A useful process to get your client up to speed on cash flow

First, separate by A, B, C cases.
If you have a C or B-, which would be characterized by someone in the early investigative Stage and is unsure of the business process and how to start – or even at the point that they have a selected business, but have too many uncertainties to start the basic elements of a business plan, you would only make them aware of the need for financial tools; the most important of which is a "Cash Flow Model". You simply tell them of the existence and necessity of the several financial instruments and that you will expand and explain as required once the basic frameworks have been finished.

If you have a B, B+ or A case, to start the area of cash flow, you make sure they start to define the following: a projected revenue time profile for 18 – 24 months; an operating expense profile for 18-24 months; and a start-up expense list. Each of these must be quantitative with detail rationale for every number [from someone's experience, quotes, catalogs, trade association standard metrics, BLS, etc.].

Once the above data are available, you explain the concept of the cash flow model – concept and understanding first; detail mechanics for use of a tool after.

The discussion could proceed as follows;:
First, recognize if you start this business, you are in fact running two businesses. The first Is the business of your personal life, where you must insure that your "family" will be warm, dry, fed, and safe with all basic needed elements covered as you start this business and you build it to a productive enterprise. Thus, you need to know the minimum required funds/month that you must have to meet the family needs until the business will contribute to your income [if these funds are covered from another source, that is fine, but the key concept is to understand the total amount needed to live and get the business going]. The "cash flow model" [CFM] will help you quantify this value.

Second, the client must define the financial goal [dollars per year by say the 18 month point] that the business must provide as it reaches this first "maturity" point.

Third you walk through the functional concepts:
- to obtain our initial insight, we will run the CFM for 18 to 24 months
- the need to convert sales/revenue to actual cash received as a function of time
- the initial run will have as its goal to find out if the business as described by:
  - projected [and converted] revenue profile
  - the projected start up cost list
  - the projected operating expense profile

  Will result in a VIABLE business as defined by meeting the goal that the client set by end month 18
- In addition, this first run will define the:
- initial capital required to get the business started
- the break even point [business receipts are capable of covering expenses on month/month basis
- the amount of nest egg needed to keep the family business covered while this business is being built

Note that this is called a CFM, because it describes the overview of the complete business from an operational cash viewpoint [as opposed to the tax viewpoint]. We will use it first to answer the question …
"is this business viable?" in a paper simulation mode. Then, if that answer is "yes", we will use it when the business is running to make sure we are in financial control. Finally, at any time, we can use it as an

tool and ask it a question by modifying the three profiles you started with and see what cash flow difference it projects [examples – should we expand in some way? – should I hire another employee? – can I afford a new piece of equipment? – etc.].

With a good understanding of how we will use it to help answer fundamental issues, we are now ready to walk through the steps of its creation.

We set some simple ground rules:
- We will start with the assumption of no start up capital – not realistic, but this will be clear shortly
- We will run for 18 to 24 months [likely 24]
- We will not consider the various tax issues that can be so important to the business [depreciation, amortization, home office, use of personal car or shared use of an asset as examples]. These all are cash flow issues, but will be handled separately as we later look at the tax issues of interest and how these play into the owners overall net cash flow through the tax system
- We will include a line for "owner's draw/distribution" to insure that the owner is being compensated in real time, but not before they are sure the expenses are covered.
- We will include a "reserve" line. This will cover the establishment of a reserve fund to cover those things that can go wrong and likely will as the business is run. Clearly, the business will not contribute to this fund until it has become cash flow positive. Further, the fund is best established by the owner analyzing the largest threats, quantifying that into dollars, and building the fund over time to a determined threshold to cover these threats. Lastly, this fund is set aside like retained earnings and goes untouched and can not be expensed for tax purposes until it is actually expended.

With that background, we now verbally run through the implementation of the CFM.
Month one, not likely any significant cash in, but clearly there are both start up and operating expenses. So, we sum for the month all cash in and all cash to be expended and end with that month's cash position. Clearly it will be negative. For talking purposes let's say it was -$1000. Now we point out that month two starts with however month one ended. So, month two is the sum of -$1000 and any cash receipts and what is expended in month two; likely a more negative value – let us say it results in -$2000. We keep this process going until the monthly sum results in a positive value that stays positive. For a full example, let the first eight months look as follows:
-1000, -2000, -4000, -5000, -3000, -1000, +1000, +3000 – and it stays positive from this point on.

What key info does this tell us about this business?
#1 – we note the largest negative value [in this example it is -$5000] – add 20%, making -$6000, and note that if we had started with $6000, we would never be negative. Thus, we need to capitalize this business with $6000 at the start [our funds, borrowed funds, etc.]. We will now rerun the CFM with $6000 as start up capital.
#2 – we note that the business hits the break even point about the seventh month. Thus, if our monthly required funding to keep the family OK is $1000/mo, in addition to the $6000 to get the business started, you will require 7X1000 = $7000 for the "personal" business. In other words, in these seven months, you will need access to $13,000 to cover all your needs.
#3 – we look at the value of potential draw/distribution at ~ 18 months or sooner if the monthly number has tended to flatten earlier and compare it to the goal for viability. Assume the owner said he needed $72,000 per year when the business is up and operating. That would require at least $6000/ mo on average. If the CFM shows that the second run [the one with $6000 added in], that at this 18 month or earlier, the business produces an average of at least $6000/mo, it is viable and we can now open it if we have that $13,000 covered.
#4 – we can start building up our reserve toward the goal at the eighth month.

For the real business operation, we augment this CFM by adding an “actual” column to compare with the “plan” column we have just analyzed. The CFM now becomes a tool to track your business. Note, every plan is an estimate that is hopefully pretty good. However, the key is to carefully monitor the actual results every month to plan and carefully watch for divergence. Plus divergence is good and you want to know why that is happening so you may do more of that. Negative divergence can be a problem and on or before the third month says get to the root cause and take proper action. In this way this tool helps plan and avoid surprises.

In the operational mode, is when the “ask it a question” process can be useful. Also there are some who would, during the planning stage, not only run the nominal case as we did above, but also analyze the biggest possible issues and create “best” and “worst” case looks to give one insight into sensitivities that could be harmful. Used right and often, this tool can keep this business from being started on an unsound basis and/or being operated without the mandatory control to keep it in the black.

At this point, we should discuss our Excel template as the detail tool [or the client can elect other detail tools if so desired]. I firmly believe that the client must do the detail planning and rationale work and create the final tool themselves, either on their own or with help of the individual who will run it when the business is open. Not every one agrees with that, but the Socratic process is powerful.

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