Friday, September 26, 2008

Handling the all-important cash flow in business

Denver Business Journal - by Michael Higgins and Darrell Mullis

Most owners and managers are stumped when asked, "Which of the following is most important to the daily operations of a business — sales, profit or cash?"

Obviously, all three are important. But like food for your body, you can operate without sales for awhile and without profits for a long time. But a business can't run for one day without cash. You may have heard the adage "cash is king," but cash management has been on the business radar screen for only the past 25 years.

Business accounting began using the balance sheet and double-entry bookkeeping as early as the 1300s, and quickly followed with the income statement. However, it wasn't until the mid-1980s that U.S. companies were required to provide a "statement of cash flows." This occurred only after several large and profitable companies, most notably retailer W.T. Grant, went bankrupt because they ran out of cash.

Except in the executive suite, you're likely to get blank stares if you ask managers, "What do you have to manage to improve cash flow?"

Get ready: We're going to dramatically improve your cash flow understanding in the next two paragraphs.

First, we have to clear up a common misunderstanding: Many people think that profit and cash are the same. They're not. Cash is the green stuff that's in your wallet or bank account. Profit is the difference between what it cost your company to provide its goods or services, and the price you charged customers to buy them. Making a profit puts you in the black. You can pay bills only with cash.

Second, good cash management means knowing there's not one but three types of cash flow — operating, investing and financing cash.

• Operating cash is the money collected or spent in day-to-day operations of your business.

• Investing cash flow occurs when you buy or sell buildings or equipment, buy another company, sell part of your company, or invest in stocks, bonds, etc.

• Financing cash is money received from or paid to stockholders (equity capital) and banks for loans (debt capital).

Which do you think is the most critical cash flow for your business? It's operating cash flow. Managing it is critical for day-to-day operating managers.

Businesses have to begin with financing capital (cash) because at first, they lack any operating cash. But no business can survive for long on invested or borrowed money. The company must generate positive operating cash flow. This begins when the marketplace starts buying your company's product or service and agrees to pay you for it. To sustain and improve operating cash, you must manage three major items.

• **Accounts receivable** — this represents money customers owe you for goods or services already provided. From the day your company sends an invoice until the customer pays that bill, your money is in your customer's bank account.

There's a measure called days sales outstanding (DSO), which tells you the average number of days it takes your company to collect cash from customers. Good cash management means reducing this time to a reasonable amount of days.

• **Inventory** — this applies to companies that sell physical products. Finished goods and work in production include raw materials plus the cost of labor, electricity, etc. that go into producing them. Eventually, every part of your inventory needs to be paid for with cash.

Think of the inventory sitting in your store or warehouse as shelves or pallets of cash that are unavailable for you to use. The only way to get to that cash is to sell the inventory. A key measure in managing inventory is days on hand (DOH) — how many days you could supply customers with what's currently in stock. The question is: How much inventory is needed to adequately supply customers? Every day of inventory in excess of that amount is just tying up or wasting cash.

Having extra inventory on hand poses additional risks. It may become obsolete because customers stop buying it; it can be damaged in storage or stolen by employees or customers, and it costs additional cash just to store and maintain it.

• **Accounts payable** — these represent things suppliers have sold you on credit and are the opposite of accounts receivable. Here, your suppliers are acting as a bank to you, so accounts payable provide some balance to accounts receivable. The key measure is days payable outstanding (DPO) — the average number of days you take to pay your

suppliers. Ideally, you want to be collecting money from customers (receivables) faster than you're paying vendors (payables).

What strategies can you employ to improve your DSO, DOH and DPO? Your primary strategy is to teach your people to make better financial decisions.

You can improve DSO quickly by teaching:

• Salespeople the importance of reducing the time they give your customers to pay their bills.

• Field personnel to get in their time-sheets ASAP so the accounting department can send out invoices.

To improve DOH, teach your operating managers:

• That inventory is tied-up cash, pure and simple.

• To partner with the sales department to make the right things at the right time, and with the finance department to make the best decisions on buying material and scheduling labor.

To improve DPO, teach the finance department:

• To stay on top of overdue bills.

• To set up vendor accounts with favorable payment terms — and stick to the terms.

Good luck, and May the cash be with you.

Michael Higgins can be reached at mhiggins@fdmnow.com

All contents of this site © American City Business Journals Inc. All rights reserved.