Ep 55: How Much Cash Do You Need?

[00:00:00] **Paul Sweeney:** Hello, and welcome to The Business Behind Your Business. I'm your host, Paul Sweeney, Chartered Accountant and Certified Business Advisor, helping you with the conversations you need to grow and survive a thriving business in whatever situation may arise. And we've got some interesting situations that we're faced with at the moment in various stages of [00:00:26] lockdown and crisis management or even recovery. If you're in that recovery stage, then that's great. So how do we plow through it? One of the questions that we're often asked is how much cash do I need, or how much cash should I be holding in my business so that I can survive.

[00:00:51] Now the answer to that question is not simple. It varies. It depends on your business. It depends on your current circumstances. [00:01:00] And it depends on your, I guess forecasts. What is going to happen or what you think is going to happen in the near future. So let's have a look at a few different scenarios. So the first one is quite common in a start-up business. So you may have an initial sum of cash. [00:01:19] that you have to start or to kickstart your business. And now for most smart start-up businesses. Uh, there is a lack of revenue in the first period, and that might be three months, six months, 12 months, depending on the style of business or the industry you're working or who you are, the type of clients that you're dealing with, or whether you've got to develop a product as part of that start-up process. So if you're a start-up, you might have an initial sum of money available to you. And that might've come from your personal funds or from a family member or maybe a loan that you're able to get from drawing down on security of some residential property. But you might have a sum of money. Now that sum of money is only going to last [00:02:00] a certain length of time. Yeah, how long it lasts. Depends on how quickly you use it. So we need to know how much we are spending per month and not just on expenses, but also on acquiring assets. Paying for finance obligations on all those assets. And how quickly we can start to turn those expenditures into revenue.

[00:02:27] So let's assume say we've got a hundred thousand dollars available to us, which is quite a large sum for it for a start-up business. But let's say let's work with a hundred thousand dollars. Now we assume that there's not going to be any revenue initially. And we're going to have expenses, which will be wages and rents and software licensing and computers.

[00:02:49] And some marketing and insurances through that initial period. And we've worked out that we know that we're going to be spending in cash, say $25,000 a month. [00:03:00] So on that basis, if we're spending $25,000 a month on our outgoings, we're physically paying cash and we've started with a hundred thousand, then our cash is going to last for four months.

[00:03:11] Okay. Now what we need to do is work out well, when can we start getting revenue? Or how can we reduce the amount that we're spending each month? Now, one of the problems of reducing your outgoings is, does it affect your ability to generate revenue? So I'm all for reducing unnecessary costs, but there are certain costs and expenditures [00:03:38] in your operations, your business, that are going to be necessary for you to be able to produce income. And that might be through selling a product or service or developing a product. So some costs you won't be able to reduce without impacting your ability to create sales. So will you need to have a look [00:04:00] at what it costs, where we're expanding? So let's say if we've got our $25,000 [00:04:04] we might have some discretionary expenditure in there. So we might get all excited about the start-up hub and we might be, you know having staff lunches and weekly staff bonding activities, which will quite add up over time. So we might be spending a couple of hundred bucks a week on that [00:04:20] that we don't need to, or we might be buying the premium kind of coffee for the facilities instead of just buying the generic. So there are ways that we can trim unnecessary spending. And we should be doing that. Do we have subscriptions that we're not actually using? Have we paid for software that we don't need to? Because subscriptions add up, particularly when you look at head count. If you've got five people using a piece of software or subscribed to a piece of software that is not using it, your costs add up pretty quickly. So we can look at reducing our unnecessary expenses.

[00:04:53] And we should do that. Every business should. And that's a way of increasing the length of our cash cycle. So if [00:05:00] we start with a hundred thousand and we can reduce our cash spending to $20,000 a month, then we have an extra month of cash flow. Or cash burn available. It takes us five months to burn through our cash instead of four.

[00:05:12] So one of the obvious ways to improve our cash burn or reduce the amount of cash that we need to have on hand is to generate income. So if we've gone from businesses not generating revenue, we need to be one that generates revenue and the sooner we can start to do that, the better from a cash flow point of view.

[00:05:30] So if we, if we were to generate $10,000 of revenue each month, And we're spending we've reduced our cash spending to $20,000 a month. They're now net cash burn for the month. It's $10,000. So if we start with an initial a hundred thousand, then we could expect that we would be able to trade for 10 months before [00:05:53] we ran out of money. Now, that's still not a good thing. Because we need to have a successful business by [00:06:00] having a positive cash flow. We need to be generating cash. Now I know that. A lot of businesses in the start-up phase when they're developing a product that cash flow [00:06:09] they're going to have a negative result for a period, but you can't sustain that. So we need to find a way of generating cash earlier. So if we know we're going to run out of cash, say in 10 months time, we need to be proactively looking for how we can get some cash injection. Oh, do we, are we able to get some finance? I'll be able to get an investor.

[00:06:29] Are there some grants or incentives that we can apply for to bring in an injection of cash into our business, which will prolong the period of our cash flow. And allow us to trade for longer. The best way though, is to start making more sales and to be profitable with our selling. So if we are profitable, then [00:06:48] we can change that. That cash burn period. Or the length of our cash cycle. Or the amount of cash that we need. So if, say we could instead [00:06:58] increase our sales to [00:07:00] $25,000. We have to be generating $5,000 of cash every month. So we'd be spending $20,000 a month would be generating $25,000 of cash every month. Now one trap that we need to be aware of is providing for payment of income tax out of those profits. One of the temptations for a lot of business owners is to say, 'Hey, we've got $5,000 of cash in the business [00:07:26] we're selling more than we're spending. That's great. So I'm going to take that $5,000 of cash out and repay that loan that I've put in. The problem with that? Is you haven't allowed for the income tax and then income tax will become payable. So it's best to leave that provision in your business.

[00:07:47] Leave it in the company trust, whichever vehicle you're trading through so that is there to pay the tax when the tax is due. So be very careful where you're planning not to pull money out of the business too quickly. It's a trap that a [00:08:00] lot of business owners get into, particularly those that don't understand their obligations for GST, superannuation, [00:08:07] Pay-as-you-go withholding and income tax. It's a trap that a lot of businesses fall into. They get caught by it and then all of a sudden they have large obligations. So they haven't retained cash to pay the superannuation entitlements for the employees, which are due every quarter for most business.

[00:08:24] They haven't retained the cash that they were withholding from wages. And so when the due date comes to pay that to the tax office, they don't have it there.

[00:08:37] They haven't withheld or retained the GST that they've collected. Now the GST is collected on sales and you do get GST credits, but not all of your expenses are going to have GST on them. So your wages won't, your superannuation won't. If you're importing products or subscriptions from other countries, it won't have GST on them.

[00:08:57] So not all of your expenses will have GST. [00:09:00] So we need to identify how much GST we need to be paying monthly or quarterly. And make sure that we keep that on hand. We've got this extra level of complexity now in working out how much cash we need to have on hand. We know, just need to have the monthly cash that we're spending, but we need to be able to make sure that we are retaining our income tax, our GST, our superannuation, our pay-as-you-go withholding so that we can physically pay that on time when it's due.

[00:09:28] So we need to keep that on hand. So when we're working out how much cash we need in our business, we need to keep those things under consideration. We need to identify them. We need to have a plan for how much we're going to keep. We need to have a plan for how much income tax we need to provide for.

[00:09:46] The superannuation is right, is set by legislation. So you need to be keeping that aside. So most payroll systems will create that as an expense and put a provision in your balance sheet. Now that is not a cash [00:10:00] expense at that point, though. So this is where we need to be careful as well in that a lot of our accounting entries are what we call accrual and that raises the expense at the time the expense is created and it creates a provision for it, but it doesn't actually physically spend the money in so it's not a cash payment at that time, the cash payment comes later. And often it's three months later. Or two months later. But we need to be aware of it.

So in our cash flow planning, we need to consider our obligations for GST, Income tax, Withholding from wages, and superannuation payments contributions for employees. Because if you're operating for a company, you are the director of that company, if you don't make those payments, you can be personally liable for those. So you have a, not just a statutory obligation, but you also have a personal liability.

[00:10:53] To make those payments. So getting back to how much cash we need to keep on hand. We know what our [00:11:00] monthly cash outgoings are. And we need one. With a bit of planning and thought we can work out how much we need to retain for our taxes [00:11:13] and employee obligations. So making sure that we have those on hand. So let's say if we, if we look at our outgoings, we've got $20,000 of expenses. And let's say we're making $25,000 of income per month. So we've got a let's say a profit of $5,000 and the company tax rate is 25% if you're [00:11:34] in Australia using the base rate entity. So your tax, there would be $1,250. So your actual cash outgoings need to take into account that we're keeping away $1,250 for income tax each month. And keeping that on hand. So we need to make sure that we've got that on hand.

[00:11:56] What are our obligations in terms of taxes? [00:12:00] Well and keep that aside. So that's adding to how much cash we need. We'll send you to look in financing. So have you financed equipment?

[00:12:09] Because your finance repayments don't show up on your profit and loss. They're not an operating expense. There are a repayment of a liability. So they're showing on your balance sheet. What will show on your, on your operating statement or your profit and loss? Is the interest component of that finance.

[00:12:27] So we also need to take into account what capital financing or equipment obligations we have with our cash flow.

[00:12:37] So as we can say, we do need, do need to spend a bit more time. Looking into what's making up our cash flow. So all things considered how much cash do we need to keep in our bank account?

[00:12:50] Part of it depends on how quickly you can get paid.

[00:12:55] Do your customers pay you on presentation of invoice, do you get to direct debit their account or do they pay by card as soon as you make a sale to them. If they do then that's great because your cash is being received as soon as you make the sale.

[00:13:10] And that's really good for, for cash flow timing.

[00:13:14] When you would contrast that to a lot of trades and service-based industries where they will present an invoice. And get paid 30, 45 days or 60 days later. So there's a delay in getting paid by your customers. So ideally if we've got a situation where we get paid, as soon as we make the sale, that's great. [00:13:35] That's great.

[00:13:37] So we need less cash on hand at that point, because we've got a regular supply of sales. Assuming we can keep that supply regular and that's been the trouble with these lockdowns is, and unless we've got a way of continuing to make sales in a virtual environment in an offline environment, or sorry, an online environment [00:13:55] those cash sales have dried up, that instant revenue has dried up. [00:14:00]

[00:14:01] So good way to make sure what we've got regular cash flow is to have what we call a recurring revenue stream. And that comes from I guess the subscription type model where customers pay you monthly for subscription or an ongoing service that you lock them in for a period. And you've got that regular sale, regular cash flow. And if you've got getting direct debits, then you don't even have to worry about collecting the sale that comes in. So that improves your cash flow if you've got that regular recurring stream.

[00:14:28] It also means you don't have to go out and look for new sales each period. You've got them lined up already. And the higher the number of recurring sales you can line up, the greater that is.

[00:14:40] But let's throw a complication in there. So we're selling our service or our product. Let's say we're selling a product. And we might sell it online and then get paid straight away, which is great. But what about buying the inventory?

[00:14:57] Often we have to buy the inventory in [00:15:00] advance. So we will buy a supply of inventory. well, in advance, it might be 30 days in advance. It might be 60, or it might be longer. It depends on how quickly you can actually sell that inventory. So we might have a situation where we have to buy our inventory, say three months before we actually kind of get to sell the first item.

[00:15:22] And often if we're importing, we're going to have, need to pay our supplier and our oversea supplier before they'll ship the stock, the products to us. So we have a cash outflow before we're even going to make a sale.

[00:15:37] So we need to factor in buying stock and paying for stock in our cash flow. So our cash expenses are going to be different to our accounting, profit and loss, our accounting expenses, each period. So if you're selling stock and you're purchasing stock in advance, be wary of that. When you purchase a stock [00:15:57] it's an asset. It's on the [00:16:00] balance sheet until you actually turn it to a sale. At that point, it becomes a cost of your sale. But you might've bought a thousand items. And this month you've only sold 10. You still got 990 on hand. You physically paid for them. So your cash flow has been depleted [00:16:18] but you're not getting the revenue from it. And it might be that if you are only selling 10 per month, it's going to take you a very long time to recover the cash flow. So cash flow planning is very important. So coming back to our initial question, how much cash do you need again? The answer is it depends on your circumstances.

[00:16:38] The more regular revenue you have, the quicker you get paid by your customers, the less cash you need to have on hand. The slower your customers pay you, the slower you turn your inventory or your services into a sale, the more cash you need to have on hand. The longer, it takes you to sell, the longer it takes you to collect money [00:17:00] from your customers, the more cash you need to have on hand. [00:17:02] If you have to pay for your supplies, your inputs. To make those sales upfront. [00:17:11] And this is a long delay, then the more cash you need to have on hand. So depending on your business, and this is where you need to work with your accountant, with your advisor, with your finance broker to actually plan through the cash flow needs. And there's a number of tools out there that help with this process, help you identify how much cash you need to have on hand.

[00:17:32] And, look we will put some links to some of those in the show notes. But really it can be done by taking an average of your cash flow. So most accounting systems allow you to run a monthly cash flow report so you can see what your inflows, your cash inflows and your cash outflows are each month. [00:17:48] And you can get an idea of what the average is. And look, it's a good idea to look at a three-month period to get an average or a 12 month period, looking at the cycles and work out what's the average [00:18:00] cash flow per month. And let's assume that if something went wrong and you couldn't make a sale for three months, how much cash would you have on hand? Would you be able to cover your cash expenses?

[00:18:10] If the answer's no, then we need to do a bit more planning about your cash flow, if the answer's yes, well, maybe you've got some surplus cash in your business and it might be better to use that to repay debt. To pay dividends. Or maybe you can start to invest in growing your business. So there's a lot of different things to consider. So cash flow is one of the three biggest items we find that businesses have trouble with.

[00:18:34] And it is for a lot of reasons, because there are so many things that affect your cash flow. But one thing is certain, without cash flow in your business, your business will suffer. It will eventually die. Because cash flow is the lifeblood of your business. So cash flow is something that has come up, has been raised with me quite a number of times recently.

[00:18:57] It's raised regularly, because it is so important for business [00:19:00] and there are specific questions that people have around cash flow. And look, we've talked about it in general today. But if you have any specific questions, then please reach out to us. You can send us an email at podcast@thebusinessbehindyourbusiness.com

[00:19:14] Or you can leave a question for us at www.speakpipe.com/thebusinessbehindyourbusiness and we'll answer that on a future episode. And look, we like to answer the questions that you actually have, that are important for your business. And that's part of what we do here. We want to bring the knowledge to you as a business owner. So we'd like to answer the questions that you have. So please reach out to us and ask your specific question and we'll feature it on a future episode of The Business Behind Your Business podcast. Thanks for joining us.