

Negative cash flow

How managers run out of companies' money without showing a loss

By Bob Lawrence

fact: More companies close from running out of cash than from “losing” money. People who are ambitious enough to go into business for themselves typically have enough experience to make more good decisions than bad. Sometime in their careers, however, difficult and emotional choices will center on protecting their employee bases when their markets slow down. Knowing how hard it is to build a decent crew of installers, the natural reaction is to reduce prices and book enough sales to keep valuable people working, even if it's just to break even.

Experienced and respected business people know how dangerous it is to lower prices or absorb cost increases during slow times. For a company that is not extraordinarily strong financially, this strategy will seed the most devastating problem in business: negative cash flow.

Negative cash flow is simple to explain: After adding up all the money expected to come in from a month's invoiced and cash sales, the total won't cover respective obligations to employees, vendors and banks, even though the financial statement does not show a loss for the month. In a financed business world, the reported profit never equates to new cash.

The majority of new glass-shop owners and managers come from the field and haven't yet had the opportunity to learn how accounting works.

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Most quickly learn that accounting systems are complicated. Few realize that they also give a false sense of security. To dramatize the impact, consider the fictitious but instructive accounting in the John Doe Glass Co. example on p.34.

Master the Basics

First, a brief explanation of the distinction between a profit-and-loss statement and a balance sheet.

- The profit-and-loss statement is a report of a specific period: what was sold, the profit made after deducting all material, labor and monthly overhead expenses such as interest on loans, insurance, fuel, utilities, depreciation and some benefits.
- The balance sheet is a summary comparison of what one has at a point in time: total assets less what one owes, or liabilities, the difference being net worth.



Take a look at the examples below.

Both profit-and-loss statements and balance sheets are critically important to understand. Far too often, new owners say, “I wrote the check, it cleared, I did not show a losing month, but now I have a lot less cash. What happened?”

When the profit-and-loss statement shows no loss at times like these, few new managers are experienced enough to recognize that negative cash flow will soon cripple their companies. Unless immediate changes are made, grave consequences will result.

Usually, principal and interest payments to banks and mortgage companies are included in one payment, on one check. Inexperienced managers are lulled into assuming the entire amount of a check written is accounted for in the profit-and-loss statement. In fact, the check is split; normally, the largest value of these checks is the principal amount recorded in the balance sheet, not in the profit-and-loss statement.

Typically, monthly interest is calculated on the total amount owed at the end of each month. The finance payment will include

that, plus the agreed monthly principal amount to reduce what was initially borrowed. Bank officers will provide amortization schedules that show how much interest and principal amounts are due each month for the course of payments. The interest paid is a monthly expense recorded on the profit-and-loss statement. The principal amount paid, however, is recorded in the balance sheet like this:

- Assets are reduced because cash is used to pay the bank or financial institution.
- Liabilities are reduced by the payment because that amount is no longer owed.
- Net worth is unaffected because the above recordings are offsetting entries.

This information can be confusing; the following example is far easier to understand.

“John Doe Glass Co.” Example

John Doe has a good company with average sales per month of \$40,000, producing a nice \$4,000

per month net profit after payment of labor and materials and overhead expenses such as office salaries, insurance, utilities, fuel and so forth. He also has bank payments, part recorded in the profit-and-loss statement and part on the balance sheet.

From the information at left, we can determine what John hasn't yet learned: After making a \$4,000 profit and paying the bank \$3,000 in principal, John has generated a positive cash flow of \$1,000. If this were an average month, in one year he would report a profit of \$48,000. But due to note payments, he will actually only create \$12,000 in “extra” cash before taxes are paid. Taxes could very well be more than 25 percent, or \$12,000 of the reported \$48,000 profit, consuming all the cash generated and netting zero extra cash after taxes are paid. Tax-and-spend legislators do not understand how difficult they've made it for small-business owners to create enough cash to flourish and provide jobs—but that's another subject!

In this example, business gets slow, so John decides to reduce his price to stay busy and keep his crew together. This is where John makes his first big mistake: He lowers his price by 10 percent and takes \$40,000 worth of work for \$36,000. He knows he won't make any money but also thinks that he won't lose any. He does this work and sends invoices to customers for \$36,000, all collected before month-end. He also makes his usual \$3,000 principal payments to the bank that same month.

Now, look what happened because he reduced his prices and sells at no profit, but no loss, either:

- He bills \$36,000 sales.
- He pays \$36,000 to cover the month's materials and labor and overhead expenses.
- He also pays \$3,000 to the bank.
- Hence, \$39,000 was paid out during the same month his sales and collections were only \$36,000, without showing a loss on his financial statement.
- So, he's got \$3,000 less cash in his bank account this month; and because he collects in full from his customers by month-end, there is nothing else coming in.

John created yet another problem: Competitors found out from their contractor customers that John's price was much lower. Each concludes that “I'm not going to let him take all the work that's normally mine, I'll meet his price.” John has to keep his low pricing to stay competitive, and it's all he can do to keep his sales at a \$36,000 per month break-even point.

John now asks himself: “I'm not losing any money. Why am I unable to pay my bills? What happened to my cash?” In a very short time, competitors who joined the fray will find themselves asking the same questions.

SIMPLIFIED PROFIT-AND-LOSS STATEMENT

Sales		\$40,000
Material costs	\$ - 20,500	
Installation labor	- 9,800	
Overhead	- 5,700	<u>-36,000</u>
<i>such as utilities, insurance, fuel, depreciation, maintenance, salaries, interest and so forth</i>		
Net profit before taxes		\$4,000

BALANCE SHEET ENTRIES

Principal amounts paid for the following:		
Trucks and autos	\$ - 800	
Land and buildings	- 1,900	
Equipment	- 300	<u> </u>
Total reduction in cash to pay down liability		\$3,000

After five months bearing low prices that John started, his cash is gone because the bank got \$15,000 in principal payments from him. The cash he generates now comes by stretching payments to vendors.

‘Where’s the money to pay my bills this month?’

They only let John get this badly extended because of his previously good pay history. Now, they voice grave concern. His cash will drain even further with slower collections, retainage, and a sweet little Internal Revenue Service bloodsucker called the alternative minimum tax.

At six months, vendors make him pay cash on delivery, plus something on account because they are not about to assume any more liability and they need some collection activity on the old invoices. And even though he’s been paying the bank promptly, its officers won’t loan him more money because he’s not profitable. If John does not improve cash flow by figuring out a way to increase profit, his will soon be another company that goes out of business by running out of cash, not “losing” money, and still owing creditors.

Recommendations

Why should members of the National Glass Association be concerned?

Too many good people lose everything they have their first time in business. At the same time, they negatively affect the market. So, it should be supported and shouted from coast to coast by every vendor who inherits a stake in customers’ success or failure: Good people who risk everything to realize

the extraordinary dream of owning their own businesses must also understand that profit is a vital factor in surviving.

John’s story is repeated all too often in real life. Anyone who goes through all the trouble of developing personnel and

customers, providing service, quality products and value deserves to make a profit. He or she must make a profit—or face going out of business.

Business owners should insist that cash-flow statements are included in their month-end financials. They should be the first reports they read; they should look something like the table below.

Business owners who don’t get regular accounting reports can apply the following self-test: Total the monthly principal payments on all financing—not straight leases or rentals—for land, buildings, equipment, trucks, phones, computers and so forth; then, compare that total to net profit. If those principal payments are higher than the monthly net profit, beware: This indicates negative cash flow. **5**

re·tain·age

DEFINITION: The money held hostage by contractors waiting to see that subcontractors do their jobs well and the work doesn't need repairing. Once everything is acceptable, then it is paid, sometimes months after the jobs are done.

When a subcontractor experiences negative cash flow, any retainage dollars typically held on jobs by contractors will exaggerate the shortage of money needed to pay current monthly obligations.

CASH FLOW STATEMENT				
	John's "Before" Average Month		After "Save Jobs" Months	
Net Income before taxes		\$4,000		\$0
Income taxes, 25 percent		(1,000)		0
Net income after taxes		3,000		0
Less balance sheet entries for principal amounts due on notes to financial institutions				
Trucks and autos	\$ 800		\$ 800	
Land and buildings	1,900		1,900	
Equipment	300	3,000	300	3,000
Cash flow (loss)		- 0 -		(3,000)

Please note that other factors will also affect cash flow, including but not limited to changes in accounts receivable, or payables, or inventory, plus any unfinanced capital expenditures. Alternative minimum tax was not calculated in this example.

Source: Steve Mort, certified public accountant and partner and general manager of Don's Mobile Glass in Modesto, CA