

# Improving cash flow using credit management

The outline case



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## Foreword

This guide explores credit and cash management in small and medium sized enterprises and includes advice on maximising cash inflows, managing cash outflows, extending credit and cash flow forecasting. It is not intended to be complex or exhaustive, but rather to act as a basic guide for financial managers in smaller businesses.

Cash flow management is vital to the health of your business. The oft-used saying, `revenue is vanity, profit is sanity; but cash is king` remains sage advice for anyone managing company finances. To put it another way, most businesses can survive several periods of making a loss, but they can only run out of cash once.

The importance of cash flow is particularly pertinent at times when access to cash is difficult and expensive. A credit crunch creates extreme forms of both of these problems. When the `real economy` slips into recession, businesses face the additional risk of customers running into financial difficulty and becoming unable to pay invoices – which, allied to a scarcity of cash from non-operational sources such as bank loans, can push a company over the edge.

Even during buoyant economic conditions, cash flow management is an important discipline. Failure to monitor credit, assess working capital – the cash tied up in inventory and monies owed – or ensure cash is available for investment can hamper a company's competitiveness or cause it to overtrade.

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## Improving cash flow using credit management – the outline case

Cash flow is the life blood of all businesses and is the primary indicator of business health. It is generally acknowledged as the single most pressing concern of most small and medium-sized enterprises (SMEs), although even finance directors of the largest organisations emphasise the importance of cash, and cash flow modelling is a fundamental part of any private equity buy-out. In a credit crunch environment, where access to liquidity is restricted, cash management becomes critical to survival.

In its simplest form, cash flow is the movement of money in and out of your business. It is not profit and loss, although trading clearly has an effect on cash flow. The effect of cash flow is real, immediate and, if mismanaged, totally unforgiving. Cash needs to be monitored, protected, controlled and put to work. There are four principles regarding cash management:

1. Cash is not given. It is not the passive, inevitable outcome of your business endeavours. It does not arrive in your bank account willingly. Rather it has to be tracked, chased and captured. You need to control the process and there is always scope for improvement.
2. Cash management is as much an integral part of your business cycle as, for example, making and shipping widgets or preparing and providing detailed consultancy services.
3. Good cash flow management requires information. For example, you need immediate access to data on:
  - your customers' creditworthiness
  - your customers' current track record on payments
  - outstanding receipts
  - your suppliers' payment terms
  - short-term cash demands
  - short-term surpluses
  - investment options
  - current debt capacity and maturity of facilities
  - longer-term projections.
4. You must be masterful. Managing cash flow is a skill and only a firm grip on the cash conversion process will yield results.

Professional cash management in business is not, unfortunately, always the norm. For example, a survey conducted by the Better Practice Payment Group in 2006 highlighted that one in three companies do not confirm their credit terms in writing with customers. And many finance functions do not maintain an accurate cash flow forecast (which is crucial, as we'll see later).

Good cash management has a double benefit: it can help you to avoid the debilitating downside of cash crises; and it can grant you a commercial edge in all your transactions. For example, companies able to aggressively manage their inventory may require less working capital and be able to extend more competitive credit terms than their rivals.

## Working capital

Working Capital reflects the amount of cash tied up in the business' trading assets. It is usually calculated as: stock (including finished goods, work in progress and raw materials) + trade debtors - trade creditors. It is made up of three components:

1. Days sales outstanding (DSO, or 'debtor days') is an expression of the amount of cash you have tied up in unpaid invoices from customers. Most businesses offer credit in order to help customers manage their own cash flow cycle (more on that shortly) and that uncollected cash is a cost to the business.  $DSO = 365 \times \text{accounts receivable balance} / \text{annual sales}$ .
2. Days payable outstanding (DPO or creditor days) tells you how you're doing with suppliers. The aim here is a higher number, if your suppliers are effectively lending you money to buy their services, that's cash you can use elsewhere in the business.  $DPO = 365 \times \text{accounts payable balance} / \text{annual cost of goods sold}$ .
3. Finally, your days of inventory (DI). This tells you how much cash you have tied up in stock and raw materials. Like DSO, a lower number is better.  $DI = 365 \times \text{inventory balance} / \text{annual sales}$ .

Almost all businesses have working capital tied up in receivables and inventory. But not all of them. Many of the UK's big supermarkets chains, for example, have negative working capital. Customers pay in cash at the tills, but stock is provided by suppliers on credit, often on very generous terms. That means that at any given time, the supermarket has excess cash which can be used to earn interest or be invested in new store roll-outs, for example. That's one reason their business model is so successful – and demonstrates the importance of cash flow management.

Working capital consultancy REL conducts an annual survey of Europe's biggest businesses. In its 2008 report, it said that in response to the global recession, they were paying suppliers more slowly to artificially bolster their balance sheets. *'But in doing so they're often damaging supplier relationships and creating gains that can't be sustained over time,'* claimed the report. *'A typical European company [in 2008 was] taking over 45 days to pay its suppliers - nearly a day and a half longer than last year.'*

So simply cutting down on your DSO or increasing your DPO are not necessarily good long-term solutions. Smart management of cash flow cycle, including tighter business processes and better credit management, is essential.



# 1. The cash flow cycle

Cash flow can be described as a cycle. Your business uses cash to acquire resources. The resources are put to work and goods and services produced. These are then sold to customers. You collect their payments and make those funds available for investment in new resources, and so the cycle repeats.

It is crucially important that you actively manage and control these cash inflows and outflows. So what do these look like?

## Inflows

Cash inflow is money coming into your business:

- money from the sale of your goods or services to customers
- money on customer accounts outstanding
- bank loans
- interest received on investments
- investment by shareholders in the company.

## Outflows

Cash outflow is, naturally, what you pay out:

- purchasing finished goods for re-sale
- purchasing raw materials to manufacture a final product
- paying wages
- paying operating expenses (such as rent, advertising and R&D)
- purchasing fixed assets
- paying the interest and principal on loans
- taxes.

## Cash flow management

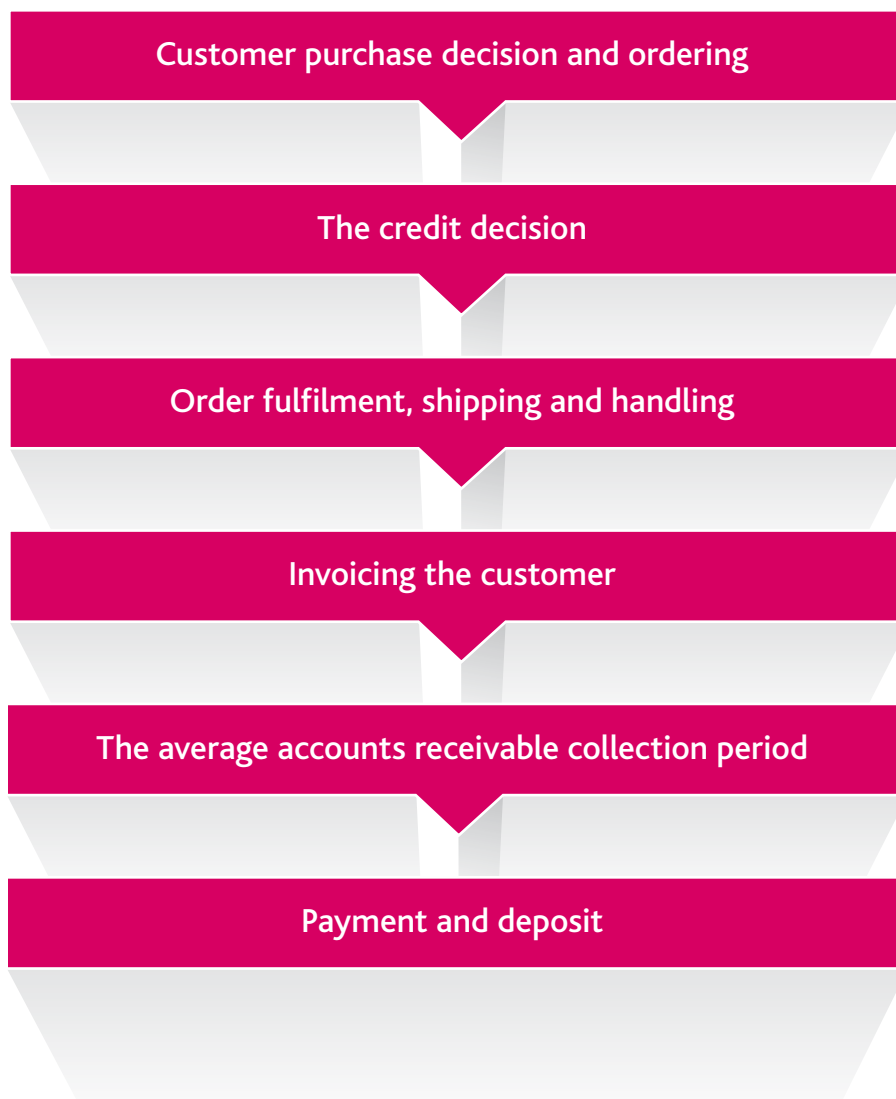
Cash flow management is all about balancing the cash coming into the business with the cash going out. The danger is that demands for cash, from the landlord, employees or the tax man, arrive before cash you're owed is collected. More often than not, cash inflows seem to lag behind your cash outflows, leaving your business short. This money shortage is your cash flow gap.

If a company is trading profitably, each time the cycle turns, a little more money is put back into the business than flows out. But not necessarily. If you don't carefully monitor your cash flow and take corrective action when necessary, your business may find itself in trouble. If cash flow is carefully monitored, you should be able to forecast how much cash will be available on hand at any given time, and plan your business activities to ensure there is always cash to meet upcoming payments.

## Advantages of managing cash flow

Having a clear view of where your businesses' cash is tied up, unpaid invoices, stock and so on, what cash is coming in (and when) and what cash commitments you have coming up is hugely beneficial:

- you can spot potential cash flow gaps and act to reduce their impact, for example, by negotiating new terms with suppliers, fresh borrowing or chasing overdue invoices.
- you can plan ahead – allowing you to make investments without worrying that existing commitments will not be met.
- you can reduce your dependence on your bankers – and save interest charges by paying down debt.
- you can identify surpluses which can be invested to earn interest.
- you can reassure your bankers, investors, customers and suppliers that your business is healthy in times of a liquidity squeeze.
- you can be reassured that your accounts can be drawn up on a 'going concern' basis and, if your accounts are subject to audit, you can also reassure your auditors.





## Cash conversion period

The cash conversion period measures the amount of time it takes to convert your product or service into cash inflows.

There are three key components, which will be familiar as constituents of working capital.

1. Inventory conversion – the time taken to transform raw materials into a state where they are ready to fulfil customers' requirements. A manufacturer will have funds tied up in physical stocks while service organisations will have funds tied up in work-in-progress that has not been invoiced to the customer.
2. Receivables conversion – the time taken to convert sales into cash.
3. Payable deferment – the time between taking delivery of input goods and services and paying for them.

*The net period of (1+2)-3 gives the cash conversion period (or working capital cycle). The trick is to minimise (1) and (2) and maximise (3), but it is essential to consider the overall needs of the business.*

The chart below is an illustration of the typical receivables conversion period for many businesses.

The flow chart represents each event in the receivables conversion period. Completing each event takes a certain amount of time. The total time taken is the receivables conversion period. Shortening the receivables conversion period is an important step in accelerating your cash inflows.

Ask yourself:

- how much cash does my business have right now?
- how much cash does my business generate each month?
- when do we aim to get cash in for completed transactions?
- and how does this compare to the real situation for cash in?
- how much cash does my business need in order to operate?
- when is it needed?
- how do my income and expenses affect my capacity to expand my business?

If you can answer these questions, you can start to plot your cash flow profile. We return to this important discipline in some detail under the budgeting section which can be viewed in the section four. But if you can plan a response in accordance with these answers, you are then starting to manage your cash flow!



## 2. Accelerating cash inflows

The quicker you can collect cash, the faster you can spend it in pursuit of further profit or to meet cash outflows such as wages and debt payments. Accelerating your cash inflows involves streamlining all the elements of cash conversion:

- the customer's decision to buy
- the ordering procedure
- credit decisions
- fulfilment, shipping and handling
- invoicing the customer
- the collection period
- payment and deposit of funds.

### Customer purchase decision and ordering

Without a customer, there will be no cash inflow to manage. Make sure that your business is advertising effectively and making it easy for the customer to place an order. Use accessible, up-to-date catalogues, displays, price lists, proposals or quotations to keep your customer informed. Provide ways to bypass the postal service. Accept orders over the Internet, by telephone, or via fax. Make the ordering process quick, precise and easy.

### Credit decisions

Dun and Bradstreet has calculated that more than 90% of companies grant credit without a reference. If credit terms and conditions are not agreed in advance and references checked, you risk trading with 'can't pay' customers as well as 'won't pay' ones. Salespeople, in particular, need to remember that a sale is not a sale until it's been paid for – and extending credit haphazardly might look good for their figures (and the P&L, at least initially), but can be disastrous for cash flow. (See section three on credit management for more details.)

### Fulfilment, shipping and handling

The proper fulfilment of your customers' orders is most important. Terms and conditions apply as much to you as they do your customers. The cash conversion period is increased significantly if your business is unable to supply to specification or within the agreed timetable, whether that's because you have a problem with inventory or production processes; or because you lack the skilled resources to provide the services requested.

Metrics such as inventory turnover, inventory levels or stock to sale ratios will help measure the efficiency of your inventory process. Benchmarking against industry standards can provide additional guidance on where you stand and highlight potential opportunities for process improvement.

### Invoicing the customer

If you don't invoice, you won't be paid. Design an invoice that is better than any coming into your own company, or copy the best ones you see. Keep it brief and clear. Get rid of any advertising clutter, the invoice is for accounts staff, not purchasers. Invoice within 24 hours of the chargeable event. Remember that you won't get paid until your bill gets into the customer's payment process.

An invoice includes the following information:

- customer name and address
- description of goods or services sold to the customer
- delivery date
- payment terms and due date
- date the invoice was prepared
- price and total amount payable
- to whom payable
- customer order number or payment authorisation
- your own details, including address, contact numbers and emails, company registration and VAT reference.

Send the invoice to a named individual. Electronic invoices, sent by email or using internet based systems, are becoming more common. If you do use the postal service, use a courier or recorded delivery for very large value invoices. Make sure, above all, that the invoice is accurate.

## Special payment terms

Accounts on special terms should be grouped together in the ledger for constant collection attention. Any default after agreement of special terms should lead to 'cash only terms'.

## The collection period

Customers are often given 30 days from the date of the invoice in which to pay. The time allowed is under your control and you can specify a shorter period if you need to, particularly if the customer is a consumer rather than a business that will be managing its own cash flow cycle. You must judge the benefit to your cash flow against the possible cost of deterring some customers.

Don't feel guilty about collecting a debt. You are owed money for goods or services supplied. The law is on your side. Start the collection process as soon as the sale is made. Never forget that the reputation, survival and success of your business may depend on how well you are able to collect overdue accounts.

Bear in mind:

- customers will list their best references on a credit application – so look beyond the obvious
- find out why they have switched business to you – is it because other suppliers have ceased trading with them?
- collecting debts is a competitive sport – if you're not getting paid then someone else might be
- verbal communication is best – and helps develop relationships that can ensure problems are flagged up early
- don't wait longer than 60 days past the due date before cutting off credit
- when things get really problematic, defer to a third party – don't get emotionally involved. Let a debt collection agency handle it.

## Late payment: a perennial problem

The Payment League Tables, a joint venture between the Institute of Credit Management (ICM), the Credit Management Research Centre (CMRC) and CreditScorer Ltd, collects information on the average number of days it takes UK plcs to pay their invoices. The data is updated throughout the year, as soon as each company files a new set of full accounts with Companies House and a dedicated website, [www.paymentleague.com](http://www.paymentleague.com), enables users to find the number of payment days by company name, as well as within an industry sector.

In January 2008

- The average length of time it takes a plc to pay its suppliers is 44 days.
- A fifth of companies listed take more than 60 days to pay.
- 19 companies are named as taking more than 200 days to pay.
- Finance companies continue to be the best sector payers, with 60% paying within the normal agreed time of 30 days.

At times when bank credit is scarce, there is a danger that companies will manage their cash flow by paying suppliers later. For example, the amount owed to smaller firms in the UK increased to more than £8.3bn even before the worst of the credit crunch hit, according to a Barclays Local Business survey conducted early in 2008. Research conducted by the Forum of Private Business in August 2008 claimed that 56% of UK small business managers thought late payment was getting worse.

*Barclays 2008*

The problem is global. In Australia, a Dun & Bradstreet report published in April 2008 revealed that the average payment period across all industries had reached 55.8 days. Companies with more than 500 employees took 62.7 days to make payments, more than double the standard payment terms, up from 58.9 days in the second quarter of 2007.

*Dun & Bradstreet 2008*

## The Late Payment of Commercial Debts (Interest) Act 1998

UK legislation gives businesses a statutory right to claim interest if another business pays its bills late. At one time, businesses were only able to claim interest on late paid debts if they included a provision in their contracts or if the courts decided to award interest in a formal dispute. The Late Payment of Commercial Debts (Interest) Act 1998 changed all that.

### Bad debts

Late payment sometimes escalates to become a bad debt. If you are making 1.5% profit on sales, an uncollected debt of £1,500 nullifies £100,000 worth of sales. Worse still, poor credit management means that you will have to expend additional time and resources to collect debts, so even if you are paid eventually, you will incur costs that are 'hidden' around those accounts. This scenario is not uncommon in business. On the other hand, the absence of any doubtful, as opposed to bad, debt may mean that you have been missing out on business by being overcautious.

Remember that bad debts sometimes arise from disputes over the goods or services you have supplied. That's why it is important to develop good interpersonal relationships with customers and their accounts teams; and why you should have a clear and rapid disputes escalation process, ensuring senior decision makers can resolve perceived problems to ensure problem accounts are quickly resolved.

### Improving your debt collection

The key to improving your ability to collect overdue accounts is to get organised.

Use aged debtor analysis. Maintain a list of accounts receivable due and past due. Senior management can use it to monitor trends and control weaknesses, while credit controllers have a ready made to-do list of customers to chase. List accounts in order of size and due date, first ranking largest debt first and second ranking earliest date first. Accountancy software will typically automate this task, but even using the SORT function in a spreadsheet will work.

Learn the debtor's payment cycle. When dealing with large companies, find out the last day for getting an invoice approved and included in the payment run. Call a couple of days before that date to make sure that they have all the documentation from you that they need.

Anticipate where you can. Consider giving a reminder call the week before your payment is due, especially if you have identified a specific group of customers which tends to pay late.

Start with a serious letter. If a problem emerges, pay a solicitor to write one for you. If you want to get results, get serious from the start.

Use personal visits. Letters are generally the least effective method of chasing debts (although legal letters do have more impact); emails and telephone calls score better; but personal visits are the most effective. If you have a problem with payment, talk to the person who is responsible for buying your goods or services. Point out that if the credit limit is breached, you may have to withhold your goods in future if payment is not made.

### Payment and deposit of funds

Even if your customers pay invoices on time, how they transfer the cash to you can make a big difference to your conversion period. Consider the customer's position. He or she will delay payment as long as possible, to improve his or her cash flow cycle. Relying on the postal service for receipt of your customers' cheques can add one to three days (possibly more) to your cash conversion period, not counting the need for a cheque to clear. So find ways to bypass the postal service, such as by using couriers, or use electronic means to pay direct to your company bank account. BACS payments are immediate.

Ask yourself:

- do invoices go out immediately after goods or services are delivered?
- do monthly statements go out reliably on the last day of the month?
- are the terms of sale clearly and precisely shown on all quotations, price lists, invoices and statements?
- what is the actual average length of credit you are giving?
- what length of credit do customers take?
- do you stick to a collection procedure timetable?
- are you polite but insistent in your collection routine?
- how do your Days Sales Outstanding (DSO) compare with industry norms?
- do you monitor your receivables report daily?
- do you watch the ratio of total debt on balances on the sales ledger at the end of each month in relation to the sales of the immediately preceding 12 months? Is the position improving, deteriorating or static? Why?
- do your sales people recognise that 'It's not sold until it's paid for'? Are they incentivised to act accordingly?
- can you identify trends that can help you anticipate customer behaviour and have action plans in place to mitigate late payment?



## 3. Credit management

Most business-to-business companies extend credit to their customers. It is often a crucial tool for attracting customers. How you manage that process is a fundamental part of cash flow management. People who owe you money, debtors, are a vital part of cash inflow and poorly managed credit can mean delays in converting sales to cash or, more seriously, trading with customers who are unable or unwilling to pay.

### Credit policy

Your company's credit policy is important. It should not be arrived at by default. The board should determine your company's credit criteria, which credit rating agency you use, who is responsible for checking prospective and existing customer creditworthiness, the company's standard payment terms, the procedure for authorising any exemption and the requirements for regular reporting. The policy should be written down and kept up to date with current creditworthiness of specific customers, especially ones with large lines of credit or that increase their orders, plus warnings or notes of current poor experience. The policy should be disseminated to all sales staff, the financial controller and the board.

### Credit in practice

Start your credit decision making process when first meeting with new prospective customers or clients. If necessary, consider allowing small orders to get underway quickly. This may be a reasonable level of risk and may ensure that new business is not lost. In a sales negotiation it is professional, not 'anti-selling', to be upfront about terms for payment. Use an 'Account Application Form' that includes a paragraph for the buyer to sign, agreeing to comply with your stated payment terms and conditions of sale. On a 'welcome letter' restate the terms and conditions. Your 'Order Confirmation' forms can stress your terms and conditions. Invoices should show the payment terms boldly on the front and re-state the date the payment is due.

It's worth bearing in mind that lax credit decisions are often exploited by fraudsters. The famous 'long fraud' involves a customer making a series of small purchases which are paid for in full. Gradually, the supplier gains confidence and extends more and more credit. The fraudster then places a very large order, and disappears with the goods. But it needn't be fraud: a company with its own problems might attempt to trade out of trouble and go bust leaving you with massive unpaid invoices.

It's a good idea to prioritise your research. The 80/20 rule suggests that 20% of your customers will generate 80% of your revenue, so list accounts in descending order of value and give the top slice a full credit check and regular review. The smaller ones do need attention, but are a lower priority, unless monitoring reveals poor payment performance.

### Credit checking: where and how

A full credit report on a limited company will cost in the region of £30 from a rating agency and include financial results, payment experience of other suppliers, county court judgements, registered lending and a recommended credit rating. The agency will provide a full description to accompany the score, and you should choose one that delivers reports immediately on request, and online.

The Register of County Court Judgements (CCJs), maintained by Registry Trust Ltd on behalf of the court service, contains details of almost all money judgements from the county courts of England and Wales for the previous six years. Any individual, organisation or company can carry out a search of the Register (by post, in person or by email) for a small fee. Some of the biggest, most respected companies in the UK have county court judgements against them, so it's not the only factor to consider.

The Companies Act requires public limited companies and their large private subsidiaries to state in days the average time taken to pay their suppliers and to publish this figure in their director's report. This information provides small suppliers with a broad indication of when they can expect to be paid.

Every company must file accounts at Companies House and although these can be somewhat out-of-date, they are a good source of general information. If your customer is a limited company, ask it to provide a current copy of its interim accounts and annual report and accounts as a condition of trading.

Finally, visiting customer premises yields valuable intelligence. It is a useful way to roughly assess general efficiency, professionalism and morale. If the company seems well run and efficient, you may be justified in extending a good line of credit. If the situation feels bad, if the premises are in poor repair, people look nervous or overworked or there's a lack of activity, be more cautious.

A great way of assessing a business is to offer a cash-up-front discount for goods and services. A well run, cash rich business will often take the discount, particularly if their finance function is sharp enough to calculate the benefit of the discount versus the value of credit. Companies that are struggling will always take the credit option; allowing you to vet them more thoroughly as described above.

## Credit insurance

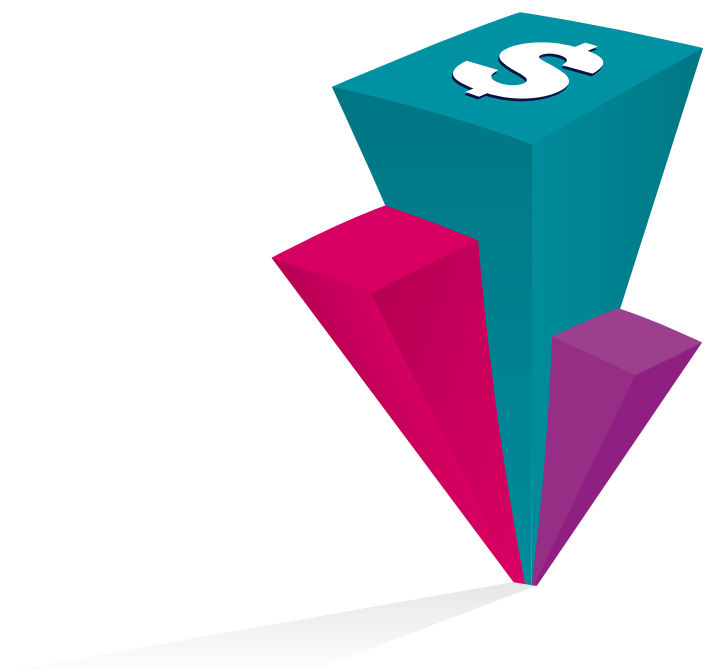
While a clear, well communicated and properly enforced credit policy will help ensure you convert sales to cash, there is an increasingly wide range of ways of managing credit and exposure to customers.

Credit insurance is one such example. Taking out this kind of policy will cover either individual accounts or a business's entire turnover. It is most commonly used in international trading, where chasing and recovering cash from customers is much harder, justifying the costs. But it can apply to any situation where large amounts of credit are extended.

Not surprisingly, it is much harder, and much more expensive, to get credit insurance when the risks increase. Both the credit crunch and the recession massively increase the risk of customers defaulting on monies owed, so it is becoming much harder to obtain cover.

Ask yourself:

- do you check the financial standing of all new customers before executing the first order?
- do you periodically review the financial standing of existing customers, especially those increasing their order size?
- do you use the telephone when checking trade references to ensure you're getting a frank opinion that might not be committed to paper?
- do you incentivise salespeople by cash in, rather than sales made? Do you include risk metrics in their performance targets?
- who supervises credit decisions and research? Who ensures the prompt collection of monies due and who is accountable if the credit position gets out of hand?
- do you measure the performance of your risk and credit control teams and are their incentives linked to those metrics?
- are your normal credit limits explicit – both in terms of total indebtedness for each customer and payment period?
- do you make your credit terms very clear up front?



## 4. Cash flow forecast

The cash flow forecast, or budget, projects your business cash inflows and outflows over a certain period of time. It can help you see potential cash flow gaps, periods when cash outflows exceed cash inflows when combined with your cash reserves, and allow you to take steps to avoid expensive, uncontrolled overdrafts or failure to meet crucial payments such as wages. These steps might include lowering your investment in accounts receivable or inventory, increasing or advancing receipts, or looking to outside sources of cash, such as a short-term loan, to fill the cash flow gaps.

If you're applying for a larger loan, you will need to create a cash flow budget that extends for several years into the future. But for most business needs, a six-month cash flow budget is probably about right. At a bare minimum, all businesses should be able to make an accurate cash forecast for 13 weeks ahead, long enough to spot potential problems and capture quarterly costs, but short enough to be realistic on sales and debt collections. This ought to be a rolling forecast, re-calculated weekly or even daily, and is particularly useful when the business is under stress or during a credit crunch.

A cash flow budget involves:

- a sales forecast
- anticipated cash inflows (a realistic assumption of payments being made)
- anticipated cash outflows (payments you'll need to make, plus operating expenses such as rents, taxes, wages and utility bills falling due)
- a cash flow bottom line (highlighting potential surpluses which could be re-invested or deposited; and deficits, which must be covered with loans or shareholder capital if cash inflows cannot be accelerated).

CIMA recommends the direct method for cash flow forecasting, where you report cash inflows and cash outflows directly from the operating activities. This prevents you from having to calculate variances from one financial statement to another and to re-classify items. Spreadsheets such as Excel are probably the most commonly used tool for the forecast. Larger companies might go for more integrated options where their operating systems can be linked to their cash forecasting system.

### Forecasting cash inflows

Forecasting your sales is key to projecting your cash receipts. Any forecast will include some uncertainty and will be subject to many variables: the economy, competitive influences, demand, etc. It will also include other sources of revenue such as investment income, but sales is the primary source. If your business only accepts cash sales, then your projected cash receipts will equal the amount of sales predicted in the sales forecast.

Projecting cash receipts is a little more involved if your business extends credit to its customers. In this case, you must take into account the collection period for your accounts receivable (AR). Money tied up in unpaid invoices is not available for paying bills, repaying loans, or expanding your business (unless you have a factoring or invoice discounting facility in place – see section 5). So you must use a realistic assessment of what proportion of AR will be realised. This can be based on:

- average collection period
- accounts receivable to sales ratio
- accounts receivable ageing schedule.

### Average collection period

The average collection period measures the length of time it takes to turn your average sales into cash. A longer average collection period represents a higher investment in accounts receivable and less cash available. Reducing your average collection period will improve your cash flow.

The average collection period in days is calculated by dividing your present accounts receivable balance by your average daily sales:

$$\text{Average collection period} = \frac{\text{current accounts receivable balance} \times 365}{\text{annual sales}}$$



## Accounts receivable to sales ratio

The accounts receivable to sales ratio looks at your investment in accounts receivable in relation to your monthly sales. Tracking this figure will help you to identify recent changes in accounts receivable. The accounts receivable to sales ratio is calculated by dividing your accounts receivable balance at the end of any given month by your total sales for the month.

$$\text{Accounts receivable to sales ratio} = \frac{\text{accounts receivable}}{\text{current sales for the month}}$$

A ratio of more than one readily shows that accounts receivable are greater than current monthly sales. This indicates that if this figure persists, month on month, you will soon run into cash flow problems.

## Accounts receivable ageing schedule

The accounts receivable ageing schedule (or aged debtors analysis) is a listing of the customers making up your total accounts receivable balance, normally prepared at the end of each month. Analysing your accounts receivable ageing schedule may help you readily identify the root of potential cash flow problems.

The typical accounts receivable ageing schedule consists of six columns:

- column one lists the name of each customer
- column two lists the total amount due
- column three is the 'current column', the amounts due from customers for sales made during the current month
- columns four to six list the amounts due from previous sales periods (columns three to six will sum to column two).

For example:

Accounts Receivable Ageing Report Technical Office Supply*, October 31, 200X, (£)					
Customer name	Total accounts receivable	Current	1-30 days past due	31-60 days past due	Over 60 days past due
Consensus Computer Supply	2400	450	750	750	450
HPJ Ltd.	4200	4200	-	-	-
South Schools Sport Stores	1500	1500	-	-	-
Denton Inc.	2400	-	2400	-	-
JBJ Unlimited	3000	1650	750	600	-
Park Enterprises	600	-	600	-	-
Online Computers	900	900	-	-	-
Freestyle Ltd.	1800	1800	-	-	-
<b>Total</b>	<b>16800</b>	<b>10500</b>	<b>4500</b>	<b>1350</b>	<b>450</b>
Percentage breakdown	100%	62%	27%	8%	3%

\*Technical Office Supply is a fictitious company for example purposes only

The ageing schedule can be used to identify the customers that are extending their payment time. If the bulk of the overdue amount in receivables is attributable to one customer, then steps can be taken to see that this customer's account is collected promptly. Overdue amounts attributable to a number of customers may signal that your business needs to tighten its general credit policy towards new and existing customers.

The ageing schedule also identifies any recent changes in the accounts making up your total accounts receivable balance. If the makeup of your accounts receivable changes, when compared to the previous month, you should be able to spot the change rapidly. Is the change the result of a change in sales, your credit policy, or is it caused by a billing problem? What effect will this change in accounts receivable have on next month's cash inflows? The accounts receivable ageing schedule can sound an early warning and help you protect your business from cash flow problems.

When in an economic downturn it is highly beneficial to review the receivables ageing schedule on a daily basis to help you to identify any change early on and give you the opportunity to react quickly. At a time where access to cash is so precious, it can make a significant difference to a business.

## Forecasting cash outflows

Projecting your expenses and costs over a period of time is critical. An accounts payable (AP) ageing schedule may help you determine your cash outflows for certain expenses in the near future. This will give you a good estimate of the cash outflows necessary to pay your bills and expenses on time. The cash outflows for every business can be classified into one of four possible categories:

- costs of goods sold (payments to suppliers)
- operating expenses (wages, rents, taxes and so on)
- major purchases (new plant or premises, for example)
- debt payments (interest and principal – plus payment of dividends to shareholders).

## Accounts payable ageing schedule

The accounts payable ageing schedule can help you determine how well you are (or are not) paying your invoices. While it is good cash flow management to delay payment until the invoice due date, take care not to rely too heavily on your trade credit and stretch your goodwill (and future credit terms) with suppliers. Worse still, late payments may drive a supplier out of business, resulting in potential supply chain problems and threatening your own business.

An accounts payable ageing report looks almost like an accounts receivable ageing schedule. However, instead of showing the amounts your customers owe you, the payables ageing schedule is used for listing the amounts you owe your various suppliers; a breakdown by supplier of the total amount on your accounts payable balance. Most businesses prepare an accounts payable ageing schedule at the end of each month.

A typical accounts payable ageing schedule consists of six columns as per the example for accounts receivable opposite. The number of columns, however, can be adjusted to meet your reporting needs. For instance, you might prefer listing the outstanding amounts in 15 day intervals rather than 30 day intervals. You should take into account your suppliers' terms of trade, to which you will already have agreed.

For example (see table on next page):

Accounts Payable Ageing Schedule Technical Office Supplies Ltd, December 31, 200X, (£)					
Supplier's name	Total accounts payable	Current	1-30 days past due	31-60 days past due	Over 60 days past due
Advantage Advertising	2400	2400	-	-	-
Manpower	4200	3900	300	-	-
BMR Distributing Ltd.	1500	900	150	450	-
E.V.Jones Bookkeeping	900	450	450	-	-
G.R.H Unlimited	3000	1650	750	600	-
Prompt Quote Insurance Co	600	600	-	-	-
Wachtmeister Office Supply	900	900	-	-	-
H.F. Dean Hardware	525	525	-	-	-
<b>Total</b>	<b>14025</b>	<b>11325</b>	<b>1650</b>	<b>1050</b>	
Percentage breakdown	100%	81%	12%	7%	

The accounts payable ageing schedule is a useful tool for analysing the makeup of your accounts payable balance. Looking at the schedule allows you to spot problems in the management of payables early enough to protect your business from any major trade credit problems. For example, if G.R.H. Unlimited was an important supplier for Technical Office Supplies Ltd, then the past due amounts listed for G.R.H. Unlimited should be paid in order to protect the trade credit established.

The schedule can also be used to help manage and improve your business's cash flow. Using the example schedule above, Technical Office Supplies will need to generate at least £11,325 in income to cover the current month's purchases on account.

Where possible you might want to think about supplier consolidation, as bigger orders should allow you to increase your power when negotiating payment terms.

## Projected outgoings

Operating expenses include payroll and payroll taxes, utilities, rent, insurance and repairs and maintenance and, like the cost of goods sold, can be fixed or variable. Rent, for example, is likely to be the same amount each month, and you'll probably have plenty of notice of any change. However, payroll, goods in or utilities may vary in line with your sales projections and have a seasonal aspect.

Purchasing new assets for the company tends to occur when the business is expanding or when machinery needs replacing. Cash outflow in this area is generally large and irregular. Examples of fixed asset expenditure would be on new company cars, computers, vans and machinery. In a situation where banks are reluctant to provide additional funding, it makes sense to delay some of your major investments.

It is critical to have a purchasing policy in place that will ensure no significant expenses are made without being approved. A 'No Purchase Order, No Pay' policy can be implemented if not already in place. Also, management accounting techniques like Activity Based Costing (ABC) will help you identify overheads or expenses that can be eliminated if your company is going through a rough time.

Projecting for debt payments is the easiest category to predict when preparing the cash flow budget. Mortgage payments and lease hire payments will follow the schedule agreed with the lender. Only payment against an overdraft, for example, will be variable by nature.

## Putting the projections together

Projected cash inflows minus outflows gives you your cash flow bottom line. The completed cash flow budget combines the following information on a monthly, weekly or even daily basis:

- Opening cash balance...
  - plus projected cash inflows
    - cash sales
    - accounts receivable
    - investment interest
  - less projected cash outflows
    - operating expenses
    - purchases
    - capital investment
    - debt payment
  - equals
- cash flow bottom line (the closing cash balance).

The above cash flow budget is just a guide, you will obviously need to include a little more detail. However, the basic cash flow budget will always remain the same.

The closing cash balance for the first period becomes the second period's opening cash balance. The second period's closing balance is determined by combining the opening balance with the second period's anticipated cash inflows and cash outflows. The closing balance for the second period then becomes the third month's opening cash balance and so on.

If a cash flow gap, where the balance is negative at any time, is predicted early enough, you can take cash flow management steps to ensure that it is closed, or at least narrowed, in order to keep your business going. These steps might include:

- increase sales – by lowering prices, or increasing marketing or utilisation rates (although this could worsen the gap if your cash flow management is already poor)
- increase margins – by cutting costs and/or raising prices (although you need to be mindful of putting off customers or squeezing suppliers)
- tighten cash processes – such as collections or inventory management
- decrease anticipated cash outflows – by cutting back on inventory purchases or cutting operating expenses such as wages
- postpone a major purchase
- sell assets (but not those core assets essential to the business unless you can arrange a sale-and-leaseback deal on, for example, property)
- roll over a debt repayment (much tougher in a credit crunch)
- seek outside sources of cash, such as a short-term loan.



## 5. Cash flow surpluses and shortages

How you deal with cash flow surpluses and shortages is a crucial part of the cash equation. Unused surpluses simply sitting in a current account suggest your business has suffered a failure of planning, and in many cases shareholders will consider it a failure of management to put their money to work. Worse, if your cash flow forecast has identified an upcoming shortage of cash and you fail to fill that gap, the result could be insolvency.

### Surpluses

If your business creates a cash surplus, you have important choices:

- deposit the surplus cash, either overnight or on term deposit with a bank or with a proprietary money fund, to earn interest until you are ready to use it elsewhere
- use the cash to fund capital investment for development and expansion in line with your longer-term corporate strategy
- pay out money to stakeholders
- pay creditors early to enhance your credit credentials for the future
- pay down debt to improve your balance sheet gearing ratio and make future interest payments more manageable. If you choose this route, then there are considerations of whether there is a premium to be paid for early repayment and whether it restricts your future flexibility given the scarcity of credit.

### Shortages

If there is a requirement for additional funds, either to meet short-term payments or for longer-term development, there are several sources of new funds:

- An overdraft facility. You should negotiate with the bank to agree acceptable limits and agree competitive interest rates. You'll be paying a premium over the base rate, so haggle. In fact, during the credit crunch, many companies have found that this type of unsecured lending (where the bank has no asset to claim if you default) is increasingly rare.
- A short-term borrowing facility. The bank will allow you to draw down a specific amount to be repaid in a specified number of days. The limits to the facility, the repayment periods and the interest rates will be negotiated with the bank. The interest on a short-term facility may be more favourable than for an overdraft, but again, banks have become increasingly risk-averse and may prefer a more structured option.
- A revolving credit facility. Again, you will agree acceptable limits to the facility and agree competitive interest rates. The facility will enable you to make withdrawals at short notice. It will also enable you to make unscheduled repayments whenever you have a cash surplus. The saving on interest owed may outweigh the interest that could have been earned from a separate investment.
- Fixed-term loans. The finance can be loan debt or, for much larger amounts, a bond issue. The interest rate can be fixed or variable. Haggle the premium and, indeed, do not be afraid to shop around. Although you will want to maintain a good relationship with your bank, there are now many competing sources of sound finance on the market, especially since the de-mutualisation of many of the building societies. It is simply good business to take the time to establish fresh links with some of these.
- Fresh equity, either from a private placing of shares, in private businesses, an injection of capital by existing or new investors, or a public offering. This is an important source of funds and can be essential if the debt-equity ratio is to be maintained at acceptable levels.

### Factoring and invoice discounting

While those options are all still open to businesses during the credit crunch, albeit in more costly and less generous forms, an increasingly common solution to short-term cash flow problems is factoring and invoice discounting.

An invoice discounting firm, often a division of a bank or large corporation, will advance you a percentage of invoiced sales. (Factoring is pretty much identical, but is an increasingly uncommon term. You'll also hear it described as 'invoice finance' or 'IF'.)

Invoice discounting contracts all have the following elements in common:

- *Advance rate* – the percentage of your accounts receivable that companies will pay you. Very few IF companies will advance you the full 100% up front. Most will advance you something above 70% and then will pay you the balance once the invoices they're lending against have been paid. The typical range is 60% to 95% of your account receivables.
- *Discount rate* – the fee charged for setting up and maintaining the facility. The typical range is 1% to 7% of your accounts receivable, depending on your payment terms.
- *Recourse vs. non-recourse* – in a non-recourse agreement, the IF company bears the burden of collecting your customers' debts. In a recourse agreement, you bear the burden of bad debts (in other words, if they are uncollectable, they will be charged back to you). Obviously for a small business owner, the non-recourse agreement is preferred, although the rates you'll get will not be as good as with a recourse agreement.

The terms will vary from one IF company to another. Always shop around before you make a decision. That said, the terms and rates offered to you will depend upon your credit (or debtor) worthiness. Small businesses with higher sales volumes or with what are viewed as stronger account debtors get better rates than those with small sales volumes or more questionable account debtors. Unfortunately, the smaller the business, typically the worse the terms.

Before you commit to factoring, approach your bank first for a loan using the accounts receivables as collateral. Bank fees will typically be much lower than factoring fees and you should definitely pursue that option if it is available to you.

Remember that passing on your invoices to be collected by a third party fundamentally changes the relationship you have with customers. You would hesitate before sending a bailiff to make good on an invoice from a customer that was only a few days overdue with a payment, but a factor or invoice discounter will chase as hard as they need to in order to get paid.

Some IF firms offer confidential invoice discounting, which means your customers never know you're using their outstanding invoices to raise finance. This leaves you with much more control over the customer relationship and nullifies any risk that customers will assume you have cash flow problems because you have resorted to factoring.

## Asset sales

Selling non-core assets could be an appealing solution if additional cash is required. For example, Lloyds TSB managed to gain additional funds through the sale of its Abbey Life business to Deutsche Bank in July 2008. Likewise, in 2008 RBS were looking to sell its ABN Amro's Australian and New Zealand operations in the hope of securing £4 billion.

And sale leaseback transactions can allow businesses to raise money by selling assets while retaining use. In 2007 HSBC agreed the sale and leaseback of its global headquarters, which raised £1.09 billion.

## 6. Using company accounts

We referred earlier to the wealth of information to be obtained from company accounts. This can provide a valuable insight into your customers, their trading performance, creditworthiness, financial health and even their expansion plans for the future.

Much of this is simply stated in the notes or can be gleaned from the written reports from the chairman, chief executive and finance director. Further insight can be gleaned from a straightforward analysis of the figures from the profit and loss, balance sheet and cash flow reports. The standard way of analysing accounts is to calculate 'ratios'. Ratios give you a set of figures to match against industry and company standards.

The following is a rough guide to acceptable ratios, but remember you must not rely on any one piece of information to assess creditworthiness. For additional guidance on using company accounts see our useful reading list at the end of this publication 'Using company accounts, further reading'.

### Current ratio

This liquidity ratio is calculated by dividing current assets by current liabilities. It measures the ability to pay bills.

Low risk	Average risk	High risk
Over 1.5	1.0–1.5	Under 1.0

Current assets (cash + stocks + trade debtors) divided by current liabilities (amounts due under 1 year)

### Liquidity ratio or acid test or quick ratio

This is a solvency ratio, the test of the company's true liquidity (actual cash + debtors vs. creditors + loans).

Low risk	Average risk	High risk
Over 1.25	0.75–.25	Under 0.75

Current assets (less stock) divided by current liabilities

### ROCE (return on capital employed)

This is a useful profitability ratio. It is used to assess the profit, as a percentage, generated by the company's assets.

Low return	Average return	High return
Under 6%	8–11%	Over 11%

Return on capital employed – profit before tax divided by capital employed x 100: Table shows example of an ROCE range assuming a bank rate of 6% and a risk margin of 2–5%

### Debt/equity (gearing)

This assesses how heavily the company is relying on external funding to support the business.

Low	Average	High
Under 50%	50–90%	Over 90%

Debt (loans, overdraft, etc.) divided by equity (shareholders' funds) x 100

An alternative definition is debt divided by (debt plus equity), which would modify the last table from the previous page:

Low	Average	High
Under 33%	33-47%	Over 47%

### Profit/sales

To assess profit margin of sales after costs.

Low	Average	High
Under 3%	3-10%	Over 10%

Profit before tax divided by annual turnover x 100

### Debtors' days sales outstanding

To assess the company's sales revenue recovery period in days.

Low	Average	High
Under 55 days	55-85 days	Over 85 days

Total of debtors x 365, divided by annual sales

### Creditors' days sales

To assess the company's payment period in days.

Low	Average	High
Under 45 days	45-60 days	Over 60 days

Total of creditors x 365, divided by annual sales



## 7. Cash management, credit and overtrading: a case study

During a credit crunch and recession, every business needs to monitor cash flow. Where it is poorly managed, even a company's successes can lead to its own downfall. Simply put, big new orders require you to pay for new plant, extra workers and additional stock before your brilliant new customer settles their invoice, resulting in you running out of cash. Hence the term 'insolvency by overtrading'. It is surprisingly common to hear people say, 'everything was all right until we got that large order' or, having just suffered insolvency, 'next time I will keep the business small'.

Here's an example to illustrate why cash flow management is vital, and how insolvency by overtrading might arise. It features fictional garage Albert's Autos, which provides car servicing and MOTs to local residents and breakdown recovery.

Business is good, there is a steady stream of income from repeat customers and the odd recovery significantly adds to the coffers. There are no significant cash reserves and there is no need for an overdraft.

Suddenly the contact that passes on most of your 'recovery work' offers Albert a contract to supply recovery services for a 50 mile radius. This is too good an opportunity to pass up. The recovery work has always been extremely profitable in the past. It is Albert's chance to expand. He anticipates that the recovery work will increase five-fold, so he takes on two extra mechanics. He has to buy additional garage space and he also needs two more recovery trucks.

Crucially, Albert does not run a cash flow forecast. So he has no idea exactly how much extra business is needed to cover the wages of the mechanics or the leases of the trucks. He borrows money for the additional garage space, but, again, does not factor debt repayments into his financial planning. Worse, because the new customer promises a lot of business, he expects credit – he'll pay for the recoveries and repairs in arrears at the end of each month.

In the first week of accepting the new contract, ten recoveries are made. Fixing these cars takes longer than expected and, to maintain credibility with his big new customer, he stops taking on work from local customers and diverts effort into upholding the terms of his new contract. That means his regular sources of cash business have declined, again, lack of a cash flow forecast means he doesn't know how this will affect his viability.

In week two, one of Albert's mechanics breaks his arm and is off sick, still being paid, but generating no income. He still has the workshop to run and the breakdowns to attend to. One of his recovery trucks is now lying idle, however. The servicing work is mounting up and he is deluged with breakdown requests. There is nothing for it but to hire more staff. He calls an agency and take on two more mechanics, paying weekly wages.

Week three: the trucks are in full use, but Albert is splitting his time between recovery work and the few remaining servicing jobs he'd already booked in. At the end of this week, cash is getting tight. Weekly wages must still be paid, but the reduction in cash customers means the bank account is emptying fast. Work in the office is still mounting up and he decides to take on an office manager so he can concentrate on the workshop to address complaints from several regulars for delays in servicing their vehicles. Meanwhile, Albert's Autos has seen no cash yet from the recoveries customer, who is so delighted with Albert's service that he proposes to increase the contract to cover an even greater distance.

If Albert does not take this contract, future work from the contact may revert to just the odd recovery. If he accepts the deal, he may go out of business: cash outflows (wages, loan repayments, operating expenses) are spiralling out of control, but he has yet to be paid for the recoveries to date and the cash work from servicing is drying up.

In considering whether to take the work he would have to consider not only whether or not he wants a bigger garage, but also whether he wants to expose his company to increased borrowing to finance the means of providing the recovery service (trucks, spares, trained mechanics). He would also probably lose his remaining local servicing customers. And if the recoveries work declines – let's assume in month four, there are 25% fewer breakdowns locally – he'll be facing the same high costs, but with drastically lower cash coming in. Worse, if Albert's contact went out of business himself, Albert's Autos would still have all the costs, but no income.

Expanding this business requires a solid business plan and cash flow forecast.

The problem is that growth is rarely of an incremental, easily absorbed nature. It usually represents a step-change. Any manager has to ask whether they can cope, and model the cash flows to show how. In the example above, by focusing solely on the need to meet the recovery work, Albert has allowed a cash crisis to develop unnoticed and unchecked.

Take the time to think big; plan your new projected cash flows, identify the shortfalls, identify the risks and secure ample lines of credit. If the step-change is revealed to be too great you will at least have spotted it in time and you can plan a different route.

For comprehensive guidance on the issue of insolvency go to the Government's executive agency, the Insolvency Service [www.insolvency.gov.uk](http://www.insolvency.gov.uk)

For a glossary of insolvency terms, go to [www.insolvency.gov.uk/information/guidanceleaflets/guide/glossterm.htm](http://www.insolvency.gov.uk/information/guidanceleaflets/guide/glossterm.htm)

## 8. Conclusion

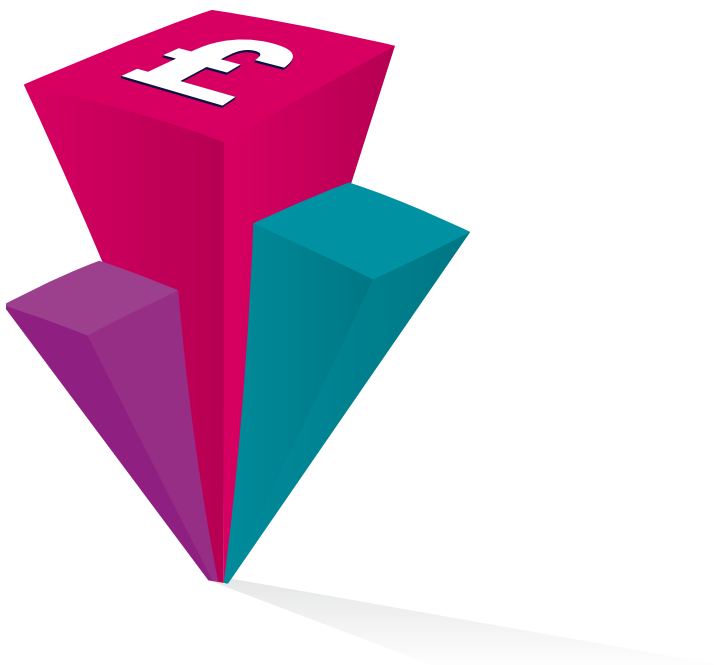
As outlined at the outset, cash flow is the life blood of all businesses, and it becomes even more important when going through an economic downturn. Cash flow has to be managed. Cash management is as much an integral part of the business cycle as any other part of the process. The effect of cash is real, immediate and, if mismanaged or not managed, it is very unforgiving. It can be your ruination, but with care will be your servant and reward.

Hopefully, this booklet has helped to illuminate where cash comes from and where it goes in the cash flow cycle, and provided you with insight into the basics of cash and credit management.

Remember, sound cash management will give your business just as much of an edge in your transactions as, say, an improvement in your manufacturing process or service delivery. Control and prosper.

## Acknowledgement

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