UNCONVENTIONAL BUSINESS NETWORK
ROUNDTABLES

LESSON 21: Business Performance

Cashflow Management

When Rick started a used car rental agency, he struggled for months to attain profitability. Finally, after six hard months he was thrilled to see a positive number on his profit and loss statement. The excitement quickly subsided, however, when he looked at his business checkbook. It reflected a negative balance and he was holding several checks that he couldn't yet send due to the lack of cash.

Rick was puzzled. How could his profit and loss say he was making money, yet there was no cash? Then he looked out the window at the cars on his parking lot and it slowly dawned on him that his cash was tied up in his inventory.

Rick, like many business owners, learned the hard way that cashflow and profitability are two vastly different concepts. Many small business owners may review their monthly profit and loss, but few have a process or system for managing and monitoring their cashflow. Why this void exists is a concern, especially when you consider that survey results of small business owners indicate cashflow as one of their top 5 concerns

UNDERSTANDING YOUR CASHFLOW CYCLE

As a small business owner, you wear many hats, so becoming an accountant is not likely on your list of skills to acquire. It is critical, however, that you understand enough of the basics of cashflow management to at least know when you need to seek help.

This lesson is designed to help you with some of those fundamentals. At the end of the lesson there are formulas for your reference that will allow you to broaden your analysis even further. To begin, we will first examine the foundational concept of cashflow cycle by examining a story about Tim (name changed to protect his identity).

Tim's Story

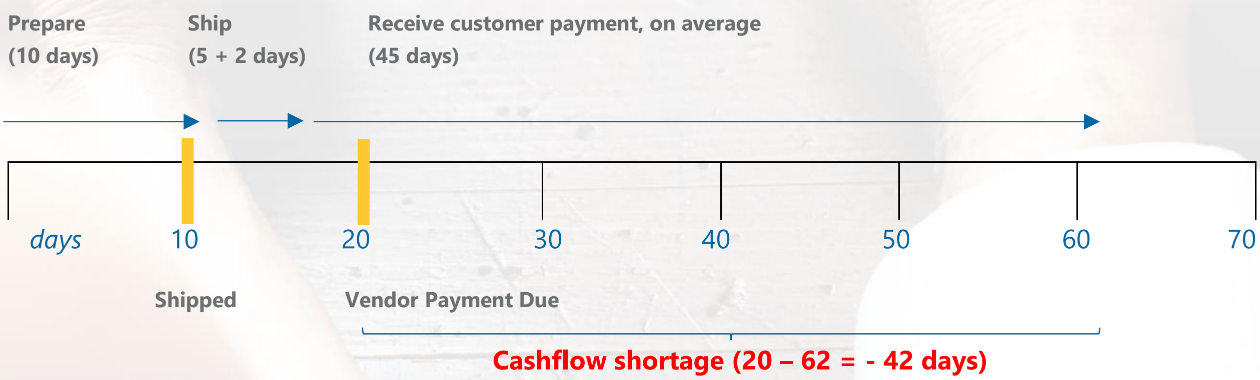
Tim owned a promotional specialties company that was growing rapidly. To grow sales even faster, he strategized to be a low-price provider. Predictably, his plan to operate with very thin margins dramatically increased the company's sales volume. To further enhance his margins, he negotiated a 2% discount with his vendors, with the caveat that he would pay them within 10 days.

Tim was thrilled every month when the profit and loss statement reflected strong sales growth and his bottom line profit was hitting desired targets. However, Tim's bookkeeper eventually informed him that they were almost out of cash and that they would no longer be able to take their vendor discounts unless something changed. Tim went to visit his banker about expanding their line of credit and was stunned when the banker declined his request. "My sales have grown more than 30% a year, and I'm profitable," he groaned. "Why would you turn down my loan request?"

Tim's banker took the time to do an exercise that was new to Tim, a Cashflow Cycle. To gain the necessary data, the banker asked Tim to walk him through a typical customer transaction. The banker then summarized Tim's cashflow cycle like this:

Day		
1		a. Customer places order
1		b. Tim places the order with his vendor
10		c. Vendor ships order and invoices Tim's company
15	g – f =	d. Vendor order arrives
17	cashflow	e. Tim's company ships order and invoices customer
20	(can be positive or	f. Vendor payment is due
<u>62</u>	negative)	g. Customer pays invoice (net 30| average receipt is 45)

TIM'S CASHFLOW TIMELINE



"Tim, from the time a customer places an order until your company receives payment, it is an average of 62 days. With an agreement to pay vendors on day 20 you have 42 days of negative cashflow (20 - 62)." When you calculate the full impact—factoring in sales volume as well as rapid sales growth—the problem becomes exponentially worse. For example, with your company grossing $1 million this year in revenue, 42 days of negative cash can generate a shortfall of $115,000. In addition, we only see a marginal build-up of equity that will never be able to compensate for these shortfalls."

DISCUSSION QUESTIONS

1. Think of an existing customer that is handled in a typical manner. Use the following timeline to map out your cashflow cycle. From the time the order is placed or the service is contracted:

a. When do you pay the vendor or salary? ____________ days

b. When does the customer pay you? _____________ days

Day

_____ a. Customer places order or contracts service

_____ b. ____

_____ c. ____

_____ d. ____

_____ e. ____

_____ f. ____

_____ g. ____

2. Determine how many days your gap is from the time a customer places an order to the time you receive cash. Next determine how many days is the gap between when you pay any vendors or payroll and when you receive cash from your customer.

____

____

3. Do you feel good about your cashflow cycle or could it use some improvement?

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IMPROVING YOUR CASHFLOW CYCLE

Tim asked his banker for ideas on how to improve the situation so that he could improve cashflow. During the next hour they discussed the following recommendations:

Customer Terms

When many business owners start their businesses, they decide if they want to offer credit to their customers and how they want their customers to pay. Unfortunately, once those decisions are made, they are rarely reviewed again. If the original decision(s) negatively impacted their cashflow cycle, they will compound the problem(s) as they grow. Here are some thoughts to consider:

- **Ask for a Deposit** | Contemplate asking customers for a deposit upfront, especially if you have material or inventory costs to cover. Some businesses can reasonably require a 30-50% deposit upfront.
- **Shorten Your Payment Terms** | Many industries have become accustomed to providing customers 30 days to pay for their services or products. Since many customers will use their vendors as a source of financing, 30 days can easily drag out to 45 days, 60 days, or even longer. Due upon receipt or Due in 15 days are both acceptable options for many businesses.
- **Hold Customers Accountable** | If you have not received payment from your customer on the date due, call them promptly. The squeaky wheel truly does get greased faster than those who let it ride. Establish a system to assure your customers know 30 days means 30 days.
- **Timely Invoices** | Many people hate to invoice, so it becomes a burden that gets pushed off. This approach dramatically impacts cashflow. Invoice promptly, and when possible, invoice electronically the day you take the order.
- **Monitor Your Accounts Receivable Turnover** | As your business grows you will not be able to keep track of each outstanding invoice. There is a turnover ratio (see the ratios at the end of this lesson) that will average your outstanding invoices and quantify (in days) how long your accounts on average are outstanding. For instance, if your terms are net 30 days, and the average is 45 days, you now know that your customers are not complying. Reviewing this calculation on monthly basis will provide you with trends and obvious warning signs that need to be addressed.

Vendor Terms

If your business requires you to carry inventory or to use contract labor to provide your service to customers, then it's likely that they are extending you credit. This can enhance your cashflow, but it comes with some tension.

It's nice to be able to use a vendor's cash as long as possible to improve your cashflow cycle. At the same time, you will want to maintain good relations, so that you obtain the best service and pricing. In addition, as a Christian you want to pay them by the agreed upon date so that you do not hinder your witness to them.

Just as you can attempt to modify accounts receivable terms with your customers, you can also work to sync your payment schedule to your vendors. There are certain industries, such as the greeting card industry, that offer extremely liberal terms due to the seasonal nature of their business.

You can pursue negotiating favorable terms with your vendors as well. If you do, however, realize that a change in terms will often impact the quality of service and/or the price you receive.

- **Invoice Timing** | Some businesses have become very efficient at invoicing when you place an order. You may be able to negotiate the terms of your payment schedule to not begin until products or services are received.
- **Discounts** | Many suppliers desire to get their cash as soon as possible to improve their own cashflow. It's not uncommon to receive 1-2% discount on your invoice, if you pay within 10 days. This may not help your cashflow cycle but is usually a good idea to take advantage of the discount, when you have the available cash. The actual rate of return on taking a 2% discount is equal to more than a 36% return on your investment.

Inventory Management

Fewer and fewer businesses have large inventories. For those who do, they can tie up a significant amount of cash. Just like managing your accounts receivable turnover, you can manage your inventory by determining how long it takes to liquidate. Markedly, inventory is even more critical to manage since the amounts can add up quickly. When you notice that your inventory is growing, you will want to act. Slash prices on obsolete inventory or focus your marketing efforts on products that need to go.

CASHFLOW FORECAST

Although few small businesses have a formal process for cashflow forecasts, many do instinctively create a mental picture of a forecast, especially when cash is tight. Cashflow forecasts do not have to be overly complicated to be helpful. Here's a simple format you can use to guide you. Producing a monthly forecast with the possibility of a weekly one when cash may be tightening is a prudent way to assure you cover your upcoming expenses without significant surprises.

Cashflow Forecast

Beginning Cash

+

Projected Cash inflows
(includes cash sales, collection of accounts receivable, sale of fixed assets)

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Projected Cash Outflows
(includes payments on accounts payable, operating expenses, cash inventory or production expenses, payroll and payroll taxes, loan and credit card payments, and fixed asset purchases)

=

Projected Ending Cash

DISCUSSION QUESTIONS

1. Discuss what methods you currently use to monitor your cashflow. Did you read anything in this lesson that might be added to your process?

   ____
   ____
   ____

2. Have you ever had a dry season when you had to monitor cash daily? How did it make you feel? How can your relationship with Christ help you through those seasons?

   ____
   ____

3. What steps will you take to improve your cashflow management? What goal might you set for your company in the amount of cash reserves you would like to have on hand?

Cashflow Formulas

Accounts receivable turnover ■ (total accounts receivable/annual sales) * 365 days = accounts receivable outstanding in days

Inventory turnover ■ (total inventory/annual cost of goods sold) * 365 days = inventory turnover outstanding in days

Accounts payable turnover ■ (total accounts payable/annual cost of goods sold) * 365 days = accounts payable turnover

Cashflow forecast ■ (beginning cash + cash inflows) – cash outflows = projected ending cash

Cashflow cycle ■ (# of days from the date of customer order until cash is collected) – (# of days from the date of customer order until cash is spent on suppliers) = # of days of negative cashflow