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Going with the (Cash) Flow Even When the Going Gets Rough

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Business failure isn't always the fault of bad planning or mismanagement of money or resources. When markets freeze and retreat as they have around the world, many businesses fail for lack of credit, loss of consumer confidence and other reasons over which an individual business owner has no control.

Cash-flow imbalance is the leading cause of business failure in a healthy economy, according to the U.S. Small Business Administration. So when the economy is ailing, it's more urgent than ever to maintain a balance between what's flowing into the business and what's flowing out.

Cash rules

In business, cash truly is sovereign. It's used to pay short-term bills, cover unexpected emergencies and invest for future business needs.

The way cash flows into and out of a business — the operating or cash cycle — is a matter of timing. Here's how it's supposed to work: Cash enters the business as capital through loans from creditors and investment from owners. Cash then is used to produce goods or services; it flows out to pay wages and purchase buildings, equipment, materials and supplies. Next it flows back to the business as payment for goods or services. Finally, it flows out again to pay taxes and debts and return money to owners before starting again at the beginning.

A breakdown at any stage can throw the operating cycle out of sync.

What to watch for

Breakdowns often happen in current assets, those cash reserves and other liquid assets — marketable securities, inventory and accounts receivable — the business expects to convert to cash within a year. Of these assets, accounts receivable are the most difficult to convert to cash. Businesses can avoid this pitfall by closely monitoring accounts receivable and establishing firm collections and credit policies before extending credit.

The time between buying or producing inventory and unloading it poses another potential obstacle in the cash-flow current. Toyota narrowed this gap with its "Just in Time" concept starting in the 1970s; rather than keep a large inventory of raw materials on hand to build cars,

the company bought materials as they were needed on the production line. Other businesses can use this same technique to quickly convert inventory to cash, and they can sell old and obsolete inventory to free up cash for other uses.

Expanding a business too quickly can also impede cash flow. According to David H. Bangs Jr., author of The Business Planning Guide, a business should not expand until employee overtime is piling up, the business has outgrown its operating plant or office space and there's a list of customers waiting to buy a product or service.

Why it matters

A stash of cash is the best assurance of keeping cash flow positive. Cash reserves are a cushion to fall back on during hard times.

But there's more to profitability than managing income and expenses. In this case, timing — the efficient management of cash as it cycles in and out of the company — is everything.

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