When running a business, the future is as clear as mud!

Chuck Hoyt | September 1, 2017

EXECUTIVE SUMMARY

How would it make you feel if your pilot said, "There is a storm cell coming up and we don't have enough fuel to go around it," and the pilot continues with "we'll just have to punch through it." Applying this analogy to your business, how is your business plan? Will you have enough cash to maneuver around the inevitable storms or will you have to just "punch through them"? In dealing with private companies in my consulting practice, I have rarely found business projections that start with a beginning balance sheet and progress through the projections to an ending balance sheet using accrual entries for accounts payable, accounts receivable, inventory and accrued interest along the way. This of course, leads to not knowing how accrual annual net income ties out to annual cash flow.

Without knowing this, however, it's like flying the airplane and not knowing whether you have enough fuel to get to where you are going; flying as long as you can until you actually run out of fuel and then landing, sometimes unpleasantly. Cash is the fuel, accrual net income is the route providing refueling stops along the way and the ending accrual balance sheet is your destination.

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INTRODUCTION

One of my clients purchased some farm land this spring and will drill a well on the property later this year to supplement the water situation. Pretty simple transaction, right? That is until my client wants to represent it on paper for their lender or investor to show what will be happening from a numbers point of view. Cash is spent, assets go up for land and loan fees, partial interest is paid, accrued interest occurs, principal payments are made, depreciation and amortization happen. Not particularly easy to properly show on paper.

Now add the actual operation of the farm on top of this and you get things like regular income and expenses creating accounts payable, harvested crop inventory, investment in next year's crops, accounts receivable in addition to capital expenditures and draws for living expenses. How much cash or line of credit will my client need because he will be investing in the next crop before his current crop is harvested?

Cash flow and net income are very different here. Which does my client follow?

BACKGROUND

Of course, we need to follow both cash flow and net income. The business can live off of the cash flow in the short term, but net income will ultimately drive the outcome.

Cash flow and net income are what financial statements are all about and properly prepared accrual financial statements do a great job sorting this out after it is all said and done, looking backward though.

The problem is in looking forward, however. In my consulting practice for over 30 years in dealing with private companies, I rarely find forward looking projections that start with a beginning balance sheet and follow through the projections to an ending balance sheet; use accrual entries for accounts payable, accounts receivable, inventory and accrued interest; show annual net income that ties out to an annual cash flow from the projections.

I often find companies being managed by ideas of item profitability that do not necessarily roll up into profitability for the whole company. In other words, businesses are often run by perceptions of profitability and, even worse, just wishful thinking. I am reminded of the circular pie. Each of the pieces of a business must add up to the entire pie. When you say that you are making money, are you taking into account all the overhead, debt service and equity requirements and other areas of your business that may be sucking cash and or profitability? You need to make sure you understand how each piece fits into the whole and what the whole pie looks like.

Without this though, it's like flying an airplane and not knowing where you are going or being sure you have enough cash to be able to get around the storms until you run out of gas and land, sometimes unpleasantly. Remember that cash is the gas, accrual net income is the route providing refueling stops along the way and the ending accrual balance sheet is the destination.

According to the Small Business Administration, about half of all establishments survive five years or longer. [(1)] Turning this around means that about half fail within the 1st five years of start up and running out of cash might be an obvious cause.

Now none of this is rocket science or new to any degree, but what happens is that a simple transaction or business can become very complex. It takes a tremendous amount of time and expertise to properly represent our plans in a plan or projection. The result of this is that it just doesn't get done. It's not that easy, so only a rare few really take the time. I have been there and understand the pressures. Most of us do operate with budgeted performance measurements: however, having those all tie out to a forward looking balance sheet is the key that represents what the destination looks like -- good or bad.

We can all fall victim to wanting to increase sales by tightening the margins, feeling that volume will make up for reduced margins. But do we fully consider the demand on cash for inventory or accounts receivable or whether the added volume at a smaller margin will actually cover administration and overhead costs? Are we really better off with the added sales at a reduced sales price level? How much are we going to have to reduce our costs to make this work and is that a reasonable assumption? Volume generally requires more cash not less; will we run out of cash at a critical performance time?

SOLUTION

Every business needs to have carefully prepared projections that begin with the beginning balance sheet, follow through with projected sales, cost of goods sold, operating expenses, debt service and capital requirements. This process should demonstrate cash flow along the way, incorporate inventory, accounts receivable, accounts payable and tie out to an income statement for the period and an ending balance sheet. The projections should be built upon detailed information at the sku or item level showing variable profit margins for the item as well as each department, division or location and all should roll into the ending balance sheet for the total company. Don't forget to provide an allocation for income taxes and any required equity withdrawals.

This will provide the map or flight plan of where you are headed before hand and will go a long way toward knowing if and when cash will need to be fortified and where it will end up. At the very least, the process may simply provide the time needed to get out of a hole. This becomes very important because in a financial workout with a lender or investor, time usually becomes a major and very costly point of negotiation.

CONCLUSION

The more knowledge we have about where we are going, the more light we can shed on how to get there. I urge each and every person responsible for financial performance of a business to take the time to prepare detailed forward-looking projections that start with the present financial position and tie out to cash along the way and an ending balance sheet with an income statement at the end of the projection period.

Gas up and go, but be sure to have a great flight plan first. Have a safe journey!

1) Small Business Administration, June 2016, www.sba.gov/sites/default/files/advocacy/SB-FAQ-2016_WEB.pdf

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ABOUT THE AUTHOR

Chuck Hoyt is the owner and founder of Charles Hoyt Company, an agricultural management consulting firm in Fresno, CA. For over 30 years, Mr. Hoyt's company has helped agricultural businesses with strategic planning, debt management, budgeting, accounting restructure, financial workouts and general management.

In 2017, Mr Hoyt put the experience that he has gained over the years into a cloud based business analysis application called ThruThink.com. This is a platform where the User enters forward-looking data for an existing business, new business acquisition or real estate deal. *ThruThink*SM produces the standard Balance Sheet, P&L, and Cash Flow analysis for each year of the User defined time period as well as a Deal Score and Evaluation of the "Deal". *ThruThink*SM is used to experiment with profit margins, overhead expenses, debt structure, equity arrangements and partial ownerships.

