

## Cash Flow Basics

Cash is the lifeblood of business. Money enables transactions, values inputs and outputs, measures performance, and funds future growth. Like a body with insufficient blood coursing through its veins, a company starving for cash is vulnerable to major health problems. Consider the analogies. When we're anemic (i.e., low red blood cell count), we're more likely to 'fail' than our non-anemic peers.<sup>1</sup> Anemia generally happens from one of three causes (let's see if we can spot the cash parallel): decreased blood cell production, excessive bleeding, and wasted/destroyed blood cells. *Hmmm*. Other low blood cell disorders can weaken our immune system – increasing the risk of being infected – and prompt unwanted bleeding in response to relatively minor trauma, sometimes even leading to death. *Hmmm!*

Positive net cash flow is *key* to business survival. Maintaining adequate cash on-hand is vital for any company seeking to be strategic and responsive to opportunities. Unfortunately, most of us aren't financial experts and may lack the understanding necessary to fully appreciate and manage cash flow. The entrepreneurial or technical gifts that enable us to launch or lead businesses aren't always accompanied by the knowledge of finance needed to sustain a healthy, growing business. For many of us, our immediate reaction to a cash flow problem is, "Sell more!" Unfortunately, this 'solution' may actually serve to *worsen* our cash position unless we're already 'in stock' or sell on a payment-up-front basis. Sadly, many talented companies have failed or been sold due to poor cash planning and management.

### A Costly Blind Spot

Cash flow management is often a blind spot for CEOs who think that looking at their P&L in the rearview mirror, and then reacting, suffices as financial leadership. In fact, *forward-looking* cash management, according to specific plans and goals, is necessary for sound financial stewardship. 'Rearview mirror' cash management can bite us, becoming a surprise stumbling block with negative long-term consequences. Many CEOs 'suddenly' find themselves strapped with excessive debt or dwindling cash that threatens to impact their stakeholders. Because they don't proactively manage future cash availability, they sometimes make major discretionary expenditures they don't know they *can't* afford. Most companies need an annual cash plan and should always be looking *at least* three months into the future at detailed projections of cash sources and uses. Since this segment can't possibly cover all of the related key concepts, checkout today's appendices and a few previous C12 segments<sup>2</sup> to go deeper.

### Cash Flow 101

Next, let's (1) simply define cash flow, (2) discuss typical problems and their root causes, and (3) look at ways to proactively address these challenges.

**Net Operating Cash Flow** is what we produce from our basic business model as determined by the calculated difference – positive or negative – between incoming and outgoing cash during a specified timeframe. It can be measured daily, weekly, monthly, quarterly, or annually, depending on our businesses' unique dynamics. A simplified formula is as follows:

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- Cash in from sales (*actually* collected, not simply shipped and invoiced)
- Operating costs incurred (payroll, materials, overhead expenses, etc.)
  - Interest paid
  - Taxes paid
- +/- Net change in working capital (inventories + receivables – payables)
- = Net Operating Cash Flow

Note that this calculation ignores depreciation/amortization expense (an accounting way to expense previously purchased assets for profit reporting purposes) and income on financial investments held on the company books, since they have nothing to do with the operational performance of the business. Net Operating Cash Flow describes the cash our company internally generates to fund discretionary spending on such things as owner dividends, new capital expenditures, and other non-operating items (e.g., unplanned ministry initiatives).

When the calculation described above produces a positive number we're said to have 'positive' cash flow. A healthy business, with consistently positive cash flow, is freely able to grow and deal with most real-time issues and opportunities. We can also have 'negative' cash flow. There's a limit, however, to how long a business with a negative cash flow can survive. We can have huge short-term variations in cash flow as the inflows (sources) and outflows (uses) of our cash reflect uneven operating performance and our unique 'cash conversion cycle.' This cycle is essentially the time span between initially incurring expenses and ultimately collecting from a customer as we provide a given product or service. On each *individual* customer order, our net cash flow is the 'contribution margin' or difference between the actual 'out-of-pocket' expense we incur (i.e., net of depreciation and fixed costs) and the customer's payment.

Most of our expenses are front-end loaded. We incur expenses while expecting future sales to be made at a sufficient price to cover them, routinely obligating ourselves to pay them before we can fully collect from our customers. This requires us to have 'working capital' to fund our operation while awaiting future customer payment. Working capital can come from several sources: previous period retained earnings, customer deposits or prepayments, investor equity, or borrowing. We need to have sufficient working capital to cover the variation in our outflow and inflow, and to invest in future growth. But we shouldn't 'blindly' take in additional investment or borrowing to cover these requirements, since they bring added costs. Instead, we need to fully understand and, perhaps, resolve the issues driving the need for additional cash (see **Appendix A**). We must guard against merely putting a Band-Aid on a cancerous condition! Still, business *is* frequently messy and few companies escape occasional cash flow problems. The best approach is to adopt basic 'forward-looking' disciplines to prevent cash flow from becoming a chronic problem in the first place!

***Let's pause to talk about whether we currently project and manage cash flow (e.g., approach, report frequency, goals, and delegation). Any 'battlefield' observations?***

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## ***Forewarned is Forearmed***

There are three basic causes of cash flow problems. Perhaps most common is growth,

which usually requires additional cash to ramp up our capacity to produce and/or sell (e.g., staff, equipment, facilities, inventory, advertising, etc.) *before* we enjoy collecting from these incremental sales. If our costs to generate this additional volume exceed our retained cash on-hand, we find ourselves in a temporary negative net cash flow position. *Today's* sales cannot be funded by *tomorrow's* profits; they're funded by ***yesterday's!***

There's a 'back of the envelope' way to predict how much additional cash we'll need to fund additional business as we grow. This simple formula ignores certain variables, but is a helpful management planning tool. We need a handle on four things:

- a) The ***sales increase*** for the period
- 2) Related ***gross margin*** (i.e., the difference between sales price and cost of goods sold)
- 3) ***Additional overhead*** needed to support this new level of business
- 4) The ***time*** it takes us to collect from customers on the new business

For example, looking forward a year, say we estimate the following: (1) a sales increase of \$100,000, (2) 30% gross margin on these sales, (3) \$10,000 in *incremental overhead/SGA* expenses (i.e., not already captured by COGS) to support the new business, and (4) customer collections according to our normal 60-day cycle. On this basis, our COGS plus added costs will be \$80,000 (i.e., [70% x \$100,000] + \$10,000). Given 365 days per year, this additional business will cost us \$220 per day. Taking this cost times the customer collection lag time (i.e., 60 days) tells us that we'll need at least \$13,200 (i.e., 60 x \$220) to 'fund' this growth.<sup>4</sup> The question is, "*do we have enough cash on-hand?*" If the answer is "yes," no problem! But, if our answer is "no," as it often is for fast-growing companies, other funding methods must be found.

Another cause of cash flow problems are low margins – due to insufficient pricing or poor cost management – resulting in profits that can't fund the business going forward. If the market tells us that our goods or services aren't worth what it costs us to provide them, we need to take decisive action! Uncompetitive operating costs (materials, labor, overhead, selling/marketing expense, etc.) must be identified and addressed to ensure the competitive 'unit costs' needed to stay in business. Pricing is a frequent 'blind spot' for CEOs.<sup>3</sup> If our prices are too low to cover our cash needs during the cash conversion cycle, we have a problem! Borrowing or taking in additional investment to cover a continuing underpricing problem can just makes things worse and delay the inevitable. Proper pricing and a cash conversion cycle that generates sustained positive cash flow are the *only real options* for a truly viable long-term business. Start-up companies often 'shoot themselves in the foot' by trying to 'buy' market share and offering special, low pricing that results in orders they really can't afford to service!

A third cause of cash flow problems is poor working capital management. We often unwittingly finance our customers' businesses by allowing them to use our money through lax collection policies and procedures. Every day that our customers delay paying us, beyond competitive terms, costs us cash. Our *daily cash cost* to conduct business is:  $\text{annual sales revenue} \times \text{borrowing interest rate} / 365$ . Each *day* we cut from our average customer collection time *saves* us that amount and each day our customers extend it *costs* us that amount. Our operating costs go on every day, whether customers pay their bills or not. Along the way, we're either using their cash, our cash, or borrowing from someone

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else. Poor collection practices contribute to cash flow deficits. The net working capital of a business can be further cut by finding creative ways to reduce normal inventory levels or to increase supplier payables 'days outstanding' without incurring premium costs.

## ***Why not Zero Working Capital?***

In mature industries – with flat prices and known 'commodity' costs – what often distinguishes the *best* companies is their management of working capital. Most of us have enormous improvement opportunities in this area. When viewed in terms of percent of annual sales tied up in net working capital, companies in the same industry exhibit wildly different performance, with the best companies requiring as little as one-third the working capital 'investment' of their sloppier peers.

Unlike *typical* similar firms with 15-30% of annual sales tied up in net working capital, Dell enjoys *negative* working capital. They actually enjoy on-going interest income on the 'surplus' cash they carry as a result of owning very little inventory, being paid upfront by their customers, and paying their suppliers on 'customary' 45-60 day terms. In a commodity niche, after years of continuous improvement in managing working capital, Dell's growth is largely financed by their customers and suppliers! Many companies are moving toward 'zero net working capital' through proper planning and diligent team execution.<sup>5</sup> Since working capital often represents a significant portion of overall operating assets, this sharply increases ROI!

## ***Even 'Success' can be Complicated***

Cash flow problems are common to both rapidly-growing companies as well as mature companies facing costly technology changes, soft sales, or eroding margins. Although very few companies avoid cash problems altogether, there are proven ways to mitigate them:

1. The best way to deal with cash flow problems is to *avoid* them! Begin each year with a serious and thoughtful sales forecast. Since forecasting is imperfect, many fail to invest the effort that it deserves. Proactive operating management begins with a solid plan for what's to be sold. We leaders are responsible for this key process. Our team needs a 'rolling' 12-month projection, detailing 'units' (i.e., mix and margin), as shared operating guidance and a basis for planning and accountability (see **Appendix B**).
2. Our sales forecast is the foundation for our operating plan (budget). Paired with our cash conversion cycle, this enables us to generate a rough-cut monthly cash flow projection to show whether we'll have sufficient cash to support the business. If not, we need to take action to provide the cash we need. Ideally, we can reduce working capital or operating expenses, or raise prices, to increase cash. Otherwise, the default method often used to cover temporary shortfalls is using a bank 'line-of-credit.' In order to facilitate this type of short-term financing, the following ideas may help:
  - a. Estimate your maximum credit line needs based on a cash flow proforma:

### **Cash Conversion Cycle (CCC, in days) =**

Days to produce the product (if you produce something)

+ Average days in inventory (if you stock/resell)

+ Average days accounts receivable (average collection time)

– Average accounts payable days (time lag in paying suppliers)

**Needed Credit Coverage = CCC x daily sales revenue**

For example, if your sales are \$1,000,000 and your cash conversion cycle is 40 days, you'll need to 'float' at least \$110,000 (i.e.,  $40 \times [\$1,000,000/365]$ ). If you don't maintain inventory and have a quick 15-day cash conversion cycle you'll need \$41,000 (i.e.,  $15 \times [\$1,000,000/365]$ ).

- b. Develop a good working relationship with your banker *prior* to needing to borrow money.<sup>6</sup> Unfortunately, since most of us don't cultivate banking relationships as we should, we're handicapped when needs arise. Bankers are people, too, and are subject to being sold 'on' or 'off' a deal or relationship. When we provide the information they need, in a form they appreciate, without our 'hair on fire,' we provide the very best environment for a win/win relationship. Remember that a really 'good' deal is good for *both* parties. Bankers appreciate clients who do their homework and approach them with well-conceived, clearly documented requests that meet the bank's lending criteria.

### **Turning Weakness into Strength**

It isn't always possible to proactively fend-off all cash flow problems. Whether we 'enjoy' unanticipated growth, hit a 'rough patch,' or lose our credit line or an anticipated source of capital, we can find ourselves in a jam! In such cases, we need to do what we can with our internal resources. Consider the following options which have been rank-ordered based on providing the most immediate relief:

1. **Decrease receivables.** Getting those who owe us to pay us faster is the quickest way to raise money. Often, slow collections are the result of sloppy procedures that are within our control. Timely collection begins with a sound business model and policy for extending credit. If we give too much credit to those who don't deserve it, or fail to establish reasonable financial consequences, there's sure to be problems. Given a proper credit policy, the next key to shortening collection time is a consistent collection process that is put into play the very day an account or invoice becomes past due, and follows a predetermined path from that point until the invoice is either paid or written off.<sup>7</sup> It may also make sense to periodically offer special terms or inducements to encourage customers to pay early.
2. **Request extended supplier terms.** We have no right to demand this. As Christians, we have an obligation to pay *what* we owe, *when* it's owed. But we always have the freedom to ask for temporary relief from creditors. Suppliers are often willing to extend special terms to businesses they see as 'partners' and loyal long-term customers. Like bankers, suppliers can be recruited. If they're treated properly, they can be immensely helpful in buffering short-term cash deficits. By extending our payables *and* decreasing receivables – thereby shortening our cash conversion cycle – we tremendously improve cash flow! Say we normally collect in 45 days while paying suppliers in 30 days. This results in 'floating' our customers for 15 days. What if we reduced our average collection time to 40 days while establishing 45-day terms with our suppliers? We'd trim our cash cycle by 20 days and be on the *receiving* end of a five-day float! Suppliers are often willing to work with a growing account. Sales terms can be modified to reduce collection days. Within the 'normal commercial range' of what our customers and suppliers see in daily business, there's often more flexibility to re-engineer our net cash flow than we imagine. Set goals and enlist internal 'gatekeepers' for each of these key areas and begin tracking improvements!
3. **Increase margins by fully pricing for market value received and reducing costs** by eliminating waste in all its forms. This is simply good stewardship. Often, during times

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of growth, it's easy to be careless and add overhead without clear justification in our rush to simply conduct business. Inflated payroll, misguided perks, poorly specified/negotiated bills-of-material, and lax performance accountability (cost/quality/service) reduce cash flow. Operating discipline and continuous improvement is an underappreciated source of improved cash flow.

4. ***Make managing cash flow a highly visible and important function*** for yourself and key team members. Generate cash flow projections, track metrics, and ensure that your various 'gatekeepers' have improvement goals (e.g., sales order gross margins, 'days' of inventory, receivables, and payables). Expect continuous improvement as they measure, monitor, and control the key cash flow variables in their areas. Arrange to get frequent (weekly/monthly) cash position reports and monthly cash flow projections. Discuss 'what if' cash flow contingency plans. Celebrate ideas and initiatives that improve cash flow. Remember, what we pay attention to always gets better!

So, there we have it... an overview of the nature, causes, and remedies related to cash flow. There's *much* more that we can learn, especially from each other. What are some of your thoughts and "lessons learned" that might help others in the group?

<sup>1</sup>[www.emedicinehealth.com](http://www.emedicinehealth.com)

<sup>2</sup>Please also refer to the related C12 segments:

- *On Funding Growth* (March, 2011) which focuses on the Operating Cash Cycle, Bootstrapping as an underused funding option, and banking relationships and has five helpful Appendices.

- *Case Study #1: Funding Growth* (March, 2010)

- *Clear-Headed Leadership in Tough Times* (November, 2008) and its Appendices, which discuss critical concepts such as contribution margin, breakeven point, and staying 'liquid' during difficult times.

<sup>3</sup>Refer to previous C12 segments: *Pricing on Purpose: Parts I & II* (April/May, 2010)

<sup>4</sup>This assumes no other net changes in working capital (i.e., inventories and payables are offsetting)

<sup>5</sup>See prior C12 segments: *An Overview of Lean Enterprise Thinking* (May, 2009) and *Applying Lean Methods* (June, 2009).

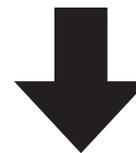
<sup>6</sup>Refer to previous C12 segment, *On Funding Growth* (March, 2011) and its *Appendix E*, which discusses banking relationships further.

<sup>7</sup>A very powerful and practical process is outlined in our *Credit and Collections* segment (May, 2012).

*Appendix A:*  
**Typical Cash Flow Statement**

**Normal Accounting P&L Statement**

Sales	
- Cost of Sales	
<b>= Gross Profit</b>	
- Depreciation / Amortization	
- Overhead / SG&A Expenses	
<b>= Operating Profit</b>	
+/- Other Income / (Expenses)	
<b>= Pre-Tax Profit</b>	
- Taxes Paid	
+/- Extraordinary Gains / (Losses)	
<b>= Net Income</b>	



**Cash Flow Statement**

Starting Point is Net Income	
+ Add Back Depreciation / Amortization	
+/- Net Working Capital	
Accounts Receivable      decrease/(increase)	
Inventory                    decrease/(increase)	
Accounts Payable        increase/(decrease)	
Other Current Assets    decrease/(increase)	
Other Current Liabilities increase/(decrease)	
<b>= Cash Flow From Operations</b>	

- Notes: (1) Cash Flow from Operations, when added to our beginning cash balance, can be used to fuel future capital expenditures, future growth initiatives, etc.  
 (2) Operating Cash Flow can be supplemented by Financing Activities (e.g., added debt and/or equity) to further impact overall cash balance  
 (3) Improvements to Operating Cash Flow are "free" while financing activities add to future costs.

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## Appendix B:

### Forecasting Revenue

[Note: each item below based on expected month of delivery]

Rolling 12-Month Forecast

Sales Projection		Rolling 12-Month Forecast					
		1	2	3	4	5	6
Already in Order Backlog	Current Year						
	Prior Year						
	% Change, O/(U)						
+ New Orders from <u>existing</u> products/markets	Current Year						
	Prior Year						
	% Change, O/(U)						
+ New Orders from <u>new</u> products/markets	Current Year						
	Prior Year						
	% Change, O/(U)						
= Total Sales Expected	Current Year						
	Prior Year						
	% Change, O/(U)						
<b>Profit/Cash Impact</b>							
Gross Profit \$ Sold	Current Year						
	Prior Year						
	% Change, O/(U)						
(-) Overhead to be covered	Current Year						
	Prior Year						
	% Change, O/(U)						
= Net Revenue available for profit, new growth, added investment (incl. any net working capital), new ministry initiatives, etc.	Current Year						
	Prior Year						
	% Change, O/(U)						

## Application Worksheet

### C12

1. Using your company's numbers, calculate your:
  - a) Cash Flow each month for the last year
  - b) Daily Cash Cost
  - c) Cash Conversion Cycle
  - d) Credit Line (or typical 'float') amount required
  - e) Cash Required to fund forward-looking incremental business
2. Scan today's footnotes and Appendices and consider the many prior C12 segments related to this topic that may be worth reading to help 'round-out' your perspective in this vital business stewardship and leadership area.
3. Share this segment (and any previous related C12 segments) with your management team and brainstorm options for improvement. Especially focus on your business model and opportunities you may have to move closer to 'zero net working capital' by adopting new standard terms and conditions with customers, suppliers, etc. Use this time to challenge your company's long-standing habits and have a 'clean sheet of paper' discussion about the best way to do things going forward. Consider even having a retreat with your key people to go deeper on these issues.
4. Consider setting clear goals and adding visual key metric tracking in each functional area of working capital and cash flow management. Make these responsibilities a formal part of various position descriptions and performance evaluations, and consider incorporating these metrics into any incentive-based compensation plans you may have.
5. Make a plan to apply the appropriate elements of this segment to help improve your cash flow and drive improved returns on investment and equity in your firm.

### KP

1. Take on the above questions for yourself as an executive development opportunity, understanding that gaining proficiency in this area is invaluable for any future general management responsibilities.
2. Ask your sponsoring CEO how you can assist him/her with items 3-5 above.

*Priorities are what we do.  
Everything else is just talk!*

*Application Notes*

*Priorities are what we **do**.  
Everything else is just talk!*