Do and maintain a dynamic cash flow forecast.

In managing a business, one of the first and most important things to do is to understand cash flow. Many times, this is more important than understanding how profits are made.

How many expenses does the business incur and pay out in cash every month? Be complete: categorize these under conventional headings:

- Salaries
- Rent
- Office expenses
- Bank loans
- Interest
- Do the same for income:
- Sales
- Monies you expect to collect from AR

Break it down weekly. The weekly cycle is important to understand: *WHEN* you receive cash is as important as *how much* you receive. If a bill is due to be paid this week and you will only receive monies next week, you have a timing issue. Once you do a cash flow cycle on a weekly basis and extend it out for to three months, you'll be able to see the repeating patterns that emerge. Then, you can take action **in advance** to match the timing of cash inflow and outflow. You can spread out payments to relieve cash flow pressures. Targets can be set for collections.

The forecast must be updated weekly, filtering in new information enabling a rolling dynamic forecast, so that, as it goes forward, it becomes a road map for the business.

Know another way to make profits.

I tell business owners that there are two ways of making money, and they usually know only one of them!

The first way is easy: **the difference between Sales and Costs results in the profit (or loss)**. This is where owners and managers focus most of their attention and energy – cutting costs, increasing sales prices, or both. It's a linear approach that has its limits, but it's what most business owners know to do.

The second way is by understanding (and managing) the velocity of money, i.e. managing how their assets turn over. If, in a given period of time your assets turn over five times, then **by improving your business to make it turn over more** (in this case six or seven times) you'll make more money because you've added an extra turn! A turn refers to the time it takes for a specific amount of monies invested to be "turned over", or replaced, in a given period. Businesses have some idea of this, but often fail to appreciate its importance or its value in generating profits.

Asset turnover can be further broken down into Fixed Asset and Current Asset turnovers. The easiest way to implement this is to concentrate on Current Assets:

- Receivables
- Inventory

If these turnovers are improved, you will achieve an increased velocity in the movement of money and add to your profits, while everything else in prices/costs remains the same.

In my experience, most businesses are reluctant to make changes in this area because it takes methodical and dedicated work. Most businesses ignore or neglect the "nitty gritty" work it takes to analyze and improve the Receivables and Inventory turnovers. However, if you can improve these, the positive impact is permanent and your business will move to a new level of prosperity!

How exactly do you do this? Start by systematically breaking down your Receivables in terms of *large and small customers* – how long does each take to pay? Do the same for the Inventory in terms of *large value and low value items*- how long do you hold them for? Know your position today, and decide where you want to be tomorrow. Then work backwards. Break down your current circumstances and your goal in quantitative terms and translate the process into a series of active steps tailored to each customer (or group) and to each Inventory item (or group).The collective improvements will have a significant cumulative impact in increasing your asset turnover.

Prepare detailed regular financial reports.

A business is always better off when it knows its numbers! It's even better off when it knows them quickly and consistently. It's akin to driving a car: you are constantly scanning the dashboard – speed, gas level, lights etc. so you can interpret and respond to what you see immediately.

Determine what numbers you need to see daily and weekly:

- Sales
- AR
- Collections
- Cash

What should they be compared to? last year same time, cumulative, etc. This broadens your understanding of what they mean and puts the numbers in the right context.

What numbers do you need to see monthly?

- P&L
- Balance Sheet
- AR, AP
- Inventory

Set up a layout over a three or six month period with comparisons to last year and budget. In this case, it's best to construct a summary set of numbers showing a high-level picture and then have a drill down capability to a more detailed set of numbers. It makes the information easier to consume – zooming in to the details after understanding the big picture.

Drive a solid bank relationship – know where you stand at all times.

Businesses that have borrowings from banks (Line of Credit, Equipment lines, etc.) have to conform to loan covenants (or ratios) that track the business's performance periodically. **It's important to know what these are and to agree only to appropriate loan covenants.**

Do this proactively:

- Test the relevant covenants on your current and forecasted financial statements during negotiations.

- Develop a set of suitable covenants and negotiate with the bank. Assess the covenants not only based on your current situation, but on your forecast for the next twelve months to three years as well. Make sure to account for your business cycle needs –expansion, contraction, and equity issues. Watch out for restrictive covenants and trigger events!

- Monitor your covenants monthly when preparing your financials, and forecast it for the next six months. Do a stress test – change revenues and variable and fixed costs up and down to see what happens to these ratios. Determine your margin for violation and work out what activity will breach them, e.g. drops in sales, increased variable costs, changed receivables/inventory levels, etc.

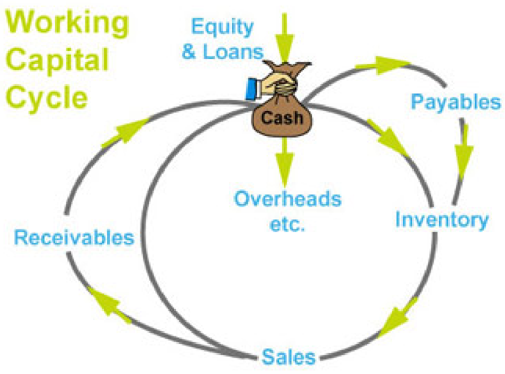
- Talk to your bank periodically about your business and its "numbers". This way, you can and *should* alert the bank of any possible problems that may arise. This will foster a good relationship and a mutual sense of comfort that you are in control of your business. Banks hate surprises!

- If there is possibility of a breach in the future, *and it should only be in the future if you are monitoring properly*, check with your banker about available options and be aware of penalty clauses that will be triggered.

Understand your working capital cycle.

What is working capital (WC) and what is the working capital cycle?

WC refers to: the investment a firm has made in Accounts Receivable and Inventory, minus the Accounts Payable (AP includes the funds suppliers have provided via goods and services). This works in a cycle, flowing in and out to benefit the business. AP is incurred because of Inventory purchases (raw material and/or finished goods, which become AR through Sales. This is converted to Cash that is used to pay AP and then new raw material and/or finished goods are purchased for Inventory which is then sold and so on, making this a continuous cycle. For a business to be (and remain) healthy, this cycle has to be actively managed, to ensure the appropriate level of investment needed in each component.



How do you do this? **First, you must understand what levels of money and time are appropriate as working capital**. When sales are made, your credit terms are usually 30 days, 45 days, or 60 days. This means that AR collections will come after this time has elapsed. What quantity of Inventory should you carry – 30 days of sales or 45 days? How long will you take to pay AP – 30, 45 or 60 days? This refers to the purchases you make for goods and services that have to be later paid; you receive goods from your suppliers and then you deduct this from the AR and Inventory to arrive at the WC investment you need.

This is how to set the process in motion - Once begun, how do you maintain a healthy cycle? You do this by constructing ratios – Days sales Outstanding (DSO), Days Inventory Outstanding (DIO), and Days Payable Outstanding (DPO) — that will tell you whether, in relation to sales, each of these components are increasing or decreasing. These ratios when tracked over a period of time indicate the health of your WC. These ratios can also tell you about the relationship between each of these components – is your AR too high when your Inventory is too low?

Assess your risk of fraud and theft.

Periodically, every six months or so, **take steps to detect and prevent theft and fraud in your business.**

Run a report of employee and vendor addresses in your Accounting and Payroll software. Compare them. Do any of them look the same? Are street numbers close by? *If they are, look into it.*

Look for checks written in round numbers, particularly large amounts relative to your average check amounts. You should not have many, so look at the ones you have. Are they genuine? Double check recurring payments, especially if they are small. Where are they going? Are extra amounts being paid relative to a twelve month period?

Review credit card payments and check whether they are set up to company names or individual names. Cross-reference names with companies. In today's word of electronic fund transfers, you have to be extra careful. Review usernames and passwords. Look into transfer limits and who has access to these.

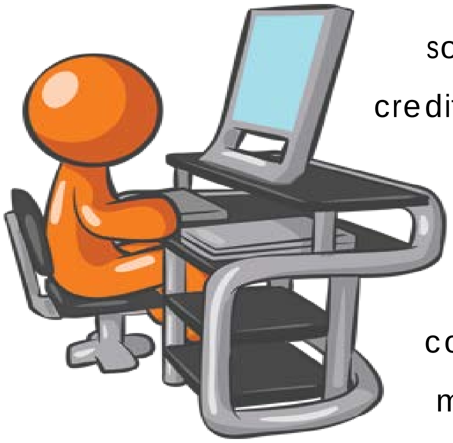
Improve data entry.

Data entry refers to the entry of business transactions into accounting software; it usually takes up a lot of time. These are primarily:

- Payroll
- Credit cards
- Banking
- Checks

All of these generate numerous transactions. As a business grows, this work grows. The accounting staff becomes caught up in tedious work and is unable to be analytical or inquisitive and therefore unable to add any real value to the business.

The answer is **electronic data entry**. Today, most data can be downloaded electronically from vendor systems directly into accounting software. Look into all your vendors that have online banking, credit card and payroll systems and wherever possible connect it to your accounting software to download this data, thereby avoiding manual input. Pay attention to how exactly this data is downloaded, avoid duplication and focus on internal controls and security. Downloads should be done daily to avoid month-end spikes in data entry time. It is incredible the amount of time you will save and mistakes you will avoid!!



Your accounting staff can now perform at a higher level as they will have the time and energy to spot anomalies and query the information in an engaged and meaningful way.

Perform complete Forecasting & Budgeting.

Forecasting and Budgeting are absent in many small and medium enterprises (SME). A lot of SMEs are aware of the need to do this and are anxious about its absence, but they don't know how to begin. Forecasting cash flow has already been addressed in this article. The next step is to do a detailed budget for your business. Most people take this to mean a Profit & Loss forecast that shows Sales & Expenses. That's only half (Sometimes even less!) of the picture! You also need to know the Assets & Liabilities and how they change. This comes from a forecasted balance sheet and a cash flow statement (not to be confused with the weekly cash flow).

When you can forecast for twelve months at a time, the patterns and any seasonality of your business emerge. A business must live in the now and future, not in the past. **A forecast enables you to do this.** It's important to do this according to good business and accounting principles. Know the key assumptions that go into this and periodically test their validity. Update this and the forecast on a quarterly basis. To make this a living, working document, make it look the same as your regular financials. This way there is no confusion and you are encouraging managers to look at the past and future in a seamless manner.

Assess business risks.

When is the last time you looked at your business and assessed it for business risks? Insurance vendors will talk to you about the need to insure all sorts of risks. HR vendors will talk to you about legal exposure related to work and employee practices. CPAs will talk to you about tax implications. But no one really talks to you about the ongoing business or financial risks that you face and what you can do about it.

What if, a large customer or Vendor changes their terms with you? What if they leave? There are a host of such "what if" questions you could ask. Subject your business to a stress test. You do this by looking at your business through your current financials and building a set of "what if "projections. These projections are modeled to answer some key questions:

- What will happen if your sales reduce 20% or even increase 20%?
- What will happen if interest rates go up by 2%?
- What happens if customer payments are delayed by 30 days?

A series of relevant assumptions modeled through a set of complete projections will give you good insight as to what stresses your business can withstand. Your projections should include more than just the income statement, which is where most businesses stop. It's important to project the Balance Sheet and Cash flow too, to understand the total picture.

Based on what you see, you can map out alternatives and standby arrangements, think ahead, and set up action plans. This allows you to calmly respond to rude surprises!

Have a manual of accounting policies & procedures.

Most companies don't have written accounting policies, and many are driven by the instructions in the accounting software to determine their policies and procedures. Such instructions are insufficient and in some cases, leave many firms incomplete in their accounting work. Just like designing an employee handbook that has HR policies, firms need a manual for accounting policies and procedures that tells employees how the company records and reports its business transactions.

The accounting world and work can be divided into several discrete areas that are common to most businesses:

- Sales
- Purchases
- Manufacturing
- Distribution
- Accounts Receivable
- Accounts Payable
- Inventory
- Banking
- Payroll
- Fixed Assets

These are all brought together through the principles of double entry via the General Ledger to produce reports. Each of these areas is in the accounting software and this is where a firm should start.

The manual should lay out policies for:

- Accrual/cash accounting
- Revenue recognition
- Expenses accruals and prepayments
- Depreciation methods
- Inventory recording and valuation

All of this makes the organization consistent in following accepted principles of accounting which go to produce quality financial reports. Closing dates and routines should also be covered.

It doesn't need to be elaborate, but when all areas are covered any employee, especially in accounting, knows what the company does to properly record its business transactions. This ensures that no transaction gets left out and consistent principles are followed every time. Monthly accounting improves. Year-end work is not any different from a regular monthly close, avoiding backlog or missed work. This also allows for good training of employees.