FINANCIAL MANAGEMENT

Cash is king

The ins and outs of mastering cash flow. By Steven Delport

A business goes bankrupt when it's unable to meet its obligations when payment is due. Bankruptcy is caused by a shortage of cash which is not necessarily related to profitability. Profitable businesses can go bankrupt too, while companies making losses can have substantial cash. So, how do we improve cash flow?

Profit versus cash flow

Here are two equations to always keep in mind. Sales (selling) less expenses (purchases) = profit or loss, while, cash receipts less cash payments = cash inflow or outflow.

The difference between a profit or loss and a cash inflow or outflow is essentially a difference in timing. Here's a simple example to illustrate.

If we buy a drink for R7 and sell it for R10 we have made a profit of R3. If this drink was sold for cash we would receive payment of R10 from the buyer. However, if the drink was sold on credit or account we would not receive any payment at the time of the sale and would hopefully receive payment in the future. In both cases the profit is the same (R3), but the timing of the receipt of cash is different.

Sources or uses of cash

There are four sources or uses of cash.

- **Operations**

Cash inflow or outflow from normal business operations or trading activities.

- **Changes in working capital**

Working capital consists of current assets (stock/inventory and debtors/accounts receivable) and current liabilities (creditors/accounts payable). An increase in stock and payables is an outflow/use of cash. An increase in receivables is an inflow/source of cash. When stock is paid for it affects cash flow, but it only affects profits when sold.

- **Investing activities**

Here we refer to capital expenditure and investments in operational fixed assets (motor vehicles, equipment, machinery, etc). Investing activities affect cash flow when paid for, but are charged against profits over the useful life of the asset in the form of depreciation. When assets are bought there is an outflow of cash, when the assets are sold there is an inflow.

- **Financing activities**

Finance is typically sourced from a combination of shareholder equity and loans. Raising equity or loans will result in an inflow of cash, while the repayment of equity (including dividends) and loans (both capital and interest) will result in an outflow of cash.

Improving cash flow

Improve cash flow by: reducing costs and expenses (if costs are reduced you pay less and use less cash); reducing fixed assets and working capital (opens a source of cash and improves cash flow); and improving processes and efficiencies.

Improvement in the management of working capital is critical to any business. The objective is to reduce the cash cycle.

Cash cycle (days) = Inventory (days) + Receivable (days) − Payable (days)

Reducing the cash cycle is achieved by reducing inventory/stock (reducing the time between buying and selling inventory); reducing receivables/debtor (reducing the time between selling inventory and receiving payment for the sale); and extending payables/creditor (and extending the time between purchasing and paying for the purchased inventory).

Understanding inventory management

Here we want to reduce the amount of inventory and the cost of inventory. Inventory costs consist of carrying or storage costs, and ordering and shortage costs.

There is an inverse relationship between these costs. Carrying costs increase with higher inventory levels, while ordering/shortage costs decline. The goal of inventory management is to minimise the sum of these two costs.

In manufacturing, companies reducing the production cycle will also help to reduce inventory levels since the time between purchasing the raw materials and selling the finished product will be shorter.

Managing inventory

Divide all of your inventory items into three or more groups in terms of:

- Inventory value
- Order lead time
- Consequences of shortages
- Managerial effort.

The logic is that a small quantity of inventory might represent a large portion of inventory value. You need to rate those groups:

- Group A consists of all high value inventories. Stocks are kept to a minimum and all items are strictly monitored and tightly controlled. Precise ordering is important.
- Group B items are of medium value and require medium monitoring and control.
- Group C inventory is basic, inexpensive items that are ordered in large quantities to ensure continuity of supply. Monitoring and control is not that important.

Debtors control

Controlling receivables is the key to cash flow management in any business. First establish a receivables policy that covers who you grant credit to, how you assess the granting of credit, and what your collection policy is.

Then closely monitor accounts taking swift action on overdue accounts. Offer cash discounts to encourage early settlement, while requesting down – and milestone – payments.

BEWARE

A shortage of cash may not be related to profitability. Your business could be profitable, but poor cash management practices mean that you aren't able to pay suppliers on time, access capital to grow your business or invest further.

Payables management

You can extend payables by negotiating better terms with your suppliers, and delaying payment without losing goodwill or trade discounts. Cash discounts are usually attractive. Where possible, take advantage of them.

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