FIS Information

KNOWLEDGE HUB

Cashflow Management

This Information Sheet looks at the key elements of cashflow, and how effective cashflow management will help protect the financial security of a business. It outlines the steps to be taken when dealing with customers, suppliers and stakeholders to improve cashflow. It also highlights common cashflow problems and how to avoid them.

What is cashflow

Cashflow is the measure of a company's ability to pay its bills on a regular basis. It depends on the timing and amounts of money flowing into and out of a business each week and month. Good cashflow means that the pattern of income and spending in a business allows it to have cash available to pay bills on time.

Cash balances include:

- Coins and notes.
- Current accounts and short-term deposits.
- Unused bank overdrafts and short-term loans.
- Foreign currency and deposits that can be quickly converted to the appropriate currency.

It does not include:

- Long-term deposits.
- Long-term borrowing.
- Money owed by customers.
- Stock.

Difference between cash and profit

It is important not to confuse cash balances with profit. Profit is the difference between the total amount a business earns and all of its costs, usually assessed over a year or other trading period. A company may forecast a good profit for the year, yet still face times when cash is limited.

The importance of cash

To make a profit, most businesses have to produce and deliver goods or services to their customers before being paid. Unfortunately, no matter how profitable the contract, if there is not enough money to pay staff and suppliers before receiving payment from customers, the business will be unable to deliver its side of the bargain or receive any profit.

To trade effectively and be able to grow, it is important to build up cash balances by ensuring that the timing of cash movements puts the company in a positive cashflow situation overall.

Bear in mind that having a lot of cash in the bank does not necessarily make good business sense. If the cash does not need to be used immediately, put this into an account where it will earn a higher rate of interest, or use it as capital for short-term investments. Advice can be sought from the company's bank, accountant or financial adviser.

Cash inflows and cash outflows

Ideally, during the business cycle, more money will be flowing in than flowing out. This will allow cash balances to be built up which can then plug any cashflow gaps, seek expansion and reassure lenders and investors about the health of the business.

Bear in mind that income and expenditure cashflows rarely occur together, with inflows often lagging behind. Aim to speed up the inflows and slow down the outflows.

Cash inflows

- Payment for goods or services from customers.
- Receipt of a bank loan.
- Interest on savings and investments.
- Shareholder investments.
- Increased bank overdrafts or loans.

Cash outflows

- Purchase of stock, raw materials or tools.
- Wages, rents and daily operating expenses.
- Purchase of fixed assets – computers, machinery, office furniture, etc.
- Loan repayments.

FIS
Olton Bridge, 245 Warwick Road
Solihull, West Midlands B92 7AH
+44(0)121 707 0077
info@thefis.org
www.thefis.org

- Dividend payments.
- Income tax, corporation tax, VAT and other taxes.
- Reduced overdraft facilities.

Many of a company's regular cash outflows, such as salaries, loan repayments and tax, have to be made on fixed dates. Ensure that these payments are always met in order to avoid large fines or a disgruntled workforce.

To improve everyday cashflow think about:
- Asking customers to pay sooner.
- Chasing debts promptly and firmly.
- Debt factoring.
- Asking for extended credit terms with suppliers.
- Ordering less stock but more often.
- Leasing rather than buying equipment.

Cashflow can also be improved by increasing borrowing, or putting more money into the business. This is suitable for coping with short-term downturns or to fund growth in line with the business plan. It should not form the basis of the business' cash strategy.

The principles of cashflow forecasting

Cashflow forecasting enables the predictiction of peaks and troughs in a company's cash balance. It helps to plan borrowing and determines how much surplus cash the business is likely to have at a given time. Many banks require forecasts before considering a loan.

Elements of a cashflow forecast

The cashflow forecast identifies the sources and amounts of cash coming into the business and the destinations and amounts of cash going out over a given period. There are normally two columns listing forecast and actual amounts respectively.

The forecast is usually done for a year or quarter in advance and divided into weeks or months. In extremely difficult cashflow situations a daily cashflow forecast might be helpful. It is best to pick periods during which most of the company's fixed costs - such as salaries - go out.

The forecast lists:
- Receipts.
- Payments.
- Excess of receipts over payments - with negative figures shown in brackets.
- Opening bank balance.
- Closing bank balance.

It is important to base initial sales forecasts on realistic estimates. If the business is well established, an acceptable method is to combine sales revenues for the same period 12 months earlier with predicted growth.

Note that all forecast figures must relate to sums that are due to be collected and paid out, not invoices actually sent and received. The forecast is a live entity. It will need adjusting in line with long-term changes to actual performance or market trends.

Accounting software

Accounting software will help to prepare the cashflow forecast, allowing projections to be updated if there is a change in market trends or the business' fortunes. Planning for seasonal peaks and troughs is simplified and 'what if' calculations can also be made. Most banks require profit and balance sheet forecasts as well as cashflow. Many accounting packages will assist with preparing these documents.

Manage income and expenditure

Effective cashflow management is as critical to business survival as providing services or products. Below are some of the key methods to help reduce the time gap between expenditure and receipt of income.

Customer management
- Define a credit policy that clearly sets out the company's standard payment terms.
- Issue invoices promptly and regularly chase outstanding payments. Use an aged debtor list to keep track of invoices that are overdue and monitor performance in getting paid.
- Consider exercising the right to charge penalty interest for late payment.
- Consider offering discounts for prompt payment.
- Negotiate deposits or staged payments for large contracts. It is in a customers' interests that the company does not go out of business trying to meet their demands.
- Consider using a third party to buy the invoices in return for a percentage of the total.

Supplier management

Ask for extended credit terms. Giving suppliers incentives such as large or regular orders may help, but make sure there is a market for the orders that are being placed. Alternatively, consider reducing stock levels and using just-in-time systems.

Taxation

The company may be liable for several different taxes including income tax, corporation tax, VAT, business rates and stamp duty. It is important to keep good records to help calculate the liability and complete any returns accurately.

If the company is registered for VAT, it makes sense to buy major items at the end rather than the start of a VAT period. This can often improve the business' cashflow, because the VAT on the purchase can be offset against the VAT that is charged on sales. This may help plug a temporary cashflow gap.

A business support service has been launched by HM Revenue & Customs (HMRC) to help businesses struggling to meet tax, National Insurance or other payments owed to HMRC.

If there is ever any doubt that payments owed, or soon to be owed, cannot not be made to HMRC then contact the HMRC Business Payment Support Service (BPSS) on 0845 302 1435. HMRC staff will review the situation and discuss temporary payment arrangements tailored to a company's circumstances.

Asset management

Consider leasing fixed assets, eg equipment, or buying them on hire purchase. Buying outright can result in a huge drain on cash in the first year of business.

Cashflow problems and how to avoid them

No matter how effective negotiations are with customers and suppliers, poor business practices can put cashflow at risk.

Look out for:

- Poor credit controls - failure to run credit checks on customers is risky, especially if the debt collection strategy is inefficient.
- Failure to fulfil an order - if an order is not delivered on time, or to specification, do not expect to receive payment. Implement systems to measure production efficiency and the quantity and quality of stock that is held and produced.
- Ineffective marketing - if sales are stagnating or falling, revisit the company's marketing plan.
- Inefficient ordering service - make it easy for customers to use the business' service / products. Where possible, accept orders over the telephone, email or internet. Ensure catalogues and order forms are clear and easy to use.
- Poor management accounting - keep an eye on key accounting ratios, this will raise alarms if there is an impending cashflow crisis or prevent orders being taken that cannot be handled.
- Inadequate supplier management – the business' suppliers may be overcharging, or taking too long to deliver. Create a supplier management system.
- Poor control of gross profits or overhead costs.

Using a cashflow forecast as a business tool

A cashflow forecast can be an invaluable business tool if it is used effectively. Bear in mind that it is dynamic – it will need to be changed and adjusted frequently depending on business activity, payment patterns and supplier demands.

It is helpful to set up a regular review of the forecast, changing the figures in light of any sales, purchases and staff costs. Legislation, interest rates and tax changes will also impact on the forecast.

Having a regular review of the cashflow forecast will help to:

- See when problems are likely to occur and sort them out in advance.
- Identify any potential cash shortfalls and take appropriate action.
- Ensure that sufficient cashflow is in place before any major financial commitment is taken on.

Using a cashflow forecast to avoid overtrading

Having an accurate cashflow forecast will help to ensure that steady growth can be achieved without overtrading. It will be apparent when the company has sufficient assets to take on additional business - and, just as importantly, when it should consolidate. This will enable the company to keep its staff, customers and suppliers happy.

It is important to incorporate warning signals into a cashflow forecast. For example, if predicted cash levels come close to any overdraft limits, this should sound an alarm and trigger action to bring cash back to an acceptable level.

Ideally, there should always be a contingency plan in place, such as retaining a minimum amount of cash in the business, perhaps in an interest-earning account. This 'rainy day' money can be used to meet short-term cash shortages.

Refinements to a simple cashflow forecast

There is no single best way to set out a cashflow forecast. However, some refinements to the most basic ways of setting out the information will give a more sophisticated view of the business' situation.

Think about separating cashflow for business operations from funding cashflow. This gives a clearer picture of the actual performance of the business and is a format that many accountants prefer.

Cashflow from operations

Includes inflows such as:

- Cash sales.
- Receipts from credit sales in earlier periods.

- Interest on savings.

Includes outflows such as:
- Payments to suppliers.
- Hire purchase and lease payments.
- Expenses - rent, rates, insurance, utilities, telephone, etc.
- Wages.
- Taxes and National Insurance contributions.
- Interest on loans and bank charges.

Funding cashflows
Includes inflows such as:
- Loans from banks.
- Increase in share capital.

Includes outflows such as:
- Dividends paid.
- Loans repaid.

With these two types of cashflow separated it is easier to gauge how self-sufficient the day-to-day working of the business is. A net outflow in operational cashflow is usually an indicator of problems that need to be addressed quickly.

Further information
Business Link – www.businesslink.gov.uk

Find an online course on working to a budget on the learndirect business website
http://www1.learndirect-business.com/?target=xpc.asp?course_id=5561%26wbt_type=course

Download cashflow management guidance from the Chartered Institute of Management Accountants website (PDF, 280K)
http://www2.cimaglobal.com/cps/rde/xbcr/SID-0A82C289-B5230B7B/live/cid_improving_cashflow_using_credit_mgm_Apr09.pdf.pdf

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