Why Cash Flow Is King (and Other Lessons in Small-Business Finance)

By QuickBooks
3 min read

Nearly a third of new employer firms fail within the first two years [PDF], according to the Small Business Administration.

There's no single reason for their failure. But after working with hundreds of entrepreneurs, consultant and author Richard Weinberger says "a lack of knowledge of basic finance is a common — and dangerous — mistake. Too many business owners don't understand their own finances, and have no idea what products or services make the most profit."

Getting a handle on your business's finances doesn't mean you have to become an accountant or earn an MBA. The basics aren't terribly hard, and if you can use a spreadsheet, you're well on your way.

Weinberger has written a concise handbook that gives practical guidance, such as how to use an income statement and a balance sheet, establish strong internal controls, and understand inventories, cash conversion cycles, and supply-chain management.

"Even if you have an accountant or a bookkeeper working with you, you still need to understand what each item means and where the numbers come from," he says. "It is your business, so why leave the explanation to someone else?"

A fledgling entrepreneur can increase his or her financial IQ in myriad ways — for example, many community colleges offer basic courses — but Weinberger's book Accelerated Action to Maximize Profit is a good starting point, and you won't have to go to class.

Weinberger recently shared some of his thoughts on the basics of small-business finance with the Intuit Small Business Blog.

ISBB: You say that many business owners don't understand their own finances. How can they start to get a handle on this?

Weinberger: First, begin a financial review. If possible, try to have at least three to five years of financial statements available. If you don't have them, tax returns can be substituted, but they might not contain all of the information you need.

You'll want to enter all of this data into a spreadsheet. Don't know how to use one? This is a great time to learn!

Why is it important to understand your cash flow?

Small businesses may be profitable but not have much cash. They may have made sales on credit, they're servicing debt, they're paying for equipment, or maybe they've got lease payments. If you know in advance that you may be short of cash, you can prepare. You could look for additional bank financing or try to modify the repayment terms on loans or other debts. But to do any of that, you have to be able to predict your cash flow.

Is there an easy way to understand your business's cash position?

It's called the quick ratio. It consists of cash, cash equivalents, and accounts receivable divided by current liabilities. It does not include inventory, because it normally takes time to work though the sales process and be converted to cash.

What about collections?

One key component of cash flow is how long it takes your customers to pay you. If you analyze this and see that the amount of time it takes you to be paid is lengthening, you have a problem. You may be extending credit to customers who aren't credit worthy, or maybe you're not putting enough effort into collections. Shortening the amount of time it takes to be paid obviously improves cash flow.

Speaking of cash, aren't there controls a business should have in place?

Here are a few: The check signer and the check writer should not be the same person. Refunds to customers should be approved by someone other than the employee actually making the refund. When that isn't possible, refund receipts should be reviewed daily.

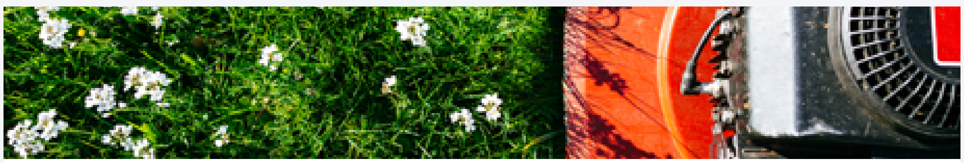
Final words of advice?

One of the best things a small business can do is to do a critical, honest self-evaluation of the business – a SWOT analysis. That stands for "strengths, weaknesses, opportunities, and threats."

I tell people that this is not the time to be a cheerleader for your company. What are you doing that's good? Let's continue to do that, and let's also look at the weaknesses and see how we can improve them. Ask: What are those competitive liabilities that let our competition do better than we are?

"Even if you have an accountant or a bookkeeper working with you, you still need to understand what each item means and where the numbers come from," he says. "It's your business, so why leave the explanation to someone else?"

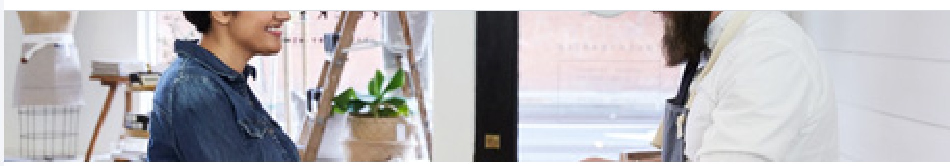
Related Articles



The Critical Difference Between Profit and Cash Flow

Profit and cash flow are both important elements of a healthy, growing…
Read more

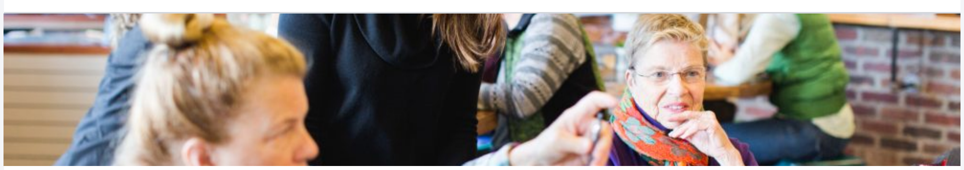
4 min read



3 Simple Ways to Optimize Your Cash Flow

It's hard to believe that 82 percent of business that shut their…
Read more

3 min read



Growing a Local Retail Store: Lessons Learned From 12 Years in the Book Business

Nicole Magistro never planned to own a bookstore. When she moved to…
Read more

6 min read