Fáilte Ireland Business Tools

Managing Cash Flow

A guide to help you broaden your understanding of how to manage cash flow in a small business

This guide looks at the key elements of cash flow and working capital and how its management will help to protect the financial security of your business. Cash flow is generally acknowledged as the single most pressing concern for owners and managers of small and medium sized enterprises. It is the life-blood of all businesses and it is the primary indicator of business health. While a business can survive for a short period of time without sales or profits, without cash it is doomed. For this reason, your company's cash flow requires careful monitoring and management.

Fáilte Ireland

How to Make Sound Financial Decisions:

Managing Cash Flow

This short guide has been developed to help broaden your understanding of how to manage cash flow in a small business. The information here is designed to provide you with a general overview of the key issues on this topic and further support can be found on the Business Tools website.

1. How Cash Flow Works

Managing cash flow is all about thinking ahead, because cash-flows work in cycles.

The first cycle is usually seasonal

You probably do better in the summer months than winter months (unless you market winter activities or products).

This means you have to anticipate and prepare for lean periods.

The second cycle is the gap between selling your product or service and getting paid for it.

If you operate a cash only business then your cash cycle is very short - you get your money immediately.

If you can transform your business into a cash-only business, you will improve your cash flow.

But if you offer credit terms, then your cash flow cycle will be longer. The danger here lies in underestimating when customers will pay you. You think you'll get the money within 30 days, but the customer may take 60 days (or longer) because times are tight for them. Meanwhile you were planning to use that money to pay bills.

The third cycle is your payment cycle.

Some bills you have to pay immediately, on others you may have 30 days or longer in which to pay.

It's important to remember tax payments as well and prepare for them.

So, the trick is to manage these three cycles: seasonal variations in cash flow, cash coming in from sales, and cash you must pay out to your suppliers and on taxes. Ideally, you will collect more money than you will spend during each cash flow cycle. However, there will be occasions when less money flows into your business than you are required to spend and it is during these periods in particular that you need to carefully monitor cash flows and to take corrective action, when necessary.

1.1 The advantages of managing cash flow

The advantages of managing cash flow are straightforward:

You will know where your cash is tied up.

You can identify potential bottlenecks and act to reduce their impact on your business.

It will assist you in forward planning.

You will be in a position to reduce your dependence on your bankers and to save on interest charges.

Surplus cash can be identified and invested to earn interest.

You are in control of your business and can make informed decisions for future development and expansion.

1.2 The difference between cash and profit

It is important not to confuse cash with profit. Profit is the difference between the total amount of your business revenues less all of its costs (whether paid or not). You may record a profit for a trading period (e.g. a month or a year) yet still face periods when your business fails to generate a positive cash-flow. Differences between your profit and your cash flow can arise for a number of reasons, the most common being:

A high proportion of your sales are on credit (e.g. corporate customers), who may not pay you for a period of time. Some of your expenditure during the period relates to the purchase of capital items (such as equipment) which is charged to the profit and loss account as depreciation over a period in excess of 1 year, rather than in the month in which you pay for it.

Payments made during the period may include VAT, which is not included within the profit and loss account.

You receive deposits in a period for events that take place in another period. Therefore, you receive the cash in advance of the event being recorded in your profit and loss account.

You delay paying your suppliers until sometime after the period in which you received, and used, their supplies.

Therefore, you have a responsibility not only to ensure that your business is profitable, but that it is also cash generative. Frequent, and properly prepared, cash flow forecasts will assist you to achieve this objective.

2. The Principles of Cash Flow Forecasting

Cash flow forecasting enables you to predict the peaks and the troughs in your cash balances. It also enables you to plan your borrowing requirements, or to identify how much surplus cash you are likely to have at a given time. Many banks require this information when considering loan applications. The cash flow forecast totals the sources and the amounts of cash coming into your business and the types and amount of expenditure that your business incurs. The forecast period can be as long as you need it to be, but it is normal to prepare cash-flow forecasts on a regular basis. It is recommended that the forecast should be prepared monthly for the forthcoming 13 week (three month) period. The cash flows should be shown on a week by week basis.

“ *forecast* ”

What you're attempting to do in the cash flow forecast is to anticipate what your future bank statements will look like. The closer your forecast figures to the actual bank statement figures when they arrive, the better your cash flow forecasting skills. Practice will help get the match closer. You can download and adapt the Annual Cash flow Forecast template for your kind of business from the Fáilte Ireland website to automatically calculate totals for you. You can base your figures on previous accounting records or bank statements, making allowances for inflation, seasonality and the outlook for tourism over the next 12 months. Be conservative in your estimates of sales and when people are likely to pay you. Be prepared to defend your estimates if you need to approach lenders for funds or bridging loans.

The quality, and the accuracy, of your cash-flow forecast will be enhanced by:

Basing your forecast of income on realistic estimates.

Ensuring that your forecast income, on a weekly basis, relates to expected cash received (including VAT), rather than the estimated sales for the week.

Weekly expenditure relates to payments (including VAT) that you expect to make, rather than invoices received weekly from your suppliers.

Studying the bottom line each month in the cash flow forecast will tell you if your business is likely to end up with a cash surplus or cash shortfall in that month. So the forecast puts you in a much stronger position to manage your cash over the year. For example, you can plan purchases for months when you expect cash surpluses and spot well ahead of time those months where you may need to approach the bank (preferably well ahead of the 'cash crunch') for a bridging loan to tide you over a lean period.

2.1 Cash flow and working capital management

Having completed the cash flow forecast, you then need to use it to help you to manage your financial affairs by:

Checking your actual expenditure and lodgements on a weekly basis and comparing these with your cash flow forecast. If the difference between your estimates and your actual flow of cash is significant, you should revise the figures in the cash-flow forecast;

Using your cash flow forecast to identify any week, or weeks, in which your cash flow and your projected cash position are negative. In such circumstances you could accelerate your debt collection activities, or defer making payments to creditors, in an attempt to prevent your business falling into a negative cash position. If this is not possible you need to inform your bank and arrange an overdraft facility;

However if your cash position is likely to be negative for a period in excess of, say, four weeks and is likely to remain so for the foreseeable future, you need to establish if your negative cash position is likely to reduce eventually, or, increase (by preparing a cash flow for a 12 month period). If the projected negative cash position is set to reduce, an overdraft facility may be sufficient to enable continued trading. However, if your cash position is likely to deteriorate further, you should arrange to meet with your accountant and your bank as soon as possible;

If your projected cash flow indicates that your cash-balance is reducing (or your overdraft is increasing) and this is due to seasonality issues in your business, you should consider activating a sales promotion campaign to improve income, and cash takings, and accelerate your debt collection activities. Additionally, you should consider what opportunities are available to you to reduce your costs during the period; and

If you have a positive cash position over the period of the cash flow forecast, you should make arrangements with your bank to transfer your surplus funds into an interest paying account.

What is working capital?

Working capital is the financial resources that you have available to you for conducting the day to day operations of your business. It is normally the excess of the current assets of the business, less the current liabilities (which are clearly indicated on your balance sheet).

Current assets typically comprise:

Cash (including bank balances);
Stocks;
Debtors (customers who owe you money).

Current liabilities typically comprise:

Creditors due to be paid within one year (e.g. suppliers)
Short-term loans
Tax and VAT etc.

2.2 Advance warning of problems

Your working capital management can also assist you in identifying problems before they can impact on your business; the sooner that you identify problems, the sooner that you can take action to avoid them or minimise their impact. The following actions will help you in this regard:

Be aware of changing market conditions - look out for developments that may affect your business (e.g. new competition, interest rate changes, currency exchange rate movements). Are these having an impact on your cash flow?

Monitor your current competitors' activities - this can have a significant impact on your income. Remember that your income may reduce more quickly than you can reduce your costs.

Build a strong relationship with your bank - your effectiveness in managing your working capital will help you in this regard.

If your credit control procedures identify particular customers who consistently fail to pay (or consistently pay late) this could indicate that an individual, or a company, is in financial difficulties. A worsening payment pattern may be further evidence of such a scenario. In these circumstances, you need to act quickly and decisively by asking your accountant to study the accounts of such organisations (if available) to establish if the organisation has liquidity problems, or by instructing your solicitor to commence debt recovery proceedings.

Do not dismiss rumours you hear in relation to the financial status of an organisation or an individual that may owe you money. Take the necessary action outlined above.

2.3 Advice for seasonal businesses

Many tourism businesses generate the majority of their trade during a relatively short period, or periods, each year. Businesses in this position may have difficulties organising their finances. The cash flow planning and management process is even more relevant in these circumstances. Businesses facing significant seasonal variations in trading patterns can use the following steps to more effectively manage their cash flow:

Get paid more quickly: issue invoices promptly, chase debts and consider offering a discount for early payment. Try to get paid in advance for as much business as you possibly can.

Keep stock levels to an absolute minimum.

Ensure that your supplier payment terms are as beneficial to you as possible (e.g. negotiate an extended payment period).

Put money aside: resist the temptation to take money out of the business during your peak trading period(s). Put money aside so that you can meet your commitments during weak trading periods.

Manage your staffing levels effectively.

Market your business so that it stays active longer.

Discuss the opportunity to arrange a repayment holiday with your bank on any loans that you have (e.g. payments are staggered so that more of the loan is repaid in periods when your trading is strong).

There is no magical solution to managing cash flow. While appropriate software might simplify the process, the information must still be studied and monitored in a way that allows for adjustments to be made in the business' activities.

2.4 Building goodwill with your bank and suppliers

Finally, it pays to build good relationships with your suppliers and your bank, because you may need to draw on their goodwill in tough times. Open and honest communications are important. If you have difficulties, discuss them early rather than ignoring or trying to hide them.

Working with your suppliers

There's no point in paying suppliers before a bill is due, but paying a supplier promptly on time establishes you as a reliable customer. Make a point of building a good relationship with your key suppliers.

They can be a source of useful information about what's happening in your industry or what competitors are doing.

In tough times you can draw on the goodwill in your relationship. The supplier may be willing to take back some stock you may have over-ordered or give you extended credit terms.

Working with your bank

The best way to get on well with lenders such as the bank or finance companies is to put yourself in their shoes. What do they want from you?

> *“no surprises”*

Don't give your bank manager any surprises; make it easy for them. Keep them regularly informed on how your business is progressing.

Be consistent, reliable and honest when presenting plans and ideas. Their systems will be telling them a pretty clear story about your finances so there is no point trying to beat them at their own game; they will only 'work with you' if you 'work with them' first.

Go well-prepared. Provide the bank with all necessary documentation / reports, so they can form a positive view of you and your business.

Show your bank your projected profit and loss accounts and cash-flow forecasts. Typically, it is best to prepare these forecasts on a monthly basis for the next six months and 12 months in detail with outline figures for the next 24 or 36 months. Show most of your assumptions and a best and worst case scenario. You must 'do the numbers' and show how you arrived at the final figures.

Demonstrate you are in control of all the essentials - managing payroll, watching gross margins, paying bills and taxes as they become due.

If necessary, illustrate how the economic climate is impacting on your business, and how you plan to manage this. They need to know that you are fully aware of your situation, and are doing everything you can to make the business prosper.

Treat your bank manager as if they are on your side. If you treat them like the enemy, then that’s how they will treat you.

In short, banks want to see rounded business skills: money skills, people management skills, business systems skills, planning skills, and marketing skills. Not everyone has all these skills, so take along your accountant or marketing person if necessary to show that you have these aspects covered, or how you plan to cover them.

> *“consolidate”*

Is your borrowing balanced? Check with your bank that you have a balanced borrowing mix. Some issues to explore:

Are your borrowing arrangements appropriate for the purpose: for example, an overdraft to cover short-term cash shortages and longer-term loans to finance assets (such as equipment)?

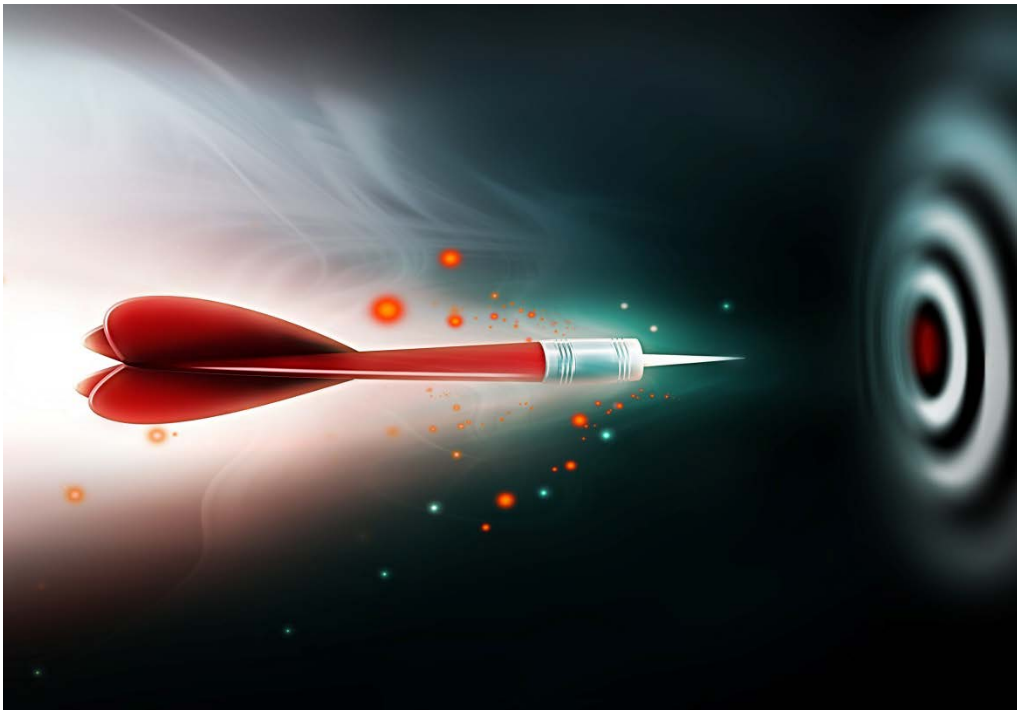
Can you consolidate loans or make different arrangements to lower repayment costs?

Are the monthly payments within the capacity of your business? If not what, can you do about it? Banks will stop lending if they know you’re over-extending. In this case you may need extra capital rather than more loans. More loans may simply be digging a deeper hole for your business.

Could you get a better deal from a different bank or lender? It’s well worth exploring what arrangements you could get elsewhere.

3. Steps you can take in your business

- ✓ Understand the importance of cash management through a cash flow forecast.
- ✓ Keep your accounts updated and produce regular reports so you make better decisions.
- ✓ Take tough decisions early before cash crunches hit your business.
- ✓ Develop efficient systems for debt collection and bill payments.
- ✓ Build good relationships with suppliers and lenders.
- ✓ Send monthly reports to the bank.
- ✓ Make sure your borrowing is balanced.
- ✓ Review all your borrowing arrangements to see if you can do better.
- ✓ Never trade while you're insolvent.



This guide has been provided to you as part of Fáilte Ireland's suite of guides and templates in the Online Business Tools resource.

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