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Keeping an Eye on Cash Flow

By Steven Becerra, director, Albuquerque South Valley Small Business Development Center

Cash is the most liquid of a business's assets. Although cash isn't obvious in a high-tech world where money mostly moves by debit and credit cards, wire transfers and other electronic transactions, the monetary standard of all these types of transactions is cash. Quiet as it's kept, cash still rules the economy. It's the easiest form of money that can be used to buy things, pay off debts or distribute capital.

Given that, business owners should have a basic understanding of cash flow and know how to ensure their businesses have sufficient cash to sustain current operations and ultimately create wealth for the owners and investors. And yet this most basic of business cycles is probably the most misunderstood — and sometimes woefully ignored — by business owners, who are vigilant about checking their account balances at the bank but fail to predict how much cash they have available at any given time to meet the needs of the business.

ABCs of cash flow:

The injection of cash — or sources of cash — come from four areas: investment, debt, sale of assets, and operating profits.

Investment is the infusion of cash by the owners of the business at its start and over its lifetime; another term for this is capital contribution. Debt describes money borrowed from a third party, such as a bank. Sale of assets refers to the unloading of property owned by the business, such as land, buildings, equipment, furniture and fixtures. Operating profits are the net result of all sales (services or products) minus all expenses. Operating profits ideally are the primary source of a business's day-to-day cash needs, but most businesses tap into all four sources of cash at one time or another.

Cash also moves outward in a process accountants call "uses of cash." These uses are varied and numerous, and they affect both the balance sheet and income statement, just as sources of cash do. Cash can be used to purchase assets, pay debts, purchase goods and services and distribute money to owners and workers.

The cash balance from operations is directly affected by these sources and uses of cash. It's also affected by the cash flow cycle — the evolution of cash from the time it is injected into the business until it is used and finally returns to the business. A simple example of a cash flow cycle starts with the injection of cash from any of the possible sources. This cash is used to buy products, which become inventories. These inventories are then sold, becoming accounts receivables. Ultimately, these receivables revert back to cash.

Timing is key:

Timing is everything with cash flow. It's not enough to know how much cash is coming in and going out; a business owner also has to know when these events will occur. A miscalculation can cause a business to fail: If an owner expects an infusion of cash that doesn't transpire, it can have a direct impact on whether he can make payroll, pay a major supplier or pay a debt.

To manage cash, prepare for a cash shortage or analyze the business's cash position, a business owner should review financial statements (balance sheet, income statement and cash flow statement) with her accountant or bookkeeper. She should prepare a cash budget — a proactive way of planning for cash sources and cash uses.

The Small Business Administration exists to help businesses with some of these problems. For free consultation on cash flow analysis and other business matters, contact a Small Business Development Center at 1-800-281-7232 or at the website for New Mexico, www.nmsbdc.org.

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