THE 7 MINUTE CONVERSATION

How To Hear The Story Your Small Business Financial Statements Are Telling You

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The 7-Minute Conversation

The Way You Should Be Thinking

About Your Small Business

Mike Milan

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ISBN:

Dedication

For all of the small business owners who endured the craziness of 2020. There was no book for that.

Acknowledgment

I want to give a special thank you to Courtney White, who is my love and life partner. She encouraged, supported, and always stopped what she was doing to humor my request for advice. E=MC2.

I also want to thank Rob & Blythe Chandler. They were instrumental in helping me set a new path in life. One that should be filled with a lot of laughs and incredible success. Here is to shaping tomorrow by understanding today.

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About the Author

Cash Flow Mike

Cash Flow Mike is addicted to starting new business ventures. His resume is super messy, probably worse than yours. Here is a short list of stuff he has done.

- Spent 16 Years in the Army National Guard and 7 Years as a Missouri State Trooper
- Built a 500-employee hotel staffing firm
- Owned and operated 3 bar/restaurants
- Owned and managed numerous pieces of rental property
- Failed at an herbal supplement company after getting the product in 119 Walgreen stores
- Ran a construction team for a large non-profit
- Built a financial software application for small businesses and accountants
- Trained 1000’s of bankers, accountants & business owners on the art of financial management
- Created The Clear Path To Cash blueprint strategy
- Wrote two books: Don’t Be A D.U.M.B. Business Owner & The 7 Minute Conversation
- Earned MBA from Baylor University
- Has Three awesome & beautiful daughters
- Is a Motorcycle and Golf Enthusiast
- Jumped from airplanes, wrote poetry, & fell in love

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Preface

Ok, so I never set out to write this book, but while I was writing "Don't Be a D.U.M.B. Business Owner", I got stumped on Chapter 3 – The Home Run Financial System. Stumped might not be the right word, but I just couldn't figure out how to cut down such a powerful topic into chapter length without losing context. Therefore, now we're stuck with yet another book on the shelf.

The 7 Minute Conversation is the written adaptation of my most popular conference seminar presentation. I have performed it live over 100 times, and it never gets old. The information is timeless, and super easy to use. So, I thought I could give it more respect if I just expanded on Chapter 3 and wrote this book as a supplement. The cool thing is, it can stand on its own.

Here is the problem with this book. On stage it takes me 60-90 minutes to explain The Home Run Financial System. In written form, it took me almost 100 pages. The goal? To have you work through the process in 7 Minutes per month or less! Thanks for taking the time to check it out.

Chapter 1

Why Isn't There an Easy Way to Look at A Business?

If you are a business owner, you must have reviewed the Income Statement of your company several times. It feels really good when the "net income" part of your income statement reflects billions of dollars. Doesn't it? Your accountant keeps telling you that your profitability is increasing manifold each year. You are satisfied because the figure on your income statement keeps growing. However, suddenly a situation arises where you get to know a shocking truth. Your company doesn't have enough funds to keep up with day-to-day operations. What a distressful situation it is. You want to bang your head against a wall because you don't understand what went wrong. Your

income statement is still showing that your business is profitable, but things are not as simple as they always seemed to be.

I know many of you must have gone through a similar situation. I am one of you. However, the good news is, with the help of my experience and learning, I have found a viable solution for this problem. I have written this book to share the secret of my business success with you. At one point in time, I ran five companies at once. I needed a quick way to analyze them each month. Moreover, at that time, I was also planning on buying a different business. I looked at all kinds of businesses from landscaping companies all the way to flower shops, I bet I looked at over 100 companies during that time. After the first few, I felt exhausted because I was having trouble comparing these companies to each other. As a result, I was quite perplexed, and I tried to analyze different aspects of those businesses. Still, I didn't arrive at a concrete conclusion.

I would get frustrated with my CPA because all he gave me were the numbers. He could do the math. He could slice and dice my financials and do anything that you

wanted him to. What he couldn't do was make the connection to real life. All I wanted him to do was help me understand how my business was doing and point me in the right direction to improve it.

How I Found a Solution

Too often, business owners either don't know how to use their financial statements, or they rely too heavily on the income statement for their financial information. There are two reasons for that:

1. They just don’t know what they are looking at, so they hope that it looks okay to their accountant and their banker.
2. They really don't care. They go to work each day and try to make enough money to survive or live the life they're comfortable with.

However, if you want to see your business grow, you can't rely on your financial advisor or accountant only. You

have to be interested in your business' operations and try to understand what each piece of information is reflecting. Your company is a machine, so you have to operate it like one. This means being methodical in your approach. Use weekly, quarterly, and annual processes to plan and measure performance. The more things are standardized, the better it is.

With the vast amount of information floating around the atmosphere, there are occasional nuggets that simply connect with you. You are introduced to them, and time stops, like an external force telling you of the moment's importance in your life. You digest the moment, and for an unknown reason, you know this piece of information will change your thought and behavior. The longer you consider the nugget of information, the more you internalize it until you can no longer tell the difference between the tidbit of information and your own beliefs.

I also went through the same situation many times in my professional life. Especially early on in my life as an entrepreneur. Like many other entrepreneurs, I didn't know where my business was going. I needed a methodology that

could help me gauge my business's performance. I realized that it was time to play an active role in my business. However, I didn't know where and how to start. Information and advice crossed my path daily, forcing me to hone a critical decision making skill to sort the good from the bad quickly. Unfortunately, I couldn’t articulate the methodology I used to determine this ranked order. I just know that it "felt" right. Something about the message resonated within me, causing me to pause and reflect. Some would say that this decision was made in the limbic system part of the brain - the part of the brain that influences behavior, but does not control language.

This partially explains why certain pieces of information "felt" right, even though I couldn't explain why. For me, it happened early in my entrepreneurial career, and it came from a long time mentor. After seeing me struggle with starting a business and all of the chaos surrounding it, he made a small comment. A comment that any other time I may have glanced over. But the stress of pouring my heart into the project really connected with the five words he spoke.

"Control what you can control."

Simple but elegant. He saw that I had been beating my head against a wall trying to solve problems that were outside my control. He saw the frustration that came from running into obstacles. He saw what I failed to see. I was trying to change my circumstances, not focus on how to operate within them.

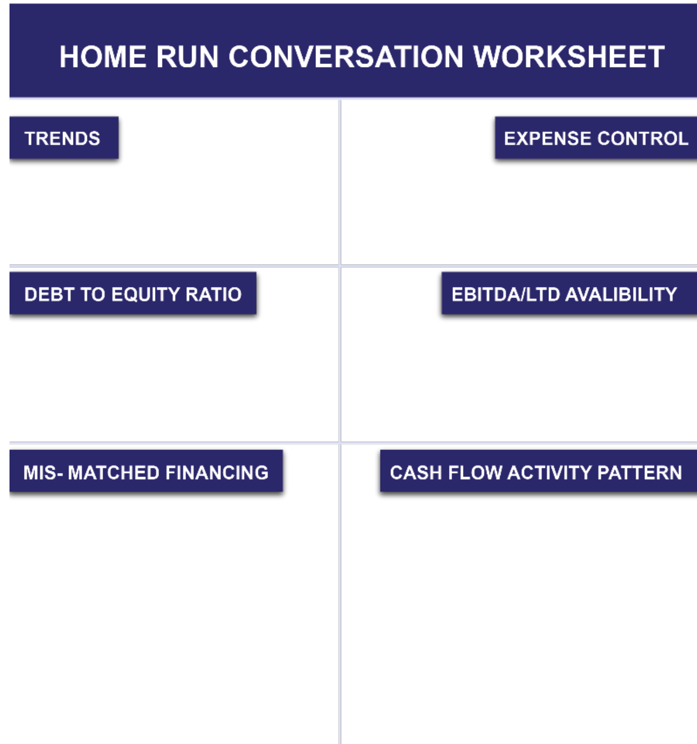
These five words resonated with me. They gave me clarity for everything that came next in my professional and personal life. His words cut through the fog of chaos and provided guidance. To him, it was a matter of fact remark designed to make me feel good about my decisions. He didn't know it would become the best small business advice I ever received.

Keeping this advice in my mind, I started working on a system that would be not only accurate but also less time-consuming. Finally, I came up with a six steps matrix that I call a "Home Run Lineup". I referred to it as the Home Run Lineup because it touched all the bases. By bases, I mean each and every financial statement that can be used to

conduct a business analysis. It incorporates income statement, balance sheet, and cash flow statement and gives a consistent approach to many of us.

The following are the six elements of the Home Run Lineup Worksheet. Analyzing these elements will not only help you filter out the good from the bad businesses, but it will also assist you in managing your or your client's existing business efficiently.

1. Trends
2. Expense Control
3. Debt to Equity Ratio
4. EBITDA/ Long Term Debt Availability
5. Mis-Financed Assets
6. Cash Flow Activity Pattern



Most of us, as business owners, rely solely on the profit and loss statement. But the fact is, there is a whole bunch of other information in the balance sheet and cash flow statement of your company that is necessary. Whether you are an entrepreneur or a financial advisor, I want you to use this Home Run Lineup. This lineup card is basically an agenda for your conversation with your clients.

It gives you six essential things that you should be talking about — considering the health and overall profitability of a company. And like I said, it's going to incorporate all three of the financial statements, so that's just a report card. It would tell you whether or not your business is viable.

It is a seven-minute conversation with either yourself or your client to assess the business you or your client wants to analyze the performance of (not just for buying a company). After reading this book, you will be able to:

- Identify the most critical measurement of profitability and health in a small business using all the financial statements.
- Learn how to have a quick, but meaningful conversation about the numbers using the Home Run Lineup Card.
- Gain trust and credibility with any business owner in one simple step.
- Set business owners up to succeed in making more money or getting a financing request.

The last two steps are specifically for advisors of small businesses, and they can avail these steps to add layers to their success. However, before discussing the Home Run Lineup, we first need to understand the purpose of all of the financial statements. Most of the people I have met don't have a finance background. As a result, they tend to lean on the income statement more heavily than the balance sheet and cash flow statement - mainly because it is simpler and much easier to understand. However, the other two statements expose a different side of the story and need to be considerate when looking at a company's performance.

Income Statement

The income statement simply tells whether your business is viable. It is a report card for your business that states if your business generates profit. While the income statement shows your business' profitability, it is good just for the period you're measuring. When that particular period ends, the income statement starts over.

Balance Sheet

The balance sheet represents the financial position of your business. In other words, it shows whether your company is in a good or a bad state. It states your assets, liabilities, and owner's equity. It is the culmination of every management decision as every decision is recorded on the balance sheet throughout the history of the company. Therefore, the balance sheet will illustrate the net worth or "book value" of your company.

Cash Flow Statement

The statement of cash flow shows where the cash in your business came from and went to. This report tells what exactly is going on in your business. In short, it is the tattle-tale of your business. It tells the story of how management sources and uses cash in their business. Hence, it is vital to understand the above three financial statements to reach a final decision.

Home Run Lineup for an Advisor

As I mentioned earlier that there was a point in time

when I was managing five businesses simultaneously. I had to evaluate five different income statements, balance sheets, and cash flow statements. What I needed was a consistent way to look at it because I tried to look at each one of them. However, sometimes I looked at them separately and guess what happened? I ended up having confusing results. They couldn't help me predict anything about my business. So I designed a method of evaluating financial statements that was consistent no matter what company I was looking at. The seven-minute conversation is based on a methodology on how to attack the financial statements from an evaluation stand. Think about it like a scientist or a doctor. We're looking at things in the same exact way, time after time after time to be able to get those predictable results that we're looking for in the future.

I can guarantee that once you use it and become familiar with it, it will become a part of your monthly ritual. It's a great tool if you're an adviser. You can use it with anybody that gives you a set of financial statements. In fact, even if your client just talks to you about their company without providing any financial statements, you know the

right questions to ask them. If you're a banker or an accountant and you’ve got a new prospect that comes in, don’t talk to them about your services. Talk about Mr. Business Owner only. Let them know what you can do for them. However, before committing anything, tell them

"Before I can help you, I have to know what's going on in your life. This little conversation is going to set the tone for our relationship. And what I mean by that is you're going to tell me something about your business I didn't know before. You tell me about your credit card processing or your tax service, so I can understand your business."

This Home Run Lineup will help your client start their financial education. It is concise and straightforward. Better yet, it gives them a well-rounded look at their business. The secondary benefit is that a sound methodical process to analyze your company makes it easier to predict the business’s performance in the future.

If you are facing the same problems as I did, don’t panic. As a way of paying it forward, I say to you, control what you can control. Look at the entire situation and spend

your creative and critical thinking skills on operating within the limits of your surroundings. This perspective makes every situation easier for me to understand. More importantly, it helps mitigate my stress and grow my success.

In the next chapter, I will explain each of the six elements of the 7-minute conversation in detail.

Chapter 2

Trends:

What Story Is Your Business Telling Everyone

Analyzing the components of the Home Run Lineup sheet is very important. So important that your company's life and death depends on you being able to interpret what you are seeing. Let's face it, it's not easy if you don't know what your looking for. To the untrained eye, most of the information you see is just a wall of numbers. And we all know that the way to build a wall is one brick at a time. The first component of The Home Run Lineup is the easiest and it deals with trends in the data.

Trends

Trends are analyzed using the most popular financial statement i.e., Income Statement. In fact, it is something that we naturally do as part of looking at a company's financial position. When we look at trends, we are looking for the general direction they appear to be going and how the trends of specific items relate to one another. I mean let's face it. It's the first thing we do when we pick up a set of financial statements that compare periods. I'm not going to pretend to teach you about seeing a trend, but

I will show you a way to analyze the relationship between the trends that you are seeing. Normally people can tell if their sales are going up or down. Sometimes, they even try to get fancy and say things like: “My sales are up 10%!” That’s awesome! But my response is always: “Great! How many percent does a gallon of milk cost?” This is because we think we are being smart by being able to know what the percent increase or decrease is. I want you to stop that way of thinking and look at everything in terms of dollars. After all, we can spend dollars, and I totally understand it when you tell me you increased sales by $100,000. It’s a communication thing, but we all understand dollars.

You see, Trends are less effective if we say things like: the trend is up. That is only half the information we need to evaluate this portion of the Home Run Lineup. We have to also look at the magnitude of change to see if it's relevant. It is one thing for a trend to be up $100 over a year, and quite another for the trend to be up $1 million at the same time.

And let me tell you, it doesn’t matter how you visualize this information. It has to make sense to you. You

can use a bar chart, line chart, heck, you can even use arrows. It doesn't matter what technique you are using. The thing that matters the most is that you can see the direction and the magnitude of change.

To narrow down our analysis, here are the four (4) line items I look at when analyzing trends. Additionally, I try to keep these questions in mind while I'm looking at the numbers.

SALES

1. Are they growing, declining, or staying flat?

2. Ask why the trend seems to be moving this way.

3. Is it normal, or is this a problem that needs to be addressed?

4. Are we staying focused on getting customers to buy – right product/service for the right price.

GROSS PROFIT

1. Which way is the gross profit trending?

2. Is it moving in the same direction as sales?

3. Should it be, or why are they different?

4. Ask about vendor pricing, relationships, efficiency, and pricing strategy.

OPERATING EXPENSE

1. Which direction is the operating expense trending?

2. What has the company increased, and is it needed?

3. What are the current cuts or items that need justification for staying?

4. Compare operating expense categories to industry averages, like advertising.

NET PROFIT

1. Is this company making money or losing money?

2. What is the trend? Increasing or falling?

3. What are the prime contributors – gross profit, expenses, sales, or all?

Let's understand the trends with the example of our sample company. You can find a set of sample financial statements in the appendix of this book.

SAMPLE COMPANY TRENDS

		Year 1	Year 2	Year 3	Year 4	Year 5
↓ $1,190	Sales	$9,639	$8,925	$9,044	$8,092	$8,449
↓ $538	Gross Profit	$3,132	$2,892	$2,794	$2,549	$2,594
↓ $416	Operating Expenses	$2,844	$2,643	$2,560	$2,390	$2,428
↓ $101	Net Profit After Tax	$112	$48	$43	$2	$11

While analyzing the trends, the first thing that we specifically look at is Sales. Also, notice that we will always use dollars to describe the magnitude of change. Since we spend dollars, we can understand the value of anything easily if it is defined in terms of dollars. I often hear that "sales are up by 10%." It indeed sounds good, but it forces me to convert 10% into dollars so I can understand it. You can't spend percentages. If you think you can, then tell me how many percent does a gallon of milk cost. Make sure you look at the changes in your accounts in terms of dollars.

When you look at the numbers from Year 1 to Year 5, it just happens to be down a little over a million dollars. And it doesn't look that great, right? My first gut reaction

about this company is that it is not performing well because its sales are down. So, from the sales perspective, the sample company isn't growing. In fact, it's just the opposite. There can be multiple reasons behind it. As of now, we are not focusing on the reason; rather, we just want to identify which direction trend are going.

But don't get hung up on the fact that sales are down. Sales is a measurement of the amount of work you put in. If you're making money, and doing less work, meaning you have less sales but more profit, this might be a good thing.

So, the second element I look at is the most important thing on the income statement. It's gross profit. I am calling it the most important element because gross profit is the only place you can get cash. This is the only element that generates cash. You can't spend sales, but you can spend the gross profit. So I manage gross profit meticulously. I mean, I'm just feverish for having gross profit because that's the only cash I have in the company to spend or to keep in my pocket. So, why are you not obsessing about gross profit???

Looking at the above income statement, you can see that the gross profit has declined by $538,000 over five years. Again, not a good indication. Generally, sales and gross profit move together in the same direction, if a company is managing to a gross profit percentage. If sales decline, gross profit also decreases. Similarly, if sales increase, then the gross profit also increases. In this example, we can say that sales and gross profit both are on a declining trend during the period of five years. Sometimes you might see them move in opposite directions. This should get your attention. This means that something is happening that needs to be identified as either positive or negative.

Here are a couple of examples: If sales were down, but gross profit is up, we can celebrate! You would want to know why, but in general, this is a positive relationship. You are working (selling) less but making more money (increasing gross profit). The opposite relationship could indicate a problem, if you were selling more and making less money. In such a case, chances are you have a higher cost of goods sold percentage, which could be because your

vendors have increased the prices. You should investigate and take corrective action to recapture the gross profit amount you previously had.

Believe it or not, there are only 8 different combinations of these variables. So far, we saw that both, sales and gross profit of the Sample Company are on a declining trend. But you don't need to worry just yet; it's looks bad, but might not be reversable. As a business advisor or business owner, you might need to analyze the companies whose trend is either increasing, flat, or decreasing. So, our purpose is just to identify the direction of the trend, no matter what it is.

The next element is operating expenses. Unlike sales and gross profit, operating expenses don't necessarily move together. Operating expenses depend entirely upon the management's decision as to how and where they spend money. In this case, we see that operating expenses are trending down by $416,000. At first glance, this seems like a good thing. It signifies that the management recognized the decrease in gross profit and started to cut expenses as a response. They realized that they had less

money coming in, therefore they felt like they should spend less money. Now, if I ask you to give your analysis regarding the decline in the operating expenses in one sentence, what would you say? When I ask this question to my seminar participants, most of them say,

"It's good that the company is cutting their expenses."

So, the next question I ask is,

"Okay, so do you think the amount the Sample Company has reduced expenses enough?"

Here comes the twist. Most people can't answer this question. They know that the company should cut expenses, but really can't tell you how much they should cut. But I have an answer to this question for you. A hint lies in the last trend, i.e., Net Profit, and the calculation can be found in the next component of The Home Run Line Up, Expense Control.

When you look at Net Profit, start with Net Profit before tax, since tax is just a result and we pay tax on this number. On the sample income statement, I numbered this

line 24.

When I look at the Net Profit, I realize that there is a significant problem with this company. In Year 1, the net profit was $150,000. Within five years, it declined to $13,000. It's such a huge decline. To understand the cause, we can look at the relationship between the first three trends.

When operating expenses are deducted from gross profit, the remaining amount is net profit. Net profit is just a result. There is nothing you can do to impact net profit directly, you have to work on one of the other three trends elements we analyzed. The purpose for including it here is to show you the results of movement in sales, gross profit, and operating expenses. The sample company is down $137,000. This is a significant amount and should motivate you to investigate the cause for the decline. In this case, it is pretty obvious that a decrease in sales is the prime contributing factor, but not the only one. Here are three things that I see.

1. Sales are down considerably.

2. Gross profit is also down but only slightly as a percentage of sales.
3. The company cut expenses but didn't appear to cut enough to maintain profitability.

This Trend Analysis gives rise to many questions such as,

- Why are the sales of the Sample Company declining to such an extent?
- Why is gross profit slipping? Is it an increase in vendor pricing?
- Even after the decline in sales, why are operating expenses increasing in year five once again?

The Home Run Line U is designed to point you toward potential problems in your company. It's a way to get a quick finger on the pulse of what is happening. You should realize that these four elements have a relationship which point to the root causes of many problems. But you don't have to be an expert in trend relationship analysis. There are just 8 different combinations of these elements and I have included this cheat sheet to help you.

Trends Cheat Sheet

Sales	Gross Profit	Operating Expenses	Net Profit	Explanation
↑	↑	↑	↑/↓	Good position to be in. Watch increase in the operating expense above gross profit increase. It could result in a decrease in net profit.
↑	↓	↓	↑/↓	Growing sales is generally a good sign, but they are losing gross profit dollars. To combat, this company should cut expenses. Check to ensure they cut enough expense to avoid a loss.
↑	↑	↓	↑	Love this!! I consider this pattern to be the perfect senario. One word of caution would be to not cut expenses too much that you can´t keep up with growth.
↑	↓	↑	↓	Watch out, this could lead to a "growing broke" situation where you don't have enough money to keep up with sales growth. Focus on increasing gross profit and cutting expenses.
↓	↑	↑	↑/↓	This one could go either way. Although sales are down, they are generating more cash. Keep an eye on the increase in operating expenses. Too much will result in a loss.
↓	↓	↑	↓	Take action NOW! Sales are decreasing, so is gross profit. This means you have less money to spend but operating expenses are increasing. you can't have less to spend and spend more.
↓	↑	↓	↑	Although sales are down, gross profit increases and operating expense decreases are helping to maintain profitability.
↓	↓	↓	↑/↓	Things aren't looking good here. But this company may have cut enough expenses to be able to maintain or increase profit. This company needs top line attention- more sales.

So, these were the four elements of Trends. That's the first metric I look at on the 7 Minute Conversation scorecard. It’s funny that it takes me about 100 pages to explain the process that takes 7 minutes to complete! But I want you to have a deeper understanding of what we're looking at and why.

In this case, you know our overall first impression of this company isn't great. The only positive thing we saw is the company trying to cut its expenses, however, that's doesn’t look like it’s very effective. That’s why this is a good place to start talking about Expense Control, the second component of our Home Run Lineup worksheet

Chapter 3

Expense Control: One Rule to Rule Them All

If you are a small business owner and you want to stay in your business for a long period of time, you have to follow one essential rule.

The rule is:

The change in your operating expense dollars should mirror the change in your gross profit dollars.

Simply put, if you have less money to spend, you should spend less money. This is typically called expense control. However, it should be called the essential function of a business. It's essential because, without it, your company will die. We know that gross profit is the money that is available to spend, and operating expenses are how we spend that money. Moreover, looking back at the

previous chapter, you can remember that sales and gross profit generally move in the same direction and are related to each other. However, operating expense is dependent upon the management's decision.

An interesting visual of this is if you were to graph out sales, gross profit and operating expenses over time. The growth patterns of both gross profit and operating expenses are unique from each other. Gross profit tends to be more fluid, moving up and down with sales. Operating expenses, on the other hand, tend to create a "stair-step" pattern, the hold flat for a while, and then increase. This occurs when business owners try to operate for as long as they can without adding expense. It's one way to maximize profit by keeping expenses static for as long as possible during growth. It’s also because operating expenses are not connected to sales, they take a management decision to increase of decrease.

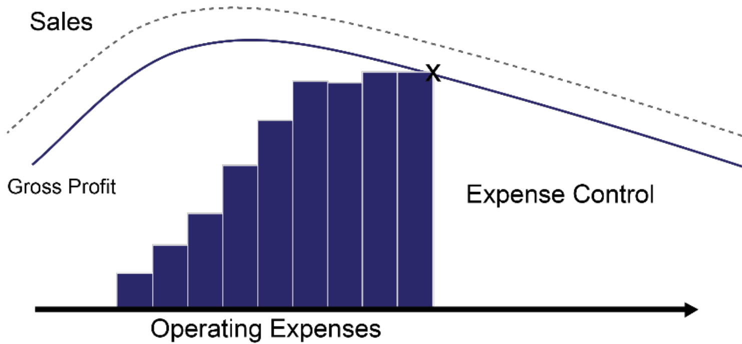
It's an interesting relationship but makes perfect sense when you think about a small business's goal of making as much money as possible. This part is easy to explain and is the most common function of businesses.

However, no business can keep its operating expenses flat forever. The reason is as your business grows, you may need to expand the business facilities, personnel or equipment to add more capacity.

You may need to buy a new asset such as a truck, equipment, or machinery to meet the production requirements. Or you may need to hire more staff to keep up the flow of work. In all these cases, your operating expenses will increase, which is pretty understandable.

The death spiral starts when gross profit declines, and the business owner does not make a similar move to reduce expenses. There are periods during the business life cycle where sales may decline with gross profit automatically following, resulting in a lack of cash to meet the business's monthly expense obligations.

Let's elaborate on this with the help of the graph below.



You can see that sales and gross profit are moving together in the same pattern. This is due to the management team's pricing strategy is to maintain a stable gross profit percentage. Now, if you look at the operating expenses, you can see that initially, they are increasing at a slower pace leaving more margin for net profit. As the business grows, we see that operating expenses are increasing at a faster pace. This is because the business owner may have hired more employees or have purchased more equipment to keep up with the growth. However, after a certain length of time, sales and gross profit in this

example start to decline. Don’t freak out in your business if you see this. It’s normal for businesses to go through rising and falling cycles due to seasonality or a host of other factors. But even with the declining gross profit, the business owner failed to manage its expenses efficiently. That's when things start to look a little bit stickier. If the management team doesn’t make a correction, new profit will simply erode away and you might encounter a point where operating expenses are equal to gross profit dollars. It's called the breakeven point. When you are neither making any money nor losing any money. You are just spending every dollar that comes in. I like to call this “practicing working”, since you are obviously not doing it for money!

Break even can either be celebrated or cursed. When you have lost money over a period of time, it’s rewarding to stop the losses. However, in this case, breakeven is not an ideal situation because the role of the manager in a firm is to maximize profits. Our sample company above has allowed them to erode away. To avoid losses, they should start cutting expenses today!

The breakeven point in our graph is a great indicator that we should cut expenses if we want to maintain profitability. As you see it approaching, you should take action. The whole point of this chapter is to get you to see gross profit decreasing and reduce operating expense by the same amount. That is the rule. The one rule that will keep you business alive.

As I said above, if you have less gross profit, you should spend less money. This is your biggest responsibility as a business owner or manager. You must control your expenses according to your gross profit. This means making some difficult decisions, including pay cuts and layoffs, to bring those operating expenses down to maintain your profit margins. No one wants to make this decision, but for the longevity of your company, you must. Think of it this way. Laying off one person today may save the rest of your employee's positions in the near future. You can always rehire the person if they're available when your business rebounds.

Consider the example of Cisco Systems Inc. After a drop in stock by more than 20% in 2011, Cisco decided to

trim about $1 billion in operating costs by cutting 9% of its full-time workforce, or 6,500 employees. The company accepted more than 2,000 early retirement packages and downsized their senior management team losing 15% of its vice president-level positions[1].

Pfizer did the same when it acquired its competitor Wyeth in 2009. The company laid off 5% of its global employees to cut costs in its research and development department. This happens because the role of the manager in the firm is to maximize shareholder value[2]. How did they know how much to cut? They saw how much gross proit had been lost and reduced operating expense to maintain the same level of profit and avoid losses.

So what happens if you don't cut expenses after you pass the break even point? You experience losses. My question to you is: how long is it acceptable to lose money?

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[1]Duffy, J. (2011). Cisco offers early retirement to certain employees. Network World. Retrieved from: https://www.networkworld.com/article/2202612/cisco-offers-early-retirement-to-certain-employees.html

[2]Giang, V. (2011). 14 Of The Biggest Mass Layoffs In 2011. Business Insider. Retrieved from: https://www.businessinsider.com/companies-with-the-biggest-layoffs-in-2011-2011-8

To answer that question, let me tell you a story that helped me understand this a little better.

I used to be a state trooper. So, people in my surrounding would often ask me,

"Hey, Mike, how fast can I drive?" And my answer to them was always the same.

"You can drive as fast as you can afford." That answer, strangely enough, actually holds true here. How long can the company operate with its operating expenses higher than gross profit or while losing money? Well, as long as they can afford to, because eventually you're going to run out of money and have to file bankruptcy. But I don't want to put you in that position. So, this is the visual effect of being able to make that change. And the action that must happen in this example is they need to cut expenses.

So far, you know that when your sales and gross profit are down, the best strategy is to cut expenses. Now the question is, how do we know how much we need to cut. Here is how you determine how much to cut.

In the previous chapter we identified that the company was down by $450,000 in gross profit. That means it had four hundred fifty thousand dollars less to spend. So, the company decided to cut its cost and reduced its operating expenses by $350,000. It's indeed praiseworthy. It made the right decision, but does it mirror the change in gross profit?

The change in gross profit was $450,000, while the change in operating expense is $350,000. There is a difference of $100,000. It means we are still spending $100,000 extra in terms of operating expenses. So, the answer is pretty clear. The expense cut is not in line with the decline in gross profit. What's the solution now?

The solution is, I need to cut another one hundred thousand dollars in expenses. If I do, I can maintain my net profit dollars. If you look at the trend of net profit in the previous chapter you'll see that it was down by $100,000. We were down $100000 in net profit! The relationship

between the trends and the answer to this question are right there in front of us the whole time.

So, when you cut one hundred thousand dollars in operating expenses, they actually flow right through to net profit, and you get them back in your pocket. As a financial advisor, if you ever encounter such a business where the change in operating expense doesn't mirror the change in gross profit, don't be afraid to tell the business owner this because it saves their business.

So, this was the second element on the home-run lineup card.

Pro Tip:

One of the best ways to control your expenses is to keep track of your daily expenses. The activity shouldn't take more than a few minutes each day if you adopt an expense-tracking approach that works for you. If you consistently track your expenses, you will be able to save more, spend less, and make other necessary changes to finances that will allow you to build wealth and go after the

things you want in life.

When you track your expenses regularly, you will be able to identify the areas where you overspend. Seeing it on a regular basis, helps you “see the fat” in your operation. It can be tempting to stop identifying expenditures and try again next month. However, it's important to be consistent and evaluate your expenses throughout the month so that you can identify what you need to change and by how much, before you HAVE to in order to keep the business alive. Violate the expense rule and eventually your company will die.

Chapter 4

Debt to Equity: Who Do You Listen To?

So far, we have discussed and understood the first two components of the Home Run Lineup. In this chapter, we will discuss the third and most important element that is the Debt-to-Equity Ratio. I call this the most important because it is somewhat difficult for people to understand. Ratios are generally difficult to grasp because they just give you a number to ponder over. It's not in dollars, so it seems difficult to interpret what this number tries to communicate. This chapter aims to clear up all these confusions and doubts.

First of all, we need to understand what the debt-to-equity ratio is. The Debt to Equity ratio compares the amount of money you borrowed for your business with the amount of money you invested in it yourself. In other words, it shows how much you believe in your company.

Through Debt Financing, companies raise money for working capital or capital expenditures by selling bonds, bills, or notes to individual and/or institutional investors. Most of us know this as getting a loan from the bank. Banks like to lend money. Mainly because it is one of the ways that they make money as a business. They get to keep the interest you pay as income for the bank. Businesses choose debt financing over an equity investment for a variety of reasons. They want to keep control of the company, they it's a fast way to access capital, and you get to claim an expense on the interest you pay, so it helps you pay less taxes. The downside of borrowing is that you have to pay it back. Also, more debt could mean a higher debt to equity ratio. This is a signal to others that you have become more dependent on the bank to keep your business open or growing. A signal that might be interpreted as a lack of confidence by the owner in the future of the company.

This ratio is an interesting one for small business owners because it makes them choose a side between the banker and the accountant. Naturally, business owners look at these two as trusted advisors for their company, but

when it comes to this ratio, they give the business owner opposite advice on what to do.

To understand why they would differ, you have to understand the objectives of both the banker and the accountant. First, the banker WANTS to give you money. One of the ways banks earn revenue is by giving loans to its customers and earning interest on that loan. So, the banker wants you to have a strong cash flow, increasing profits and retained earnings and a lower amount of outstanding debt. The accountant, on the other hand, WANTS you to pay the least amount of taxes possible each year. So, they use tax strategies that show more expense during the period to reduce net profit. We pay taxes on net profit and net profit is then transferred onto the balance sheet in the form of retained earnings. In other words, owners' equity. Therefore, when we reduce our net profit with higher expenses, we are also reducing the amount of equity being captured by the company's operations.

This is a major issue. You see, both advisors who you love and trust are giving you advice, but it's opposite of each other. Another problem is that their both right!

They're just not both right at the same time. So who do you trust? The answer is: it depends on your plans for next year. Yep, 12 months in the future.

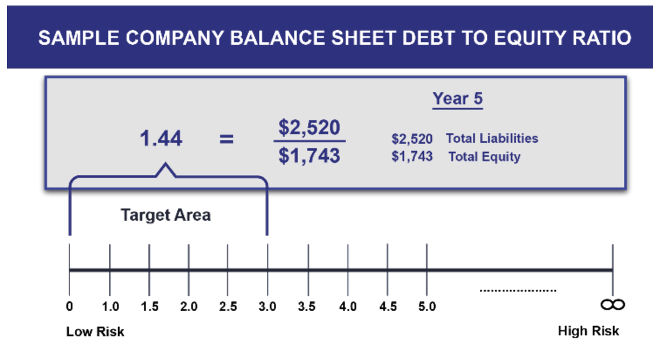
The Debt to Equity ratio is calculated by dividing Total Liabilities by Total Equity. A Debt To Equity Ratio of 2.5 is a good target ratio to achieve. A 2.5 means that for every $1 an owner has invested in their company; they have let the bank invest an additional $2.50. Lower than 3 is GOOD and shows less risk. Higher than 3 indicates more risk to bankers or investors. The data to calculate this ratio is extracted from the company's balance sheet. Believe it or not, this is also the answer to the "banking test". You put yourself in a great position to apply for a loan when your Debt To Equity Ratio is under 3.

Think about it this way. When you buy a house, you typically put down 20% of the purchase price, and the bank loans you the remaining 80%. 80% is the liability and 20% is your equity. You've got skin in the game, so the bank trusts you. Divide these two numbers and you arrive at a Debt to Equity Ratio of 4.0. This means for every $1 you put into the house, you let the bank put in $4 and everyone is happy. To

better understand risk to the bank, take the same example, and only put in 10% of the purchase price. You put in 10% and the bank puts in 90%. Divide 90% of the price, by the 10% you put down and the result is a Debt to Equity Ratio of 9.0. The bank has more risk when the number is higher.

Consider the following sample balance sheet.

Figure 3



In the sample company balance sheet, the debt to equity ratio is 1.44, which is less than 2.5. It is a good ratio, and lenders and investors can trust this company while making business decisions.

So, who do you listen to as a business owner, the banker, or the accountant? Remember when I said, that it

depends on what you want to do next year? The adviser with the best advice for you depends on the answer to this question. “Do I think I will need a loan next year to fund my company’s growth or operation?” Notice I said NEXT YEAR. That’s because if you need to apply for a loan, the banker will be looking at how the Debt to Equity Ratio trends in your company over time. They want to know that you have skin in the game through your investment in retained earnings. Do you actually keep money in the company to make sure that it runs efficiently?

If you think you might need a loan next year, start managing your debt to equity ratio today. When you lower net profit to avoid paying taxes, you are also reinvesting in your company at a lower rate than expected by lenders. It's an indication that you don't believe in your company, so much so that you want even put money into it. So, the bank may ask if you don't believe in the company, why should we?

On the other hand, if you have no intention of applying for a loan, then listen to your accountant and pay as little tax as you legally can. The choice should be a little

more clear now.

In business, it can be difficult to know exactly when to take risks and when to play it safe. Investors and bankers require data and financial analyses to give them the confidence they need to take a chance. Tools like the Debt To Equity Ratio provide a picture of a company’s capital structure and potential for success. Business administrators who comprehend the benefits, nuances, and importance of this ratio can use the information to grow their companies in competitive markets. Better yet, measuring your company to the expectations of the bank will help you have a healthier and more profitable company overall.

Chapter 5 – EBITDA: Another Word for Cash Flow

In just three components of the Home Run Line Up, we learned a ton about our sample company. Their trends are moving in the wrong direction. They have an expense control problem, and if they need a loan; they have a little room to take on more debt. In this chapter, we will explore a way to use, EBITDA. This one is confusing to just about everybody unless you're a banker. It's not surprising, but it's a reality that many business owners don't even know what EBITDA stands for.

In general, most people don't pay attention to it. Nobody calls their accountant and asks *"Hey what is my EBITDA today?"* unless they are asked for that by their bank. In fact, I'd be willing to bet that even at this moment, while reading this chapter, many of you are confused about what EBITDA is. So, before I give you a way to use EBITDA, let's

first understand what the acronym stands for.

EBITDA represents Earnings (net profit) Before Interest, Taxes, Depreciation, and Amortization. Or you can say it is a proxy word for cash flow which represents how much real cash is moving through a particular business. It is the measure of the company's overall financial performance. Now a question might pop up in your mind that why does it even matter? EBITDA may not be very important for you but it matters for your banker. If you look back at the previous chapter, I mentioned that before lending money to your business a banker will first analyze the financial position of your company. EBITDA is the most important element that a banker looks at. The primary goal of bankers, venture capitalists, and other investors is to predict FUTURE cash flows from the business. Not only do these cash flows drive the valuation of your business, but they also affect the business' ability to make payments on debt, and generally fund your company's operations.

It's a super interesting calculation. What makes it interesting is that it helps level the playing field, so you can compare companies with each other. By adding things like

interest and depreciation to your net profit, you can take out the effects of accounting and financing decisions a company has made. What I mean by that is EBITDA focuses on the operating decisions of a business because it looks at the business' profitability from its core operations before the impact of how you fund your company's growth, how much debt you may have, and non-cash items such as depreciation are taken into account. It excludes non-operating expenses, like taxes and other expenses you claim as part of your tax strategy, like depreciation and amortization. The purpose of adding these deductions back into net profit is to remove the factors that business owners have discretion over.

For example, as a business owner, you have a choice to decide whether you want to opt for debt financing, equity financing, or a combination of both. Interest expense reflects the cost incurred for financing (borrowing) and is considered a non-operating expense on the income statement. It represents interest payable on any type of borrowings, whether they take the form of bonds, loans, convertible debt, or lines of credit. So, while calculating

EBITDA, you add back the amount of interest in net profit which takes out the effect of financing. Secondly, depreciation captures the economic and functional decline in the value of a tangible asset (such as property, plant, and equipment over the expected life of the asset. Whew, let me say that differently. Depreciation / amortization follows the accounting principle of "matching", where you attempt to match the cost of your equipment with the future revenue you expect the asset to generate.

Multiple methods are used in US GAAP (Generally Accepted Accounting Principles) to capture the decline in the asset value and match expenses to revenues generated during a certain period. You have an option to choose the most suitable method of depreciation for your fixed assets. You might use straight-line depreciation, which just spreads the expense out evenly over time. Or you might choose a method like double-declining balance, which takes more depreciation in the earlier years of the life of the asset. A company might choose this one because they expect more repair and maintenance cost as the piece of equipment gets older. The depreciation method you choose changes the

amount of expense you claim on the income statement and affects your net profit. So, we also add back depreciation expenses in the net profit that takes out the effect of accounting decisions. Similar to depreciation expense, amortization represents the decline in the value of a long-lived intangible assets (things you can’t touch with your hands) over its expected economic life. As with depreciation, there are many ways a company could amortize the use of these assets. A few examples of intangible assets are: capitalized software, goodwill, trade names, customer relationships, and technology. As a review, you depreciate things your can touch with your hands, and you amortize things you can’t.

Similarly, your accountant can also guide you on the methods of lowering tax liabilities. Plus taxes aren’t part of your operating expenses, they are a result. So, taxes are also added back to your net profit. In short, a business owner has control over these non-operating expenses, therefore, the effect of these is removed while calculating EBITDA.

If you're an adviser, this calculation is a great

opportunity to educate your client. Not only will they understand what EBITDA is, you will also be able to give them a way to use it during the regular course of their business.

Let's calculate EBITDA for our Sample Company.

SAMPLE COMPANY EBITDA

Earnings (Net Profit After Tax)	$11,000		
BEFORE	+		
Interest	$154,000		EBITDA
Taxes	$2,000	=	$385,000
Depreciation	$218,000		
Amortization	$0		

In the above figure, you can see that net profit after tax of the sample company is $11,000. They have got $154,000 in

interest and they pay $2,000 in taxes. Similarly, the amount of depreciation is $218,000. The company has not incurred any expense for amortization. That's pretty normal. A lot of small businesses don't have amortization, unless they have bought another business and have to account for goodwill. So, when we add back these elements to net profit after taxes, we get EBITDA that equals $385,000. You can see our EBITDA is a lot better than the reported earnings of $11,000. In actuality, I'm felling a lot better about this company's ability to take on new debt.

So, what's next? We can't just be happy that we have $385,000 in terms of EBITDA. There must be some purpose that this number serves. What is that? As a business owner, knowing EBITDA is kind of unimpressive. How can I use it with a client? How can I use it as a business owner? Basically, what I want to do is take my EBITDA number and apply it somewhere else.

Well, here is a way to use EBITDA. As a rule of thumb, EBITDA can be used to determine what the Long-Term Debt Capacity (LTD Capacity) of your company is. LTD capacity refers to the total amount of debt a business can incur and

repay according to the terms of a debt agreement. A business takes on debt for several reasons, such as boosting production or marketing, expanding capacity, or acquiring new businesses. However, incurring too much debt or taking on the wrong kind can result in damaging consequences. The problem usually is that business owners never know how much debt they can have. They're in the dark and relying on the banker to not over-extend them. As a business owner, you should know how much you can borrow.

While working with banks around the country, I was able to determine that although every bank has a different calculation, they all arrive at an amount that is approximately 3 times EBITDA for a company's long-term borrowing capacity. So, if we multiply EBITDA by 3, we should arrive at the long-term debt capacity or a ceiling of debt for our company. In this case, the sample company is qualified to borrow up to $1,155,000 in long-term debt. So, as a business owner, if you need a loan, now you know that you can ask for about $1.1 million. That's a good thing to know because you don't want to walk into a bank, apply for

a loan, and they decline your loan. Or maybe approve you for a lower amount. Knowing about EBITDA actually helps you get in the ballpark. It may not be the exact number, but it's going to get you in the ballpark where you're not totally off base with how much you think you can afford.

However, LTD Capacity is the total amount. You can't stop at this number. You have to go back and look at the balance sheet and determine how much you have already borrowed and still owe. If you have a LTD amount listed on your balance sheet, then that amount should be deducted from your LTD capacity.

Refer to Sample Company's Balance Sheet in the Appendix, using Year 5 to determine if they have any LTD on the books.

You will find the sample company has already borrowed long-term funds of $713,000. So, now you don't have availability of $1,155,000. It is reduced by the amount you have already borrowed. When you subtract $713,000 from $1,155,000, you are left with $442,000. This number is the key to making good financial decisions about asking the bank for money in the future. For example, if you want to

buy a piece of equipment next year that costs $600,000, your remaining LTD capacity tells you that you need to come up with another $158,000 yourself before you go to the bank and ask for a loan. Your equipment costs $600,000. Your LTD Capacity is $442,000. The difference between the two is $158,000. You would be short this amount to buy the equipment.

Here is how the calculation looks.

SAMPLE COMPANY LONG TERM DEBT AVALIBILITY

EBITDA			Long Term Debt Capacity
$385,000	x 3	=	$1,155,000

LTD Capacity		LTD on Balance Sheet		Long Term Debt Capacity Available
$1,155,000	-	$713,000	=	$442,000

Having a constant awareness of your debt capacity, which can change every so often, can help your business in the following ways:

Effective Strategic Planning

Oftentimes, a business management team spends a lot of time and resources to develop a strategic plan. However, in the end, they find out that they can't obtain the funding to implement their plan. With an awareness of your business's long-term debt capacity, strategic planning becomes more meaningful and efficient. You plan according to your fund obtaining capability which saves a lot of your time and energy.

More Opportunities

You never know when an opportunity will arise and when it does, whether you will have the capacity to fund it. If you are unaware of your debt capacity, the opportunity may pass you if you can't get a quick answer from your lender. By being well aware of your LTD capacity, you can make better use of available opportunities.

Faster Lending Process

When you need to obtain a loan, it could require several meetings with your banker to answer questions. If you don't have the information that your banker needs, it

raises more questions and delays in determining how much you can borrow. Knowing your debt capacity will get you past many initial questions and to your loan amount more quickly.

If you want to grab the next best opportunity, it would be useful to first calculate your debt capacity. That way you can assess your capacity to borrow well in advance of your need.

Chapter 6

Mis-Matched Financing: Like Buying A House with A Credit Card

The fifth element of the Home Run Lineup Worksheet is the most confusing one and we call it Mis-Matched Financing. This is the silent killer of businesses. And the funny part is most of us don't even think about it. Mis-matched financing means that you use the right loan product to buy assets for your business, if you don't use cash. If you're doing it right, the length of the loan should match the life of the asset. So, if I can depreciate an asset for five years, I should use a five-year term loan to finance the purchase of that asset. That way, when the depreciation schedule ends, so do your payments for the asset.

Believe it or not, sixty percent of small businesses

out there currently have mis-matched financed assets. However, no one ever mis-finances their company on purpose. It generally occurs during routine transactions. The small business owner is just trying to solve a problem. It happened to me.

While running one of my bar/restaurants, one of the large bottle coolers compressor went out. I walked into the building one morning and saw this pool of brown goo oozing from the bottom of the cooler. I knew it was shot. I quickly emptied out the beer from the cooler and headed to the restaurant supply store. I order a replacement cooler and put the $5,000 expense on my credit card. Problem solved! Yea, but I also mis-financed the purchase and cost myself a bunch of money. How? I used a credit card, with 16% interest, instead of cash or a term loan.

Cash is the lifeblood of any company. Use debt properly is an important element of how cash flows through a business. Many business owners believe that debt is debt. They don't understand the difference between long-term and short-term debt. They use their line of credit to make

large equipment purchases and then use their cash to pay down the line of credit. Owners see the ease of access to capital with a line of credit or a credit card as a simple way to buy stuff for their business. In some cases that's true. Like buying more inventory to meet seasonal demand, or buying a new light fixture for an office. But larger purchases need a different approach. Interest on smaller purchases doesn't eat up much cash, but that's not true for something a lot bigger.

For example, most people wouldn't use their credit card to buy a house. You wouldn't do that right? I mean, you could get a ton of airline miles out of the deal, but it would cost you a fortune. The house you buy is a long-term asset, whereas the type of loan you are using to buy it is short-term i.e. credit card. Generally, the rate of interest on the credit card is about 15 to 20%. However, if you use the long-term mortgage to buy the same house, you will pay about 4 to 5% rate of interest. A huge difference, isn't it? This is because short-term money is more expensive than the long-term. If you use the wrong loan product to finance your assets, it will eventually rob your company of cash in

the form of paying higher interest. You just write the check each month, and don't pay attention to the amount of interest your hard earned cash is going towards.

Another common problem that arises with mis-matched financing, is that the cash that should be allocated for growing the business is withdrawn to pay off the line of credit. Instead of utilizing cash to invest in hiring additional resources to grow business, a company is unable to accept new jobs or clients because they do not have any cash to grow. You put yourself in a catch-22. You can't grow because you don't have enough cash, and you don't have enough cash because you can't grow.

Once a company has been mis-financed it can be hard to recover. Companies in this situation stretch their accounts payable so far that they are unable to take advantage of vendor discounts. In the worst cases, their vendors no longer want to do business with the company. From a cash flow perspective, the business typically struggles for survival and may not have enough left on their line of credit to cover their seasonal financing needs. The

silent killer is at work. Starving your business of the cash it needs to survive.

There are three places that a trained eye goes to on a company's balance sheet to identify mis- matched financing; gross fixed assets, long-term debt, and retained earnings. If the company has been properly financed, the owner would have used cash, long term debt, or a combination of the two to buy the assets it needs to grow. So, on the balance sheet, we will be looking to see how fixed assets are purchased. If the change in retained earnings and the change in long-term debt equal the change in fixed assets, then the balance sheet balances, and the company is properly financed. If fixed assets are greater than the sum of retained earnings and long-term debt, then the company has been mis-financed. Frankly, you bought something you can depreciate with short term credit. To diagnose mis-financing, you will need to look at the variations in these three categories over a multi-year period.

The best way to start checking for mis-matched financing is by looking at the balance sheet. Check the business' gross fixed assets (GFA), long-term debt (LTD),

and retained earnings (RE). How do these three accounts change over the time period you are looking at. The change in GFA between periods must be equal to a corresponding change in LTD and/or RE. This is a simple variation of the Basic Accounting Formula: Assets = Liabilities + Equity. By narrowing it down to only GFA, LTD, and RE, we are focusing in on assets you bought and the method you used to pay for them. In this case, we want you to buy GFA with cash, long term debt, or a combination of both.

An increase in GFA means that you bought something. There should be an equal increase in LTD if you used a term loan to finance the purchase. There may be an increase in RE if you used cash to pay for the purchase. Remember that cash in your company can be derived from profit from your operation. At the end of the period, an increase in profit means that RE was increased with a corresponding increase in cash, (or Accounts Receivable to be collected as cash).

By leaving out Current Liabilities from this equation, we can surmise that if the mis-matched financing equation does not equal, the purchase was probably made with a

short-term credit product like a credit card or a line of credit. If your company's mis-financing calculation does not equal; **call your banker for help**. It may put more cash in your pocket by lowering your interest expense.

The effects of improper debt structure can be debilitating to a business. Finding mis-matched financing in its early stages can help to mitigate the effects it has on a business.

The rule here is that the length of your loan must match the useful life of your asset.

That is, if you can depreciate an asset for 5 years, you should use a 5-year term loan to finance it.

The following chart can help you while analyzing your business. In this case, we found that our Sample Company has mis-matched financing. The numbers can be found by looking at the changes in GFA, LTD, and RE on the balance sheet in the Appendix.

SAMPLE COMPANY MIS-MATCHED FINANCING

△ Gross Fixed Assets		△ Long Term Debt		△ Retained Earnings
$1,210,000	=	$256,000	+	$104,000

$1,210,000 ≠ $152,000

MATCH! Looks like you have financed all your assets using the proper financing product.

NO MATCH! You may be paying than more interest necessary. Contact a banker for help.

Chapter 7

Cash Flow Activity Pattern: The Tattle Tale

So far, we have talked a lot about debt and earnings. Now is the time to have some discussion about the lifeblood of any business. Yes, you got it right. I am talking about cash. Your company requires a steady supply of money to function properly. Cash flow is the prime contributing factor for the survival of any business, no matter how awesome of product or service you might have. This goes beyond just showing a net profit at the end of the month. If your company's ability to generate and use cash is inefficient, you can go bankrupt pretty fast.

The Cash Flow Statement is the most important financial statement because it gives you a real picture of what's happening in your business. I call this report the Tattle Tale of a business. It tells the reader exactly where

the cash came in from and how you used it. Your business is alive. It is a dynamic and fluid machine capable of way more than we often give it credit for. Just like the human body, your company can generate a lot of positive energy and accomplish things that most people can only imagine. But, when things aren't quite right, the body breaks down very quickly.

Showing a profit at the end of the month, isn't the true measurement of success in a company. You have to have cash. With 200,000 businesses failing every quarter, and almost 50,000 business filing bankruptcy per year, they all have something in common – poor cash flow. Seven out of the top ten reasons for failure all involve poor cash flow management, and the other three are related to personal issues. Being a manager that can focus on cash flow is your best defense against failing in small business.

The main categories found in a cash flow statement are (1) operating activities, (2) investing activities, and (3) financing activities.

Operating activities

These include cash activities related to net income. For example, cash generated from the sale of goods (revenue) and cash paid for merchandise (expense) are operating activities because revenues and expenses are included in net income. Operating cash flows also include cash flows from interest and dividend revenue interest expense and income tax. Most of your core business activities will fall into this category. You'll be able to find most of these activities on the income statement.

Investing activities

These include cash activities related to noncurrent assets. Noncurrent assets include (1) long-term investments; (2) property, plant, and equipment; and (3) the principal amount of loans made to other entities. For example, cash generated from the sale of land and cash paid for an investment in another company is included in this category. Most people don't realize that even buying a new vehicle for their business is considered an investing activity. Therefore, most investing activities can be found on the balance sheet.

Financing activities

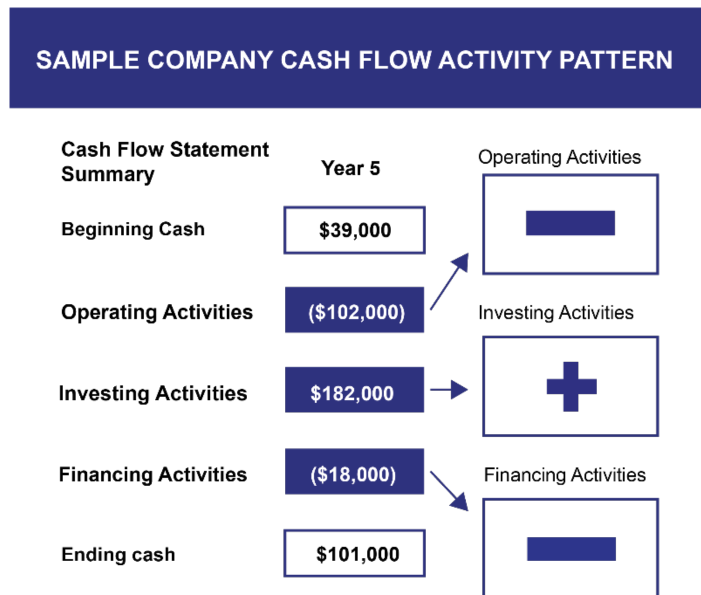
These include cash activities related to noncurrent liabilities and owners' equity. Noncurrent liabilities and owners' equity items include (1) the principal amount of long-term debt, (2) stock sales and repurchases, and (3) dividend payments. Yep, the money you raise to fuel the company is considered a financing activity and usually found on the balance sheet.

Cash flow from these three activities can either be negative or positive. These negative or positive figures tell you a lot about the performance of your company. Accountants will use the terms inflows and outflows, while bankers call them sources and uses of cash.

The following chart is the summarized cash flow statement of our sample company. It can be used to identify how your company is performing based on your cash inflows and outflows. More importantly, it tells you how the management of any company generates and uses cash in their business. A positive amount in any of the three activities represents that there is more cash flowing in than

flowing out. Similarly, a negative cash balance depicts that the company has more outflows than inflows. In short, they spent more than they received. In symbolic form, the following statement gives us "**- + -**". What does it represent?

Figure 7.1



To understand this symbolic language, we have a rule chart. So before further discussing the performance of our sample company, let's first have a look at the rule chart.

Figure 7.2

CASH FLOW ACTIVITY PATTERN LEGEND

OPERATING ACTIVITIES	INVESTING ACTIVITIES	FINANCING ACTIVITIES	INTERPRETATION
+	+	+	This company is building cash and is highly liquid.
+	−	−	This company generates cash from operations and is buying assets and paying debt and owners.
+	+	−	This company is using cash from operations and selling assets to pay debt and /or owners.
+	−	+	This company uses cash from operations and from borrowing / investment to expand.
−	+	+	This company covers cash flow problems by selling assets and by borrowing / investment.
−	−	+	This company is growing but has shortages from operations and buying assets with debt.
−	+	−	This company is trying to stay in business by selling their assests to cover expenses.
−	−	−	This company is burning through cash reserves to cover shortfalls and pay creditors/ investors.

According to the above cash flow activity pattern, if the cash flow from all three activities is positive, it depicts that the company is building cash and is highly liquid.

If the cash flow from operating activities is positive but the cash flow from investing and financing activities is negative, it shows that the company is generating enough cash from its operations that it can buy new assets and pay its debts and owners.

The next pattern is **"+ + -"** , which means that though the company is generating cash from its operations, it has to sell its assets to pay its debts and/or owners.

Red Flag Alert: Unless the assets are old or obsolete, selling assets to generate cash is bad. Your assets are designed to help you produce revenue and profit. Getting rid of them, also reduces your ability to do so.

The fourth pattern shows that the company is generating cash from its operations but it is not enough, therefore, the company has to raise money through financing activities to buy a new asset or expand the business. This isn't uncommon. In fact, most high growth software companies look at raising capital as a massive accelerator of growth. This is where you see the headlines that ABC Software just closed a funding round for $100 million.

In the next step, the company is not generating enough cash from its operations. Therefore, to cover its day to day cash needs, it has to sell its assets and raise money through borrowing/investment. When I see this pattern "- + +", I am concerned that this company is entering a death spiral where they are hindering their ability to generate cash, while not being able to generate cash with their core business.

In the sixth pattern, the company is growing but has shortages from operations. So it is using debt to buy new assets. You might see this pattern when a company is starting to outrun its own operating capacity. You might dream about getting a contract at a major retailer, but then you have build the capacity to fill the orders.

In the seventh pattern, the company is in a critical condition. It is trying to stay in business by selling its assets to cover expenses. This company is on the ropes and struggling for survival. It is only a matter of time before they fail.

The eighth and the last pattern is showing that the company is burning through cash reserves to cover shortfalls and pay creditors/investors. You might think that is bad, but they do have cash reserves. So, at one time, they had the formula for success figured out. I think they might be able to turn this company around.

Now if we look back at figure 7.1, in light of the above cash flow activity pattern chart, our sample company is a struggling business where the company's management

is trying to cover its operating shortfalls and long-term debt payments by selling their assets. This is a recipe for disaster. The only reason to buy assets is to generate revenue and profit. So, when a company is selling its assets to cover expenses, it is also reducing its ability to generate revenue and profit. This is an indicator that the company is in a death spiral.

If you want to stay in your business for the long-term, you must work on improving your cash flows.

As a small business owner, I always got excited to see a month with a profitable income statement. That meant that customers were buying, and I was being smart with how I spent money. At least on paper. However, there were those times where I could see that I made money, but it just didn't make it into the bank account. I still felt like I was struggling to pay bills, even though the financial statements told me I shouldn't have a problem. Where was the cash going?

There were five different places where cash was hidden from the income statement. These five areas were

killing my cash flow and making it harder to stay in business. Once I made the connection between cash flow and profit, I was able to change the whole trajectory of my business and its future. If you feel this way, look here.

1. **Accounts receivable** – Make sure you are being paid as quickly as possible. I had a service-based business, where my largest expense was payroll. I had to educate my customers to treat my invoices more like a payroll expense and pay more frequently.
2. **Accounts payable** – This may sound a little odd, but don't pay much earlier than the due date, unless you are getting a discount. This is like a free loan and keeps cash in your company.
3. **Inventory management** – Learn to set your base level inventory amounts. This is where you have just enough of an item between orders. Look at history and match your orders to your customers. If they normally buy 10 of a particular item in a week, then you should have 10-12 on hand. Your

quantity on hand should match your base level (or par) at the beginning of an order cycle.

4. **Expense control** – There is a hard and fast rule here. The change in operating expenses should mirror the change in gross profit. If the gross profit is reduced by $10k, then you should also reduce your operating expense by $10k. Simply put, when you have less money, you should spend less money.
5. **Mis-matched financing** – Almost none of us check for this regularly, but we should. This is where you have purchased a long-term asset, with a short-term product. Like buying a house with a credit card. You wouldn’t do this unless you wanted the miles! No, you wouldn’t do this because the cost of borrowing is too high, and it would increase your interest expense. The length of the loan should match the life of the asset is the rule.

These are the 5 silent killers of cash flow in a company, and although you might not see them specifically on the cash flow statement, they are there. On the cash flow

statement, you see the change in accounts between two time periods. This is one of the things that makes this report harder to understand. It is not just adding and subtracting what happened during the month. It is what happened differently between last month and this month. By applying the symbolic technique, I taught in this chapter, you can quickly understand what is happening in any company. The pattern will tell on the managers.

Chapter 8

The 7-Minute Conversation

I always think its funny that it takes me an hour, or in this case 100 pages, to teach someone how to have a 7 Minute Conversation about their business. But trust me, it only takes a few minutes once you get into the routine. How else, was I able to review about 100 different companies when I was looking to invest in a new venture. More importantly, running 5 different profit centers at one time, the Home Run Lineup Worksheet became my security blanket.

In just 7 minutes per month, I could get a complete picture of my company's financial position. If any of these elements were alarming, I knew where to look to find the problem. Similarly, if they looked good to me, I'd just keep up with my business routine of trying to provide the best service possible to my clients. Here is what the completed Home Run Line Up would look like for our sample company. As you can see, there are plenty of problems for the management team to address. But this is where the magic of the Home Run Lineup kicks in. As you read about each element, imagine you are having a conversation with your team about how to improve the company. You'll find that the analysis is quick and very thorough.

HOME RUN CONVERSATION WORKSHEET

TRENDS

		Year 1	Year 2	Year 3	Year 4	Year 5
$1,190	Sales	$9,639	$8,925	$9,044	$8,092	$8,449
$538	Gross Profit	$3,132	$2,892	$2,794	$2,549	$2,594
$416	Operating Expenses	$2,844	$2,643	$2,560	$2,390	$2,428
$101	Net Profit After Tax	$112	$48	$43	$2	$11

EXPENSE CONTROL

Change in Gross Profit ($538) = Change in Operating Expense ($416)

Not Equal

Cut $122,000 in Operating Expenses

DEBT TO EQUITY RATIO

Debt to Equity Ratio 1.44

Target D/E Ratio 2.5

Total Liabilities $2,520,000

Total Equity $1,743,000

EBITDA/LTD AVALIBILITY

EBITDA $385,000 x 3 = Long Term Debt Capacity $1,155,000

LTD Capacity $1,155,000 - LTD on Balance Sheet $713,000 = Long Term Debt Capacity Available $442,000

MIS- MATCHED FINANCING

Δ Gross Fixed Assets $1,210,000 = Δ Long Term Debt $256,000 + Δ Retained Earnings $104,000

$1,210,000 ≠ $152,000

X NO MATCH! You may be paying more interest than necessary. Contact a banker for help.

CASH FLOW ACTIVITY PATTERN

Cash Flow Statement Summary	Year 5
Beginning Cash	$39,000
Operating Activities	($102,000)
Investing Activities	$182,000
Financing Activities	($18,000)
Ending cash	$101,000

Operating Activities −

Investing Activities +

Financing Activities −

Trends

During the period of five years, the sample company's

- Sales were down by $1,190,000
- Gross profit declined by $538,000
- Operating expenses decreased by $416,000

- Net profit had plummeted from $112,000 to just $11,000

According to the Trends Cheat Sheet, this company is not in a good position. Although the company may have cut operating expenses to maintain its net profit, it needs a two-pronged approach to restore its former level of profitability. The two things that the company needs to focus on are sales and operating expense. First, the company has to work on increasing its sales. Sales drive the train, and this one is slowing down rapidly. Second, the company has to continue cutting its operating expenses to be more in line with the decline in gross profit if it wants to recapture net profit.

Expense Control

The second element of this Home Run Lineup is Expense Control. We can see that the company has started to reduce its operating expenses which is the right move in this case. However, this reduction doesn't match the decrease in gross profit. The change in gross profit during the 5 years is $538,000. Whereas, the change in operating expenses is $416,000. This change should be equal if the company doesn't want to compromise on its net profit.

Though the company has reduced its operating expenses, it is still spending $122,000 extra as compared to its gross profit. So, the simple solution here is that you should cut operating expenses by another $122,000 to improve your net profit.

Debt to Equity Ratio

If you look back at chapter 4, you may remember that the ideal debt to equity ratio is 2.5 from a banker's perspective. A ratio lower than 3 is good as it shows less risk to the bank, because the owner has "skin in the game." The debt to equity ratio of our sample company is 1.4. What does it indicate? As I mentioned any ratio of less than 3 is good. So, it seems our sample company is looking pretty good. Lenders and investors can trust this company while making a business decision, because the owners have been very responsible at using debt.

Managing your debt-to-equity ratio is crucial because lending should be an enhancement to your operation. You use debt to grow, not just survive. That's what gets owners in trouble. They take on too much debt and their cash gets eaten up by interest payments.

So, as a business owner, if you think that you will be needing a loan the next year to hit your growth goal, keep this number in mind. You'll need it to be at a 2.5 or lower. On the contrary, if you don't need a loan, the number doesn't mean as much. You can allow it to creep higher as you try to minimize your income tax obligations by reducing your net profit.

EBITDA/ LTD Availability

EBITDA is the fourth element of our Home Run Lineup worksheet and it is simply another term for cash flow. According to the calculations we made in this book, the sample company is in a lot better position in terms of EBITDA, when we compare it to net profit. One of the ways a business owner can use EBITDA is to know what the long-term debt capacity of your company is. The LTD capacity of our sample company is $1,155,000, which is EBITDA times 3. We have already borrowed $713,000, so that leaves a remaining availability of $442,000. Knowing how much you can borrow is a good thing. Especially if you want to buy a piece of equipment in the future.

Mis-Matched Financing

Mis-Matched Financing is the silent killer of businesses, and it happens without you even realizing it. Our sample company has fallen victim to buying something with the wrong type of credit product. The change in gross fixed assets (GFA) are not equal to the sum of the change in long-term debt and retained earnings. It means the company is most likely using short-term debt to finance its long-term equipment needs. This means they are probably paying too much in interest, but it's fixable. Our sample company just needs to contact a banker to help restructure the loans on some of their past purchases.

Cash Flow Activity Pattern

The last element of the Home Run lineup worksheet is the cash flow activity pattern. The management probably already knows this, but we determined that this company is experiencing some cash flow issues. The company is selling its assets to cover its day to day expenses and pay off its debt. This kind of approach leads right to a shut down of the business. A company buys assets to generate revenue. When the same assets are sold to meet the operating expenses requirement, they reduce their ability to generate revenue from their operation. We call this the death spiral.

So, did you see, how quickly we identified the major problems in our sample company? Moreover, we easily got to know the root causes of these problems as well. It becomes quite easy for a business owner or the financial advisor to solve the issues when they know the root cause of the problem, and the Home Run Lineup touches all the bases!

Benefits of Home Run Lineup Worksheet

Home Run Lineup Worksheet will help you look at the financial health of any business in minutes. No one wants to devote the hours it can take to understand their business's financial metrics. But everyone can benefit from seeing their business through the eyes of the financials, in just a few minutes per month. After the first time you give this technique a try, you will have a better understanding of your company's true financial position.

Now give it a try yourself and you will be on The Clear Path To Cash. Speaking of, if you like to swim at the deep end of the financial pool, like I do, check out my book called "Don't Be A D.U.M.B. Business owner. You will learn 8 steps to maximizing cash in your business and better yet, you'll be building a lifestyle friendly business.

Here's a secret: the Home Run Lineup is part of The Clear Path To Cash, so you are already on your way.

Best wishes for success.

Appendix

Sample Company Financial Statements

INSERT INCOME STATEMENT, BALANCE SHEET, and CASH FLOW STATEMENT from Sample Financial Statement PPT in the files

INCOME STATEMENT

Sample Company
Income Statement (000's)

		YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
1	**SALES**	**$9,639**	**$8,925**	**$9,044**	**$8,092**	**$8,449**
2	Cost of Goods Sold	(6,507)	(6,033)	(6,250)	(5,543)	(5,855)
3	**GROSS PROFIT**	**$3,132**	**$2,892**	**$2,794**	**$2,549**	**$2,594**
4	**OPERATING EXPENSES**					
5	Owners Salary	$107	$83	$60	$60	$60
6	Other Salaries	$926	$801	$738	$613	$605
7	Commissions	$482	$446	$452	$405	$417
8	Salary Related Expense	$376	$355	$312	$269	$262
9	Advertising	$99	$89	$86	$83	$80
10	Bad Debts	$26	$19	$23	$13	$21
11	Business Taxes & Licenses	$95	$90	$92	$82	$87
12	Depreciation	$125	$174	$179	$209	$218
13	Insurance	$113	$112	$114	$121	$125
14	Legal & Accounting	$25	$27	$26	$31	$29
15	Maintenance & Repair	$70	$61	$71	$75	$77
16	Office Expense	$30	$27	$29	$26	$27
17	Telephone & Utilities	$154	$161	$170	$177	$188
18	Travel & Entertainment	$64	$48	$49	$58	$62
19	Vehicle Expense	$56	$58	$62	$73	$76
20	Other Admin Expenses	$96	$92	$99	$94	$95
21	**TOTAL OPERATING EXPENSES**	**($2,844)**	**($2,643)**	**($2,560)**	**($2,390)**	**($2,428)**
22	**OPERATING PROFIT**	**$288**	**$249**	**$234**	**$159**	**$167**
23	Interest Expense	(138)	(193)	(184)	(156)	(154)
24	**NET PROFIT BEFORE TAX**	**$150**	**$56**	**$50**	**$4**	**$13**
25	Income Tax	(38)	(8)	(7)	(1)	(2)
26	**NET PROFIT AFTER TAX**	**$112**	**$48**	**$43**	**$2**	**$11**

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THE 7 MINUTE CONVERSATION

The 7 Minute Conversation is based on Step 2 in Cash Flow Mike's signature small business training course called The Clear Path To Cash. Learn how to simplify and add power to your financial analysis. We'll discuss a technique, The Home Run Financial System, that will help you look at the financial health of any business in minutes. No one wants to devote the hours it used to take to understand their businesses financial metrics. But everyone can benefit from seeing their business through the eyes of the financials, a few minutes per month. We'll show you a few critical items you can discuss with your team to set them on the path to more cash in your business. After one conversation, any small business owner will have a better understanding of their true financial position.

In this book we'll look at:

- Identifying the most critical measurements of profitability in a small business
- Learning how to have a quick, but meaningful conversation about the numbers
- Introducing a quick analysis technique to your team in one simple step
- Setting up for success in making more money or getting a financing request approved

Mike Milan, "Cash Flow Mike", made his debut as an author with the book, "Don't Be A D.U.M.B. Business Owner." He quickly began writing "The 7 Minute Conversation", after the success of his financial methodology, The Home Run Financial System, got national attention with bankers, accountants, and small business owners alike. By combining personal experience with an MBA from Baylor University, Cash Flow Mike has created a powerful program to maximize cash in your business. Grab a copy now and learn how to lift the fog of business and follow The Clear Path To Cash.

Clear PATH To Cash