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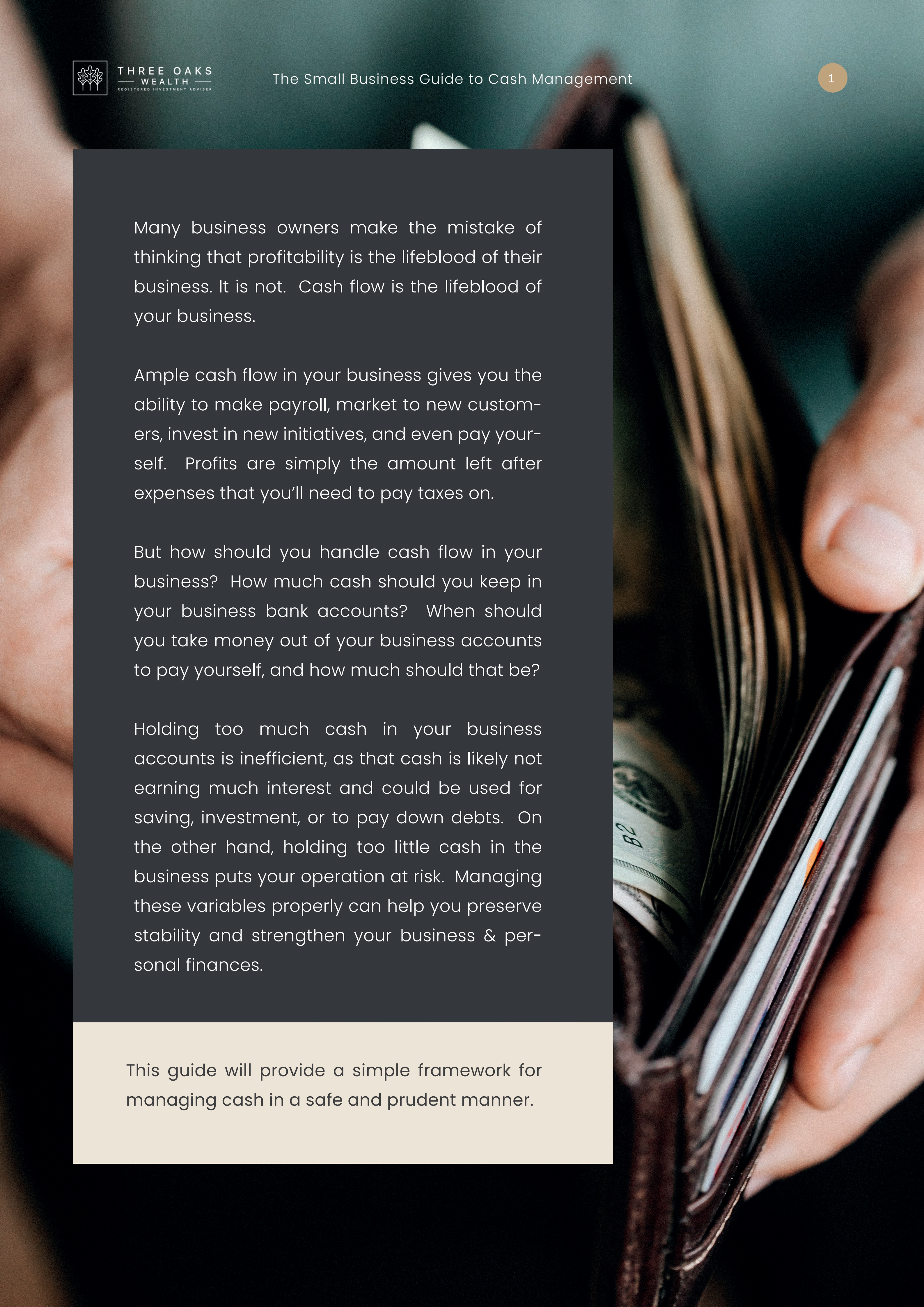
The Small Business Guide to Cash Management



Many business owners make the mistake of thinking that profitability is the lifeblood of their business. It is not. Cash flow is the lifeblood of your business.

Ample cash flow in your business gives you the ability to make payroll, market to new customers, invest in new initiatives, and even pay yourself. Profits are simply the amount left after expenses that you'll need to pay taxes on.

But how should you handle cash flow in your business? How much cash should you keep in your business bank accounts? When should you take money out of your business accounts to pay yourself, and how much should that be?

Holding too much cash in your business accounts is inefficient, as that cash is likely not earning much interest and could be used for saving, investment, or to pay down debts. On the other hand, holding too little cash in the business puts your operation at risk. Managing these variables properly can help you preserve stability and strengthen your business & personal finances.

This guide will provide a simple framework for managing cash in a safe and prudent manner.

Keep Your Business and Personal Accounts Separate

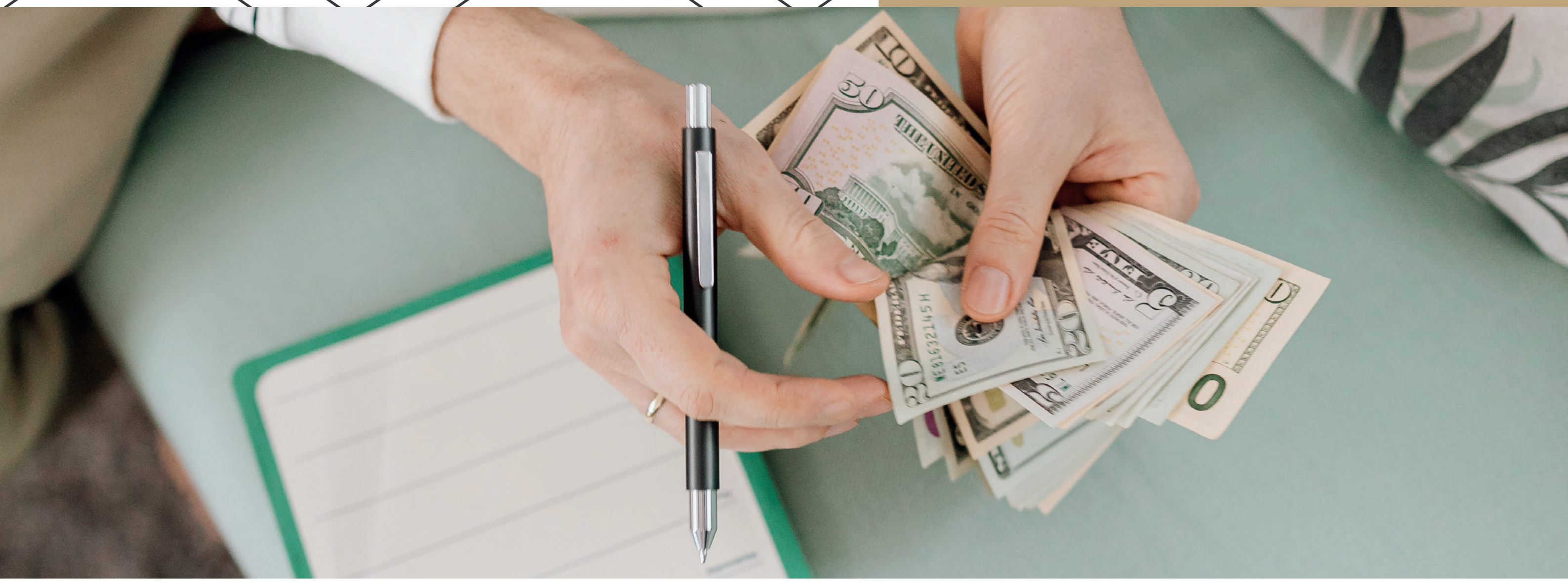
First off, if you haven't opened a bank account for your business please do so now. Your accountant may have told you that you don't necessarily need one. That you can use your personal bank accounts, and share with them which expenses are for business purposes. This is true, but doing so will make your life unnecessarily complex. Opening an account in the name of your business only costs you a few minutes of your time, and is the easiest way to keep business and personal transactions separate.

Forecast Your Expenses

To determine when and how to take cash out of your business, we first need to know how much you'll need to keep in your business. The best way to do this is to forecast your expenses.

Most businesses have semi-consistent operating expenses each month, but that may or may not be your situation. If you do have level expenses each month, most businesses aim to keep 3-6 months' worth in the bank at all times. Think of this cash as your emergency fund. If revenues ever dried up, you'll have that cash ready and accessible to make payroll. In business settings this cash is typically called "working capital."

Where your business fits in the range of three to six months depends on cash flow volatility and your personal preference. If you have a very stable business with even cash flows and you're comfortable with risk, three months of expenses should be fine. Seasonal businesses, newer businesses, or owners with less comfort level with risk may need six months or more.



Set Your Distribution Rules

Now that you've set a target for how much cash to keep in the business, you can set distribution rules surrounding how much to take out. Most businesses should perform this exercise and review cash balances at least quarterly. Quarterly reviews align with quarterly estimated tax payments, and the short end of the 3-6 month working capital range.

Monthly cash reviews work well for many businesses too but may be unnecessary for some. While cash flow is indeed the lifeblood of your business, it makes little sense to postpone important tasks like marketing or customer service just to dive into cash spreadsheets more frequently.

When you review your business's cash levels, simply compare the total cash in the bank to your working capital target. If you have more cash than you need for working capital, simply distribute the excess by transferring it from your business accounts to your personal accounts. This distribution can then be used for your personal expenses, savings, investments, or to pay down debts.

Do not fret if you have less cash than your working capital target. It often takes time to build up to our savings goals. Try to keep as much cash in the business as possible – particularly if you need to take a distribution to pay your personal expenses.

Note that your business's form of organization will have a dramatic impact on cash flow management. If you own an S-corporation you're already paying yourself a w-2 wage as part of normal operating expenses. This means that when keeping all cash in the business (pursuant to your working capital target) you're still earning some type of wage.

Sole proprietorships, partnerships, and LLCs do not pay owners a w-2 wage. Owners take distributions or "draws" from the business after paying operating expenses. Thus, by keeping all extra cash in the business to build toward your working capital goal, you would be doing so at the expense of your personal compensation.

Here's an Example:

Let's say you have a floral business that produces $10,000 per month in revenue and has $3,500 in expenses before your personal compensation. You prefer a six month working capital target, meaning you're building cash in the company accounts until you reach $3,500 * 6 = $21,000.

Right now you have $10,000 in the company account. If the business is a single member LLC, you'd have $10,000 - $3,500 = $6,500 in monthly income. Provided you have the cash at home to pay your personal expenses, you might decide to keep the entire $6,500 after expenses in the business accounts in order to reach your working capital target. By doing so you'd reach that target sooner but forego any personal compensation along the way.

On the other hand, let's assume the business is an S-corporation. Since you're required to pay yourself a w-2 wage, you do so with half of the cash remaining after operating expenses, or $6,500 / 2 = $3,250. In this situation your business expenses would include your personal compensation. Rather than having $6,500 left over each month, you'd have $10,000 - $3,500 - $3,250 = $3,250 remaining. (This example omits payroll taxes for simplicity). You could keep the $3,250 in the business to build toward your working capital goal, and still have $3,250 of personal compensation via your w-2 wages.

Plan For Taxes

Finally, we need to account for taxes. Your accountant has likely explained how quarterly estimated tax payments work: you can make estimated payments based on your income last year or your income this year.

If you make payments based on your income last year, your accountant can instruct you how much to pay in even quarterly installments. If you make payments based on your income this year, your total payments need to reach 90% of your aggregate tax liability to avoid penalties.

Whether you make payments based on this year's income or last year's, it's important to keep cash available to make the payments on time. The easiest way to do this is to earmark a certain percentage of each distribution for taxes. Some business owners prefer to open savings accounts just for this purpose.

Wherever you decide to park extra cash, it's very important to incorporate taxes into your cash flow planning. Failing to do so has created major problems for countless businesses and business owners.

This is another situation where form of organization matters. If your business is a C-corporation, you'll need to keep cash in the business to pay tax liabilities. Do not distribute cash meant for taxes in this situation. Owners of S-corporations could keep cash in personal accounts earmarked for estimated payments.

Every business is different, just like every business owner is different. The ideas suggested in this guide provide sound framework, but requires customization based on your specific circumstances. Form of organization, industry, revenue & cash volatility and comfort level with risk should all be considered when creating a cash management strategy for your business. Doing so can have a dramatic benefit to your business operations and finances.

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