Understanding Cash Flow

Cash flow can be complicated, but it's not rocket science. While there are many moving parts, how they function together is easier to understand when you break it down into individual components.

In this article we'll take an in-depth look at the cash flow fundamentals every business must master to be successful. Whether you run a small company with a limited number of customers or serve a worldwide client base, the insights shared here can make cash flow work for you.

Why Cash Flow is So Important

According to the Small Business Administration (SBA), one of the top reasons businesses fail is due to cash flow problems. The dysfunction can stem from a variety of factors ranging from failure to collect payments for goods and services on time, to poor accounting and recordkeeping. Regardless of the cause, the bottom line is that problems in any area of the cash flow process can have a ripple effect that can seriously jeopardize the future of your business. And that's reason enough to understand the basics.

Several Definitions, One Goal

While the definition of cash flow can vary depending on who you talk to (or what you Google), the broadest and simplest meaning is 'the measure of money that comes in and out of a business account over a given period of time.' "For most companies, this means what remains in its business checking account at the end of the month, but some businesses measure cash flow on a weekly or even daily basis," says Morgan Dornfeldt, Business Banking Advisor at Bank Five Nine.

Regardless of the time frame, the goal for every business is the same: to have more money flowing into the account than flowing out. In bank accounting terms, this is called having a positive cash flow position. By the same token, if the opposite is true—less money is coming in than going out—it's called a negative cash flow position.

According to Dornfeldt, the benefits of a positive cash flow position go beyond the financial. While having money left over at the end of a cycle gives you the option of investing in the business or saving for future growth, it also provides greater peace of mind. "At a minimum, you'll sleep better at night as you consider the future of your business," she says.

A negative cash flow, on the other hand, is a sign that something needs adjusting. And while a cycle or two of negative cash flow may not spell immediate disaster, it's an unsustainable long-term position that needs to be addressed. Negative cash flow will eat away at surplus and sends a business deep into debt if left unchecked.

The Ins and Outs

So, what determines whether a business' cash flow is positive or negative? According to Dornfeldt, many banks break it down into three categories consisting of operating activities, investing activities and financing activities. In addition, Dornfeldt stresses that reporting also plays a critical role.

We take a closer look at each area here:

Operating Activities

Simply put, operating activities consist of money coming into and going out of the business account. "Think of the payment methods your business accepts as your incoming," Dornfeldt says. Whether you accept cash, checks, merchant services, such as credit and debit card payments or anything else, they all fall into this category.

The goal is to get your hands on incoming funds as quickly as possible. For example, if you're a merchant, cash and card payments ensure funds arrive fairly quickly. If you accept checks, it can slow things down and there's always the risk of a check not clearing.

If you invoice on a net 15- or 30-day basis, the process slows down even further—and that's assuming your customers are paying on time. According to a survey conducted by PaySimple, businesses can expect to be paid at least two weeks late on average. And more than half of the businesses surveyed reported clients that paid no sooner than two months after being invoiced.

Late payments can have an immediate impact on a business' cash flow position. To speed up the process Dornfeldt recommends reviewing your payment terms and adjusting as needed. "It could be as simple as rewording your invoices from 'net 30 days' to 'within 30 days'," he says. For services that take longer to complete, you might consider invoicing half up front with the remainder due once the project is complete.

Money leaving the account is what your business pays to cover expenses, and it can exit a variety of ways, including by check, Automated Clearing House (ACH) payment, wire transfer, online bill pay or debit card. The key here is to hang onto your money as long as you can which gives you more time to put the funds to work for your business.

If you're getting paid quickly and holding onto your funds as long as possible and still having cash flow problems, you'll have to identify where the problem exists. "You may be paying too much for rent or not charging enough for the products you're selling," Dornfeldt says. "Or, you could be spending too much time developing products that aren't making money yet."

Bank Five Nine recommends a thorough look at everything expense related to find what the cause might be.

Investing Activities

Assuming your cash is flowing in and out in a timely manner and your position at the end of the cycle is positive, the next challenge is figuring out what to do with the funds you're accumulating. There are a variety of options for businesses with positive cash flow. We look at three popular choices here:

- Business Sweep Account
  An investment account into which excess funds are 'swept' at the end of the business day. Interest rates are typically higher with sweep accounts.

- Business Money Market or Savings Account
  An interest-earning deposit account designed for 'rainy day' funds. Interest rates are usually tiered based on balances. Preauthorized withdrawals are allowed but limited.

- Business Checking Account
  Keeping excess funds in the business checking account is always an option.

The account you choose depends on your business goals. "The best way to decide is to sit down with your business banker and discuss your situation," says Dornfeldt.

Financing Activities

Even businesses with excess funds at the end of the cycle will need to finance some expenses from time to time. Unexpected expenses can cause short-term borrowing needs, and there are times when financing makes more sense than tapping into the funds you have on hand.

"When a business needs financing, it's important to choose a solution that's right for the company," says Matt Schwechel, SVP, Director of Commercial Lending, Bank Five Nine. This may mean more than one type of credit.

Schwechel advises adding a line of credit to the business account as an insurance policy against unexpected expenses on those occasional months of negative cash flow. Business lines of credit, in general, feature lower interest rates and are typically reserved for higher ticket items like large shipments or equipment.

For everyday borrowing, Schwechel recommends a business credit card. They can be used to cover nearly any expense and work best when you pay down your balances quickly.

"While you may have a specific need in mind when you apply for financing, your best bet is to discuss it with your business banker," says Schwechel. He or she can make sure you're getting the best vehicle for the need at hand. Your banker can also look at your overall financial picture to assess if your cash flow and financing are in sync.

Reporting

Of course, a critical factor in all of this is reporting—the ability to see all of your cash flow activities at a given point in time. Fortunately, we live in an age where this information is literally at our fingertips.

“Online banking makes it incredibly easy for businesses to keep tabs on all areas that impact cash flow,” says Dornfeldt. In addition to traditional online banking via the desktop or laptop, business owners also have access to mobile apps that provide even greater convenience and access. A monthly statement—also available online—can provide additional insights into cash flow.

By monitoring operating, investing and financing activities available through these resources, keeping the pulse of your cash flow position is fairly simple.

Your Role

As a business owner you have the ability to directly impact your cash flow position by understanding the fundamentals and staying on top of things. For some, this is an intuitive process but for many others, it’s not. “Most business owners aren’t in the business of managing cash flow,” she says. “Just as most cash flow managers aren’t in the business of brewing craft beer or whatever they do for a living.”

If you have the time and aptitude to tackle it yourself, Dornfeldt recommends giving it a shot. If not, however, she recommends reaching out before it’s too late. “Enlisting the resources of a business banking professional can spell the difference between success and failure.”

We’re Here to Help

If you’d like to discuss your business banking and cash flow management needs, Bank Five Nine is here to help. We’re here to help you understand the real-world factors that impact your business, so you can achieve long-term success.

Contact Morgan Dornfeldt, Business Banking Advisor at (262) 560-6365 or for your commercial lending needs, call Matt Schwechel, Senior Vice President, Director of Commercial Lending at (262) 670-3021. We look forward to hearing from you.