Cash Flow 101

Maybe you remember studying cash flow for a semester or two, many moons ago, and you're a bit hazy on the details. Maybe your business has always been flush with cash, and you've never given the concept a second thought. Or, maybe you've never even heard the words "cash flow" put together before.

Whatever the case may be, here's a quick refresher: **Cash flow refers to the revenues a business generates (and collects) compared to expenses it pays out over a fixed period of time.**

Broadly speaking, businesses bring in money through sales, financing, and returns on investments, and they spend money on supplies and services, as well as utilities, taxes, and other bills.

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Being cash flow positive means that you're bringing in more money than you are spending, and your business is in good shape. Being cash flow negative means—you guessed it—that you are spending more than you have coming in, and you're headed for trouble.

Unfortunately, business owners can't predict the future—particularly when it comes to any unforeseen expenses they might incur (e.g., a truck breaking down prematurely and needing replacement, or a data breach resulting in a forced increase in IT spend). And they also can't know for certain that their clients will pay their bills on time.

Together, these uncontrollable variables lead to a rather logical conclusion: Cash flow problems affect many businesses. According to a recent survey, three out of every five businesses experience problems with cash flow. Still, while cash flow problems are not uncommon, business owners are better off doing whatever they can to avoid them altogether.

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The benefits of positive cash flow

Back to the basics: Positive cash flow is defined as ending up with more liquid money on hand at the end of a given period of time compared to what was available when that period began.

Businesses that master cash flow management can:

- **Pay their bills.** Positive cash flow ensures employees get checks each payroll cycle. It also gives decision makers the funds they need to pay suppliers, creditors, and the government.
- **Invest in new opportunities.** Today's business world moves quickly. When cash is readily available, business owners can invest in opportunities that may arise at any given point in time.
- **Stomach the unpredictable.** Having access to cash means that whenever equipment breaks, clients don't pay their invoices on time, or new government regulations come into effect, businesses can survive.

There's negative cash flow, too

Of course, life doesn't always work out the way we want it to. So even when decision makers do their due diligence, cash flow problems may still arise from time to time—that's just how it is.

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Negative cash flow is defined as not having enough cash on hand to pay immediate outstanding obligations. When cash flow is negative, businesses may struggle to pay their bills, might not be agile enough to respond to new opportunities, and can have a hard time figuring out how to cover expenses they haven't budgeted for.

This is the first installment in a six-part series focusing on everything you need to know about cash flow. Up next, we'll show you the symptoms that might indicate cash flow problems are in your future.

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Read more: http://articles.bplans.com/cash-flow-101-the-basics/#ixzz3gSW2UwLU

Cash Flow 101 Symptoms:

Though they're by no means uncommon, cash flow problems can cripple businesses of all sizes, and smaller ones are perhaps more vulnerable. Without access to capital, companies are unable quickly adapt to today's ever-changing business world. As such, they're unable to grow.

The good news is that cash flow problems aren't entirely out of your control—and they're not unpredictable, either. Proper budget forecasting, coupled with an understanding of symptoms that might indicate cash flow problems are in your future can help you protect your business from scrambling to figure out where to get its next infusion of cash.

If your business is suffering from any of the following five symptoms, cash flow problems may very well be on the horizon:

1. Your accounts receivables are high

While it might feel great to extend lines of credit to your customers, if they're not paying their invoices promptly, what's the point? Yes, your accounts receivables may be high, but you won't have access to that cash right away.

And, who knows when or even *if* you will? When your accounts receivables are high, you're essentially giving your clients interest-free loans. It doesn't sound too good when it's phrased that way, does it?

To see whether your business is doing well with collecting its accounts receivables, consider keeping track of your receivables turnover ratio (net credit sales over average accounts receivables balance). A low ratio might indicate it's time to reassess how you do business.

2. You have too much inventory on hand

Businesses that sell their products to other businesses may like to have a lot of inventory on hand to ensure they're able to accommodate orders of all sizes. But if a majority of your funds are tied up in that inventory and your customers aren't racing to buy all of it, your business may have a hard time growing until sales are made.

To ensure your company has the products it needs to grow on hand while also being able to access cash when needed, it might be worth taking a look at whether it's time to revise your order cycles, reconsider how many product quantities to keep in stock, or make use of inventory optimization tools, among other things.

3. You're overextending your business

Though you might be very eager to grow your business quickly, it's important you make sure to do so at a reasonable rate. If you overextend your company, chances are a lot of your cash will be tied up in capital and operating expenses, leaving your business less flexible in the short term.

To avoid having to deal with the problems related to overextension, be sure to thoroughly plan your growth well in advance. You might also want to consider reexamining your business processes to see what aspects of your organization would benefit from automation. But remember, the key to successful business growth starts with having a crystal clear vision of what you hope your organization will accomplish when you start expanding.

SEE ALSO How to Forecast Cash Flow

4. Your sales are declining

Maybe the economy is in shambles. Maybe you've got a lot of new competition. Whatever the case may be, if sales have been steadily declining over the last few quarters, there's a good chance your profit margins are getting sliced as thin as possible—if they still exist at all.

Since your overhead costs likely won't change, declining sales may indicate that cash flow problems are imminent. To combat declining sales, you might want to adjust your strategy. When was the last time you redefined your customer personas or looked at updating your messaging? How customer-focused is your brand? Today's technology-driven world changes quickly, and your business has to keep up if you want it to survive.

SEE ALSO How and Why to Manage Cash Flow

5. Your business just isn't profitable

At the end of the day, if you're spending more money than you're taking in, it shouldn't take a rocket scientist to tell you that you'll probably have cash flow problems sooner or later.

If you find yourself in such a position, you might want to reexamine your business model to see how it can be changed to enhance profitability. For starters, you could get creative and figure out how you can lower your expenses; for example, you might find that moving your computing infrastructure to the cloud will save money and increase productivity. It might also be time to think about whether it makes sense to increase your prices.

This is the second installment in a six-part series focusing on everything you need to know about cash flow. Up next, we'll take a look at building cash flow statements—a tool you can use to make sure your business always has access to capital.

Has your business experienced any of these symptoms? Were you able to stop a cash flow crisis before it happened?

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Cash Flow: Building a Cash Flow Statement

In order to make sure that their businesses are always able to access the cash they need to grow, many business owners—or at least their accountants—produce cash flow statements at monthly, quarterly, or even yearly intervals.

While large organizations, such as Google or Apple, that are flush with cash might wait until the end of the year to produce these statements (by law, all publicly traded companies are required to produce them), small business owners are usually inclined to prepare them more regularly, so there aren't any extra surprises when December rolls around.

Most simply, cash flow statements very quickly tell the story of how much revenue a company has coming in (inflows), and how much it has going out (outflows). That information can be leveraged to gauge an organization's liquidity and to predict where a company will stand financially in the near future.

Cash flow statements are important to many different stakeholders for many different reasons. For example, accountants use cash flow statements to make sure companies can pay their bills on time. Creditors might look at them to decide whether an organization is well-situated to repay loans. And, before buying shares, investors will probably want to take a peek at them as well.

The components of a cash flow statement

Generally speaking, cash flow statements are comprised of three core components:

1. Operating activities. How does your business make money on a day-to-day basis? Your organization's operating activities include everything that relates to how you generate revenue. Most basically, cash inflows are generated whenever customers buy your products or services; outflows occur when you pay employees, suppliers, taxes or interest, among other things.

2. Investing activities. Most transactions relating to the sale or purchase of property, equipment, or other non-current assets are included in your investing activities, as are any expenses tied up in mergers or acquisitions. If your business plays in the stock market at all, you'll also have to indicate when you buy or sell securities here as well.

3. Financing activities. This section of the cash flow statement includes information about taking out loans to buy property or equipment; issuing stock to employees, the public, or other stakeholders; paying out dividends, and so on.

It's worth noting that cash flow statements can be affected by non-cash transactions, like depreciation or bad-debt expenses. Additionally, many businesses choose to add supplemental information about large transactions that don't involve cash, like converting debt to equity or issuing shares in return for assets.

Cash flow statements—which are considered one of the four major financial statements along with income statements, balance sheets and statements of retained earnings—can be prepared using one of two methods: the direct method or the indirect method, both of which produce the same results.

Because it's easier to do, most businesses build their statements of cash flow via the indirect method, so let's turn our attention there first.

Building a cash flow statement: The indirect method

Many businesses choose to construct their cash flow statements using the indirect method because the numbers they need are easily gathered from the accounts and numbers they already maintain. Cash flow statements generated this way reconcile reported net income with cash generated through operations.

To construct an indirect cash flow statement, you first need to focus on operating activities. To do that, determine net income and remove non-cash expenses (e.g. depreciation and amortization) from that number.

Next, you need to consider your gains and losses on any sales of assets made during the pertinent reporting interval. You also need to report changes in receivables, payables and inventories, as well as any bad debts you might decide to write off.

Once you've figured out your net cash provided by operations, you need to then record your cash flows from investing and financing activities. These two sections are reported in the same manner on cash flow statements prepared using both the indirect and direct methods using the criteria discussed above.

Building a cash flow statement: The direct method

Due to the differences in reporting operating activities, cash flow statements prepared via the direct method provide a much clearer view of how cash moves through a business. But they're harder to prepare—which is why they're less common.

Instead of starting from net income, cash flow statements made through the direct method instead focus on gross cash inflows and gross cash outflows that occur naturally through operations. Businesses that use the direct reporting method need to consider cash received from client accounts; cash paid to employees and suppliers; interest payments; income tax payments; and any interest or dividend revenue that was received.

Unlike the indirect method, when cash flow statements are generated through the direct method, it's considerably easier to see where cash payments were made and where cash payments were received. But because most accounting reports don't include the necessary information the direct method requires, many businesses choose to take the easier route and produce their statements of cash flow using the indirect method.

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