

Excellence in Financial Management

Discussion Board Articles – Cash Flow Management

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Cash Flow Management

Basic Cash Flow Management

Managing cash must take an equal stature with Net Income. In financial management, "cash is king" is a frequent motto. Your first step in managing cash is to elevate the importance of cash. The basic process for managing cash is straightforward. Try to maintain an adequate level of cash to meet current obligations and invest idle cash into earning assets. Earning assets must have high liquidity; i.e. you must be able to convert investments back into cash quickly. Additionally, you want to protect your cash balance by paying obligations only as they come due.

Managing cash also involves aggressive conversion of current assets into cash. Inventory levels must be converted into accounts receivables and accounts receivables must be converted into cash. Ratios should be used to monitor the conversion of cash, such as number of days in inventory and number of days in receivables. Cash balances are the result from a combination of cycles: inventory, purchasing, receivables, payables, etc. The key is to properly manage these cycles for conversion into cash.

Once conversion cycles are identified, cash forecasts can be prepared for managing cash. Weekly cash reports are used to monitor balances. Since everything ultimately passes through your cash account, a strong internal control system is required. This involves the separation of duties in handling cash, reconciling cash accounts, adequate support for cash disbursements, and other control procedures. The overall objective is to protect cash just like any other asset through a system of internal controls.

Quick Tips for Improving Cash Flow

The first step for improving your cash flow is to understand the history of your cash flow. This requires scheduling cash inflows and outflows. Once you understand the history, you can take steps to cut cash outflows and increase collections.

One of the biggest cash outflows is payroll. Payroll should be managed with flexibility in mind. You need a workforce that works when needed as opposed to 5 days a week, 8 hours a day. Consider diversifying your work force into a mix of temporary workers, part-time workers, and outsourcing of non-value added activities. Also, don't forget you can extend your payroll float by distributing payroll checks after 2:00 o'clock on Fridays.

Your purchasing practices should also consider a mixed approach. For example, why do you have to buy everything new? Purchasing used items or renting can save a lot of cash flow. You may want to purchase in minimum quantities, especially if your cash flow is tight. And do not hold inventory that isn't moving - get rid of it!

Other cash traps include insurance. Do not use insurance to cover all risks. Make sure you retain some risks, especially if the risk is not materially significant and not likely to occur very often. One of the fastest rising insurance outflows is health care costs. Make sure you have a preventive program for your employees. This can include things like annual cholesterol screenings, reimbursement for quit smoking programs, and company participation in outdoor activities. Finally, aggressively monitor your outstanding receivables and begin to take action at the first sign of trouble. If you have doubts about a customer's ability to pay, require an advance deposit.

Cash Support for Sales Growth

As sales grow, cash needs will grow. Planning for future sales must include planning for additional requirements for cash. A basic formula can be used to help determine the amount of additional cash needed for new sales. The formula is calculated as follows:

Additional Cash = ((New Sales - Gross Profit) + Additional Overhead) / (Sales Growth Duration in Days x Average number of days to collect Receivables + Safety Factor)

Example: We expect \$ 10,000 of additional sales during the year (365 days) with a corresponding increase of \$ 3,000 in overhead. All payables are paid on time, we do not expect any changes in our collection periods, and we expect a continued gross profit margin of 25%. The average period to collect receivables is 40 days and we will add in a safety factor of 20% into our estimate.

$(\$ 10,000 - \$ 2,500) + \$ 3,000 / 365 = \$ 28.77 \times (40 \times 1.20) = \$ 1,381$ of additional cash is needed to support the \$ 10,000 of additional sales.

The above formula is a quick and rough estimate for estimating how much cash is needed to carry additional sales. Changes in collections and payment cycles need to be considered when using this formula.

Basic Accounts Receivable Management

This article will outline some of the basic components for managing accounts receivable, ranging from policies and measurement to outsourcing options.

The foundation behind account receivables is your policies and procedures for sales. For example, do you have a credit policy? When and how do you evaluate a customer for credit? If you look at past payment histories, you should be able to ascertain who should get credit and who shouldn't. Additionally, you need to establish sales terms. For example, is it beneficial to offer discounts to speed-up cash collections? What is the industry standard for sales terms? There are several questions that have to be answered in building the foundation for managing accounts receivables.

A system must be in place to track accounts receivables. This will include balance forwards, listing of all open invoices, and generation of monthly statements to customers. An aging of receivables will be used to collect overdue accounts. You must act quickly to collect overdue accounts. Start by making phone calls followed by letters to upper-level managers for the Customer. Try to negotiate settlement payments, such as installments or asset donations. If your collection efforts fail, you may want to use a collection agency.

Also remember that the collection process is the art of knowing the customer. A psychological understanding of the customer gives you insights into what buttons to push in collecting the account. One of the biggest mistakes made in the collection process is a "sticks only" approach. For some customers, using a carrot can work wonders in collecting the overdue account. For example, in one case the company mailed a set of football tickets to a customer with a friendly note and within weeks, they received full payment of the outstanding account.

Measurement is another component within account receivable management. Traditional ratios, such as turnover will measure how many times you were able to convert receivables over into cash.

Example: Monthly sales were \$ 50,000, the beginning monthly balance for receivables was \$ 70,000 and the ending monthly balance was \$ 90,000. The turnover ratio is:
 $.625 (\$ 50,000 / ((\$70,000 + \$ 90,000)/2))$. Annual turnover is $.625 \times 360 / 30$ or 7.5 times. If you divide 360 (bankers year) by 7.5, you get 48 days on average to collect your account receivables. You can also measure your investment in receivables. This calculation is based on the number of days it takes you to collect receivables and the amount of credit sales.

Example: Annual credit sales are \$ 100,000. Your invoice terms are net 30 days. On average, most accounts are 13 days past due. Your investment in accounts receivable is:

$(30 + 13) / 365 \times \$ 100,000$ or \$ 11,781.

Example: Average monthly sales are \$ 10,000. On average, accounts receivable are paid 60 days after the sales date. The product costs are 50% of sales and inventory-carrying costs are 10% of sales. Your investment in accounts receivable is:

$2 \text{ months} \times \$ 10,000 = \$ 20,000 \text{ of sales} \times .60 = \$ 18,000.$

Measurements may need to be modified to account for wide fluctuations within the sales cycle. The use of weights can help ensure comparable measurements.

Example: Weighted Average Days to Pay = $\text{Sum of } ((\text{Date Paid} - \text{Due Date}) \times \text{Amount Paid}) / \text{Total Payments}$

Example: Best Possible Days Outstanding = $(\text{Current A/R} \times \# \text{ of Days in Period}) / \text{Credit Sales for Period}$

Receivable Management also involves the use of specialist. After-all, you need to spend most of your time trying to lower your losses and not trying to collect overdue accounts. A wide range of specialist can help:

- Credit Bureau services to review and approve new customers.
- Deduction and collection agencies
- Complete management of billings and collections

Examples of specialist include www.clect.net , www.ecredit.com , and www.iab-inc.com . Finally, don't overlook software programs for managing receivables, such as www.getpaid.com .