Bonus chapter 01: Cash flow

Managing cash effectively is an important challenge for all creative firms. “Cash” includes not just currency but also checks, money orders, bank transfers, and the like. The term “cash flow” refers to the overall movement of money into and out of your business during a given span of time. If a company has positive cash flow, money will be available for such things as expanding operations or making distributions to the owners. However, if a company has negative cash flow, it may have to borrow money to continue operating. This chapter will help you get a handle on this vital business issue.

There are three standard tools used by well-managed businesses to analyze their cash activity:

- A short-term cash flow projection
- A long-term cash flow projection
- A cash flow statement

Let’s discuss each of these tools individually.

Short-term cash flow projection
This is a forecast of the cash that you anticipate receiving and disbursing within the next sixty days. It’s usually organized into four columns, each representing a fifteen-day span (see Figure 14.01). In order to prepare the projection, you must first print two small reports from your financial system: an updated accounts receivable aging and an updated accounts payable aging. An accounts receivable aging report is a list of unpaid client invoices, usually grouped by name. On the left, each invoice is listed in order of the date issued. On the right, there are columns to identify how long you’ve been waiting for payment. You can set these preferences in your financial software — for example, “current” (less than 15 days), “15 to 30,” “30 to 45,” and “45 or more.” Unless a client has informed you to the contrary, your expectation is that the oldest invoices will be paid first. Your accounts payable information should be aged in the same way. Typically, you’ll pay the oldest vendor invoices first, although priorities sometimes shift. Don’t forget that you may have a few additional obligations that do not go through the accounts payable system, such as monthly rent, payroll, and loan payments. We’ll list these as “direct disbursements.”

To start your short-term cash flow projection, enter your beginning cash balance at the top of the first column. This should include the amount in your checking account plus cash reserves such as savings accounts or money market accounts.

Now, enter all anticipated receipts and payments (from your aging reports, plus direct disbursements) into the appropriate columns. Within each fifteen-day period, you’ll see the beginning balance, the expected cash in, the planned cash out, the net change, and the ending balance that will result. The ending balance at the bottom of the first column becomes the starting balance at the top of the next, and so on. This short-term format is very

Figure 14.01. It's important to note that this shows open receivables as of today only — future billings are not included. Similarly, it shows open payables as of today only — future purchases are not included. If you had to close your doors today, this is how cash activity would wind down. You don't want the final balance to be negative!

60-DAY CASH FLOW PROJECTION

All amounts as of: **October 1**		*Oct 1 to 15*	*Oct 16 to 31*	*Nov 1 to 15*	*Nov16 to 30*	*Later dates*
BEGINNING BALANCE						
Cash on hand						
Checking account	*30*					
Savings account	*5*					
Combined	*35*					
Total beginning balance		35	2	22	2	0
CASH IN						
Accounts receivable aging						
Over 90 days	*2*	2	0	0	0	0
60 to 90 days	*6*	3	3	0	0	0
30 to 60 days	*100*	0	50	50	0	0
0 to 30 days	*142*	0	0	0	71	71
Total accts receivable	*250*					
From other sources						
Line of credit		0	0	6	0	0
Loans		0	0	0	0	0
Total cash in during period		5	53	56	71	71
CASH OUT						
Accounts payable aging						
Over 90 days	*0*	0	0	0	0	0
60 to 90 days	*12*	0	6	6	0	0
30 to 60 days	*60*	0	0	30	30	0
0 to 30 days	*20*	0	0	0	10	10
Total accts payable	*92*					
Direct disbursements						
Rent		5	0	5	0	5
Payroll		27	27	27	27	27
Sales tax		6	0	8	0	0
Repay line of credit		0	0	0	6	0
Loan payments		0	0	0	0	0
Total cash out during period		38	33	76	73	42
NET CASH FLOW		-33	20	-20	-2	29
ENDING BALANCE		2	22	2	0	29

conservative. It shows only actual amounts that are already on your books. It doesn't factor in any potential or speculative future activity.

Update this projection every week before you make any disbursements. Most design firms try to prepare the majority of their checks in one weekly batch because it's a more efficient approach than writing checks in dribs and drabs.

If your short-term projection shows that cash will go negative during any of the upcoming fifteen-day periods, you need a plan for dealing with that temporary shortfall. Your options include the following:

- Speed up receipts
  It's difficult to get clients to pay early, but you can definitely speak with any clients who are habitually late. Negotiate with them to bring their payments up-to-date.
- Slow down payables
  Some business expenses, such as payroll, rent, and taxes, must be paid on specific dates. However, you may have more leeway in scheduling payments to vendors. If you're facing a cash shortage, it may be possible to negotiate with some vendors to slow down your payments, perhaps by breaking large invoices into a series of partial payments. On a related note, many design firms pay vendors for project-related expenses only after client money has been received. Be cautious about this, however. It's important to be fair to your suppliers. If you happen to be late in billing a client, or are in a dispute with the client over an unrelated matter, the vendor should not suffer for it.
- Borrow
  If you're facing an immediate deadline such as payroll, you might consider short-term borrowing. Many design firms have a line of credit available from the bank. If you exercise a line of credit, be sure to repay the funds promptly to minimize the total interest expense.
- Obtain additional investments from owners
  It may be possible to arrange additional cash inflow from the owners of the firm. That is to say, owners might use personal funds to increase their equity stake in the company.

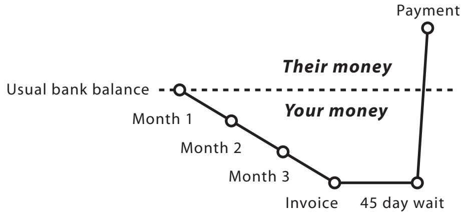

Figure 14.02. If you wait to bill the client at the end of the project, and then wait another 30 to 45 days for payment, you will have to cover labor and other expenses in the meantime. This means that your cash will be tied up in work-in-process inventory.

Maintaining healthy cash flow is crucial to the success of your design firm. You need to have enough cash available to pay creditors, employees, and others on time. Several basic business practices will make this easier for you:

- Always ask for an up-front deposit before commencing a new project, especially if it's a large one.
- On large projects, don't wait to bill everything at the very end. Instead, submit a series of progress billings (see Figures 14.02 and 14.03). Send invoices at least monthly.
- Make sure that your invoices are self-explanatory. Include complete reference information (requisition number, purchase order number, contact name, and so on) so that invoices are very easy for large client organizations to process.
- Follow up on unpaid invoices by sending each client a month-end statement of account, providing additional copies if needed, and phoning on due dates to inquire about payment status.
- Collect the full amount of each invoice. This is sometimes a challenge for recent grads and small firms. If you have a fixed-fee agreement in place with your client and you've provided everything that you promised, don't let the client get away with paying you less. The time for the client to negotiate pricing is before the work is done, not after.

Now that we have a handle on short-term needs, we're ready to take a much broader view by preparing a completely different sort of report.

Long-term cash flow projection

This is normally prepared as part of a business plan. Specific formats for business plans vary. This section

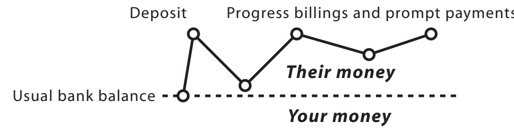

Figure 14.03. Bill frequently and work with clients to receive payments within terms. This way, the project can be completed entirely with cash from the client.

might be called the "cash plan," "cash budget," or "pro forma cash flow." Many samples can be found online and in books about business planning. Essentially, it's a prediction of the cash demands that you expect to face over the course of the next three years. It's not tied to the clients and vendors currently on your books.

Preparing it requires you to make a series of very broad assumptions about future activities. You need to give careful consideration to such things as changes in the overall size of the business, possible adjustments to staffing levels, potential changes to your mix of client categories or services offered, the timing of any major purchases, and other potential milestones such as relocation.

With each issue, you need to be as logical and objective as possible. Don't let yourself get carried away by unrealistic expectations. Your month-by-month sales projections should be based on past averages, adjusted to reflect current trends and planned changes. Monthly expense targets will be determined in a similar way.

Because this long-term projection is based on so many assumptions, it tends to become less accurate as it moves further out into the future. For this reason, you should update it on a regular basis so that it keeps pace with your evolving business. Your goal in preparing this projection is to anticipate and estimate the resources and reserves that will be needed to support your continued success. For example, some businesses (such as annual report firms) go through seasonal cycles of profits and losses. If that's your situation, it may be necessary to borrow money to maintain operations during times of low sales or heavy expenses. The cash projection shows the amount of credit needed as well as the plan for repayment. (For more information about long-term financial projections, please see Chapter 27.)

As you go through this planning process, keep the following tips in mind:

- It may seem obvious, but for the long-term viability of your firm, your accounts payable must consistently be less than your accounts receivable. If this is not the case, see whether your prices can be raised and/or your costs lowered.
- Whenever possible, avoid draining current cash balances to buy long-term assets such as equipment. It's much better to finance big purchases so that long-term assets are paired with long-term liabilities.
- In periods where your cash balance is healthy, have arrangements in place to sweep any excess amounts into an interest-bearing account. Many banking systems will allow you to do this automatically.

Cash flow statement

In this final report, we turn from predicting the future to recapping the past. The cash flow statement can also be called a "statement of cash flows" or "sources and uses of cash." Samples can be found online and in most accounting textbooks. It's one of three standard financial statements that well-run businesses prepare at the end of each month, quarter, and year (the others are the balance sheet and the profit and loss statement).

This retrospective report shows the amount of cash that was generated and used by your company during a particular period in the past. From an accounting standpoint, it doesn't include any accrued amounts. This means that income and expenses are included only if cash was actually received or paid. It doesn't include any non-cash activity such as depreciation.

The report is divided into these standard sections:

- Operations
  This shows cash flow that was related to the sale of goods and services. It includes the majority of daily activities involving customers, suppliers, and employees.
- Investment
  This shows cash flow that was related to discretionary business activities such as the purchase or sale of property and equipment.
- Financing
  This category includes external sources and uses of cash, such as loan activity or the payment of dividends to owners.

At the end of the cash flow statement, you'll see the net change that resulted from the listed activities, broken down by account (cash in the bank as well as any cash equivalents such as marketable securities).

Using these tools

As a smart businessperson, you'll want to master each of the management tools we've discussed in this chapter. They'll help you to spot trends and anticipate future needs. Planning and managing cash effectively is vital for the overall health of your creative firm.