Understanding Cash Flow

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Cash flow is one of the most critical components for a small or mid-sized business. It is the oil that keeps the company's engine moving. Its importance cannot be overstated as poor cash flow management is a primary cause of business failure.

What is cash flow? In its simplest terms, it is the movement of funds in and out of a business. There are two kinds of cash flow:

- ✓ Positive Cash Flow – This occurs when the amount of cash received from sales and accounts receivable is more than the amount of cash spent for accounts payable, payroll and monthly operating expenses directly associated with the product or service.
- ✓ Negative Cash Flow - This is the opposite of positive cash flow and, naturally, occurs when the outflow of cash is greater than incoming cash.

Achieving a positive cash flow does not come by chance. A business owner needs to work at it. Cash flow needs to be tracked on a regular basis (weekly, monthly or quarterly) and there needs to be diligence in managing the company's operating cycle. The operating cycle is the process by which a company delivers a product or service to a customer and collects money for that product or service. **It is illustrated as follows:**

Understanding where cash is used during the operating cycle allows the business owner to plan to meet those needs. For example, if the company manufactures a product using raw materials, the greatest need for cash may be for the purchase of materials and the payroll to manufacture the product. If the company provides consulting services, the need for cash may be to support accounts receivable until payment is made by the client. Understanding the company's operating cycle allows the business owner to target those areas where cash is needed and to minimize the negative impact on overall cash flow.

Profit versus Cash Flow

Profit does not equal cash flow. Because of the variables involved in the operating cycle, including accounts receivable, inventory, accounts payable, and payroll as well as other variables such as capital expenditures and debt service, the calculation of cash flow can differ significantly from the calculation of the company's profit.

A positive cash flow is needed to generate profits. If the company does not have enough cash to pay its employees and suppliers so that it can make its product or supply its service, it cannot consummate the sale and, therefore, cannot make a profit. When a business is growing, the strain on cash becomes even more pronounced as expansion calls for investments in employee talent, operations and physical space.

How to Improve Cash Flow

While it may seem that sales growth is the solution to cash flow challenges, this is not necessarily the case. Growth increases the need for cash. A business owner needs to plan for growth and the related cash outlays in advance to avoid running short of cash. In addition to sales growth, try these ways to improve cash flow:

- ✓ Collecting receivables – Consider that the longer it takes to collect receivables the greater the likelihood of collection problems (including bad debt). Additionally, longer collection times cause the level of accounts receivable to increase. These increases require additional cash availability.

  Shortening the accounts receivable collection time reduces cash requirements (and interest costs on any borrowed funds) while at the same time reducing the likelihood of collection problems. A way to judge this efficiency is by calculating receivables days and tracking it during the year.

- ✓ Tightening credit requirements – If a business owner decides to extend credit to customers, a credit review should be completed. This may be as minor pulling a credit report on the business or as extensive as asking for references and financial statements. Extending credit for the sake of growth without an understanding of the creditworthiness of your customers leads to increased collection issues.

- ✓ Pricing discounts – Offering discounts to customers who pay early on their invoices also helps to shorten the operating cycle. While this practice may have an impact on profit margin, it helps improve cash flow management by providing an incentive for faster payment. A company may also use the same discounts when paying its suppliers to improve its profitability.

- ✓ Manage Inventory – The idea behind "just-in-time" inventory is to keep just enough inventory or raw material on hand to meet near-term needs. Stockpiling of excessive inventory ties up cash and lengthens the operating cycle, both of which have a negative impact on cash flow. While bulk-purchase discounts from suppliers may be attractive, they can come with a downside.

Financing Options to Manage Cash Flow

In addition to its own cash, a business can also obtain short-term financing which will help with cash flow management. These options include the following:

- ✓ Receivables Factoring – Factoring is when a business sells a receivable to a third-party financing company (called a factor) at a discount. The factor provides the company an advance on the receivable of 70% to 85% and then collects the monies due from the customer. Upon receipt of the money, the factor deducts a commission plus other charges and sends the remaining balance back to the company. Factoring can be an expensive way to manage receivables as the transaction costs are higher than other forms of short-term financing.

- ✓ Working Capital or Payroll Financing – Similar to receivables factoring, this type of specialty financing seeks to help businesses with their short-term cash flow needs. The lender or finance company will analyze the company's invoices and inventory balances to determine an advance amount. As with factoring, this can be an expensive form of financing.

- ✓ Line of Credit – A business line of credit from a credit union or bank allows the business owner to have an affordable and flexible resource which helps support receivables, inventory and payroll. It is meant to be used solely for short-term cash flow needs and should revolve as the company draws upon it as needed and pays it down when cash is received from customers.

- ✓ Trade Credit – This represents credit offered by a company's suppliers for inventory or raw materials. It is classified as accounts payable on the balance sheet and can be an inexpensive form of financing for the operating cycle. Suppliers will often offer discounts for early payment of the outstanding balance.

Common Mistakes When Managing Cash Flow:

1. Using the line of credit or trade credit line for long-term asset purchases or for items unrelated to the operating cycle.

   A line of credit is to assist the business owner in managing the operating cycle. Tapping a company's line of credit for longer-term asset purchases such as equipment or a vehicle disrupts the ability to have funds readily available for inventory, materials and payroll. It also has the negative effect of mismatching the assets and liabilities on the company's balance sheet. Make sure you match the purpose of the loan to the loan product. A term, equipment, or vehicle loan should be used to finance long-term assets while the line of credit is best used for short-term assets such as inventory and accounts receivable.

2. Mismatching the receivables terms offered to customers with the terms given the company by its suppliers.

   Suppliers may ask for payment of the inventory or materials purchased before the company has turned them into a sale or collected on a receivable. If the company is offering credit to its customers or if the product has a long turnover period, make sure to match the supplier's payment terms with the collection of monies from the customer.

3. Too much reliance upon higher-cost factoring or finance company alternatives.

   Be cautious in placing too much reliance upon factoring when managing the company's cash flow. Factoring should be used as a temporary solution and is not meant for permanent cash flow management due to its higher cost. Once a business has a solid financial track record, its goal should be to use its own cash or to utilize a line of credit along with trade credit.

Conclusion

Managing a company's operating cycle to better improve its cash flow will help a business succeed and grow. There will be less anxiety in meeting the immediate cash needs to support receivables, inventory, and payroll. Working with the lender and accountant, the business owner can concentrate on meeting customer needs and not be distracted by cash flow concerns.

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