



ALEXANDER ASSOCIATES

Cash Flow – The Pulse of Your Business

There are frighteningly many small business owners out there who do not understand their cash flow statement. A shocking fact considering that all businesses essentially run on cash. And Cash flow is the life-blood of your business. Some business experts go so far as to say a healthy cash flow is even more important than your business's ability to deliver its goods and services! You may find that perspective hard to swallow, but consider this – if you fail to satisfy a customer and lose that customer's business, you can always work harder to please the next customer. But if you fail to have enough cash to pay your suppliers, creditors, or your employees, you're out of business!

What Is Cash Flow?

Cash flow, simply defined, is the movement of money in and out of your business; these movements are called inflow and outflow respectively. Inflows for your business primarily come from the sale of goods or services to your customers. The inflow only occurs when you make a cash sale or collect on receivables, however. Remember, it is the cash that counts! Other examples of cash inflow are borrowed funds, income derived from sales of assets, and investment income from interest.

Outflows for your business are generally the result of paying expenses. Examples of cash outflow are... paying employee wages, purchasing inventory or raw materials, purchasing fixed assets, operating costs, paying back loans, and paying taxes. Your accountant is the best person to help you learn how your cash flow statement works. At your annual review or audit, make sure your accountant explains where the numbers come from in your cash flow statement.

Cash Flow Verses Profit

Profit and Cash flow are two entirely different concepts, each with entirely different results. The concept of profit is somewhat broad and only looks at income and expenses over a certain period of time, say a fiscal quarter. Profit is a useful figure for calculating your taxes and reporting to the IRS.

Cash flow, on the other hand, is a more dynamic tool focusing on the day-to-day operations of a business owner. It is concerned with the movement of money in and out of a business. But more importantly, it is concerned with the times at which the movement of the money takes place.

Theoretically even profitable companies can go bankrupt. It would take a lot of negligence and total disregard for cash flow, but it is possible. Consider how the difference between profit and cash flow relate to your business. For example, if your retail business bought a \$1,000 item and turned around to sell it for \$2,000, then you have made a \$1,000 profit. But what if the buyer of the item is slow to pay his or her bill, and six months pass before you collect on the account? Your retail business may still show a profit, but what about the bills it has to pay during that six-month period? You may not have the cash to pay the bills despite the profits you earned on the sale. Furthermore this cash flow gap may cause you to miss other profit opportunities, damage your credit rating, and force you to take out loans and create debt. If this mistake is repeated enough times you may even go bankrupt!

Analyzing Your Cash Flow

The sooner you learn how to manage your cash flow, the better your chances for survival will be. Furthermore you will be able to protect your company's short-term reputation as well as position it for long-term success.



The first step towards taking control of, and properly managing your company's cash flow is to analyze the components that affect the timing of your cash inflows and outflows. A thorough analysis of these components will reveal problem areas that lead to cash flow gaps in your business. Narrowing, or even closing, these gaps is the key to cash flow management.

Some of the more important components to examine are:

Accounts Receivable. Accounts receivable represent sales that have not yet been collected in the form of cash. An account receivable is created when you sell something to a customer in return for his or her promise to pay at a later date. The longer it takes for your customers to pay on their accounts, the more negative affects there will be on your cash flow.

Credit terms. Credit terms are the time limits you set for your customers' promise to pay for the merchandise or services purchased from your business. Credit terms affect the timing of your cash inflows. One of the simplest ways to improve cash flow is to get customers to pay their bills more quickly.

Credit policy. A credit policy is the blueprint you use when deciding to extend credit to a customer. The correct credit policy is necessary to ensure that your cash flow doesn't fall victim to a credit policy that is too strict or to one that is too generous.

Inventory. Inventory describes the extra merchandise or supplies your business keeps on hand to meet the demands of customers. An excessive amount of inventory hurts your cash flow by using up money that could be used for other cash outflows. Too many business owners buy inventory based on hopes and dreams instead of what they can realistically sell. Keep your inventory as low as possible.

Accounts payable and cash flow. Accounts payable are amounts you owe to your suppliers that are payable sometime within the near future, "near" meaning 30 to 90 days. Without payables and trade credit you'd have to pay for all goods and services at the time you purchase them. For optimum cash flow management, you'll need to examine your payables schedule.

Some cash flow gaps are created intentionally. That is, a business will sometimes purposefully spend more cash to achieve some other financial results. For example, a business may purchase extra inventory to take advantage of quantity discounts, accelerate cash outflows to take advantage of significant trade discounts, or spend extra cash to expand its line of business.

For other businesses, cash flow gaps are unavoidable. Take, for example, a company that experiences seasonal fluctuations in its line of business. This business may normally have cash flow gaps during its slow season and then later fill the gaps with cash surpluses from the peak part of its season. Cash flow gaps are often filled by external financing sources. Revolving lines of credit, bank loans, and trade credit are just a few of the external financing options available that you may want to discuss with your accountant.

Managing Your Cash Flow

Now that you have considered how your business practices affect your cash flow, you are ready to develop some additional strategies for dealing with, narrowing, or closing cash flow gaps.

Contingency plans. You should have a "life is beautiful" plan a "life is life" plan and a "don't even talk to me about life" plan. The first plan forecasts high sales, low expenses and everything going



better than expected. The second is based on realistically achievable sales and honest expenses. The third plan specifies how to survive if everything goes wrong. The flag for going from the realistic plan to the survival plan is a sudden or steady decline in sales.

Cash Forecasting. The biggest problem for business start-ups is the owner failing to plan for how much cash the business needs throughout the year. This applies especially to businesses where payments usually come in over several months or after the work is complete. Business owners must also forecast expenses that aren't due each month, such as annual insurance premiums.

Spending Controls. Keep an eye on all spending; try to keep enough money in the company to get through tough times. New business owners are often tempted to spend too much for nonessentials. Make sure you carefully negotiate leases and solicit price quotes from several vendors to find the best value. Also, stop selling products that are losing money and avoid buying assets that require substantial cash outlays.

Accumulate Salary. If necessary to maintain a positive cash flow, you may need to forfeit part of your own salary. Many entrepreneurs go bankrupt because they don't pay attention to the financial state of their business and insist on paying themselves big salaries no matter what.

Add Employees cautiously. Delay hiring workers as long as possible. Instead, look for ways to maximize your own productivity and that of any existing employees. Also consider lower-cost alternatives, such as outsourcing work to independent contractors.

What To Do With A Cash Surplus

Managing and improving your cash flow should result in a cash surplus for your business. How you handle your cash surplus is just as important as the management of money into and out of your cash flow cycle.

Paying down any debt you have is generally the first option you should consider when deciding what to do with your cash surplus, because a short-term investment is not likely to yield a return equal to or greater than the rate of interest on any of your debt. However, the decision to automatically pay down debt may not be correct in all cases. Your accountant is the best person to help you make these decisions.

Monitoring and managing your cash flow is an important task to perform in order to ensure the vitality of your business. The first signs of financial woe will appear in your cash flow statement, giving you time to recognize a forthcoming problem and plan a strategy to deal with it. Furthermore, with periodic cash flow analysis, you can head off those unpleasant financial glitches by recognizing which aspects of your business have the potential to cause cash flow gaps. With cash flow management and analysis, you will be able to plan on how you're going to direct your cash surplus with assurance that you will have adequate funds to cover day-to-day expenses.