# Managing Your Cash Flow: The Critical (Unspoken) Ingredient of a Successful Freelance Business

(with Liz Farr)

# Summary Handout

*Disclaimer: This Academy Insider episode is for informational purposes only. Before making any decisions about your personal and/or business finances, you should always consult with a professional.*

## Introduction

When it comes to cash flow management, most of us take a “hope and pray” approach.

Which can lead to a vicious cycle of bad pricing decisions, poor-quality clients, as well as stress and anxiety.

In this installment of the Academy Insider, we dig into cash flow management and its role in running and growing a successful freelance business.

My guest for this installment — long-time Academy member and CPA Liz Farr — shows you how to manage cash flow effectively, regardless of your income level. And she explains how having a simple cash flow management system will help your freelance business thrive.

### About Liz Farr

Liz is a Certified Public Accountant and talented copywriter. Her clients are primarily accounting firms and companies that sell to accounting firms. She also writes for a number of respected journals and publications, including Journal of Accountancy, AccountingWEB and Intuit’s Firm of the Future.

**What do we mean by the term "cash flow"? Why do you feel it's more important to focus on it than income?**

"Cash flow" is the cash that comes into your business as you receive payments from your clients and the cash that goes out of your business when you pay your business expenses.

Cash flow is the lifeblood of your business. If you don't have a positive cash flow, then you have more money going out of your business than coming in — and your business probably won't last very long.

It's also a way of looking at your business at a point in time. It's a forward-looking metric in that it helps you plan for future expenses.

Income is a backward-looking metric. You can have a positive income but not have any money in the bank. If you just focus on income, you might not have enough cash to pay bills when they come due.

Many entrepreneurs make the mistake of running their business off their bank balance. They have money in the bank, so they think they have money to spend.

**When it comes to cash flow management, most of us seem to take a "hope and pray" approach. Why is that?**

Moving from employee to freelancer requires a mindset shift.

When you get paid as an employee, all that money is yours. You can do what you want with it.

As a freelancer, you can't do that. You have to pay self-employment taxes and business expenses.

Plus, most of us never really learn how to manage our money.

**Can you give us an overview of the cash flow system you use?**

The system Liz uses is based on the system described by Mike Michalowicz in his book *Profit First*.

This system is a variation of the old envelope system. With the envelope system, every time you get a paycheck, you divide it up into different envelopes. These envelopes could include things like mortgage, food, electricity, gas, vacation, rainy day fund, entertainment, etc.

The money you put into each envelope is all the money you have to spend on that category.

Michalowicz adds another layer to this system by building in profits. In the envelope system, your profit is whatever's left over after pay all of your expenses. This makes it a low priority.

But with the Profit First system, you take out your profit at the beginning. It's the "pay yourself first" philosophy applied to businesses.

As service-based professionals, we tend to confuse profit with owner compensation.

Owner compensation is what we pay ourselves to live on.

Profit is our long-term savings. It's our nest egg and safety net. It can also be "fun money."

Under the Profit First system, you set up different bank accounts for categories instead of using envelopes.

Then, you set up target allocation percentages for each category.

**Describe the categories that Michalowicz suggests**

1. **Income account:** Where all payments from clients go, including deposits, wire transfers, PayPal transfers, and checks.

2. **Business expense account:** Use to pay business expenses.

3. **Long-term savings account:** Use for long-term savings.

4. **Owner pay account:** Use to pay yourself.

5. **Tax account:** Use to pay taxes. Michalowicz suggests making this account hard to access so you're not tempted to spend it on other things.

Liz uses a simplified version of this system. She has set up four accounts at her credit union (instead of five) by combining the income account and business expense account.

As you get money from clients, you periodically allocate a percentage of this income to each account. Michalowicz suggests the following allocations:

- 10% to profit
- 50% to owner pay
- 25% to tax
- 15% to business expenses.

These are just estimates. If you're just starting out, you may need time to reach these percentages.

You can estimate your tax account allocation percentage by looking at what you paid in taxes last year.

**When do you transfer these allocations from your income account to the other accounts?**

Liz goes into her income account on the 10th and 24th of each month and adds up all of her client deposits since the last allocation.

She will then transfer the allocation amounts into the separate accounts.

Before she makes the transfer, she considers what will be left in her checking account. If she won't have enough to pay expenses, she will lower the profit allocation — although she tries not to.

On allocation days, she will also pay herself by transferring money from her owner pay account to her personal account.

**Does this create a bookkeeping nightmare?**

This system may seem complicated at first, but today's cloud-based accounting software makes it much easier. You can set up a system that will automatically import transactions from your bank account. So it's not extra work.

Don't try to do this manually in Excel!

Once you get the hang of it, it's pretty easy. It forces you to have some discipline and helps you get a better handle on your business.

**Can I change my allocation percentages?**

Yes, you can, and you should! You can start with Michalowicz's percentages and then tweak as you go. As your business grows, your needs will change.

**What will this do to my taxes?**

Putting your money into separate accounts won't change your tax return.

However, it will make tax preparation easier and eliminate the headache of trying to find money to pay taxes every quarter.

**Why should I bother with separate bank accounts? Can't I just do this with a spreadsheet?**

You could do that. But it's a lot of extra mental work every time you log into your bank account. With money coming in and expenses going out, you'll spend a lot of time trying to reconcile things.

**What simple next steps can someone take to get this system kick-started?**

Start by setting up some bank accounts. (Make sure all your business accounts are separate from your personal account!)

Set aside a percentage of your income for long-term savings — even if it's only one percent.

Then figure out how much you should pay yourself every month.

Liz also recommends ordering a copy of *Profit First* by Mike Michalowicz.

**What other resources do you recommend?**

*Simple Numbers, Straight Talk, Big Profits* by Greg Crabtree.

*The Creative Professional's Guide to Money* by Ilise Benun.

Mike Michalowicz also has a podcast, and you can find him on YouTube.

**Where can listeners learn more about you?**

Liz Farr's website

LinkedIn

Twitter