CASH FLOW AND TAXES
ENTREPRENEURSHIP: Starting and Operating a Small Business, 3/e
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UNIT 3 • SHOW ME THE MONEY: FINDING, SECURING, AND MANAGING IT

9
CASH FLOW AND TAXES

Performance Objectives
After this lecture, you should be able to complete the following Performance Objectives

1. Understand the importance of cash flow management.
2. Know the difference between cash and profits.
3. Read a cash flow statement.
4. Create a cash budget.
5. File appropriate tax returns for your business.

9
Cash Flow: The Lifeblood of a Business

Cash is the energy that keeps your business flowing, the way electricity powers a lamp. The success of your business will depend upon, cash, from start-up through entire existence. Cash is essential for initial investment, ongoing operations, and growth.

The Income Statement does not Show Available Cash

There is often a time lag between making a sale & getting paid. A company may show a profit and have a negative cash flow; cash and profit are not the same.

Cash flow statement- financial document that tracks the money coming into and going out of an organization.

9
Rules to Keep Cash Flowing

- Collect cash as soon as possible.
- Pay your bills by the due date, not earlier.
- Check your available cash daily.
- Lease or finance instead of buying equipment where practical.
- Avoid buying inventory that you do not need.

9 Noncash Expenses Can Distort the Financial Picture

Noncash Expenses – adjustments to asset values not involving cash, such as depreciation.
The Working Capital Cycle

Working capital - the value of current assets minus current liabilities.

\[ \text{Current Assets - Current Liabilities} = \text{Working Capital} \]

Working capital tells you how much cash the company would have if it paid its short-term debt with the cash it had on hand.

The Cyclical & Seasonal Nature of Cash Flows

There are cash flow cycles that occur for every business that are important to understand because they can make the difference between success and failure.

In addition to having cash flow cycles relative to specific transactions, cash flow can be seasonal for many businesses, meaning that the amount of cash flowing into a business may depend on where the business is in its fiscal year.

Examples:

- A flower store may have more cash around Mother’s Day & Valentine’s Day & less cash during the summer.
- A college bookstore will have more cash once school starts & less when it has to buy inventory before the school year begins.

Reading a Cash Flow Statement

Whereas income statements and balance sheets provide considerable insight into a company, the cash flow statement gives a clear picture of its cash position.

Cash Flow Equation

Cash flow statement - Inflows and outflows of cash are divided into three categories:

1. **Operations** (money used to run the business)
2. **Investment** (money going into and out of investments in the business, such as equipment, vehicles, or real estate)
3. **Financing** (Money used to finance the business (debt & equity))

Forecasting Cash Flow: The Cash Budget

The are two steps to forecasting cash flow receipts –

1. Project cash receipts from all possible sources.
2. Subtract expenditures that would need to be deducted to meet this level of cash receipts.

Creating a Healthy Cash Flow

Healthy cash flow management means keeping sufficient cash on hand and available to pay your bills in a timely fashion, and in general to have financial resources available to you when you need them.
Figure 9-3

Cash Flows

<table>
<thead>
<tr>
<th>Owner Investment</th>
<th>Fixed Asset Purchases</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proceeds of Financing</td>
<td>Inventory &amp; Operating</td>
</tr>
<tr>
<td></td>
<td>Payments</td>
</tr>
<tr>
<td>Customer Payments</td>
<td>Company</td>
</tr>
<tr>
<td></td>
<td>Debt Repayment</td>
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<tr>
<td></td>
<td>Land &amp; Building Purchases</td>
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<tr>
<td></td>
<td>Taxes</td>
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<td></td>
<td>Earnings on Investments</td>
</tr>
<tr>
<td></td>
<td>Dividends</td>
</tr>
</tbody>
</table>

Managing Inventory to Manage Cash Flow

Inventory is often one of the largest components of a company's assets and controlling it is critical step in managing company cash flow.

There are two other risks involved with inventory – storage costs and pilferage – which is theft of inventory.

Freeing Up Cash by Reducing Inventory

Tracking Inventory

Controlling Inventory Levels

Managing Receivables to Manage Cash

The Cash Effects of Accounts Receivable

The Life Cycle of Accounts Receivable – You have to invoice promptly and collect promptly. If you don’t ask, you won’t get.

Guidelines that will keep a balance:
- Establish clear credit arrangements acceptable terms for both of you.
- Create comprehensive written credit and collection policies, share them with your team, and implement them.
- Use collection techniques appropriate to the level of delinquency.
- Avoid using salespeople as collectors on their assigned accounts.
- Comply with the Fair Debt Collection Practices Act and do not use intimidation or deception in collections.
- Recognize that some clients are worth “firing” as credit customers.

The Financing of Accounts Receivable – factoring provides cash to companies in exchange for the rights to the cash that will be collected from their customers.

Managing Accounts Payable to Manage Cash

Credit – the ability to borrow money.

Negotiating Payment

Timing Payables – just as you should establish an accounts receivable aging schedule, you should also create an accounts payable aging schedule.

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Capital Budgeting and Cash Flow

The Burn Rate – the pace at which a company spends capital before generating positive cash flow.

\[
\frac{(\text{Cash Available} + \text{Revenue}) - \text{Negative Cash Outflow per Month}}{\text{Monthly Cash Outflow}} = \text{Number of Months before Cash Runs Out}
\]

The Value of Money Changes over Time

Future Value – the amount an asset will gain over time

Compound Interest – the interest or rate of return accumulating on the interest or other returns in addition to earnings on the principal.

The Present Value of Money
1. Inflation
2. Risk
3. Opportunity

Present Value – the worth (face value) of a future asset or other investment discounted back to the present.
Cash and Taxes
- Self-employment taxes – federal tax that business owners pay on wages paid to themselves.
- Sales tax – tax levied by governments on retail purchases and collected by merchants.

Filing Tax Returns
Collecting Sales Tax

Each legal structure has tax advantages and disadvantages:
- Sole Proprietorship
- Partnership
- Limited Partnership
- Corporation (subchapter C)
- S Corporation
- Limited Liability Company (LLC)

Make Tax Time Easier by Keeping Good Records
You and your tax preparer will have an easier time if you have been keeping accurate records throughout the year.
If your prepare your own tax returns on a computer, it is still a good idea to have a tax professional review them.
Maximize the amount of professional advice and you will minimize the chances of problems with the IRS.

KEY TERMS
- burn rate
- cash flow statement
- compound interest
- credit
- factoring
- future value
- noncash expenses
- pilferage
- present value
- sales tax
- self-employment tax
- working capital