

The Ups and Downs of Cash Flow

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Let's start out with where to look for problems. There are some areas of the financial picture that drive cash flow in every business. Then we'll look at how those areas act in combination – and why things get confusing when they do. We'll wrap up with some suggestions on how to protect your company in the future.

Where do you want to look, when figuring out what's going on with cash flow? Here are your top targets: accounts receivables – the money your customers owe you, spending on bigger ticket items, taxes you'll have to pay in the future, deposits from customers, cost of goods sold, overhead costs, loans and leases, inventory, reserves, and new business. Sounds like a lot? Just about every part of your business affects your cash flow picture, in one way or another.

Here's one important set of outcomes to keep in mind. As your business grows, your cash flow will go down, not up. As the business slows, your cash flow will go up. Sounds crazy, doesn't it? Read on, and you'll get some insight into why this happens.

Let's take a look at how these different areas of your business affect cash flow, when taken independent of each other.

Accounts receivable is the money your customers owe you. It isn't cash. You can't deposit it, or pay employees or vendors with it. You

can only hope it comes in sometime in the future. Accounts receivable is a predictor of what future income might be, based on how long it typically takes clients to pay you, and depending on how many clients tend to stiff your company for part, or all, of the invoice. On its' own, then, a/r is only a prediction tool.

Buying a new computer network, acquiring new equipment for you field operations, upgrading equipment on the shop floor, and expanding operations, in order to bring in a new line of business, are all examples of spending on big ticket items. So are buying a car or truck, upgrading the office furniture, painting and installing new carpet. You get the idea – laying out bigger than normal dollars. The mistake most companies make is taking the money directly out of deposits to pay for these items. That usually leads to the company being caught short elsewhere, financially. Instead, you want to pay for big ticket items by taking money out of reserves or through financing, assuming you know the business can afford it. The other big mistake many owners make is they buy based on need, or assumption of need, rather than basing the decision on future cash flow. How many times have you said, I need it, therefore I'll have to make it work. I know I have, on occasion made that mistake. Unfortunately that's not necessarily the smartest way to go.

“Taxes you'll owe in the future” is often overlooked as we plan cash flow, because it's so hard to figure out. Taxes are based on profit, and until you get to the end of a period and know how much profit you're going to make, you can only guess at how much tax you'll have to pay. As a result, many businesses end up paying taxes this year for work done last year. And that distorts the picture, as you charge taxes against a period different from the period in which the liability was incurred.

“Deposits from customers” refers to the money you put into a bank account, because customers pay their bills. You may get a payment today for work your company did yesterday, last week, last month, last quarter, last year, 5 years ago – you get the idea. Deposits vary based on a number of factors, including how good your company is at hounding customers to pay their bills, and the financial strength of the markets your customers occupy. The time of the year can affect cash flow - for example things often get sticky in retail right after April 15, as we finish paying our tax bills. General economic trends and real outliers like hurricanes, terrorist attacks, snow days, and your client's bookkeeper calling in for holiday or illness, can hurt, or help your cash flow – usually we notice when it hurts. Deposits are the heart of cash flow, and may be generally predicted based on historical trends, but, because of

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the list of variables, may swing seemingly without warning.

Cost of goods sold (COGS) is what it costs your company to produce and deliver whatever you sell, whether that's a product or a service. I like to include sales commissions, but not sales salaries, in COGS. Definitely include travel and shipping costs, if they are incurred as part of delivering your products or services. As the business grows you spend more actual dollars producing what you sell. If the business shrinks, so should your cost of goods sold, in terms of actual dollars. That's why we measure cost of goods sold as a percentage of gross revenue, rather than referring to it in actual dollars. You want to watch cost of goods sold like a hawk, because if you don't, you may let expenses get out of hand, and eat into profits.

Overhead costs are the expenses your business incurs, whether you sell anything, or not. Things like rent, phones, computers and copiers, sales salaries and marketing costs, general business insurance, payroll for office staff, are some of the expenses that belong here. Some businesses have higher overhead than others. For example, you may have high end customers who visit you often and expect to see a nice, well outfitted office when they do – think of banks, accountants and attorneys, for example. Other businesses never

see their customers, outfit their employees with laptops and have them work from home, or run the business from a cell phone – these firms would have much lower overhead, typically. Of course, as the business expands, so will the overhead, but much more slowly than COGS does. That's why we look at overhead expenses from period to period as fixed.

Loans and leases are to pay for things you need or want to acquire. They allow you to spread out payments over time, rather than hitting cash flow all at once. You can over burden the business with loans, otherwise known as debt, by buying too many things on credit.

Inventory mostly applies to manufacturing and wholesale companies. Fortunately for service companies, this is one variable they don't have to deal with. The big factor with inventory is turns, or the number of times in a year that a company sells what it holds in inventory. You want to work on keeping inventory low, without hurting your ability to deliver within reasonable timeframes. Production and supplier efficiency directly impact the amount of inventory you need to carry. If you can produce quickly, and if your suppliers can get things to you quickly, you can keep your inventory costs down; if not, you're going to eat up profits carrying inventory.

Reserves are what you put away for a rainy day, for big dreams, and for things that come up. In other words, you want to have money available when things don't go according to plan. And most entrepreneurial businesses, in my experience, don't have enough set aside. There are lots of reasons why, which may be another article for another day. For today, let it suffice to say that you need 6 months of expenses, set aside, to be really secure. Reserves are what you use, when cash flow dips.

New business is a tool. It makes the business healthy by creating a future. It brings in revenue. It brings with it new ideas, excitement, headaches and problems to solve. It also eats up cash flow.

Here's what happens as a business expands. New orders or requests for services come in – more than you've handled in the past. You have to order more parts, inventory and equipment, hire more people to do the work. You know the drill. You have to lay out money upfront to do that. You eat up cash flow to get things set up for expansion.

Additionally, you're feeling really great about all those new orders or requests for services. So you approve a couple extra expenditures, give out a couple raises, figure it's time for bonuses, lease a new car for yourself, upgrade the shop or the

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office. There's always been a long list of things to spend money on. With new, additional revenue coming in, it seems like a good time to get a few extra things done. You dip into cash flow to do it.

You decide to pay for a couple big purchases outright. Or, you add a new person to the payroll. After all, you'll have money coming in shortly, so you figure you'll be alright. There goes some more of your existing cash flow.

As you produce and deliver the extra orders, or deliver the expanded services, your operations group has a few problems handling the newly expanded volume. Things are less efficient than you expected. That waste eats into cash flow in the form of extra payroll, extra material, and credits to customers to earn back goodwill.

You prepare invoices and bill customers. Unfortunately, most customers don't pay right away. The bills for the parts, inventory, equipment and people's salaries have to get paid before you get enough money in from customers to pay the bills. You use what cash flow you have to pay what you can.

When you run short on cash, you stop paying some or all of the bills coming in. That means you get behind with accounts payable, and end up paying interest and late fees. Now you

owe more than you planned, and have to wait it out until customers pay. Cash flow dips again. And some customers may pay really late, or pay less than they owe. Cash flow dips again.

Whatever reserves you had on hand turn out to not be enough. You use them up, and need more. You hit the bank for a loan, which you get, if you're lucky and are not already over extended. Now you owe principle and interest. Cash flow dips gain.

More orders come in, requiring you lay out more funds in advance of payments. Cash flow dips again. Voila. All that great opportunity you saw coming, all those wonderful new orders or requests for more services, is now looking like the lights of an oncoming train. Then, just when you think you're at the end of the tunnel, your accountant tells you about the tax bill you're going to have to pay for all of that profit you supposedly made, but never got to realize in terms of cash flow. Boom! You've been knocked into the cash flow trench, and your business is suffering from all that seemingly wonderful growth opportunity.

By now you should be getting the idea. As income grows, cash flow dips. But, you say, it will all catch up in the end. Yes, it may. But in the meantime, you use up a lot of the profits chasing cash flow you need but don't have, filling in

gaps and trying to fix problems related to cash flow gaps.

All that wonderful growth opportunity turns into a major pain in the neck. It's enough to make you think that growth isn't worth pursuing. Before you give up, however, there are some things you can do to preserve and protect cash flow.

Here's your checklist, to protect against cash flow dips. Have money set aside for reserves; get your reserve fund to at least 3 months of expenses – 6 months is better. Negotiate terms with customers to include upfront payments, and interest charges for anything over 30 days. Focus on growing customers that pay right away; wean yourself off customers who pay over 90 days – they're risky and hard to manage. Keep a tight lid on inventory and inventory costs. Know your cost of goods sold percentage, and keep in on target. Hold the line on expenses. Demand more efficiency from your operations as you take on more volume. Build a budget and a forecast; include future tax payments and funds to cover things that go wrong. Stick to a plan of slow, steady growth. Use loans wisely and carefully, as part of your overall plan. If you do take on a growth leap, get your likely cash flow gap taken care of before you start, and then stick with the plan until things stabilize again.



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