

# A practical guide to cash-flow management



## Foreword

It is more than a business cliché to state that 'cash is king'. However, as with all clichés, the statement is borne in fact. None more so than this, which highlights the vital importance of cash to modern small businesses. While profit, turnover and even market share are all indicators of success, if there is no cash in the bank to meet monthly bills, wage runs and loan payments then any business will ultimately fail.

At Finance Wales we are able to provide small and medium-sized enterprises (SMEs) and social enterprises with a range of support to assist with cash flow. From providing your business with the right sort of financial support for asset purchase to assisting you in the development of your business, we can help ease the strain on your cash reserves. By choosing the right combination of debt and equity, your business will be able to take the fullest advantage of any opportunity without draining the life blood of your business, its cash.

We also have a wide range of business support programmes that can provide guidance on how best to deploy your cash to its best advantage. While we cannot make decisions for you, our expert mentors and investment support team can point you in the right direction.

Cash-flow management is vital to the health of your business and it is in the day-to-day management of your business that cash is most effectively controlled. Those day-to-day decisions rest firmly with company directors and business owners. This guide is designed to be used on an ongoing basis as a support tool for long-term planning and day-to-day reference. It explores cash management and looks at maximising cash inflows, managing cash outflows, cash-flow budgeting and using company accounts. It is not intended to be complex or exhaustive, but rather to act as a basic guide to the smaller business.

I am delighted that we have been given the kind permission of the Chartered Institute of Management Accountants (CIMA) to reproduce this guide, which is one of a series of business guides prepared by CIMA and produced by Finance Wales. Assistance was gratefully received from Paul B. Jackson, Consultant Financial Management and Anita Allott, Research Analyst, Consensus Communications. We acknowledge CIMA's assistance and would like to thank them for their support.


Finance Wales and CIMA champion management accountancy worldwide. In an age of growing globalisation and intensified competition, modern businesses demand timely and accurate financial information. That is why high quality professional advice and support are vital to the success of 21<sup>st</sup> century businesses.

From its headquarters in London and eleven offices outside the UK, CIMA supports 60,000 members and 77,000 students in 155 countries. CIMA's focus on management functions makes them unique in the accountancy profession. The CIMA qualification is recognised internationally as the financial qualification for business and its reputation and value are maintained through high standards of assessment and regulation.

To find out more about the Chartered Institute of Management Accountants, contact:  
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Finance Wales is dedicated to providing financial investment and management support to new and aspiring Welsh businesses. With a range of funding and management support solutions and with close links to business support agencies throughout Wales, we are uniquely placed to provide the right assistance at the right time.

**For more information on the ways in which Finance Wales can assist businesses and social enterprises, contact us on 0800 587 4140 Email: info@financewales.co.uk Web: www.financewales.co.uk**

If you are a textphone user, , you can contact us on **18001 0800 587 4140** or **18001 029 2033 8156**.

**Sian Lloyd-Jones**

Chief Executive of Finance Wales

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## Cash-flow management – the outline case

Cash flow is generally acknowledged as the single most pressing concern of the SME (small and medium-sized enterprise). In its simplest form cash flow is the movement of money in and out of your business. Cash flow is the life-blood of all growing businesses and is the primary indicator of business health. The effect of cash flow is real, immediate and, if mismanaged, totally unforgiving. Cash needs to be monitored, protected, controlled and put to work.

There are four principles regarding cash management:

- First, cash is not given. It is not the passive, inevitable outcome of your business endeavours. It does not arrive in your bank account willingly. Rather it has to be tracked, chased and captured. You need to control the process and there is always scope for improvement
- Second, cash management is as much an integral part of your business cycle as, for example, making and shipping widgets or preparing and providing detailed consultancy services
- Third, you need information. For example, you need immediate access to information on:
  - your customers' credit worthiness
  - your customers' current track record on payments
  - outstanding receipts
  - your suppliers' payment terms
  - short-term cash demands
  - short-term surpluses
  - investment options
  - current debt capacity
  - longer-term projections
- Fourth, be masterful

Professional cash management in business is not, unfortunately, always the norm. In a poll conducted on the Better Practice Payment Group website during November 2003, nearly a quarter of the respondents declared that they never confirm their credit terms in writing with customers. You will find, therefore, that the cash management process has a double benefit: it can help you to avoid the debilitating downside of cash crises and, in addition, grant you a commercial edge in all your transactions.

# 1. Cash-flow cycle

**Cash flow can be described as a cycle: your business uses cash to acquire resources.**

The resources are put to work and goods and services produced. These are then sold to customers, you collect and deposit the funds and so the cycle repeats. But what is crucially important is that you actively manage and control these cash inflows and outflows. It is the timing of these money flows which can be vital to the success, or otherwise, of your business.

It must be emphasised that your profits are not the same as your cash flow. It is possible to project a healthy profit for the year and yet face a significant and costly monetary squeeze at various points during the year, such that you may worry whether your company can survive.

## Inflows

Inflows are the movement of money into your business. Inflows are most likely from the:

- receipt of monies from the sale of your goods/services to customers
- receipt of monies on customer accounts outstanding
- proceeds from a bank loan
- interest received on investments
- investment by shareholders in the company

## Outflows

Outflows are the movement of money out of your business. Outflows are most likely from:

- purchasing finished goods for re-sale
- purchasing raw materials and other components needed for the manufacturing of the final product
- paying salaries and wages and other operating expenses
- purchasing fixed assets
- paying principal and interest on loans
- paying taxes

## Cash-flow management

**Cash-flow management is vital to the health of your business.** Hopefully, each time through the cycle, a little more money is put back into the business than flows out. But not necessarily, and if you don't carefully monitor your cash flow and take corrective action when necessary, your business may find itself sinking into trouble.

Cash outflows and inflows seldom seem to occur together. More often than not, cash inflows seem to lag behind your cash outflows, leaving your business short. This money shortage is your cash-flow gap. Managing your cash flow allows you to narrow or completely close your cash-flow gap and you do this by examining the different items that affect the cash flow of your business as listed above.

Answer the following questions:

- How much cash does my business have?
- How much cash does my business generate?
- When should I get it?
- When, from experience, do I get it?
- How much cash does my business need in order to operate?
- When is it needed?
- How do my income and expenses affect my capacity to expand my business?

If you can answer these questions, you can start to plot your cash-flow profile and importantly, we return to this in some detail under the budgeting section later. If you can plan a response in accordance with these answers, you are then starting to manage your cash flow!

## Advantages of managing cash flow

The advantages are straightforward.

- You should know where your cash is tied up
- You can spot potential bottlenecks and act to reduce their impact
- You can plan ahead
- You can reduce your dependence on your bankers and save interest charges
- You can identify surpluses which can be invested to earn interest
- You are in control of your business and can make informed decisions for future development and expansion

## Cash conversion period

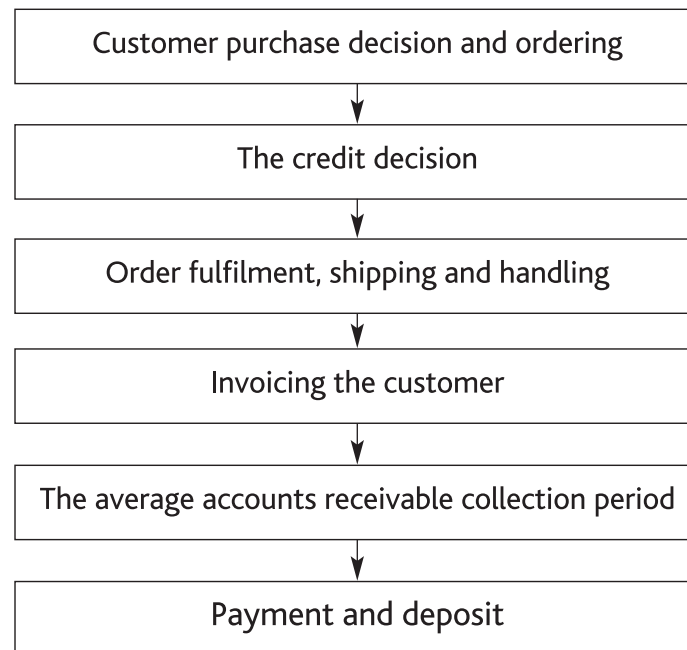
**The cash conversion period measures the amount of time it takes to convert your product or service into cash inflows.**

There are three key components:

1. The inventory conversion period – the time taken to transform raw materials into a state where they are ready to fulfil customers' requirements. This is important for both manufacturing and service industries. A manufacturer will have funds tied up in physical stocks while service organisations will have funds tied up in work-in-progress that has not been invoiced to the customer.
2. The receivables conversion period – the time taken to convert sales into cash inflows.
3. The payable deferrable period – the time between purchase/usage of inputs e.g. materials, labour, etc. to payment.

The net period of  $(1+2)-3$  gives the cash conversion period (or working capital cycle). The trick is to minimise (1) and (2) and maximise (3), but it is essential to consider the overall needs of the business.

The chart below is an illustration of the typical receivables conversion period for many businesses.



The flow chart represents each event in the receivables conversion period. Completing each event takes a certain amount of time. The total time taken is the receivables conversion period. Shortening the receivables conversion period is an important step in accelerating your cash inflows.

## 2. Accelerating cash inflows

**Accelerating your cash inflows will improve your overall cash flow.** The quicker you can collect cash, the faster you can spend it in pursuit of further profit. Accelerating your cash inflows involves streamlining all the elements of the cash conversion period:

- The customer's decision to buy
- The ordering procedure
- Credit decisions
- Fulfilment, shipping and handling
- Invoicing the customer
- The collection period
- Payment and deposit of funds

### Customer purchase decision and ordering

**Without a customer, there will be no cash inflow to manage.** Make sure that your business is advertising effectively and making it easy for the customer to place an order. Use accessible, up-to-date catalogues, displays, price lists, proposals or quotations to keep your customer informed. Provide ways to bypass the postal service. Accept orders over the Internet, by telephone, or via fax. Make the ordering process quick, precise and easy.

### Credit decisions

**The Bank of England estimates that only one in two companies agree their payment terms in writing.** Dun and Bradstreet has calculated that more than 90 per cent of companies grant credit without a reference<sup>1</sup>. Inadequate credit processes can seriously damage a company's health.

### Credit policy

Your company's credit policy is important. It should not be arrived at by default. It should be a Board decision and should determine such items as your company's credit criteria, the credit rating agency to be used, the person responsible for obtaining that credit rating, the company's standard payment terms, the procedure for authorising any exemption and the requirements for regular reporting. The policy should be written down and kept up to date with supplements as necessary concerning any changes to the creditworthiness of specific customers, any warnings or notes of current poor experience. The policy should be disseminated to all sales staff, the financial controller and the Board.

<sup>1</sup> Better Payment Practice Guide: Your guide to paying and being paid on time. DTI URN01/620

### Customer credit worthiness

Credit checks for new customers and reviews for existing customers are important. Checking credit references, obtaining credit reports and chasing references will cost time and resources.

Start your credit decision-making process when first meeting with new prospective customers or clients. If necessary, consider allowing small orders to get underway quickly with a small start limit for new accounts of, say, £500. This may be a reasonable level of risk and may ensure that new business is not lost.

With existing customers or clients, it is best to anticipate a request for an increase in their credit limit whenever possible. This can be accomplished by monitoring your customers' current credit limits and payment performance and comparing them with your expected levels of future business.

Ask yourself:

- Do you methodically check the financial standing of all new customers before executing the first order?
- Do you periodically review the financial standing of existing customers?
- Do you undertake a full recheck of the financial standing of existing customers whose purchases have recently shown a substantial increase?
- Do you use the telephone when checking trade references? Suppliers will often tell you over the telephone what they would not put in writing
- Do you recognise that salesmen are by nature optimists? Use other sources of information before increasing/establishing credit for customers
- Is there one person in your firm who is ultimately responsible for supervising credit and for ensuring the prompt collection of monies due and who is accountable if the credit position gets out of hand?
- Are you clear in your own mind as to how you assess credit risks and how you impose normal limits – both in terms of total indebtedness for each customer's account and also in terms of payment period?
- Do you make your credit terms very clear? In a sales negotiation it is professional, not anti-selling, to be upfront about terms for payment. On an 'Account Application Form' include a paragraph for the buyer to sign, agreeing to comply with your stated payment terms and conditions of sale. On a 'welcome letter' restate the terms and conditions. On an 'Order Acknowledgement' again stress your payment terms and conditions of sale. On 'Invoices and Statements' show the payment terms boldly on the front. On invoices also show the due date e.g. 'payment terms: X days from invoice date – payment to reach us by (date)'

To save time and resources use the 80/20 rule to identify the few accounts that buy most of your sales; that is, list accounts in descending order of value and give the top 80 per cent a full credit check and review; undertake only brief checks on smaller ones. Review the check on specific smaller accounts if monitoring starts to reveal a poor payment performance.

A full credit report on a limited company will cost in the region of £30 from a rating agency. Credit agencies should give you full customer details, financial results, payment experience of other suppliers, county court judgements, registered lending and a recommended credit rating. This information can be received online. Use an agency with a complete database and a fast response. The reference agency will also provide a rating/score i.e. 80/100 would indicate a safe risk, 60/100 is not so safe, 20/100 would probably indicate that the company is either unlikely to survive or may be a new start-up with little capital (or both). The agency will provide a full description to accompany the score.

If your customer is a sole trader or a partnership you can still obtain information in the same way as you would with a limited company.

### Register of County Court Judgements

The Register of County Court Judgements (CCJs), which is maintained by Registry Trust Ltd<sup>2</sup> on behalf of the court service, is a public register open to all. It contains details of almost all money judgements from the county courts of England and Wales and these remain on the Register for six years.

Any individual, organisation or company can carry out a search of the Register at a fee of £4.50 for each search. It is worth noting that some of the biggest companies in the UK have county court judgements against them and you will need to consider whether to deal with them.

### Open new accounts properly

This is the best chance to get payments properly arranged. You should expect your customer to request credit and your customer should expect to be checked out.

Actions:

- Credit Application Form – obtain correct name, payment address, person for payments, phone, e-mail and fax numbers and acceptance of terms
- Get credit references or not, according to policy. Decide maximum credit amount
- Allocate account number and set up correct account details
- Send 'welcome letter' to make contact with payments person, stating how and where payment should be made
- Now you are ready to sell to the customer on a credit basis

### The time it takes plcs to pay up

The Federation of Small Businesses (<http://www.fsb.org.uk>) publishes league tables of the average payment times of public limited companies and their large private subsidiaries. The idea is to allow small suppliers, over time, to monitor and compare the payment times of these companies. Their most recent report, published in January 2003, based on the analysis of 3,243 plcs, shows several interesting findings:

- The average length of time it takes a plc to pay its suppliers is 46 days – the same figure as the last few years
- A fifth of companies listed take more than 60 days to pay
- Nineteen companies are named as taking more than 200 days to pay!
- Finance companies continue to be the best sector payers, with 60 per cent paying within the normal agreed time of 30 days

<sup>2</sup>Registry of County Court Judgements, Registry Trust Ltd., 173-175 Cleveland Street, London W1T 6QR

### Bad debts

Late payment sometimes escalates to become a bad debt. A culture of late payment permeates British business. It is an almost accepted practice to delay paying invoices in order to manage cash resources.

Do you recognise that if you are making 1.5 per cent net sales, a loss of £1,500 in bad debts nullifies the net profit on £100,000 of sales and destroys all the effort involved in making those sales? Do you recognise that a loss of £1,500 in bad debts means that effort will have been expended in trying to collect this money before it is written off and that the cost of this effort is probably 'hidden' and never identified? This scenario is not uncommon in business.

On the other hand, do you recognise that the absence of any doubtful – as opposed to bad – debt may mean that you have been missing out on business by being 'overcautious'?

### Published company accounts

The Companies Act requires public limited companies and their large private subsidiaries to state in days the average time taken to pay their suppliers and to publish this figure in their director's report. This information provides small suppliers with a broad indication of when they can expect to be paid.

Make good use of published company accounts. You can order from Companies House<sup>3</sup> or from the company direct. There are many good, simple, inexpensive books on the subject of company accounts and how they can be read. Some useful pointers are given later. You will not get a list of CCJs from the company accounts, however and these will have to be obtained separately. If your customer is a limited company, ask it to provide a current copy of its interim accounts and annual report and accounts each year as a condition of your trading terms.

### Visit customer premises

This is a useful way to roughly assess the general efficiency and morale of a customer. If the company seems well run and efficient, you may be justified in extending a good line of credit. If the situation feels bad, start at a level of credit you are comfortable with.

### Fulfilment, shipping and handling

**The proper fulfilment of your customers' orders is most important.** The cash conversion period is increased significantly if your business is unable to supply to specification or within the agreed timetable. For any business that sells products rather than services, this occurs when the business fails to control its inventory or its production process. For a service-related business, this occurs when the business cannot provide the skilled resources to provide the services requested.

<sup>3</sup> Companies House, Central Enquiry Unit, Crown Way, Cardiff CF14 3UZ.  
Tel: 0870 3333636

## Invoicing the customer

### Design an invoice that is better than any coming into your own company.

Keep it brief and clear. Get rid of any advertising clutter – the invoice is for accounts staff. Invoice within 24 hours of the chargeable event. Remember that you won't get paid until your bill gets into the customer's payment process.

An invoice includes the following information:

- Customer name and address
- Description of goods or services sold to the customer
- Delivery date
- Payment terms and due date
- Date the invoice was prepared
- Price and total amount payable
- To whom payable
- Customer order number or payment authorisation

Send the invoice to a named individual. Use first class post to beat customer payment deadlines. If there are ways to bypass the postal system, such as the Internet, use them. Use a courier for very large values. Make sure, above all, that the invoice is accurate.

### Special payment terms

Accounts on special terms should be grouped together in the ledger for constant collection attention. Any default after agreement of special terms should lead to 'cash only terms'.<sup>4</sup>

### The collection period

#### Customers are generally given 20 or 30 days from the date of the invoice in which to pay.

The time allowed is under your control and you can specify a shorter period if you need to.

Some companies specify a period of fourteen days to all its customers. You must judge the benefit to your cash flow against the possible cost of deterring some potential customers.

Don't feel guilty about collecting a debt. You are owed money for goods or services supplied.

The law is on your side. Start the collection process as soon as the sale is made. Debtors often put off paying small businesses longer than they would a large company. Never forget that the reputation, survival and success of your business may depend on how well you are able to collect overdue accounts.

Try applying these ideas when you are contemplating a sale of goods or services, thinking about extending the line of credit, or dealing with an overdue payment:

- Realise that when a customer lists references on credit application, they will put down their best references. Find out why they have switched business to you. Find out if they have other debt and whether other suppliers have cut them off
- Take action when a client, especially a new account, is seven days past its due date. Collecting is a competitive sport; if you're not getting paid then someone else is

- Verbal communication is best. Don't wait longer than 60 days past the due date before cutting off credit
- When you need to, defer to a third party – don't get emotionally involved. Let a debt collection agency handle it

Ask yourself the following questions:

- How soon do your invoices go out after the goods are dispatched? Can this be speeded up?
- How soon do monthly statements go out following the last day of the month? Can this be speeded up?
- Are the terms of sale clearly and precisely shown on all quotations, price lists, invoices and statements?
- What is the actual average length of credit you are giving – or your customers are taking? What length of credit do you allow?
- Do you have a collection procedure timetable? Do you stick to it?
- Are you politely firm but insistent in your collection routine?
- Do you watch the ratio of total debt on balances on the sales ledger at the end of each month in relation to the sales of the immediately preceding twelve months? Is the position improving, deteriorating or static? Why?
- Do your sales people recognise that 'It's not sold until it's paid for'?

<sup>4</sup> Better Payment Practice Guide: Your guide to paying and being paid on time, DTI URN01/620

### Improving your debt collection

The key to improving your ability to collect overdue accounts is to get organised.

*Aged debtor analysis* – Listing the accounts receivable due and past due is the essential working tool for debt collection. It is also the best control document for senior management to monitor trends and control weaknesses. List accounts in order of size and due date – first ranking largest debt first and second ranking earliest date first. If you have a lot of customers buying on credit throughout the month, each with different terms, keeping track can be difficult. There is a number of software programmes, however, that can greatly simplify this task.

*Use personal visits* – There are four basic means of contacting your customer – letters, e-mail, telephone calls and personal visits – letters are generally the least effective method, e-mails and telephone calls score better, while personal visits are the most effective. If you have a problem with payment talk to the person who is responsible for buying your goods or services. Your best leverage is to threaten to withhold your goods in future if payment is not made.

*Start with a serious letter* – If you use a letter, pay a solicitor to write one for you. If you want to get results, get serious from the start.

*Learn the debtor's payment cycle* – When dealing with large companies find out the last day for getting an invoice approved and included in the payment run. Call a couple of days before that date to make sure that they have all the documentation from you that they need.

### Payment and deposit of funds

**Payment and deposit of funds is the last step in the cash conversion process.**

This involves looking at when and how you get paid and how long it takes you to see the cash inflow in your bank account.

Consider the customer's position. He or she will delay payment as long as possible, to improve his or her cash flow cycle. It is up to you to insist on prompt payment. Think of ways to encourage your invoice to be settled on time. Remember, relying on the postal service for receipt of your customers' cheques can add one to three days (possibly more) to your cash conversion period. Find ways to bypass the postal service, such as by using couriers or electronic means to pay direct to your company bank account. This will accelerate and improve your cash inflow.

### The Late Payment of Commercial Debts (Interest) Act 1998

**The Government has introduced legislation to give businesses a statutory right to claim interest if another business pays its bills late.** Until now, businesses have only been able to claim interest on late paid debts if it is included in the contract or if they pursue the debt through the courts and the courts decide to award interest.

The legislation is called the Late Payment of Commercial Debts (Interest) Act 1998. The Better Payment Practice Group has published a guide to the legislation called The Late Payment of Commercial Debts (Interest) Act 1998 – A User's Guide. To obtain a copy call 0870 150 2500. Quote order reference URN 00/1308. These guidance notes explain how the Act works and how it affects businesses.<sup>5</sup>

<sup>5</sup> Better Payment Practice website: [www.payontime.co.uk](http://www.payontime.co.uk)

## 3. Cash-flow budget

**The cash-flow budget projects your business cash inflows and outflows over a certain period of time.** A typical cash-flow budget predicts cash inflows and outflows on a month-to-month, weekly or daily basis.

The cash-flow budget can help predict your business's cash-flow gaps – periods when cash outflows exceed cash inflows when combined with your cash reserves. This will allow you to take steps to ensure that the gaps are closed, or at least narrowed, to avoid expensive, uncontrolled overdrafts. These steps might include lowering your investment in accounts receivable or inventory, increasing or advancing receipts, or looking to outside sources of cash, such as a short-term loan, to fill the cash-flow gaps.

If you're applying for a loan, you will need to create a cash-flow budget that extends for several years into the future, as part of the application process. But for your business needs, a six-month cash-flow budget is probably about right. It predicts future events early enough for you to take some corrective action and yet may minimise the amount of uncertainty involved in the budget preparation.

Preparing a cash-flow budget involves:

- preparing a sales forecast
- projecting your anticipated cash inflows
- projecting your anticipated cash outflows
- putting the projections together for your cash-flow bottom line
- identifying surpluses and the opportunity to place short-term money on deposit to earn interest
- identifying deficits and the need to accelerate cash flows or borrow short-term money
- identifying longer-term surpluses to fund expansion and development
- identifying longer-term needs for funds, either from banks or shareholders

### Cash inflows

**Forecasting your sales is key to projecting your cash receipts.** Any forecast will include some uncertainty and will be subject to many variables: the economy, competitive influences, demand, etc. It will also include other sources of revenue such as investment income, but sales are the primary source. If your business only accepts cash sales, then your projected cash receipts will equal the amount of sales predicted in the sales forecast.

Projecting cash receipts is a little more involved if your business extends credit to its customers. In this case, you must take into account the collection period for your accounts receivable.

### Accounts receivable

If credit is normally extended to your customers, the payment of accounts receivable is likely to be the most important source of cash inflows. At worst, unpaid accounts receivable will leave your business without the cash to pay its own bills. More commonly, late-paying or slow-paying customers will create cash shortages, causing your business to be late in covering its own payment obligations, spoiling its reputation and upsetting its suppliers.

Accounts receivable can be looked upon as an investment. That is, the money tied up in accounts receivable is not available for paying invoices, repaying loans, or expanding your business. The payoff from an investment in accounts receivable does not occur until your customers pay your invoices.

The following analysis tools can be used to help determine the effect your business's accounts receivable is having on your cash flow:

- Average collection period measurement
- Accounts receivable to sales ratio
- Accounts receivable ageing schedule

#### Average collection period

The average collection period measures the length of time it takes to turn your average sales into cash. A longer average collection period represents a higher investment in accounts receivable and less cash available to cover cash outflows such as for purchases and expenses. Reducing your average collection period will reduce your investment in accounts receivable and improve your cash flow.

The average collection period in days is calculated by dividing your present accounts receivable balance by your average daily sales:

$$\text{Average collection period} = \frac{\text{current accounts receivable balance}}{\text{average daily sales}}$$

$$\text{where average daily sales} = \frac{\text{annual sales}}{365}$$

#### Accounts receivable to sales ratio

The accounts receivable to sales ratio looks at your investment in accounts receivable in relation to your monthly sales. Tracking this figure will help you to identify recent changes in accounts receivable. The accounts receivable to sales ratio is calculated by dividing your accounts receivable balance at the end of any given month by your total sales for the month.

$$\text{Accounts receivable to sales ratio} = \frac{\text{accounts receivable}}{\text{current sales for the month}}$$

A ratio of more than one readily shows that accounts receivable is greater than current monthly sales. This indicates that if this figure persists, month on month, you will soon run into cash-flow problems.

#### Accounts receivable ageing schedule

The accounts receivable ageing schedule (aged debtors analysis) is a listing of the customers making up your total accounts receivable balance, normally prepared at the end of each month. Analysing your accounts receivable ageing schedule may help you readily identify the root of potential cash-flow problems.

The typical accounts receivable ageing schedule consists of six columns:

- Column 1 lists the name of each customer with an accounts receivable balance
- Column 2 lists the total amount due from the customers listed in Column 1
- Column 3 is the 'current column'. Listed in this column are the amounts due from customers for sales made during the current month
- Column 4 shows the unpaid amount due from sales made in the previous month
- Column 5 lists the amounts due from sales made two months prior
- Column 6 lists the amount due from sale over two months prior
- Columns 3 to 6 will sum to Column 2

The following is a sample accounts receivable ageing schedule from Technical Office Supply:

<b>Accounts Receivable Ageing Report</b>					
<b>Technical Office Supply*</b>					
<b>October 31, 2000</b>					
<b>(£)</b>					
1	2	3	4	5	6
Customer Name	Total accounts receivable	Current	1-30 days past due	31-60 days past due	Over 60 days past due
Consensus Computer Supply	2400	450	750	750	450
HPJ Ltd	4200	4200	–	–	–
South Schools Sport Stores	1500	1500	–	–	–
Denton Inc.	2400	–	2400	–	–
JBJ Unlimited	3000	1650	750	600	–
Park Enterprises	600	–	600	–	–
On line Computers	900	900	–	–	–
Freestyle Ltd	1800	1800	–	–	–
<b>Total</b>	<b>16800</b>	<b>10500</b>	<b>4500</b>	<b>1350</b>	<b>450</b>
<b>Percentage Breakdown</b>	<b>100%</b>	<b>62%</b>	<b>27%</b>	<b>8%</b>	<b>3%</b>

\*Technical Office Supply is a fictitious company for example purposes only

The ageing schedule can be used to identify the customers that are extending the payment time. If the bulk of the overdue amount in receivables is attributable to one customer, then steps can be taken to see that this customer's account is collected promptly. Overdue amounts attributable to a number of customers may signal that your business needs to tighten its general credit policy towards new and existing customers.

The ageing schedule also identifies any recent changes in the accounts making up your total accounts receivable balance. If the makeup of your accounts receivable changes, when compared to the previous month, you should be able to spot the change rapidly. Is the change the result of a change in sales, your credit policy, or is it caused by a billing problem? What effect will this change in accounts receivable have on next month's cash inflows? The accounts receivable ageing schedule can sound an early warning and help you protect your business from cash-flow problems.

### Cash outflows

**Projecting your cash outflows for your cash-flow budget involves projecting your expenses and costs over a period of time.**

An accounts payable ageing schedule may help you determine your cash outflows for certain expenses in the near future – 30 to 60 days. This will give you a good estimate of the cash outflows necessary to pay your accounts payable on time. The cash outflows for every business can be classified into one of four possible categories:

- Costs of goods sold
- Operating expenses
- Major purchases
- Debt payments

By classifying your business expenses, you will help to ensure that all your outflows are readily identified.

### Accounts payable ageing schedule

The accounts payable ageing schedule can help you determine how well you are (or are not) paying your invoices. While it is good cash-flow management to delay payment until the invoice due date, take care not to rely too heavily on your trade credit and stretch your goodwill with suppliers. Paying bills late can indicate that you are not managing your cash flow the way a successful business should.

An accounts payable ageing report looks almost like an accounts receivable ageing schedule. However, instead of showing the amounts your customers owe you, the payables ageing schedule is used for listing the amounts you owe your various suppliers – a breakdown by supplier of the total amount on your accounts payable balance. Most businesses prepare an accounts payable ageing schedule at the end of each month.

A typical accounts payable ageing schedule consists of six columns as per the example for accounts receivable opposite. The number of columns, however, can be adjusted to meet your reporting needs. For instance, you might prefer listing the outstanding amounts in 15-day intervals rather than 30-day intervals. You should take into account your suppliers' terms of trade – to which you will already have agreed.

The following is a sample accounts payable ageing schedule from Technical Office Supply:

<b>Accounts Payable Ageing Schedule</b>					
<b>Technical Office Supplies Ltd</b>					
<b>December 31, 2000</b>					
<b>(£)</b>					
1	2	3	4	5	6
Supplier's name	Total accounts payable	Current	1-30 days past due	31-60 days past due	Over 60 days past due
Advantage Advertising	2400	2400	–	–	–
Manpower	4200	3900	300	–	–
BMR Distributing Ltd	1500	900	150	450	–
E.V. Jones Bookkeeping	900	450	450	–	–
G.R.H. Unlimited	3000	1650	750	600	–
Prompt Quote Insurance Co	600	600	–	–	–
Wachtmeister Office Supply	900	900	–	–	–
H.F. Dean Hardware	525	525	–	–	–
<b>Total</b>	<b>14025</b>	<b>11325</b>	<b>1650</b>	<b>1050</b>	<b>–</b>
<b>Percentage Breakdown</b>	<b>100%</b>	<b>81%</b>	<b>12%</b>	<b>7%</b>	<b>–</b>

The accounts payable ageing schedule is a useful tool for analysing the makeup of your accounts payable balance. Looking at the schedule allows you to spot problems in the management of payables early enough to protect your business from any major trade credit problems.

For example, if G.R.H. Unlimited was an important supplier for Technical Office Supplies Ltd, then the past due amounts listed for G.R.H. Unlimited should be paid in order to protect the trade credit established.

The schedule can also be used to help manage and improve your business's cash flow. Using the example schedule above, Technical Office Supplies will need to generate at least £11,325 in income to cover the current month's purchases on account.

### Projecting operating expenses

Expenses tend to come under four headings: debt payments, cost of goods sold, asset purchases and operating expenses. Operating expenses include payroll and payroll taxes, utilities, rent, insurance and repairs and maintenance. Operating expenses can be fixed or variable. Rent, for example, is fairly fixed, being the same amount each month. However, payroll or utilities may vary in line with your sales projections and have a seasonal aspect.

### Projecting cost of goods sold

Outflows for the cost of goods sold, i.e. purchases of materials, will be in line with the sales projection after allowing for your production cycle, changes in the level of inventory and your payment terms.

### Projecting major purchases

Purchasing new assets for the company tend to occur when the business is expanding, or improving its cash-flow position, or the result of machinery needing to be replaced. Cash outflow in this area is generally large and irregular. Examples of fixed asset expenditure would be on new company cars, computers, vans and machinery.

### Projecting for debt payments

Projecting for debt payments is the easiest category to predict when preparing the cash-flow budget. Mortgage payments and lease hire payments will follow the schedule agreed with the lender. Only payment against an overdraft, for example, will be variable by nature.

### Putting the projections together

**Putting the projections together – the projected cash inflows and outflows – gives you your cash-flow bottom line.** The completed cash-flow budget combines the following information on a monthly, weekly or even daily basis:

- Opening cash balance
  - » *plus* Projected cash inflows
    - Cash sales
    - Accounts receivable
    - Investment interest
  - » *less* Projected cash outflows
    - Operating expenses
    - Purchases
    - Capital investment
    - Debt payment
  - » *equals*
    - cash-flow bottom line (the closing cash balance)

The above cash-flow budget is just a guide, you will obviously need to include a little more detail. However, the basic cash-flow budget will always remain the same.

The closing cash balance for the first period becomes the second period's opening cash balance. The second period's closing balance is determined by combining the opening balance with the second period's anticipated cash inflows and cash outflows. The closing balance for the second period then becomes the third month's opening cash balance and so on until the last period of the cash-flow budget is completed.

A positive cash-flow bottom line indicates your business has a cash surplus at the end of the period. You can plan to place money on short-term deposit to earn interest, or fund capital investment for longer-term expansion and development. A negative cash-flow bottom line indicates that your business has a cash-flow gap. If a cash-flow gap is predicted early enough, you can take cash-flow management steps to ensure that your cash-flow gap is closed, or at least narrowed in order to protect your business for the future. These steps might include:

- increasing sales
- increasing margins, i.e. maximise the difference between costs and prices by cutting costs and/or raising selling price. However, care must be taken not to compromise on quality or to lose customers because your prices are now too high
- preventing leakage from the cycle. We have already mentioned the importance of managing debtors, but you also need to control stocks effectively to avoid theft, deterioration, etc.
- increasing your anticipated cash inflows from accounts receivable collections
- decreasing your anticipated cash outflows by cutting back on inventory purchases or cutting certain operating expenses
- postponing a major purchase
- rolling over a debt repayment
- looking to outside sources of cash, such as a short-term loan

## 4. Cash-flow surpluses and shortages

### Surpluses

As your business creates a surplus so you have choices:

- First, you may put the surplus to work by placing the surplus on short-term deposit, either overnight or on term deposit with a bank or with a proprietary money fund, to earn interest until you are ready to put the money to other uses
- Second, you may use the money to fund capital investment for development and expansion in line with your longer-term corporate plan
- Third, if the funds truly are surplus to current and future requirements, then you can pay out money to stakeholders
- Finally, you can advance your payments to creditors and by so doing enhance your credit credentials for the future. Similarly, you can pay down debt to improve your balance sheet gearing ratio and make the payment profile for future principal and interest payments more manageable. If you choose this route, then there are considerations of whether there is a premium to be paid for early repayment and whether it restricts your future flexibility unduly

### Sources of finance

**If there is a requirement for additional funds, either to meet short-term shortages or for longer-term development, there are several sources of new funds that can be considered.**

These are outlined, in brief, below.

First, you will have an overdraft facility with your relationship bank. You should negotiate with the bank to agree acceptable limits to the facility and agree competitive interest rates. You'll be paying a premium over the base rate; haggle the premium.

Second, establish a short-term borrowing facility with the bank whereby, at short notice, you can draw down a specific amount to be repaid in a specified number of days. The limits to the facility, the repayment periods and the interest rates will be negotiated with the bank. The interest on a short-term facility may be more favourable than for an overdraft.

Third, as a natural extension of the two sources above, establish a revolving credit facility with the bank. Again, you will agree acceptable limits to the facility and agree competitive interest rates. The facility will enable you to make withdrawals at short notice. It will also enable you to make unscheduled repayments whenever you have a cash surplus: the saving on interest owed may outweigh the interest that could have been earned from a separate investment.

Fourth, for longer-term needs, raise fixed-term finance from the bank or other institutions. The finance can be loan debt or bond issue and can be general company debt or project specific. The interest rate can be fixed or variable. Haggle the premium; and, indeed, do not be afraid to shop around. Although you will want to maintain a good relationship with your bank, there are now many competing sources of sound finance on the market, especially since the de-mutualisation of many of the building societies. It is simply good business to take the time to establish fresh links to some of these.

Beyond that you can raise further equity, either from a private placing of shares or a public offering. This is an important source of funds and can be essential if the debt-equity ratio is to be maintained at acceptable levels. It requires consideration of the time, effort and cost required for set-up. Further discussion of this lies outside the scope of this paper.

Finally, an excellent and sometimes overlooked, source of finance is factoring, which we turn to in some detail below.

### Factoring

**A possible solution to short-term cash-flow problems is factoring.**

Factoring involves 'selling' your accounts receivable to a factoring company at a discount. That is, getting cash immediately for your sales with a cut being taken by the factoring company.

Factoring contracts all have the following elements in common:

- *Advance rate* – The advance rate is the percentage of your accounts receivable that companies will advance to you. Some companies will advance you the full 100 per cent up front. Others will advance you, say, 70 per cent and then will pay you the balance once the receivables are collected. The typical range is 60 per cent to 90 per cent of your account receivables
- *Discount rate* – The discount rate is the fee charged by the factoring company for the financing. The typical range is 1 per cent to 7 per cent of your accounts receivable, depending on the accounts receivable payment terms
- *Recourse vs. non-recourse* – In a non-recourse agreement, the factoring company bears the burden of collecting the accounts receivable. In a recourse agreement, the small business owner bears the burden of bad debts (in other words, if they are uncollectable, they will be charged back to you). Obviously for a small business owner, the non-recourse agreement is preferred, although the rates you'll get will not be as good as with a recourse agreement

The terms will vary from one factoring company to another. Always shop around before you make a decision. That said, the terms and rates offered to you will depend upon your credit (or debtor) worthiness. Small businesses with higher sales volumes or with what are viewed as stronger account debtors get better rates than those with small sales volumes or more questionable account debtors. Unfortunately, the smaller the business, typically the worse the terms.

Before you commit to factoring, approach your bank first for a loan using the accounts receivables as collateral. Bank fees will typically be much lower than factoring fees and you should definitely pursue that option if it is available to you.

## 5. Using company accounts

We referred earlier to the wealth of information to be obtained from company accounts.

The information can provide a valuable insight into your customers and their business: their trading performance, creditworthiness, financial health and even their expansion plans for the future. Much of this is simply stated in the notes or can be gleaned from the written reports from the chairman, chief executive and finance director. Further insight can be gleaned from a straightforward analysis of the figures from the Profit and Loss, Balance Sheet and Cash Flow reports. The standard way of analysing accounts is to calculate 'ratios'. Ratios give you a set of figures to match against industry and company standards.

The following is a short rough guide to acceptable ratios (but remember you must not rely on any one piece of information). For additional guidance on using company accounts see our useful reading list at the end of this publication 'Using company accounts, further reading'.

### Current ratio

This liquidity ratio is calculated by dividing current assets by current liabilities. It measures the ability to pay bills.

<b>Low risk</b>	<b>Average risk</b>	<b>High risk</b>
Over 1.5	1.0 - 1.5	Under 1.0

Current assets (cash + stocks + trade debtors) divided by current liabilities (amounts due under 1 year)

### Liquidity ratio or acid test or quick ratio

This is a solvency ratio, the test of the company's true liquidity (actual cash + debtors vs. creditors + loans).

<b>Low risk</b>	<b>Average risk</b>	<b>High risk</b>
Over 1.25	0.75 - 1.25	Under 0.75

Current assets (less stock) divided by current liabilities

### Roce (return on capital employed)

This is a useful profitability ratio. It is used to assess the profit, as a percentage, generated by the company's assets.

<b>Low return</b>	<b>Average return</b>	<b>High return</b>
Under 6%	8 - 11%	Over 11%

Return on capital employed – profit before tax divided by capital employed x 100:

Table shows example of an ROCE range assuming a bank rate of 6% and a risk margin of 2-5%

### Debt/equity (gearing)

This assesses how heavily the company is relying on external funding to support the business.

<b>Low</b>	<b>Average</b>	<b>High</b>
Under 50%	50-90%	Over 90%

Debt (loans, overdraft, etc.) divided by equity (shareholders' funds) x 100

An alternative definition is debt divided by (debt plus equity), which would modify the above table as follows:

<b>Low</b>	<b>Average</b>	<b>High</b>
Under 33%	33-47%	Over 47%

### Profit/sales

To assess profit margin of sales after costs.

<b>Low</b>	<b>Average</b>	<b>High</b>
Under 3%	3-10%	Over 10%

Profit before tax divided by annual turnover x 100

### Debtors' days sales outstanding

To assess the company's sales revenue recovery period in days.

<b>Low</b>	<b>Average</b>	<b>High</b>
Under 55 days	55-85 days	Over 85 days

Total of debtors x 365, divided by annual sales

### Creditors' days sales

To assess the company's payment period in days.

<b>Low</b>	<b>Average</b>	<b>High</b>
Under 45 days	45-60 days	Over 60 days

Total of creditors x 365, divided by annual sales

## 6. Insolvency by overtrading

In situations where cash flow is poorly managed, a company's success can lead to its own downfall, hence the term 'insolvency by overtrading'. It is surprisingly common to hear people say, 'everything was all right until we got that large order' or, having just suffered insolvency, 'next time I will keep the business small'.

But how does this situation arise? If your 'cash inflow' lags significantly behind your 'cash outflow' then your operating business model is in a state of 'cash shortfall'. Further, it follows that this 'cash shortfall' is proportional to your trading volume. In a normal steady trading situation you will have found a way of plugging the cash-flow gap, through retained profits for example. But suppose your trading volume suddenly rises, you have secured a profitable new order. Yes, in the long term this new order will translate into profit. But in the short term increased trading volume means increased 'cash shortfall'. Unless this shortfall has been anticipated and plugged, or your cash flow tightened so that the lag is not so great, there will quite simply be bills to pay that cannot be met.

### Overtrading scenario

Let us give an example to illustrate how insolvency by overtrading might arise: consider **Albert's Autos**. This is a small garage providing car servicing and MOTs to local residents. The garage also provides occasional breakdown recovery.

Business is good, there is a steady stream of income from repeat customers and the odd 'recovery' significantly adds to the coffers. There are no significant cash reserves and there is no need for an overdraft. Suddenly your contact that passes on most of your 'recovery work' offers you a contract to supply 'recovery services' for a 50-mile radius. This is too good an opportunity to pass on. The recovery work has always been extremely profitable in the past. It is your chance to expand. You anticipate that the recovery work will increase five-fold, so you take on two extra mechanics. You also need more recovery trucks, so two more are purchased. So far, so good, but then what happens when more work than expected comes in?

In the first week of accepting the new contract, ten recoveries are made (usual amount is one or two). Fixing these cars takes longer than expected and, to maintain credibility, you stop work on your local services and divert effort into upholding the terms of your contract. In week two one of your mechanics breaks his arm and is off sick. You still have the workshop to run and the breakdowns to attend to. One of your recovery trucks is now lying idle. The servicing work is mounting up and you are deluged with breakdown requests. There is nothing for it but to hire more staff. You use an agency and take on two more mechanics.

Now it is week three, the trucks are in full use, but you are splitting your time between recovery work and servicing jobs. At the end of this week, you have lost many days' work on your main business, servicing cars, to attend to the breakdowns. On the breakdown side of the business, due to no fault of your own, you have had further staffing problems, leading to overtime payments for existing staff. Work in the office is mounting up and you decide to take on an office manager. You have yet to be paid for any of the recovery work to date and in week four calls slack off and the trucks lie idle for three days. You have complaints from several regulars for delays in servicing their vehicles.

Your contact arranges to meet with you and explains that he is so delighted with your service, that he proposes to increase the contract to cover an even greater distance.

### Result

If you do not take this work, future work from your 'contact' may revert to just the odd recovery. If you take the work, you are unlikely to survive because this increase in business is out of your control, your garage work is suffering and your cash outflows (wages, loan repayments, operating expenses) are spiralling out of control. You have yet to be paid for the recoveries to date and the cash work from servicing is drying up, due to loss of goodwill with your regulars.

In considering whether to take the work you would have to consider not only whether or not you want to be a bigger garage, but whether you want to expose your company to increased borrowing to finance the means of providing the recovery service (trucks, spares, trained mechanics). You would also probably lose your close contact with your local servicing customers.

If the recovery work represented over 50 per cent of your income, you would be susceptible to the contact's price and terms and payment delays. If your contact suddenly changed to another garage, how would you meet your cash outflow obligations, if he demanded a 10 per cent increase in service, with a 10 per cent drop in price? How would this impact on your cash-flow obligations?

Expanding the business should be based on a solid business plan.

In business you have to grow. You have to keep pedalling. If you stop pedalling, you eventually fall off your bike. Even when you become 'bigger', you will still be small by other standards and you will need to keep pedalling ever harder. But you need to have control over the growth or it will be the ruin of you (the wheels fall off). The problem is that growth is rarely of an incremental, easily absorbed nature. It usually represents a step-change. And you have to ask yourself whether you can think big enough to cope. In the example above, by focusing solely on the need to meet the recovery work, you have allowed a cash crisis to develop unnoticed and unchecked.

All your good cash-management skills have just been dumped. Cash will become your ruination rather than your servant and reward. Take the time to think big; plan your new projected cash flows, identify the shortfalls, identify the risks and secure ample lines of credit. Now you're pedalling. If the step-change is revealed to be too great you will at least have spotted it in time and you can plan a different route.

For comprehensive guidance on the issue of insolvency go to the Government's executive agency, the Insolvency Service <http://www.insolvency.gov.uk>

For a glossary of insolvency terms, go to [www.insolvency.gov.uk/information/guidanceleaflets/guide/glossterm.htm](http://www.insolvency.gov.uk/information/guidanceleaflets/guide/glossterm.htm)

## 7. Conclusion

**As outlined at the outset, cash flow is the life-blood of all growing businesses.**

Cash flow has to be managed. Cash management is as much an integral part of the business cycle as any other part of the process. The effect of cash is real, immediate and, if mismanaged or not managed, it is very unforgiving. It can be your ruination, but with care will be your servant and reward.

This booklet has looked at cash-flow management. Hopefully, we have helped to illuminate where cash comes from and where it goes in the cash-flow cycle and provided you with insight into the basics of cash management. It cannot be exhaustive but, hopefully, it has touched on all the areas of immediate importance for the survival and future development of your business.

Remember, sound cash management will give your business just as much of an edge in your transactions as, say, an improvement in your manufacturing process or service delivery. Control and prosper.

## 8. Useful reading

*A User's Guide to Late Payment Legislation: the Late Payment of Commercial Debts (Interest) Act 1998, as amended and supplemented by the Late Payment of Commercial Debts Regulations 2002.*

DTI URN 02/833. Available free of charge from DTI Publications Orderline, Admail 528, London SW1W 8YT. Tel: 0870 150 2500 or download from <http://www.payontime.co.uk>

*Better Payment Practice Guide: Your Guide to Paying and Being Paid on Time.*

DTI URN 04/606. Available free of charge from DTI Publications Orderline, Admail 528, London SW1W 8YT. Tel: 0870 150 2500 or download from <http://www.payontime.co.uk>

*Cashflow* part of an online guide to Starting up in Business available free of charge from Business Link at <http://www.businesslink.gov.uk>

*Financial Management for the Small Business: published in association with The Sunday Times,* Colin Barrow, (5th ed) 2001 [Kogan Page]

*Financial Management Development: a no nonsense guide* available free of charge at <http://www.financialmanagementdevelopment.com>

*Getting Paid on Time*, available from the Business Link website at <http://www.businesslink.gov.uk>

Chartered Management Institute, *Checklist 120: Cash Flow for the Small Business*, £3 from Lavis Marketing, 73 Lime Walk, Headington, Oxford. Tel: 0845 7023736 or <http://www.managers.org.uk>

Chartered Management Institute, *Checklist 194: Finding Information on the World Wide Web*, £3 from Lavis Marketing, 73 Lime Walk, Headington, Oxford. Tel: 0845 7023736 or <http://www.managers.org.uk>

### Using company accounts, further reading

Anthony, R.N. and Breitner, L.K. (2003) *Essentials of Accounting & Post-test Booklet 8*, 8th ed. [Prentice Hall]

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### NOTES

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