Three-Dimensional Cash Flow

It's a Matter of Timing

We all live in a three-dimensional world and are limited by the scientific laws that govern it – we can't fly, we can't create matter, etc. So why should we expect running a small business to be any different? Small business owners are not exempt from the basic laws of physics – they cannot speed up time, or slow it down, they cannot create money (legally), they cannot spend cash they do not have on hand, and they have only limited control over key factors in their environment, such as how their vendors and their clients behave.

To be successful, business owners must have an appreciation of their own environment – the world in which they hope to succeed. This article explores the three dimensions of cash flow in that world, and the critical factor of timing that can determine success or failure for your organization. The fact is, businesses that ignore these issues will likely fail. Many businesses fail each year, even though they were able to show a net profit on their income statement. They failed because they could not anticipate the flow of cash through their organization.

Can you think of any competitors in your industry who have failed during the last three years? Did they have a good business strategy? Were they profitable on paper?

The truth is, many of them failed because they did not fully understand, or at least respect, the relationship between time and the three dimensions of their operating cash flow. They may have understood the balance sheet and the income statement. Odds are they failed because they did not understand the importance of timing and the need to maintain a reserve pool of cash for their organization.

To succeed in business, we have to stop thinking of our organizations as the two-dimensional objects that exist on paper. We have to start realizing that they are three-dimensional in nature, and must be treated as such.

Doing so will help you to see that there are things you can do to bring more cash into your business each day.

Exploring Your Three-Dimensional Organization

Sources of Cash

This is money coming into your business from new sales, financing, liquidation of assets, etc. In daily practice, however, it is much more than that. To actively manage the flow of cash in your organization you need to consider how much control you have over sales, and more importantly the payment stream that results from your sales. You also need to consider the effect that any financing will have on your cash position, and whether it helps to drive more sales or is a net cost to your business. If financing is not going to create new business opportunity, or reduce your operating expenses, then it should not be in your business plan. Lastly, you need to evaluate the assets currently owned by your organization. Are these assets productive, or are they obsolete? Could the sale of these assets result in new cash for more productive assets, or the elimination of debt?

Here are a few key questions to help you begin evaluating your current sales plan, and whether it is allowing you to maximize the flow of cash and the timing of that flow:

Vendor relationships

- Are you on COD terms with your vendors, or do they allow trade credit?
- Do your vendors offer discounts, and do you take advantage of them?
- How good is your payment experience with vendors?
- Does that payment history give you any leverage to negotiate better terms and/or prices?

Client relationships

- What terms can you afford to offer to your clients?
- Have you ever demanded COD from certain clients because of past payment experience?
- Are you a slave to your client (perhaps a large institutional company), or do you have some control over when you get paid?
- Can you afford to offer discounts or special pricing incentives to bring cash in faster?
- How do you determine who gets what prices and terms? Do you know how that would affect per item profitability?

Financing relationships

- Do you have bank or investor debts?
- Do these obligations help you to increase sales or reduce operating cost? For example, is the financing for a new piece of equipment that will help you produce products that are in high demand? Will it help you produce product at lower cost?
- Do the terms of those obligations match the benefit that money is bringing to your business?
- Have you ever been past due with your bank? Do you have any leverage to gain better terms?

Asset management

- Are you holding on to obsolete equipment or inventory?
- Could the sale of those assets bring more cash into your organization?
- Could new equipment purchases increase your capacity to produce goods or services?

The process of managing incoming cash involves a continuous review of your vendor, client, and financing relationships, as well as your overall asset structure. Business relationships should work for you – not against you. If a vendor is not bringing value to your process – consider new vendors. If clients are paying inconsistently or slowly, consider how your trade terms can influence their behavior. Don't be happy with the status quo. Instead, always ask yourself whether the deal you have today is as good as it can be.

Uses of Cash

This is money exiting your organization to pay expenses, reduce debt, buy materials, purchase key assets, etc. Just as you do with a personal budget, your business must have a plan for every dollar that goes out the door. Are you and your employees spending effectively? Have you negotiated the best terms for your supplies and materials? Are you actively managing operating cost within your business?

Vendor relations

- If you had cash to pay all of your vendors within five to seven days, could you negotiate better prices, or volume discounts?

Client relations

- Could you increase sales by offering more flexible trade terms to your clients?

Financing relations

- Is your debt productive, or is it holding you back?
- How would it affect your business if you could reduce the cost of your financing, or become debt free?

The answers to the above questions will determine when, and if, you will get paid for your products and services. They will have a dramatic effect on the "timing" of cash into your business. **Both personally and professionally, most of us know what it is like to feel "cash poor" even though our overall income is greater than our overall expenses.** Active management of these first two dimensions, sources and uses, will begin arming us with the freedom we need to take our businesses to the next level. To succeed in the long term, however, we need to consider the third dimension – the depth of our cash pool.

Depth of Cash

This is the pool of cash you currently have at your disposal. How does your current cash position affect today's income and expenses, and your ability to negotiate better terms with vendors, clients, banks, and investors? One key to success in this dimension has to do with retained earnings, since many businesses fail after siphoning off too much of the company's earnings.

We've all heard the old clichés that "money talks" and "cash is king," but are we learning the lesson? **Are we as business owners retaining enough cash to maximize our leverage in the marketplace?** A business with cash has much more negotiating power than a cash poor organization that is highly leveraged. Here are some questions to consider regarding the cash position of your business.

- Do you have enough cash to operate every day of the year?
- Do you have a reserve of cash (or liquid investments) to operate for at least a month or two if your cash supply were cut off or otherwise inhibited?
- Do you ever receive calls from your bank about overdrafts or uncollected funds?
- Have you ever had to skip a paycheck so that your employees could get paid?
- Does your business operate with a strict monthly budget?
- Do you escrow for irregular expenses and taxes?

Just as with our personal finances, our business plans must allow for the unexpected. Some cash must be on hand to meet life's "little emergencies" at the front door – rather than allowing them to create problems. In business, these could be as simple as an interruption in the flow of our raw materials, an interruption in payments from our clients, or failed equipment that needs to be replaced yesterday. There is no way to predict these in our budget, but we must realize that they will exist – and plan accordingly.

Time Factor

As you can see, the three dimensions of cash flow are interrelated by the time factor. Terms you offer to your clients are critical to your current cash position. Terms you are granted by your bank are also intertwined into your daily cash flow and your ability to budget expenses each month. Vendor terms and prices are even more critical to the long-term success of your organization. Each dimension is woven into the other.

Just consider a small business holding an average of $130,000 in accounts receivable and experiencing a 45-day A/R turn rate. For every day they can improve their A/R turn, they can increase their average cash deposits by almost three thousand dollars.

The delicate balance of time that exists between the three dimensions determines whether you have money every day of the year to keep the lights on, the doors open, and the conveyor belt running at full speed. After all, a past due payment from your largest customer does nothing to help you meet payroll.

The Critical Need for Forecasting

The most successful business owners will be those who can forecast incoming and outgoing expenses with some level of confidence. The most profitable in the long term will be able to leverage that information to reduce their cost of goods, develop the strongest supplier relationships, and offer the best overall terms to their customers. This is why bankers are so concerned about prior experience when they underwrite a loan to a new business. They know that you are more likely to succeed if you have done your homework, and if you understand the typical client and vendor relationships in the industry.

It is not enough to simply understand the dynamics of your industry and to make an initial business plan. That plan has to grow with you through the process of active sales and expense forecasting. While you cannot break the basic laws of physics, you can make the most of your opportunities by respecting these three dimensions and their effect on your organization.

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