

Making Everything Easier!™

Cash Flow

FOR

DUMMIES®

Learn to:

- Grasp the basic principles of cash flow management
- Secure business with positive and consistent cash flow
- Bring financial security to your company
- Distinguish profit and cash flow from profit

Tage C. Tracy

Principal owner of TMK & Associates

John A. Tracy

Author of Accounting For Dummies



Get More and Do More at Dummies.com®



Start with **FREE** Cheat Sheets

Cheat Sheets include

- Checklists
- Charts
- Common Instructions
- And Other Good Stuff!

To access the Cheat Sheet created specifically for this book, go to
www.dummies.com/cheatsheet/cashflow

Get Smart at Dummies.com

Dummies.com makes your life easier with 1,000s of answers on everything from removing wallpaper to using the latest version of Windows.

Check out our

- Videos
- Illustrated Articles
- Step-by-Step Instructions

Plus, each month you can win valuable prizes by entering our Dummies.com sweepstakes.*

Want a weekly dose of Dummies? Sign up for Newsletters on

- Digital Photography
- Microsoft Windows & Office
- Personal Finance & Investing
- Health & Wellness
- Computing, iPods & Cell Phones
- eBay
- Internet
- Food, Home & Garden

Find out “HOW” at Dummies.com

*Sweepstakes not currently available in all countries; visit Dummies.com for official rules.



Cash Flow
FOR
DUMMIES®

Cash Flow FOR **DUMMIES®**

by Tage C. Tracy and John A. Tracy



John Wiley & Sons, Inc.

Cash Flow For Dummies®

Published by
John Wiley & Sons, Inc.
111 River St.
Hoboken, NJ 07030-5774
www.wiley.com

Copyright © 2012 by John Wiley & Sons, Inc., Hoboken, New Jersey

Published by John Wiley & Sons, Inc., Hoboken, New Jersey

Published simultaneously in Canada

No part of this publication may be reproduced, stored in a retrieval system or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning or otherwise, except as permitted under Sections 107 or 108 of the 1976 United States Copyright Act, without the prior written permission of the Publisher. Requests to the Publisher for permission should be addressed to the Permissions Department, John Wiley & Sons, Inc., 111 River Street, Hoboken, NJ 07030, (201) 748-6011, fax (201) 748-6008, or online at <http://www.wiley.com/go/permissions>.

Trademarks: Wiley, the Wiley logo, For Dummies, the Dummies Man logo, A Reference for the Rest of Us!, The Dummies Way, Dummies Daily, The Fun and Easy Way, Dummies.com, Making Everything Easier, and related trade dress are trademarks or registered trademarks of John Wiley & Sons, Inc., and/or its affiliates in the United States and other countries, and may not be used without written permission. All other trademarks are the property of their respective owners. John Wiley & Sons, Inc., is not associated with any product or vendor mentioned in this book.

LIMIT OF LIABILITY/DISCLAIMER OF WARRANTY: THE PUBLISHER AND THE AUTHOR MAKE NO REPRESENTATIONS OR WARRANTIES WITH RESPECT TO THE ACCURACY OR COMPLETENESS OF THE CONTENTS OF THIS WORK AND SPECIFICALLY DISCLAIM ALL WARRANTIES, INCLUDING WITHOUT LIMITATION WARRANTIES OF FITNESS FOR A PARTICULAR PURPOSE. NO WARRANTY MAY BE CREATED OR EXTENDED BY SALES OR PROMOTIONAL MATERIALS. THE ADVICE AND STRATEGIES CONTAINED HEREIN MAY NOT BE SUITABLE FOR EVERY SITUATION. THIS WORK IS SOLD WITH THE UNDERSTANDING THAT THE PUBLISHER IS NOT ENGAGED IN RENDERING LEGAL, ACCOUNTING, OR OTHER PROFESSIONAL SERVICES. IF PROFESSIONAL ASSISTANCE IS REQUIRED, THE SERVICES OF A COMPETENT PROFESSIONAL PERSON SHOULD BE SOUGHT. NEITHER THE PUBLISHER NOR THE AUTHOR SHALL BE LIABLE FOR DAMAGES ARISING HEREFROM. THE FACT THAT AN ORGANIZATION OR WEBSITE IS REFERRED TO IN THIS WORK AS A CITATION AND/OR A POTENTIAL SOURCE OF FURTHER INFORMATION DOES NOT MEAN THAT THE AUTHOR OR THE PUBLISHER ENDORSES THE INFORMATION THE ORGANIZATION OR WEBSITE MAY PROVIDE OR RECOMMENDATIONS IT MAY MAKE. FURTHER, READERS SHOULD BE AWARE THAT INTERNET WEBSITES LISTED IN THIS WORK MAY HAVE CHANGED OR DISAPPEARED BETWEEN WHEN THIS WORK WAS WRITTEN AND WHEN IT IS READ.

For general information on our other products and services, please contact our Customer Care Department within the U.S. at 877-762-2974, outside the U.S. at 317-572-3993, or fax 317-572-4002.

For technical support, please visit www.wiley.com/techsupport.

Wiley also publishes its books in a variety of electronic formats and by print-on-demand. Some content that appears in standard print versions of this book may not be available in other formats. For more information about Wiley products, visit us at www.wiley.com.

Library of Congress Control Number: 2011939639

ISBN 978-1-118-01850-7 (pbk); ISBN 978-1-118-16392-4 (ebk); ISBN 978-1-118-16391-7 (ebk); ISBN 978-1-118-16390-0 (ebk)

Manufactured in the United States of America

10 9 8 7 6 5 4 3 2 1



About the Authors

Tage C. Tracy (Poway, California) is the principal owner of TMK & Associates, an accounting, financial, and strategic business-planning consulting firm focused on supporting small- to medium-sized businesses since 1993. Tage received his baccalaureate in accounting in 1985 from the University of Colorado at Boulder with honors. Tage began his career with Coopers & Lybrand (now merged into PricewaterhouseCoopers). More recently, Tage coauthored with his father, John, *How to Manage Profit and Cash Flow* and *Small Business Financial Management Kit For Dummies*.

John A. Tracy (Boulder, Colorado) is professor of accounting, emeritus, at the University of Colorado in Boulder. Before his 35-year tenure at Boulder, he was on the business faculty for four years at the University of California at Berkeley. He served as staff accountant at Ernst & Young and is the author of several books on accounting and finance, including *Accounting For Dummies*, *Accounting Workbook For Dummies*, *The Fast Forward MBA in Finance*, and *How to Read a Financial Report*. He has coauthored two books with his son Tage, *How to Manage Profit and Cash Flow* and *Small Business Financial Management Kit For Dummies*. Dr. Tracy received his BSC degree from Creighton University and earned his MBA and PhD degrees from the University of Wisconsin. He is a CPA (inactive) in Colorado.

Dedication

We would like to dedicate this book to the backbone of the U.S. economy, namely the tens of thousands of business owners, managers, and entrepreneurs that battle every day to make their companies succeed. Remember that while the deck at times may seem stacked against you during these trying economic times, your spirit cannot be deterred. Our simple hope is that for those of you experiencing cash flow problems or just simply looking to understand cash flows a little better, this book can help ease your pain and offer additional insight on how to improve and manage your business interests.

We also want to mention who this book is not dedicated to: the politicians in Washington and across the U.S. and the banksters that have lost sight of what it means to create, launch, build, and operate a business. Simply put, these parties have spent too much time managing other people's hard-earned money and not enough time creating real value, wealth, and opportunity. Think of the Grinch from the wonderful story by Dr. Seuss, *How the Grinch Stole Christmas*. The Grinch attempted to "steal" Christmas by taking all of the trees, presents, decorations, and whatever else was available from Whoville. Yet Christmas still came, and it was then that the Grinch realized that "Maybe, just maybe, Christmas meant a little bit more." When the politicians and banksters finally realize that maybe, just maybe, owning a business and risking everything one has to pursue a dream means just a little bit more, the unparalleled historical disconnect between the twin Ws (Washington and Wall Street) and Main Street America will begin to evaporate, allowing for real growth to resume.

From Tage Tracy: I would like to dedicate this book to my old man and coauthor (or as I refer to him, TOP, or The Old Pro). About seven years ago, my dad, in a manner reminiscent of Vito Corleone of *The Godfather*, made me an offer I couldn't refuse: Take over the family business or else. (Thank goodness we didn't own a horse, but I was concerned about our cat from time to time). In this case, the family business involved carrying on his remarkable and deeply insightful legacy of being able to translate even the most complex and difficult accounting and financial concepts into easy-to-comprehend layman's terms. As for the "else," well let's just say that the old man has threatened to ditch me from his will more than once (a running joke in our family). I am forever grateful for the opportunity to write with and learn from TOP.

Acknowledgments

We are deeply grateful to everyone at John Wiley & Sons, Inc., who helped produce this book. Their professionalism and courtesy were much appreciated. First, we thank Stacy Kennedy, the acquisitions editor. She helped us develop the concept for the book. We appreciate her encouragement. Our editors, Tim Gallan and Caitie Copple, were exceptional. It was a pleasure working with them. We owe them a debt that we cannot repay. So a simple but heartfelt “thank you” will have to do. Every author should have such superb editors.

Publisher's Acknowledgments

We're proud of this book; please send us your comments at <http://dummies.custhelp.com>. For other comments, please contact our Customer Care Department within the U.S. at 877-762-2974, outside the U.S. at 317-572-3993, or fax 317-572-4002.

Some of the people who helped bring this book to market include the following:

Acquisitions, Editorial, and Vertical Websites

Senior Project Editor: Tim Gallan

Acquisitions Editor: Stacy Kennedy

Copy Editor: Caitlin Copple

Assistant Editor: David Lutton

Editorial Program Coordinator: Joe Niesen

Editorial Manager: Michelle Hacker

Editorial Assistants: Rachelle S. Amick,
Alexa Koschier

Cover Photos: © iStockphoto.com /
Amanda Rohd

Cartoons: Rich Tennant
(www.the5thwave.com)

Composition Services

Project Coordinator: Nikki Gee

Layout and Graphics: Carrie A. Cesavice,
Sennett Vaughan Johnson,
Lavonne Roberts, Corrie Socolovitch,
Christin Swinford

Proofreader: Bonnie Mikkelson

Indexer: Ty Koontz

Publishing and Editorial for Consumer Dummies

Kathleen Nebenhaus, Vice President and Executive Publisher

Kristin Ferguson-Wagstaffe, Product Development Director

Ensley Eikenburg, Associate Publisher, Travel

Kelly Regan, Editorial Director, Travel

Publishing for Technology Dummies

Andy Cummings, Vice President and Publisher

Composition Services

Debbie Stailey, Director of Composition Services

Contents at a Glance

<i>Introduction</i>	<i>1</i>
<i>Part I: Fitting Cash Flow into the Big Picture of Running a Business</i>	<i>7</i>
Chapter 1: Getting in Sync with the Rhythm of Cash.....	9
Chapter 2: Why Accrual Accounting Is Essential.....	23
Chapter 3: The Big Three Financial Statements.....	37
Chapter 4: Getting a Grip on the Statement of Cash Flows	59
<i>Part II: Using Financial Statements to Assess Cash Health.....</i>	<i>81</i>
Chapter 5: Mining the Balance Sheet for Cash.....	83
Chapter 6: Digging Deeper into Cash Flow	113
Chapter 7: Understanding Liquidity versus Available Cash.....	131
<i>Part III: Getting Intimate with Your Company's Cash Flow Needs.....</i>	<i>157</i>
Chapter 8: Creating a Business Plan to Secure Cash.....	159
Chapter 9: Building Best-in-Class Projection Models to Manage Cash	173
Chapter 10: Identifying and Securing External Sources of Capital	193
Chapter 11: Knowing When to Use Debt to Finance Your Business.....	213
<i>Part IV: Managing Your Business with Cash Flow in Mind</i>	<i>239</i>
Chapter 12: Covering the Basics of Cash and Cash Activity	241
Chapter 13: Preventing Cash Losses from Embezzlement and Fraud.....	267
Chapter 14: Managing the Selling Cycle to Improve Cash Flows	281
Chapter 15: Managing the Disbursement Cycle to Improve Cash Flows	311
<i>Part V: The Part of Tens</i>	<i>331</i>
Chapter 16: Ten Keys to Managing Cash Flows in a Small Business	333
Chapter 17: Ten Tales of Cash-Flow Woes.....	341
<i>Index</i>	<i>351</i>

Table of Contents

***Introduction* 1**

About This Book	1
Conventions Used in This Book.....	2
What You're Not to Read.....	3
Foolish Assumptions.....	3
How This Book Is Organized	4
Part I: Fitting Cash Flow into the Big Picture of Running a Business	4
Part II: Using Financial Statements to Assess Cash Health.....	4
Part III: Getting Intimate with Your Company's Cash Flow Needs	4
Part IV: Managing Your Business with Cash Flow in Mind	5
Part V: The Part of Tens	5
Icons Used in This Book	5
Where to Go from Here.....	6

***Part I: Fitting Cash Flow into the Big Picture of Running a Business* 7**

Chapter 1: Getting in Sync with the Rhythm of Cash 9

Not Letting the Well Run Dry	10
Outlining Profit Accounting Basics	11
Reviewing revenue accounting	11
Examining expense accounting.....	12
Contrasting cash- and accrual-basis accounting	13
Seeing Why Profit and Cash Flow Are Different Bottom Lines	14
Considering what the income statement doesn't say about cash flow	14
Exploring cash flow from profit	15
Identifying and Reporting Basic Types of Cash Activities	19
Cash flow from investing activities.....	20
Cash flow from financing activities.....	20
Cash flow from operating (profit-making) activities	21
Putting cash-flow activities together.....	21

Chapter 2: Why Accrual Accounting Is Essential 23

Finding Out the Four Functions of Accounting.....	24
Keeping records (Bookkeeping)	25
Giving company management the information it needs	26
Complying with tax laws	28
Reporting financial information	29
Examining the Nature of Accrual Accounting.....	31
Uncovering the inadequacy of cash-basis accounting.....	32
Recognizing accrual accounting in financial reports	32
Reporting Assets and Liabilities in the Balance Sheet.....	34

Chapter 3: The Big Three Financial Statements 37

Why Financial Statements Are Essential	38
Who gets financial statements and why	40
Who doesn't get financial statements and why	41
Facing Off: The Balance Sheet.....	42
Strolling through the balance sheet	42
Putting accounts in their right places.....	44
Dealing with the limitations of the balance sheet	45
Tracing revenue and expenses in the balance sheet	47
Managing capital	49
Making Profit: The Income Statement.....	52
Moving from the revenue top line to the profit bottom line	54
Deciding which is more important: Revenue or expenses	54
Summarizing Cash Flows: The Statement of Cash Flows	55
Showing cash flow from operating (profit-seeking) activities	56
Listing other sources and uses of cash.....	57

Chapter 4: Getting a Grip on the Statement of Cash Flows. 59

Distinguishing Cash Flows.....	60
Adjusting your way to cash flow from operating activities.....	62
Cogitating on cash flow from investing activities.....	66
Considering cash flow from financing activities	66
Getting to Know the Dual Personality of the Statement of Cash Flows	69
Spotting changes in financial condition.....	69
Building the year-end balance sheet	70
Comparing Cash-Flow Scenarios	72
Starting with cash flow in a steady state	73
Assessing cash-flow effects of growth and of decline.....	75
Understanding negative cash flow.....	76
Recognizing Problems with the Statement of Cash Flows	77
Getting skipped by small businesses	77
Providing too much or too little information.....	78

Part II: Using Financial Statements to Assess Cash Health..... 81

Chapter 5: Mining the Balance Sheet for Cash.....83

Reading the Balance Sheet from a Cash-Flow Perspective	84
How assets are listed in the balance sheet	
in relation to generating cash.....	85
How liabilities are listed in the balance sheet	
in relation to consuming cash	89
What the balance sheet doesn't disclose about cash flows.....	91
Giving the Balance Sheet a More Thorough Examination.....	93
Using key balance sheet performance-measurement tools.....	93
Evaluating your assets	96
Taking a closer look at your liabilities	100
Scrubbing the Balance Sheet Clean for Its Users	103
A case study: Scrubbing the balance	
sheet of ACME Distribution, Inc.	103
Aiding internal business management	109
Providing confidence to outsiders	109
Unlocking Hidden Cash from the Balance Sheet	110
Turning over current assets	110
Investing in long-term assets.....	111
Leveraging your current liability friends.....	111
Using notes payable, loans, and leases appropriately.....	112

Chapter 6: Digging Deeper into Cash Flow 113

Tying Up Cash Flow in a Neat Bundle	113
Presenting financial statements for analyzing cash flows	114
Cutting the balance sheet down to size	115
Reviewing sources and uses of cash	119
Zeroing in on changes in financial	
condition from making profit.....	119
Developing Benchmarks for Cash Flow	121
Comparing cash flow with sales revenue momentum	121
Using other tools for cash-flow analysis	124
Massaging Cash-Flow Numbers	127

Chapter 7: Understanding Liquidity versus Available Cash.....131

Defining Business Solvency and Liquidity	
(Hint: Not the Same Thing).....	132
Applying Business-Solvency and Liquidity Measurement Tools.....	137
Measuring and monitoring solvency	137
Keeping tabs on liquidity	140