Cash Flow Management During Good Times and Bad

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Cash flow is the lifeblood of a business. To survive and thrive, a company must apply cash flow management best practices to support generating sufficient cash from its business operations, investments and other sources to meet payroll, purchasing material inputs and supplies, paying for utilities, making required payments on previously incurred loans, paying required rents or mortgages for facilities, and making investments for future growth.

However, due to a variety of circumstances, a company may not generate sufficient cash at any particular time to cover its expenses. The causes of a shortfall may include, among other reasons, an unexpected decline in revenues (e.g., from a recessionary drop in demand or a new competitive product entering the marketplace); an unanticipated rise in costs (e.g., rising raw material prices, rising energy costs, increased wages won by unionized employees); or a recessionary slowdown in invoice payments by customers).

Cash shortfalls put companies at risk. They may expose a company to potential reductions in their credit ratings, put limits on their ability to borrow, increase their borrowing costs, and position them to be less effective competitors within their industry. Any prolonged cash shortfall could result in a complete collapse of the business and put it in line for bankruptcy protection.

For companies that are struggling to improve their sales and profitability, cash flow management shortcomings further aggravate their business condition.

Even Healthy Companies Can Experience Cash Flow Problems
But even companies that have healthy sales and earnings can experience a cash flow gap. The P&L may show a profit – perhaps even a sizable one. But unless the company manages its cash properly in any particular period, it may not have sufficient funds to meet its current obligations.

A company's product or service may be well-accepted in the marketplace – with significant order inflow. But it may still not be able to meet that demand because insufficient liquidity prevents it from ordering enough raw material inputs, for example. In such cases, larger and/or better-funded firms can often outdo smaller, more innovative businesses.

For small businesses, a severe cash flow shortage can even force a company into bankruptcy. Such a situation can occur, for example, during a recession, when customers tend to extend payment timeframes and/or demand suddenly shifts downward.

The bottom line is that no company can go for long with a mismatch in its cash flows. That's especially true during recessionary economic periods, when revenue may lag and customers are likely to stretch out their invoice payments. Thus, companies experiencing cash flow gaps will need to adopt cash flow management best practices if they are to survive, grow and prosper.

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Strategies for Cash Flow Management

At its heart, successful cash flow management requires the acceleration of incoming payments and the slowing down of cash outflows to the optimal feasible extent.

As part of the process of managing cash flow, a CFO would typically forecast both cash inflows and cash outflow needs over a given time period. If expected inflows are insufficient to meet the company's cash requirements over the timeframe, then the CFO must determine what actions can be taken to bring the situation into balance.

There are many strategies to accelerate cash intake and to slow down payment outflow. Here are some ways that companies use to help manage and accelerate their receivables:

- Offer discounts for early payment by customers, motivating some customers to accelerate their payments.
- Ask for deposits on incoming orders, thus getting some cash upfront. The risk here is that some customers may be alienated. Therefore, the company should be secure with the strategy, e.g., with the knowledge it has sufficient competitive advantage to overcome customer resistance to such a program.
- Invoice customers promptly, as soon as work is done or product is shipped, and continue to monitor receivables to make sure of timely receipt of payment.
- Require cash on delivery (COD) for customers with a record of slow payments, as opposed to dropping them as customers.
- To reduce the risk of taking on high-risk customers with poor credit histories, make credit-checks of all non-cash customers. If they don't meet a pre-determined credit standard, you can refuse to do business with them, or require COD payments.

Managing Payables

Increasing top-line revenue growth and accelerating receivables is just half the battle of managing cash flow. The other side of managing cash flow is slowing down cash outlays. There are many strategies for postponing cash outflows. Here are some:

- Take full advantage of creditors' payment terms to slow down payments. Don't pay early unless you receive a substantial discount for doing so.
- When selecting suppliers, consider factors other than price. Flexible payment terms from alternative vendors may more than offset a slightly higher price.
- Sometimes, you can negotiate a stretched-out payment schedule if you are in good standing with your suppliers. Regular communication and consistent payments to a schedule are important to make this a viable strategy.
- Another strategy to reduce cash outflows is to eliminate certain costs where possible, especially unnecessary expenditures. You should comb through your expenses on a regular basis to see if there is anything that you can do without. For example, you may be able to reduce some travel expenditures by substituting videoconferencing for some face-to-face meetings.

Estimating Cash Flows

Proper cash flow management requires a CFO to forecast cash inflows and cash outflow requirements on a regular basis. Doing this enables the company to anticipate if and when there would likely be a cash shortfall, and take corrective action as necessary.

Many CFOs have found that a 13-week (3-month) cash flow forecast model goes out long enough to assist them in managing and controlling their cash flow.

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The 13-week cash flow model is essentially a spreadsheet model that begins with cash on hand, adds cash expected from outstanding invoices, from work in progress and new business expected over the next 13 weeks. From this total, the model subtracts cash requirements for completing work in process, anticipated costs and overhead.

This is a rolling model that is updated every week. In the process, the estimated cash flow at the end of each week becomes the cash on hand anticipated for the beginning of the following week. A bottom-line end-of-period cash flow forecast is updated each week.

The 13-week cash flow forecasting model enables a CFO to see potential obstacles in sufficient time to make course corrections in the company's cash outlays and to try to boost incoming cash and enhance revenues. That's especially important during difficult economic times, when revenues may be slowing down and customers are delaying their payments.

This model has been particularly useful in bankruptcy and turnaround situations, when lenders and creditors are seeking to reverse the company's course and extract the funds they have previously committed to the company.

In these types of situations, the 13-week cash flow model "communicates the quantified operating and strategic plans for a company based on its defined exit plan, such as restructuring, recapitalization, going-concern sales or orderly liquidation," according to Frank R. Mack, senior managing director at AS Capital Partners, Chicago, and formerly a member of the Continuing Education Committee of the Chicago/Midwest Chapter of the Turnaround Management Association. "Over the duration of a 13-week cash flow model, the underlying operating plan should maximize the net cash flows and enterprise value of the company within its constraints."

Furthermore, Mack says, the 13-week cash flow model "not only serves as the company's overall business and strategic plan, but also accommodates an understanding of the financial impacts of [the model] to the respective recovery and/or transactional strategies" of all parties who have an interest in the turnaround.

The Bottom Line

Good cash flow management is vital to the sustainability and growth of every company. A prolonged cash shortfall can spell the decline of even an innovative company with a solid potential for growth. Therefore, the CFO, the CEO and other company executives need to pay strict attention to their cash flow condition on a continuing basis, and actions to correct a potential cash shortfall should be implemented at the first sign of a potential problem. Here are some key guidelines:

- Monitor and forecast cash flows on an ongoing basis, to detect the potential for cash shortfalls in a timely fashion. The 13-week cash flow model has been shown to be effective in providing the CFO with advance warning of potential cash shortfalls.
- If you're experiencing a cash shortfall, or foresee one in the near term, accelerate your cash inflows to the greatest extent possible using such strategies as offering discounts to customers for early payment; invoicing customers promptly; and requiring COD for slow-paying customers.
- To avoid a cash crunch, delay cash outlays to the extent possible, for example, by taking full advantage of suppliers' payment terms (e.g., net 30 days); choosing suppliers with more flexible payment terms; and canceling or postponing unnecessary expenditures.

Los Angeles CEOs and CFOs are normally able to monitor and manage their cash flow so that they are in a liquid position to meet their required cash outflows. However, if the company's internal resources are stretched, it may be a good idea to seek external financial expertise such as from an outsourced CFO services firm to handle cash flow management on either a temporary or ongoing basis.

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References and Further Reading

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