

# Part V

## The Part of Tens

The 5<sup>th</sup> Wave

By Rich Tennant



"But rather than me just sitting here talking,  
why don't we watch this video of me sitting  
here talking?"

## *In this part . . .*

**T**he Part of Tens contains a couple shorter chapters. Chapter 16 summarizes the top ten keys for managing cash flow in small businesses. Chapter 17 offers ten true stories of cash-flow woes, based on author Tague's business and financial consulting experience. Only the names are omitted to protect the innocent.

## Chapter 16

# Ten Keys to Managing Cash Flows in a Small Business

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### *In This Chapter*

- ▶ Understanding *all* the financial statements
  - ▶ Managing your business's critical cycles
  - ▶ Protecting cash and cash-producing assets
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**I**f cash could talk, it might quote Tony Montana in the movie *Scarface*, who states, “I always tell the truth, even when I lie.” Even when the income statement and balance sheet are “lying” (that is, misrepresenting the facts), the cash-flow statement always tells the truth about the state of the business's cash. Simply put, the cash-flow statement is one of the best management tools to help determine if your income statement and balance sheets are lying.



We've said it before, but it's worth mentioning again here: In the black, but where's the green? Translation: Just because your company generates a profit doesn't mean it's generating positive cash flow.

So with this relatively simple but extremely important concept in mind, this chapter provides you with ten tips for managing cash flow so your business always has enough cash available when opportunities occur or disasters strike. These tips have all been discussed in the book and range from the basics of understanding your financial statements to the importance of managing your critical cash inflow and outflow cycles to working with the wonderful world of financing sources, but they all circle back to Tony Montana's quote. That is, if the cash-flow statement displays relatively poor cash flow but large profits, then chances are your business may have an issue (some asset or liability is consuming cash) to address in the balance sheet and income statement.

## *Respect and Understand Financial Statements*

Small businesses are notorious for not maintaining proper accounting books and records. According to some surveys, 25 percent of businesses don't even maintain accounting records (let alone produce financial statements), a number that still stuns us. And when financial statements are produced, most small businesses generally tend to focus on the income statement first and foremost. They may then take a crack at the balance sheet (sometimes without a clue as to what it's really saying), but most business managers leave the statement of cash flows for the bean counters to deal with.

The bottom line for small businesses is simple. If you don't make an effort to prepare, review, and completely understand your financial statements, then you need to ask yourself why you're in business in the first place. And this especially holds true for the statement of cash flows, because an abundance of invaluable information is available from this most commonly overlooked and mismanaged financial statement.



You know your mom was right when she constantly harped on you to always eat your fruits and vegetables. So if you must, think of all the financial statements as fruits and vegetables. Although you may not want to eat them, in the end, you will be stronger and extremely thankful you did. You can get started understanding all three important financial documents in Chapter 3.

## *Plan, Do Projections, and Plan Some More*

Proper planning is essential to the launch, growth, management, and ultimate success of your business as measured by the ability to generate profits and, just as important, to avoid running out of cash. Dedicating resources to this all-important function cannot be underestimated in today's rapidly changing and complex marketplace. Having access to sound financial plans structured for different operating scenarios is an absolute must.

During the planning process, keep in mind these two critical elements:

- ✓ **Planning is an ongoing and constantly changing and evolving process.** Treat the business plan as a living, breathing tool that is constantly changing and needs constant attention as market conditions shift. The ability to adapt and remain flexible to changing market conditions has never been more critical than in today's fiercely competitive global marketplace.

✓ **Financial planning starts with identifying, obtaining, and evaluating reliable business, operational, and market data and information (both from internal and external sources).** Yes, you may be surprised that the authors of this book (both being accountants) acknowledge the importance of accumulating nonfinancial and accounting data first, but we're not dealing with "the chicken or the egg" riddle — data must come before any financial forecasts or projections can be completed. Reliable internal and external data and information are the basis of any sound business plan and forecast.

Chapters 8 and 9 walk you through the background work necessary for planning, help you create a viable business plan, and provide the basis for building best in class projection models.

## *Focus on Capital and Cash: The Lifeblood of Any Business*

You must secure the proper amount, type, and structure of capital to provide your business with the necessary financial resources to execute the business plan. One of the most common reasons small businesses fail is that they lack adequate cash or capital, not only to survive difficult times, but also (and more important) to prosper during growth opportunities. Although having a war chest to tap during down times is important, having the proper amount and type of capital available to support a rapid-growth period is even more critical, because although surviving is nice, most companies are in business to create wealth and value to the owners. Face it; in a capitalist economic system, wealth creation is of paramount importance, and wealth is created most often by not treading water and staying afloat but by riding the monster wave when it arrives. So be prepared. Raising capital has been and will continue to be one of the most critical and time-consuming tasks business owners and managers ever undertake, and its importance should never be underestimated.



Remember, one of the greatest losses a small business can realize is that of lost opportunity, which has its roots in not being prepared to properly capitalize on market opportunities. The harsh reality is that this great loss is never accounted for or presented in any way, shape, or form on the business's financial statements. Rather, missed market and business opportunities lurk in the background, haunting the business owner, manager, or entrepreneur with the torturous thought, "Imagine what I could have achieved!" Chapters 10 and 11 can help you understand how to secure capital as needed so you won't ever have to face this regret.

## *Understand Your Selling Cycle*

From an accounting perspective, the selling cycle basically commences with the initiation of a sales order, which then turns into the issuance of an invoice, which, of course, eventually results in the receipt of payment. The accounting cycle, although relatively easy to define, is only one element of the entire selling cycle that starts with conducting proper planning and market research and doesn't end until the customer's needs are completely satisfied (to ensure the customer returns). The length of the complete selling cycle is often much longer than the aspiring entrepreneur projects and/or wants to believe. And if not properly managed, the selling cycle generally becomes one of the largest consumers of cash in a business (as sales goals and objectives are not met, capital is depleted more rapidly than forecasted, and management's creditability is impaired). Without fail, almost every aspiring business owner, at one point or another, will experience delays in the selling cycle.



The selling cycle involves more than selling a product or service and collecting the cash. Rather, the selling cycle in its entirety spans the time from the very start of the process when a product or service is first visualized and developed (that customers may actually purchase) to supporting customers after the sale and developing additional products or services that may be in demand (thus completing the circle). The lesson learned from understanding the complete selling cycle can and should also be applied to almost any business function, from raising capital to securing management to developing new products. Make sure you apply the concept of the selling cycle to every aspect of your business to ensure that you develop proper plans and secure capital resources to handle the inevitable bumps in the road that will come. Chapter 14 can help you on your way.

## *Manage Your Disbursements Cycle*

The selling cycle is generally the largest consumer of cash for most businesses. To counteract this cash consumption machine, businesses need to understand that the disbursement cycle (managing expenditures and cash payments to vendors, employees, and other creditors) can be leveraged and managed to be a primary source of cash for your business. You may be thinking, "What, have the authors lost it? Everyone knows that sales produce cash and disbursements consume cash!" Well, at the end of each of these cycles, your objection is absolutely correct, but in 90 percent of the activity and transactions that occur prior to the end of each cycle, you can manage things to alter how cash is consumed and generated. Chapters 14 and 15 offer detailed tips on how to improve cash flows, ranging from structuring

customer payment terms to entice customers to pay quicker to developing relationships with vendors and understanding how much time you can really buy before you have to pay outstanding invoices, to approaching financing sources on how to squeeze more money from lending agreements.



When at all possible, invoke one of the most important accrual-based accounting principles — the matching principle. That is, similar to properly matching revenue and expenses to ensure that an accurate measurement of a business's profit or loss is obtained, you should be able to match cash inflows and outflows. This effective management tool is used in a wide range of environments and is best understood by taking a closer look at paying sales commissions. Generally, sales representatives earn commissions when sales occur. If the commission is paid in the same month the sale is recorded (regardless of if the customer has paid), then cash outflows may be accelerated. However, if the commission is paid when the customer pays, the cash inflow from the customer is matched with the cash outflow to the sales representative.

## *Be Creative to Generate Cash*

Small businesses must continually (and quickly) innovate, create, adapt, and adjust to have a chance at competing against the corporate behemoths that dominate so many markets. Deep pockets are a luxury that most small businesses generally don't have, as sitting on mounds of cash is a problem that most companies would love to have but few will ever experience. To stay afloat, small businesses should apply to accounting the same business creativity they use when developing new products or services, figuring out how to reach customers more efficiently, or structuring employee compensation plans to retain the best talent available.

The following three areas offer significant opportunities for creativity when looking to improve cash flows:

- ✓ **Turn your assets over quicker.** Assets consume cash. The quicker you can turn over assets, the quicker they turn into cash. It's as simple as that.
- ✓ **Leverage your vendors, suppliers, and financing sources.** These businesses are your vendors, but, more important, you are their customer. They don't want to lose your business, so placing just the right amount of leverage on these groups can result in enhanced cash flows because liabilities offer a source of cash. Looking at it from another perspective, if a vendor offers your company 30-day payment terms that you can stretch into 45 days, in effect, you have 15 extra days to remit payment (and thus keep cash with your company longer).

- ✔ **Manage external sources of cash proactively.** You can proactively manage your relationships with banks, leasing companies, and even the federal government to ensure that cash is made available when needed. If you give an inch with these groups, they most likely will take a mile, so be sure your business takes the lead with managing these types of external parties.

## Balance the Balance Sheet

Many businesses overlook the concept of properly managing the financial structure of their balance sheet, which has gotten more than a few businesses in trouble. Your business needs to strike a proper balance between making sure that current assets (on the left side of the balance sheet) are financed or supported with current liabilities (on the right side of the balance sheet) and making sure that long-term assets are financed (again, on the left side of the balance sheet) or supported with long-term sources of capital (such as a five-year note payable or equity). Every business should strive to achieve a financial condition that ensures constant maintenance of adequate levels of both solvency (the ability to pay all just debts) and liquidity (the ability to quickly access cash to support business operations).



For a case study on how to fail at financing, look no farther than the federal government. The problem is not only that the federal government is running enormous deficits that it's funding with debt, but also that the composition of the debt in relation to the federal government's expenditures is out of balance (and problematic). The federal government is currently utilizing more and more short-term treasury bills (30, 90, or 180 days until maturity) to finance long-term structural expenditures (such as the military). Although implementing this strategy helps reduce interest expense (because the interest rates on short-term debt are less than 1 percent compared to ten-year rates of closer to 3 percent), this type of imbalance increases potential financing risks down the road: If short-term rates rise or market conditions change dramatically (and selling the debt becomes more difficult), access to cash to fund ongoing government operations may become a very big problem, very quickly.

## Understand External Capital Markets

Business owners love to quote two old sayings when it comes to banks: Banks always have money available to lend when you don't need it, and banks love to say yes, yes, yes, yes — and then, when it's time to make the commitment, *no!* To be fair, these statements also apply to basically all types of external sources of capital, ranging from investors to alternative lending sources. The following key concepts help you understand how to prepare for and deal with external sources of cash or capital:

- ✔ **Think well ahead.** In today's economic climate, it takes a long time to identify external sources of capital (because fewer choices are available) and to secure them (because the review or underwriting process is very stringent, not to mention that more businesses are competing for capital). So plan well ahead to make sure that you'll have cash available when needed, because it's not a process you can rush.
- ✔ **Think expensive.** For the biggest companies, like Apple and McDonald's, money is still cheap (in fact, extremely cheap). For the balance of the business community, money is expensive (often very expensive). Being realistic on how expensive money is and what source is most appropriate for your business should be understood from the beginning so that you can avoid sticker shock and properly plan for financing related costs (making sure that your projections are as accurate as possible and that cash will be available to meet loan obligations).
- ✔ **Think colonoscopy.** Examinations, reviews, audits, evaluations, due diligence — however you refer to it, the bottom line is that when you pursue external capital, the process undertaken to verify your business's information is going to be very detailed, broad, time consuming, and lengthy. So if you're not properly prepared for the underwriting process, then don't bother, because the end result will be easily predictable.



Also think *internal* by scrubbing the balance sheet to find hidden cash and sources of capital. When appropriate, external sources of capital should be pursued to secure cash to finance a business (and we discuss these sources and scenarios in Chapters 10 and 11). But businesses need to remember that countless internal sources of cash may be available to support the operation and maybe, just maybe, alleviate the need for loans or outside investments.

## Protect Cash at All Times

Cash represents an asset just like trade accounts receivables, inventory, and equipment, and like those assets it must be controlled, managed, and protected at all times. However, cash has a very unique characteristic unlike these other assets that makes it highly susceptible to additional risk of loss: Cash is an extremely liquid and marketable asset.

Most assets require a series of transactions or steps in order to be converted into cash. Sometimes those steps can protect businesses from fraud. For example, if theft occurs with inventory, it first must be taken from the business and then converted into cash from some type of fraudulent transaction. Furthermore, the party purchasing the inventory usually knows that the transaction isn't legitimate and will deeply discount their purchase to account for increased risk. So inventory that may sell for \$100 in a store and has a cost of \$50 may actually only sell for \$20 in this type of environment. Needless to say, \$20 isn't much of an incentive to steal the item. The problem

with cash, however, is that it doesn't require a conversion transaction, and when it's stolen, it retains its face value.

So the basic rule of thumb for all assets (and particularly cash) is that with a higher level of convertibility and net-realizable face value, the higher the level of controls, policies, procedures, and management attention that needs to be applied.



Advances in the digital or Internet age have had significant influences on the management of cash, both positive and negative. Although improving business efficiencies and lowering the risk of handling actual cash receipts (including checks), they have also opened the door to an entirely new type of electronic fraud and theft. Utilizing technology to manage cash receipts and disbursements is definitely the wave of the future, but it should be accompanied by the appropriate accounting policies, procedures, and controls to manage the increased risks.

## *Always Think of CART*

If you remember one acronym from this book, remember CART — complete, accurate, reliable, and timely. Your company's financial and accounting information system needs to produce complete, accurate, reliable, and timely financial information, reports, data, and so on, which management can use to make informed business decisions. Without CART, a business cannot function properly, nor can it make informed and timely business decisions. Furthermore, CART is essential to improving cash flows because a direct correlation links improved CART and improved cash flows.



Without producing CART invoices for your customers, payments will be delayed. Without having CART financial statements or reports, your chances of securing a loan from a bank will be significantly impaired. And without providing CART data to shareowners or the board of directors, you can kiss your job goodbye (and your ability to generate positive cash flow).

## Chapter 17

# Ten Tales of Cash-Flow Woes

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### *In This Chapter*

- ▶ Consuming cash in underperforming assets
  - ▶ Utilizing loans, debt, and liabilities incorrectly
  - ▶ Being caught off guard by changing market conditions
  - ▶ Making management mishaps, mistakes, and mayhem
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**T**ime and time again, business gurus write articles and reports on the most common reasons small businesses fail. At the top of the list, you almost always find the issue of undercapitalization, or lack of enough cash to support the operating strategy. This chapter provides ten other tales of how companies got into to severe cash-flow crunches by not attending to critical accounting, financial, and operational issues properly.



An underlying trend with almost every cash-flow woe is poor management. Yes, the economy crashed, but management in many cases was not prepared. Yes, market conditions changed, but management often didn't understand the competitive forces to begin with. The point is that just as poor management can make a difficult situation even worse, solid management can help offset the damage of a number of cash-flow sins.

## *Misunderstanding Trade Account Receivables*

The number of cash-flow woes that can be attributed to mismanaging trade accounts receivable are endless. One specific, extremely problematic issue we've encountered over the years is centered in what a business considers a legitimate trade receivable, because financing sources don't lend against receivables with certain characteristics. Examples of problem receivables include federal government sales, foreign sales, related/affiliated party sales, concentrated sales, receivables subject to future discounts/adjustments, and others. (See Chapters 11 and 14 for further information on why these types of receivables present lending problems.) These receivables may be completely

legitimate and eventually be collected, but from a financing source's perspective, they're too risky to lend against. The following examples demonstrate how businesses can go wrong with accounts receivable:

- ✔ A professional service firm was pursuing a large contract that it felt assured of receiving. Although it hadn't obtained a signed contract, it established billing jobs and codes to capture the initial work and invoice the customer. When the contract fell through, the invoices became uncollectible, which resulted in the receivables being written off and the company taking a loss. Furthermore, when the receivable dropped from the borrowing facility (that is, the receivable extended past 90 days from the original due date before it was written off, which made the receivable no longer eligible to borrow against), access to available cash was reduced because the company couldn't use this receivable as collateral to borrow against.
- ✔ A medical device distribution company sold various medical equipment and supplies to customers throughout the country. The company's standard practice was to match any competitor price if pressured by customers. An audit of the business determined that the average discount offered and subsequent billing adjustment was 20 percent. Prior to the audit, the financing source had been lending at a rate of 80 percent against eligible receivables. Subsequent to the audit, the lending rate was reduced to 65 percent as a result of the high billing discounts and adjustments provided to the customers. In order to remain in compliance with the lending facility, the company had to pay down the line of credit, which reduced cash levels very quickly.

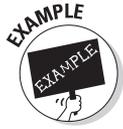


Always obtain a true understanding of the real value of your trade receivables by making sure that proper reserves are established for potential bad debts, product returns, and/or other billing adjustments. Establish proper reserves in a prudent and objective manner based on analyzing reliable sales and trade receivables data, reports, and information to calculate correct reserve amounts. Don't trick yourself into believing that 100 percent of all customer invoices will eventually be received — we have yet to see a business achieve this objective.

## *Letting Good Inventory Go Bad*

The reality of the economy is that industries and markets can move so fast that today's highly successful products can quickly become obsolete in less than six months. Just ask anyone operating in the consumer electronics business, such as Apple, Sony, or RIMM, because without a constant product-development and market-introduction strategy, these companies can move from Hero to Zero in the blink of an eye.

Of course, the consumer electronics market isn't the only industry that can suffer from inventory obsolescence issues. The distribution company in the following example learned that lesson quickly.



A distributor of both domestic and imported picture and mirror framing and molding products had operated a successful business for over 25 years. The company amassed a large inventory of specialty and unique products sold primarily to niche framing and molding retail shops located throughout the country. Unfortunately, two events occurred that quickly turned good inventory into worthless wood:

- ✓ First, the company never properly evaluated and managed specific inventory lines or items in relation to how quickly the products were turning over into sales. In some cases, the company had over a two-year supply of certain products.
- ✓ Second, the company's customer market was dramatically reshaped over a ten-year period as the smaller niche retail stores it relied on for the majority of its revenue decreased from an estimated 40,000 shops to less than 15,000 due to competition by big box retailers (such as Michaels).

In the end, the company's inventory problem created two cash problems: Cash was used to purchase inventory that was taking more than a year to sell, and having the excess inventory required storage, maintenance, and administrative support, which resulted in higher operating expenses. In this situation, for every \$100 of inventory owned, these added costs amounted to 10 percent annually. And finally, to add insult to injury, the inventory's value wasn't even 50 percent of the original cost due to styles changing and storage-related damage.

One of the simplest ways to avoid these types of inventory-management problems is to generate frequent inventory performance reports by product line and SKU (or individual product) to determine how quickly products are selling, what gross margins are being generated, and other potential trending information. If management stays on top of these reports, inventory problems can quickly be identified with corrective action taken (such as simply reducing purchases of slow-moving items).

## *Improperly Investing in Soft Assets*

When the term *soft assets* is used, it usually refers to some type of intellectual property such as patents, trademarks, trade names, publications, trade secrets, and/or some other type of proprietary business asset that generates earnings (or cash flows). For example, the formula of Coca-Cola is one of the most valuable and highly guarded assets in the world, but yet no tangible or hard asset is present. However, soft assets can quickly turn into cash-guzzling machines, as the following situation highlights.



A sports nutrition company developed and sold a highly successful muscle-building nutrient that produced strong revenues and profits (as well as cash flows). To leverage this success, the company elected to develop and publish a bimonthly fitness magazine, which required significant cash investments upfront to produce all the content needed for the magazine (as well as to publish the initial edition of tens of thousands of copies). A cash problem arose before one dollar of cash was actually received from subscription or rack sales, and a total of only four editions were produced and published. The problem was that the parties handling both the subscription and rack sales used magazine sales remittance strategies (customary in the industry) that stretched the end customer sales (the point at which a consumer would purchase a magazine from a retailer such as a grocery store) out roughly eight months. If the consumer purchased the magazine for \$5 in March, the company didn't receive actual payment for their share until November. To compound this problem, in an attempt to keep from overloading readers with endless amounts of advertising, the fitness magazine didn't secure advertising revenue from third parties in the original editions.

Needless to say, the company's mismanagement of both the receivables cycle and advertising potential in the magazine quickly changed (via watching cash levels quickly fall) after this painful cash lesson was learned.



Soft assets can have a double-negative impact on cash. First, an investment in the soft asset needs to be made (which consumes cash). And second, cash receipts driven from soft-asset-generated sales can often take much longer to materialize than a more traditional manufacturing or service-based business.

## *Falling into the Taxable Income Trap*

The number of potential problems and pitfalls with taxes are so extensive that providing a complete discussion would warrant an entire book. However, one tax trap has created grief more than a few times. The distribution of taxable income from flow-through entities (that is, subchapter S corporations, limited liability companies, and partnerships) has a negative impact on personal income tax obligations all too often.



A manufacturing company aggressively used tax incentives, including accelerated depreciation on equipment purchases and the cash method, when reporting taxable income for a number of years. During these years, book income was positive but taxable income was neutral to negative. Cash balances built during these years were subsequently distributed to the owners who, in turn, used the majority of the cash for personal expenditures. Eventually, the business's reportable sizable taxable earnings as accelerated depreciation deductions were eliminated and the benefit of the cash method of reporting flattened out. When the business reported the taxable income,

which flowed through to the owners, the owners had not set aside the appropriate amount of cash from the earlier years to cover the tax liabilities. To pay the bill, they tapped the business for cash, which produced two negative side effects. First, cash the business needed to reinvest and support growth was not available. Second, when the cash was distributed to the owners, it had the effect of reducing the business's net equity, triggering a subsequent increase in its debt-to-equity ratio (because debt remained constant but equity decreased), creating a covenant default with a bank loan.



Entities that are legally structured to allow taxable income to flow through to owners don't report income tax expense and aren't obligated to report income tax obligations. Rather, these responsibilities fall on the owners of the business. Business managers and owners must always have a clear understanding of any potential income tax obligations that are outstanding and take care to reserve the appropriate amount of cash for these obligations (at either the company or individual level). Remember, most tax rules and regulations are structured to enable a company to defer income taxes, not eliminate or avoid income taxes, so eventually cash will be required.



Given the complexity of tax issues that most business have to operate under (at the federal, state, and local levels), securing professional tax assistance is essential to avoid getting some nasty surprises down the road. The tax environment is only going to get worse and more complicated as every government entity expands its search for tax revenue, so staying on top of tax issues early and complying with all rules and regulations should be a top priority.

## Misapplying Available Debt-Based Capital

The best way to highlight how misapplying available debt-based capital can wreak havoc on a business's available cash is with the following two rather simple but devastating real-world examples:

- ✓ A wholesale food producer secured a working capital line of credit to support anticipated receivables growth from recently acquired large customers. The line of credit was designed to be used to purchase raw materials and finance increases in trade receivables. The company elected to draw on the line of credit to invest in property leasehold improvements and repay some old debt. Unfortunately, when the growth opportunity arrived, the company had used its remaining cash and available borrowing capacity on the line of credit and didn't have any liquidity left to purchase raw materials and support new orders. Needless to say, the discussion between the bank and the company was very lively, and the management team immediately lost credibility with the bank. So the wholesale food producer missed out on a wonderful growth opportunity.

- ✔ Company X was profitable, with strong earnings and a solid balance sheet. The founders of Company X then became part owners in a new business operation that required periodic cash infusions to support its launch and subsequent growth. Company X advanced or loaned cash to the new company, which used the money for general operating purposes. As you may have guessed, Company X then found itself in need of the cash to cover various obligations, but the new business was unable to repay (because it was sunk in start-up costs and other illiquid assets). Not much longer after this, the ownership of the companies changed dramatically as trust between the owners disintegrated.



Just because cash is available doesn't mean that your company has a green light to spend it, loan it, distribute it, or use it in another capacity. Exercise extreme caution and care with excess cash because it has a tendency to disappear very quickly.

## *Failing to Prepare for the Economic Hard Landing*

We doubt that many businesses want to revisit the problems created courtesy of the Great Recession (from late 2007 through early 2010). In fact, most companies would just as soon block this time period from memory, given the severity of the economic contraction. But a number of invaluable lessons were learned during this period that relate to managing cash and liquidity. Following are two of these critical items:

- ✔ **Companies that didn't maintain a strong balance sheet with ample liquidity quickly became casualties.** The combination of both the speed and depth of the economic contraction caught a number of businesses off guard. As for speed, businesses witnessed sales evaporate in a matter of months, not years. The depth of the economic contraction also stunned businesses, as expected 10 to 15 percent revenue reductions experienced over a 12- to 18-month period (in a normal recession) were replaced by 30-plus percent sales decreases experienced over a 6- to 12-month period. The bottom line is that businesses simply couldn't adjust and adapt their economic operating models fast enough, which resulted in significant negative operating losses (translating into large cash losses as well).
- ✔ **Companies without multiple operating plans to cover potential disaster scenarios had to scramble quickly and redeploy business resources just to survive.** Business managers and owners tend to become very complacent when economic times are more robust. Added bonuses are paid, questionable asset investments are made (based on assuming that growth will continue), cash that may in fact be needed down the road is used to repay debt, and so on. But economic "hard

landings” can quickly underscore how important it is to have multiple operating plans and forecasts available to support timely business decision making. Companies learned that they should have multiple operating plans/projection models ready to go in the event that rapid and rash decisions have to be made. Simply having the “expected” operating case to work with was not nearly adequate, because what most companies needed was access to a “disaster” plan in order to properly evaluate and implement the choices available.

As we write this book, Corporate America (that is, the Fortune 500) sits on over \$2 trillion of cash with record earnings being reported over the past year. Hardly the type of statistics you’d expect coming out of what’s considered the second-worst economic contraction America has experienced, but representative of how financially strong these companies are and how well they plan. Or as Warren Buffett stated, “When the tide goes out, we’ll see who’s left standing naked on the beach.” For businesses that were fully clothed (having solid plans and being well prepared with strong balance sheets and high liquidity), when the tide went out, the pain was far less severe and recoveries were very robust. And the market quickly disposed of businesses that found themselves wearing nothing but their birthday suit during this same period.

## *Getting Left in the Cold by Changing Market Conditions*

The economy goes through natural periods of expansion and contraction, which can be very painful (as summarized in the preceding section). In addition, competitive forces throughout the economy are constantly reshaping industries, whether or not the overall economy is growing or contracting. During the Great Recession, most industries were contracting, yet pawnshops saw an increase in demand. And today, the technology industry is expanding by leaps and bounds, but certain niches within the industry are looking at the end. (For example, are DVD players even needed anymore?). The following example illustrates how even a very mature industry can be reshaped by competitive market forces.



A single-branded oil and gas distributor operated a family-owned business serving a secondary market (that is, not a major market in a metropolitan area such as Atlanta or Chicago but a smaller, rural market with a wider geographical reach). Over the years, a number of large oil and gas suppliers determined that supporting the secondary markets was far more efficient if the local distributors began carrying multiple brands to improve their operating efficiency (such that delivery equipment could then be used at a 90-plus percent efficiency ratio). After this strategy was enacted, the multibranded local distributors then passed on lower costs to their retail customers, who could then

charge a lower price for gas and oil. This change placed significant competitive pressure on retail customers supplied by the single-branded distributor and forced price decreases as well. In the end, the single-branded distributor's operating performance moved from generating profits to producing losses, which drained the company's cash reserves and ultimately forced its sale (at a deep discount).

## *Making Overly Optimistic Sales Forecasts*

We harp on our concerns about the selling cycle throughout this book, and here we once again call out a way that this cycle can drain cash.

Back in the 1990s when the dot-com craze was in full swing, a number of companies built business plans for delivering products or services through stand-alone, electronic kiosks. To provide a frame of reference, these kiosks looked and operated somewhat like Redbox (which distributes DVDs) and Coinstar (which counts coins and exchanges them for cash or gift certificates) but suffered the following fatal flaws as a result of not understanding the selling cycle adequately:

- ✔ **Unreliable kiosks:** Every selling cycle needs to ensure not only that sales are made but also that the customer experience and the service provided guarantee repeat business. In this case, the kiosks proved to be unreliable, which turned customers off very quickly. Improvements were made, but by that time, customers were lost and the economic model no longer worked because management had underestimated the amount of repairs and maintenance needed to ensure properly operating kiosks.
- ✔ **Unrealistic volume expectations:** Even when the kiosks worked and were rolled out on time and customers purchased products, the miss in the selling cycle was on volume, because transactions took longer to process and customer participation rates were lower than anticipated. With a relatively high fixed operating cost, the kiosks could not generate enough profit to cover expenses and thus drained the company of its remaining cash.
- ✔ **Inability to compete in technologies and pricing:** Kiosks that were based on the distribution of information were quickly displaced by more-efficient and reliable competing technologies that generally provided a better product at a lower price.



Remember, the selling cycle can drain cash in countless ways, ranging from purchase timing to volumes to price to product/service reliability. Understanding all critical aspects of the selling cycle is essential to calculating just how much cash will be consumed.

## Robbing Peter to Pay Paul

Small-business owners are by nature entrepreneurs and, generally, forever optimists. Their spirit is often best measured in the satisfaction they receive from providing a product or service of value to the market and not just based in the amount of money they make. Although this trait is admirable, it can also be a flaw because entrepreneurs often stop at nothing to see their ideas succeed and business survive for decades. Engaging in business and ensuring its ultimate survival, at any cost without looking at the big picture, is where the blacks and whites of running a business often turn gray and transaction legitimacy comes into question. Business owners often become some consumed in whether they *can* do something (which in this case means keeping the business afloat by overstepping critical boundaries) that they forget to ask the more important question related to whether they *should* be doing this.



A manufacturing company experienced a sharp downturn in sales as a result of a number of confluencing factors. The company developed a turnaround plan but had run out of cash, so it began using partial, advance, and pre-billing strategies to process invoices before the products were actually shipped. Instead of waiting to access cash against the receivable when the complete shipment and sale occurred (30 days in the future), they robbed the future by accessing the cash today to pay current outstanding obligations. These invoices were provided to the manufacturing company's financing source, which in turn advanced cash (assuming a valid receivable was present) to finance the company's turnaround. The company initially intended to use this strategy as a stop-gap measure on a limited basis. In the end, the strategy was used much longer and more extensively than planned. Eventually, the problem was rectified, but the impact on cash (not to mention management credibility) was significant, because cash was repeatedly pulled forward and used for historical needs with nothing left to support future needs.



Business owners typically want to believe the best about their businesses, so although their intent is not to commit fraud, they often undertake small accounting “adjustments” to buy another week or month — a practice that can soon accumulate into a major problem. By robbing Peter (accelerating a sale set for the next month to the current month) to pay Paul (using the sale to meet a current target), all you do is make the next month's targets even more challenging to achieve. And if this practice continues for a long period of time, eventually the weight of the problem implodes on the business. Forming strong boards of directors or advisory boards that actively participate in the business can help provide the proper insight and guidance to avoid falling into this trap.

## *Growing Yourself Out of Business*

Companies that simply grow themselves out of business are a good example of the dangers of equating profits with cash flow. In one particular case, entrepreneurs launched an ecommerce-based retail business that specialized in selling consumer goods. The company was highly successful as measured by annual revenue growth, which in year one was less than \$500,000 but exploded to over \$12 million in five years. The primary problem this company faced was that the suppliers of the consumer goods generally required payments upon delivery (to secure the best pricing) for products that would be marketed over a period of 6 to 12 months (as a result of seasonality sales strategies). The company assumed that financing would be available from either primary or secondary lending sources (to support the growth), but given the nature of the product, the age of the company, and the status of the financial information, securing external financing proved to be a significant challenge.

This cash-flow tale of caution doesn't end too badly: The company continued to operate profitably albeit at a much lower growth rate. But the cash-flow woe does highlight the importance of securing proper amounts and types of financing to support rapid-growth scenarios.



Rapidly growing industries or markets are going to attract the interest of numerous competitors. By not having a plan in place with the proper amount of capital or cash, companies leave the door open to bigger and stronger competitors that will take market share and may ultimately force smaller and weaker businesses out of the market.