THE 4 FORCES OF CASH FLOW

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How to Not Stress Your Cash Cow!

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Seeing Beyond Numbers

Understand the true forces of cash flow and how to set your business up for maximum success without financial stress!

The 4 Forces of cash flow

HOW TO NOT STRESS YOUR CASH COW!

The problem with cash flow is that it lags behind profit for most businesses. Unless your customers pay you and you pay your vendors at exactly the same moment, there will always be a time lag. If you understand the correct order of priority for cash flow, you will avoid the disconnect.

My first assumption is that your business is profitable. If it is not profitable, you have to fix that problem first, as it is a far more pressing concern than cash flow. You can look at our website www.seeingbeyondnumbers.com for more detailed discussion on solving that issue.

Now that you are profitable, you must understand that there are 4 Forces that demand satisfaction out of your cash flow – and I can also assume they are in opposite order to what you would prefer:

1. **Taxes** – You must either set aside money or pay chunks of taxes as you go to avoid the April surprise (or October surprise if you extend how long you stick your head in the sand)
2. **Debt** – Lines of credit are crack cocaine for entrepreneurs: get off the drug as soon as you can
3. **Core Capital** – retain after-tax profits until you reach your core capital target, which we generally define as 2 months of operating costs in cash with nothing drawn on the line of credit and your anticipated taxes set aside
4. **Distributions** – Reap your reward and finally take after tax profits to diversify your wealth outside of the business

Let's take a look at each one in more detail:

Taxes:

The first thing I want my clients to understand is that if you did not pay any taxes, you either didn't make any money or you cheated: *both are bad*. The biggest hindrance to paying taxes is the complexity of the tax code; the second is not planning to set aside cash for paying the taxes. That is why we monitor our clients' profitability each quarter and give them guidance on how much to set aside or pay in, depending on the rules.

We want you to pay only what is required at the last possible moment to not incur a penalty, but that also means you have to know to set taxes aside as profit is earned. Get your tax advisor to do this for you each quarter – it will be worth it.

Debt:

Poor management of debt has killed many good businesses. It is like a drug in that it allows you to postpone the hard decisions too long before you are forced to make them when you run out of credit. We do not recommend funding losses with line of credit financing. I am ok with using lines of credit to fund profitable growth, but the moment you use a line to cover a monthly loss, you have started down a slope that too often ends badly. Make the hard decisions sooner!

The other key about debt is knowing that you can only repay debt with after-tax profits, with very few exceptions. This is a big hit to most entrepreneurs who have a great year and think they can use 100% of all their pre-tax income to pay off debt.

As for term debt, only use this debt when you are purchasing a necessary asset and the payments truly reflect the cost of using that asset over its useful life.

Core Capital:

Somewhere along the way, we forgot to give business owners a simple calculation to let them know what a healthy business is. Your business may be profitable, but if you are pulling all of your cash out of the business for the wrong reasons, you will find your cash cow is out of milk when a downturn happens. By studying client data, we determined that the deepest downstroke in operating cash flows for most businesses is equal to two months of operating expenses.

This discovery led us to recommend setting the "core capital target" at two months of operating expenses in cash, in addition to owing nothing on the line of credit and setting aside any tax amount currently due. You may want to set the target higher, but you would never set it lower.

Distributions:

Once you have taken care of the first three cash flow forces, you get to enjoy the fruit of your labor. You can now use those after tax profits that the business does not need to diversify your wealth. Notice I said diversify, not consume! Unless you have multiple sources of income beyond your needs, the moment you are looking to the profits of your business to meet your consumption needs, you have headed down a dangerous path. This is why we recommend our clients pay themselves a market-based wage for the "job" they do in their business and live off their salary. When the business has profits to distribute, it is first used to eliminate personal debt and then to build assets outside of the business.

In summary, once you are profitable, it is taxes, debt, core capital and then you can have a distribution. It is a great formula for building lasting wealth from your entrepreneurial efforts, and keeping your cash cow healthy for years to come.