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Understanding, Planning & Managing Cash Flow

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Folks often receive misguided advice concerning cash flow management. Sales volume is important to a successful business, as is the timing of sales and payments. Cash flow is primarily the difference between cash coming into the business and cash going out of the business during a given time period. But every business has a cash cycle. The cash that comes into the business does not always correspond to the same time or same rate as the cash that goes out. It is practically impossible to iron out all the discrepancies in cash inflows and outflows and do a perfect job of controlling and coordinating the movement of cash in a business. But it is possible to develop an understanding, appreciation and consciousness of cash flow. This is often the first critical step in managing the cash flow of a business.

Financial management educators often compare cash in a small business with blood in the human body. Cash is often described as the life-giving fluid that keeps a business going. So, if cash is the blood of a business, cash flow is the circulation of the blood throughout the system. Circulation involves both cash flowing in and out of the business. However, just because blood circulates through the body does not ensure a good blood pressure. The same is true for cash and a business. Simply generating sales revenue does not ensure that the business is profitable. Therefore, the cash handled by a business must be monitored through proper cash flow management [1].

Many small businesses note that cash flow is a big problem/obstacle to their business success. Lack of available cash can weaken a business and even lead to business failure. Cash that flows irregularly and unpredictably can be as disastrous as no cash at all. Effective cash flow management addresses both short-term and long-term planning. Managing cash flow is really nothing more than managing information. Cash flow management is critical to all businesses, but is probably most critical for businesses whose trading can be seasonal and unpredictable.

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[1] Sunny Agboola, Cash, Cash Flow and Staying Solvent, Svoboda's Home & Small Business Interactive.

Short-term cash flow management strategies rely on record-keeping systems that provide quick and accurate access to revenue and expenditure transactions. Important information for cash flow management can be obtained from a variety of sources including procedure manuals, bank statements, cash flow forecasts, reports on debt collection and accounts payable. Routine cash management reviews must keep a close eye on debt collection, sales and deliveries, status of invoices, receipt of payments and depositing of payments. The best cash flow management strategies usually result from systems that are fully understood by the cash flow manager. Sometimes such systems are computerized, while others are manual. Cash flow management does not need to be complex to be effective. It does, however, have to be performed.

There is no magical solution to managing cash flow. Like the commercial . . . "Just Do It." While a computer and proper software program may expedite, simplify and standardize financial information, the information must be studied and monitored in a way that allows for adjustments to be made in the business' activities. Cash flow can be as simple as ensuring that you have enough sales, at a profitable price. The complexity of cash flow, however, seems to arise in the often overlooked "timing" element. Higher than expected sales at a price exceeding costs is worthless if you can't pay your bills during the time it takes for the product to be made and sold. The old saying, "it takes money to make money" should be extended to "it takes money today to make money tomorrow." Simply put, cash flow must be:

1. **planned** in advance in anticipation of certain changes in income and expenditures
2. **monitored** to make adjustments to business and financial operations
3. **managed** to "average" out the peaks and valleys of cash flows

Despite the complexities of dealing with cash flow, there are some rule-of-thumb items that can be considered.

1) **Decrease the amount of money that is owed to you**. In other words, get people to pay their bills. Overdue accounts receivables can pull down a business. One way to address this problem is to keep credit current and at a minimum. This is often a bigger task than it may seem. Caution should be taken when credit is first extended to customers. Consider giving discounts for advance payments incentives for payments made by the due date.

2) **Cut out excess overhead expenditures.** Good spending discipline should keep unnecessary expenditures to a minimum, but good cash flow management should help to virtually eliminate excess overhead expenditures. Bad spending habits are often picked up when cash is plentiful.

3) **Keep a close eye on inventory**. Product sales and inventory management are complex issues that can be likened to the "chicken and egg." A business needs enough inventory to fill orders in a timely manner, but adequate sales are needed to minimize inventory. Inventory includes finished products held for future sales as well as raw materials held for future production. Both types of inventory represent cash that has been spent but that has not generated a return. It is often best to sell inventory items that are just gathering dust at a discounted price.

4) **Don't overpay Uncle Sam**. Most small businesses pay quarterly taxes which are based on estimates of their tax burdens (90% of current year or 100% of prior year taxes). Although often a minor difference, cash flow can be improved by paying the lesser amount of estimated taxes.

5) **Review owners' compensation**. For some small businesses, the owner's compensation is often a large portion of the business' expense. Especially in the developing years of a business, the owner's draw can be a big burden on the cash flow of the business. That is why secondary incomes are valuable to the success of many small business ventures, especially in the early years.

6) **Maintain tight reigns on billing and collections.** Because cash flow management is so closely tied to time (flows), the time lag between shipping finished products and receiving payment for them should be minimized. The time lag issue must be aggressively addressed by collecting payments and sending invoices in a timely manner. Consider weekly or semimonthly invoicing rather than monthly or bimonthly invoicing. Another tactic for improving the timing of billing and collections is to establish a quick turnaround on incoming and outgoing mail. Daily deposits can help minimize cash flow problems.

7) **Consciously structure the payment of your bills**. Electronic deposits and delayed payment of bills can improve cash flow problems. However, there is often a fine line between delayed payments and late payments. Crossing that line and incurring additional costs for late payments is normally not a good cash flow management procedure. Discounts on bills should be evaluated, i.e., consider discounts that offer less than the amount you save by delayed payments. All non-discount bills should be delayed as late as possible without compromising good relations. Do not hesitate to take advantage of credit offered by suppliers and feel free to negotiate for more favorable terms.

8) **Consider biweekly or monthly paychecks.** Biweekly and monthly payrolls allow the business to hold onto money longer. It also allows for less frequent deposit of payroll taxes.

9) **Continually update company procedures**. Monitoring certain customers may provide insight into their payment schedule. A business should consider dropping or implementing new payment procedures for customers who continually pay late. When taking on new customers, consider implications on cash flow as part of the evaluation criteria, not just increased sales. Payment terms influence potential customers, but be cautions not to offer over generous payment terms. Also consider leasing assets rather than buying them.

10) **Plan ahead**. A projected cash flow plan should be developed. Deposits into the business operating account (in times of cash deficiencies) should be made from a line-of-credit loan or from a savings account, whichever offers the lowest interest rate. Excess funds in the operating account should be quickly transferred to accounts that earn higher rates of interest. Electronic transfers help speed up this process as well. Consider cash saving activities such as renting versus buying, used equipment versus new, automation versus labor, subcontracting versus manufacturing and cash and quick paying customers versus credit and late payers.

11) **Develop a good record-keeping system**. Continual cash flow management is only as good as the information on which it is implemented. A record-keeping system that provides information useful to making decisions regarding cash inflows and outflows is essential.

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