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Nov/Dec 2003

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Managing Cash Flow

Our mission is to provide information and strategies to business owners and managers for improvement in the effectiveness of its business management so that key objectives can be realized.

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Managing Cash Flow – A Key Ingredient for Business Success

Cash flow has often been characterized as the "life-blood" of any business. The reason is quite simple. Any business, no matter how large or small, that fails to properly manage cash flow is doomed for failure. By simple definition, cash flow is the number of dollars collected verses the number of dollars paid out over a given time period. A negative cash flow means more dollars were paid out than were taken in. If this continues over a long period of time, the business may find itself in bankruptcy. Many profitable businesses, including some with enviable sales growth rates, have found themselves on the brink of disaster because cash flow was not being properly managed. Many methods have been used to manage cash flow. Three methods, in particular, have condensed the cash conversion cycle in many businesses, or the time required for a dollar spent to be returned. These three methods include placing controls on spending, accelerating receipts and maintaining lean inventories.

To gain a better understanding of cash flow management, it is important to first understand the difference between cash flow and profitability. Cash flow is not only concerned with the movement of dollars in and out of a business, but more importantly, the timing of that movement. Profitability, on the other hand, is a measure of the surplus (or shortage) of dollars remaining after all obligations have been met for the reporting period. It is possible, and not uncommon, for a profitable business to experience a critical short-term cash flow deficiency.

Suppose a business purchases the raw materials in January to manufacture a product that will be sold during the following Christmas season. In this case, a significant dollar outflow might occur in the first quarter with little or no dollar inflow expected until the fourth quarter. If the business does not adequately plan around its seasonal sales cycle, the routine expenses that occur during the second and third quarters could create the need to borrow operating capital just to survive until Christmas sales begin. Borrowed capital then creates additional interest expense that ultimately serves to reduce profitability. This cycle might be repeated year after year, exposing the business to a declining profit margin and eventual bankruptcy. To avoid this trap, a business must forecast, budget, analyze and proactively manage its cash flow on an ongoing basis.

Spending Controls. Cash conservation must start with the spending habits of the business. Businesses generally require cash for wages, equipment, raw materials, office furnishings and fixtures, rent, taxes, utilities and more. Many of these costs are fixed and little can be done to reduce them. Discretionary items, on the other hand, may provide a fertile field for conserving cash. Fancy offices and luxury automobiles may say something about management's style, but do they help the business stay afloat during hard times? How about new equipment? Leasing new equipment may make more sense than purchasing it. Lease payments not only conserve cash on-hand, but they are tax deductible. And, what about outsourcing? It may be more efficient to outsource certain jobs than supporting the overhead associated with a full time employee.

Accounts payable could be the most important area of all for proactively managing cash conservation. Discounts for prompt payment can be rewarding. For example, a 2% discount for paying a bill within ten days may be better than earning double digit interest on the balance due for the next month. It is also important to negotiate better purchase terms. Many suppliers will agree to defer billing or extend no-interest loans to make the sale. Controlled spending is only a part of managing cash flow, accelerating cash receipts is another.

Managing Cash Flow – A Key Ingredient for Business Success (cont.)

Accelerating Cash Receipts. Accounts receivable represents sales that have not been converted into cash. The longer it takes to collect these amounts, the more detrimental the effect on cash flow. Early payment discounts may expedite the receipt of cash, but at what cost? The simplest way to improve cash flow would be to require cash-on-delivery. This requirement also has a downside. Some companies facing this dilemma have reverted to selling accounts receivable to a third-party on a discounted basis. This is known in financial circles as "factoring." Again, this is not without cost. The answer to managing this facet of the cash flow equation may best be resolved by the establishment of a corporate credit policy that serves as a guide for extending customer credit. The credit policy essentially sets the terms and conditions based on the individual customer's credit history. The final piece of the equation for cash flow management lies in inventory control.

Inventory Controls. Inventory describes the extra materials and/or products that are on-hand for future use. Excessive inventories of raw materials or finished products can be detrimental when it comes to managing cash flow. The dollars tied up in this inventory are not capable of earning interest and they are not available for other business use. So, determining the minimum acceptable inventory level and maintaining it, is an absolute must for responsible cash flow management. With the advent of computerized technology and automated warehousing, many progressive businesses have adopted an inventory control system known as "just-in-time inventory." This system basically coordinates the upstream logistics of moving the required materials or products to the right place at the right time, just as they are needed. Needless to say, cash flow management has a real friend in "just-in-time inventory."

Cash Conversion Cycle. The business of managing cash flow may be condensed into a fairly simple empirical equation known as the "cash conversion cycle" or CCC for short. Using the metrics of days, the cash conversion cycle equation may be stated as follows:

$$CCC_{days} = \text{sales outstanding}_{days} + \text{sales in inventory}_{days} - \text{payables outstanding}_{days}$$

This equation allows a business to actually grade itself, with a real number, on its overall effectiveness at managing cash flow. For example, your business has the equivalent of 45 days of sales in accounts receivable, 20 days in inventory and 30 days in accounts payable, its cash conversion cycle would be a very acceptable 35 days. To phrase it another way, a dollar spent today would theoretically be returned in 35 days.

Managing cash flow is one the key ingredients for success in any business. Proper forecasting, combined with the implementation of spending controls, accelerating cash receipts and monitoring inventory may be the recipe for success. We have a great deal of experience in this area, and can work with you to maximize cash flow. Give us a call today.