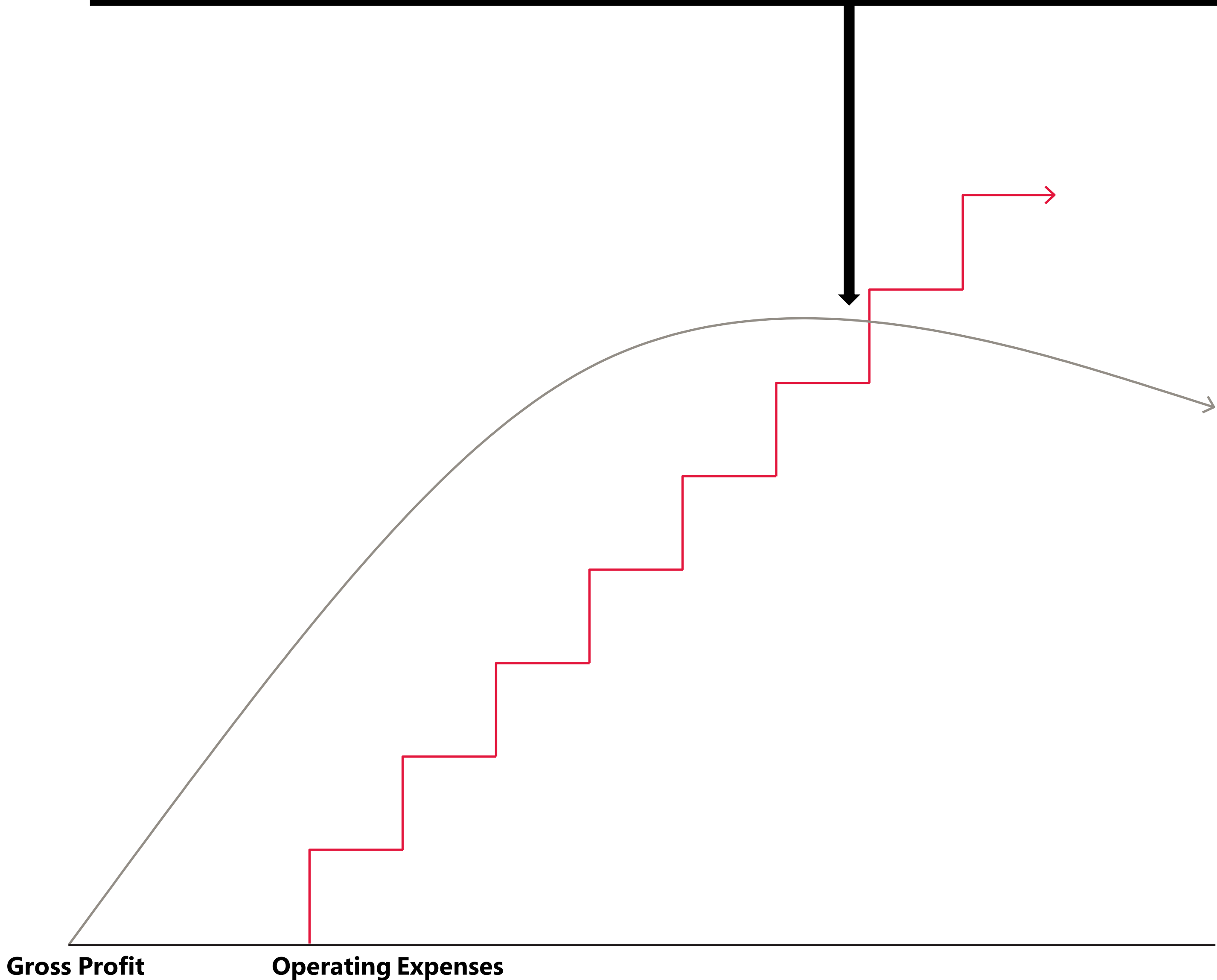
Handout Resources

Lesson 4 Resources

Business

Cash Flow Essentials

Lesson 4 Resources
Expense Control Graph



Gross Profit is the amount of money you have to spend. Operating expenses are how you spend it. Change your spending habits in line with the change in gross profit coming in.

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Lesson 4 Resources
More about Mis-Financing

A staggering amount of businesses in this country are mis-financed. As a business owner you must not only be able to identify mis-financing, but also understand the importance of the proper use and structure of debt. A company that has a proper fixed asset financing structure has matched the length of the loan with the purchased assets ability to repay. **A mis-financed company uses short-term money (e.g. line of credit) to pay for long-term use (e.g. equipment).**

The starting place in identifying mis-financing is to define what is considered long-term debt versus short-term debt. Long-term debt is defined as any loan that is payable in more than a year. Loans that are due in less than 12 months would be considered short-term.

Next, there are three places that a trained eye goes to on a company's balance sheet to identify mis- financing; gross fixed assets, long-term debt and retained earnings. If the company has been properly financed, it would have enough cash between retained earnings and long-term debt to finance fixed assets. If retained earnings and long-term debt equal fixed assets, then the balance sheet balances and the company is properly financed. If fixed assets are greater than the sum of retained earnings and long-term debt, then the company has been mis-financed. In order to diagnose mis- financing, you will need to look at the variations in these three categories over a multi-year period.

Why is it important for owners to understand if they are mis-financed? For a company, cash is king. Having proper fixed asset financing is an important component of how cash flows through a business. Many business owners view debt as debt and do not understand the nuances between long-term and short-term.

They use their line of credit to make large equipment purchases, and then use their cash to pay down the line of credit. Owners see the favorable interest rates on a line of credit as benefit of using their short-term financing to pay for their fixed asset purchases. This structure is the equivalent of buying a house using a credit card and can create a number of cash flow problems for a company.

For example, a mis-financed company is more likely to max out their line of credit, and lack the cash to rest the line, creating an evergreen loan scenario. However, many bankers believe the days of evergreen loans are gone. In the past several years, they have heard stories of companies who have had their lines reduced or called because they were not able to provide a resting period. These owners were mis-financed and never understood the benefit of having the proper financing structure for their assets.

Another common problem that arises with mis-financing, is that the cash that should be allocated for growing the business is sucked out to pay off the line of credit. Instead of utilizing cash to invest in additional personnel, resources, etc. to grow sales, a company is unable to accept new jobs or clients because they do not have any cash to grow.

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More about Mis-Financing (cont.)

Once a company has been mis-financed it can be hard to recover. Companies in this situation have typically pushed their accounts payable out so far that they are unable to take advantage of vendor discounts or worse, their vendors no longer want to do business with the company. The business typically is struggling from a cash flow perspective and may not have enough left on their line of credit to cover their seasonal financing needs.

These issues compound and can be a recipe for disaster. Being able to understand the benefits of proper fixed asset financing can be a powerful tool in establishing a sustainable business. While you may pay more in interest fees for a long-term loan, the benefit of improved cash flow will far outweigh the cost.

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Start by gathering your financial statements. In order to have enough information to be meaningful, you will need to have at least 2 years, ideally 5 years of financial information. This data will provide you with a window from which you will be able to more clearly identify mis-financing.

The growth in Gross Fixed Assets should equal the growth in Long Term Debt plus the growth in Retained Earnings.

$$GFA = LTD + RE$$

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Inventory Management

Managing inventory is a juggling act. Excessive inventory can place a heavy burden on the cash resources of a business. Insufficient inventory can result in lost sales, delays for customers etc. The key is to know how quickly your overall inventory is moving or, put another way, how long each item of inventory sit on shelves before being sold. Obviously, average inventory-holding periods will be influenced by the nature of the business. For example, a fresh vegetable shop might turn over its entire inventory every few days while an engine manufacturer would be much slower as it may carry a wide range of rarely-used spare parts in case somebody needs them.

Nowadays, many large manufacturers operate on a just-in-time (JIT) basis whereby all the components to be assembled on a particular today, arrive at the factory early that morning, no earlier - no later. This helps to minimize manufacturing costs as JIT inventory take up little space, minimize inventory-holding and virtually eliminate the risks of obsolete or damaged inventory. Because JIT manufacturers hold inventory for a very short time, they are able to conserve substantial cash. JIT is a good model to strive for as it embraces all the principles of prudent inventory management.

The key issue for a business is to identify the fast and slow inventory movers with the objectives of establishing optimum inventory levels for each category and, thereby, minimize the cash tied up in inventory. Factors to be considered when determining optimum inventory levels include:

- **What are the projected sales of each product?**
- **How widely available are raw materials, components etc.?**
- **How long does it take for delivery by suppliers?**
- **Can you remove slow movers from your product range without compromising best sellers?**

Remember that inventory sitting on shelves for long periods of time ties up money which is not working for you. For better inventory control, try the following:

- **Review the effectiveness of existing purchasing and inventory systems.**
- **Know the inventory turn for all major items of inventory.**
- **Apply tight controls to the significant few items and simplify controls for the trivial many.**
- **Sell off outdated or slow-moving merchandise - it gets more difficult to sell the longer you keep it.**
- **Consider having part of your product outsourced to another manufacturer rather than make it yourself.**
- **Review your security procedures to ensure that no inventory "is going out the back door!"**

Higher than necessary inventory levels tie up cash and cost more in insurance, accommodation costs and interest charges.

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Handle Your Accounts Receivable

Cash flow can be significantly enhanced if the amounts owing to a business are collected faster. Every business needs to know.... who owes them money.... how much is owed. ... how long it is owing .... for what it is owed.

Slow or late payments extend the working capital cycle, eroding profits and can lead to bad debts.

The following measures will help manage your customers:

1. **Ensure you are putting the right amount of emphasis on your cash collection practices.**
2. **Establish clear credit practices as a matter of company policy, and practice what you preach.**
3. **Make sure that these practices are clearly understood by staff, suppliers and customers.**
4. **Check out each customer thoroughly before you offer credit. Use credit agencies, bank references, industry sources etc.**
5. **Establish credit limits for each customer. .. and stick to them.**
6. **Continuously review these limits when you suspect tough times are coming or if operating in a volatile sector.**
7. **Keep very close to your larger customers.**
8. **Invoice promptly and clearly.**
9. **Consider charging penalties on overdue accounts.**
10. **Consider accepting credit /debit cards as a payment option. You can also collect a portion of the total invoice in advance.**
11. **Monitor your customer balances and aging schedules, and don't let any debts get too large or too old.**

Recognize that the longer someone owes you, the greater the chance you will never get paid. If the average age of your debtors is getting longer, or is already very long, you may need to look for the following possible defects:

- **Weak credit judgement**
- **Poor collection procedures**
- **Lax enforcement of credit terms**
- **Slow issue of invoices or statements**
- **Errors in invoices or statements**
- **Customer dissatisfaction**

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Handle Your Accounts Receivable

Debtors due over 90 days (unless within agreed credit terms) should generally demand immediate attention. Look for the warning signs of a future bad debt. For example:

- **Longer credit terms taken with approval, particularly for smaller orders • use of post-dated checks by debtors who normally settle within agreed terms**
- **Evidence of customers switching to additional suppliers for the same goods**
- **New customers who are reluctant to give credit references**
- **Receiving partial payments from debtors.**

The act of collecting money is one which most people dislike for many reasons and therefore put on the long finger because they convince themselves there is something more urgent or important that demand their attention now. There is nothing more important than getting paid for your product or service. A customer who does not pay is not a customer.

Here are a few ideas that may help you in collecting money from debtors:

1. **Develop appropriate procedures for handling late payments.**
2. **Track and pursue late payers.**
3. **Get external help if your own efforts fail.**
4. **Don't feel guilty asking for money .... it's yours and you are entitled to it.**
5. **Make that call now. And keep asking until you get some satisfaction.**
6. **In difficult circumstances, take what you can now and agree terms for the remainder. It lessens the problem.**
7. **When asking for your money, be hard on the issue - but soft on the person. Don't give the debtor any excuses for not paying.**
8. **Make it your objective is to get the money**

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Handle Your Accounts Payable

Creditors are a vital part of effective cash management and should be managed carefully to enhance the cash position.

Purchasing initiates cash outflows and an over-zealous purchasing function can create liquidity problems. Consider the following:

- **Who authorizes purchasing in your company - is it tightly managed or spread among a number of people?**
- **Are purchase quantities aligned with your company's seasonality?**
- **Do you use order quantities which take account the difference between purchasing discounts and cash flow?**
- **Do you know the cost to the company of carrying inventory?**
- **Do you have alternative sources of supply? If not, get quotes from major suppliers and shop around for the best discounts, credit terms, and reduce dependence on a single supplier.**
- **How many of your suppliers have a return policy?**
- **Are you in a position to pass on cost increases quickly through price increases to your customers?**
- **If a supplier of goods or services lets you down can you charge back the cost of the delay?**
- **Can you arrange (with confidence!) to have delivery of supplies staggered or on a just- in-time basis?**

There is an adage in business that if you can buy well then you can sell well. Management of your vendors or suppliers is just as important as the management of your customers. It is important to look after your suppliers - slow payment by you may create ill-feeling and can signal that your company is in trouble!

Remember, a good supplier is someone who will work with you to enhance the future viability and profitability of your company.

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