

# UNDERSTANDING CASHFLOW

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## **CASH THE LIFE BLOOD OF BUSINESS**

As the economic outlook continues to deteriorate cashflow management will

determine the firms that will survive the downturn and those that will not.

Controlling the flow of funds in and out of a company can be difficult without appropriate systems being in place and effective controls that ensure timely and accurate information is produced. Often decisions are made to spend money based on misunderstandings of the company's true financial position and this can have a devastating effect on the financial health of a firm. The key to avoiding this predicament is to be aware of the pitfalls that arise in relation to cash management and the appropriate safeguards to put in place.

The main tool used to manage the cashflow of a business is a cashflow forecast report.

This report in its most basic form is a list of all the payments due out and all the receipts due in during a period, usually twelve months. The purpose of the cashflow is to anticipate what funds are going to be spent and received and the timing of same.

The cashflow forecast should be produced in conjunction with a forecast profit & loss account and a forecast balance sheet, this will ensure greater accuracy as the three reports are interlinked.

## **PITFALLS**



### **Misunderstanding the difference between cash and profits**

Profits are calculated by adhering to accounting rules. They are subject to opinion, interpretation or an accountant's judgement. Cash is easier to understand than profit, either you have cash in the bank or you don't. When comparing a profit and loss account to a cashflow forecast the main differences in how the figures are presented will relate to VAT, timing and how capital expenditure is recorded. In order to make effective spending decisions a business needs to have information .....

### **Overtrading**

Overtrading refers to a situation where a company is taking on too much business and cannot afford to fund it. An example of this is when a company builds up its stocks in anticipation of selling them onto its customers. If sales do not increase at a corresponding rate to purchasing then creditors will increase i.e. This will mean that the company will be paying out for stocks and not be receiving sales revenue to cover the payments to suppliers, this in turn leads to stock piling.

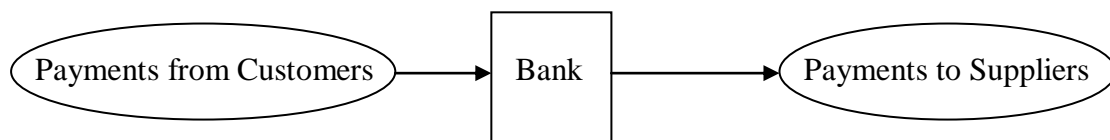
A similar situation can occur where a company invests in fixed assets and tries to fund this increased capital expenditure through its working capital i.e. the cash it needs to pay for its day to day expenses. An example of this would be the purchase of a new computer system for €20k, this could use up all the available funds so that there is no cash left for payroll at the end of that particular month



### **Failure to communicate credit terms**

All companies are eager to increase sales, even more so when they have just recently commenced trading. This can be done by not being as stringent with credit checks on new customers and not emphasising the credit terms of trading. Even a blue chip company can cause problems by delaying payment. It is important to discuss payment terms at the beginning of a trading relationship with a customer so that no grey areas exist.

### **Lack of knowledge of the cash cycle**



The cash cycle refers to the loop in which cash is circulated to and from the bank account as a result of paying creditors and receiving remittances from debtors. Some industries' cash cycles are longer than others. A property developer will have to invest a considerable amount of cash in a property deal and may have to wait many months before any receipt of cash will materialise, whereas a shopkeeper will be paid instantly for his goods and pay his suppliers up to ninety days later. When planning the finances of a business it is important to be familiar with the cash cycle of the

industry as this will have a major impact on how the company manages its cashflow.

Debtors days and creditors days can be calculated using the formula detailed below.

The figures to slot into the formula can be found in the balance sheet. When the credit days given by suppliers and taken by customers is identified it needs to be viewed in the context of the industry in which the company operates. The most important issue relating to the figures for debtor days and creditors days is the trend over a period of time. If debtor days are increasing this can increase the cash cycle and cause problems for the business.

Debtor Days = (trade debtors / credit sales) x 365 days

Creditor Days = (trade creditors / credit purchases) x 365 days

### **Hidden liabilities**

A familiar trap that an entrepreneur can easily fall into, especially during the early years of a business, is to look at the bank balance and assume that all the money shown is available to spend. This is not always the case. If a bank balance is in credit to the tune of €5k it is important to know what it comprises of. Some part of that balance maybe comprise of VAT or PAYE . These prior charge items need to be identified and included on the cashflow forecast.



## **SAFEGUARDS**

### **Regular monitoring of cashflow**

A cashflow forecast should be produced on a regular basis and used to compare forecast figures to actual figures. Because the cashflow is a forward viewing document anticipating the likely cash movements of a company the business should be able to identify in advance any problems that appear likely to occur. This proactive approach contributes to the smooth management of the company's finances.

Another

### **Sufficient funding**

A general rule of thumb to ensure that a company has sufficient funding is to have enough cash on account to cover at least two months worth of overheads. This assumes that the company's supplier payments and customer receipts are relatively evenly matched. This level of funding will create a buffer for periods of lower than expected sales and months where customers are slow to pay. Many companies may not be fortunate enough to have this amount of funds available and if this is the case it may be worthwhile re-evaluating the company's funding. If a company does not have sufficient financial reserves in place it is putting itself in a particularly difficult situation and the cracks will appear when the lean times arrive. Many companies suffer from under funding which impacts negatively on growth and causes ongoing stress for management as they continually have to operate in survival mode.

### **Effective credit control**

Credit control is the function of ensuring that your customers pay promptly and that any queries in relation to their sales invoices are dealt with quickly. Clear

communication with the customer is vital and there should be procedures in place to ensure that the customer has agreed to the company's payment terms, preferably in writing. The credit control procedures should make sure that customers adhere to the credit terms and do not exceed their credit limits. By far the most effective way of securing payment is to telephone the customer and request settlement. The longer a debt is due the more difficult it is to collect, therefore a close eye needs to be kept on which customers debts are outstanding the longest.

## **SOURCES OF HELP**

### **Yourself**

The more you know about cash management the better. Read up on the subject. Set up a basic cashflow and play around with the figures.

### **Your accountant**

If you have an accountant you should seek his/her advice concerning the set up of procedures and templates to monitor cashflow and also on suitable software to facilitate the process.

### **Your bank manager**

The earlier you anticipate a problem with your cashflow the more likely your bank manager will be prepared to help. If you go to him/her at the last minute when you are in a crisis it will reflect poorly on how you run your company. If you go to your bank manager and request an overdraft for three months hence and can show him/her why you need it he/she will be more inclined to accommodate your request.

### **Your local City and County Enterprise Board**

There are 35 CEBs that offer advice to entrepreneurs for companies pre or post trading. A specialist consultant can be allocated to a company for up to twenty hours free of charge.

Proper cash management instils confidence in your suppliers and your bank manager.

It makes running a business more controlled and therefore less stressful. Cashflow management is one major internal discipline that every company should have.



## **APPENDIX A**



### **HOW TO GET OUT OF THE RED**

If the bank balance of the company is at its overdraft limit there are several areas that can be looked at with a view to reducing it. These measures can be split into short and medium term actions.

#### **Short Term**

- Identify items of expenditure that can be deferred – e.g. capital expenditure
- Contact your largest suppliers and request extended credit terms
- Request deposit payments from new customers
- Request payments on account from slow paying customers
- Use staged payments for major overheads e.g. insurance

#### **Medium Term**

- Renegotiate credit terms with your suppliers
- Obtain a short term loan
- Factor out the sales ledger
- Restructure the overhead base