Cash Is King: Managing Cash Flow

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The most important resource for starting and staying in business is cash. While sales, gross/profit margins and controlling expenses are also critical, a business that cannot manage its cash will probably be out of business, soon.

Effective cash management starts with a cash flow plan. This plan should detail where and when, cash will be required (cash outflow) and where and when, it is expected to come in (cash inflow). The cash flow plan is not to be confused with a business plan or profit-and-loss projection – while these are important management tools, they serve other purposes. The cash flow plan addresses areas that use cash, including inventory, accounts receivable, fixed monthly overhead expenditures and capital outlays.

Getting Started

A cash flow plan begins with certain assumptions regarding sales and the sales mix (cash, credit terms, etc.). The plan helps determine an acceptable level of sales that can be carried by way of accounts receivable, and the length of time they can be carried for. For example, offering 30 day payment terms is realistic for some companies, but not for others.

Sales Are Not Enough

Monthly monitoring of receivables activity is important. If customers are taking an average of 60 days to pay, but the cash flow plan assumes an average of 30 days, the business will eventually experience a cash-flow crunch. One should not expect to solve the problem by generating sales, since this does not ensure the business will have readily available cash to meet ongoing obligations. On paper, a transaction may indicate that a sale resulted in an operating profit, or even a net loss, but either scenario can be problematic. For example, if a sale generates an account receivable rather than cash, it could be weeks before payment is received. A business relying on early-or near immediate customer payment to pay its bills, meet a bank loan payment or order stock may therefore find itself in a precarious position.

Keeping the Customers on Track

Selling on terms is attractive, and often necessary, for developing a larger clientele. Nevertheless, when customers must constantly be reminded to pay, or persist in delaying payment, the cost of carrying and monitoring their accounts will erode the initial profit margin. Selling terms to tardy customers should be reviewed – even so far as to amend terms to COD only.

Establishing a Line of Credit

When accounts receivable are a significant part of business sales, the business will often establish an operating credit line with its local bank. The bank operating line will permit financing of outstanding accounts receivable up to a certain level, usually 75 percent of invoice value, subject to a number of conditions. Even at the 75 percent level, a cash flow plan should recognize that the business can only borrow $0.75 on every dollar carried as accounts receivable. This means at least 25 percent of this major current asset is tied up and cannot support any other business cash flow needs. Owners must be familiar with extending credit to customers.

Inventory Movement

Inventory may or may not be easily converted to cash if emergencies arise. How much inventory the business carries depends on many factors, including: cash reserves, space, customer and seasonal demand, designated lines of credit and the possibility of early obsolescence of inventory. Bank financing is often arranged, and while levels vary, 50 percent of cost inventory is average. Thus, for every dollar of inventory held, the business must commit at least $0.50 of its own working capital. Should the business elect to carry merchandise for an extended period of time, it may cause the true cost of goods sold to end up higher than the eventual retail selling price. Specialty items can require a different approach, since they typically remain in stock for longer periods, but their selling price must reflect this additional carrying cost. Periodically, owners should review product lines to ensure merchandise in moving at an acceptable rate. The longer inventory ages, the more difficult it will be to sell at a price that recovers costs, let alone generate a profit. You should compare inventory turns with industry averages and be prepared to sell at a discount, or negotiate return terms with suppliers.

Suppliers and Customers

Suppliers and customers can also contribute positively to business cash flow needs. Suppliers often provide terms such as net 30 days or offer a discount if paid within shorter period. For customers with terms, consider allowing modest discounts for prepaid orders or obtain deposits on speciality orders. It is always better when the money is in the company's bank account instead of some else's.

Seasonality

Seasonality also has a major impact on cash flow. With the Spring/Summer and Fall/Winter seasons and special holidays, inventory is usually required to be ordered well in advanced. Should supplier terms call for payment upon delivery, there is often a considerable time gap between when you pay and when you hope to sell, so negotiate extended supplier terms whenever possible. During slow months where cash in-flow is reduced, clear out slow-moving merchandise. Negotiating principal payment terms on any major debt will ensure cash is not leaving the company when it is most needed.

What to Do With Extra Cash

Time and effort on the owner's part may result in surplus cash being generated – cash not immediately necessary for day-to-day financial obligations. While having extra cash is not a problem, there can be "opportunity cost" when not working for the business. As such, there are several factors to consider:

1. When cash results from increased sales it will likely be a surplus, but before using it, consider if this surplus is temporary (due to seasonality), or best earmarked for replacement inventory. (This will be the case in most retail operations.)

2. Cash from the sale of a business asset (such as equipment or surplus stock) is truly "extra" cash only when those assets need not be replaced.

3. If the owner has recently contributed extra cash-equity into the business, determine if it is for immediate use or for reserve. If it is for reserve, then a short term, liquid investment may be in order.

Should the business have a true surplus of cash, here are some strategies for maximizing its value:

• Use all or part of the surplus to pay down long-term debt. While one may need to borrow additional funds at some later date, do not pass up the opportunity to save interest costs when it is prudent to do so;

• Purchase additional fixed assets (those the business was planning to buy or borrow for in the near future);

• Consider short, medium or long-term financial investments, but be sure the terms of investment and redemption are clear, and reflect the cash flow plan

When making investment decisions, the business owner must consider how much cash they need in reserve for daily expenses, working capital, debt servicing and planned capital expenditures. However, with the correct investment products and strategies, a business can maximize its investment returns without sacrificing liquidity. In this regard, business owners should also discuss the options and opportunities available with their local bank.

Being complacent about cash flow will eventually have negative consequences. However, effectively managing cash flow will contribute to overall financial stability and improve one's chance of surviving uncertain periods in the business cycle.

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