



# Cash flow



**As the well worn cliché would have it – cash flow is king.**

Controlling cash flow should be a key business objective but so often it is overlooked. A business may even be profitable but still be forced to close its doors because it doesn't have the necessary cash available when needed.

This Guide is designed to help you begin to analyse your existing cash flow and plan for the future. We strongly recommend you also seek the advice of a qualified accountant with experience in your industry to assist in setting your cash flow forecast. However, before you do that, it is certainly wise to get a sense of the issues you need to address.

## Understanding cash flow

**The simplistic explanation of cash flow is the money flowing in and out of your**

**business. If you have more money coming in than you do going out, then the business will be able to operate.**

Many small businesses operate with very little cash reserves; some believe this to be a good thing. They feel that having large cash reserves sitting in the bank is a waste of resources. However, holding only a small level of cash can lead to immediate problems if you have not accurately planned your cash flow or find yourself chasing bad debts.

A business doesn't even need bad debts to get into trouble. All that is needed for a problem to arise is a lack of planning or a lack of contingency should the planning prove inaccurate.

Clearly there are a number of ways to ensure you have access to cash when you



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- Cash flow planning
- Managing your cash flow
- Getting help



need it and we will look at those later in the Guide. We will first look at understanding the basics of cash flow.

### Profits versus cash

One of the first things to understand is that profits don't automatically equal cash. In fact, you could have a highly profitable business that runs out of cash and is forced to cease trading.

For example, let's say you have just made a £30,000 sale. Your operating expenses represent 10% (£3,000) of the sale revenue and the stock cost you 50% (£15,000). That's £12,000 profit; well done.

For the sake of this example, let's now assume you offer your customers 30 days' credit. The customer pays a 10% deposit (£3,000) on receipt of the goods and will pay the final £27,000 in 30 days. However, you have paid for the stock and operating expenses up-front.

In this example, your costs are £18,000 and you have collected £3,000. Hence, you have a cash flow shortfall of £15,000 to carry for the next 30 days. What happens if you

make two more sales? On paper you would have profits of £36,000 (3 x £12,000). You would also have a cash flow shortfall of £45,000.

In this case, if the business owner didn't have access to £45,000, how could s/he afford to operate? Imagine the angst of turning away another sale because you simply couldn't afford to carry the debt. How long would it take before amenities such as the telephone and electricity were cut off because bills were not being paid?

### Understanding your operating cycle

It is fair to say the example above is relatively simplistic, but the point is valid. If you do not plan your cash flow and understand your operating cycle, you could find yourself shutting the doors even though the basics of your business are sound.

Getting a sense of your operating cycle is relatively straightforward.

First, leave all the other reasons for being in business to one side and look at the end result solely as cash. You can construct a diagram like

the one below for your business. You will notice the times when cash moves out and in and how part of this cash is reinvested as the operating cycle turns full circle and continues.

The length of the operating cycle is the key to understanding how much cash a business must have on hand (or have access to). The shorter the cycle, the fewer cash reserves are needed.

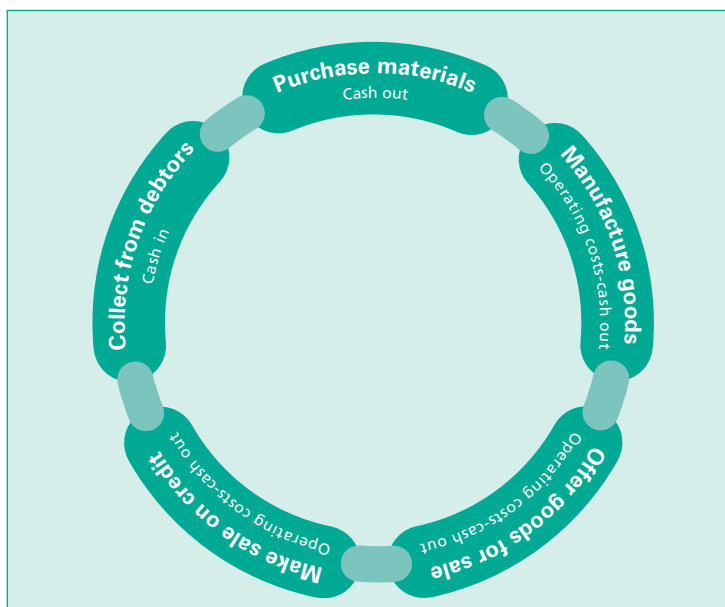
If you run short of cash at any stage in the cycle, then this can cause hold-ups. What may start as a short-term delay could be fatal to the business.

In the example we have used, if you are waiting on debtors and cannot purchase materials, manufacturing will be delayed. If the delay is significant, you may begin to run out of stock to offer for sale. The result will be a shortfall in sales, which in turn leads to less cash coming in, causing another delay in the purchase of materials and a further delay in manufacturing. As you can see, this cycle can quickly spiral out of control.

Note: In the above example we have made no provision for the cash which will leave and enter your business without impacting on the operating cycle. This could include the purchase or sale of fixed assets, directors' fees, profits distributed to shareholders and repayments on borrowings.

## Cash flow planning

**With a basic understanding of the things which will impact your cash flow, it is time to begin planning. Cash flow forecasting is usually done over a 12-month period (matching your business planning year) on a monthly**



**basis. If you feel it is necessary, you can break down your forecast on a weekly basis; however, this level of detail can make it difficult to judge the bigger picture. To maintain focus on the bigger picture you should ensure the forecast has a system for keeping track of the cumulative figures.**

Your cash flow forecast should also be a document you use regularly. It should be compiled in a way that allows you to match the actual flow of cash in and out of the business with the original projections. This will allow you to easily review your performance, take steps to rectify any problem areas and confidently project your likely cash flow into the future.

Your cash flow forecast should also include your estimated bank balances at the time.

The most common way to forecast cash flow is also the most simple: estimated cash receipts and payments.

## Forecasting

The next step is to begin to forecast sales and expenses for each month over a 12-month period. These forecasts will almost inevitably differ from the actual results. However, it is an important process and one that should be done with thorough research.

Your past performances will be a good guide, particularly if you have been relatively consistent in terms of your sales and expenses. If you are just starting out in business, forecasting your sales will be even tougher. If you have researched your market and developed a thorough business plan, you will be in a much better position to make educated assumptions. For more help, you may like to

read our Guide to **“Preparing and reviewing your business plan”**.

## Sales

This is a matter of looking at likely sales in terms of the number of units sold or the number of customers serviced. Then you need to convert the figures into pounds based on your price structure. Forecasting your sales is key to developing a sound cash flow budget. Sales are likely to be the most volatile and the area that is hardest to predict.

It is wise to be conservative with your sales forecasts but you should still aim to be within a realistic range. If sales growth is much faster than predicted, then this will be a bonus.

Once again, if you have been in business for some time, setting realistic sales forecasts should be a little easier. Look at your previous years' figures, factor in any likely changes to your business and the market, and that should give you a good basis for your forecast.

As we have already mentioned, if you are just starting out you will need to conduct thorough research.

## Cash receipts

When you begin to look at the cash coming into your business, it is important to separate the regular operational income (as defined in your operating cycle) and non-operational receipts.

### Non-operational receipts

could include a loan or other capital you have injected into the business or money received as the result of a one-off sale of an asset. This cash is not received as a result of your core operations and therefore must not be factored as cash you will receive on an on-going basis.

**Operational receipts** are directly related to the operating cycle we discussed earlier in the Guide. If you do not offer credit, and sell on a cash only basis, then your planned operating receipts will mirror your sales forecast.

If you operate on credit, then you will need to factor in two things: the percentage of total sales that are made on credit and the average length of time it takes to collect from debtors.

## Cash disbursements

Like cash receipts, you need to separate your disbursements and look at non-operational and operational disbursements separately.

### Non-operational

**disbursements** are expenses (often fixed) that the business incurs regardless of the operating cycle. These can include items such as interest repayments, lease payments, base salary and other employment entitlements, utilities, insurance and directors' fees.

Some fixed payments fall due at particular times of the year and businesses can get into difficulties if they have not planned for these. If, for example, you have a £5,000 insurance payment that falls due in April, you should factor this in for April — not just as a



**Did you know...**  
**Depreciation on equipment is not included in your cash flow statement because depreciation does not represent cash.**



payment that is covered by total revenue.

**Operational disbursements** are usually more variable and are part of the day-to-day operations of your business as you defined them earlier. Do not forget to include things such as sales commissions and marketing expenditure. In most cases your operational disbursements will also be impacted by the sales forecast. You will have to buy stock to match supply with your likely sales forecast (another reason why careful planning is needed when setting sales forecasts). Your cash flow statement should also factor in your payment terms. If you receive stock in August but payment does not fall due until September, then your cash flow forecast should see that money scheduled to be paid in September.

### Net cash flow

In simple terms, you need to summarise (yearly, on a monthly basis) the total cash receipts and the total cash disbursements. This will give you a net total figure on a monthly basis and will reveal which months will be cash flow positive and which will be cash flow negative.

This will give you a chance to plan. If you have the happy circumstance of a large amount of cash coming in, you may plan to investigate ways to re-invest and grow the business. Your net cash flow may reveal the opposite scenario. Hopefully, cash flow will only be negative in certain months and you will have a plan to cover this shortfall. If your forecast reveals more on-going problems, you will need to look at ways to increase profits or cut costs.

The good news is you have some warning, which gives you the chance to take action.

## Managing your cash flow

As every business is different, this Guide cannot look at specific methods for managing cash flow in your particular business. However, the principles remain the same and can be customised for your own circumstances.

Some of the issues we have already discussed are vital in managing your cash flow. The first is to have a plan.

Don't throw your plan in the top drawer and forget it. If you use your plan to place actual monthly results next to forecasts you will have a sense of how things are progressing. This will allow you to judge how often you need to review the plan itself. If things are going along reasonably well, you may only review the plan yearly. If you are beginning to see problem areas developing, then your review will occur more regularly.

On the other hand, you may find yourself in the situation of having cash coming in more quickly than you had anticipated. You will need to make a decision about how this cash can best be utilised. You have a number of choices, which include:

- Re-investing in growth.
- Paying off a portion of long-term debt.
- Distributing the profits to shareholders and directors.
- Investing elsewhere.
- Keeping some funds in reserve.

You should consider these options carefully and also determine if your increased cash flow is a seasonal or

more permanent occurrence. If the increase is due to seasonal factors and is unlikely to be sustained, then you will have to plan to return to more normal circumstances. In other words, don't spend money today that you may need tomorrow.

Here are some areas to examine as you look to manage your cash flow.

**Operating cycle** – One way to attack your cash flow problems is to shorten your operating cycle. To do this, you will need to look at the individual components and see which ones can become more efficient. The most obvious is to collect debts sooner. Getting money in more quickly will obviously improve your cash flow. We will discuss this in more detail in a moment.

There will also be other areas to examine. While every business is different, things to look at include:

- Reducing the level of excess stock on hand (be careful not to leave yourself short and unable to meet customer demand).
- Obtaining stock on a consignment basis, so you don't pay for it until it is sold.
- Reducing the time it takes to manufacture your product, sell your product or provide your service.
- Reducing costs. This will obviously increase your cash in hand and your overall profits. You should carefully consider all expenditure but make sure you cut areas that will not negatively impact the quality of your product and service standards.

### Accepting credit cards –

These are particularly important for businesses that

have a large number of small transactions. It eliminates much of the paper work involved and also allows you to offer the advantage of “instant credit”. The other advantage to you is the elimination of much of the cost and risk associated with trade debtors. Provided you have followed the process correctly, the bank is the one assuming the risk for this debt.

If you have accessed your card facility from a bank, then you should be able to deposit your receipts daily and your account is immediately credited.

Specialist credit card operators offer similar facilities; however, they do not credit your current account as a bank would. Instead you submit the vouchers and then wait for payment.

**Trade debtors** – The time it takes to collect on your invoices can be vital to cash flow survival. As we have already mentioned, if you operate on a cash-only basis then you will not have any trade debtors. However, for many businesses this is simply not possible and insisting on payment up-front could cost market share.

Remember, there is an opportunity cost to trade debtors. The money tied up with trade debtors belongs to your business. It could be much more productively invested elsewhere and, if you are operating an overdraft, trade debtors may also cost you interest.

That having been said, offering credit is a proven way of increasing sales volume. However, you need

to be careful how this is done.

First you need to determine your average collection period. This is the time it takes, on average, to receive payment. If the average collection period is increasing, then you will be increasing your business investment in trade debtors and lengthening your operating cycle.

Next, if you choose to increase the credit terms, you may have an increase in trade debtors on two fronts. The offer of extended terms will obviously lengthen your average repayment period and it may also increase the number of sales. This could lead you to having more people owing more money for a longer period.

This is not to say that offering credit is bad business. Far from it; many retailers have used the practice successfully for years. However, you must be aware of the risks and measure the impact of the increased payment terms on your cash flow forecasts.

**Collecting debt** – You should be clear about your payment terms up-front to ensure there is no misunderstanding when you begin to chase the account. It is also sensible to ensure your customer is good for the credit you are offering.

The common view is that the best time to chase an account is the moment it falls due, with the assumption that the

longer a debt remains unpaid, the more likely it is that it won't be paid. Yet many small businesses wait for much longer periods to pursue debt.

Perhaps these business owners are embarrassed about chasing the account; they may feel they could embarrass the customer or even lose the customer. Remember, this is your money and your business; asking to be paid for services rendered is not something to be embarrassed about.

Many believe the secret is in the system used. If the reminder is timely, friendly and in the spirit of a business relationship, then it will be more successful in terms of both obtaining payment and maintaining the relationship. A letter that is needlessly rude, or sent out incorrectly, (when the account is not actually overdue) may indeed alienate the customer.

Some businesses use the “carrot and stick” method, providing discounts for accounts paid on time and penalties for late payments.

This can be as simple as a 10% discount for on time payment and interest charged when the account falls past due. You should seek professional advice and be careful regarding this type of system.

Depending on the level of penalty you impose and how this has been communicated,



### Did you know...

**The fees associated with credit cards are negotiable and you should shop around for the facility that best suits your business.**



in some circumstances you could be breaking the law. Conversely, offering discounts could reduce profits substantially just to collect money that is essentially yours anyway. We will discuss getting professional accountancy advice a little later.

**Debtor finance** – There are a number of systems available but, in short, debtor finance is where a lender provides cash advances against your outstanding invoices. This can be done without your customer being aware of this facility. You can also turn over your entire ledger administration and debt collection to the lender, so this part of your business management is handled for you.

Whatever system you use, you must ensure it is both cost effective and prudent for your business.

**Industry average** – You may wish to consider how other businesses in your industry treat credit. This is not to say you have to operate as a mirror image of your competitors. However, from both a marketing and business perspective, it can be dangerous to fall too far outside the industry standard.

**Progress payments** – You may be able to arrange to have payments made at different stages of your operating cycle. This is particularly effective for contractors providing a service. You arrange for a certain level of funds to be paid prior to the job, further funds released during the work and the remainder paid on completion.

**Ex-factory sales** – If you are a manufacturer, holding a “direct from the factory sale” can generate immediate cash.

However, you must be careful this does not damage your relationship with retailers who currently stock your product.

**Leasing** – Instead of purchasing equipment, leasing can free substantial amounts of cash. However, you should carefully consider the additional cost of the finance and how this may impact on your overall profit margin.

**Increase profits** – While we know this is easier said than done, areas to examine are obviously your price structure, costs and total sales. If you can sell the same products and services at greater profit, you will raise the level of funds available. It won't speed up the collection of these funds but there will be more left over once you have collected. If you are looking to increase your profits, you should also understand the impact this will have on your sales volume.

If you can increase your sales volume this should also positively impact on your cash flow, provided you have addressed any difficulties in your operating cycle.

**Reduce sales** – This would appear to be in direct conflict with the point above and to suggest deliberately reducing sales sounds very negative. Indeed, it is not the first step we would suggest and many small businesses cannot even contemplate doing so.

However, as we discussed earlier in the Guide, in certain circumstances it is possible that increasing sales will further burden your cash flow. If you are in this situation, you have a number of long-term issues that need to be addressed; while doing so, you will need to consider your sales volume very carefully.

The long-term answer is to review your operating cycle and solve the issues which are leading to your cash flow problems, prior to growing your sales volume.

**Extend the trading terms with your suppliers** – One way to improve your operational cash flow is to take longer to pay your suppliers. If you pay your suppliers cash on delivery, then wait to make a sale and wait a further 30 days to collect from your customers, you will clearly have some cash flow issues. If your turnover and profit margin is such that this is becoming a problem, speak to your suppliers. Some areas to consider include:

- Creating credit.
- Extending your existing credit terms.
- Taking stock on consignment (this means you don't pay for it until it sells).

**Finance** – Do you know if your business finance is costing you more than it should? Do you know if the type of finance product you are receiving is the best possible for your particular business?

These questions can appear difficult to answer but, at the very least, your business banker should clearly understand your particular needs and be able to explain how they are being serviced by the products recommended.

**Short-term finance** is used to manage seasonal issues such as the need for more stock. This is usually done through an overdraft or loan. This sort of finance should be self-liquidating. This means that the moment the operating cycle goes back to normal you have the cash to immediately clear the overdraft or repay the loan.



## Did you know...

**If you are experiencing cash flow problems, or your plan reveals that you will in the future, you should speak to your suppliers immediately. It is much better to negotiate terms than simply stretch payments past the previously agreed limits, which can negatively impact on your credit reputation.**

It is also wise to plan ahead. You don't want to be in the situation of frantically calling lenders trying to organise short-term finance due to an unforeseen problem. The rush and panic may lead you to accept finance at less than ideal terms.

From the lender's perspective the fact that you need the money urgently due to an unforeseen problem is also a concern. This shows that you have not adequately planned. Instead, it would be much better to organise access to funds well in advance.

If your cash flow forecast shows a need to alter your arrangement with the lender, then doing so in advance with a comprehensive plan will give you a much better chance of accessing funds on the best possible terms.

**Long-term finance** should not be used to attack short-term operational cash flow problems. Long-term finance is normally used for the purchase of fixed assets such as new equipment or office premises. You should be careful to ensure any purchase is justified from a business perspective. The lender will also want details of your business plan to ensure the investment is sound. You may also choose to invest more of your own money into the business or seek finance

by releasing equity in the business. This can be done by offering a share of the business to new partners in exchange for funds. For more information on these options, you may like to read our Guide to **"Preparing a case for finance"**.

**The risks of finance** – You should carefully consider the risks attached to seeking finance. It is fair to say that the greater the borrowings the greater the financial leverage and, in the right circumstances, this can have a positive impact on the return on your own investment. However, if sales fall, a business that is heavily in debt will drop below its break-even point more quickly than a business with minimal borrowings.

Therefore you must understand the costs and benefits of borrowing. To benefit, the return on the borrowed money must clearly outweigh the cost in terms of the interest rate. You will also need to understand how

stable that return will be. If it is likely to be consistent in the future, then the risk of borrowing will be lower. Remember, debt has to be repaid and, if you fall behind in your repayments, in some circumstances you could lose control of your business.

You may want to consider borrowing as little as possible. This is not to say you should stifle your business by not having access to necessary funds, however why pay interest on a greater amount than is necessary? Perhaps more importantly, if you have reached your maximum level of borrowing you won't have room to move later if you need further finance.

**Cash reserves** – Are your cash reserves working as hard as you are? Many people believe having cash on hand earning minimal interest does not make a great contribution to your bottom line profits. Ideally, you will have the bare minimum in reserve to cover your bills as they come to hand. If you feel you need to keep large cash reserves, this could be a sign of other problems with your operating cycle. There may also be many more cost effective alternatives.

Let's look at a hypothetical example. For the sake of this exercise, we will assume money invested in your



## Did you know...

**The lending institution will want to see your cash flow forecast and your business plan. These documents will display your understanding of your business, the market and your ability to make realistic assumptions based on sound research.**



business generates a 20% return. Let's say the money you have in your business bank account generates 2% return. You would be 18% better off investing this money in the business. However, how do you gain access to funds when you need them if you have no cash reserves and something goes wrong with your operating cycle?

For some businesses the answer is an overdraft facility from your lender. To take our example the next step, if your overdraft carries an interest rate of 4% you will still be 16% better off using the overdraft to finance business activities than you would by limiting your activities due to a temporary cash flow restraint.

## Getting help

**Given how important planning your cash flow is and the major role it can play in the survival of your business, you should seek help from a suitably qualified accountant, financial or business adviser.**

In choosing the professional to assist you with your cash flow planning and overall financial forecasts, you may like to use

the following questions as a guide:

- What is the fee per hour and who will do the work? (junior or partner, etc).
- Will you hold regular meetings to ensure things are going to plan?
- What experience do you have with my type of business?
- What processes and protocols can you offer to assist me in getting the financial affairs of the business in order?
- Can you supply references from other clients?
- Is there a charge for telephoning for further advice?
- Do you offer services such as tax advice and on-going financial planning?

When you have decided on your accountant, insist on getting important advice in writing, so there is no chance of a misunderstanding.

**What to do if you're in trouble** – If your business has hit a cash flow crisis, don't panic. Many businesses have traded out of what appeared to be hopeless situations.

What you may need now is specialist advice. In this case, your existing accountant may not necessarily be the right person for the job. You may need an accountant who

specialises in insolvency problems. If you are hoping your business can trade out of the situation and survive, you don't want an accountant who specialises in winding up companies and selling off the assets; you want someone who can help get your business back on its feet.

Make sure you are dealing with a person who has experience in situations like your own. Also, be prepared; you will waste time and money if you turn up to the adviser with nothing more than a profit and loss statement. Prepare full details of your creditors and debtors and also prioritise your goals. You may want to save the business — but not at the expense of the family home. Be prepared to tell the adviser exactly what you want to achieve and what you are prepared to risk.

**Note: You should also be aware that trading while knowingly insolvent is against the law and can lead to harsh penalties for business owners, directors and executives. You should seek legal advice well in advance if you feel your company is heading for major financial trouble.**

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