Jerry Faulring

Cash Flow Analysis Wins the Day...*Now, More Than Ever*

I am not an accountant and apologize to any accountants reading this. I can only offer what I have learned over the years told in a non-technical manner.

Times Are Changing.

It is possible the economy as we knew it just a few years ago has profoundly changed for many years to come. It is becoming clear that the weather is changing. As members of the green industry and all involved in small business, these factors predict certain change in how we operate. Snow plows may become dinosaurs. Plants we know and love may not thrive in the new climate. Consumers may become more housebound and have less interest in their gardens. Drought may restrict water usage and extreme weather events may change everyone's priorities. All these potential changes may impact how we manage our businesses and think about the future. Ignoring what is going on around us can't be useful. In my 40 year business career I have seen six downturns and recoveries. If history repeats the cycle on time, we will soon engage another downturn. Now, more than ever, a focus on money should be a priority as we feel our way into the future securing new operating strategies, business models, and preparing for the next downturn.

Finding New Opportunities in the Financial Statements.

Many small business owners dread the idea of studying their business from a financial point of view. For many, it's not fun, it does not, in their mind, serve their business needs as importantly as making sales, analyzing productivity or a myriad of other more fun activities. This is so because of fear, lack of understanding, or the best age old excuse; "I just don't have time".

Forty years ago, when I was just starting out, I felt the same way. I was happier designing and building equipment, making sales, developing good advertising, and working on anything but financial analysis. I don't remember exactly when, but I came to that crisis year when there wasn't enough cash on hand to pay the bills precisely on time. I solved the cash problem by borrowing money and never missed an expense payment. However, it was a wake up call and I had to resolve the need with speed or risk losing the business.

I decided to make cash flow analysis into a game. The game was to prepare a cash flow statement and compare the forecast with actual results each month. I became obsessed with beating the budget, although the trick is to make the budget very realistic and not create a false sense of success at the expense of building a better business. Further, the extreme game is to do a 12 month forecast, cast it in stone, and then do the monthly analysis. Over time, one will see opportunities to capitalize on either top line cash income or all the in-between expense lines. The most important thing to consider is that an income statement only shows income, expense and profit. What it does not show is non-operating cash expenses like principal payments which can consume a lot of cash.

For many years while operating a more complex, multi-location business I had a daily, one page 'Sources and Uses of Cash Flow Statement'. That document became the most important operations tool available to me. It also caused more adrenaline spikes than any other source…both positive and negative but at least I got the bad news the day it happened; not months after the fact.

Cash flow analysis will create an intense understanding of one's business from the most critical perspective. Large businesses can pay people to perform this function but then managers may lose touch with daily cash positions and possibly lose control of the enterprise – we saw this in the financial meltdown of recent years.

Getting Started.

If you are just starting out in business, you have the greatest challenge. There is no history and even though you apply very thoughtful analysis, it's guessing. When asked about this I recommend making a very thoughtful cash flow statement; then halve the income and double the expenses. This is probably how it will work out because one will always be optimistic about sales and pessimistic about expense. This may be an extreme strategy but it will force more extreme analysis that may create the best cash flow forecast possible without any history.

If you have a history, it gets easier. Convert the last two year's monthly profit and loss statement to a cash flow statement as a starting point. A cash flow statement or forecast differs from a profit and loss statement because it shows all cash flows, some of which are not on the P&L. Think of a cash flow statement as your wallet without credit/debit cards. You put cash into the wallet and you take it out to buy things. There is no paying or receiving later; it's just cash in and out. Look at every expense line and ask yourself why it will go up or down when looking forward. The statement should be as detailed as possible without becoming ridiculous. Accountants love consolidation for eloquence and simplicity. However, the more detail a manager can analyze; the more likely one can see opportunity, or error.

My current cash flow statement has 3 lines for income (not sales – cash receipts): cash receipts less cash discounts equals net cash flowing into the business. It has 76 line items for expense! This could be easily reduced but I prefer lots of detail to track changes from year to year in every corner of the enterprise. There are 5 more lines for 'other cash income and cash expense' which typically relate to items not resulting from operations such as the sale of a piece of equipment. After this, there is one line per non-operating item such as individually identified principal payments or repayment of an operating loan or taxes paid by the owner in an LLC or sole proprietorship.

After all the addition and subtraction, there will be a number at the end of each column for each month. If the number is positive, you had more cash coming in than going out or vice versa which is the gloomy outcome. However, almost all businesses and industries experience some seasonality and there will be negative monthly outcomes. The bills can only be paid out of cash reserves or an operating loan, often called a line of credit.

If reserves are slim, one has to borrow to stay afloat. Without a good cash flow forecast, it is impossible to know how much a line of credit must be. The forecast had better be pretty accurate. The first red flag for a banker is to have you ask for more credit after the agreement is made. There will be logical reasons but there may also be bad analysis involved. Bankers just hate negative surprises.

The Details.

Previously I said I like enormous detail from which to base the forecast. For example, insurance could be lumped into one line that includes health, liability, vehicle, workman's compensation, and maybe the sailboat. I like all categories presented individually. If I forecast one line to be at $1,000.00 in July and the actual payment is $1200.00 it could be a billing error or an unexpected increase. If the increase persists for 6 months, my forecast is gone and it means I have to find $1200.00. Hourly payroll forecasts can easily go bad due to a variety of conditions, possibly out of your control, such as weather, overtime, or overruns on a project. If one has a $500,000 annual payroll budget and it is higher by $25,000 in one month it has to be corrected in future months unless income increases. There are dozens of situations that can occur in a business, any one of which may not make a huge difference but if 15 lines are over forecast, it can be catastrophic.

Embezzlement.

Small businesses are extreme targets and easy prey for employees in need of cash. I know of many such situations. I once made substantial home improvements for an office manager and never got the money returned. With perfect cash flow analysis on a monthly basis, one has a better chance of avoiding embezzlement. The very best way I can state this is to say, anyone working in your business that has access to payments coming in, bank deposits or check writing can not be trusted!! I don't care if you say "I would trust them with my life", they will steal your money if the need arises and the opportunity is made easy. Avoid embezzlement by having all banking functions put in different hands. The owner should sign checks or secure a bond on another

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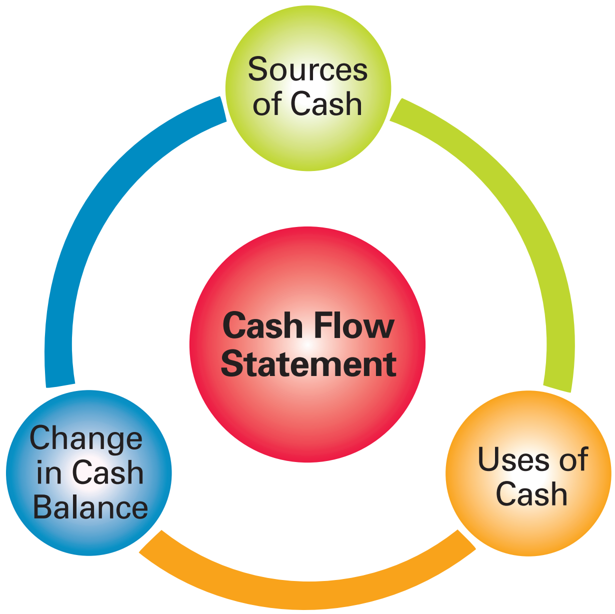
signer. There should not be any rubber stamps available to sign checks. The person counting the money should not be able to take it to the bank. This is an extremely important topic for which many experts are available for advice. One more thing. Reconcile the bank statement within days of its availability. It's a very easy way to make sure things are going as you expect. Further, banks are not responsible for bad things happening, such as fraudulent transactions, after 45 days from when the statement is available. NEVER trust that they look to see who signed a check. I lost $3200.00 to a facsimile check signed by another name; they didn't even try to forge my signature. You guessed it; the banks rammed this through Congress.



Improving Cash Flow.

Lots of businesses have reasonably good sales to support their operations but suffer from chronically slow playing customers. When one sees the income statement on an accrual basis, sales look good as do profits but this does not reflect in any way what the cash position is. Most accounting systems will show profit and loss statements for accrual basis (all income and expense; many of the transactions will be made in the future) or cash basis which is actually how cash is moving in and out of the business. Yet, it will not show non-operating cash expenses. Slow paying customers can look good if you only look at receivables in a cursory way. Having receivables is a necessary evil for most businesses but they should be as current as possible. There are ways to convert receivables to cash to pay the bills but this is often a cultural business problem rather than a customer's inability to pay. By cultural, I mean no one is tending the issue. I hear, "we've been friends forever and I know he will pay". This is an extremely dangerous position to take unless you are managing his accounting system. Best friends go bankrupt and you will be the last to know if he owes you money.

There is only one way to have cash flow occurring when you forecast it to happen; mandate that agreed upon terms are adhered to without exception. Yes, you will still have a dog in the pen from time to time but if the culture is to expect payment when it is due and you make darn sure the customer knows this expectation, predicted cash flow is more likely to happen. Persistent and timely adherence to a strong collection policy is the owner's responsibility. It's not a fun part of running a business but is much more attractive than the alternative-not having a business.

In my former business we had 30,000 retail, reoccurring customers at our peak. These were small transaction accounts averaging about $50 per transaction. For years, average receivables were about 38 days; not horrible but still not what I wanted. I implemented statements being sent every 15 days instead of 30 days and average receivables fell to 21 days. Analysis showed that the initial increased expense was offset by decreased borrowing expense. After a short while the cost became almost nothing as customers started paying faster with our new expectation in place. In this case we clearly trained the customer to do the right thing.

At Waverly Farm, I resisted taking payments with credit cards for years. As we received increasing criticism from government buyers who can reduce paperwork by half a tree's worth of paper per purchase, we agreed to use cards. I have been completely surprised at the outcome. The biggest benefit has been getting paid by folks who still had credit left but no cash. People use credit cards way too freely in my opinion but this behavior has a significant advantage of getting paid on time, sometimes months before we ship material to customers without an established credit relationship. The fees we pay are offset for me principally through reduced frustration in collecting money. This cost can also be factored into the price schedule with just a tiny increase.

Summary.

The is no more critical management tool than to perform excellent cash flow forecasting with no less than monthly analysis. It becomes a habit that will reward the business owner, its staff and vendors. No one wants to be a bank for our customers. Good collection systems coupled with vigilant awareness for cash management makes for happy times. ❦

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