The Importance of Cash Flow Planning

Some capital expenditures cannot wait, but for most there is an optimal time to purchase. Cash flow planning can help you plan large purchases to avoid a cash crisis.

We've all been there. Your business is in its off-season and out of the blue some of your more expensive equipment quits on you. Perhaps the copier decides it has copied its last copy, or the forklift has finally kicked the bucket. Now you're looking at tens of thousands of dollars for a replacement. Where is the money going to come from? Just last week you did some financial juggling to meet the payroll and keep everyone happy. Do you go to your bank for a loan? Do you put in personal cash temporarily? Will the vendor offer you a good rate to finance the purchase? While not all expenses can be foreseen, adopting cash flow forecasting practices can help you plan your cash situation so that you can better respond to capital investment needs.

When you ask the owner of a small or medium-sized business what would be the number one thing that she could change if she wanted to, the response is often "I want to grow and expand the business" or "I want to increase my bottom line". While few would argue that growth is bad for a business, the responses highlight a focus on revenue rather than the all-important cash flow. Cash flow is often known as the "lifeblood" of a company because a good flow is vital to the health of any organization.

In an unexpected cash-tight situation, most SME owners' reaction is to borrow money to meet short-term needs, whether it be dipping into an emergency line of credit or applying for a new bank loan. But this option has hidden costs. Borrowing money in a tight situation:

- May expose the borrower to unfavorable rates
- Sends a signal to lenders that the business is not planning well
- May be a "quick fix" to an underlying cash flow problem

Good cash flow forecasting practices provide a business more flexibility in cash arrangements as needs are anticipated well before "crisis" stage. Some solutions for avoiding a cash crisis include:

- Getting a larger line of credit at favorable rates to allow a “buffer” in case of crisis
- Equity participation
- Utilizing leasing arrangements instead of purchasing
- Pricing strategies
- Tax strategies and planning techniques
- Utilizing a cash flow forecasting tool

A cash flow forecasting tool allows an owner to analyze the way cash flows into and out of their organization, allowing them to make better-informed strategic and one-time purchase decisions. In its simplest form, a cash flow tool has five categories that it tracks in monthly increments over 1-2 years:

- **Beginning balance**: the amount of cash in the bank when opening the account
- **Cash Inflows**: expected sources of cash from sales (remember: just because you sold it doesn’t mean you’ve collected any money for it yet!), investment income, etc.
- **Cash Outflows**: payroll, lease/rent, taxes, office supplies, utilities, and any other predictable monthly bills
- **Total net change in cash**: Inflows minus Outflows
- **Ending cash balance**: Beginning balance plus total net change

Good cash flow practices ensure smooth operation of the company when accrued revenue is still sitting in accounts receivable. Often an increase in sales does not mean an increase in cash flow, at least not right away. For instance, a company with $3M in annual revenues and a 30-day float between average days AR and AP is likely to be more cash-rich than a company with $5M in sales and a 3-day float. Just ask any business that contracts for the government—because completed work is invoiced doesn’t mean that cash is in the bank. By using cash flow forecasting practices, you can anticipate when you are most likely to be cash-flush, and when you are most likely to be cash-strapped, and plan your capital purchases accordingly.

Another benefit of cash flow planning is smoothing out annual business cycles. Many businesses operate in cycles over the years. For example, construction companies may earn the bulk of their revenue over the spring and summer months, charter plane services may have more work during the dry fire season, and retail operations may have as much as 30% of their sales around the Christmas holidays. But the bills come due regularly every month.

Owners that do not employ any measure of cash flow management often have sleepless nights about whether they will be able to meet payroll and whether checks to critical vendors will bounce. This leads to decreased credit rating as the company becomes more of a credit risk, making it more difficult to borrow in times of future cash crunch. Sales may increase, but there may not be money for costs of those goods sold. In extreme cases owners borrow against their own accounts to fund the company, putting their family's finances at risk. Typically owners that fail to employ some level of cash flow forecasting experience:

- Stress over where money is going to come from
- Wondering when the next cash crisis will pop up
- Confusion over when to expect cash
- Worrying about vendor and bank relations
- Mood swings with the presence/absence of cash available

Owners of SMEs that utilize cash flow management practices have the ability to plan purchases and make payroll with no surprises or headaches. Owners can make decisions regarding stretching accounts payable and put more efforts into focused AR collections. They borrow money when they have more flexibility to get the best conditions and rates, that is, when they aren't forced to take whatever is offered.

As with all best practices, the efficacy of any cash flow management technique is increased when implemented with other best practices such as a flexible budget and other organizational controls. The important take-away is that anticipating and forecasting your cash flow is a simple way to increase the financial security of your company so that you can respond better to both unexpected and planned cash demands, and ultimately sleep more soundly knowing your back is not up against the wall when the next expensive piece of equipment suddenly decides to retire.

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