Keeping Small-Business Cash Flow on Track

by Nancy Opiela

If there's one thing that will make or break a small business, it's cash flow. "Small-business owners live and die for cash flow. Depending on their size, their anxieties range from, Am I making payroll? to Am I paying myself?" says Mark H. Friedman, founder of Real Time Strategy, a Salem, Massachusetts, company that focuses on business issues ranging from strategy development to operational improvement.

Friedman's advice to his clients is simple: "If you don't want cash flow to become a problem, you need to think about it every single day." Of course, that's easier said than done. Here, planners and consultants who specialize in working with small-business owners offer advice and strategies to overcome, and ideally avoid, the most common problems and pitfalls.

Cure for Hero/Zero

The most common problem Mary Durie, CFP®, sees is what she refers to as the "hero/zero syndrome." Durie, of Quest Capital Management Inc. in Dallas, Texas, explains, "When business is going really well with a lot of cash coming in, small-business owners tend not to focus on efforts to begin the next round of business. It's all well and good to work really hard to service the clients you have, but when you complete the project, there is often a lull because there isn't any new business coming in the door—and that can create a cash-flow problem."

Because, to a certain extent, every business goes through these "hero/zero" cycles, Durie says her biggest challenge is to help small-business owners stabilize their cash flow. Her solution is to work with clients on developing a "consistent, methodical approach to bringing in new business." A tool Durie uses to get busy clients to dedicate the time they should to marketing is a monthly management report.

"Everyone gets so busy working in their business that they forget to work on their business, so every month we generate a report on key prospects for the business," Durie says. "If there's a month with no new clients, you can pretty much predict that 90 days into the future, you are going to have a cash-flow problem. I have my clients track the number of new contacts, ongoing leads, and new clients. Even if they are running a one- or two-person office, clients must develop a system that ensures that the marketing they need to get done to grow their business is getting done. The more they treat their business like a business, the easier the marketing work becomes."

Not only will this approach ease a cash crunch, says Durie, it also can increase the value of a business. "I had a small-business owner as a client—a prosthetist who manufactured and fit amputees with artificial legs—who didn't think his business had any value," she says. "In the early years, he felt like he was more of an artist than a businessman. He felt his special skill was what produced the value to his patients and his business, and that if something happened to him, there would be no business. Over the years, we helped him realize that his skill could be taught and transferred to others, and that left him time to focus on growing the business and reducing its dependence on him. As he reached out to new patients, his monthly management reports became more detailed as he became increasingly focused on marketing his business. A decade later, he sold his business for $4 million."

As an example for clients, Durie follows her own advice; her firm's been doing monthly management reports for 18 years. "We track new clients, assets under management, and the average fee for new clients," she explains.

Keep Your Finger on the Pulse

Guy Cumbie, CFP®, of Cumbie Advisory Services in Fort Worth, Texas, says the biggest mistake small-business owners can make is "not keeping their finger on the pulse of cash balance and cash flow. If you don't monitor cash balance and cash flows monthly, you have a huge problem before you know it," he says. "I have my operations person here do a cash balance report monthly. Separate and apart from normal financials, it is an accounting of every checking account, money market fund, business account, and mutual fund account."

Good software can help. An expert on business planning once told Cumbie during a discussion on the best business planning software that "the biggest distinguishing characteristic between good packages and bad packages was how they enabled the business owner to keep a rein on cash and operating expenses. The best programs generate monthly reports, whereas some programs do only quarterly or semi-annual assessments of cash."

What clues business owners should focus on depends on whether they are a start-up or mature business. Cumbie says it's surprisingly easy for mature businesses to get caught off guard. "When business is going well, a few negative reports in a row are easy to overlook, especially if you have ten years of positive history," he says. "However, three months in a row is a pattern, a trend that you have to react to. If you have three months in a row where your profitability is going down, you'd better stop denying you have a problem and recognize the pattern as a trend you must respond to."

Cumbie has also noticed that the more mature the business is, the easier it is for owners who have grown attached to their business to pump significant amounts of personal assets into a failing business. "Obviously, we've done the planning necessary to isolate personal assets and liabilities from the business and to milk the assets of the business into the client's personal accounts during good times. But in bad times a client's first instinct is to have the reverse happen—and that's a mistake. Business owners should have a limit on the extent to which they will open their personal coffers to the business. When this happens, it's important to recognize what you are doing and to know when to stop."

In fact, Cumbie asks his business-owner clients to specify in advance how much of their personal assets they would feel comfortable pumping into their business if it should land in troubled waters. "While most business owners have a business plan, they lack a document that outlines the relationship between their personal and business assets," he explains. "We think of this as the equivalent of an investment policy statement. It's the results of a conversation we've had about how much of their personal assets they would be willing to put into the business. Some clients might be willing to let their personal assets be taken all the way down; others have firm barriers between personal and business assets."

Cumbie says the goal of this document is to prevent purely emotional decisions. "Even if clients choose to violate their policy, there's a lot of consciousness around that decision," he adds.

As for an appropriate focus for a start-up company, he understands that the business can be in such a hurry to get a product out the door or finish a project, that the owner doesn't have the time to set up templates and reports. "The time crunch is understandable, but that's a bad habit to get into," he says. "As you get used to working like that, you continue to ignore the need to develop these reports."

Guy Cumbie notes, too, that in the start-up phase business owners also must monitor the "burn rate of working capital," and where they could obtain financing if need be to bridge the rough patch. "You need to know how many *months* your capital will last—not quarters or years," he says. "You also can get working capital from credit facilities. And the important thing about credit facilities is to get your credit established when you don't need it. If you wait until you need it, you won't get it."

In fact, he says setting up credit facilities in advance saved a brother/sister team in the high-end landscaping business. "Although they'd been in business for a decade and were very established in their marketplace, they didn't have solid, deep financials," says Cumbie. After 9/11, their business got creamed as people tightened their budgets. Even the people building huge houses weren't spending on lavish landscaping. Their business fell off the cliff and it caught them off guard, largely because they did not have a lot of reserves. A growth phase had been soaking up their cash; they were even putting some of their personal funds in to finance the growth of the business," he says.

While the business was able to stay afloat with loans, as it turned out, 9/11 was only the first part of the squeeze. The real issue came in 2005. Cumbie explains, "They had hunkered down and worked hard on marketing for a couple of years. Then, just when they had the business built back up and the profits back in place, all of a sudden they were hit with a huge tax bill because they had become profitable again. However, they didn't have money to pay the taxes because all of their money was going to pay off the debt they incurred in those few down years. This was especially disheartening because although profits were back, they weren't seeing any increase in what they were taking out of the business. Everything extra was paying off debt. They weren't seeing the profits the government was taxing them on."

Cumbie's solution? "They hunkered down more in terms of what they were taking out, and watched cash flow more than ever through monitoring and measuring," he says. "In addition, they slowed down expansion, even though business was good, by putting off some new hires and depleting some of their of cash reserves."

Understand Your Business's Economics

Mark Friedman, whose clients range from public companies on the New York Stock Exchange to small start-ups, says the key to success is for business owners to understand the economics of their business, where they make money, and what costs them money. "I've worked with small construction firms that don't understand, across each piece of their business, the profitability of the services they provide," Friedman says. "They may be on a 30-day payment cycle, but they have a lot of materials they use, consuming as they go. It's surprising how many people make the mistake of managing their top line and bottom line separately."

Central to developing a clear economic picture is viewing a business through a profitability lens, says Friedman. Accordingly, he encourages small-business owners to look at their work on a detailed project-by-project basis. "Initially the dollar value of the work may look impressive, but when you factor in the time you spend to deliver the products or services, it may not be positive for your bottom line. You need to track your profitability religiously. I was once in a partnership where the senior partner couldn't get his arms around this concept and as a result, after I left, the firm closed its doors."

It's critical, too, says Friedman, to measure progress: "That way you not only can move forward, but manage how you move forward and understand whether you're on plan or off plan—not just from a revenue perspective, but from an operating perspective. You want to evaluate not just whether the revenue came in, but whether the revenue came from where you thought it would. If it didn't, you need to understand what happened and whether you need to change your business assumptions."

Also important is understanding the level of risk associated with each element of the business. "A small business's customers could range from billion-dollar public companies to nonprofits, and each has a different level of risk associated with it," Friedman says. The risk level is a function of who the client is and how much time you are spending on them.

Friedman addresses business economics monthly. His analysis addresses questions such as

- Where am I relative to my plan?
- Are my assumptions holding true? If not, why not?
- Do I need to revise my assumptions?
- Where am I today relative to where I want to be?
- What do I want to accomplish?

- How am I making money?
- If I want to expand, what piece of the business makes the most sense to grow?

"I want clients to make conscious decisions about their business, not just to go along and watch things happen," Friedman says. "An important component to ensuring rational decisions is to have six months to one year in cash. This way, you don't shift into panic mode if something changes unexpectedly."

In fact, Friedman has struggled with cash-flow issues in his own business. He explains, "There was a management turnover at a company where I was about to begin a large piece of work and I lost the business. All of a sudden, the work I expected wasn't there. I had been concentrating on that potential job to such a degree that I had cut back on other business development efforts. If you have an emergency business fund, you can manage the feast and famine cycle and don't run the risk of making a bad or emotional decision that takes your business in the wrong direction."

Fix a Cash Crunch Without Financing

Of course, in spite of the best business planning, cash-flow problems can surface for a number of reasons. Maybe a business relies too much on one client and is surprised when new management brings in another vendor. In addition, a health issue with a family member could lead to a lot of time out of the office, or a combination of vendors pushing for funds and slow-paying customers could create pressure on the cash flow.

In the early stages of a cash crunch, many business owners will borrow from personal funds, delay paying some vendors or payroll, or attempt to collect from customers early. Later on, when the balance sheets may not look attractive to potential lenders, it may be necessary for the business to generate capital internally. "The business owner could consider offering a discount for customers who pay early, thereby accelerating collection of receivables, or disposing of surplus or outdated inventories to generate cash," says James Quinlan, CFP®, CPA, ChFC, of the accounting firm Smart and Associates in Devon, Pennsylvania. In extreme situations, it may be necessary to sell other assets like equipment or company cars to generate immediate cash.

Quinlan, who works with companies ranging from the Fortune 500 to start-ups, adds that if a business has outstanding invoices, a collection campaign can often produce significant amounts of capital. A hard look at expenses, from magazines to memberships, may also identify expenses that the business doesn't take full advantage of or no longer uses.

Additionally, he encourages businesses to establish policies and procedures that will reduce the possibility of future cash shortages. "If collection on invoices is an issue, it may be helpful to establish more rigorous credit standards for new customers," he explains. "In addition, if a creditor offers a discount for paying early, take advantage of that. Also, use electronic funds transfer, so if payment is due on the 15th of the month, it doesn't have to be in the mail on the 12th. That way, you keep the cash in your bank account as long as possible."

Business owners also can control costs by requiring or tightening the rules on competitive bids, instituting a purchase-order program, and analyzing what each product or project costs the company, so pricing can become more efficient.

Quinlan also helps his clients evaluate how they make money and what their unique revenue-generating talents are. "If you're spending a lot of your time on tasks you aren't getting paid for, it may be wise to get outside help," Quinlan says. "If you are worth $100 an hour and can pay someone $20 an hour to do the bookkeeping work you are doing, it's well worth it. Spending money is often a difficult hurdle for mom-and-pop operations to get over, but it's important to understand what you do best and outsource the rest. I tell clients to find their unique ability and figure out how to maximize it."

Even if these moves don't generate all the immediate capital a business needs, Quinlan says his advice helps the business avoid future cash crunches, and can even put it in a better position in a lender's eyes.

Integrate a Financial Planning Perspective

Because meeting personal financial goals often depends on the business generating a positive cash flow, Guy Cumbie says it's imperative that planners have an integrated picture of personal and business finances. At his firm, that begins with his liquidity assessment worksheet, which breaks down typical cash needs into six basic categories:

1. An Operating Account for one month's ordinary and recurring budgeted inflows and outflows of cash
2. An Emergency Reserve to provide at least three months' living expenses
3. Business Operations to fund operations equity infusions or expansion
4. Short-Term Dedicated Funds to cover special expenditures within two years such as a vacation or down payment
5. Opportunity Money for special gifts or events, in addition to timely investments
6. Emotional Comfort Money that may be necessary for the client to sleep at night

Mark Friedman says that while the six-step financial planning process is a well-defined, effective process, business owners require a step seven. "The personal financial plan doesn't present the full picture. Without addressing the business's revenue stream, we have no idea whether the client's financial plan is feasible," he explains. "Planners should discuss a range of issues with clients, from the operating assumptions and priorities of the business to what's necessary for the business to be successful and how to measure progress."

If those are areas where planners feel uncomfortable offering advice, Mark Friedman suggests that planners supplement their services with outside business expertise. "Clients may balk at the idea of hiring another advisor, but to be forward-looking and really integrate personal and business planning, business owners need to do more than hire a CPA to tell them what they owe in taxes at the end of the year," Friedman concludes. "An active, ongoing review of a business is crucial to avoiding cash-flow problems and meeting a client's goals. The sooner business owners see a problem on the horizon, the longer they have to deal with it—and that decreases the chance that a business problem undermines personal financial goals."

Nancy Opiela, based in Medfield, Massachusetts, is a contributing writer for the Journal of Financial Planning.

Sidebar

Do Your Clients Need Debt Financing?
Questions You Can Ask First

Debt financing ranges from borrowing from family or friends and using personal credit cards to a range of commercial, personal, and state- or federally backed loans. Whether your clients are starting a small business or expanding their company, proper financing is a key to their long-term success.

To direct the financing search and prepare information for potential lenders, the United States Small Business Association (SBA) suggests answering the following questions before approaching lenders:

- Do you need more capital or can you manage existing cash flow more effectively?
- How do you define your need? Do you need money to expand or as a cushion against risk?
- How urgent is your need? You can obtain the best terms when you anticipate your needs rather than looking for money under pressure.
- How great are your risks? All businesses carry risks, and the degree of risk will affect cost and available

financing alternatives.
- In what state of development is your business?
- For what purposes will the capital be used?
- What is the state of your industry? Depressed, stable, or growth conditions require different approaches to money needs and sources.
- Is your business seasonal or cyclical?
- How strong is your management team?
- How does your need for financing mesh with your business plan?

An added benefit: If your clients do not already have a business plan, the answers to these questions can help them write one.

Source: United States Small Business Association (SBA)
For more information, visit www.sba.gov.