

How to manage cashflow

Cash is the oxygen that enables a business to survive and prosper and is the primary indicator of business health. While a business can survive for a short time without sales or profits, without cash it will die. For this reason the inflow and outflow of cash need careful monitoring and management.

I will briefly look at the key elements of cashflow and at how effective cashflow management will help protect the financial security of your business. I will outline the steps that you can take when dealing with your customers, suppliers and stakeholders to improve cashflow. I will also highlight common cashflow problems and how to avoid them.

What is cash?

Cashflow is the measure of your ability to pay your bills on a regular basis. It depends on the timing and amounts of money flowing into and out of the business each week and month. Good cashflow means that the pattern of income and spending in a business allows it to have cash available to pay bills on time.

Your available cash includes:

- notes
- money in current accounts and short-term deposits
- any unused bank overdraft facility
- foreign currency and deposits that can be quickly converted to your currency

It does not include:

- long-term deposits (if these cannot be withdrawn)
- money owed by customers
- stock

Difference between cash and profit

It is important not to confuse cash balances with profit. Profit is the difference between the total amount your business earns and all of its costs, usually assessed over a year or other trading

period. You may be able to forecast a good profit for the year, yet still face times when you are strapped for cash.

The importance of cash

To make a profit, most businesses have to produce and deliver goods or services to their customers before being paid. Unfortunately, no matter how profitable the contract, if you don't have enough money to pay your staff and suppliers before receiving payment from your customers, you'll be unable to deliver your side of the bargain or receive any profit.

To trade effectively and be able to grow your business, you need to build up cash balances by ensuring that the timing of cash movements puts you in a positive cashflow situation overall.

But bear in mind that having a lot of cash in your bank does not necessarily make good business sense. If you do not need to use it immediately, put spare cash into an account where it will earn a higher rate of interest, or use it as capital for short-term investments. Get advice from your bank manager, accountant or financial adviser.

Cash inflows and cash outflows

Ideally, during the business cycle, you will have more money flowing in than flowing out. This will allow you to build up cash balances with which to plug cashflow gaps, seek expansion and reassure lenders and investors about the health of your business.

You should note that income and expenditure cashflows rarely occur together, with inflows often lagging behind. Your aim must be to speed up the inflows and slow down the outflows.

Cash inflows

- Payment for goods or services from your customers.
- Receipt of a bank loan.
- Interest on savings and investments.
- Shareholder investments.
- Increased bank overdrafts or loans.

Cash outflows

- Purchase of stock, raw materials or tools.
- Wages, rents and daily operating expenses.

- Purchase of fixed assets - PCs, machinery, office furniture, etc.
- Loan repayments.
- Dividend payments.
- Income tax, corporation tax, VAT and other taxes.
- Reduced overdraft facilities.

Many of your regular cash outflows, such as salaries, loan repayments and tax, have to be made on fixed dates. You must always be in a position to meet these payments in order to avoid large fines or a disgruntled workforce.

To improve everyday cashflow you can:

- ask your customers to pay sooner
- chase debts promptly and firmly
- use factoring
- ask for extended credit terms with suppliers
- order less stock but more often
- lease rather than buy equipment
- improve profitability

You can also improve cashflow by increasing borrowing, or putting more money into the business. This is suitable for coping with short-term downturns or to fund growth in line with your business plan, but shouldn't form the basis of your cash strategy.

The principles of cashflow forecasting

Cashflow forecasting enables you to predict peaks and troughs in your cash balance. It helps you to plan borrowing and tells you how much surplus cash you're likely to have at a given time. Banks require forecasts before considering a loan.

Elements of a cashflow forecast

The cashflow forecast identifies the sources and amounts of cash coming into your business and the destinations and amounts of cash going out over a given period. There are normally two columns listing forecast and actual amounts respectively.

The forecast is usually done for a year or quarter in advance and divided into weeks or months. In extremely difficult cashflow situations a daily cashflow forecast might be helpful. It is best to pick periods during which most of your fixed costs - such as salaries - go out.

The forecast lists:

- receipts
- payments
- excess of receipts over payments - with negative figures shown in brackets
- opening bank balance
- closing bank balance

It is important to base initial sales forecasts on realistic estimates. If you have an established business, an acceptable method is to combine sales revenues for the same period 12 months earlier with predicted growth.

Note that all forecast figures must relate to sums that are due to be collected and paid out, not invoices actually sent and received. The forecast is a live entity. It will need adjusting in line with long-term changes to actual performance or market trends.

Accounting software

Accounting software will help you prepare your cashflow forecast, allowing you to update your projections if there's a change in market trends or your business fortunes. Planning for seasonal peaks and troughs is simplified and you can also make 'what if' calculations. Most banks require profit and balance sheet forecasts as well as cashflow. Many accounting packages will assist with preparing these documents.

Manage income and expenditure

Effective cashflow management is as critical to business survival as providing services or products. Below are some of the key methods to help reduce the time gap between expenditure and receipt of income.

Customer management

- Define a credit policy that clearly sets out your standard payment terms.
- Issue invoices promptly and regularly chase outstanding payments. Use an aged debtor list to keep track of invoices that are overdue and monitor your performance in getting paid.
- Consider exercising your right to charge penalty interest for late payment.
- Consider offering discounts for prompt payment.
- Negotiate deposits or staged payments for large contracts. It's in your customers' interests that you don't go out of business trying to meet their demands.

- Consider using a third party to buy your invoices in return for a percentage of the total.

Supplier management

Ask for extended credit terms. Giving your suppliers incentives such as large or regular orders may help, but make sure you have a market for the orders you're placing. Alternatively, consider reducing stock levels and using just-in-time systems.

Taxation

You may be liable for several different taxes including income tax, PAYE, GST, FBT, etc. It is important to keep good records to help you calculate your liability and complete your returns accurately.

Asset management

Consider leasing fixed assets, e.g. equipment, or buying them on hire purchase. Buying outright can result in a huge drain on cash in the first year of business.

Cashflow problems and how to avoid them

No matter how effective your negotiations with customers and suppliers, poor business practices can put your cashflow at risk.

Look out for:

- Poor credit controls - failure to run credit checks on your customers is risky, especially if your debt collection strategy is inefficient.
- Failure to fulfil your order - if you don't deliver on time, or to specification, you won't get paid. Implement systems to measure production efficiency and the quantity and quality of stock you hold and produce.
- Ineffective marketing - if your sales are stagnating or falling, revisit your marketing plan.
- Inefficient ordering service - make it easy for your customers to do business with you. Where possible, accept orders over the telephone, email or internet. Ensure catalogues and order forms are clear and easy to use.
- Poor management accounting - keep an eye on key accounting ratios that will alert you to an impending cashflow crisis or prevent you from taking orders you can't handle.
- Inadequate supplier management - your suppliers may be overcharging, or taking too long to deliver. Create a supplier management system
- Poor control of gross profits or overhead costs - assess where you can cut costs. Consider outsourcing non-core activities such as payroll services. Review your utilities contracts to see whether it is possible to reduce costs by switching tariff or supplier.

Using your cashflow forecast as a business tool

A cashflow forecast can be an invaluable business tool if it is used effectively. Bear in mind that it is dynamic - you will need to change and adjust it frequently depending on business activity, payment patterns and supplier demands.

It's helpful to set up a regular review of the forecast, changing the figures in light of your sales, purchases and staff costs. Interest rates and tax changes will also impact on the forecast.

Having a regular review of your cashflow forecast will enable you to:

- see when problems are likely to occur and sort them out in advance
- identify any potential cash shortfalls and take appropriate action
- ensure you have sufficient cashflow before you take on any major financial commitment

Using a cashflow forecast to avoid overtrading

Having an accurate cashflow forecast will help ensure that you can achieve steady growth without overtrading. You will know when you have sufficient assets to take on additional business - and, just as importantly, when you need to consolidate. This will enable you to keep staff, customers and suppliers happy.

It is important that you incorporate warning signals into your cashflow forecast. For example, if predicted cash levels come close to your overdraft limits, this should sound an alarm and trigger action to bring cash back to an acceptable level.

Ideally, you should always have a contingency plan, such as retaining a minimum amount of cash in the business, perhaps in an interest-earning account. This 'rainy day' money can be used to meet short-term cash shortages.

Cash management in action

The following simple example shows how a small, profitable business can run into unforeseen cashflow problems when it takes on a new large order.

XYZ manufacturer is a small but profitable designer and supplier with four full-time staff (including

the owners). It outsources production, but supplies the raw materials itself to save on costs. It then finishes and packages the final product on site.

XYZ does not have any loans or overdrafts. It has a long-term customer base of small shops and visitor centres.

XYZ suddenly wins a large order to supply for a chain of stores. The contract promises to double its turnover.

The team takes on an additional employee and works flat out to meet the deadlines. It doesn't notice an impending cashflow crisis resulting from a fall in repeat orders from existing customers combined with a jump in raw material costs.

To make matters worse, the new client keeps changing its mind about designs. A misunderstanding means the first run of goods is rejected, causing a delay in payment and increased production costs. XYZ orders additional materials to make up the shortfall in the run.

By the time the order is complete, XYZ is running an expensive overdraft. Profit margins have been squeezed to the limit and it has lost several of its existing customers. A downturn in the fortunes of the retail chain means that it doesn't place any further orders.

After a lot of hard work, XYZ finds itself back where it was five years earlier.

Tighter cashflow management would have highlighted the fall in repeat orders and rise in raw material costs. XYZ would also have benefited from a client contract that included:

- milestone payments and penalty provisions for changes such as those to designs - e.g. increased fees
- sharing the cost of additional materials with the new client or getting the client to pay for them

Refinements to a simple cashflow forecast

There is no single best way to set out a cashflow forecast. However, some refinements to the most basic ways of setting out the information will give you a more sophisticated view of your business' situation.

You could, for example, separate cashflow for business operations from funding cashflow. This gives a clearer picture of the actual performance of your business.

Cashflow from operations

Includes inflows such as:

- cash sales
- receipts from credit sales in earlier periods
- interest on savings

Includes outflows such as:

- payments to suppliers
- hire purchase and lease payments
- expenses - rent, rates, insurance, utilities, telephone, etc
- wages
- taxes
- interest on loans and bank charges

Funding cashflows

Includes inflows such as:

- loans from banks
- increase in share capital

Includes outflows such as:

- dividends paid
- loans repaid

Cashflow tips of the day:

- "Don't sit on your money - bank it daily or the instant it comes in."
- "Shop around - there's always a better deal that will reduce your costs."
- "Monitor the effectiveness of your marketing and modify it as necessary."