Avoiding Cash-Flow Problems

By BNET Editorial

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Cash flow is the life blood of any business, and a core indicator of an enterprise's financial health and viability. While not a failsafe way to appraise performance, cash flow is as good a barometer as any to quickly judge the financial performance of an entire company, an operating unit, or a specific project. Invariably, cash flow is among the key measures used by analysts and prospective investors to judge a business.

Cash flow is easy to understand. Essentially, it expresses the comparison between the money received over a given period of time, and the money spent. No business can endure for long if cash flow is negative. That is why many experts insist cash flow is the number one cause of business failures—and why companies need to avoid cash flow problems.

What You Need to Know

Exactly how is cash flow used?

First and foremost, it evaluates ongoing business performance. Cash flow also can identify liquidity problems. That is important, because being "profitable" does not necessarily mean being liquid, i.e. having cash in hand to pay bills or to act on unexpected opportunities. Plenty of profitable companies fail because they lack cash at critical times. Cash flow is also used to examine income and/or growth, especially when other accounting methods, like the accrual approach, for example, will not accurately or fully reflect economic reality. Cash flow is also used to help gauge a projected rate of return, because it tracks when money flows into and out of a project or business venture.

Are there different kinds of cash flow?

Yes, indeed. "Operating cash flow" is the cash a company's core business receives and spends during a given period of time. Needless to say, this comparison is critical. "Investment cash flow" tracks the monies collected and spent by a capital expenditure to help reveal whether or not the investment was wise. "Financing cash flow" tracks money collected and received from financial activities, for example, receiving or paying down loans, paying dividends and issuing or repurchasing stock. Finally, there is also "free cash flow," which refers to monies available for distribution among a business's stockholders and debt holders.

What is a cash flow statement?

It is one of four primary financial statements a business will issue. A cash flow statement reveals a company's short-term viability. If cash is increasing, a company is considered healthy, at least for the time being; it can meet its payroll, pay its bills and remain solvent. Negative cash flow is a red flag, because it indicates exactly the opposite. Properly prepared, a cash flow statement identifies the sources of cash being generated: operations, investment, and finance. This is important because while one source may be generating too little cash, other sectors may offset it and vice versa. Examined carefully, a cash flow statement can detect fraudulent business practices. In 2002, for instance, WorldCom, which had been a high-flying U.S. telecommunications company, was found to be classifying ordinary expenses as "capital investments," an accounting practice that helped make net income look far more robust than it really was. A careful look at the cash flow statement sooner might have exposed the practice and saved investors millions, if not billions.

What is "discounted cash flow analysis?"

This term defines the cash a project will generate in future years by using the concept of the time value of money, i.e., the value of a dollar or a Euro will be different in the future than it is at present. It is typically used for long-term planning by corporate financial managements, often to help gauge the long-term profitability of a major investment, capital project, or real estate development. If, for instance, a venture is projected to generate a profit of $10 million, the time value of money concept holds that the sum will likely be "x-percent" less due to inflation or other factors—a situation that investors need to consider.

What to Do

Be Realistic

To some, "cash flow" means nothing more than, "Do I have enough cash available to pay bills?" Yes, it sounds simplistic, but the implication of that question is ignored far more than it should be, and by persons who should know better. Company owners need to be realistic about the cash their venture will generate, and ruthlessly so. That means being conservative and not overestimating revenues and income while creating "worst-case" scenarios to estimate expenses. Being ambitious and confident is an important attribute any new venture needs, but only to a degree. Being wildly optimistic is foolish and downright dangerous. A common cause of cash flow woes—and business failures—is that managements are confronted by a sudden and unforeseen expense, do not have the cash to cover it, and run out of money.

Use a Spreadsheet and Track Cash Flow Exhaustively

Using a computer spreadsheet to carefully track cash in and cash out should enable a business to both spot potential problems early and address them successfully. Experts recommend projecting at least three months into the future; projecting twelve months is even better and often recommended. Regular updates are just as important, because predictions are just that, and as often as not can be wrong.

Spend with Care, Especially at First

Constantly asking, “Do I really need this?” is almost essential. If the answer is “No,” hang onto your money. It is easy to be lulled into “needing” a new computer, telephone system, prestigious automobile, or fancy office suite, but not at the expense of not being able to meet your payroll or pay for machinery you *do* need. Bartering for certain services and equipment is another way to keep down expenses, but it has its limits and its pitfalls—one of them being bartering for unneeded services just because they look attractive and are available.

Grow with Care

Yes, expanding is a worthy objective, but wild, unbridled growth can be dangerous and even fatal. It often leaves a company facing mushrooming expenses without the revenues to cover them. This is a classic example of escalating negative cash flow. A tool that can help to manage growth is what is called the “cash conversion cycle,” or “CCC.” Essentially, it is the time it takes to convert business activities that require cash (and other resources like time) into revenues. A CCC that is declining is desirable; one that is growing is cause for concern.

Arrange for Payments in Stages

For large projects especially, being paid in several increments can help cash flow immensely. For example, an initial deposit, then periodic payments as portions of the project are completed and delivered.

Monitor and Cut Expenses Whenever Possible

Cutting costs is never a one-time exercise. Make it a point to be always looking for ways to get something for less, or to eliminate a cost altogether. For example, does your business need all those telephone lines? Communications technology being what it is, one line may deliver the services of three. Or, might independent sales agents generate as much or more business as an in-house sales team but without the overhead costs of benefits? A recommended way for an owner to study expenses is to simply review all the checks that are written for a given month—or, better still, sign all the checks yourself.

Do Not Let Unpaid Receivables Linger

If someone has not paid a bill by the due date of the invoice, find out why. Badgering a customer is not fun, but if the customer gets the notion it can get away with paying you late, you can guess which company will be placed last on the list. Yours! Customer service is vital, but it need not and should not extend to your company becoming your customers' de facto banker and creditor.

What to Avoid

You Isolate "Operating Cash Flow"

Used alone, it can distort a company's true position. Operating cash flow also can be manipulated to hide problems. For instance, a company having trouble collecting what it is owed could sell its receivables (monies to be collected) as a bulk item for less than the face value amount. That does generate cash—once—but it also may hide long-term problems with customers or poor collection practices.

You Assume People Pay on Time

Many do not, so simply expect customers to take more time to pay that you would like, and plan accordingly. If cash is dependent upon a certain customer paying on time, contact the customer several weeks ahead of the due date to ensure prompt payment. It is not uncommon to offer discounts for prompt payment. If such a plan is offered, though, be sure your company's cash flow statement reflects it.

You Fail to Build Cash Reserves

Initial success, or a single project that generates a great deal of cash can easily give a false sense of security and lead to a spending spree, instead of to savings put aside for a rainy day. Tales of malfunctioning computers suddenly requiring thousands of dollars in service costs for businesses that can ill afford them are legendary. So are tales of a major customer suddenly going out of business or taking its business elsewhere. The lesson is clear: whenever possible, save extra cash, just in case. Having enough to cover at least two to three months' worth of expenses is best.

You Rely On Just One or Two Customers

Having to depend on one or two customers or clients is living dangerously. For one thing, a client who knows "he's all you've got" might be more inclined to drag his heels and delay paying his bills. A diversified roster of customers is sound protection against cash flow woes.

You Take On Too Much Debt

When borrowing money, understand fully what the payback schedule and terms are. Do not assume that "future profits" will cover what is owed, especially if it is a hefty amount. After all, "future profits" might wind up being much leaner than anticipated.

Where to Learn More

Books:

Campbell, Philip, Never Run Out of CASH. Grow and Succeed Publishing, LLC, 2004.

Tracy, John A., CPA, and Tage C. Tracy, How to Manage Profit and Cashflow: Mining the Numbers for Gold Hoboken, NJ: Wiley, 2004.

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ArticleBiz.com: www.articlebiz.com/article/131–1

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