

# **Business Owner Guide to Understanding Cash Flow in Three Easy Steps**



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## Introduction

The most valuable asset in a business is cash; however, 86% of business owners don't understand cash flow, nor have their cash flow under control.

Running a profitable has its benefits: Your business consistently take care of you financially even in times of turmoil; it enables you to afford a nice home, a comfortable retirement, pay for health care for your family, university education for your kids and take family holidays every year.

This primary purpose of this guide is to empower small business owners to overcome the most common problems they face when trying to understand the cash flow driver reports, such as:

1. Not understanding the factors affecting cash flow apart from profit and loss; for example, borrowings, buying assets for the business, paying suppliers, paying salaries, etc.
2. Confusing cash with the profits the business generates
3. Trying to find a definite figure like the profit or loss figure.
4. Lack of understanding that an increase in cash flow is not always positive; a decrease in cash flow is not always negative.

You might be asking yourself why I should dedicate time to understand and manage cash flow when most business owners have problems understanding cash flow reports.

**There are three main reasons.**

1. **To avoid cash flow anxiety impacting your personal life.** Business owners rely on gut instinct and their own spreadsheets to make their business decisions. Their main worry is not being able to cover the day-to-day costs of running their business.

Business owners start to spend more time trying to sort out short term cash flow issues while maintaining the business afloat and keeping key staff motivating becomes the secondary focus of their efforts. The anxiety turns into stress and fear of losing what they have worked so hard for as the cash levels start to deplete.

2. **Cashflow management is the cornerstone of a healthy business:** Business success is achieved when you can work profitably (earning more cash than you spend). Your business should take care of you financially, not the other way round.
3. **To avoid failure.** The main reason for business failure is because the business runs out of cash. Unless you put time and attention to identifying warning signs when your business is running out of money and take action before it's too late, the dream of achieving financial independence is unlikely to materialise.

## Understanding basics

### What is a Cashflow Report?

It is a statement of cash flows listing the cash inflows and cash outflows for the business for a period of time.

The statement of cash flow splits into three categories.

**Cashflow generated from operating activities.** These are the day-to-day trading activities that comprise sales from customers and outgoing expenses such as paying suppliers, HMRC or employees.

**Cashflow generated from investing activities.** These could be assets the company buys or sells for cash.

**Cashflow generated from financing activities.** These could be cash injection into the business from sources such as Directors of the company, banks or investors, or monthly payments related to a bank loan or paying back money owed to directors.

### How do I generate a cashflow report?

Mainstream cloud accounting software such as QuickBooks and Xero allow you generate a statement of cash flow which you can download. However, the reports' accuracy depends on whether the business' bookkeeper or accountant keeps good records and regularly updates the accounts.

## The three-step simplified process to preparing a cash flow driver report.

The simplified three-step process offers the direction of a simple solution to understanding your cash flow.

The process should not take more than 30 minutes of your time every month, starting with making sure bookkeeping is up to date. We will use a real-life business QuickBooks cash flow statement to explain the process.

- a. Download the Statement of Cash Flow report in excel format and also print a copy. In QuickBooks online, the report is in the 'for my accountant section' under reports. In Xero the cash flow report is under accounting then financial reports. I have run a cash flow report for Rapid services for October by setting the period to 1st October to 31st October 2020

## Rapid services

### Statement of Cash Flows

October 2020

	Total
<b>OPERATING ACTIVITIES</b>	
Net Income - Profit	95,100
Adjustments to reconcile Net Income to Net Cash provided by operations:	0
Debtors (money owed to the business by customers)	25,840
Payroll Liabilities:HMRC	5,917
VAT Control	9,825
Wages and salaries	10,115
Total Adjustments to reconcile Net Income to Net Cash provided by operations:	51,697
Net cash provided by operating activities	43,403
<b>INVESTMENT ACTIVITIES</b>	
Equipment	11,000
Net cash provided by investment activities	11,000
<b>FINANCING ACTIVITIES</b>	
Director's current account	8,500
Bank loan	10,000
Net cash provided by financing activities	1,500
Net cash increase for period	33,903
Cash at beginning of period	18,442
Cash at end of period	52,346

- a. We will use a shorter version of the cash flow report save it under name Cashflow Driver report Month – Year. Below is the template I use for this exercise, you can download the template [here](#)

<b>What happened to the cash last month?</b>			
			<b>Is the change</b>
		<b>One line explanation of the change</b>	<b>Good or Bad?</b>
Beginning cash balance	£0		
	£0		
	£0		
	£0		
	£0		
All other changes, net	£0		
Net cash flow	£0		
Ending cash balance	£0		

We are ready to go.. let's have a look at a real example Rapid Services Cash Flow.

### Step One: Identify the four most significant changes in cash during the month.

This entire process is not about detailed analysis – it's about understanding the four largest cash changes in a particular month.

- Enter on the first column the list of the accounts that had most significant changes and next to each account, enter positive amounts in black and negative amounts in red. Lastly, next to each figure, write a one-line explanation of the change based on what has happened during the month.
- Determine whether each change in cash is good or bad and right the word good or bad next to the short comment.
- Lastly, run through the remaining items, and identify whether those items are regular changes, such as VAT control account, wages and salaries, payroll liabilities to HMRC.

Activities	Amount	Reason	Good - Bad
Opening balance	£18,442		
1 Net profit	£95,100	Profit is below Budget by 10% for the third month in a row	<b>Bad</b>
2. Debtors	(£25,840)	Three new large projects initiated; deposit received; remaining balances are due in the following two months.	Good
3. Equipment purchase	(£11,000)	Equipment was upgraded and was bought in one lumpsum using bounce bank loan as it was cheaper than under lease finance	Good
4. Bank loans repayment	£10,000	A bounce bank loan has been taken to cover future overheads should the the current market conditions continue.	Good
5. Other cash movements net	£34,357	Remaining cash movement changes were expected to happen. Paying employees, and VAT also directors taking funds out of the business.	Nothing unusual
Net cashflow increase	£33,903		
Closing balance	£52,346		

1. The most considerable cash change was net income - profit. I labelled it as **Bad** because profits have been below sales expected for the third month in a row.
2. The second-largest cash change was debtors balance (money owed to the company). The money owed increase means Rapid Services sold more than it collected in from its customers. This is a good cash change in this instance, but in other times this cash change might be Bad.

QuickBooks cash flow report allows to drill into a particular figure to look at the detailed activity. After drilling down into the debtor's balance and looked at Rapid services list of invoices; there were three invoices issued to customers for new large projects where a deposit was paid, but the remainder of the invoice is due to be collected in the following two months. So, I labelled that as **good** as it is part of Rapid Services' standard procedures.

3. The third-largest change was equipment. I labelled this change as **good** as the business upgraded a piece of equipment. Since there were enough cash reserves the equipment was paid in full, which is cheaper than financing the purchase.
4. The fourth-largest change was bank loans; the company took a bounce bank loan to build up its reserves. I labelled this as **good** as it was a good decision to take the loan.

## Remember

After calculating the other cash movements, I identified that all the changes were expected to happen, e.g., paying employees, and VAT also directors taking funds out of the business.

**Step Two. In a couple of short paragraphs describe the actions are to be taken in the next month about future cash movement**

### Actions to be taken

Net Profits are behind budget by 10%, the reason should be determined. A starting point could be to compare the profit and loss for the same period for previous year, to try and identify difference in income and expenses.

Debtors balance change are due to three new projects which will be completed in the next month or two, all payments due dates for the remainder of the invoices should be monitored.

A cashflow forecast on a monthly basis and use as the basis for managing the business operations, monitoring market conditions regularly and adjusting both budget and cash flow forecast will help with the efficient allocation of cash reserves.

## Completed sample cashflow driver report for October 2020

### Cash Flow Driver Report

Step 1. reasons for four largest cash changes

Activities	Change amount	Reason	Good - Bad
Opening balance	£18,442		
1 Net profit	£95,100	Profit is below Budget by 10% for the third month in a row	Bad
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Net cashflow increase	£33,903		
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## Step 2: Actions to be taken in the next month about future cash movement

Profits are behind budget by 10%, the reason should be determined, and profit budget amended on a more regular basis to reflect current market conditions. Cashflow forecast report is a better tool for decision making as the business trading conditions are not the same as at the start of 2020.

Debtors balance change are due to three new projects which will be completed in the next month or two, and payments due dates for the remainder of the invoices should be monitored.

A cashflow forecast should be updated monthly and use as the basis for managing the business operations, monitoring market conditions regularly and adjusting both budget and cash flow forecast will help with the efficient allocation of cash reserves.

## Step 3. Share your report with others.

Informing other partners in the business and your spouse on the business's cash position shortly and concisely will help you not only get feedback and bounce ideas on improving any cashflow shortfalls and share successes on the changes marked as good. You can then plan and take action on the outcome of the discussion.

This part of the process also will develop your skills should you need to pitch to investors or lenders as cashflow is one of the essential assets in the business and places a big part in their decision to invest in your business or grant you a loan.

## Most common cashflow drivers

As you become more familiar with the three-step roadmap, you will come across the main drivers on your business cash flow.

### **Remember**

This exercise is about focusing only on the four big drivers of the change in cash for a particular month. Since you will be able to follow the three-step process to prepare a cash flow driver report each month, you will become more familiar on how these drivers impact your business cashflow.

It is advisable to run the profit and loss on an accrual basis. You can select the option on your cloud accounting software.

The profit and loss report based on accrual basis is the most relevant view of your business profitability, and this is one of the reports that both banks and investors and other lenders would want to look at.

1. Sales vs cash collected.

Accounts receivable is a good example that explains what running profit and loss on an accrual basis mean. When you sell to a customer on credit, you record the invoice as sales, but the cash is collected based on the payment terms given to the customer, which might be a month or two later.

2. Cost of goods sold vs Stock

When you buy stock, it is recorded as an expense in the profit and loss when you receive an invoice from the supplier; however, the stock is held before you can sell it to customers.

3. Accounts payable – Creditors vs payments

There is a time difference when you record invoices as an expense when receiving an invoice from your supplier; some suppliers would allow you to buy on credit, so the cash goes out to pay the supplier a month or two later depending on the credit terms.

4. Other payables - Amounts accrued vs payments.

One example of accrued expenses is services such as solicitors' fees. There is a time difference when you record these services on the profit and loss report and when you make payment to solicitors.

You would record the initial figure quoted by solicitors as an expense (this entry is called an accrual) since you don't normally receive an invoice from solicitors at this stage. When the solicitors complete their work, you receive the invoice then you can record the both the invoice balance on the profit and loss. Total invoice is payment might happen a month or two after the initial figure quoted was recorded as an expense.

#### 5. Borrowing or paying off debt.

You see a change in the cash when you take a loan or pay off any loans during the month. Even though it does not create an expense in the profit and loss, it does impact your cash balance. When paying down loan capital, it does not create a cost in the profit and loss either but reduces cash balance in that month.

#### 6. Capital – Owner investments vs Withdrawals.

When an owner injects cash into the business or take dividends or recovers the money invested, this incoming and outgoing transactions do not create income or expense entry in the profit and loss account, but they impact cash.

#### 7. Property – Capital expenditure vs sale of assets

You see a change in cash before this type of purchases are recorded as an expense for profit and loss. These are assets recorded in the Balance Sheet and are depreciated during the asset's useful life. Likewise, you see a positive change in the cash and asset is sold for a cash.

### One final recommendation

Take action now while the three-step process is still fresh in your mind.

Please send me an e-mail at [ruth@oasisaccountants.co.uk](mailto:ruth@oasisaccountants.co.uk) I will be happy to answer any questions you have to complete your first use this three-step process in your business.

Remove chaos from your business by automating cashflow reports using software that predict future activities and their impact on cash

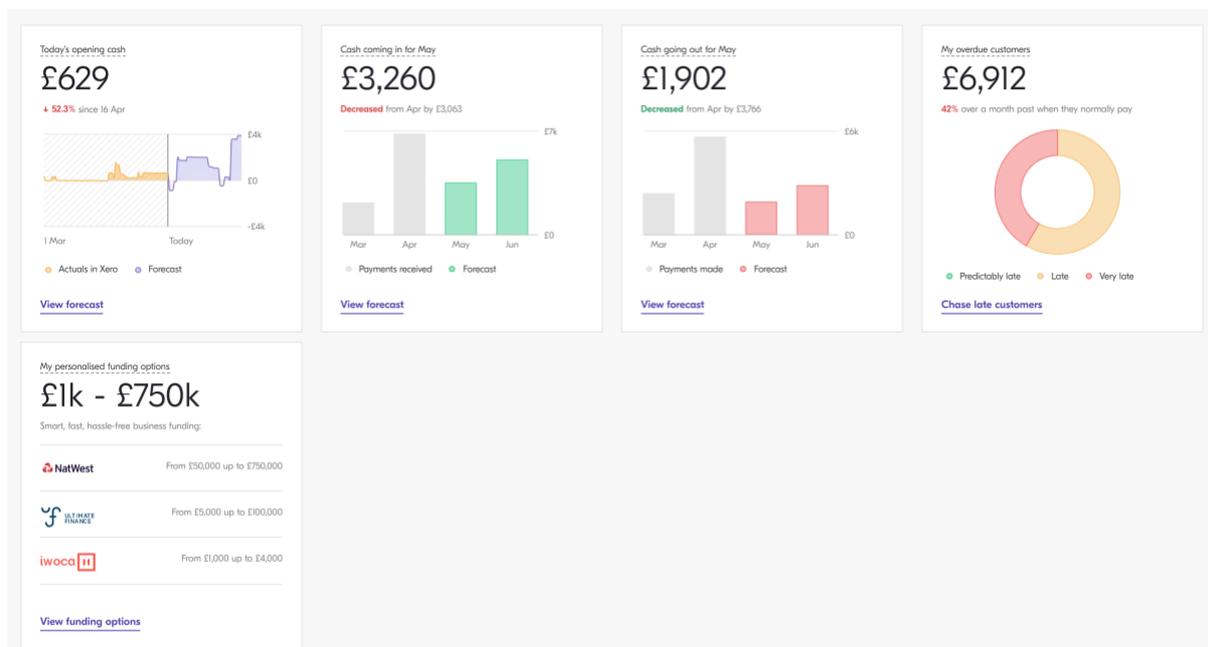
Due to the current trading restrictions and the uncertainty of what the market conditions would be like when the crisis is over, your business needs more than ever more insightful reports that can look in detail into the business activities and the impact they have on cash.

At Oasis Accountants we use automated technology that links to the main cloud accounting software that predicts payments and show you exactly when they will impact cashflow, it also predicts vat and tax liabilities and builds what-if scenarios so that you never run out of cash.

Remove chaos from your business by automating cashflow reports using software that predict future activities and their impact on cash

Due to the current trading restrictions and the uncertainty of what the market conditions would be like when the crisis is over, your business needs more than ever more insightful reports that can look in detail into the business activities and the impact they have on cash.

Flourish consultants uses automated technology that links to the main cloud accounting software that predicts payments and show you exactly when they will impact cashflow, it also predicts vat and tax liabilities and builds what-if scenarios and funding options so that you never run out of cash.



Please send me an e-mail with any queries at [ruth@oasisaccountants.co.uk](mailto:ruth@oasisaccountants.co.uk). Or call us on 078941067410

"Never put off till tomorrow what you can do today."