AVOID CASH FLOW CATASTROPHES

Improve your forecasts

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Remember Borders books?
Or Circuit City?
How about Pan Am Airlines?

Each of these once-highflying brands is now gone because their companies eventually ran out of cash to pay bills.

But it's not just big companies with declining sales that run into problems with cash flow. Talk with any accountant or other financial expert and you're likely to hear a story like this: "I had a friend/client/relative who was very profitable but who grew themselves into trouble when their cash couldn't keep up with their increasing expenses." Or, "I had a friend/client/relative who was very profitable but who let their accounts receivable get out of control, and their business imploded. It was ugly."

These professionals know better than most that businesses can run into trouble when management doesn't pay close attention to cash. By knowing exactly what cash you have coming in and going out and when those transfers occur, you ensure you have enough cash to continue operating from day to day.

A key to making sure you don't get caught by surprise is knowing what cash you ***should*** have coming in and going out – in other words, having an accurate cash flow forecast. "If you don't want to get into a liquidity crisis and lose your company, you have to do a cash flow forecast," says Rebel Cole, professor of finance at DePaul University.

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> Professor of Finance
> DePaul University

There are other, often related, reasons to improve your cash flow forecasts:

- To be prepared to apply for a loan
- To make sure you can fund future growth
- To know you can save for a rainy-day expense.

Why is it so difficult?

But many financial professionals and business owners struggle with cash flow forecasting. Why is that?

By their very nature, cash flow forecasts can be complicated, according to Brandon Otis, a manager in the Business Valuation & Litigation Support Services group of Pittsburgh-based accounting firm Alpern Rosenthal. Professionals who generate them on a regular basis say that forecasts change from year to year because the economy changes, various rates used in estimating items change, and there can be changes tied to new legislation, market dynamics or industry trends. “While a financial manager like me would be able to ask the questions, we have to work in tandem with business owners to understand all the aspects related to different businesses,” Otis says.

In this article, you’ll get advice from experts on options for generating a forecast, read recommendations for how frequently your forecast should be reviewed and learn more about acceptable levels of cash to maintain. You’ll learn how cash flow forecasts can go wrong and get tips for improving your forecasts. You’ll also hear of additional resources that are available, including some benchmarking tools to see how your cash situation compares with other companies in your industry.

How do I do it?

One way you can tell that cash flow forecasting is a pain point for many people is the number of templates and software solutions that are available online. But David Douglass, a partner with Atlanta-based professional services firm Tatum, says you can also start simply, by thinking about your forecast as a personal check register.

PLEASE BE SURE TO DEDUCT ANY PER ITEM CHARGES OR SERVICE CHARGES THAT MAY APPLY TO YOUR ACCOUNT

ITEM NO.	DATE	PAYMENT ISSUED TO OR DESCRIPTION OF DEPOSIT	AMOUNT OF PAYMENT	✓	(-) CHECK FEE (IF ANY)	AMOUNT OF DEPOSIT		BALANCE FORWARD 800 00
581	7/1	To Food Mart					Payment or Deposit	-36 32
		For Groceries	36 12		.20		Balance	763 68
/	7/15	To Deposit					Payment or Deposit	+220 50
		For Paycheck				220 50	Balance	984 18
/	7/16	To Withdrawal					Payment or Deposit	-20 00
		For Automatic Teller	20 00				Balance	964 18
/	7/31	To Service Charge					Payment or Deposit	-5 00
		For Month of July	5 00				Balance	959 18
		To					Payment or Deposit	
		For					Balance	
		To					Payment or Deposit	
		For					Balance	

He suggests listing your sources of incoming cash, such as:

1. cash sales to customers
2. sales on credit to customers with specific payment terms
3. borrowings from lenders
4. investments from owners.

Then, you should list the known, recurring reasons for cash going out the door – things such as payroll, taxes, rent and payments to vendors for raw materials.

"For both cash inflows and outflows, start with the big items first and work down to smaller amounts," Douglass says. "Be specific in noting the week, or even the day of the week, that disbursements are made." For example, you may pay employees on Friday, but the cash to cover payroll, including taxes, medical premiums, 401k contributions, etc., might need to be in the bank by Wednesday. At the same time, if you pay vendors by check and mail those on Friday afternoon, they may not "clear your account" until the following Tuesday or Wednesday.

Douglass says some of the templates or Excel spreadsheets online might be helpful. But, he says, "They don't eliminate the need to think carefully about your specific company – each is different," he adds.

How do I do it?

Later, we'll cover some of the ways each company is different in terms of how cash flows into and out of the business, and that may give you some ideas for specific areas of interest to your business. But at least initially, don't get too hung up on a lot of detail in your forecast.

"Pick a level of detail that is relatively easy to develop and maintain, and then refine the forecast as time goes on and you get better at forecasting," Douglass says.

Your current cash cushion should also determine how much detail you use at first. If you don't have much cash on hand, you'll need to be more detailed and accurate, he says.

Michael Voie, a CPA and partner with Stallcup & Voie LLP in San Francisco, says that if you've got the equivalent of one month of expenses in the bank, you should probably think about taking a closer look at your cash flow forecast often. But if you've got six months of expenses covered by your bank balance, your time might be better spent focusing on some other aspect of managing the business than on more frequent cash flow updates. "It's kind of a balancing act," he says.

Cole notes that popular accounting software programs such as QuickBooks often have built into them the ability to generate a cash flow forecast, but you also can generate your own forecast using a spreadsheet, with each column representing a day or a week, and then rows representing cash inflows, outflows and the cash balance.

More advanced forecasting tools let you experiment with "what-if" scenarios – what happens to your company's cash and financial position if sales increase by 20 percent? If you purchase this piece of equipment for $X but expect it to generate an additional $Y in revenue? These advanced solutions are a great help for contingency planning, in which you can think through possible reactions and outcomes. See some options for this kind of analysis in the additional resources section of this paper.

Contingency Planning:

Leave nothing to fate. Systematically review the steps in a chain of events in order to anticipate and plan for possible interruptions. For cash flow, the goal is for the business to avoid a cash shortage.

How often do I do it?

As with many things in finance, how often you perform or update your cash flow forecast depends on the business and your circumstances, according to Lauren Prosser, manager of advisory services at Sageworks. A retailer that sells many products of various types and with different costs each day would need a more frequent analysis and forecast of cash flows than would a retailer selling a couple of major pieces of farm equipment each month.

Glenn L. Friedman, a CPA and managing partner of New York accounting firm Metis Group CPAs LLC, says that since the biggest business surprises are typically unknown ahead of time, it's a good idea to provide cash flow forecasts that are as close to real time as possible. "If the bottom drops out, or you don't make your numbers, you want to know that sooner [rather] than later," he says.

If your cash flow forecast review is quarterly and you discover something amiss, that's 25 percent of the year that's already gone, he says. "That doesn't give you a lot of time to adjust." And since most management decisions don't happen overnight, you'll give yourself more time to adjust (expenses, income) if you review and adjust cash flow forecasts more often, he says.

"In an economy that's tight and volatile, you don't want to be looking in a rear view mirror," he says. Similarly, if you know cash is tight or you have several big customers who are tardy in their payments, you would want to have more frequent checks on your cash flow forecast than if you have a big cushion and regular payers.

Frequent checks give you more options for adjusting, too, according to Prosser. Small, family-owned businesses often have employees that have been with them forever, and letting them go is the last thing owners want to do. Paying attention to how your overhead and sales are tracking relative to your cash flow forecasts may give you the time for alternatives, such as pressuring vendors for lower prices.

Douglass notes that many companies must provide cash forecasts to their lender and must report, often quarterly, to the lender that their performance is meeting minimum criteria. "Without a cash forecast process in place that is updated more frequently than the bank requires, it may be too late for the company to recover from a cash shortage or having failed to meet minimum performance standards," Douglass says.

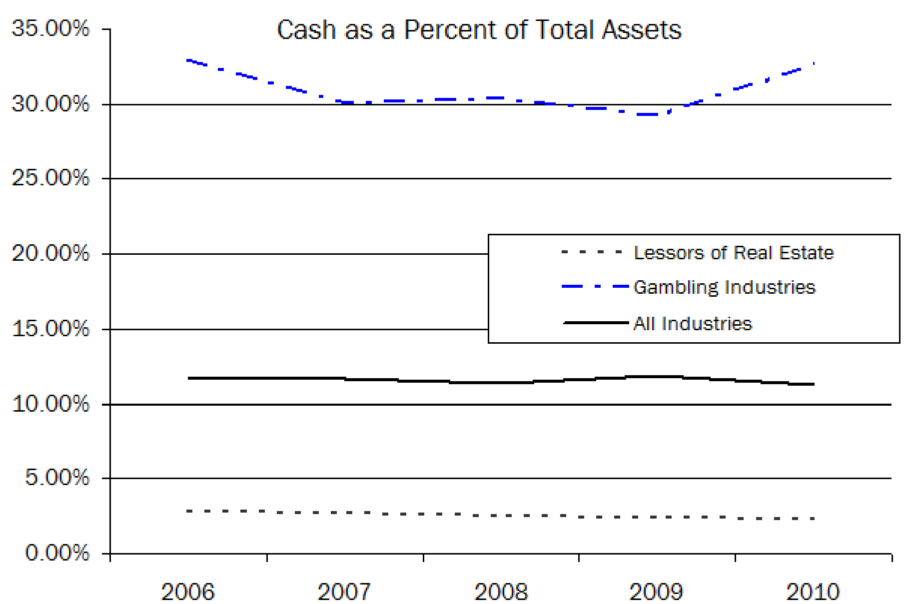
How much cash should I have?

Cole says an acceptable level of cash depends on several things. It varies by industry, by size of firm and by how often you have customers who are tardy paying their bills.

"You want to make sure you have a positive cash balance every day and every week," Cole says. "What's a good threshold? Something that's positive."

Companies with late-paying customers need a bigger cash balance. "Often, you have to pay vendors or rent before you necessarily receive money from customers," says Otis. "That's especially true when you're dealing with large customers that have a significant amount of buying power." That's why it's important for accountants, advisors and business owners to work together to take into account all of the aspects related to different businesses, he says.

One way to develop your own goal for cash is to study benchmarks for competitors in your industry. For example, it's not surprising that casinos, bingo halls and other gambling industries have a higher average percentage of assets in cash than do lessors of real estate. It makes sense that workers who are facilitating housing sales need to have a lower percentage of cash on hand than would a casino that regularly doles out prize money.



How can cash flow forecasts go wrong?

Experts say cash flow forecasts can be tripped up by several common items that business owners and financial managers might overlook. Generally, these can be blamed on two factors: omission or over-optimism. We'll discuss over-optimism later, but let's start with common items left out of cash flow forecasts that can diminish accuracy.

Omissions abound

1. **Year-to-year operational changes.** A good forecast starts with what happened last year, but then you must consider what's changed, according to Friedman. Maybe it's pricing or promotional activity. "Maybe you're doing an ad campaign you didn't do last year, and you will believe it will generate X amount of revenue," he says. Or maybe you're planning an earlier ad campaign this year, so you will need to adjust the expected timing of revenue associated with that. In the case of service-oriented businesses, consider whether you plan to do some work earlier or later this year, Friedman adds. This is also the time to take a look at your client list and adjust your cash forecast based on the loss of a big client or the addition of several new ones.

2. **Non-expense payments.** Friedman says people often think about cash flow using their profit and loss statement. "They forget that there are cash requirements in balance sheet items as well," he says. Repayment of debt is one example.

3. **Infrequent items.** Other common omissions include estimated tax payments for employees, monthly loan payments, periodic contributions to retirement plans or savings, and occasional expenses tied to unexpected surprises, such as equipment repairs or automobile maintenance.

4. **Seasonality.** Most businesses have busy and slow seasons, so taking that into account as you estimate cash outlays for inventory or staffing can help avoid a cash crunch. How holidays fall on the calendar can affect a retailer's year. If you sell ice-removal products and last year was an unusually icy winter, you may need to plan for a more normal business pattern this year.

How can cash flow forecasts go wrong?

Omissions abound (cont.)

5. **Commodities.** Fluctuations in commodity pricing or currencies can be difficult to price ahead of time, but it's important to take these trends into consideration when estimating your cash flow.

6. **Capital expenses.** Otis says forecasts can be spoiled if you omit property, plant or equipment investments for normal replacements or when something has become technologically obsolete. Since these expenses can be completely unexpected, they can wreak havoc on short-term cash flows.

7. **Payroll.** Michael Cole, audit principal at Southern California CPA firm Holthouse Carlin & Van Trigt LLP, says payroll can often cause big mistakes in cash flow forecasts. "If companies pay people on a monthly payroll or weekly payroll, then every seven years, they're going to have an extra pay period," he says. If they forget to plan for that, they could come up short for payroll, he adds. Similarly, cash outflows associated with annual or holiday bonuses or with quarterly estimated tax payments for your employees can be substantial enough to cause problems.

> Small, family-owned businesses often have employees that have been with them forever. Letting these employees go or even just holding a paycheck is the last thing owners want to do.

Finally, don't forget that staff turnover creates something called "productivity churn," which has an impact on cash flow. Voie of Stallcup & Voie LLP suggests that if you lose an employee, determine how that person affected your business relative to his or her replacement. And it's not just salary and benefit costs. "Are they a production person, and were they putting in 250 units a day and this [new] person is putting in 100? What if sales come in less?" he says. You need to think through the variance that will occur because of those changes.

How can cash flow forecasts go wrong?

The second general culprit of errors in cash flow forecasts – over-optimism – is pervasive but understandable, experts say. “Business people by nature are optimistic people, and that hurts them when they’re making cash flow projections,” Prosser says.

Over-optimism

Here are several ways that too much optimism can confound your cash flow forecasts:

1. **Sales and payments.** By far, the most common issue cited by financial experts is when you’re too optimistic about when sales will occur and too optimistic about how soon customers will pay. “Don’t forget that a customer may say, ‘The check is in the mail,’ but you can’t spend those funds until the check has been deposited in your bank and cleared successfully,” says Douglass.

2. **“Averages.”** In quickly changing times, averages used in your cash flow projections might become inaccurate, Douglass says. “For example, if your customers generally pay in 30 days after being invoiced and then suddenly delay payment for an additional 15 days, the extra 15 days often means you will have to cover another payroll,” he says. “There’s hardly anything worse than not having enough cash to cover payroll.”

Average for All Industries in 2011	
Accounts Receivable Days	29 days
Accounts Payable Days	25 days

   Even when measuring accounts receivable and accounts payable days for all industries, the averages will fluctuate from year to year. Those variances are magnified when looking at a smaller period of time like monthly or quarterly averages, and variances can lead to cash shortages if forecasts didn't anticipate the change.

3. **Gaps tied to growth.** Growing businesses often run into cash troubles when they incur new costs associated with growing (e.g., new staff, logistics) but they inaccurately estimate when the cash benefits of those investments will start coming in, says Cole of Holthouse Carlin & Van Trigt LLP. Otis echoes that concern. "In the end, what we find very often is people aren’t getting nearly as much cash flow from their growth as they expect there to be, because they need the money to pour back into the business.”

Tips for better cash flow forecasts

While cash flow forecasts may be tricky, there are several steps you can take to improve their accuracy.

Be conservative. Be skeptical about your managers' and your own forecasts, especially when it comes to sales and expenses. "One incorrect assumption can have a large effect on your cash flow," says Paula Griffo, chief financial officer of VoIP Supply, an Amherst, N.Y., provider of VoIP. "I always underestimate cash inflows and overestimate cash outflows to be on the safe side."

Be aware of common pitfalls. For example, since you know accounts receivable is an area that can quickly ruin your cash flow forecast, improve your AR processes. Douglass recommends that as customers go past 30 or 60 days, start calling, and set and enforce penalties. "If you are the CEO, send a message to the management team that invoicing customers as soon as possible, cash collections and cost controls are the lifeblood of any business, [and] are therefore 'everyone's concern,' " he says. "If the CEO doesn't take cash forecasting very seriously, nobody else will."

Update regularly. Perform and update cash flow forecasts frequently enough that you're not surprised by the updated forecast, and as a result, caught with insufficient time to respond.

Learn from mistakes. Strive to improve accuracy by comparing your actuals to your forecast so that you can learn from the process.

Hold others accountable. Several experts say that while the CFO is ultimately responsible for developing and updating a cash flow forecast, sales, manufacturing, shipping, accounting and other parts of the business should be held accountable for their roles in helping to achieve the forecast. Business owners and managers can structure performance quotas to meet a cash flow forecast and can manage workers to those quotas.

Seek advice. "Everybody wonders, 'What's the secret to cash flows?' and there isn't one," says Prosser. "There's never a black-and-white answer. It's always a matter of sitting down, looking at what you have and some what-if scenarios, and saying 'I'm going to try that.'" Don't be afraid to ask your accountant for help; he or she would probably welcome the chance to be more of an advisor for your business. "It's a thought process, and someone has to walk you through it," Prosser says.

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> David Douglass
> Partner, Tatum

Tips for better cash flow forecasts

Seek automated help. Cash flow forecasts are typically a standard part of budgeting or business modeling applications. "If you are considering an upgrade to your business modeling/forecasting processes, be sure that any applications being considered provide an integrated cash flow forecast that ties to the income statement and balance sheet," says Douglass.

Additional resources

Sageworks' solutions for cash flow analysis and projections, including "what-if" contingency planning:
http://web.sageworksinc.com/cash-flow-forecasting/

JaxWorks Small Business Spreadsheet Factory: downloadable worksheets for weekly cash flow projections, 12-month cash flow forecast, etc.
http://www.jaxworks.com/library.htm

How to Read a Financial Report, by John A. Tracy, John Wiley & Sons, 2004.
http://books.google.com/books?id=Xzd3-NojmkgC&printsec=frontcover#v=onepage&q&f=false

Articles on Cash Flow Forecasting from the Government Finance Officers Association:
http://www.estoregfoa.org/StaticContent/staticpages/TM0407.htm#1a

Sageworks' Benchmarking Best Practices Whitepaper: how to use financial benchmarks and see how your business compares to its industry
http://web.sageworksinc.com/benchmarking-white-paper/

About

Sageworks Inc. is a financial information company that works with financial institutions, accountants, and private company executives across North America to collect and interpret financial information. The mission of the company is to help people make more-informed financial decisions in a business by giving them information they can understand and use. Sageworks' data, the largest database of private company financial information in the U.S., grows as more than one thousand reports are run each day, and the new data is screened and anonymously incorporated into our industry statistics.

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Brandon Otis is a manager in the Business Valuation & Litigation Support Services group of Pittsburgh-based accounting firm Alpern Rosenthal.

David Douglass is a partner with Atlanta-based professional services firm Tatum who assists clients with all sorts of CFO-level issues such as selecting investment bankers to help prepare for raising capital or consulting and mentoring currently seated CFOs.

Michael Voie is an active CPA with the state of California and a partner with Stallcup & Voie LLP in San Francisco, and he leads the business consulting, accounting and part-time CFO/Controller practice within the firm.

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Michael Cole is audit principal at Holthouse Carlin and Van Trigt LLP (HCVT), a Southern California CPA firm serving large and small privately held companies, public companies, high net worth individuals, and family offices in a variety of industries.

Paula Griffo is chief financial officer of VoIP Supply, an Amherst, N.Y., provider of VoIP (Voice over Internet Protocol) solutions. She previously owned her own accounting practice, where she acted as the CFO for businesses in transition, with a focus on pre-audit work.