Managing Cash Flow

Cash Management

- Young, growing companies are "cash sponges"
- A business can be earning a profit and be forced to close because it runs out of cash!
- Cash management - forecasting, collecting, disbursing, investing, and planning for the cash a company needs to operate smoothly

Causes of Cash Flow Problems Among Small Businesses

Cash Management

- Fast growth puts a strain on a small company's cash flow
- Study: 68% of small businesses perform no cash flow analysis at all!
- First step: Understanding a company's cash flow cycle - the time lag between paying suppliers for merchandise and receiving payment from customers

The Cash Flow Cycle

<table>
<thead>
<tr>
<th>Order Goods</th>
<th>Receive Goods</th>
<th>Pay Invoice</th>
<th>Deliver Goods</th>
<th>Send Invoice</th>
<th>Customer Pays</th>
</tr>
</thead>
<tbody>
<tr>
<td>Day 1</td>
<td>Day 14</td>
<td>Day 25</td>
<td>Day 178</td>
<td>Day 230</td>
<td>Day 280</td>
</tr>
</tbody>
</table>

Cash Flow Cycle = 240 days

* Based on Average Inventory Turnover: 365 days = 178 days = 2.05 times/year

** Based on Average Collection Period: 365 days = 50 days = 7.31 times/year

Five Cash Management Roles of an Entrepreneur

- Cash Finder
- Cash Planner
- Cash Distributor
- Cash Collector
- Cash Conserver
Chapter 9: Cash Flow

The Cash Budget

- A “cash map” showing the amount and the timing of a firm's cash receipts and cash disbursements over time
- Predicts the amount of cash a company will need to operate smoothly
- A helpful tool for visualizing the firm's cash receipts and cash disbursements and the resulting cash balance

Preparing a Cash Budget

1. Determine a Minimum Cash Balance
2. Forecast Sales
3. Forecast Cash Receipts
4. Forecast Cash Disbursements
5. Estimate End-of-Month Cash Balance
Chapter 9: Cash Flow

Determine a Minimum Cash Balance

Remember Goldilocks, the Three Bears, and the porridge:
Not too much...
Not too little...
but a cash balance that's just right... for you!

Forecast Sales

- The heart of the cash budget
- Sales are ultimately transformed into cash receipts and cash disbursements
- “Lumpy” sales patterns are common
  - 40% of toy sales take place in last 6 weeks of the year
  - Super Bowl Sunday is the single largest revenue-generating day for pizzerias

Forecast Sales

- Prepare three sales forecasts:
  - Most Likely
  - Pessimistic
  - Optimistic
Sales Forecast for a Start-Up

Example:
Number of cars in trading zone = 84,000
Number of imports = 20,160

Total import repair sales potential = $9,777,600

Sales estimate = $967,982

Forecast Cash Receipts

- Record all cash receipts when actually received (i.e. the cash method of accounting)
- Determine the collection pattern for credit sales; then add cash sales

Collecting Delinquent Accounts

<table>
<thead>
<tr>
<th>Number of Months Delinquent</th>
<th>Probability of Collection</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>3.60%</td>
</tr>
<tr>
<td>2</td>
<td>3.60%</td>
</tr>
<tr>
<td>3</td>
<td>3.60%</td>
</tr>
<tr>
<td>4</td>
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<tr>
<td>5</td>
<td>24.80%</td>
</tr>
<tr>
<td>6</td>
<td>37.60%</td>
</tr>
<tr>
<td>7</td>
<td>57.60%</td>
</tr>
<tr>
<td>8</td>
<td>75.60%</td>
</tr>
<tr>
<td>9</td>
<td>85.20%</td>
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<td>10</td>
<td>93.80%</td>
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<td>23</td>
<td>93.80%</td>
</tr>
<tr>
<td>24</td>
<td>93.80%</td>
</tr>
</tbody>
</table>
Managing Accounts Receivable

Example:
Average collection period: 65 days
Less credit terms: - 30 days
Equals excess in accounts receivable: 35 days

Average daily sales: $21,500
Times days excess in accounts receivable: \( \times 35 \) days
Equals value of excess accounts receivable: $752,500

Value of excess accounts receivable: $752,500
Times rate of return on investment: \( \times 10\% \)
Equals annual cost of excess: $75,250

Forecast Cash Disbursements

Key: Record cash disbursements when you will pay them, NOT when you incur the obligation to pay them

- Start with those disbursements that are fixed amounts due on certain dates
- Review the business checkbook to ensure accurate estimates
- Add a cushion to the estimate to account for “Murphy’s Law”
- Don’t know where to begin? Try making a daily list of the items that generate cash and those that consume it
**Estimate End-of-Month Balance**

- Take Beginning Cash Balance...
- Add Cash Receipts...
- Subtract Cash Disbursements
- Result Is Cash Surplus or Cash Shortage (Repay or Borrow?)

**Benefits of Cash Management**

- Increase amount and speed of cash flowing in
- Reduce the amount and speed of cash flowing out
- Develop a sound borrowing and repayment program
- Impress lenders and investors
- Reduce borrowing costs by borrowing only when necessary

**Benefits of Cash Management**

- Take advantage of money-saving opportunities such as cash discounts
- Make the most efficient use of available cash
- Finance seasonal business needs
- Provide funds for expansion
- Plan for investing surplus cash
Chapter 9: Cash Flow

The "Big Three" of Cash Management

- Accounts Receivable
- Accounts Payable
- Inventory

The Cash Conversion Cycle

Cash Conversion Cycle = Days' Inventory Outstanding + Days' Sales Outstanding – Days' Payable Outstanding

Accounts Receivable

- About 90% of industrial and wholesale sales are on credit, and 40 percent of retail sales are on account
- "Leakages" rob companies of 2% of their sales each year
Chapter 9: Cash Flow

Which Cash Flow Process is the Most Challenging to Manage?

- Collecting accounts receivable, 51%
- Managing and moving cash, 22%
- Paying accounts payable, 15%
- Determining available cash, 12%

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Accounts Receivable

- Remember: “A sale is not a sale until you collect the money”
- The goal with accounts receivable is to collect your company’s cash as fast as you can

Beating the Cash Crisis

Accounts Receivable

- Establish a firm credit-granting policy
- Screen credit customers carefully
- Send invoices promptly
  - Cycle billing
- When an account becomes overdue, take action immediately
- Add finance charges to overdue accounts (check the law first!)
- Develop a system of collecting accounts

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**Accelerating Accounts Receivable**

- Ask customers to fax or e-mail orders
- Send invoices when goods are shipped
- Highlight the due date on invoices
- Restrict customers’ credit until past-due bills are paid
- Deposit checks and credit card receipts daily

**Accelerating Accounts Receivable**

- Identify the top 20% of your customers and monitor them closely
- Ask customers for up-front payments
- Watch for signs that a customer may be about to declare bankruptcy
- Consider using a lockbox service
- Track the results of your company’s collection efforts

**Beating the Cash Crisis Accounts Receivable**

- Stretch out payment times as long as possible without damaging your credit rating
Chapter 9: Cash Flow

Dell Inc.’s Cash Conversion Cycle

Cash Conversion Cycle = Days’ Inventory + Days’ Sales Outstanding – Days’ Payable Outstanding

= 5 + 30 – 71

= -36 days

Beating the Cash Crisis

Accounts Receivable

- Stretch out payment times as long as possible without damaging your credit rating
- Verify all invoices before paying them
- Take advantage of cash discounts (e.g., “2/10, net 30”)

The Cost of Foregoing a Cash Discount

$1,000 invoice 2/10, net 30

\[ R = \frac{1}{P \times T} = \frac{\$20}{\$980 \times 20/360} = 36.7\% \]
Beating the Cash Crisis
Accounts Payable

- Negotiate the best possible terms with your suppliers
- Be honest with creditors; avoid the “the check is in the mail” syndrome
- Schedule controllable cash disbursements to come due at different times

Beating the Cash Crisis
Inventory

- Monitor it closely; it can drain a company’s cash
- Avoid inventory overbuying. It ties up valuable cash at a zero rate of return

Beating the Cash Crisis
Inventory

- Mark down items that aren’t selling
- Schedule inventory deliveries at the latest possible date
- Negotiate quantity discounts with suppliers when possible
- Consider suppliers that can make fast, frequent deliveries
Avoiding the Cash Crunch

- Use bartering, exchanging goods and services for other goods and services, to conserve cash
- Trim overhead costs. For example:
  - Lease rather than buy
  - Avoid nonessential cash outlays
  - Negotiate fixed loan payments to coincide with your company's cash flow

(Continued)

Avoiding the Cash Crunch

- Trim overhead costs. For example:
  - Buy used equipment
  - Look for simple ways to cut costs
  - Hire part-time employees and freelancers
  - Outsource
  - Control employee loans and advances
  - Use e-mail or faxes rather than mail

(Continued)

Avoiding the Cash Crunch

- Trim overhead costs. For example:
  - Use credit cards to make small purchases
  - Establish an internal security and control system
  - Devise a method to battle check fraud
  - Change shipping terms
  - Switch to zero-based budgeting
Avoiding the Cash Crunch (Continued)

- Start selling gift cards
- Invest surplus cash
- Be on the lookout for employee theft
  - Employee theft costs small businesses $40 billion per year
  - 75% of all employee theft goes unnoticed
- Keep your business plan current

Employee theft costs small businesses $40 billion per year.

75% of all employee theft goes unnoticed.

Keep your business plan current.