

Cash Flow - The Key To Success

"Cash flow... the key to success" should perhaps be renamed "Cash flow... the key to survival!"

Australian Securities & Investments Commission statistics tell us that in 2004 and 2005 there was an average of 18,000 businesses that entered into external administration or insolvency. Furthermore, the Small Business Development Corporation statistics tell us that 60% of small businesses fail in the first three years of operation. We believe that in many, instances, these failures are due to a lack of understanding of the importance of cash flow.

The flow of cash, in and out of your business, is its lifeblood. Whoever said "You'll never go broke making a profit" got it absolutely wrong. You may be trading profitably in the sense that you are "making a profit", but unless your cash flow is under control, you could go out of business.

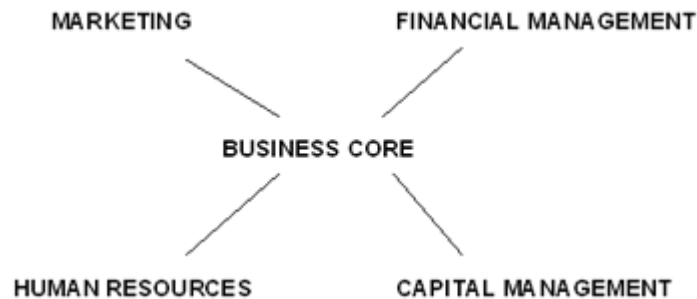
Today's economic conditions make cash flow planning even more critical to the survival, growth and profitability of your business. It is fundamental that appropriate forward cash flow planning be undertaken to assist in survival. With little or no planning you could be forced to borrow additional funds or even have to sell up to cover debts.

The business structure

It is important for you to know just where cash flow management fits into your business cycle in terms of invoicing and retentions and why cash flow is different from profit.

Principally, profit should never equal cash flow.

For example, recognition of income under the Australian Accounting Standard AASB 1009, requires recognition of revenue and expenses by reference to the stage of completion of a contract. This is often referred to as the percentage of completion method, which means that there will be a difference that arises between profit and cash flow. Alternatively, you may have purchased capital assets that reduces cash flow and only provides a portion of the asset as an expense/depreciation.



As highlighted by our diagram, all businesses require a finely tuned business structure. The correct balance of Marketing, Human Resources, Financial Management and the Management of Capital will provide a solid foundation for the successful operation of your business.

If the information regarding your market is not up to date, you could find that your turnover could drop significantly while you are geared up for further expansion. Therefore, your cash flow will drop, as will your return on capital invested.

Financial management

Within the business structure there is one area that is often overlooked. It does not have the excitement of gaining a new contract, the appeal of capital equipment expansion or a new staff appointment.

And yet it is the most fundamental and vital part of your business. It is the area of financial management. Without sound financial management your business will simply not survive.

We suggest, that as a minimum requirement your business should have:-

Financial reports - which should include detailed profit and loss statements, balance sheet and statistical performance indicators.

Three way budgets - that should include profit and loss forecasts, balance sheet forecasts and cash flow forecasts.

Businesses should have, as a minimum, monthly financial reporting including a detailed profit and loss statement and on a quarterly basis compare actual results with forecasts.

It is far simpler to combat a problem before it actually happens!

The need for cash flow management

A common mistake of many businesses is to concentrate too much on profit - and too little on cash flow. And yet without a balanced cash flow, your business cannot survive. Profits are essential for the long term survival of all businesses and it is essential to find the correct mix of cash flow and profit management.

We have all seen the number of corporate collapses, where companies who were reflecting excellent profits due to expansion found themselves "caught by the cash flows", ending eventually in liquidation.

As business owners, you represent a prime example of private enterprise, with all its risks, yet with all its rewards.

So concentrate on cash flow. Because it will provide you with:-

Discipline,
Direction, and
Control in your business environment.

Businesses only fail when they run out of cash sales. They say a dead man never hears the bullet that shot him. So if you know what's coming - you can duck!

Had a talk to your bank lately?

We bet you have. And haven't things changed? The reality is that businesses are now required to justify their future cash flow predictions to their financial lending institutions, and in some instances even to their creditors.

The difference between a positive and negative decision from a bank so often depends upon how you present information reflecting your current and future cash flow position.

Just what is a "cash flow forecast"?

We define a cash flow forecast as a quantitative expression of a plan of action and an aid to the coordination and implementation of financial goals.

This simply means an action plan expressed in monetary terms, preferably produced for an 18 month period on a rolling quarterly basis.

Cash flow forecasts provide a benchmark against which actual performance can be monitored and the rolling forecast can be altered on a quarterly basis to take account of current changes such as; legislature, petrol price changes, steel price changes etc.

Perhaps each one of you knows what your current cash position is - but how many of us know what our future cash flow requirements are? And what will it be in three months time?

Yet you can and should know. Because this knowledge will enable you to effectively manage your businesses cash flow and you will be in control of your own destiny!

If you have a cash flow budget which is reviewed against actual cash flow performance, on a rolling quarterly basis, you will be in an excellent position to analyse your business position and, where necessary, to implement corrective actions.

We may not be able to supply you with a crystal ball....but a cash flow budget is certainly the next best thing!

For example, a minor improvement in any of the following financial areas could contribute to a significant improvement to your cash flow improvement and success:-

Asset utilisation
Accounts receivable management
Accounts payable management
Contract negotiations

When to prepare a cash flow forecast

Let's look at the definition of a forecast. It is:

"... A quantitative expression of a plan of action and an aid to the coordination and implementation of financial goals".

So we must complete cash flow budgets on a timely basis.

As a general rule, cash flow budgets should be prepared on a rolling 18 month basis - on an ongoing basis - with quarterly reviews as a minimum. Better to be sure than sorry!

Medium to long term budgets are certainly not the flavour of the month.

A cash flow forecast provides you with the ability to effectively plan and control your expenditure in co-ordination with your income as it is received.

Who should prepare the cash flow forecast?

The answer, in most instances, is obviously... you! (unless you have an accountant to assist). Because as either manager or owner you are in a position to know what's happening within your business and what is likely to happen.

As cash management is a key to your business success, let's take a look at a cash budget and control checklist:-

1. Prepare a rolling cash flow forecast.

2. Keep your bank manager informed of your progress and your plans. If you require new finance, apply well in advance.
3. Establish an effective cash reporting system, including:

A daily cash report including surplus cash available.

A monthly bank reconciliation.

A monthly comparison of actual cash flow against forecasted cash flow.

Review your progress on projects and identify ways of speeding up cash receipts, particularly by:

Negotiating favourable contracts

Effective credit control

Prompt banking

Review payment policy and determine whether better payment terms can be achieved

How to prepare a cash flow forecast

Ordinary incremental? Priority incremental? Or zero based budgeting? There are several options, so let's take a look at them.

A. Ordinary incremental

This method involves adding a percentage to last year's figures. It is not a recommended method, although believe it or not, many businesses continue to use it.

We don't like it because it does not allow for cyclical trends and business operation/environment changes.

B. Priority incremental

This method is similar to the ordinary incremental method. However, narratives are added, describing the effect on a particular item within the forecast if the percentage figures were increased or decreased. Again, it does not look ahead and allow for trends or forecast problems and opportunities.

C. Continuous planning and rolling forecasts

Jackpot! Continuous planning and rolling forecasts involves a continuous management cycle of - planning, action, measure, forecast, re-planning. At the heart of the plan is a model (or models) of the business. A properly constructed model enables managers to test the likely impact of their plans and of uncontrollable factors. If you cannot build a model of the business and understand what drives performance, you cannot plan or forecast effectively.

Key issues to focus on include; factors most sensitive to change, factors that are most volatile/influential on profit and cash flow e.g. contract clauses, retentions etc.

Update models regularly for changing conditions, particularly; products and processes, cost drivers, capital costs, taxes etc. Updates should be looked at on a quarterly basis to assist in accountability. Why? Because it requires justification of each major variance from the forecast, and how many companies feature in yesterday's news wish they had required that!

Cash flow forecasting performance measures

As we mentioned earlier, once the cash flow forecast has been finalised it is then critical that these estimates be measured against actual performance. For instance, it is important to know how you have performed in relation to your forecasted sales and expenses and other targets defined in your cash flow forecast.

In broad terms, the process of comparing actual results with forecasted amounts provides an appraisal of the success or failure of your performance in implementing your plans. Further to this, it enables you as a business operator, to identify actions required to maintain or improve your business's cash flow performance.

Summary

Cash flow forecasting within a business provides:-

Discipline

Direction, and

Control

In other words, it provides you with the opportunity to be a master of your own destiny.

It's much better to invest time and effort in adequate cash flow forecasting than it is to put time and effort into talking to receiver managers!

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