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Cashflow Management – Part 1

The expression "Cash is King" is an important axiom when it comes to running a business. Too often, business owners lose sight of the importance of cash, thinking that as long as the company continues to grow, the cashflow will take care of itself. Nothing could be further from the truth.

A growing company will experience an increase in its working capital requirements. If it's not properly funded, cash will always be tight.

An owner's time should be spent growing his business rather than worrying about short-term cash flow issues.

So how does a business owner ensure that there are adequate funds available to pay suppliers and meet payroll on an ongoing basis?

1. **Implement cash flow forecasting.**

   Implement a rolling four to six week forecast initiative; forecast expected cash inflows (i.e. customer collections) and cash disbursements (i.e. supplier payments, payroll, government remittances, rent and other overheads) on a weekly basis. At the end of each week, the completed week is dropped and a new week is added. This will highlight any imminent cash flow crunches and allow management to take appropriate steps to address them well before they occur.

2. **Ensure sufficient access to your operating line.**

   Use an operating line facility to finance the company's working capital. Access to the line is usually based on the lesser of:

   a) The overall value of the line established by the lender; and
   b) The margin calculation, defined as a percentage of the company's accounts receivable and inventory.

   As the company grows, it's not uncommon for cash flow needs to bump up against one or both of these limits. It's important to maintain ongoing communication with the lender to insure that the operating line limit and margin calculations are adjusted where necessary in order to facilitate growth.

3. Do not finance capital expenditures through your operating line.

Capital expenditures (or "capex") such as fixed asset purchases and leasehold improvements should not be funded through a company's operating line. Rather, capex should be financed by way of separate loans that are paid off (or amortized) over the useful life of the assets being purchased. The maximum term of these loans is usually five years.

Obtaining separate loans for capex ensures the operating line is used solely for working capital financing and mitigates short term cash crunches when the assets are purchased.

4. Calculate your cash conversion cycle on a monthly basis.

The cash conversion cycle ("CCC") is the number of days it takes a company to convert its inputs into cash. It is defined as:

Days Sales Outstanding ("DSO") + Days Inventory Outstanding ("DIO") – Days Payables Outstanding ("DPO").

- DSO refers to the number of days needed to collect the company's accounts receivable. A smaller DSO is preferred.
- DIO refers to the number of days it takes to sell the company's inventory. A smaller DIO is also preferred.
- DPO refers to the company's payment of its own bills, or accounts payable. By maximizing this number, the company holds onto cash longer, increasing its investment potential. Thus, a longer DPO is usually preferred.

By calculating the CCC each month, management can determine trends in each of the components and focus on which ones require attention and improvement.

Aries Advisory Group has extensive experience in the management of cash flow for its clients. We will work with you to design cash flow forecasting models and metrics to stay on top of your ongoing cash flow needs. We will also assist you in the negotiation of the appropriate operating line and term debt facilities to ensure that adequate financing exists in order for you to meet your short and long-term objectives. Please contact us at info@ariesag.com or at (416) 467-7878 to see how we can help.