Getting a Handle on Cash Flow

by Shawn McCadden

Many small businesses, even profitable ones, fail because they can't pay their bills on time. But with a proper understanding of how to track and manage cash flow, you can avoid their fate. Your vendors will be happy to work with you because they'll be able to count on timely payments — they might even give you a discount if you pay early.

First, let's define cash flow. It's called that because money flows in from customers and flows out to pay bills. A business with good cash flow can pay its bills on time because it collects a sufficient amount of money from customers before the bills come due. Think of it this way: Water will keep flowing over a dam only if there is enough new water coming into the pond behind the dam.

That may sound simple, but to ensure good cash flow, you must know how much money you will need at any given point and have a plan to collect it.

Don't Confuse Underpricing With Bad Cash Flow

If you don't charge enough for your jobs, you will experience what seems to be a cash-flow problem. It's not. When underpricing is the issue, you'll never be able to collect enough money to pay the bills — there just isn't enough water to flow over the dam.

An example of this is when you pay the bills for yesterday's project with the deposit money from a job you haven't started yet. That may seem to solve a cash-flow problem, but the truth is you are buying jobs instead of selling them. Not understanding that concept put a lot of contractors out of business when the recession hit; as new job deposits dried up, there was no money in the bank to pay the bills.

To avoid underpricing, you need to know what it costs your business to do business. There are two areas to consider. For one, you must accurately estimate what it costs to produce a project. These are called direct costs because they relate directly to building that project. Missing an item in an estimate and not charging for upgrades are clear examples of underpricing.

Second, you need to know what your business's overhead and profit costs are (I consider profit a cost of doing business) for your expected volume of sales. Only with this knowledge can you determine how much to mark up your direct costs to arrive at the right selling price. If you miscalculate overhead costs, or don't know what they are, you risk underpricing your work. There's more to overhead and profit, but it's beyond the scope of this article.

Payment Schedules

By itself, selling jobs at the right price won't generate good cash flow — you must also collect your money before the bills are due. You can do this by building good cash flow into project payment schedules.

Start by choosing several milestones of the project that can easily be identified by you and your customer. Your detailed proposal should describe the work sequence so that the milestones — and what it takes to achieve each of them — are clear. This will help your customer understand why you need periodic payments.

Calculate what the direct costs will be for each stage of the project and apply your markup. Use these amounts to develop a payment schedule for your customer. Collecting the payments at each milestone will provide at least enough money to pay the direct costs incurred by that point. Being able to cover overhead as well, however, will depend on how much is owed, how much is left after paying your direct costs, and when the overhead-related bills are due.

If at any time you owe more for overhead than you've collected to that point, you will be left tight on cash. I suggest you give yourself a financial cushion by "front-loading" the scheduled payments. This means you collect more money at each milestone (and less for the final payment) than the amount you arrived at above. Another way to front-load is to collect a deposit at contract signing and hold on to all or most of that money until you're close to completing the project. Before you use front-loading, be sure it's legal where you do business, as some states don't allow it.

A lot of contractors say front-loading isn't fair. I disagree. If Dell can get you to pay in full before it builds you a computer, and American Airlines can get you to pay in full before you fly, why can't contractors expect the same from their customers before starting work on the next milestone?

Consider this. The alternative to front-loading is paying for your customer's job with your own money. If you do that, why bother worrying about cash flow to begin with? If you finance

your customer's project, you won't have that money in the bank earning interest. Worse, if you have to borrow money because you didn't get it from your customers in time, you'll *pay* interest on the borrowed funds. Meanwhile, your customers will earn interest on the money as it sits in their bank account instead of yours.

After you develop your payment schedule, the next challenge is getting the customer to adhere to it. The wording you use can help. Rather than saying a payment is due on completion of a milestone, your contract should state that payment is due before you'll start on the next milestone. This tells your customers that the job will stop until payment has been received, and makes it more likely you'll actually collect the payment on time. Go over it with your customers before they sign, to confirm they understand how things will work.

Stick to what you say. If you start work on the next milestone without receiving the payment due, you are in essence telling the customer that it's okay to ignore your agreement. Do that and you will have compromised your cash flow, as well as opened the door to deviations from the rest of your contract.

One last option to consider is making the cost of borrowing money a cost of doing business. To do this, calculate the interest you will have to pay and add it to your overhead costs before you determine what markup to use. I don't advocate this option, because it raises costs for all your customers, making you more expensive than the guy who properly manages his cash flow and doesn't need to pay interest.

Tracking Cash

The only way to know if you will meet your business's cash-flow needs at any given time is to track the money you expect to come in and go out of your business. This requires what is called accrual accounting.

With this accounting method, expenses are recognized at the time they are incurred, even if they don't have to be paid at the time of purchase. This identifies accounts payable, or how much money will be owed when the bills come in. On the income side, money is counted as received as soon as it comes in, and it's counted as receivable as soon as the customer is invoiced. This approach to accounting keeps track of how much money is on hand (working capital) and how much money is expected by a certain date (accounts receivable), such as when the bills come due.

When Things Don't Go as Planned

Sometimes no matter how hard we try or how much planning we do, the money just isn't there when we need it. Here are a few options to cover cash flow when that happens.

First, you could establish a bank line of credit for your business. You can borrow money to cover cash-flow needs and pay it back when payment comes in. You could also use a credit card the same way — paying it off when you're paid — though the interest rate may be much higher than on a line of credit. (Do not use a line of credit or credit cards to cover losses from underpricing jobs.)

Finally, you could establish a reserve fund by setting aside some of your profits, and tap into that when you need to. Remember to pay the money back to your fund when payment is received. ❖

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