WHIP YOUR BUSINESS INTO SHAPE & TAKE HOME MORE CASH

RHONDALYNN KOROLAK

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Perhaps the most significant learning of my life is this: if you want to make a new contribution, promote understanding and inspire change you have to be willing to look at what you do from a completely new perspective and take a risk. Financial Foreplay is a marked deviation from anything that I have ever done before. It doesn't look or read anything like an accounting or finance book... and therein lies its charm and potency. The book was born out of a very simple desire to help business owners with some of their most formidable challenges – enhancing profitability and cash flow, reducing risk, knowing what to measure and focus attention on and identifying opportunities. That desire combined with the input and talent of some special people has produced a book that I am extremely excited about.

The success of this book and the overwhelming media support is largely due to the effort of three very talented gentlemen. David Brewster, who helped me to bring this material to life in way that is memorable, thought provoking and empowering. Without him, this project could have easily been "just another finance book" that no one wants to read. His vision, influence and expertise really brought the client stories to life in a way that will resonate with the millions of entrepreneurs who are struggling right now day-to-day in their businesses. Ben Angel, who challenged me to go beyond the norm and what would have been expected of a "typical finance book" and into the realm of controversy, intrigue and edu-tainment. And Ben May, my trusted graphic designer and web developer, who brought the concept of Financial Foreplay to life in such a memorable and captivating way. I could not be more proud and grateful to have had the support, guidance and encouragement of these three.

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Introduction

If you are like most small business owners I work with, you went into business because you are good at what you do – graphic design, hospitality, construction, farming, retailing – and you wanted the autonomy and financial freedom of owning your own business. You were probably thinking, "as long as I am good at what I do, how hard can it be to make a decent living and support my family?" And you have probably discovered that it is harder than you thought.

You may be one of the 95% of small business owners who discover that although they work like dogs every day, they have little to show for it. You may be one of the many who find themselves isolated because they don't feel there is anyone to discuss or share their greatest fears and challenges with.

You may be feeling overwhelmed right now by any number of issues. Your workload, a shortage of customers, supplier issues, customer service challenges and the fact that there never seems to be enough time to plan ahead, to budget or review your progress. Or you may simply be wondering why you never seem to have any extra money, even though your accountant says that you are making a profit.

Which leads me to one area I'm guessing is definitely harder to grasp than you thought it would be: the management of money.

If you are like most small business owners I work with, you never dreamed that the ability to understand how money works would be very important. You thought: "That's for the accountant (or bookkeeper) to worry about. Sure, the accountant shows me a few reports from time to time, but I don't see the need to *really* understand what they mean. If there was a problem, he would tell me, wouldn't he?".

You probably don't realize that all those numbers - the financial DNA of your business - can tell you a lot more than you thought. They can tell you why you're suddenly struggling to pay the bills. They can explain why your business is not performing as well as you thought it would - or as well as

you were promised it would when you bought it. They can reveal why you'll have to forego your salary - again - because there just isn't enough cash.

The financial numbers of your business are the story of your business. The numbers don't lie. They are one of the few objective indicators of how your business is performing and where the problems are. Regardless of any justifications you use to explain why your business is not performing - the economy, the shortage of 'good' staff, the competition, the rent - the numbers tell the truth and can lead you to the solution. You just need to learn HOW to use them to your advantage.

You need a bit of *Financial Foreplay*.

In this book you will learn:

- Why cash, more than profit, is the key to success in business;
- How to find and unlock the hidden profit and cash that are trapped in your business;
- How to use the numbers in your financial statements to give you information that is useful for you - not just useful for your accountant. For instance, I'll show you how to calculate a few simple but important ratios, to understand the results and to monitor them on an ongoing basis;
- How to stop making common business mistakes that are preventing you from being as successful as you deserve to be;.
- Why too much inventory can strangle your business;
- How to manage debts owed to you and minimize the risk of default;
- How to charge the right price for your goods and services;
- How to decide whether an investment will be a good use of your company's money or not;
- How to work out when, during each month, you 'hit the front' and start being profitable;
- How to set powerful and meaningful targets that will focus the attention of both yourself and your staff on making good decisions and taking positive actions ALL the time;
- A way to measure and track your financial success in a simple and meaningful way; and

- How to eliminate the unproductive habits that have been holding you back.

You will learn all this through the stories of my clients. Powerful stories about real business owners, just like you, with common financial problems. I'll show you how these business owners found themselves in trouble, how they worked out what was wrong (with a little help from the financial numbers) and how they took action to turn things around.

This book is not another one of those 'finance for non-finance' books full of indecipherable financial statements and scary calculations. In fact, this book contains less actual calculations than any other business finance book on the market.

I encourage you to read the stories, learn the lessons ... and have a bit of fun discovering how *Financial Foreplay* can get your business to show you more love!

CHAPTER 1

The Secret to Never-ending Satisfaction

Finding the sweet spot in your business...

In This Chapter

Getting to First Base: Profit is Pointless...Cash Flow is King

Don't Come on Too Strong

When is it PC to Talk About P&C?

If You Want a Date, You Have to Ask

Your Bookkeeper is From Mars and Your Accountant is From Uranus

"A visionary company doesn't simply balance between idealism and profitability: it seeks to be highly idealistic and highly profitable. A visionary company doesn't simply balance between preserving a tightly held core ideology and stimulating vigorous change and movement; it does both to an extreme."

Jim Collins

Serge was very proud of his café. I could see why when he showed me around in the week before it opened. Serge had a strong belief that for a café to succeed quickly, it needed to look 'serious' right from the start. He had invested heavily to achieve this. The tables and chairs were in place, the drinks fridges were already well-stocked, the kitchen was ready to roll with both equipment and non-perishable supplies. Serge had hired three staff members and spent a week training them to ensure a smooth opening. Any customer walking in the following Monday lunchtime would be forgiven for thinking this café had been running for a year rather than a few hours.

Getting to this point hadn't been easy. Serge had drawn down on his mortgage and used his considerable persuasive skills to convince his bank that an overdraft was necessary. Between these two actions he had generated enough cash to pay for his initial rental period, the fit-out of the restaurant and staff wages for the first fortnight. He'd talked his way into a 30-day account with the drink and snack distributor which had allowed him to stock the shelves. He'd also done a deal with a coffee company to supply him with a free espresso machine and a first batch of coffee that didn't need to be paid for two weeks. He had deliberately avoided using his credit card because he knew he would still need to buy a supply of fresh food just before opening.

But although things were tight, Serge wasn't particularly worried. He had a big business background – he'd worked in sales for the past decade

– and he understood the importance of Profit Margin. He had carefully calculated the prices on his menu to make sure they would be profitable. His well-practiced spreadsheeting skills had been tapped to ensure all his costs – including wages and rent – were included in the prices of his products. Finally, he had used his knowledge of marketing to build a real sense of anticipation about his café in the local community. Serge was confident that, from day one, he would be running profitably.

The next week, as he had expected, the opening was a success. He and his staff found themselves working hard within just a few hours. Serge was thankful that he had stocked up so well and trained his staff before the big day. By the end of that first day, he was already on the phone to all his suppliers ordering new stock; he was pleased to be able to pay them directly from a bank account freshly topped-up with the day's takings.

While business continued strongly, cracks were starting to show when I called to see Serge at the end of his first month. I found him sitting in his office, papers spread all around him and his costing spreadsheet open on the computer in front of him. He looked up with a frown.

"I can't work it out," he said. "I know that we're running profitably. I've been over my calculations a few times and I can see that for every meal we sell, we take in more money than we spent on putting it together. But I still have all these bills in front of me. I have to pay the staff again. I have to pay the coffee account. I have to pay the rent. And even though I've included all these things in my profit calculation, I'm still bumping up against my overdraft limit and struggling to find the money to make all these payments."

He looked back at his spreadsheets with a confused look on his face. "How can I be profitable and still have trouble paying my bills?" he said, partly to the computer and partly to me.

"It's actually quite simple," I replied, drawing a look of doubt from Serge. "You've fallen for the same trick that many small businesses fall for, especially early on. You've confused Profit with Cash Flow."

Serge looked confused. "There's a difference?" he asked.

Getting to First Base: Profit is Pointless… Cash Flow is King

Understanding the importance of Cash Flow, as opposed to Profit, is absolutely critical to running a successful business, yet it is often overlooked. In fact, more businesses go bankrupt due to a lack of Cash Flow than for any other reason. If you can grasp the difference between Profit and Cash Flow and become a master at finding and keeping cash in your business, success will be inevitable.

The common assumption is that if, like Serge, you are running a business in which the price you charge for your products is greater than what they cost you, everything will be okay: you will be profitable and successful. Profit is good – don't get me wrong – but it is not enough on its own. To be sustainable, your business must also have a healthy *Cash Flow*. Let me explain.

Every business has two young 'employees' whom you never see, but who are as important as any others. The first is an 18-year-old woman – we'll call her Penny – and she gets her energy from *spending*. (That shouldn't be too hard to imagine.) The second is a 19-year-old man – we'll call him Ernest – and he gets his energy from *earning*. As the business's cash registers and bank accounts swell, Ernest's stamina increases. Penny and Ernest are good reliable employees – you can be sure they will be with you for the life of your business, and, being imaginary, you don't have to pay them. The main problem with the pair is that they are constantly courting each other: they love playing that cat-and-mouse 'come and get me' type of chasing game.

Before a business opens, Penny, powered by all those start-up expenses, runs off. The more money spent, the further she runs. Penny beckons playfully back to Ernest, urging him to chase. He wants to run and play, of course, but he can't – not until the business starts bringing in some money. Only after the lights have been turned on, the coffee machine fired up and the first customer has paid her bill can Ernest take off in pursuit of his girl. His aim is simple: to catch Penny and, with plenty of silly laughter between them, to do, well, whatever it is that young men and women do when they are in love and chasing each other. It's all good, clean fun – but the business

owner does need to keep these games under control lest they get out of hand.

Now an important thing to realize about Penny and Ernest is that their respective energy boosts – from spending and earning – only come from money *physically* leaving or coming into the business. This might be in the form of cash, bank transfers, incentives or rebates. Penny and Ernest do *not* get any energy from credit-related transactions until those transactions are settled. So Penny doesn't get an energy boost when Serge buys his coffee on a 14-day account; the spending boost comes when he pays the coffee account. Similarly, Ernest wouldn't get any extra momentum if Serge gave a customer a week's credit; his power would come when the customer settled up.

In other words, Penny and Ernest are only affected by what accountants call 'cash'.

Let's revisit Serge's situation. Recall all the money he had to spend before he started. Fitting out the café, paying rent in advance and paying wages to his staff while they trained. By drawing down on his savings and overdraft, Serge paid for these in cash. As a result, Penny was able to run a long way before opening day, giving her a good head-start on Ernest.

Things started to change immediately after Serge served his first customers. We know that the nature of a café is that most of its revenue is received as cash over the counter, so Ernest was able to start chasing Penny straight away. We also know that Serge had done his calculations and that his prices were high enough to cover his costs: he was earning at a higher rate than he was spending. So Ernest not only started chasing Penny, but he had more energy than her and started making up ground from the beginning.

However – and this is the bit Serge didn't see coming – combined with a good head-start from all that early spending, Penny had some additional sources of energy up her sleeve. Just as her stamina started to flag – as spending started to slow a little – Serge ran up against his first round of bills. After two weeks, his first coffee account was due and another round of wages had to be paid. More spending, and Penny was off running again. Shortly afterwards, the initial account of his drink and snack distributor was also due, as was another rental payment. More push for Penny. By the

end of the first month it was clear that, while 'spending Penny' slowed down from time to time, she wasn't going to stop running.

It was a positive that Ernest kept on running also, as customers continued to come through Serge's door. His café quickly built a solid word-of-mouth reputation. But this wasn't proving enough to prevent much head scratching in Serge's office.

Serge's problem was that although Ernest was, on average, catching up to Penny, he wasn't doing so quickly enough. And in the meantime, Serge had to keep spending. Supplies had to be replenished quickly and constantly. No sooner was one bill paid than another – often bigger – took its place. The only way that Serge could spend what he needed to was to operate close to the limit of his overdraft, with his credit card as backup. And both these lines of credit had their own costs, in the form of interest, which Serge had not factored into his costing calculations.

Serge was becoming as confused and frustrated as Ernest would have been, had he been a real life boy chasing a real life girl for all this time.

KEY POINT
Regardless of your Profit Margin, cash coming in must exceed the cash going out at any point in time.

When Serge showed me his accounts, he was able to demonstrate that, on average, Ernest was catching up to Penny slowly: his overall 'cash in' exceeded his overall 'cash out' by about 10% per month. His business was operating 'profitably' in this sense. But I had to point out to him that no matter how profitable his day-to-day operation, he would not be making a real profit until Ernest caught up, and in fact overtook, Penny. At that point, his start-up expenses would have been paid off and sales income would exceed expenditures (including covering all his upfront bills). In the meantime, he needed to be able to keep spending on stock, rent and wages etc – to keep feeding Penny – or the whole game would come to a very abrupt halt.

KEY POINT
You cannot take profit to the bank and save or spend it. Profit is meaningless unless it is accompanied by underlying positive Cash Flow.

It took some time for all this to sink in for Serge. In his former, large corporate life, things had seemed more simple – from his point of view at least. His job had been to sell products for an amount larger than their 'standard cost' – the bigger the Profit Margin the better. What he hadn't properly realized was that behind the scenes in this large company was a finance department which had responsibility for managing Cash Flow. He hadn't needed to concern himself with it. Now, as a small business owner, he was his own finance department – both Cash Flow *and* Profit Margin were his responsibility.

At this point Serge and I wrapped up our first conversation about Cash Flow. I asked Serge to give some thought to how he might improve his situation. On returning the next day, his answers proved to me that he had understood some, but not all, of the concept.

Don't Come on Too Strong

Instead of invoices, Serge's desk was covered in newspapers. He was on the phone when I arrived, clearly talking advertising rates and negotiating in his highly enthusiastic way. By the look of the notes in front of him, Serge had already called a number of papers and, no doubt, struck attractive deals with each. As I waited, I noticed a sandwich board leaning against the office wall, ready to be placed out the front of the café. Chalked on to the board, in large letters, was: "COFFEE AND CAKE ONLY $5".

Oh dear, I thought.

Serge got off the phone looking pleased with himself. He always seemed in his element when driving hard bargains.

"I've thought about what we discussed," he said, "and as far as I can see there is only one solution. Even though we got off to a strong start, we have to increase sales even further. I know that my margins are profitable, even if we aren't making a 'real' profit yet. So it's simple: I need to sell more. The

more I sell, the quicker your friend Ernest will run, and the sooner he'll catch up to Penny."

Well, I thought, at least he took the Ernest/Penny analogy to heart.

Serge went on quickly: "I've been in touch with all the local papers and organized some great advertising. We'll have half-page ads in all the main ones for the next month. Most of them will also do a 'review' – which I get to write! – because I'm going to spend so much with them. And did you see the sandwich board? I was just about to take that outside. Lots of other cafés around here offer these sorts of coffee and cake combinations at a discount, so why let them take my potential customers? I reckon we'll see an increase in Ernest's speed as early as today."

"Serge," I said quietly. "Do you think we could grab one of your corner tables and have a coffee?" My low-key response had the desired effect: Serge's enthusiasm immediately started to ebb away.

"I can see you've given some good thought to getting Ernest running faster by bringing in more customers," I said once we were sitting together. "But it probably won't work out just as you've planned."

I went on to explain that there were two major flaws in Serge's plans. Both were errors that I have seen made many times.

Serge's first problem related to his idea that simply increasing sales, by increased patronage, would speed up 'earning Ernest' sufficiently to catch his girl. The issue was that he had forgotten to consider the impact on 'spending Penny' of the changes he proposed.

First, Serge had committed to spending a substantial amount of money on advertising in order to increase the number of customers. This was money he was not already spending elsewhere, that is, it was new spending. Sure, he could probably buy the advertising on account, but that was irrelevant. Whether immediately or in a few weeks, this extra cash would need to be found, helping Penny run faster. (For the moment I spared Serge the discussion about the fickle nature of advertising and its lack of guaranteed success.)

Second, but on a similar note, an increase in Serge's turnover (assuming no other changes) would increase the amount of stock he would need to buy and, probably, the number of staff he would need to hire. Again, there would be an increased need to spend, helping Penny to run faster.

In short, Serge's plan to increase sales revenue (helping Ernest to run faster) would see Penny running faster too. What's more, the new spending on advertising would reduce his Profit Margin, making the task of catching up even harder for Ernest.

Serge's face dropped as the implications of what I was telling him started to sink in. It dropped further still when I pointed out that, quite possibly, carrying out his plan might see him run out of cash – and therefore go out of business – more quickly than if he did nothing.

KEY POINT
Increasing sales will not improve a Cash Flow shortage if the increase in revenue is cancelled out by greater spending to achieve the increase in sales.

"Okay," Serge said gingerly, after a few minutes. "What about the coffee and cake combination. Surely that's a simple enough plan to work?"

"I'm afraid not, Serge," I replied, "and you should be able to see the problem with this one yourself, given your understanding of the importance of Profit Margin. How much do you normally charge for coffee and cake, without the discount?"

"$7: three for the coffee, four for the cake," he said. "But not a lot of people buy both. So I figure if we can get an extra two bucks out of a few people, we'll come out ahead. The cake only costs me $2 a slice, so at worst we get extra cash in for no extra cash out, and some of the customers will no doubt buy some other things as well, boosting sales further. I know this won't get Ernest running much faster, but it shouldn't make Penny any faster either, should it?"

I had to acknowledge that on the basis of margin alone, Serge's thinking had some merit. I have had many other clients who give discounts which result in actually making a loss on some of their products. But I had to point out that Serge was still misunderstanding his central problem: a lack of Cash Flow.

"Do you see that by effectively giving away the cake for what you paid for it, each boost in Ernest's speed will be matched by an identical increase in Penny's. The end result will be no net change, assuming you do not have

to hire extra team members to serve up the additional coffee and cake. And if the combination leads to better sales of other products, you're back to the same problem we have just been discussing: sales which you don't have the cash to support."

> **KEY POINT**
> **Discounting is bad for your Cash Flow – it rarely has the desired effect.**

(If you would like to see some numerical examples of how discounting prices affects your bottom line, refer to the Imagineering Profit website. In some cases, just a simple discount of 10% can result in you having to double or triple your sales in order to come out further ahead.)

"So what should I do," asked Serge with exasperation, "apart from cancel all that advertising I just booked?"

"What you need to do," I explained, "is increase your focus on Cash Flow, while maintaining your profitability. You need to give Ernest a chance to catch up to Penny – not by speeding Ernest up, but by slowing Penny down. Even if that means slowing Ernest down a little bit."

"You're saying I might need to reduce my sales rather than increase them? That, I have to say, is a bit hard for an old sales rep to swallow!" said Serge.

I understood Serge's difficulty with this, but it was important for him to get the point. Sometimes being successful in business means being counter-intuitive.

We knew that Serge had a positive Net Profit Margin so that, given time, his revenue – his Ernest – would eventually catch up to his spending – his Penny – and all would be well with the world. But because of the head-start that Penny had been given, and because he had left himself little room to expand his debt in the short term, it had to be accepted that Ernest's chase was going to take some time.

Possible actions Serge could take included:

- Making sure there was no unnecessary spending in the short term
- Subtle price increases in selected areas which would have little or no impact on sales (speeding up revenue – Ernest – without increasing spending – Penny)
- Negotiating extended payment terms with suppliers (This only delays the boost to Penny's energy, but it is a viable approach in Serge's case, where Net Profit Margin is positive.)

When is it PC to Talk about P&C?

What's the difference between 'Profit' and 'Cash Flow'? Remember that the money movements represented by Ernest and Penny are *cash* movements: *real* money moving in and out of a bank account and/or cash register. That's a good thing, because it means that when a business's earnings, represented by Ernest, finally catch up to and pass the business's spending, represented by Penny, then the resultant cash surplus is a *real* profit – one you can see reflected in your bank account.

In most businesses the accounts show things a little differently. Most businesses use what's called 'accrual' accounting (or what some jokingly refer to as 'cruel' accounting). Rather than record spending as 'money spent', they record spending as 'money spent *plus* money committed to be spent'. So if, for example, some stock has been purchased on account, accrual accounting includes the value of that purchase from the point it is made – not from the point when the account is paid. To use the Penny analogy, accrual accounting looks at how far Penny has run so far, then adds the distance she will run on energy she has already taken on board but not yet used. The same thing happens in reverse with earnings. Accrual accounting records earnings as 'money received *plus* money owed (expected to be received)'. When a sale is invoiced with 30 days to pay, the value of that invoice is included in accrual earnings even though the money won't be received for another 30 days (at least). In this case, Ernest is attributed all the distance he has already run, plus the distance he is expected to run using these 'outstanding' earnings.

When most accountants talk of 'profit', then, they are usually talking of '*accrued* profit' as opposed to what we called '*real* profit' above. Accrued profit is the expected real profit after 'spending already committed to', and 'earnings expected to be received', are taken into account along with real (cash) spending and real (cash) earnings. Rather than the difference between Ernest and Penny now, '*accrued* profit' is the expected difference between Ernest and Penny at some time in the future, when all outstanding debts and credits have been settled. You will see that a profit showing on your Income (or Profit and Loss) statement, in this sense, is a much more complicated – and arguably less 'real' – representation of the current financial situation of a business.

In practice, it is usually wise to have an eye on both your real profit (also known as your 'cash balance') as well as your accrued profit. It is a common error to focus on accrued profit only – an error which has the potential to send a business to the wall prematurely – and well before anyone expected.

Serge's café business was simpler than many in that its revenue was predominantly cash over the counter. The majority of businesses make their sales on invoice, for future payment, which adds a layer of complexity. (We're going to discuss this further in Chapter 3 when we discuss 'Receivables'.) But the basic rules of Cash Flow remain, and the basic game of 'earning Ernest chasing spending Penny' still needs to be managed.

If You Want a Date, You Have to Ask *(aka Remember to Invoice)*

When I first met Jason he was excited, to say the least. His start-up business was going great guns and, apart from a few minor issues he wanted to talk to me about, the future was looking as bright as his eyes.

Jason had started his domestic electrical business as both an escape from the constraints of working for someone else, and as a way of giving him and his wife, Amy, the flexibility to support managing a family. For five years Jason had been a maintenance electrician at a large food factory. There was no problem with the work, but the rotating shifts – day shift one week, afternoon the next and then a week of nights – were really getting to him. Not to mention the constant rounds of job cuts and never knowing whether it would be his turn next. Amy had a secure job as an office manager with a construction company so the couple was comfortable that they could ride out any temporary dip in their income.

Getting set up had been straightforward. Jason and Amy had solid savings behind them and with the various equipment Jason had collected over the years – including his van – he didn't need to invest a lot at the outset. A bit of sign-writing and a few ads in the local paper and he was away. Amy was able to tap into her established networks for a few clients to get Jason going, and with that start he went from strength to strength. Jason immediately enjoyed the variety of running his own business, and they both appreciated his ability to work something close to 'normal' hours.

As Jason's business grew he wondered why he hadn't made the change years before. His only concern was that, despite his success, the credit card was running at its limit and it was getting harder to pay the bills. He couldn't understand why this was happening, which eventually prompted him to look for some outside help.

As it turned out, it was lucky he did. If he hadn't, he would have been out of business, or refinancing his home mortgage, within a few months.

On the surface, Jason's business was simpler than Serge's. His original start-up costs were low, so his 'spending Penny' should not have been able to get much of a head-start to his 'earning Ernest'. Provided he was charging his customers the full value of any hardware he bought, plus a fair rate for his time, he should have found his Ernest catching up to his Penny quite quickly. But this wasn't happening. Much as had happened to Serge,

Jason was clearly having problems with his Penny (spending) getting too far ahead of his Ernest (earning), leaving the latter tired and frustrated.

The day I met Jason I joined him in his van as he went about his work. Our first call was to his local wholesaler from which he needed to pick up some parts for the day's jobs. It was fairly routine stuff – even I knew what most of the products were: various power-points and other wall outlets, a few light fittings and the like. I had noticed that there didn't seem to be a lot of stock in the back of the van, and Jason explained that he preferred to buy most of his supplies as he needed them. (A big tick right there, I thought to myself.) And besides, he went on to explain, he didn't have much spare cash to stock up anyway.

Jason had an account with the wholesaler which had to be squared up monthly. This had worked well early on, but now in his third month he admitted he was concerned about making the next payment. Something wasn't adding up, but for the moment I let that comment go.

We pulled up to the first job – a simple installation of a replacement fan in the customer's main bathroom. With the owner's permission I went in as well, though I did feel a bit awkward – I was hardly dressed as a tradesperson. The job was done quickly and I trailed Jason back to his van. He opened the center console of the van and pulled out an invoice pad. I noticed that the pad – a simple hand-filled duplicate pad – was quite thick though nearly used up. On the first blank form, Jason scribbled out a description of what he had done, along with his customer's details. He tore off the original and returned to the house to leave it with his customer.

In the few moments that he was gone, I flicked through the duplicates in the pad ... and saw immediately where Jason's problem lay.

"Jason," I said as he got back into the van. "I notice there are no prices written on these invoices. How do people know how much to pay you?"

He laughed. "Yeah, well, I haven't been doing this long enough to know all the prices off the top of my head. So I just write out what I've done, then take the book back to the office where Amy helps me match up these duplicates with the receipts from the wholesaler. We then use that information to produce proper invoices on the computer which we post out to our customers."

I asked the next question tentatively, even though I had a good idea what the answer would be. "How often do you do that – the reconciliation and the invoicing?"

"We try to do it at least weekly," he replied, "though I must admit we've got a bit behind. The matching-up takes ages, and we're still learning how to use the bookkeeping software so invoicing has got beyond us too."

I flicked through the book again. "So would you be two, maybe three weeks behind with your invoicing?"

"Yeah, at least that," he said. Then, after a few moments: "Probably a month, come to think of it. We've been pretty busy. Did I tell you Amy is pregnant?"

He hadn't, so I passed on my congratulations. Then I launched into my Penny and Ernest story. It turned out that Jason's situation was quite simple after all, but it had become more complicated because, to use our analogy, he had taken his eye off Penny and Ernest and forgot to focus on his Cash Flow.

As I mentioned before, Penny had not got much of a head-start in Jason's case as setting up his business did not require a lot of funds. His situation was helped even further by his main supplier – the wholesaler – being willing to extend credit to him right from the start. In effect, Penny had hardly run any distance at all in the first month of Jason's operation. Penny's first real push-along didn't come until the end of that first month, when his first wholesaler account became due. At that point Jason's spending became a bit more serious.

Meanwhile, Jason's 'earning Ernest' could have been well underway in his chase after Penny from very early on. Within a few weeks, Penny and Ernest could have been cuddling up to each other and working together on a profitable enterprise. But they weren't, for one simple reason: Jason hadn't been invoicing his work. Effectively, he had done nearly all his work for free, with a promise to invoice, but then left the invoicing for weeks. His customers were 'lucky' if they saw an invoice within a month of having had work done. With the usual delay between invoice and payment, Jason wasn't actually being paid for his work until around two months after the job. Rather than closing the gap (catching up with 'spending Penny'), 'earning Ernest' had hardly left the starting line.

KEY POINT
No one pays without an invoice, and until you get paid, you are out of pocket for the invoice amount, your time and the cost of the materials. Forgetting to invoice is a little bit like wanting to go out on a date but never bothering to ask.

Thankfully Jason didn't take long to understand what I was telling him. His problem wasn't that he was stupid – he just didn't understand the priorities. Coming from his background – a big factory where getting paid just wasn't a concern of the maintenance guys – the 'Penny and Ernest' game wasn't something he was familiar with.

And we had caught the problem in time. We agreed that Amy would take on the role of invoicing outstanding work and following up previous invoices that had not yet been paid. Together, Jason and I created a simple table which helped him convert time spent on a job into billable dollars. He then used this table, along with his wholesaler invoices, to hand-write invoices – including dollar amounts – at the time he did the jobs. With new clients, he asked for payment on the spot, by cash or check. With existing clients, he continued to offer credit, but offered a 5% discount for immediate payment.

Before long, all Jason's clients were paying him immediately on completion of work. Amy took on the task of banking checks daily. Within a month or so, his Ernest was running as fast as ever. Better still, because he was being paid for the hardware he used before he had to pay for it himself (by paying his account in 30 days), his earning Ernest was running *ahead* of his spending Penny. Jason found himself in the ideal business situation of having money come in before its related expenses go out.

Your Bookkeeper Is From Mars and Your Accountant is From Uranus

We will come back to concepts of spending and earning, profit and cash – and Ernest and Penny – many times during the rest of this book. But before we move on, let's have a very quick overview of where we're going.

After Jason and I had talked invoicing – following my discovery of his invoice book in the van – Jason quizzed me about the idea of Cash Flow. He was a keen learner. He now understood, courtesy of his harsh lesson, that 'doing profitable work' was a very different thing from maintaining a workable Cash Flow. He also understood his limitations as a small business operator who, like so many others, had started his business without any real training. And he wanted to avoid, if he could, making more 'classic' mistakes in the future.

I explained to Jason that even though his bookkeeper or accountant never discussed these important issues with him whey they reviewed his financial statements, there are four broad areas that could have an effect on his future Cash Flow:

- The first is **Inventory**. *Increasing Inventory reduces Cash Flow*. "Imagine," I explained, "that instead of buying your supplies as you need them, you stocked up your van with 'some of everything' so that you only had to go the wholesaler once in a while. Do you see that doing that would mean spending a lot of money?" Jason nodded and I went on: "Increasing Inventory is like giving energy bars to Penny while weighing Ernest down with a heavy pack. Penny would race ahead (energized by the money spent on the new Inventory) while Ernest, for reasons I'll explain later, would quite likely slow down eventually." We will discuss the effect of Inventory on Cash Flow in more detail in Chapter 2.
- Next is **Receivables**. *Increasing Receivables – the amount of money owed to a business – also reduces Cash Flow*. This was effectively Jason's problem because he wasn't getting his invoices out; the more common situation, I explained, is where invoices have been sent but aren't being paid on time. "In either case, Ernest

is held back – not by losses but by a failure to turn work done into cash. Remember that Ernest can't move until the cash comes in. Meanwhile Penny continues to race ahead as money is spent on fresh supplies so that new work can continue." We'll look at Receivables and their impact in Chapter 3.

- Third are **Payables** (and GST payments). *Increasing Payables – the amount you owe others – by holding back payment increases Cash Flow*. I told Jason about Serge and why I had encouraged him to negotiate longer payment terms with his suppliers. "When payment is delayed, the effect is to slow down 'spending Penny'. It doesn't remove her energy for good, but it does delay her ability to use it. Meanwhile, Ernest powers ahead (hopefully) on the revenue earned from sales, closing the gap between him and his girl." The smaller the gap, the greater the Cash Flow. Jason eventually learnt this once he had his invoicing in order. With his payable terms on his wholesaler account at 30 days, and his receivable terms as cash-on-delivery, his cash revenue quickly outstripped his cash spending. We'll investigate Payables in Chapter 3 also.
- Finally, there is **spending on Assets** (which accountants call 'Fixed Assets'). *Spending money on Fixed Assets decreases Cash Flow*, at least in the short term. Assets are listed by accountants separately from Inventory because they are 'permanent' as opposed to the transient nature of stock. The effect on Cash Flow of buying an Asset is similar to the effect of buying Inventory but more detrimental. Spending on a major Asset is much like starting up another business. The challenge is similar to what was faced by Serge: how to deal with a large up-front expense which turns into a big head-start for 'spending Penny'. I asked Jason to think about what would happen if he were to buy or lease a new van. He would need to make sure that the extra spending wouldn't harm his healthy cash situation by draining cash from his business. This is a more complicated topic which we'll return to in Chapter 5.

Elsewhere in this book, we'll look the other important areas you need to manage in order to run a sustainable and profitable business. These include **Pricing** (Chapter 4), managing **Costs** (Chapter 6), achieving your **Break-**

even (Chapter 7) and managing **Debt and Equity** (Chapter 8). We'll finish off by looking at the ways you can use **Measurement** to help you manage all these things (Chapter 9), and ways to get the best out of yourself (Chapter 10).

But to reiterate the main point I've been trying to make in this chapter. The distinction between Profit and Cash Flow is absolutely critical. **Failure to understand the difference, and failure to detect and fix negative Cash Flow issues, are the main reasons why most small businesses fail.** Nothing could be more deserving of your time and attention. The payoff is HUGE. Finding hidden cash in your business and putting it to work today will enable you to succeed in any economic environment and reward yourself with a much deserved pay increase.

Whip Your Business Into Shape NOW!

The Secret to Never Ending Satisfaction – Give Your Bank Balance a Dose Of Viagra!

- It is important to look at your financial statements each month. As a minimum, you need to view your Income Statement (or Profit and Loss), Balance Sheet, Aged Receivables and Aged Payables reports
- Cash Flow is easy to calculate:

PROFIT +/- Inventory changes +/- Receivables changes +/- Payables (& GST changes) +/- Fixed asset changes = **CASH FLOW**

- Check your bank account. If you don't have any money in it and are constantly relying on credit, this is a good sign you have a Cash Flow problem that must be addressed quickly
- Tips to increase earning and make Ernest run faster:
  - ✧ Brainstorm ways to increase sales without discounting or incurring costs (e.g., advertising) to do so
  - ✧ Stop discounting
  - ✧ Calculate how much Profit Margin you are making on everything you sell – more on this in Chapter 4
  - ✧ Work out where you can increase prices without having a negative impact on sales
  - ✧ Collect all money owed to you – more about this in Chapter 3
  - ✧ Investigate ways to get paid immediately (COD terms)
- Tips to slow 'spending Penny' down:
  - ✧ Re-negotiate better supplier terms
  - ✧ Minimize unnecessary spending on Fixed Assets. Before you invest in plant and equipment, determine how much sales will have to increase before you pay off the item. More about this in Chapter 5
  - ✧ Order only as much inventory as you absolutely need. If you can get new shipments of stock in 3-5 days, there is no need to have 3 months worth of sales sitting on your shelves – more about this in Chapter 2
  - ✧ Cut unnecessary expenses

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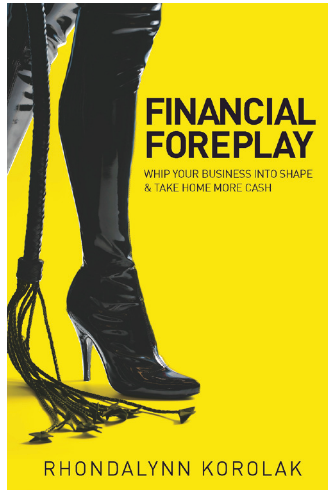

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