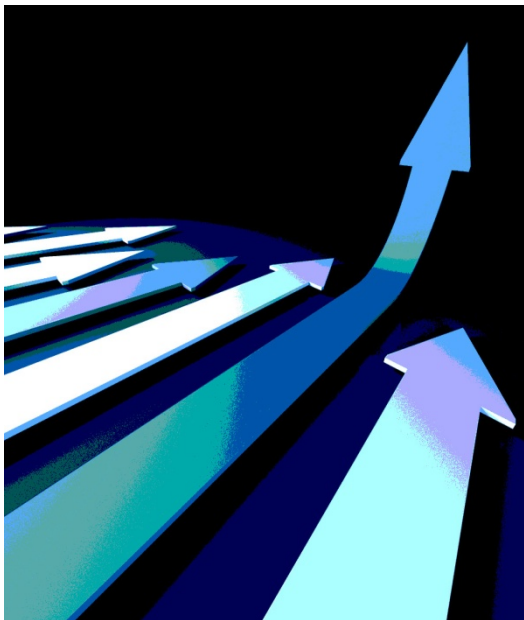


# Proper planning can drive real results

by: Joanne Baginski

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If you don't know where you're going,  
it doesn't matter how you get there.



Proper planning is paramount in both good and bad economies. It helps you proactively adjust your operations to ever-changing market conditions and business opportunities. Ultimately, it can increase profitability, improve cash flows and strengthen your financial position.

### **The Nature of Business Failures**

There are many causes of business failure. Bad debts, competition, lack of financing and loss of market share are just a few. Most external causes of declining businesses result from changes that threaten the core of a business, including changes in macro and microeconomic conditions, the competitive landscape, societal conditions and technological conditions.<sup>i</sup> Effective business managers should be constantly planning and positioning their companies to proactively adapt to changing conditions. Failure to anticipate change and to calculate its consequences can result in the business suffering.

While external conditions certainly can cause businesses to fail, experts agree that between 65% and 95% of failures are primarily attributable to internal problems, the most common being non-constructive and non-responsive behavior by management. Too many business managers ignore the warning signs and only react when symptoms are present.

One common example of non-responsive behavior occurs when companies lack sufficient working capital for day-to-day operations. Working capital is the difference between a firm's current assets and current liabilities. When this ratio is kept in proper balance, companies are able to meet their financial obligations on time, take advantage of discounts on purchases and limit the amount of cash that is tied up in inventory and accounts receivable. Too often, business leaders ignore the relationship between their current assets

and current liabilities until they run out of cash. With proper planning, management can continually monitor working capital trends and avoid potential cash drain.

### **Short-Term Planning Starts with a Clear Long-Term Vision**

Proper business planning begins with a long-term plan based on a vision and a mission that describe where the company is going and what it intends to accomplish along the way. While it is the long-term plan that tells you where you're going, it's the components of short-term planning that get you there. Successful companies employ short-term planning to manage daily operations and goals.

### **Cash Flow Forecasting**

One vital component of short-term planning is a 13-week cash flow forecast. When preparing a cash flow planning model, a business manager should do the following:<sup>ii</sup>

1. Understand how cash flows contribute to different product lines, business units and overall strategies.
2. Define and communicate key performance measurements on a regular basis.
3. Base cash flow planning and updates on organizational capacity.
4. Quantify size and likelihood of risks and opportunities.

Those who will be held accountable for cash flow performance should be involved in the planning process, and should be responsible for monitoring their areas at least weekly.

## Financial Analysis and Reporting

Successful companies monitor short-term plans with ongoing financial analysis and reporting.

Measurement tools such as ratios, trending analyses and key performance indicators play a critical role in monitoring performance. Some useful ratios can be seen in Figure A.

**Figure A: Important Financial Ratios**

<p><b>Liquidity Ratios:</b> Current Ratio = Current Assets/Current Liabilities (aim for &gt;1.2)</p>
<p><b>Leverage Ratios:</b> Debt to Equity Ratio = Debt/Equity (aim for &lt;3.0) Debt Service Coverage Ratio = EBITDA / Current maturities of LTD + Interest Expense (aim for &gt;1.25)</p>
<p><b>Efficiency Ratios:</b> Total Asset Turnover Ratio = Sales/Total Assets (industry dependent) Cash Gap = AR Days + Inventory Days – AP Days (industry dependent)</p>
<p><b>Profitability Ratios:</b> Net Profit Margin = Earnings after Taxes/Sales Return on Assets = Net Income/Total Assets Return on Equity = Net Income/Shareholder’s Equity</p>

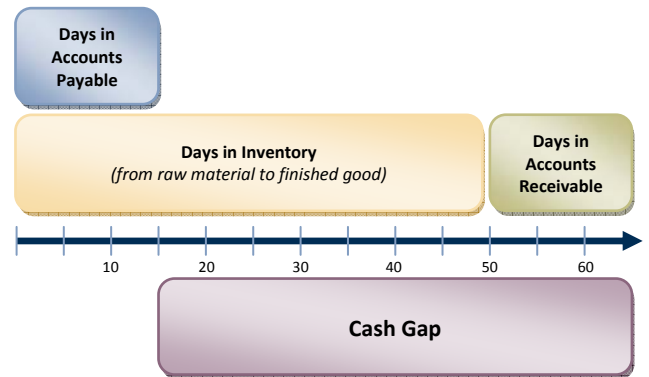
Key performance indicators that are based on your budget should be consistently and regularly compared to actual results. Access to these measurements should be reserved for internal operations, not parties outside of the organization.

### Working Capital Management

Working capital management is a critical component of proper short-term planning. By managing working capital, companies can get tax-free and interest-free financing. One way to analyze working capital is to look at the cash conversion cycle, which shows the length of time (in days) that it takes for a company to convert resources into cash. It measures the amount of time

each net input dollar is tied up in the production and sales process before it is converted into cash.

**Figure B: Cash Conversion Cycle**



The cash conversion cycle (figure B) is most commonly influenced by inventory, accounts receivable and accounts payable. Looking at each of these elements separately brings valuable information to light and proposes a series of additional questions. You need to ask whether you are selling the right products to the right customers at the right price.

When analyzing inventory, you should determine whether your products are profitable, high volume or useful for strategic purposes. If you have products that are profitable but low volume, consider creating an incentive plan for your sales people to push those products. If you have products that are unprofitable, strategize ways to reduce costs. If you have products that are unprofitable, low volume and not strategic, consider discontinuing them altogether. There is a myriad of combinations for these three factors and each one requires specific actions.

When looking to optimize accounts receivable, you should examine the root causes of delayed collections and not just the symptoms. Is the longer collection period truly due to outside factors like the financial condition of your customer or is it something internal like poor quality of products or delayed fulfillment?

A well designed credit policy that is enforced and frequently reviewed is important for risk mitigation. Putting stops on shipments until payments are made and maintaining close contact with customers and the sales team are a few additional ways to mitigate risk. Including sales personnel in the collection process can help them better understand where they should be placing their efforts.

Accounts payable cash management strategy centers on vendor management. Understanding your credit limits and terms with key vendors is essential. You need to know how far you can stretch your vendors in a tight spot. Track your vendors' credit terms (both written terms and actual tolerance). Identify critical and strategic vendors to determine how much quantity you should be buying from each. Too much dependency on one vendor creates unmitigated risk, and sometimes having more vendors can result in a higher borrowing capacity. Pay invoices separately to take advantage of the maximum borrowing period on each invoice. EFT can also help you keep borrowed cash for as long as possible.

### **Fixed Asset Budgeting**

Investments in fixed assets are usually significant and should be evaluated carefully before making the expenditures. Capital programs include maintenance, expansion, new product investments or acquisition programs. For any of these, a cash outflow in one year will not result in cash inflows until a future period. They will also affect future operating results and the strength of a company's financial position. Ensuring that these investments provide adequate returns is essential in planning for fixed asset outlays.

### **Capital Structure and Financial Strategy**

An academic approach to calculating the cost of capital, and finding the optimal mix of debt and equity is useful, but must be considered in light of other factors. For example, when developing an optimal capital structure, companies should choose a financing mix that matches the assets being financed. Mathematical models don't account for practical considerations that are critical to maintaining fluid operations. Long-term assets should be supported by long-term financing while short-term assets should be supported by short-term financing.

### **Contingency Planning**

When you plan for your business, you can be sure that not everything will go according to your plans. As a result, business managers should use contingency planning in the form of a sensitivity analysis. In a sensitivity analysis, plans are created in the form of multiple scenarios: best, worst and most likely. As time passes, one of the

scenarios will be more in line with reality than the others. With a plan already in place, managers can act quickly in accordance with their sensitivity analysis.

### **Communication Buy-in**

No matter how good your short-term and long-term plans are, you will not be able to follow them without proper communication and buy-in. Employees cannot implement plans if they don't know what they are. Similarly, plans will not be executed if the company's stakeholders don't believe in them. To ensure that plans are both accepted and followed, it's important that those who will be carrying out the plans are part of the actual planning process.

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<sup>i</sup> *Causes of Business Decline and Failure*. Turnaround Management Association, 2006: Lesson 1-1/2

<sup>ii</sup> *ibid*

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