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The Importance of Forecasting Cash Flow

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The combination of high operating costs, low profit margins, tight credit and a challenging economic environment can mean poor cash flow. In turn, effectively managing cash flow can mean the difference between a sustainable or collapsed business.

However, it can be difficult to clearly assess cash flow. HMWC CPAs & Business Advisors prepares a "Statement of Cash Flows" for our clients, who find that it is a highly useful document that allows management to track key financial information and, more important, forecast financial trouble. In fact, in the current economic situation, it is often vital for companies to manage their business on a 13-week cash flow forecast.

Key Facts

Your company's financial statement is composed of a balance sheet, an income statement and a cash flow statement. All three statements comprise the same accounting information, but each one serves a different function. The balance sheet provides a presentation of your company's assets, liabilities and net worth. The income statement indicates the business's profitability during a specified period. The cash flow statement, however, connects the two to provide a more comprehensive view of your finances.

A cash flow statement is a financial accounting document that is essentially concerned with the flow of cash in and out of a business. It shows how changes in balance sheet accounts and income affect cash and cash equivalents. The statement captures both the current operating results and the accompanying changes in the balance sheet. As an analytical tool, the statement of cash flows is useful in determining the short-term viability of a company, particularly its ability to pay bills.

How and when is a cash flow statement useful in ana-

lyzing a company's financial situation? When analyzing your company's liquidity, for example, cash flow information is more informative, while balance sheet data is more static, measuring a single point in time. The income statement is also not quite as useful in assessing liquidity because it contains many arbitrary non-cash allocations, such as pension contributions and depreciation and amortization.

A cash flow statement reconciles both of these much in the same manner that a checkbook would reconcile a checking account. It records the changes in the other statements and nets out the bookkeeping, showing the amounts and sources of profits and losses for any given period. The cash flow statement also maintains records of your company's fiscal transactions.

A snap-shot of activities

If you're operating under the accrual method of accounting, sales and expenses often appear on financial statements before payment is received or made. A cash flow statement converts financial data recorded on an accrual basis in the income statement and balance sheet to a cash basis. The statement shows sources of cash receipts, where cash is spent, and the net change. To arrive at the net change, the statement focuses on three areas of activity:

- 1. Operations.** Operating activities are a company's daily internal activities that generate cash or require its expenditure. These include cash collections, operating expenses (such as payroll, rent, supplies and inventory) and income taxes.
- 2. Investing.** This varies depending on your industry. For example, with manufacturers investing generally involves the purchase or sale of equipment.
- 3. Financing.** Loans and leases that provide or require cash generally fall under financing.

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The Importance of Forecasting Cash Flow (continued)

You can measure cash flow using the direct or indirect method. The direct method uses the cash activity recorded in the company's checkbook. Cash receipts and disbursements shown are totaled and classified in the three categories above. The more common, and more complicated, indirect method uses information gathered from the income statement and balance sheet.

Cash for investing and financing is calculated in the same manner under both methods, but the calculation of operating receipts and disbursements differs. Under the indirect method, the income statement must be adjusted for any non-cash items and any changes in the business's current assets and liabilities, such as accounts receivable and accounts payable.

Regular analyses

Even if a company is turning a profit, it can still go out of business if it is experiencing negative cash flow and is unable to pay its bills. By regularly analyzing cash flow statements, you can pinpoint reasons for negative cash flow, such as poor collections or changes in fixed assets and debt. You can then begin to develop plans to remedy them by implementing ways to reduce your company's day-to-day operating expenses.

You might, for example, find it more cost effective to outsource certain areas of the business, such as human resources, payroll and benefits management, or information technology support. Or you might choose to implement inventory management agreements with suppliers that allow you to house inventory at their sites for longer periods, allowing you to save on storage and interest costs.

Cash flow ratios

You can plug data found on your cash flow statement into simple ratios to gain a better understanding of your company's financial condition. For example, if cash is critical to servicing long-term debt, then "cash flow to long-term debt" would be a useful ratio.

Using the "operating cash flow" ratio helps gauge your short-term liquidity by comparing the amount of cash

generated to outstanding debt. This can help you understand how your current liabilities are covered by the cash flow generated by your company's operations, giving you a quick appraisal on whether you'll be able to manage future loans, interest payments, payroll and other expenses.

Seek Our Assistance

A cash flow statement provides information that is not easily extracted from an income statement or balance sheet, such as where your cash is and where it's being generated. Only by analyzing the components together along with other critical data can you understand your company's financial outlook. HMWC CPAs & Business Advisors can help your company by not only preparing financial statements but also assisting you in analyzing them so that you can more effectively manage your business.

Jeff Hipshman and Curtis Campbell, are partners at HMWC CPAs & Business Advisors in Tustin (www.hmwc CPA.com). Contact them at (714) 505-9000 to discuss how your company or client could benefit from the firm's services.



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