UNDERSTANDING CASH FLOW

Cash is king in small businesses and serves several purposes. First, it is used for meeting normal cash obligations (i.e: paying bills). Second, it is held as a precautionary measure for anticipated problems. Third, it is held for potential investment purposes. The term 'cash' refers to:

- Cash
- Check
- Money Orders
- Checking Accounts

The Operating Cycle – The operating cycle can be defined as the system through which cash flows, from the purchase of inventory through the collection of accounts receivable. It measures the flow of assets into cash and is, in effect, a business stopwatch. For example, the operating cycle may begin with both cash and inventory on hand. Additional inventory is purchased on account to work as a cushion for future sales to guarantee that you will not deplete your stock. Except for cash sales, when some inventory isn't sold, accounts receivable increases, but your cash doesn't.

Typically, you pay for the inventory you have purchased thirty days after its received. When the payment for inventory is made, both cash and accounts payable are reduced. Thirty days after the sale inventory, receivables are usually collected, which increases cash. Now your cash has completed its flow through the operating cycle and is ready to begin again.

Current Assets – Cash and other balance sheet items which convert into cash within twelve months are referred to as current assets. Typical current assets are:

- Cash
- Marketable Securities
- Inventory
- Receivables
- Pre-paid Expenses

A Plan is Necessary – Cash flow analysis shows whether your daily operations have generated enough cash to meet your obligations and it shows how major outflows relate to major inflows. As a result, you can tell if inflows and outflows from your operation combine to result in a positive cash flow from operations or in a net drain. Any significant changes over time will also appear. Understanding this will lead to better control of cash flow and will allow adequate time to plan and prepare for the growth of your business.

It is best to have enough cash on hand each month to pay the cash obligations for the following month. A monthly cash flow projection helps to project funds and compare actual figures to past months. It is important to project your monthly cash flow to identify and eliminate deficiencies or surpluses in cash. When cash flow deficiencies are found, business financial plans must be altered to provide more cash. When excess cash is revealed, it might indicate excessive borrowing or idle money that could be invested. The objective is to develop a plan which will provide a well-balanced cash flow.

Planning a Positive Cash Flow – To achieve a positive cash flow, you must have a solid plan. Cash reserves can be increased by:

- Collection of Receivables
- Tightened Credit Requirements
- Price of Products
- Loans
- Increasing Sales

Collection of Receivables – Actively manage accounts receivable and quickly collect overdue accounts. Revenues are lost when a firm's collection policies are not aggressive. The longer your customer's balance remains unpaid, the less likely it is that you'll receive a full payment.

Tightened Credit Requirements – As credit and terms are tightened, more customers must pay cash for their purchases, thereby increasing the cash on hand and reducing the bad debt expense. While tightening credit is helpful in the short run, it may not be advantageous in the long run. Looser credit allows more customers the opportunity to purchase your products or services. Be certain that the increase in sales is greater than the increase in bad debt expenses.

Loans – Loans from various financial institutions are often necessary for covering short-term cash flow problems as well as financing long-term assets. Revolving credit lines and equity loans are common types of credit used in this situation.

Increasing Sales – Increasing sales would appear to increase cash flow, but be careful. For many companies, a large portion of sales are purchased on credit. Therefore, when sales increase, accounts receivable increases – not cash. Collection of receivables is usually 30 days after the purchase date and sales expenses are most often incurred before receivables are collected. When sales rise, inventory is depleted and must be replaced. Because receivables have not yet been collected, a substantial increase in sales can quickly deplete a firm's cash reserves. By using a computer, you can maintain this critical data, as well as speed the time required to consider the 'what if' concept.

Cash Reserve – You should always keep enough cash as an added cushion for security on hand to cover expenses. But it is unwise to keep more money on hand than is necessary to keep your obligations. Excess cash should be invested in an accessible, interest bearing, low-risk account, such as a savings account or short-term CD. Keeping excess cash on hand reduces both the growth and the return on investment.

Projections – Good accounting records and projections are important tools for a small business. Qualified accountants are necessary to help keep your records accurate and current. However, you can reduce your accounting expenses by producing your own summary statistics and projections. With the help of a computer and a good financial management package, you can successfully project your future activity, as well as use the 'what if' analysis to test various management decisions.

Preliminary Income Statement – Basic financial statistics are generally available for most businesses from trade and industry associations, government agencies, universities, banks, and the Indiana Small Business Development Center. These statistics, however, are based on the results of companies that have been operating for many years and that have millions of dollars in sales and revenue.

The performance of your company (at least initially) will most likely not mirror that of those larger corporations, thus, you should forecast your own income statement based on the figures you believe are feasible and accurate. Do not be influenced by industry figures. In analyzing the financial projections of your company, consider the following:

1. What is the normal makeup in this line of business, i.e., the dollar difference between the cost of goods sold and selling price, expenses as a percentage of sales?
2. What is the average cost of goods sold as a percentage of sales?
3. What is the average inventory turnover, i.e., the number of times the average inventory is sold each year?
4. What is the average gross profit as a percentage of sales?
5. What is the average net profit as a percentage of sales?
6. Take the preceding figures and work backwards using a standard income statement format and determine the level of sales necessary to support your desired income level.
7. From an objective, practical stand point, is this level of sales, expenses and profit attainable?