

Managing Cash Flow

You own a business to make a profit and focus much of your attention on that objective. However, if there is no money in the checkbook, it may be difficult in the short run to stay in business. Cash management is important for survival and may, at some point in a company's life, take priority over profit.

There are two parts to managing cash flow. First, you need to understand and be able to project how and when cash will be received and spent. Second, you need to take steps within several categories of revenue and expenditure to optimize timing and amounts.

Cash Projections

The purpose of a cash projection is to predict potential cash shortfalls weeks in advance, in time to take preventive action. Cash projections should be maintained by the business owner and/or bookkeeper and should be updated just before paying bills, typically weekly. Many modern accounting software packages include a cash flow projector, but often the software derived projections need so much editing they can be more trouble than they are worth.

Spreadsheets make projecting cash flow very easy. Austin Associates can set up a cash flow projection template for you or you can do this in-house. The spreadsheet has a date for each column, generally the day you plan to pay bills. Dates are typically weekly for the next six weeks and monthly out to 12 months. The rows consist of:

- Beginning balance for the sheet and a formula for each column.
- An array and total for cash receipts. This should include both revenues and outside sources such as loan proceeds and capital contributions.
- An array and total for expenditures. This should include expenses, capital expenditures and loan payments.
- Ending balance formula. The balance is transferred by formula to the following column.

Limit the number of rows in major categories to keep making a projection manageable. Typically there are 3-5 cash receipts lines and 10-20 expenditure lines. You can use accounts receivable and accounts payable reports for much of the projection, but must also consider receipts and expenditures that do not go through these systems.

Once the projection is complete it should be obvious if and when there are cash flow "pinch points". The next step is to fix those pinch points by controlling cash flow.

Controlling Cash Flow

Controlling revenues and costs, or the income statement will be the subject of another article. Controlling cash flow assumes the income statement items are as they should be and manages assets and liabilities. Cash management is all about collecting fast and paying slow. Depending on the nature of your company, there are six basic elements of cash management. Each is outlined below, but several may be the subject of future articles:

1. Revenue – Sales revenue for this purpose is payments received, not sales generated. Whether you book accounts receivable or record sales when payments are received is not an issue. You need to minimize the time and dollars between doing the work or delivering the product and depositing the money. Here are some of the ways:

- a. Contractors, develop a formula for job progress payments. This might be 1/3 upon signing the contract, 1/3 upon start of work and the balance upon satisfactory completion. Commercial contractors often must accept 5-10% retainage by the property owner or prime contractor for up to a year. To the extent you can prevent retainage or quickly deal with your customer's punch lists, you will collect sooner.
 - b. When selling to consumers or small businesses, consider accepting credit cards instead of extending credit. The loss on one bad debt can wipe out years' worth of credit card fees.
 - c. With larger business customers, you may be forced to extend credit as a condition of doing business. However, you can collect faster by offering prepayment, or early payment discounts. Austin Associates can help you establish a policy that makes financial sense.
 - d. Use your accounting program's Accounts Receivable (AR) reports to spot overdue invoices. Obtain credit reports to be sure customers will pay their bills and spend time collecting delinquent accounts. The AR module can also track customer advance deposits; they simply show up as negative balances that can be adjusted in aggregate to a liability account at year-end.
 - e. Pay commissions on collections, not sales. This gives salespeople an incentive to be sure sales are booked and collected properly.
2. Loan proceeds – Your business may need loans from a bank, your personal account or other sources in order to finance inventory, accounts receivable, capital equipment or seasonal losses. It is important to know what kind of loan you need, when you need it and how much you need. Always try to borrow more than you need and hold some of the funds in reserve. Business financing will be the subject of a future article.
 3. Routine expenses including goods and services going through Accounts Payable and those, such as payroll, that are paid immediately.
 - a. Immediate payments cannot be controlled except through reduction of expenses. We recommend using a payroll service that collects payroll taxes each week. This avoids payroll tax delinquency and eliminates preparing payroll reports. Trying to improve cash flow by doing your own payroll is not worth the risks.
 - b. In today's business environment, you may have larger vendors, particularly in franchisors, who want direct access to your checking account. While electronic payment can be very convenient if you are initiating the transaction (push payments), it can be disastrous if a vendor can dip into your checkbook (pull payments). Timely recording these vendor payments and accurately applying them to your internal accounts can be difficult. If done poorly, it can result in overdrafts and bounced checks. We recommend avoiding vendor controlled payments, including Direct Debits or Pre-approved Checks (PAC).
 - c. If your accounting software includes Accounts Payable (AP), consider using that module even if your taxes are filed on a cash-basis. This permits ageing bills by due date and paying them at the last minute. You need the highest possible AP balance consistent with your expenditures. That way, you can run your business with other peoples' money.
 4. Inventory – While inventory may be necessary for your business, it also represents a cash outlay that may not be working for you. Inventory turnover¹ is often slower than other

¹ Inventory turnover = annual cost of sales / inventory balance. It can also be expressed as the number of day's costs in inventory.

elements working capital². The right turnover varies by industry, but generally lower gross margins require higher turnover. A supermarket may turn its inventory every 2-3 days, while a furniture store may need 150 days inventory to offer a good selection. You should invest the time and resources to track inventory by item and find ways to dispose of items that do not turn. Some vendors have annual programs where for a restocking fee, typically 30%, you can return merchandise that won't sell. Taking a loss on non-moving inventory is financially better than keeping it for years. Income from high turnover items that replace non-moving inventory more than offsets typical disposal losses. Some vendors offer seasonal dating programs where merchants can receive inventory 3-12 months before they must pay for it. Dating can be effective if you choose the right merchandise, but can create serious turnover and cash flow problems if you buy non-moving merchandise or cannot sell it before the dating payments are due. Use these programs only for merchandise you know can be sold before the dating is due.

5. Capital Expenditures – Unless your business is flush with cash, most capital expenditure should be partly financed with loans under terms consistent with the life and productivity of the new asset. They should not be financed with credit lines designed to deal with seasonal business fluctuations.
6. Debt Service – The only way to control debt service is to evaluate the cash flow impact of each loan before taking the money. Purchases made with the proceeds of each loan should support debt service through increased sales or decreased costs.

Working Capital Cycle

Since the three major elements of working capital, accounts receivable, inventory and accounts payable, can all be expressed in days, they can be collectively expressed as the working capital cycle. Working Capital Cycle = Days AR + Days Inventory – Days AP. While the working capital cycle varies with industry, it should remain fairly constant within your industry or business and should not vary much seasonally. When business slows, the dollar balances of AR and AP should drop significantly but inventory dollars may drop more slowly. To keep the working capital cycle constant and cash flow healthy, manage collections aggressively, plan ahead to reduce inventory before the slowdown and extend payments to offset slower inventory turns.

Conclusion

Cash management is complex. Future articles will deal with various aspects in more detail. Austin Associates has references to determine the ideal working capital cycle for most industries. Our management advisory service is available to diagnose cash flow issues, recommend and implement solutions. If your business has difficulty maintaining a positive cash flow, contact your Austin Accountant to arrange a consultation.

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² Working Capital = Current Assets - Current Liabilities