

Finance for the non-financial manager

A Guest Article by Paul Lower
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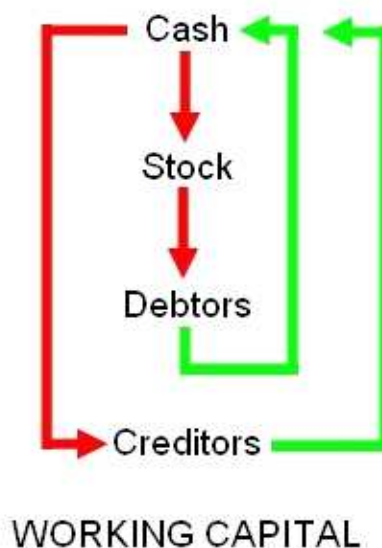
How to control working capital and cash flow

The banking crisis, credit crunch and global recession have provided the backdrop for some of the most turbulent economic conditions that have been seen for generations. Many firms have come to appreciate why “cash is king” is often quoted as the first rule of business.

Any additional cash funds needed for business traditionally came from two sources: short-term finance in the form of bank overdrafts, and active working capital management. For many companies, loans and overdrafts have either dried up or become too expensive. This has made the role of effective working capital control even more important.

The three key components of working capital

Working capital is the name for the components involved in the trading activity of a business. For a company that sells products rather than services, the three components of working capital are represented in the diagram below.



Cash funds are first converted into stock; when stock is sold to customers on credit terms the stock is then converted into debtors. When the customers settle their invoices, debtors are converted back into cash funds. This circular process is sometimes referred to as the “business cycle” or “trade cycle”. If the company can buy stock and other goods and services on credit terms from its own

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suppliers, this represents a temporary source of additional funds in the form of creditors.

Cash flow is sometimes called the “lifeblood” of business and that’s a good way of thinking about how the cash flows around inside a company. The circular flow between stock, debtors and cash must happen as quickly and smoothly as possible to guarantee the health of the company. It is essential that each of the three key components is maintained at an optimum level to avoid needlessly tying up funds and reducing cash flow.

Key component 1: Stock

If your company sells physical products, stock will be the first key component of working capital. Investing funds in stock means that customers can be offered a wide choice of products and can be supplied quickly. This can often make the difference between you or one of your competitors making the sale; holding stock is expensive, but a “stock out” could prove much more expensive if you lose a sale or, worse still, a customer.

However, many businesses are not good at managing stock. They carry high levels of surplus stock that will take years to sell and hold on to old and obsolete stock that will probably never sell. These slow-moving stocks tie up cash funds and they also take up expensive storage space.

Managing stock levels

Selling off surplus and obsolete stocks can be a good way to generate extra cash flow. The best way to identify surplus stocks is to calculate how long it will take to sell the stock held for each item. For example, if a company sells 5 widgets each month and there are 200 widgets in stock, then it is going to take 40 months to sell them. Although it often helps to buy large quantities in order to get the best unit price, the impact on working capital requirements must also be taken into account when cash funds are tight.

Generally speaking, when stock levels go beyond the equivalent of 12 months’ sales the excess stock must be thought of as overstocks or obsolete stocks. When cash flow is tight, steps must be taken to liquidate these excess stocks without damaging sales of normal product.

Surplus stocks can sometimes be exported at a reduced price without damaging domestic sales. Alternatively, slow-moving or obsolete stock might be offered at a special price to existing customers but linked to additional purchases of current stock items.

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This is not just fine tuning. Let's take the example of a small business whose annual cost of goods sold is £1.2 million. If this company could reduce its overall level of stock by just one month's sales then this would generate an additional £100,000 of cash flow!

Key component 2: Debtors

The second component of working capital is debtors, or what the Americans call receivables. For professional service companies, and many other companies, debtors are the largest component of working capital.

Giving generous credit terms to your customers makes it easy for them to do business with you. In industry sectors where this is an accepted part of doing business, offering better payment terms than your competitors can often be the deal clincher. But these "free loans" to customers are expensive: apart from the cash funds and the financing cost, there are also significant costs involved in running the credit sales department.

It is essential that the sales manager responsible for negotiating terms with customers is aware of the true cost of giving away an additional ten days' credit to sweeten a deal.

Managing debtors

It's quite frightening how much cash can get tied up in debtors. Let's say a company has a customer to whom it sells £100,000 of goods or services every month on 60 day credit terms. The "free loan" provided by the company to the customer will (after taking into account VAT) tie up £235,000 of cash funds.

In practice, even greater levels of cash funding are needed because debtors are frequently badly managed: customers are allowed to take longer than they should to pay and old debts are left to go uncollected.

Have a good credit manager

A good credit manager and sound policies for accepting credit customers, for invoicing and for collecting debts is the starting point for effective receivables control. A monthly Aged Debtors Analysis is the best way to monitor and control the "free loans" to customers. This report shows how long each customer is taking to pay their invoices and highlights where action is needed to chase up any overdue amounts.

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Smaller companies are often tempted to leave this job to a busy bookkeeper, but an effective credit manager will be much better at collecting overdue payments and will very quickly cover their own salary costs.

Consider invoice factoring

Invoice factoring can be a good way for some small and medium sized companies to use their debtors to improve cash flow. Invoice factors are specialist financial institutions that will, subject to certain preconditions, take over the entire credit management of a company.

The factoring company will invoice and collect all amounts due and will also take responsibility for any bad debts. The invoice factor will often pay a cash advance on commencement of the arrangement and will make regular payments to the company each month thereafter.

The factoring company charges a fee for the service but, for smaller companies, this might be more cost effective than running their own credit management department.

Key component 3: Creditors

The third component of working capital is creditors: what the company owes to those suppliers who have allowed time to pay their invoices. When cash flow gets tight it can be very tempting to take longer to pay these creditors. But this is a very easy way to damage valuable business relationships and, in the worst case, cause disruption to the business if a key supplier such as the website host or IT service provider decides to withdraw its services.

Communicate with your creditors

If there are cash flow problems, the best approach is to speak to suppliers as soon as possible, keep them informed and keep them "on side". This is particularly important with Her Majesty's Revenue & Customs. HMRC is being more flexible under the current crisis, but it is still essential that it is kept informed of any payment problems.

For many companies with loans and overdrafts, the bank is their key creditor. It is absolutely essential to maintain communications with the bank contact manager at all times. Any reports required by the bank should be supplied before the deadline, and all measures subject to loan covenants should be regularly checked well in advance to make sure they are not being breached.

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If this does happen, it should be discussed with the bank as soon as there is full understanding of how the situation has arisen and when there is a plan of action of how to deal with the situation.

Managing cash flow

One of the best ways of keeping control of working capital and cash flow is to use a simple monthly cash flow forecast. Most companies are able to calculate fairly easily how much cash will be collected and paid out in the course of the next 30 days. The same calculation for the two subsequent months can often be made by focusing on the important items and making a few assumptions.

Cash forecasting has two major benefits: it focuses attention on the important things that affect cash flow, and provides an opportunity to plan corrective action. It also makes it much less likely that there will be any nasty surprises coming out of the blue!

Paul Lower
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If you would like more information on any of the points covered in this Guest Article, please contact **TCii** on **020 7099 2621**.