Managing your cashflow

A business can survive for a short time without sales or profits, but not without cash. It is cash which pays the bills and allows trading to continue. And if you are growing, and extending credit to more customers, the need for cash is greater.

This briefing explains:

- The main components of cashflow.
- How to forecast and control cashflow.
- Tactics for generating more cash.
- Tips on using the right types of finance for your needs.

1 Components of cashflow

Your cashflow is the balance of all the money which flows into, and out of, your business each day. Cashflow is the actual payments of money, as opposed to what is owed by your debtors or to your creditors.

There are five main components of cashflow.

1.1 The main inflow of cash is usually the cash from **sales**.

- If you sell on credit, your cash inflow is delayed until you are actually paid. Effective credit control is essential (see **5**).
- A business which purchases on credit and is paid in cash, such as a retailer, is at a great advantage in cashflow terms.

1.2 New finance provides a one-off boost to your cashflow.

- In the past, most businesses have relied on bank overdraft finance and have reached their borrowing limits quickly. Alternative methods of funding allow you to raise more finance (see **7**).

1.3 The main outflow of cash is the money used for **expenditure**, including paying for your overheads.

- Salaries are often the largest and most inflexible cost.
- Other major costs might include stock, raw materials and any capital expenditure.
- Many businesses have to fund large amounts of work-in-progress.
  For example, a design agency might spend six months on a project before the client is prepared to be invoiced. In the meantime, the agency has to pay for all the materials and labour that go into the job.

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1.4 VAT and **tax** are regular cash outflows that tend to be paid out in large lumps. You can be penalised heavily for late payments.

- Buying significant items just before a VAT period ends, rather than at the start of the next one, can help your cashflow.

1.5 Your business needs to give its owners and financiers a **return on their investment**.

- You must pay interest — and repay capital — to lenders such as the bank.
- If there is spare cash, you — and other shareholders — may want to draw back any personal loans made to the business.

The cashflow generation of your business may be limited by what industry you are in. But to a large extent it depends on how well you run your business (see **2**–**6**).

2 Cashflow forecasting

The more warning you have of cashflow peaks and troughs, the more time you have to deal with them.

2.1 Accounting software makes it easier to prepare budgets and revenue and expenditure forecasts for the months and years ahead.

- You can quickly update your projections and make 'what if' calculations. For example, what if sales are 20 per cent below forecast for six months in a row?
- For maximum flexibility and ease of use, you can use special forecasting software.
- You could use graphics to make it easy to detect patterns and step changes.

2.2 Prepare **budgets** showing the level of sales and profits you expect to achieve, and the costs involved in doing so.

- Estimate the sales and margins, based on past experience. Don't be too optimistic in your forecasts, or you risk losing credibility. Overheads such as rent can be accurately predicted.

2.3 Prepare monthly (or weekly) **cashflow forecasts**, looking ahead one year, updated monthly.

These forecasts show what cash you expect to come in, and when (if at all) you expect to run into problems.

- Identify the major outgoings, especially those on fixed dates, such as the monthly payroll.
  Make sure you will have sufficient cash on the day, to cover each payment.
- The key is to be realistic. For your regular sales, use the established figures for sales volumes, debtor periods and bad debts. For any new products or customers, be pessimistic — expect problems and delays, and do not book a sale until the customer has paid the invoice.
- Be aware that monthly forecasts do not take into account weekly fluctuations.

2.4 Include **key indicators** that give a picture of the health (and prospects) of your business.

- For example, the volume and status of sales leads and the volume of orders.

2.5 Include the budgets and forecasts in the management accounts which you regularly send to the **bank**.

- A bank which trusts your forecasts will be more prepared to extend your borrowing facility when you need extra finance. Consider meeting with your bank on a regular basis, so they are aware of your financial situation.

3 Using the forecasts

3.1 Monitor your **actual performance** against the budget and the cashflow forecast regularly — at least once a month. Identify any problems and take immediate action.

- For example, if you know you will be short of cash in three months' time, you might reduce stocks, slow down sales growth, or agree extended credit from a major supplier for that period.
- The only way to generate cash over the long term is through retained profits.
  By comparing your performance with the budget, you can quickly judge whether sales and profits are going to plan.

3.2 Before taking on any large **financial commitment**, including major new orders, check that you will have sufficient cashflow (or other finance) to pay the costs involved.

- Create a useful yardstick by calculating how much extra working capital is required to fund each 10 per cent increase in sales.
- Restrict the growth of your business to whatever you can comfortably afford to

finance. Always keep a financial reserve available for contingencies.

3.3 Develop **red light** systems to warn you automatically if something needs querying.

- Your sales manager must let you know as early as possible if leads, orders, or sales, fall below a certain threshold, or if planned sales are delayed or a substantial customer stops buying from you.
- Your financial controller should warn you if key indicators such as profit margins, liquidity ratios and stock ratios deteriorate beyond an agreed limit.
  You also need to know about any substantial invoices which are in dispute, particularly late debts and customers exceeding their credit limits.

Build productive relationships with your key suppliers, so they are prepared to extend extra credit to you when you need it.

For businesses struggling with cashflow during the current economic downturn, HM Revenue & Customs (HMRC) have lauched a dedicated Business Payment Support Service (Tel 0845 302 1435, Mon-Fri 8am to 8pm, Sat and Sun 8am-4pm).

If you're worried about being able to meet tax, National Insuance or VAT payments, HMRC staff can review your circumstances and discuss temporary measures such as arranging for payments to be made over a longer period.

No profits and no cashflow

Here is a list of the bad business practices that cause many needless business failures.

- Taking on financial commitments before the business can afford to pay for them.
- Doing large amounts of speculative work in the hope that a customer might then purchase what you have produced.
- Overvaluing stock, work-in-progress and fixed assets such as machinery.
- Making no provision for major expenses which you know are likely to happen.
- Failing to do any cashflow forecasting, particularly if your business is struggling to grow.
- Failing to agree the details of an order with the customer, or the payment terms, which leads to a dispute.
- Failing to implement an effective credit control system, starting with credit checking prospective customers.

4 Sales and marketing

4.1 Today's sales are **tomorrow's cashflow**, so your overall aim is to keep increasing sales and profitability.

- Increasing prices may reduce sales (and therefore cashflow) in the short term.
  But this can be outweighed by its major positive impact on profitability and cash generation over the longer term.

4.2 Even profitable companies can — and do — become insolvent through **overtrading**.

This happens when you have to pay the costs you incurred fulfilling an order before you receive payment from your customer.

- To avoid this risk, you may need to delay some orders and decline others. (See **3.2**.)

4.3 When **negotiating contracts** with customers, make generating cashflow one of your primary objectives.

- You may be suprised at how easy it is to obtain deposits.
- Negotiate stage payments for contracts which will take time to complete.
  Include a timetable for the customer to pay invoices as part of this agreement.
- Agree a clear specification for the work to be completed, to minimise the chance of the customer disputing any invoices.

4.4 Improve your sales and profit margins by making sure all your work is **invoiced** for as soon as possible.

- Suppliers are often asked to perform beyond their original remit.
  It is reasonable to negotiate additional payments in these circumstances.

4.5 If you need to improve your cashflow temporarily, **adjust your sales** and marketing plans to suit.

- Bring forward sales by offering customers incentives to purchase quickly.
- Bring forward payments by offering early-payment incentives (eg discounts).
- Focus your marketing on short-term lead generation, rather than longer term objectives like brand recognition.

4.6 If you pay **sales commission**, link it to receipt of payment rather than receipt of order.

There is a double cashflow benefit:

- You delay payment of the commission.

- Your sales people will persuade your customers to pay promptly.

5 Credit control

An efficient credit control system speeds up your cash collection and reduces bad debt. It also saves time and demonstrates you run your business professionally.

5.1 Control how much **credit** you provide and to which customers. Consider using credit scoring systems and setting appropriate credit limits for all customers.

- Avoid giving any customer more credit than you could afford to lose if the sale turned into a bad debt.

5.2 Send out **invoices** immediately after you have supplied the goods or service.

- If appropriate, make a follow-up call. Confirm that all the invoice details were correct and that there will be no problem paying it by the due date.

5.3 Monitor late payments and chase them up methodically, largest debtors first.

- All businesses — and the public sector — have a legal right to charge interest on late payments.
- Using a debt collection agency, or a specialist solicitor, can be an effective method of dealing with non-payers.

6 Controlling expenditure

6.1 Shop around, so you know the prices and service which you should insist on from your suppliers.

- Consider whether you could make savings by purchasing some types of capital equipment secondhand.

6.2 Implement simple **cost control** systems across your whole business, to identify scope for cost savings. For a start, four types of easy savings can usually be found:

- Overcharging by your suppliers, such as double billing or missing discounts.
- Unnecessary costs, such as heating your premises at night.
- Excessive costs, such as high priced services that can be sourced more cheaply.
- Inefficiency, such as laborious paper-based systems which could be computerised.

6.3 If you hold stock, good **stock control** can release substantial sums of money.

- Aim to hold just enough stock to service your customers on an on-going basis. Identify seasonal peaks and troughs.
- Set a target stock-turn (eg six times a year), then monitor your performance.
- The faster your suppliers can deliver to you, the less stock you need hold.
- Consider selling off any old or obsolete stock to raise extra cash.

7 New funding

You need a solid financial base to underpin the cashflow of your business. Take full advantage of the different types of finance available.

7.1 Overdraft and loan finance may be limited by the security you can give the bank.

7.2 Factoring allows you to raise finance based on the value of outstanding invoices.

- Growing businesses in particular often find that factoring provides a more substantial and flexible source of working capital than overdrafts or loans.

7.3 Consider using **asset finance** to purchase computers, vehicles, plant and machinery.

- For example, both hire purchase and leasing allow you to spread the cost of the acquisition, with the asset itself providing the main security.

7.4 A strong financial base of **equity finance** (and directors' loans) is vital when a business starts up. Subsequent injections of equity finance can help you achieve step changes in the growth of the business.

- For example, if you need extra finance to buy another firm or open a new factory.

Consider generating cash by selling off underutilised assets and leasing them back. Before doing so check whether it will result in a profit or loss, otherwise you risk generating cashflow to the detriment of your profit and loss account.

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