CASH FLOW & FORECASTING

A CDS White Paper Authored by: Bill Fenske, CPA, CVA, CMA, FHFMA, FACHE

What Is Cash Flow?

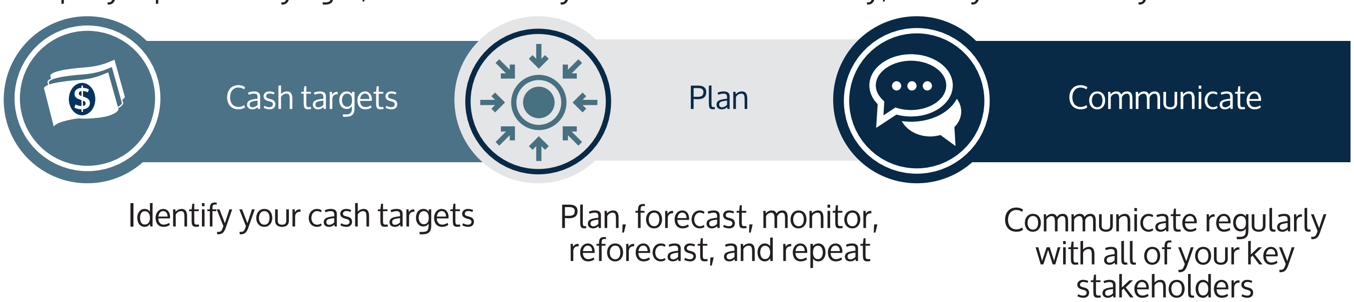
Cash flow is the movement of cash into or out of a business, usually measured during a specified period of time. Cash is king and cash flow is queen when it comes to the financial management of a growing company. You need to understand your cash and your cash flow along with your working capital needs. At its simplest, cash flow management means matching outlays of cash with money owed to your business.

What is cash flow forecasting?

A cash flow forecast is a projection of an organization's future financial position based on anticipated inflows and outflows from revenues and expenses. In addition, capital expenditures, debt payments, and any debt borrowings need to be factored into the projection. The process of deriving a cash flow forecast is called cash flow forecasting.

How often should cash flow forecasts be created?

Forecasting is an iterative process. New iterations of forecasts are referred to as reforecasts. It is common for businesses to reforecast on a quarterly basis, providing figures based on the variance between actual and forecasted activity from the previous quarter. However, if the cash position of a company is particularly tight, businesses may reforecast on a monthly, weekly or even daily basis.



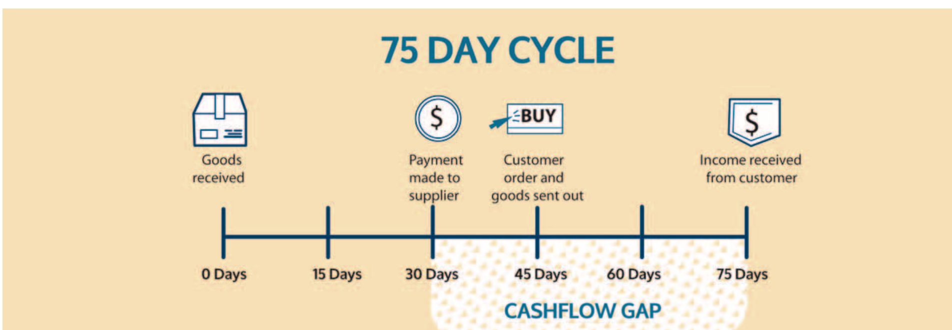
Proper cash flow management is integral to any business, sometimes marking the difference between success and failure. Obviously, you need cash in the bank to pay your bills and to pay your employees. Most critically, you need cash to implement your strategy. You may be doing well and are considering your next strategic initiative such as expanding into new markets, investing in new products, or recruiting new staff. Having accurate cash flow projections and financial plans will help you understand if and when you can afford to take the plunge.

Key Assumptions

Before you create a cash flow projection for your business, it's important to identify your key assumptions about how cash flows in and out of your business each month and what are the drivers affecting cash flows.

Key assumptions should relate to four primary areas:

1. **Receivables:** These assumptions should outline how quickly you receive payment from your customers. For example, if most of your customers pay you within 30 days, a key assumption could be: 90% of sales will be collected the month after the sale.



2. **Payables:** These assumptions should outline when your payments are due. For example, if your vendors require payment within two weeks of delivery, a key assumption could be: payables are due within 14 days of purchase.

3. **Capital Expenditures:** These assumptions should outline the amount and timing of your annual capital budget.

4. **Debt Activity:** If you have outstanding debt payments, this should outline timing of the debt payments (principal and interest) along with any anticipated new debt being considered.

Preparing a cash flow forecast begins with looking back

Historical financial information can provide valuable scale for making projections, but more importantly it provides the relationships between numbers that are essential when making estimates.

For example, understanding historical profit margins is critical for estimating future profitability. Likewise, collection and payable rates along with historical capital spend permit estimates about future uses of cash.

A thorough analysis of financial data is necessary, and insight into past financial performance influences the forecasting process. Future estimates rely on accurate historical information.

A Company-wide Approach to Cash Management

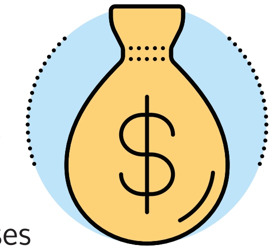
You cannot manage cash in a vacuum, particularly if you have various locations or retail outlets. You need the ability to resolve cash flow crunches no matter where they show up through a company-wide cash management process. To gain a company-wide culture of cash flow management, it's important to track your cash in and out of your business by both type and location. It can also mean engaging functions such as sales, purchasing, and operations more meaningfully in the cash management process.

By gaining a holistic view of your cash flows, you should be able to answer the following questions:

- How does cash flow in your business and what responsibilities/accountabilities do finance/accounting, and other functions have in relation to cash management?
- If you consolidate your various bank accounts and/or streamline the way each location collects receivables, can you reduce the amount of cash trapped in transit?
- Is working capital performance a component of executive or team member compensation?
- How do you compare to internal and external benchmarks?
- Do you have capital spending plans in place?
- Do I have real-time cash visibility and cash flow allocation?
- How much cash do you need to hold at each location?
- What is your process for funding different business locations that may be experiencing short-term cash flow shortages?
- Do you have a line of credit and if so how often do you access the line?
- How are cash generation or business development actions encouraged and incentivized across your company?
- How would a significant change in interest rates or sales volumes affect cash flow?
- What am I solving for? Define the objectives of cash flow forecast, what problems the cash flow forecast will solve and how the cash flow forecast result will benefit your customers, team members and stakeholders. Corporate strategy will drive the flow of corporate cash.

Cash flow forecasting involves input, time, and effort from across the organization. Before requesting complex itemized forecast submissions from throughout the business, and requesting yet another deliverable from your already busy staff and colleagues, it is critical to clearly determine and communicate the decisions the cash flow forecast information will facilitate and benefits this will bring to the organization.

The Biggest Cash Flow Forecast Pitfalls



Cash flow forecasts are a critical financial tool for any company, especially small businesses with frequently volatile timing issues in working capital. Here are FOUR pitfalls of the cash flow forecast and suggestions to overcome them.

UNDER-ESTIMATING WHAT IT TAKES TO DELIVER ON SALES

» Do you have an accurate assessment of your front-end costs before the cash is collected for forecasted sale and the ability to deliver on time. These costs may include labor, materials, technology, and your vendor-supplied resources.

Possible Solution.
Integrating your operations delivery and sales planning is key. When sales and operations communicate effectively, many issues can be avoided. Also, know your vendor limitations. Keep your suppliers informed about your business sales and operations so they can plan ahead.

SALES AND COLLECTIONS TIMING

» Forecasting new product sales can be daunting and a changing competitive landscape may swing forecast accuracy. This is even more difficult for start-up companies. Once you feel you have a realistic annual forecast, the next challenge is timing throughout the year, especially when products and services are seasonal.

Possible Solution.
Build a sales plan with strong metrics (i.e. number of salespeople, sales calls per day, close rates, success rates based on experience) and have a contingency plan when the numbers don't pan out as expected.

EVALUATE CUSTOMERS AND SUPPLIERS

» In times of economic uncertainty, businesses could see increased pressure on the purchasing power and credit-worthiness of customers while also facing tighter credit terms and product availability from suppliers.

Possible Solution.
Do not assume that your customers are financially healthy. Visit with your customers to better understand their needs.

Continuously monitor vendor accounts and negotiate for the most favorable credit terms with suppliers. Visit with your suppliers to share with them any concerns that you may be encountering or special needs for a new customer.

KEEP STRONG COMMUNICATION LINES OPEN BETWEEN YOUR LENDERS

» Your existing lenders will likely know you and your business best. Communicate with them early and often, explaining any situations that may arise and the actions you propose to address them. Transparency and open communication will serve you both well. Your existing lender could be your fastest source of additional liquidity.

Possible Solution.
Communication is one of the keys to accurate cash flow forecasting. An effective forecast requires input from a variety of individuals throughout your organization who can provide important figures and valuable insights that will increase understanding of what drives the numbers. Visit with your lender on banking services and products that maximize efficiency of your depository needs. Remember to include a discussion on the applicability and appropriateness of an open line of credit.

How Do I Prepare a Cash Flow Forecast?

So, how do you go about producing an accurate cash flow forecast? Here are five tips that will help your organization bring more precision to the process. You may be doing well and are considering your next strategic initiative such as expanding into new markets, investing in new products, or recruiting new staff. Having accurate cash flow projections and financial plans will help you understand if and when you can afford to take the plunge.

Identify Your Inflows and Outflows

Your cash flow forecast should be a detailed look at your company's cash position relative to its inflows and outflows. To start, how much money will you be bringing in over the period in question and from what sources?

Create Several Different Scenarios

When you create multiple scenarios (3-4 is common) with your company's future cash flows, you will be able to visualize the impact of certain future conditions, as well as quickly adapt your company's processes when necessary.

Plan, Forecast, Monitor, Reforecast, & Repeat

No cash flow forecast should be set in stone, since there may be customers who fail to pay, sales that don't materialize, or unexpected expenses that show up on your doorstep. Using the PDSA model of Plan, Do, Study, and Act, we adjusted the steps for the cash flow forecast process to Plan, Forecast, Monitor, and Reforecast. Once you publish a forecast and share it with management, continue to monitor results in real time as much as possible. Doing this will allow you to identify opportunities to improve your process.

A sound, realistic cash flow projection enables a business to make investments with confidence, plan capital expenditures strategically and set reasonable goals. A cash flow forecast should be thought of as a living document and updated regularly to reflect new information, such as macro-economic factors, micro-economic trends or new business activities that could impact the business, its clients or its cash flow. Proactive cash flow management requires a systematic approach that enables management to understand its cash cycle and to manage cash outflows, make well-timed expansion and hiring decisions, and, above all, anticipate potential cash flow gaps or other associated problems.

At CDS, we understand the importance of cash flow forecasting for your business. Our mission is to help our clients through expert accounting services tailored to each client's individual needs.

We are here to help and guide you!

Bill Fenske , CPA, CMA, CVA,
FHFMA, FACHE

Director of Business Advisory Services

bfenske@cdscpa.com

P (320) 214-2998

Kelly O’Farrell, CPA, CVA

Partner

kofarrell@cdscpa.com

P (320) 214-2959