

Cash Flow is the key

A good understanding of cash flow is a key element of successfully running a business. However, many entrepreneurs with successful businesses sometimes fail to understand some basic concepts regarding cash flow, particularly if they have not had financial training.

Cash flow is the blood stream of your business and as such understanding it well may help you manage your business more effectively.

Working capital

Working capital is the resources that a business needs to allow it to meet its operational demands for cash. These resources allow the business to meet its obligation towards its creditors and fund its operational costs whilst waiting for the payment to be collected from the clients.

If this working capital is not positive the business will simply be unable to operate. Your current assets (stock, debtors and cash) should always exceed your current liabilities (trade creditors and other short term obligations). Maintaining the correct balance in your current assets and liabilities will invariably lead to a healthy business. This will sometimes require an external injection of funds into the business.

Profit ≠ Cash

Businesses need to generate both profits and positive cash flows to survive. Profit alone is not enough to allow the business to thrive. In fact, profitable businesses can go bankrupt if they fail to satisfy their cash needs.

It is not uncommon for entrepreneurs to express surprise when they see a profit on the bottom line, yet they cannot afford to pay the tax bill that will arise from such result. How is it possible, where has the money gone? Profit may not be available for distribution as it may be trapped in areas such as stock, debtors or decreasing creditors.

Debtors

Effective collection of debtors should be one of the prime objectives of your business; there is no point in increasing your sales if the business is failing to collect payments in the appropriate manner. Furthermore, if your business has high levels of debtors you may well find difficulties when the time comes to make the quarterly VAT and tax payments. The credit terms you offer your clients will depend on both your industry and your business style. However, to speed up your debt collection you can:

- Start with formalising the credit terms of your company. The more standard your terms are the easier it will be to manage debtors
- Clarify your credit terms with your customers when the order is placed or the services are agreed
- Consider the need to request payments on account in advance either partly or totally
- Use a direct debit system
- Ensure you have an effective internal control system to keep track of your debtor balances. A proper accounting system is of course recommended, but if you don't have one, you can keep good track with manual filing systems
- Use alternative documents to request payments prior to issuing your invoices (delivery notes, statements of account, purchase orders). Remember that as soon as you issue your invoice the transaction has been formalised from a tax point of view so the VAT will be payable and the profit recognised
- Stick to your terms. Don't be embarrassed to request payment when due. Formalise a standard system of reminders which is professional yet polite

Stock

Stock can consist of goods, for manufacturing or retail companies, or indeed work in progress for service businesses. In either case the amount of stock should be kept to a minimum to minimise the resources tied up on this business element.

To minimise stock levels for goods you can:

- Have good stock control systems that allow you to identify and manage your stock levels, the slicker your system the more likely it will be that you can operate a just-in-time system
- Choose your suppliers carefully to ensure they can deliver promptly

To minimise work in progress on your books you can:

- Have an effective work-in-progress system to allow you to identify which jobs you have not yet invoiced for
- Invoice promptly. Forgotten un-invoiced work can place considerable strain on a busy business

Creditors

Maintaining a good relationship with your creditors will help your business as you are dependant on them. However, if the balance between the amounts your clients owe you and what you owe your creditors is not right you will not be able to pay your bills. Consequently, whilst aiming to settle creditor accounts promptly, do use their credit period to delay payment as long as possible.

If you need to delay payment or break credit terms, do talk to your creditors as it is important that relations are not damaged. Warning creditors that payments may be delayed is better than waiting for an embarrassing call.

Forecasts

If you are able to anticipate the cash needs of your business, you will be able to take the necessary steps in advance to meet those needs. Therefore you should aim to:

- Be aware of both your average monthly income and expenditure but more importantly your ad-hoc and annual costs
- Make the time to set some forecast, either yearly or every six months
- Monitor progress in relation to your forecasts
- React in advance to needs. Don't wait until you run out of cash

Bank accounts

If you deal with client money or tend to have considerable amounts of VAT payable at the quarter end, keep more than one bank account: one for the business basic transactions and another for the funds that need to be set aside.

Beware of growth

When a business is growing its cash needs increase as the amount of resources required as working capital also rise. Sometimes, cash shortages can be disguised by growth as the new sales allow the business to satisfy its creditor obligations. However, if the trend changes, and the business is no longer growing (or indeed decreases) then these shortages that were not noticed before become apparent. This may lead to an inability to meet payments. For this reason it is essential to monitor both profit and cash flow on a regular basis.