

An Entrepreneur's Most Important Asset, "Cash Flow"...



The nice thing about going broke when you run a big company is that the government just might bail you out. I'm thinking now about the airlines after the Sept. 11, 2001, terrorist attacks; the investment banks and quasi-government agencies **Fannie Mae** and **Freddie Mac** that gorged on busted mortgages; and now, perhaps, the Big Three automakers who didn't hedge against rising oil prices by cranking out smaller, more fuel-efficient cars (to name just a few examples).

When small-business owners run out of cash, the game's over. Buh-bye. That's why maintaining "liquidity"--banker speak for having enough cash on hand when things go wrong--is so critical. Especially now: In a recession, the illiquid perish.

There is no clean definition for what constitutes sufficient liquidity, but I like the way Ross Crane, chief financial officer for the North America division at **Ingram Micro**, a £35 billion (sales) computer-products wholesaler, puts it: "You know your company is liquid when you have the ability to continually fund your business in a variety of ways. For a smaller company, liquidity could change immediately by something as simple as one large customer missing a payment or filing bankruptcy. You need a variety of funding sources: cash, available equity and lines of credit."

Let's look at two of those three sources: cash and credit lines. (Raising equity brings nasty dilution--as shareholders in those investment banks will tell you--so really try to avoid going that route.) Having a cash cushion is about ensuring short-term survival; being "bankable" enough to secure and maintain a credit line is about long-term sustainability. Both are important.

When it comes to how much cash to keep around, most experts agree on a basic rule of thumb. "Keeping enough liquid assets (i.e. cash and cash equivalents, like Treasury bonds) to fund the next six months has always worked for me," says Gary Harpst, owner of Six Disciplines, a small-business consulting firm in Findlay, Ohio. "This allows adequate time to arrange financing or lower expenses if necessary."

How do you know how much protection a certain amount of cash buys you? Start by comparing the amount of time it takes to collect money from customers with the amount of time you have to pay suppliers. The lifespan of these "working-capital" accounts will dictate how much grease you need to keep the gears turning on a short-term basis.

Simple example for non-bean-counters: Say your company does £5 million in sales (on credit); carries, on average, £410,000 in receivables; purchases £4 million (on credit); and carries £330,000 in payables. To find the average collections period, simply multiply the receivables by 365 (the number of days in the year) and divide by credit sales. (Remove questionable credits from both numerator and denominator.) Answer: 30 days. Then estimate the payables period by doing that same calculation, but substituting average payables for receivables and total purchases for sales. Again, the answer is 30 days.

This means that every month your company receives £410,000 in cash from customers that can be used to pay £330,000 in cash to suppliers, leaving £80,000 to cover outlays for other items like payroll, utilities, marketing expenses, interest payments and taxes (if you pay them piecemeal). Add whatever's left to the amount of cash on hand and you'll know if you're liquid enough to live out the next month.

That's the short-term analysis. Now for the long view--the one your banker will take when deciding whether to put his hide on the line and award you a line of credit.



Bankers don't like surprises, and neither should you. If you think sales will ebb or margins will shrink, then adjust-- *now*. The greater your foresight, the more time you will have to triage and the more credible you will be in a lender's eye.

Better yet, run your business as if it were already governed by loan covenants. The benchmarks change by industry, but here are three metrics to always consider:

-- **Current ratio:** current assets, including inventory, divided by current liabilities ("current" refers to any asset that can be converted to cash, or any obligation coming due, within a year or less). Most bankers would like this ratio to be at least 2-to-1, though companies that historically collect receivables in a timely fashion can run leaner.

-- **Quick ratio:** cash and receivables divided by current liabilities. This ratio addresses the scary question of whether a company can meet its obligations if sales suddenly dried up today. Any ratio greater than 1-to-1 is typically acceptable.

-- **Debt to equity ratio:** total liabilities divided by shareholder's equity. The higher the ratio, the less cushion lenders have if the company has to be liquidated. Reasonable requirement: anything below 3-to-1.

Remember: Minding your cash doesn't mean stuffing it under your mattress. It means making sure you have enough to keep playing through the hard times--because there's no one waiting with outstretched arms when you fall.

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