbursements)
 - d. Financing (borrowings)
4. *Don't run out of fuel.* Keep adequate cash on hand. In our opinion, this means having a *monthly net cash flow* (cash receipts – cash payments) of at least three times the amount of a typical month's operating expenses. A sufficient cash balance is required for normal business operations. For large transactions, many businesses choose to use leasing as a financial vehicle. This approach keeps cash available and allows for a tax deduction.
5. *Create a guideline for cash management decisions.* These decisions should consider the best use of your cash by receiving cash sooner and paying cash later.
6. *Create cash flow reports.* The Statement of Cash Flows classifies cash receipts and cash payments from (1) operating, (2) investing, and (3) financing activities. This statement is useful because it provides valuable information that is not available in the balance sheet or income statement.
7. *Implement internal controls.* In a cash driven business, it becomes paramount to institute adequate internal controls over cash receipts and disbursements.

How can you avoid common pit falls? All salons and spas at some time remodel, expand and/or relocate. These projects can be exciting and enjoyable. But, because it is impossible to accurately anticipate the length of construction delays, the number of

staffing issues that will arise, etc., budgeting becomes critical. Improper budgeting can create one of greatest risks to your business's health...a cash flow deficit.

One option to help avoid this serious problem is to keep your cash available by utilizing your borrowing power. By leveraging you can accomplish your growth goals and in many cases avoid creating cash flow concerns. Obviously, many problems arise when capital budgets are too tight and money starts to dwindle. As a solution, many businesses find leasing is a great way to increase purchasing power and "staying" power. The streamlined approval process and the flexibility in payment structures can enhance your ability to endure construction delays, equipment changes, staffing issues, etc. It can also help reduce the need to sell unattainable quantities of product and services as you reopen for business.

How do you choose a leasing company? Start by networking. Ask around. Reputable distributors and manufacturers are usually able to refer you to a quality leasing company. Distributors and manufacturers take these referrals very seriously as the manner in which the leasing company handles the transaction directly reflects on them.

What can you expect from your leasing company? Choose a lease company that knows the industry well. The company should have specialized programs to meet the needs and demands of the beauty industry. These programs should include financing for equipment, furniture, computer (hardware and software), construction, carpet, paint, plumbing, inventory, etc. If your current lease company cannot provide funding for the many varied products and services you require to expand, remodel or open a new location, perhaps a new lease company could provide broader opportunity and leverage for you and your business.

In summary. Cash flow is important now more than ever. Business owners are responding by taking steps to enhance their use of capital and cash flow management. One important tool that is becoming a bigger and bigger part of our industry is leasing. It provides owners with purchasing and staying power, especially in times when cash flow can easily become an issue. When the time comes to remodel, expand or open a new location, find a knowledgeable leasing company. The right choice can save you money and worry.