"You Can Observe a Lot by Watching"

By Scott Manley

Former Yankee baseball great and manager Yogi Berra is known for his many misstatements and general mangling of the English Language and the title of this column is just one of those. I'm amazed, however, at the simple yet profound wisdom contained in those seven words, particularly in the economy we've experienced recently. With that in mind, I want to discuss three things that entrepreneurs need to watch: profit, cash flow, and equity.

<u>Profit</u>

This seems like a simple concept: you've got to earn a profit to be successful in business. Unfortunately, it's not quite that easy, because there are two types of profit: gross and net. Over the long term, businesses that are not profitable are also not viable.

Gross profit refers to the money that is left over after the cost of the goods or services sold has been paid. Gross profit is the money that pays the bills, so a key basic concept is to generate as much gross profit as possible by maintaining adequate markup and margins and generating significant sales volume.

Net profit is the money that remains after all operating expenses have been paid. Negative net profit, referred to as a loss, must be financed. In other words if a business is losing money, it must come from somewhere: either an increase in liabilities or an infusion of equity.

<u>Cash Flow</u>

There are three types of cash flows: operating cash flows, investing cash flows, and financing cash flows. Any of the three can either be positive or negative cash flows, and it is important to realize how and why. It's also important to realize that with a negative cash flow, you aren't going to be in business for very long.

Operating cash flows come from "the business of being in business." Even if there is a positive net income, operating cash flows can be negative because of fluctuations in current assets such as inventory and accounts receivable or fluctuations in current liabilities such as taxes and accounts payable.

Investing cash flows are calculated based upon the purchase or disposition of fixed assets. For instance, if you purchase (invest in) a fixed asset such as a computer, machine, vehicle, or real estate, that purchase will require a cash outlay or negative cash flow. If you sell a fixed asset, that sale will result in a cash receipt or positive cash flow.

Financing cash flows come from the borrowing and/or repayment of debt obligations. Obtaining a loan results in a positive cash flow, while the repayment of a loan results in a negative cash flow. Also, an infusion or withdrawal of equity from an owner typically is a financing cash flow. Likewise, this can also result in positive or negative cash flows.

<u>Equity</u>

Equity is quite often misunderstood, but not if you think of your home: if you own a home and owe a mortgage, the difference between the value of the home and your mortgage balance is your equity. This equity can also be positive or negative, as was painfully revealed by the bursting of the housing bubble. Lenders generally won't loan more than an asset is worth, so negative equity generally means the business won't be able to secure financing.

Unfortunately, there are only two methods through which equity can be increased: it must either come through the earning and retention of profits, or it must be paid in by the owners. Again, if the business owes more than it owns, equity will be negative. Negative equity often results in painful, if not fatal outcomes from companies.

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How does all this relate? For most companies, the financial information needed to be successful is readily available. The sad reality is that very few entrepreneurs even take the time to look at this information, much less understand, interpret, and apply this information. Our recent economy has removed many of these entrepreneurs from the marketplace, but as Yogi Berra also said, "It ain't over till it's over." Start working on your business today by sitting down and spending some quality time with your financial statements. If you don't understand the statements, call a trusted advisor such as your CPA or a business consultant from the Georgia SBDC Network.

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