May 2012

The importance of proper cash flow management

OVERVIEW

Cash flow management is an essential element of financial planning which at times is overlooked by individuals and inadequately serviced by advisers.

An adviser frequently needs to coach and remind clients of the importance of 'spending less than they earn' and demonstrate how they can manage their cashflows well. Planning strategies which encourage effective cash flow and debt management can significantly improve a client's ability to achieve their goals and objectives and deliver financial security.

FEATURED INTERVIEWEES

Grant McCorquodale
Head of Cash Services, Commonwealth Bank of Australia

'There is now really great software which can dynamically explore [and review] a client's cost of living expense budgets ... which can also then address what's the investment strategy, funding strategy and review [these] ongoing.'

Howard Ghedia
Managing Director, Lifestyle Planner Australia

'If the client wants to achieve long-term results they need to be prepared to change their spending habits if they are blowing all the budget or are spending on non-discretionary consumables or lifestyle expenses. They need to direct it back to income-producing assets.'

LEARNING OBJECTIVES

After reading this article you should be able to:

- Explain what is meant by cash flow and how it differs from an individual's income or net asset position.
- Explain the implications of debt for management of cash flow.
- Apply selected cash flow strategies to specific client scenarios.
- Discuss the importance of effective debt and cash flow management to a client's overall wealth creation plan.

KNOWLEDGE AREA AND ACCREDITATION

Knowledge area: Financial Planning (30 minutes).

FPA CPD points 0.5 Dimensions: Capability, Critical Thinking (FPA 005337).

AFA CPD points 0.5 (AFA 01022009).

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WHAT IS CASH FLOW MANAGEMENT?

Cash flow and wealth are different concepts. From an economic perspective, wealth can be defined as 'a store of spending power that can be carried into the future' (Jones & Perkins, 1986). It includes a wide variety of financial assets and non-financial assets such as shares, property and business assets that can be used to generate future income.

Simply put, cash flow is the way income flows into an individual's bank account and then flows out to fund expenses, while cash flow management is the analysis and management of cash flow.

These terms are frequently used in a business context. Cash flow is often said to be the 'lifeblood' of a business, and a company needs to have good cash flow management in order to pay its bills and invest for future growth.

The same concept applies to individual investors. Good cash flow is essential for wealth creation. Therefore, cash flow management should be an important part of any financial plan.

CASH FLOW MANAGEMENT PATTERNS

It is necessary to understand the three cash flow management patterns which ultimately determine whether an individual becomes wealthy or stays poor. These include:

› hand to mouth
› hand to bank
› handled for growth.

Hand to mouth

In this category all of a person's income from wages or salary flows out to pay expenses including groceries, rent and utilities. The cost to income ratio here is 100%. The result is that wealth does not grow because nothing is saved or invested to create wealth.

Consequently, when their income from a person's job ceases, their only hope is the reliance on government support, Grant McCorquodale, Head of Cash Services, Commonwealth Bank of Australia (CBA) said.

Hand to bank

This approach is often adopted by those who spend and live beyond their means.

In the hand to bank pattern, an individual or household has more than enough cash flow to meet expenses, but the remainder is spent on items 'which make them look rich', McCorquodale said.

So in addition to meeting expenses seen in the hand to mouth pattern, the individual or household adds liabilities to their balance sheet.

'You've got more free cash flow, and you use that free cash flow not to buy investment assets, but to buy a lifestyle.

'You're buying a house, your boat, your cars and therefore money in and money out. Now these things actually don't yield any investment cash flow back to the investor; in fact costs more and added to the expense line,' McCorquodale explained.

As a result, the individual or households 'feels' as though they have high net worth. In reality, those assets are a drain on cash flow as they have been artificially purchased through big loans that need to be repaid as well as the extra cash flow now to maintain them, all too often at the expense of genuine wealth creation.

> ***'Good cash flow management is where a client is disciplined enough to channel their cash flow in creating a positive cash flow that includes paying off their income expenses, meeting their liabilities, and excess cash flow is diverted towards paying off the debt'***
>
> Howard Ghedia

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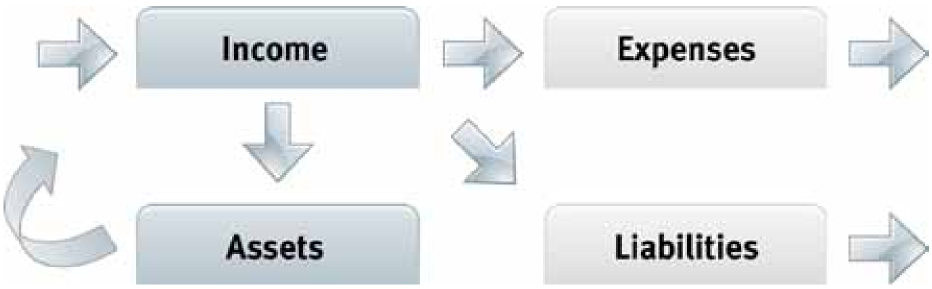
Handled for growth

This approach focuses on wealth creation first.

The handled for growth pattern resembles the individual who is able to pay off debt in an efficient manner, while also having enough money to invest and cope with life's unexpected emergencies, Howard Ghedia, Managing Director, Lifestyle Planner Australia, said.

'Good cash flow management is where a client is disciplined enough to channel their cash flow in creating a positive cash flow that includes paying off their income expenses, meeting their liabilities, and excess cash flow is diverted towards paying off the debt (depicted in Figure 1). And the surplus cash is actually used to [buy] income-producing assets,' he explained.

Figure 1: Cash flow for the handled for growth model



Source: Commonwealth Bank of Australia

McCorquodale said this is the cash flow discipline that clients require in order for them to achieve financial independence. 'That is the day when we've got enough free cash flow to replace our employment cash flow to fund our cost of living cash flow,' he said.

BENEFITS OF INCORPORATING CASH FLOW ADVICE FOR PRACTICES

Incorporating cash flow management advice into an adviser's service offering provides several significant benefits, according to Ghedia and McCorquodale. These include:

› allowing advisers to gain a thorough understanding of clients' actual earnings and spending habits, and identify whether any surplus cash flow could be used to build wealth
› forming part of a more holistic approach to financial planning.

By exploring elements such as cash flow in the financial planning process, the adviser moves the adviser/client relationship away from being purely product driven, creating a more solid basis for an ongoing value added relationship.

Ghedia argued that advisers will need to provide comprehensive cash flow management advice in order to demonstrate value amid choppy investment markets and impending Future of Financial Advice (FOFA) reforms.

'Cash flow has now become critical in the new environment because there have been so many changes in the financial industry.

'Advisers must demonstrate appropriateness of the advice which means that regulators are looking at how they are delivering their services under fee-for-service and cash flow management will become a hub for advisers to deliver new services,' he said.

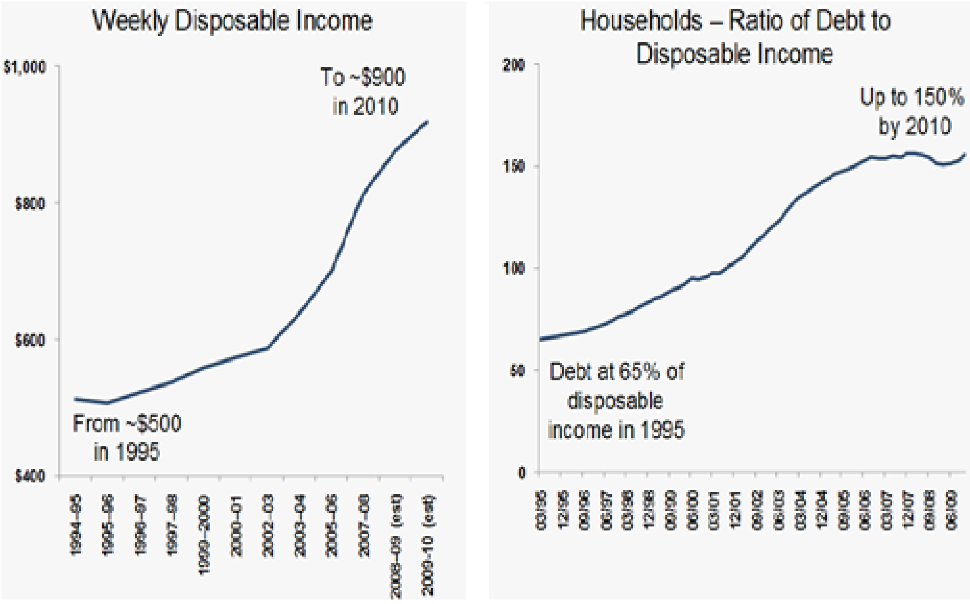
Household debt problems

There is also a significant opportunity to offer this type of advice to the general population, given the high levels of debt among Australian households, McCorquodale said.

Reserve Bank of Australia (RBA) figures released in 2009 showed that mortgage, credit card and personal loan debts stood at $1.2 trillion, up 71% from the previous five years and equating to $56,000 for every man, woman and child in the country (Davidson Institute, 2011).

And in the period from 1995 through 2010, the ratio of household debt to disposable income has significantly outpaced growth in weekly disposable income (Battelino, 2010). This is illustrated in Figure 2.

Figure 2: The ratio of household debt to disposable income from 1995 to 2010



Sources: Australian Bureau of Statistics, Reserve bank of Australia

McCorquodale explained that the data highlighted the fact that Australian households are very far from gaining financial freedom and that there was a heightened need for strategic cash flow and debt management advice to borrowers.

‘Making money isn’t our problem. It’s what we’re doing with it is the problem. What you see from 1995, the actual debt to disposable income, the ratio was 65%, now it’s over 150%.

‘It’s what people have done with their cash flow is really significant. Over that period they have got themselves so deep in debt they are now further from financial freedom than they’ve ever been.

‘They have ignored the basics of good business management [which is] sound cash flow management and relied on economic growth to get them through. When growth stopped their strategies collapsed,’ he said.

STRATEGIES TO HELP CLIENTS BETTER MANAGE THEIR CASH FLOW

There are several steps that an adviser needs to take in order to assist clients improve their cash flow management so that they can transit to the ‘handled for growth’ pattern. These include:

- conducting detailed cash flow analysis
- purchasing cash flow management software
- determining a client’s goals
- implementing debt management strategies
- setting up an investment plan
- considering lifestyle changes
- setting up a personal budget.

Conducting detailed cash flow analysis

Gaining an understanding of a client’s finances through cash flow analysis is vital and should be the first step taken in the process, as it provides a logical link between the individual’s long-term goals and objectives, and their current financial situation.

Ghedia commented that while many planners probe into clients' cash flow situation in fact find questionnaires, the problem is that these usually only provide a superficial insight of their financial situation.

This is because fact find questionnaires are generally not in-depth enough as they look at income and expenses over very short periods of time, he said. In addition, Ghedia argued clients end up providing data based on rough estimates and recollection, rather than actual documented figures, hence forcing advisers to rely on potentially inaccurate data.

'When they actually come to fill in the fact find, the fact find's data is incomplete. They actually guesstimate household expenditures and within the household expenditures, they have no idea whether they are really creating cash flow that is actually going to pay off their debt,' he said.

Both Ghedia and McCorquodale stressed it is important for advisers to conduct a robust and comprehensive cash flow analysis, which involves getting documented and detailed information of the components that make up an individual's cash flow. These components include:

› income
› fixed expenses
› variable expenses
› discretionary expenses.

Getting the underlying information within these components will assist an adviser in obtaining a much clearer picture of a client's cash flow situation, and will help determine the financial strategies and lifestyle changes appropriate for implementation.

Income

'Within income you've got salary and wages income; you've got interest income, passive income the individual might be earning or they might be getting government support such as Centrelink and Family Part A,' Ghedia said.

Fixed expenses

Fixed costs include necessary but relatively set living expenses such as mortgage repayments, rent, utility bills and insurance premiums, McCorquodale explained.

Variable expenses

Variable costs are also necessary living expenses, but can be somewhat controlled. Variable expenses include groceries, clothing, and car and home maintenance products.

Discretionary expenses

Discretionary expenses can be recurring or non-recurring costs for non-essential items or services.

'Those are the ones where you say "well, they're not really fundamental to an existence but they're nice to have". It could be the difference in buying an exceptional suit as opposed to buying an ordinary suit,' McCorquodale said.

Statement of net worth

A statement of net worth should also be prepared in conjunction with the cash flow analysis. This statement is like a balance sheet and shows the client's assets and liabilities and distinguishes lifestyle assets (for example, car, family home) from investment assets (for instance, shares and super).

Cash flow management software

Ghedia and McCorquodale argue that one of the critical tools advisers need in order to analyse and monitor clients' cash flow effectively and efficiently is appropriate software.

'There is now really great software which can dynamically explore [and review] a client's cost of living expense budgets … which can also then address what's the investment strategy, funding strategy and review [these] ongoing,' McCorquodale said.

Cash flow management software takes information directly from an individual's bank account and investment cash management account statements and produces detailed cash flow statements, Ghedia explained.

'Once the [data] comes into the software, the expenses are then analysed into essential expenses, non-essentials and what percentage of your income is servicing debt.

'At the end of the day as an adviser I like to know how much cash they have generated in say a one-year period and where they spend all the cash,' he said.

Software can also create personal budgets for clients, and help both the adviser and client track expenses and determine whether financial goals are likely to be met.

'Good software will allow advisers to stay on top of their clients' cash flows, as they are tracking their money to which their advisers have access to in a "real time". Thus, eliminating finding too late to do anything for their clients who may have gone "off course",' Ghedia added.

Determining a client's goals

Understanding a client's goals and objectives are prerequisites in determining which financial strategies and/or lifestyle changes should be implemented, and the appropriate amount of cash flow that should be directed to each.

▶ For example

A client may be seeking to reduce their mortgage, increase their super and fund an investment portfolio, McCorquodale said.

'Each goal will carry its own cash flow funding strategies. The client and adviser need to cost each out then put in place a prioritisation strategy around which to focus on,' he explained.

Implementing debt management strategies

After the cash flow analysis is complete and the adviser has a clear understanding of the client's goals, a number of debt management strategies can be considered in order to maximise (or turn around) a client's cash flow situation. Some of these strategies include:

- redraw facility
- offset account
- debt consolidation
- debt optimisation
- debt prioritisation.

Redraw facility

A redraw facility is a feature of a loan that allows a borrower to make additional lump sum or regular payments on top of their minimum payments and then withdraw the additional funds at later stages.

By paying off a greater amount of the loan, the borrower saves money as no interest is charged on the amount already repaid, and the facility can double up as an emergency savings account.

While making extra repayments on a loan can be a great use of surplus cash flow, Ghedia said advisers need to be cautious about recommending redraw facilities as they may not suit clients with bad financial habits.

'The problem is if the clients do not have discipline on spending, most likely they will draw more than they are earning so the income may not be covering the cost. So the redraw facility can be good for some clients but not for others,' he said.

Advisers will have to play a key role in identifying a loan facility that may suit their client, he said.

Offset account

An offset account is a savings account that is linked to a home loan. The interest charged on the loan is offset against the interest earned on the savings, thereby reducing it.

Debt consolidation

Debt consolidation involves combining separate loans to minimise the number of fees and repay higher cost funds in favour of one larger loan at a lower interest rate.

Ghedia said it is important to be aware that debt consolidation solutions will typically reduce an individual's monthly repayments at the cost of *increasing* the overall loan term.

Debt optimisation

Debt optimisation (commonly also known as 'debt recycling') involves replacing 'inefficient' (non tax-deductible) home loan debt with 'efficient' (tax deductible) debt, such as an investment or margin loan.

In this strategy an individual would divert a significant chunk of their surplus cash flow to reduce or eliminate the home loan debt as quickly as possible in order to increase the equity of the property more rapidly.

Then, the individual would borrow against the increased equity to purchase other investments with the corresponding loan representing efficient debt.

Debt prioritisation

It makes sense to pay off some debts quicker than others. Debt prioritisation involves paying off loans with the highest interest rates as fast as possible to free up cash flow over time.

Ghedia observed that many individuals are juggling between credit card and home loan debt at the same time. But it should be a top priority to divert surplus cash flow to the former because of high interest rates on credit cards.

'Credit cards are very expensive. The interest rate can range anything from 13.5% to say 29/30%. The home loan interest rate could be low compared to that — 6 or 7% so they need to prioritise,' he said.

Setting up an investment plan

Debt management strategies play a key role in good cash flow management, but it should not be the only consideration, according to McCorquodale.

While it is important to reduce debt, it is also vital to build wealth for the long term by investing regularly in a diversified portfolio of equities, bonds and other assets so that the income generated from these investments can contribute and eventually meet an individual's living costs (as shown in Figure 1).

'Wealth is not a measure of how much money you earn, it's how much money your money earns, and by understanding these basic financial principles you can employ a far greater successful investor relationship,' he said.

McCorquodale said too many people wait until their home loan is paid off before thinking about investing and hence end up investing later in life and do not give those assets enough time to grow in value.

They also defer the opportunity to gain the critical financial literacy skills of investment experience from not being an investor. It is important to build investment simultaneously to focusing on reducing their debts.

Even if a client cannot afford to place big lump sum towards an investment portfolio, regular contributions and/or gearing should be considered, he commented.

The importance of insurance and savings

'Defence wins the game' may be one of the oldest litanies around, but nowhere does it ring truer than when it comes to protecting wealth.

While it can be very rewarding from an individual's perspective to have high free cash flow and good management of that cash flow, having adequate insurance is a must in order to protect the reliability of that cash flow in the event of an accident or illness.

'It's like the heart. The cash flow system is the heart and around the heart blood is pumping around the body, allowing the body to thrive and grow and develop. If the cash flow stops, if the blood flow stops, the strategy stops.

'The primary thing therefore is that an investor needs to put in play insurance from that as a fundamental necessary insurance to ensure those important strategies can survive if the individual loses income for a time,' McCorquodale said.

'It's like the heart. The cash flow system is the heart and around the heart blood is pumping around the body, allowing the body to thrive and grow and develop. If the cash flow stops, if the blood flow stops, the strategy stops.'

Grant McCorquodale

Have a minimum six-month emergency savings cushion

Ghedia also advocated that it is crucial that advisers encourage clients to set aside a minimum six months worth of living expenses in an emergency fund, as not everything can be covered by insurance.

'Should an emergency arise where storm, drought or a medical emergency or they become unemployed — that emergency cash reserve should be able to fund their essential expenses for a minimum of six months.

'So that includes mortgage repayments, the purchase of groceries, lease payments, minimum credit card repayments so emergency cash reserves are absolutely critical for advisers to focus on,' he said.

Considering lifestyle strategies

Debt management strategies and investment may not be sufficient to improve a client's cash flow position and/or help them to meet their goals and objectives, particularly for 'hand to bank' clients.

Hence, an adviser may also need to have a conversation with clients and discuss a number of lifestyle strategies. These could include:

› delaying retirement
› increasing earnings through working full time rather than part time
› selling assets such as an investment property or business
› downsizing the home
› reining in discretionary spending.

'If the client wants to achieve long-term results, they need to be prepared to change their spending habits if they are blowing all the budget or are spending on non-discretionary consumables or lifestyle expenses. They need to direct it back to income-producing assets,' Ghedia said.

Setting up a personal budget

A personal budget is simply a written breakdown of an individual's monthly income and expenses. It also sets out a plan for how future expenses will be paid for, and how much cash flow will be allocated to the strategies appropriate for the client.

Setting up a budget for a client from an adviser's perspective involves several key steps:

› record all components of cash flow
› determine funding allocation
› set up regular monitoring and accountability.

Record all components of cash flow

The adviser and client should record all the components of a client's cash flow (income and expenses) as a monthly amount.

Additionally, any substantial or one-off income sources and expenses should also be noted down, as these will impact cash flow and will need to be planned accordingly.

These may include:

- dividends from investments
- lump sum payments from selling property and shares
- employer bonuses
- tax refunds
- tax debt owed to the ATO
- payment due for a child's private school/tuition fees.

Determine funding allocation

Ghedia and McCorquodale said the adviser and client will need to go through the challenging task of negotiating how much surplus cash flow should be channelled to the strategies designed to assist the client reach their goals and objectives.

▶ For example

A client's goals and objectives include saving up $3,000 for a holiday in the short term and $25,000 for an investment property deposit within three years.

'So the adviser could recommend the client saves regularly till they have got that $3,000 by the time they want to take that holiday,' Ghedia said.

'If you are budgeting to buy an investment property and you need say $25,000 and the goal is to accumulate that over say a three year period, you need to have savings channeled through different accounts so you can achieve the deposit you require to purchase the investment property.'

Set up regular monitoring and accountability

It is paramount that both the adviser and the client take the time to regularly review the budget and ensure that it is being adhered to.

McCorquodale suggested that budgets should be reviewed every six months to see how much free cash flow has gone towards building wealth and if there has been any overspending.

Ghedia said while the hard work is ultimately up to the client, the adviser will need to provide a sense of accountability and provide constant mentoring support to the client to keep their spending habits and the overall budget in check.

He recommended that advisers who are weak in the area of coaching and mentoring undertake training to build more effective ties with clients, particularly given that cash flow management requires a long-term relationship.

'The adviser needs to also upskill their coaching and mentoring role because some of the financial planning that you undertake for your clients will be long-term,' Ghedia said.

CASH FLOW PLANNING IN PRACTICE

The following is a sample case study of a cash flow management plan in practice.

Case study: Alex and Linda

Alex and Linda both work and have two children. They recently bought a house and a car, and have been using their credit card heavily. They owe $247,000 on their home mortgage, $11,000 on their car and have $3,000 of credit card debt outstanding.

The couple, wishing to improve their cash flow, decide to visit their adviser and explain that their goals and objectives include:

› paying off the credit card
› paying off the car
› putting some money aside for retirement
› saving for children's education
› paying off the home.

The adviser conducts a thorough cash flow analysis on Alex and Linda, which shows the following results:

Income		**Converted to monthly amounts**
Alex's take home pay	$1,707 fortnightly	$3,710
Linda's take home pay (works part time)	$969 fortnightly	$2,106
Family Tax Benefits	$3,772 yearly	$314
Total income	**$6,130**	
Expenses		**Converted to monthly amounts**
Home mortgage repayments	$2,081 monthly	$2,081
Car loan repayments	$508 monthly	$508
Credit card interest payments	$590 for 2 years	$25
Car running costs	$4,500 yearly	$375
Food and groceries	$260 weekly	$1,130
Holidays, entertainment	$100 weekly	$435
All other costs (school, clothing, medical, insurance, repairs, rates, water, electricity)	$1,290 monthly	$1,290
Total expenses	**$5,844**	
What Alex and Linda save each month	**+$286**	

› Pay off the car (within three years) – The extra cash flow gained from paying off the credit card should then help pay off the car loan quicker and increase their monthly savings.
› Put money aside for retirement (long-term) – After the credit card and car loan have been paid off, salary sacrifice a small amount into super and make regular contributions to an investment fund outside super.
› Save for children's education (medium- to long-term) – Make contributions to a high-interest savings account.
› Pay off the home – Make payments fortnightly and pay a bit more than required each time through a redraw facility.

Source: Lifestyle Planner

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IN CONCLUSION

Analysing a client's cash flow is similar to a doctor conducting a full health check on their clients at the start of their relationship or a personal trainer with their client when they come to the gym to change their state of health.

It gives an adviser a realistic look into their client's income and expenditure as well as a gauge on the client investment behaviour characteristics, thus providing a realistic framework for advice, what needs to change and where focus and coaching needs to be applied. All in all, it provides a more holistic approach to financial planning.

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Discussion questions

1. What should advisers consider when starting an investment portfolio for clients who also have a home loan?
2. During cash flow analysis, clients are often able to quantify their income but have difficulty with their expenses. What techniques can advisers use to approximate client expenses for a particular period?