CHAPTER 9 Managing Cash Flow

Whatever you have, spend less.

—Samuel Johnson

A deficit is what you have when you haven't got as much as when you had nothing.

—Gerald F. Lieberman

LEARNING OBJECTIVES

Upon completion of this chapter, you will be able to:

1. **EXPLAIN** the importance of cash management to a small business's success.
2. **DIFFERENTIATE** between cash and profits.
3. **UNDERSTAND** the five steps in creating a cash budget and use them to create a cash budget.
4. **DESCRIBE** fundamental principles involved in managing the "big three" of cash management: accounts receivable, accounts payable, and inventory.
5. **EXPLAIN** the techniques for avoiding a cash crunch in a small company.

Cash—a four-letter word that has become a curse for many small businesses. Lack of this valuable asset has driven countless small companies into bankruptcy. Unfortunately, many more firms will become failure statistics because their owners have neglected the principles of cash management that can spell the difference between success and failure. "Everything is about cash," says entrepreneur-turned-venture-capitalist Guy Kawasaki, "raising it, conserving it, collecting it."[1] Indeed, developing a cash forecast is essential for new businesses because early profit levels usually do not generate sufficient cash to keep the company afloat. A common cause of business failures is that owners neglect to forecast how much cash their companies will need until they reach the point of generating positive cash flow. Another problem, especially in start-up and fast-growth companies, is overemphasis on increasing sales with little concern for collecting the receivables those sales create. The result is always the same: a cash crisis.

Controlling the financial aspects of a business using the traditional analysis of basic financial statements with ratios (the topic of Chapter 10) is immensely important; however, by themselves, these techniques are insufficient to achieve business success. Entrepreneurs are prone to focus on their companies' income statements—particularly sales and profits. The income statement, of course, shows only part of a company's financial picture. It is entirely possible for a business to earn a profit and still go out of business *by running out of cash.* In other words, managing a company's total financial performance effectively requires an entrepreneur to look beyond the "bottom line" and focus on what it takes to keep a company going—cash.

A Company Example

"This [monitoring your cash flow statement] is more important than watching your income statement or balance sheet," says Scott Trenner, owner of ***S.T. Lube****, a company that operates six Jiffy Lube franchises. Trenner knows firsthand the importance of positive cash flow. His company ran into serious cash flow problems as he focused on rapid growth. "I was building a multi-million-dollar empire," he recalls, "but my revenues never caught up with my expenses." Cash was so tight that Trenner had trouble meeting the payroll for his company's 65 employees. "I once had to get a two-week, $30,000 loan from my father when we were struggling," he recalls. The turning point came when Trenner created a statement to track and analyze his company's cash flow. "We stopped focusing only on expansion and started paying attention to day-to-day management," he says. "By keeping a close eye on our cash flow statement, we went from a negative cash flow to a positive cash flow of $1,000 a week and turned around a $140,000 deficit in three years."*[2]

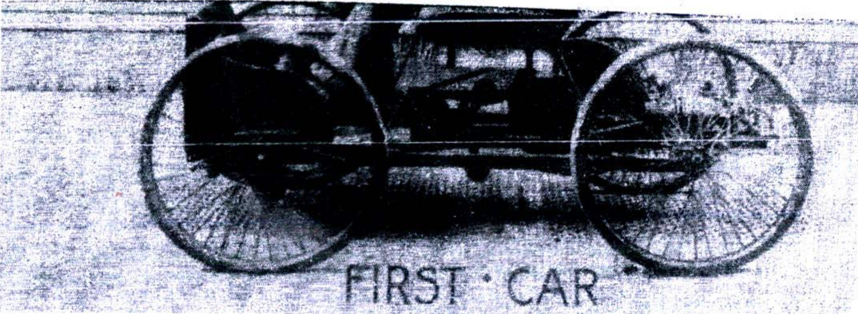
CASH MANAGEMENT

1. Explain the importance of cash management to a small business's success.

cash management—*the process of forecasting, collecting, disbursing, investing, and planning for the cash a company needs to operate smoothly*

A survey by the National Federation of Independent Businesses found that 67 percent of small business owners say they have at least occasional problems managing cash flow; 19 percent of business owners report cash flow as a continuing problem.[3] The only way to avoid this potentially business-crushing predicament is by using the principles of cash management. **Cash management** involves forecasting, collecting, disbursing, investing, and planning for the cash a company needs to operate smoothly. Cash management is a vital task because cash is the most important yet least productive asset that a small business owns. A business must have enough cash to meet its obligations or it will be declared bankrupt. Creditors, employees, and lenders expect to be paid on time, and cash is the required medium of exchange. But some firms retain an excessive amount of cash to meet any unexpected circumstances that might arise. These dormant dollars have an income-earning potential that owners are ignoring, and this restricts a firm's growth and lowers its profitability. Investing these dollars, even for a short time, can add to a company's earnings. Proper cash management permits the owner to adequately meet the cash demands of the business, to avoid retaining unnecessarily large cash balances, and to stretch the profit-generating power of each dollar the business owns.

Although cash flow difficulties afflict companies of all sizes and ages, young companies, especially, are cash sponges, soaking up every available dollar and always hungry for more. The reason usually is that their cash-generating "engines" are not operating at full speed yet and cannot provide enough power to generate the cash necessary to cover rapidly climbing operating expenses. Entrepreneurs must manage cash flow from the day they launch their businesses.



Henry Ford displays the first car built by the Ford Motor Company. Within a month of its launch, Ford's company nearly failed because of a cash crisis before growing into one of the largest companies in the world.

Courtesy of Getty Images Inc. - Hulton Archive Photos.

A Company Example

Shortly after he launched his new company on June 16, 1903, entrepreneur Henry Ford ran headlong into a cash crisis that nearly wiped out the **Ford Motor Company**. *Start-up expenses (including $10,000 to the Dodge brothers for engines and other parts and $640 to the Hartford Rubber Works for 64 tires) quickly soaked up Ford's $28,000 in start-up capital that he and 11 associates had invested. By July 10, the company's cash balance had fallen to a mere $223.65. Another payroll and more parts orders were just around the corner, and the 25-day-old company was already on the brink of a financial collapse. On July 11, an investor saved the day with a $5,000 contribution. Four days later the Ford Motor Company sold its first car to Dr. E. Pfennig of Chicago, pushing the company's cash balance to $6,486.44. From this shaky financial beginning grew one of the largest automakers in the world!*[14]

Managing cash flow is also an acute problem for rapidly growing businesses. In fact, fast-track companies are most likely to suffer cash shortages. Many successful, growing, and profitable businesses fail because they become insolvent; they do not have adequate cash to meet the needs of a growing business with a booming sales volume. If a company's sales are up, its owner also must hire more employees, expand plant capacity, increase the sales force, build inventory, and incur other drains on the firm's cash supply. During rapid growth, cash collections typically fall behind, compounding the problem. Cash flows out of these high-growth companies much faster than it comes in. The head of the National Federation of Independent Businesses says that many small business owners "wake up one day to find that the price of success is no cash on hand. They don't understand that if they're successful, inventory and receivables will increase faster than profits can fund them."[5] The resulting cash crisis may force the owner to lose equity control of the business or, ultimately, declare bankruptcy and close. Table 9.1 shows how to calculate the additional cash required to support an increase in sales.

The first step in managing cash more effectively is to understand the company's **cash flow cycle**—the time lag between paying suppliers for merchandise or materials and receiving payment from customers for the product or service (see Figure 9.1). The longer this cash flow cycle, the more likely the business owner is to encounter a cash crisis. Preparing a cash forecast that recognizes this cycle, however, will help avoid a crisis. Understanding the cash flow patterns of a business over the course of a year is essential to creating a successful cash management strategy. Business owners should calculate their cash flow cycles whenever they prepare their financial statements (or at least quarterly). On a *daily* basis, business owners should generate reports showing the following items:

cash flow cycle—*the time lag between paying suppliers for merchandise or materials and receiving payment from customers.*

TABLE 9.1

How Much Cash Is Required to Support an Increase in Sales?

Source: Adapted from Norm Brodsky, "Paying for Growth: How Much Cash You Need to Carry New Sales" Inc. Online Tools & Apps: Worksheet, www.inc.com/tools/details/0.6152. CNT61_HOM1_LOC0_NAVhome TOL11648.00.html.

Too often, entrepreneurs believe that increasing sales is the ideal solution to a cash crunch only to discover (often after it is too late) that it takes extra cash to support extra sales. The following worksheet demonstrates how to calculate the amount of additional cash required to support an increase in sales.

To make the calculation, a business owner needs the following information:

- the increase in sales planned ($)
- the time frame for adding new sales (days)
- the company's gross profit margin, gross profit ÷ net sales (%)
- the estimated additional expenses required to generate additional sales ($)
- the company's average collection period (days)

To calculate the amount of additional cash needed, use the following formula:

Extra cash required = ((New sales − Gross profit + Extra overhead) × (Average collection period × 1.20*)) ÷ (Time frame in days for adding new sales)

Consider the following example:

The owner of Ardent Company wants to increase sales by $75,000 over the next year. The company's gross profit margin is 30 percent of sales (so its gross profit on these additional sales would be $75,000 × 30% = $22,500), its average collection period is 47 days, and managers estimate that generating the additional sales will require an increase in expenses of $21,300. The additional cash that Ardent will need to support this higher level of sales is:

Extra cash required = (($75,000 − $22,500 + 21,300) × (47 × 1.2)) ÷ 365 = $11,404

Advent will need $11,404 in extra cash to support the additional sales of $75,000 it plans to bring in over the next year.

*The extra 20 percent is added as a cushion.

total cash on hand, bank balance, summary of the day's sales, summary of the day's cash receipts and cash disbursements, and a summary of accounts receivable collections. Compiling these reports into monthly summaries provides the basis for making reliable cash forecasts.

The next step in effective cash management is to analyze the cash flow cycle, looking for ways to reduce its length. Reducing the cycle from 240 days to, say, 150 days would free up incredible amounts of cash that this company could use to finance growth and dramatically reduce its borrowing costs. What steps would you suggest the owner of the business whose cash flow cycle is illustrated in Figure 9.1 take to reduce its length?

Table 9.2 describes the five key cash management roles every entrepreneur must fill.

FIGURE 9.1

The Cash Flow Cycle

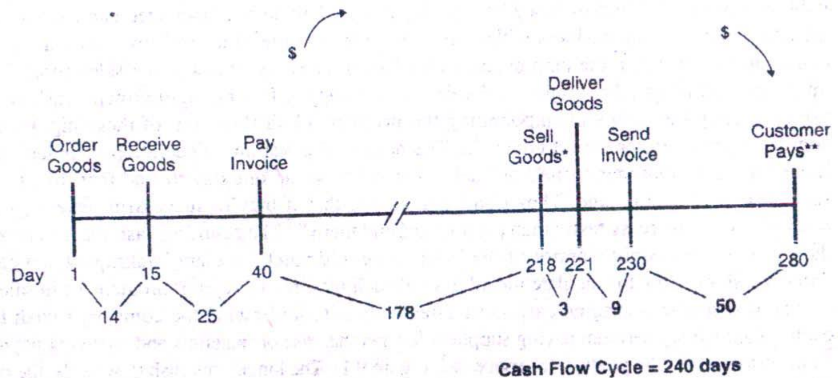


TABLE 9.2
Five Cash Management Roles of the Entrepreneur

Role 1: Cash Finder. This is the entrepreneur's first and foremost responsibility. You must make sure there is enough capital to pay all present (and future) bills. This is not a one-time task; it is an ongoing job.

Role 2: Cash Planner. As cash planner, an entrepreneur makes sure the company's cash is used properly and efficiently. You must keep track of its cash, make sure it is available to pay bills, and plan for its future use. Planning requires you to forecast the company's cash inflows and outflows for the months ahead with the help of a cash budget (discussed later in this chapter).

Role 3: Cash Distributor. This role requires you to control the cash needed to pay the company's bills and the priority and the timing of those payments. Forecasting cash disbursements accurately and making sure the cash is available when payments come due are essential to keeping the business solvent.

Role 4: Cash Collector. As cash collector, your job is to make sure your customers pay their bills on time. Too often, entrepreneurs focus on pumping up sales while neglecting to collect the cash from those sales. Having someone in your company responsible for collecting accounts receivable is essential. Uncollected accounts drain a small company's pool of cash very quickly.

Role 5: Cash Conserver. This role requires you to make sure your company gets maximum value for the dollars it spends. Whether you are buying inventory to resell or computers to keep track of what you sell, it is important to get the most for your money. Avoiding unnecessary expenditures is an important part of this task. The goal is to spend cash so it will produce a return for the company.

Source: Adapted from Bruce J. Blechman, "Quick Change Artist," *Entrepreneur*, January 1994, pp. 18–21.

CASH AND PROFITS ARE NOT THE SAME

Learning Objective
2. Differentiate between cash and profits.

When analyzing cash flow, entrepreneurs must understand that cash and profits are not the same. Attempting to discern the status of a small company's cash position by analyzing its profitability is futile; profitability is not necessarily highly correlated with cash flow. Profit (or net income) is the difference between a company's total revenue and its total expenses. It measures how efficiently a business is operating. Cash is the money that is free and readily available to use in a business. **Cash flow** measures a company's liquidity and its ability to pay its bills and other financial obligations on time by tracking the flow of cash into and out of the business over a period of time. Many small business owners soon discover that profitability does not guarantee liquidity. As important as earning a profit is, no business owner can pay suppliers, creditors, employees, the government, and lenders in profits; that requires *cash*! Although profits are tied up in many forms, such as inventory, computers, or machinery, cash is the money that flows through a business in a continuous cycle without being tied up in any other asset. "Businesses fail not because they are making or losing money," warns one financial expert, "but because they simply run out of cash."[6]

cash flow—*a method of tracking a company's liquidity and its ability to pay its bills and other financial obligations on time by tracking the flow of cash into and out of the business over a period of time.*

Figure 9.2 shows the flow of cash through a typical small business. Cash flow is the volume of actual cash that comes into and goes out of the business during an accounting period.

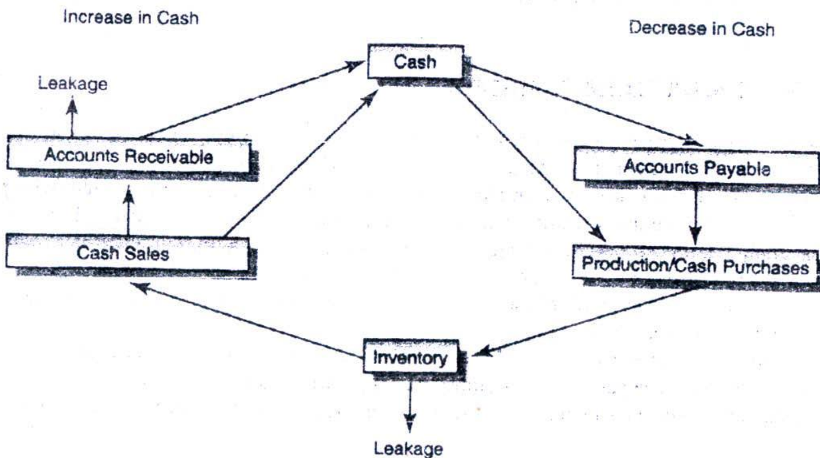


FIGURE 9.2
Cash Flow

Decreases in cash occur when the business purchases, on credit or for cash, goods for inventory or materials for use in production. A business sells the resulting inventory either for cash or on credit. When a company takes in cash or collects payments on accounts receivable, its cash balance increases. Notice that purchases for inventory and production *lead* sales; that is, these bills typically must be paid *before* sales are generated. But collection of accounts receivable *lags* behind sales; that is, customers who purchase goods on credit may not pay until next month.

THE CASH BUDGET

The need for a cash budget arises because in every business the cash flowing in is rarely "in sync" with the cash flowing out of the business. This uneven flow of cash creates periodic cash surpluses and shortages, making it necessary for entrepreneurs to track the flow of cash through their businesses so they can project realistically the cash available throughout the year. Many managers operate their businesses without knowing the pattern of their cash flows, believing that the process is too complex or time consuming. In reality, entrepreneurs simply cannot afford to disregard the process of cash management. They must ensure that their businesses have on hand an adequate, but not excessive, supply of cash to meet their operating needs. The goal of cash management is to have enough cash available to meet the company's cash needs at a given time.

How much cash is enough? What is suitable for one business may be totally inadequate for another, depending on each firm's size, nature, seasonal pattern of sales, and particular situation. The small business manager should prepare a **cash budget**, which is nothing more than a "cash map," showing the amount and the timing of the cash receipts and the cash disbursements day by day, week by week, or month by month. It is used to predict the amount of cash the firm will need to operate smoothly over a specific period of time, and it is a valuable tool in managing a company successfully. A cash budget can illuminate a host of approaching problems, giving entrepreneurs adequate time to handle, or better yet, avoid them. A cash budget reveals important clues about how well a company balances its accounts payable and accounts receivable, controls inventory, finances its growth, and makes use of the cash it has.

cash budget—*a "cash map," showing the amount and the timing of cash receipts and cash disbursements on a daily, weekly, or monthly basis.*

One consultant recalls how a cash budget helped salvage a once successful service firm that had fallen on hard times. The five-year-old firm with $20 million in annual billings began to lose money and was having trouble paying its bills. After working with the consultant, the company began sending customer invoices much faster and implemented a much stricter collection policy. The new collection system involved employees in collecting overdue payments and took immediate action when an account became overdue. Managers set up a receivables report and reviewed it at weekly staff meetings. They also beefed up the company's financial reports, added a cash budget, and used it to make managerial decisions. Within six months, the company's cash balance had improved dramatically (a turnaround of $1.5 million), managers were able to pay down a line of credit at the bank, and the business was back on track again!

Learning Objective

3. Understand the five steps in creating a cash budget and use them to create a cash budget.

PREPARING A CASH BUDGET

Typically, small business owners should prepare a projected monthly cash budget for at least one year into the future and quarterly estimates for another. The forecast must cover all seasonal sales fluctuations. The more variable a firm's sales pattern, the shorter its planning horizon should be. For example, a firm whose sales fluctuate widely over a relatively short time frame might require a weekly cash budget. The key is to track cash flows over time. The timing of a company's cash flow is as important as the amounts. "An alert cash flow manager keeps an eye not on cash receipts or on cash demands as average quantities but on cash as a function of the *calendar*," says one business owner.[7]

Regardless of the time frame selected, a cash budget must be in writing for an entrepreneur to properly visualize a company's cash position. Creating a written cash plan is not an excessively time-consuming task and can help the owner avoid unexpected cash shortages, a situation that

can cause a business to fail. One financial consultant describes "a client who won't be able to make the payroll this month. His bank agreed to meet the payroll for him—but banks don't like to be surprised like that," he adds.[8] Preparing a cash budget will help business owners avoid such adverse surprises and will also let an owner know if he is keeping excessively large amounts of cash on hand. Computer spreadsheets such as Microsoft Excel and Lotus 1-2-3 make the job fast and easy to complete.

The cash budget is based on the cash method of accounting, which means that cash receipts and cash disbursements are recorded in the forecast *only when the cash transaction is expected to take place*. For example, credit sales to customers are not reported until the company expects to receive the cash from them. Similarly, purchases made on credit are not recorded until the owner expects to pay them. Because depreciation, bad debt expense, and other noncash items involve no cash transfers, they are omitted entirely from the cash budget.

The cash budget is nothing more than a forecast of the firm's cash inflows and outflows for a specific time period, and it will never be completely accurate. But it does give an entrepreneur a clear picture of the firm's estimated cash balance for the period, pointing out where external cash infusions may be required or where surplus cash balances may be available to invest. Also, by comparing actual cash flows with projections, an owner can revise his forecast so that future cash budgets will be more accurate.

A Company Example

Joseph Popper, CEO of ***Computer Gallery****, knows how deadly running out of cash can be for a small company and does everything he can to make sure his business avoids that trap. Popper uses a computer spreadsheet to extract key sales, collection, and disbursement totals and to generate the resulting cash balance each day. Even when he is traveling, Popper keeps up with his company's daily cash balance. He has the spreadsheet results sent to an Internet service, which e-mails them to his alphanumeric pager every day he is out of the office. "We've been paranoid about cash from day one," Popper says. But his system keeps accounts receivable in control, ensures that the company's available cash is working hard, and improves his relationship with the company's banker.*[9]

Formats for preparing a cash budget vary depending on the pattern of a company's cash flow. Table 9.3 shows a monthly cash budget for a small department store over a four-month period. Each monthly column should be divided into two sections—estimated and actual (not shown)—so that each succeeding cash forecast can be updated according to actual cash transactions. Comparing forecasted amounts to actual cash flows and learning the causes of any significant discrepancies allow entrepreneurs to improve the accuracy of future cash budgets. There are five basic steps in completing a cash budget:

1. Determining an adequate minimum cash balance.
2. Forecasting sales.
3. Forecasting cash receipts.
4. Forecasting cash disbursements.
5. Determining the end-of-month cash balance.

Step 1: Determining an Adequate Minimum Cash Balance

What is considered an excessive cash balance for one small business may be inadequate for another, even though the two firms are in the same business. Some suggest that a firm's cash balance should equal at least one-fourth of its current debts, but this general rule clearly will not work for all small businesses. The most reliable method of deciding cash balance is based on past experience. Past operating records should indicate the proper cash cushion needed to cover any unexpected expenses after all normal cash outlays are deducted from the month's cash receipts. For example, past records may indicate that it is desirable to maintain a cash balance equal to five days' sales. Seasonal fluctuations may cause a firm's minimum cash balance to change. For example, the desired cash balance for a retailer in December may be greater than in June.

TABLE 9.3 Cash Budget for Small Department Store

Assumptions:

Cash balance on December 31 = $12,000

Minimum cash balance desired = $10,000

Sales are 75% credit and 25% cash.

Credit sales are collected in the following manner:

- 60% collected in the first month after the sale
- 30% collected in the second month after the sale
- 5% collected in the third month after the sale
- 5% are never collected

Sales forecasts are as follows:	Pessimistic	Most Likely	Optimistic
October (actual)		$300,000	
November (actual)		350,000	
December (actual)		400,000	
January	$120,000	150,000	$175,000
February	160,000	200,000	250,000
March	160,000	200,000	250,000
April	250,000	300,000	340,000

The store pays 70% of sales price for merchandise purchased and pays for each month's anticipated sales in the preceding month.

Rent is $2,000 per month.

An interest payment of $7,500 is due in March.

A tax prepayment of $50,000 must be made in March.

A capital addition payment of $130,000 is due in February.

Utilities expenses amount to $850 per month.

Miscellaneous expenses are $70 per month.

Interest income of $200 will be received in February.

Wages and salaries are estimated to be

January—$30,000
February—$40,000
March—$45,000
April—$50,000

Step 2: Forecasting Sales

The heart of the cash budget is the sales forecast. It is the central factor in creating an accurate picture of the firm's cash position because sales ultimately are transformed into cash receipts and cash disbursements. For most businesses, sales constitute the major source of the cash flowing into the business. Similarly, sales of merchandise require that cash be used to replenish inventory. As a result, the cash budget is only as accurate as the sales forecast from which it is derived.

For an established business, a sales forecast is based on past sales, but owners must be careful not to be excessively optimistic in projecting sales. Economic swings, increased competition, fluctuations in demand, normal seasonal variations, and other factors can drastically affect sales patterns and, therefore, a company's cash flow. Most businesses, from retailers and hotels to accounting firms and builders, have sales patterns that are "lumpy" and not evenly distributed throughout the year. For instance, 40 percent of all toy sales take place in the last six weeks of the year, and companies that make fruitcakes typically generate 50 percent to 90 percent of their sales during the holiday season, making proper cash management an essential activity.[10] Several quantitative techniques, which are beyond the scope of this text (linear regression, multiple regression, time series analysis, exponential smoothing), are available to

Cash Budget—Pessimistic Sales Forecast

	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.
Cash Receipts:							
Sales	$300,000	$350,000	$400,000	$120,000	$160,000	$160,000	$250,000
Credit Sales	225,000	262,500	300,000	90,000	120,000	120,000	187,500
Collections:							
60%—1st month after sale				$180,000	$54,000	$72,000	$72,000
30%—2nd month after sale				78,750	90,000	27,000	36,000
5%—3rd month after sale				11,250	13,125	15,000	4,500
Cash Sales				30,000	40,000	40,000	62,500
Interest				0	200	0	0
Total Cash Receipts				$300,000	$197,325	$154,000	$175,000
Cash Disbursements:							
Purchases				$112,000	$112,000	$175,000	$133,000
Rent				2,000	2,000	2,000	2,000
Utilities				850	850	850	850
Interest				0	0	7,500	0
Tax Prepayment				0	0	50,000	0
Capital Addition				0	130,000	0	0
Miscellaneous				70	70	70	70
Wages/Salaries				30,000	40,000	45,000	50,000
Total Cash Disbursements				$144,920	$284,920	$280,420	$185,920
End-of-Month Balance:							
Cash (beginning of month)				$12,000	$167,080	$79,485	$10,000
+ Cash Receipts				300,000	197,325	154,000	175,000
− Cash Disbursements				144,920	284,920	280,420	185,920
Cash (end of month)				167,080	79,485	(46,935)	(920)
Borrowing/Repayment				0	0	56,935	10,920
Cash (end of month [after borrowing])				$167,080	$ 79,485	$ 10,000	$ 10,000

(continues)

owners of existing businesses with an established sales pattern for forecasting sales. These methods enable the small business owner to extrapolate past and present sales trends to arrive at a fairly accurate sales forecast.

The task of forecasting sales for the new firm is more difficult but not impossible. For example, the new owner might conduct research on similar firms and their sales patterns in the first year of operation to come up with a forecast. The local Chamber of Commerce and trade associations in the various industries also collect such information. Publications such as *Robert Morris Associates' Annual Statement Studies*, which profiles financial statements for companies of all sizes in hundreds of industries, are also a useful tool. Market research is another source of information that may be used to estimate annual sales for the fledgling firm. Other potential sources that may help predict sales include census reports, newspapers, radio and television customer profiles, polls and surveys, and local government statistics. Talking with owners of similar businesses (outside the local trading area, of course) can provide entrepreneurs with realistic estimates of start-up sales. Table 9.4 provides an example of how one entrepreneur used such marketing information to derive a sales forecast for his first year of operation.

No matter what techniques entrepreneurs employ, they must recognize that even the best sales estimates will be wrong. Many financial analysts suggest that the owner create *three*

TABLE 9.3 Cash Budget for Small Department Store *(continued)*

Cash Budget—Most Likely Sales Forecast

	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.
Cash Receipts:							
Sales	$300,000	$350,000	$400,000	$150,000	$200,000	$200,000	$300,000
Credit Sales	225,000	262,500	300,000	112,000	150,000	150,000	225,000
Collections:							
60%—1st month after sale				$180,000	$67,500	$90,000	$90,000
30%—2nd month after sale				78,750	90,000	33,750	45,000
5%—3rd month after sale				11,250	13,125	15,000	5,625
Cash Sales				37,500	50,000	50,000	75,000
Interest				0	200	0	0
Total Cash Receipts				$307,500	$220,825	$188,750	$215,625
Cash Disbursements:							
Purchases				$140,000	$140,000	$210,000	$175,000
Rent				2,000	2,000	2,000	2,000
Utilities				850	850	850	850
Interest				0	0	7,500	0
Tax Prepayment				0	0	50,000	0
Capital Addition				0	130,000	0	0
Miscellaneous				70	70	70	70
Wages/Salaries				30,000	40,000	45,000	50,000
Total Cash Disbursements				$172,920	$312,920	$315,420	$227,920
End-of-Month Balance:							
Cash (beginning of month)				$12,000	$146,580	$54,485	$10,000
+ Cash Receipts				307,500	220,825	188,750	215,625
− Cash Disbursements				172,920	312,920	315,420	227,920
Cash (end of month)				146,580	54,485	(72,185)	(2,295)
Borrowing/Repayment				0	0	82,185	12,295
Cash (end of month [after borrowing])				$146,580	$ 54,485	$ 10,000	$ 10,000

estimates—an optimistic, a pessimistic, and a most likely sales estimate—and then make a separate cash budget for each forecast (a very simple task with a computer spreadsheet). This dynamic forecast enables the owner to determine the range within which his sales will likely be as the year progresses.

Step 3: Forecasting Cash Receipts

As noted earlier, sales constitute the primary source of cash receipts. When a firm sells goods and services on credit, the cash budget must account for the delay between the sale and the actual collection of the proceeds. Remember: You cannot spend cash you haven't collected yet! For instance, an appliance store might not collect the cash from a refrigerator sold in February until April or May, and the cash budget must reflect this delay. To project accurately the firm's cash receipts, the owner must analyze the accounts receivable to determine the collection pattern. For example, past records may indicate that 20 percent of sales are for cash, 50 percent are paid in the month following the sale, 20 percent are paid two months after the sale, 5 percent

Cash Budget—Optimistic Sales Forecast

	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.
Cash Receipts:							
Sales	$300,000	$350,000	$400,000	$175,000	$250,000	$250,000	$340,000
Credit Sales	225,000	262,500	300,000	131,250	187,500	187,500	255,000
Collections:							
60%—1st month after sale				$180,000	$78,750	$112,500	$112,500
30%—2nd month after sale				78,750	90,000	39,375	56,250
5%—3rd month after sale				11,250	13,125	15,000	6,563
Cash Sales				43,750	62,500	62,500	85,000
Interest				0	200	0	0
Total Cash Receipts				$313,750	$244,575	$229,375	$260,313
Cash Disbursements:							
Purchases				$175,000	$175,000	$238,000	$217,000
Rent				2,000	2,000	2,000	2,000
Utilities				850	850	850	850
Interest				0	0	7,500	0
Tax Prepayment				0	0	50,000	0
Capital Addition				0	130,000	0	0
Miscellaneous				70	70	70	70
Wages/Salaries				30,000	40,000	45,000	50,000
Total Cash Disbursements				$207,920	$347,920	$343,420	$269,920
End-of-Month Balance:							
Cash [beginning of month]				$ 12,000	$117,830	$ 14,485	$ 10,000
+ Cash Receipts				313,750	244,575	229,375	296,125
– Cash Disbursements				207,920	317,920	343,120	269,920
Cash (end of month)				117,830	14,485	(99,560)	36,205
Borrowing/Repayment				0	0	109,560	0
Cash (end of month [after borrowing])				$117,830	$ 14,485	$ 10,000	$ 36,205

after three months, and 5 percent are never collected. In addition to cash and credit sales, the small business may receive cash in a number of forms—interest income, rental income, dividends, and others.

Collecting accounts receivable promptly poses problems for many small companies; in fact, difficulty in collecting accounts receivable is the primary cause of cash flow problems cited by small business owners (see Figure 9.3).[11] Figure 9.4 demonstrates how vital it is to act promptly once an account becomes past due. Notice how the probability of collecting an outstanding account diminishes the longer the account is delinquent. Table 9.5 illustrates the high cost of failing to collect accounts receivable on time.

Step 4: Forecasting Cash Disbursements

Most owners of established businesses have a clear picture of the firm's pattern of cash disbursements. In fact, many cash payments, such as rent, loan repayments, and interest, are fixed amounts due on specified dates. The key factor in forecasting disbursements for a cash budget

TABLE 9.4

Forecasting Sales for a Business Start-Up

Robert Adler wants to open a repair shop for imported cars. The trade association for automotive garages estimates that the owner of an imported car spends an average of $485 per year on repairs and maintenance. The typical garage attracts its clientele from a trading zone (the area from which a business draws its customers) with a 20-mile radius. Census reports show that the families within a 20-mile radius of Robert's proposed location own 84,000 cars, of which 24 percent are imports. Based on a local consultant's market research, Robert believes he can capture 9.9 percent of the market this year. Robert's estimate of his company's first year's sales are as follows:

Number of cars in trading zone	84,000	autos
× Percent of imports	× 24	%
= Number of imported cars in trading zone	20,160	imports
Number of imports in trading zone	20,160	imports
× Average expenditure on repairs and maintenance	× $485	
= Total import repair sales potential	$9,777,600	
Total import repair sales potential	$9,777,600	
× Estimated share of the market	× 9.9	%
= Sales estimate	$967,982	

Now Robert Adler can convert this annual sales estimate of $967,982 into monthly sales estimates for use in his company's cash budget.

is to record them in *the month in which they will be paid, not when the obligation is incurred.* Of course, the number of cash disbursements varies with each particular business, but the following disbursement categories are standard: purchase of inventory or raw materials; wages and salaries; rent, taxes, loans and interest; selling expenses; fixed asset purchases; overhead expenses; and miscellaneous expenses.

Usually, an owner's tendency is to underestimate cash disbursements, which can result in a cash crisis. To prevent this, wise entrepreneurs cushion their cash disbursement accounts, assuming they will be higher than expected. This is particularly important for

FIGURE 9.3

Collecting Delinquent Accounts

Source: Commercial Collection Agency Section of the Commercial Law League of America.

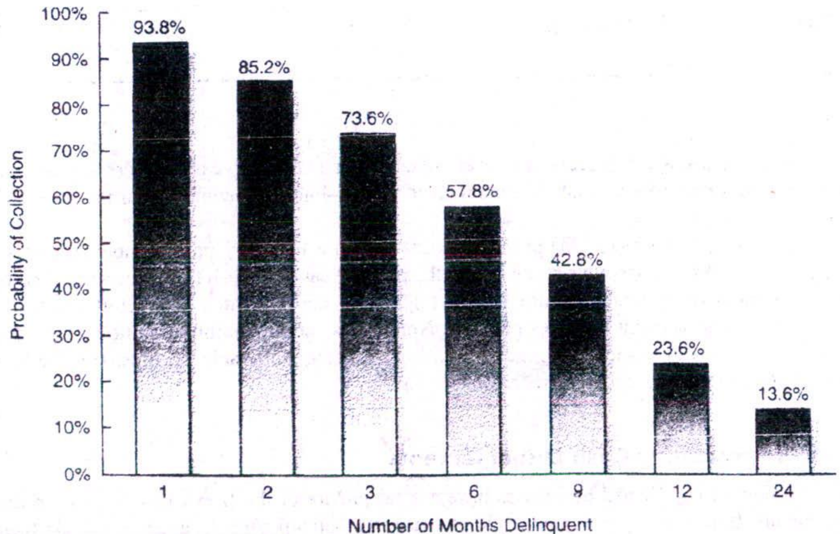


TABLE 9.5

Managing Accounts Receivable

Source: Adapted from "Financial Control," *Inc.*, reprinted with permission of the publisher.

Are your customers who purchase on credit paying late? If so, these outstanding accounts receivable probably represent a significant leak in your company's cash flow. Slow paying customers, in effect, are borrowing money from your business interest free. They are using your money without penalty while you forgo opportunities to place it in interest-earning investments or while you pay interest on money you must borrow to replace the missing funds. Exactly how much is poor credit control costing your company? The answer may surprise you.

The first step is to calculate your company's average collection period ratio (see "Operating Ratios" section in Chapter 10). The second step is to age your accounts receivable to determine how many accounts are current and how many are overdue. The following example shows how to use these numbers to calculate the cost of past-due accounts for a company whose credit terms are "net 30":

Average collection period	65 days
– Credit terms	–30 days
Excess in accounts receivable	35 days
Average daily sales of $21,500* × 35 days	$752,500
× Normal rate of return	× 8%
Annual cost of excess	$ 60,200

Slow-paying customers are costing this company more than $60,000 a year! If your business is highly seasonal, quarterly or monthly figures may be more meaningful than annual ones.

*Average daily sales = Annual sales ÷ 365 days = $7,847,500 ÷ 365 = $21,500

entrepreneurs opening new businesses. In fact, some financial analysts recommend that new owners estimate cash disbursements as best they can and then add another 10 to 25 percent of the total. Whatever forecasting technique is used, entrepreneurs must avoid underestimating cash disbursements, which may lead to severe cash shortages and possible bankruptcy.

Sometimes business owners have difficulty developing initial forecasts of cash receipts and cash disbursements. One of the most effective techniques for overcoming the "I don't know where to begin" hurdle is to make a *daily* list of the items that generated cash (receipts) and those that consumed it (disbursements).

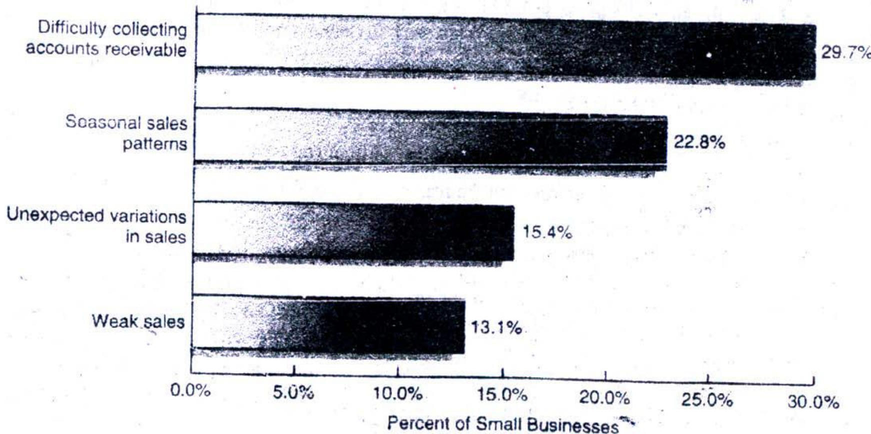


FIGURE 9.4

Causes of Cash Flow Problems in Small Businesses

Source: Reprinted by permission of NFIB.

A Company Example

For example, Susan Bowen, CEO of ***Champion Awards****, a $9 million T-shirt screen printer, monitors cash flow by tracking the cash that flows into and out of her company every day. Focusing on keeping the process simple, Bowen sets aside a few minutes each morning to track updates from the previous day on four key numbers:*

- ***Accounts receivable:*** *1. What did we bill yesterday? 2. How much did we actually collect?*
- ***Accounts payable:*** *3. What invoices did we receive yesterday? 4. How much in total did we pay out?*

If Bowen observes the wrong trend—more new bills than new sales or more money going out than coming in—she makes immediate adjustments to protect her cash flow. The benefits produced (not the least of which is the peace of mind knowing no cash crisis is looming) more than outweigh the 10 minutes she invests in the process every day. "I've tried to balance my books every single day since I started my company in 1970," says Bowen.[12]

Step 5: Estimating the End-of-Month Cash Balance

To estimate a company's cash balance for each month, a small business manager first must determine the cash balance at the beginning of each month. The beginning cash balance includes cash on hand as well as cash in checking and savings accounts. As development of the cash budget progresses, the cash balance at the end of a month becomes the beginning balance for the following month. Next, the owner simply adds total cash receipts and subtracts total cash disbursements to obtain the end-of-month balance before any borrowing takes place. A positive amount indicates that the firm has a cash surplus for the month whereas a negative amount shows a cash shortage will occur unless the owner is able to collect or borrow additional funds.

Normally, a firm's cash balance fluctuates from month to month, reflecting seasonal sales patterns. Such fluctuations are normal, but business owners must watch closely for patterns of increases and decreases in the cash balance over time. A trend of increases indicates that the small firm has ample cash that could be placed in some income-earning investment. On the other hand, a pattern of cash decreases should alert the owner that the business is approaching a cash crisis.

A cash budget not only illustrates the flow of cash into and out of the small business, but it also allows the owner to *anticipate* cash shortages and cash surpluses. "Then," explains a small business consultant, "you can go to the bank and get a 'seasonal' line of credit for six months instead of twelve. Right there you can cut your borrowing costs in half."[13] By planning cash needs ahead of time, a small business is able to achieve the following benefits:

- Increase the amount and the speed of cash flowing into the company.
- Reduce the amount and the speed of cash flowing out of the company.
- Make the most efficient use of available cash.
- Take advantage of money-saving opportunities, such as quantity and cash discounts.
- Finance seasonal business needs.
- Develop a sound borrowing program.
- Develop a workable program of debt repayment.
- Impress lenders and investors with the firm's ability to plan and repay financing.
- Provide funds for expansion.
- Plan for investing surplus cash.

"Cash flow spells survival for every business," claims one expert. "Manage cash flow effectively, and your business works. If your cash flow is not well managed, then sooner or later your business goes under. It's that simple."[14] Unfortunately, most small business owners forgo these benefits because they fail to manage their cash properly. One study reported that just 2 percent of all small businesses used formal techniques for tracking the level of their cash balances.[15] Because cash flow problems usually sneak up on a business over time, improper cash management often proves to be a costly—and fatal—mistake.

THE "BIG THREE" OF CASH MANAGEMENT

Learning Objectives
4. Describe fundamental principles involved in managing the "big three" of cash management: accounts receivable, accounts payable, and inventory.

It is unrealistic for business owners to expect to trace the flow of every dollar through their businesses. However, by concentrating on the three primary causes of cash flow problems, they can dramatically lower the likelihood of experiencing a devastating cash crisis. The "big three" of cash management are accounts receivable, accounts payable, and inventory. A firm should always try to accelerate its receivables and to stretch out its payables. A good cash management "recipe" involves collecting your company's cash as quickly as possible, economizing to keep costs low, and paying out your company's cash as slowly as possible. Business owners also must monitor inventory carefully to avoid tying up valuable cash in an excessive stock of inventory.

Accounts Receivable

Selling merchandise and services on credit is a necessary evil for most small businesses. Many customers expect to buy on credit, and business owners extend it to avoid losing customers to competitors. However, selling to customers on credit is expensive; it requires more paperwork, more staff, and more cash to service accounts receivable. Also, because extending credit is, in essence, lending money, the risk involved is higher. Every business owner who sells on credit will encounter customers who pay late or, worst of all, who never pay at all.

Selling on credit is a common practice in business. Experts estimate that 90 percent of industrial and wholesale sales are on credit and that 40 percent of retail sales are on account.[16] One survey of small businesses across a variety of industries reported that 77 percent extend credit to their customers.[17] Because credit sales are so prevalent, an assertive collection program is essential to managing a company's cash flow. A credit policy that is too lenient can destroy a business's cash flow, attracting nothing but slow-paying and "deadbeat" customers. On the other hand, a carefully designed policy can be a powerful selling tool, attracting customers and boosting cash flow. Entrepreneurs must remember that a sale does not count until they collect the cash from it! Transforming accounts receivable into cash is essential to staying in business.

A Company Example

When many of her public relations company's clients in the high-tech industry began to fail, Lynn Parker of ***Parker LePla*** *realized her business faced a serious threat. "We had several hundred thousand dollars in overdue accounts," she says. "We knew we were going to have to make collecting accounts receivable a priority." Parker implemented a flowchart process for collecting her company's cash that prescribed the steps each employee should take, ranging from a simple e-mail from one of her account executives to turning the account over to a collection attorney. Her efforts paid off; in just six months, accounts past due for more than 90 days shrank from $450,000 to $45,000.*[18]

HOW TO ESTABLISH A CREDIT AND COLLECTION POLICY. The first step in establishing a workable credit policy is to screen customers carefully *before* granting them credit. Unfortunately, few small businesses conduct any kind of credit investigation before selling to a new customer. According to one survey, nearly 95 percent of small firms that sell on credit sell to *anyone* who wants to buy; most have no credit-checking procedure.[19]

A Company Example

Rene Siegel, president of ***HighTech Connect****, a public relations firm that focuses on high-technology companies, recognizes the danger of performing services for companies that subsequently fail to pay. The chances of uncollectible accounts are especially high for HighTech Connect because the majority of its customers are risky high-tech start-ups. Before accepting a new client, Siegel invests the time to check out the company's credit rating, its capital base, its financial backers, and its reputation. In addition to a formal credit investigation, Siegel also relies on her extensive network of contacts in Silicon Valley to get the "inside scoop" on the companies wanting to hire HighTech Connect. Her screening diligence has paid off; since she initiated the process, only one customer has failed to pay HighTech Connect for its services, and that was a company that declared bankruptcy.*[20]

YOU Be the Consultant . . .

In Search of a Cash Flow Forecast

"I'll never make that mistake again," Douglas Martinez said to himself as he got into his car. Martinez had just left a meeting with his banker, who had not been optimistic about the chances of Martinez's plumbing supply company getting the loan it needed. "I should have been better prepared for the meeting," he muttered, knowing that he could be angry only at himself. "That consultant at the Small Business Development Center (SBDC) was right. Bankers' primary concern when making loans is cash flow."

"At least I salvaged the meeting by telling him I wasn't ready to officially apply for a loan yet," Martinez thought. "But I've got a lot of work to do. I've got a week to figure out how to put together a cash budget to supplement my loan application. Maybe that consultant can help me."

When he returned to his office, Martinez gathered up the file folders containing all of his fast-growing company's financial reports and printed his projected revenues and expenses using his computer spreadsheet. Then he called the SBDC consultant he had worked with when he was launching his company and explained the situation. When he arrived at the consultant's office that afternoon, they started organizing the information. Here is what they came up with:

Current cash balance	$8,750
Sales pattern	71% on credit and 29% in cash
Collections of credit sales	68% in the same month as the sale;
	19% in the first month after the sale;
	7% in the second month after the sale;
	6% never collected (bad debts).

Sales forecasts:

	Pessimistic	Most Likely	Optimistic
July (actual)	—	$18,750	—
August (actual)	—	$19,200	—
September (actual)	—	$17,840	—
October	$15,000	$17,500	$19,750
November	$14,000	$16,500	$18,500
December	$11,200	$13,000	$14,000
January	$ 9,900	$12,500	$14,900
February	$10,500	$13,800	$15,800
March	$13,500	$17,500	$19,900

Utilities expenses	$800 per month.
Rent	$1,200 per month
Truck loan	$317 per month

The company's wages and salaries (including payroll taxes) estimates are:

October	$2,050
November	$1,825
December	$1,725
January	$1,725
February	$1,950
March	$2,425

The company pays 63 percent of the sales price for the inventory it purchases, an amount that it actually pays in the following month. (Martinez has negotiated "net 30" credit terms with his suppliers.)

Other expenses include:

Insurance premiums	$1,200, payable in August and February
Office supplies	$95 per month
Maintenance	$75 per month
Computer supplies	$75 per month
Advertising	$550 per month
Legal and accounting fees	$250 per month
Miscellaneous expenses	$60 per month

A tax payment of $1,400 is due in December.

Martinez has established a minimum cash balance of $2,000.

"Well, what do you think?" Martinez asked the consultant.

1. Assume the role of the SBDC consultant and help Martinez put together a cash budget for the six months beginning in October.

2. What conclusions can you draw about Martinez's business from this cash budget?

3. What suggestions can you make to help Martinez improve his company's cash flow?

A detailed credit application is the first line of defense against bad debt losses. Before selling to *any* customer on credit, business owners should have the customer complete a customized application designed to meet their companies' specific needs. After collecting enough information to assemble a credit profile, the business owner should use it by check

ing the potential customer's credit references. The savings from lower bad debt expenses can more than offset the cost of using a credit reporting service such as TRW or Dun & Bradstreet. The National Association of Credit Management (www.nacm.org) is another important source of credit information because it collects information on many small businesses that other reporting services ignore. The cost to check a potential customer's credit at reporting services such as these ranges from $15 to $85, a small price to pay when considering selling thousands of dollars' worth of goods or services to a new customer. The Internet has made the job of credit checking much easier. Sites such as Dun & Bradstreet (www.dnb.com), Experian (www.experian.com), Equifax (www.equifax.com), Veritas Credit Corporation (www.veritas-usa.com), and KnowX (www.knowx.com) help entrepreneurs gather credit information on potential customers. Unfortunately, few small businesses take the time to conduct a credit check; in one study, just one-third of the businesses protected themselves by checking potential customers' credit.[21]

The next step involves establishing a firm written credit policy and letting every customer know in advance the company's credit terms. Industry practices often dictate credit terms (30 days is common), but a business does not have to abide by industry standards. A credit agreement must state clearly all the terms the business will enforce if the account goes bad—including interest, late charges, attorney's fees, and others. Failure to specify these terms in the contract means they *cannot* be added later after problems arise. When will you invoice? How soon is payment due: immediately, 30 days, 60 days? Will you add a late charge? If so, how much? The credit policies should be as tight as possible and within federal and state credit laws. According to the American Collectors Association, if a business is writing off more than 5 percent of sales as bad debts, the owner should tighten its credit and collection policy.[22]

The third step in an effective credit policy is to send invoices promptly because customers rarely pay *before* they receive their bills. The cornerstone of collecting accounts receivable on time is making sure you invoice your customers or send them their periodic billing statements promptly. "The sooner you mail your invoice, the sooner the check will be in the mail," says one entrepreneur. "In the manufacturing environment, get the invoice en route to the customer as soon as the shipment goes out the door," he advises. "Likewise, service industries with billable hours should keep track of hours daily or weekly and bill as often as the contract or agreement with the client permits."[23] Some businesses use **cycle billing**, in which a company bills a portion of its credit customers each day of the month to smooth out uneven cash receipts.

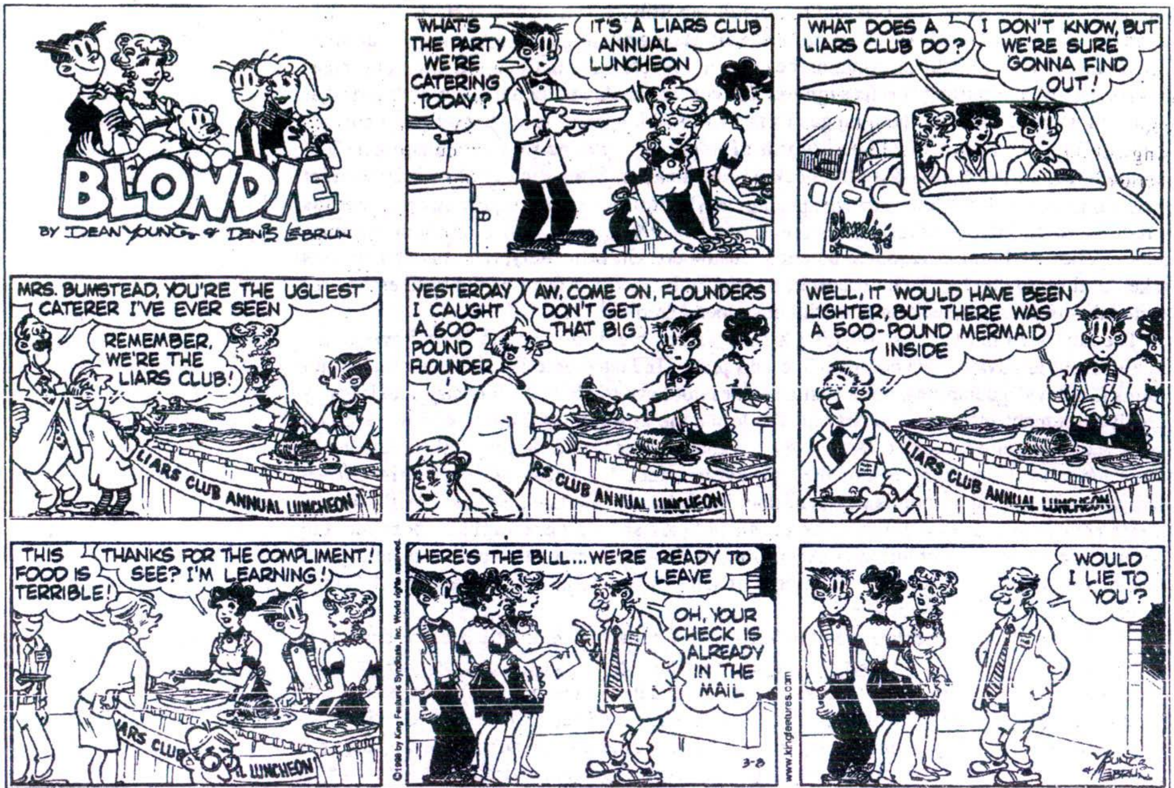
cycle billing—*a method in which a company bills a portion of its credit customers each day of the month in order to smooth out uneven cash receipts.*

Small business owners can take several steps to encourage prompt payment of invoices:

- Ensure that all invoices are clear, accurate, and timely.
- State clearly a description of the goods or services purchased and an account number.
- Make sure that the prices and the language on invoices agree with the price quotations on purchase orders or contracts.
- Highlight the balance due and the terms of sale (e.g., "net 30") on all invoices. A study by Xerox Corporation found that highlighting with color the balance due section of invoices increased the speed of collection by 30 percent.[24]
- Include a telephone number and a contact person in your organization in case the customer has a question or a dispute.

When an account becomes overdue, a small business owner must take *immediate* action. The longer an account is past due, the lower is the probability of collecting it. As soon as an account becomes overdue, many business owners send a "second notice" letter requesting immediate payment. If that fails to produce results, the next step is a telephone call. When contacting a delinquent customer by phone, the goal is to get a commitment to pay the full amount of the bill by a specific date (*not* "soon" or "next week"). Following up with an e-mail to the customer summarizing the telephone commitment also helps. If the customer still refuses to pay the bill, collection experts recommend the following:

- Sending a letter from the company's attorney.
- Turning the account over to a collection attorney.
- As a last resort, hiring a collection agency. (The Commercial Law League of America (www.clla.org) can provide a list of reputable agencies.)



Source: REPRINTED WITH SPECIAL PERMISSION, KING FEATURES SYNDICATE.

Although collection agencies and attorneys will take 25 to 50 percent of any accounts they collect, they are often worth the price. According to the American Collectors Association, only 5 percent of accounts more than 90 days delinquent will be paid voluntarily. When dealing with delinquent customers, business owners must be sure to abide by the provisions of the federal Fair Debt Collection Practices Act, which prohibits any kind of harassment when collecting debts (e.g., telephoning repeatedly, issuing threats of violence, telling third parties about the debt, or using abusive language). The primary rule when collecting past-due accounts is "*Never* lose your cool." Establishing a friendly but firm attitude that treats customers with respect is more likely to produce payment than hostile threats.

Table 9.6 outlines 10 collection blunders small business owners typically make and how to avoid them.

OTHER TECHNIQUES FOR ACCELERATING ACCOUNTS RECEIVABLE. Small business owners can rely on a variety of other techniques to speed cash inflow from accounts receivable:

- Speed up orders by having customers e-mail or fax them to you.
- Send invoices when goods are shipped—not a day or a week later; consider faxing or e-mailing invoices to reduce "in transit" time to a minimum. Most small business accounting software has features that allow users to e-mail the invoices they generate.
- Indicate in conspicuous print the invoice due date and any late payment penalties. (Check with an attorney to be sure all finance charges comply with state laws.)
- Restrict a customer's credit until past-due bills are paid.
- Deposit customer checks and credit card receipts *daily*.
- Identify the top 20 percent of your customers (by sales volume), create a separate file system for them, and monitor them closely. Twenty percent of the typical company's customers generate 80 percent of all accounts receivable.

TABLE 9.6

10 Collection Blunders and How to Avoid Them

Sources: Adapted from "Tips for Collecting Cash," *FSB*, May 2002, p. 72; Janine Latus Musick, "Collecting Payments Due," *Nation's Business*, January 1999, pp. 44–46; Bob Weinstein, "Collect Calls," *Entrepreneur*, August 1995, pp. 66–69; Elaine Pofeldt, "Collect Calls," *Success*, March 1998, pp. 22–24.

Business owners often make mistakes when trying to collect the money their customers owe. Checking potential credit customers' credit records and creating a thorough sales contract that spells out exactly what happens if the account becomes past due can help minimize collection problems. Sooner or later, however, even the best system will encounter late payers. What happens then? Business owners should avoid these collection blunders.

Blunder 1: Delaying collection phone calls. Many entrepreneurs waste valuable time and resources sending four or five "past-due" letters to delinquent customers, usually with limited effectiveness.

Instead: Once a bill becomes past due, call the customer within a week to verify that he received the bill and that it is accurate. Ask for payment.

Blunder 2: Failing to ask for payment in clear terms. To avoid angering a customer, some entrepreneurs ask meekly, "Do you think you could take care of this bill soon?"

Instead: Firmly, but professionally, ask for payment of the full amount by a specific date.

Blunder 3: Sounding desperate. Some entrepreneurs show weakness by saying that they must have payment or they "can't meet payroll" or "can't pay bills." That gives the customer more leverage to negotiate additional discounts or time.

Instead: Ask for payment simply because the invoice is past due—without any other explanation. Don't apologize for your request; it's *your* money.

Blunder 4: Talking tough. Getting nasty with delinquent customers does not make them pay any faster and may be a violation of the Fair Debt Collections Practices Act.

Instead: Remain polite and professional when dealing with past-due customers, even if you think they don't deserve it. Never lose your temper. Don't ruin your reputation by being rude.

Blunder 5: Trying to find out the customer's problem. Some entrepreneurs think it is necessary to find out why a delinquent customer has not paid a bill.

Instead: Don't waste time playing private investigator. Focus on the "business at hand," collecting your money.

Blunder 6: Asking customers how much they can pay. When customers claim that they cannot pay the bill in full, inexperienced entrepreneurs ask, "Well, how much can you pay?" They don't realize that they have just turned control of the situation over to the delinquent customer.

Instead: Take charge of negotiations from the outset. Let the customer know that you expect full payment. If you cannot get full payment immediately, suggest a new deadline. Only as a last resort should you offer an extended payment plan.

Blunder 7: Continuing to talk after you get a promise to pay. Some entrepreneurs "blow the deal" by not knowing when to stop talking. They keep interrogating a customer after they have a promise to pay.

Instead: Wrap up the conversation as soon as you have a commitment. Summarize the agreement, thank the customer, and end the conversation on a positive note.

Blunder 8: Calling without being prepared. Some entrepreneurs call customers without knowing exactly which invoices are past due and what amounts are involved. The effort is usually fruitless.

Instead: Have all account details in front of you when you call and be specific in your requests.

Blunder 9: Trusting your memory. Some entrepreneurs think they can remember previous collection calls, conversations, and agreements.

Instead: Keep accurate records of all calls and conversations. Take notes about each customer contact and resulting agreements.

Blunder 10: Letting your computer control your collection efforts. Inexperienced entrepreneurs tend to think that their computers can manage debt collection for them.

Instead: Recognize that a computer is a valuable tool in collecting accounts but that you are in control. "Past-due" notices from a computer may collect some accounts, but your efforts will produce more results. Getting to know the people who handle the invoices at your customers' businesses can be a major advantage when collecting accounts.

- Ask customers to pay at least a portion of the purchase price up front. To preserve her company's cash flow, Jane Conner, owner of the Whitefish Gymnastics Club, requires her customers to pay for their 10-week exercise classes after the first session.[25]
- Watch for signs that a customer may be about to declare bankruptcy. If that happens, creditors typically collect only a small fraction, if any, of the debt owed.

Lockbox—*an arrangement in which customers send payments to a post office box a company's bank maintains; several times a day, the bank collects payments and deposits them in the company's account.*

- Consider using a bank's lockbox collection service (located near customers) to reduce mail time on collections. In a **lockbox** arrangement, customers send payments to a post office box the company's bank maintains. Several times each day, the bank collects payments and deposits them immediately in the company's account. The procedure sharply reduces processing and clearing times, especially if the lockboxes are located close to the firm's biggest customers' business addresses. The system can be expensive to operate and is most economical for companies with a high volume of large checks.
- Track the results of the company's collection efforts. Managers and key employees should receive a weekly report on the status of the company's outstanding accounts receivable.

A Company Example

Although project managers at **Ransom Environmental**, *an environmental consulting company in Newburyport, Massachusetts, viewed collecting accounts receivable as a necessary evil, CEO Steve Ransom decided his company had to make collections a priority to improve cash flow. Ransom began distributing a receivables status report at the company's weekly operations meetings. Given to every manager, the report features a receivables-aging chart showing whose customers were behind on their payments and by how many days. Ransom Environmental quickly began to see an improvement in its collection patterns and in its cash flow. The company's average collection period has fallen from 75 days to 60 days, and faster collections have boosted cash flow, enabling Ransom to save between $1,000 and $2,000 a month in interest on its line of credit.*[26]

security agreement—*a contract in which a business selling an asset on credit gets a security interest in that asset (the collateral), protecting its legal rights in case the buyer fails to pay.*

Another strategy small companies can use to protect the cash they have tied up in receivables is coupling a security agreement with a financing statement. This strategy falls under Article 9 of the Uniform Commercial Code (UCC), which governs a wide variety of business transactions, from the sale of goods to security interests. A **security agreement** is a contract in which a business selling an asset on credit gets a security interest in that asset (the collateral), protecting its legal rights in case the buyer fails to pay. To get the protection it seeks in the security agreement, the seller must file a financing statement, the UCC-1 form, with the proper state or county office (a process the UCC calls "perfection"). The UCC-1 form gives notice to other creditors and to the general public that the seller holds a secured interest in the collateral named in the security agreement. The UCC-1 form must include the name, address, and signature of the buyer; a description of the collateral; and the name and address of the seller.

Suppose that Lanford Mechanical sells a piece of manufacturing machinery to Abbott Chemical Company for $64,000, accepting $12,000 in cash and retaining the $52,000 balance on account, payable over 24 months. As part of the sales contract (which also is governed by the UCC, Article 2), Lanford gets Abbott to sign a security agreement, giving Lanford a security interest in the machine. If Lanford files the financing statement (UCC-1 form) with the secretary of state for a small fee, it has perfected its security interest in the machine. If Abbott fails to pay the account balance in full, Lanford can repossess the machine and sell it to satisfy the remaining balance. If Abbott were to declare bankruptcy, Lanford is not guaranteed payment, but its filing puts its claim to the machinery ahead of those of unsecured creditors. Lanford's degree of safety on this large credit sale is much higher with a security agreement and a properly filed financing statement.

Accounts Payable

The second element of the "big three" of cash management is accounts payable. The timing of payables is just as crucial to proper cash management as the timing of receivables, but the objective is exactly the opposite. Entrepreneurs should strive to stretch out payables as long as possible *without damaging their companies' credit rating*. Otherwise, suppliers may begin demanding prepayment or C.O.D. terms, which severely impairs a company's cash flow, or they simply stop doing business with it. When one computer manufacturer ran into cash flow problems, it deferred payments to its suppliers for as long as 100 days (compared to an industry average of about 40 days). Because of the company's slow payments, many suppliers simply stopped selling to the computer maker.[27] One cash management consultant says, "Some companies pay too early and wind up forgoing the interest they could have earned on their cash.

Others pay too late and either wind up with late penalties or being forced to buy on a C.O.D. basis, which really kills them."[28] It is perfectly acceptable for small business owners to regulate payments to their companies' advantage. Efficient cash managers set up a payment calendar each month that allows them to pay their bills on time and to take advantage of cash discounts for early payment.

A Company Example

Nancy Dunis, CEO of ***Dunis & Associates****, a Portland, Oregon, marketing firm, recognizes the importance of controlling accounts payable. "Our payables must be functioning just right to keep our cash flow running smoothly," says Dunis. She has set up a simple five-point accounts payable system:*[29]

1. ***Set scheduling goals.*** *Dunis strives to pay her company's bills 45 days after receiving them and to collect all her receivables within 30 days. Even though "it doesn't always work that way," her goal is to make the most of her cash flow.*
2. ***Keep paperwork organized.*** *Dunis dates every invoice she receives and carefully files it according to her payment plan. "This helps us remember when to cut the check," she says, and "it helps us stagger our payments, over days or weeks"—significantly improving the company's cash flow.*
3. ***Prioritize.*** *Dunis cannot stretch out all of her company's creditors for 45 days; some demand payment sooner. Those suppliers are at the top of the accounts payable list.*
4. ***Be consistent.*** *"Companies want consistent customers," says Dunis. "With a few exceptions," she explains, "most businesses will be happy to accept 45-day payments, so long as they know you'll always pay your full obligation at that point."*
5. ***Look for warning signs.*** *Dunis sees her accounts payable as an early warning system for cash flow problems. "The first indication I get that cash flow is in trouble is when I see I'm getting low on cash and could have trouble paying my bills according to my staggered filing system," she says. Other signs that a business is heading for cash flow problems include difficulty making principal and interest payments on loans and incurring penalties for late payment of routine bills.*

Business owners should verify all invoices before paying them. Some unscrupulous vendors will send out invoices for goods they never shipped or services they never rendered, knowing that many business owners will simply pay the bill without checking its authenticity. A common invoice scam aimed at small business owners involves bogus operators sending bills for ads in nonexistent printed or online "yellow pages" directories. In some cases, the directories actually do exist, but their distribution is so limited that ads in them are useless. A survey by the real Yellow Pages Publishers Association found that one-third of businesses had received bogus bills for Yellow Pages advertising.[30] To avoid falling victim to such scams, someone in the company—for instance, the accounts payable clerk—should have the responsibility of verifying *every* invoice received.

Generally, it is a good idea for owners to take advantage of cash discounts vendors offer. A cash discount (e.g., "2/10, net 30"—take a 2 percent discount if you pay the invoice within 10 days; otherwise, total payment is due in 30 days) offers a price reduction if the owner pays an invoice early. Failing to take advantage of this particular cash discount is the equivalent of borrowing at an interest rate of 36.7 percent! A clever cash manager also will negotiate the best possible credit terms with his suppliers. Almost all vendors grant their customers trade credit, and small business owners should take advantage of it. However, because trade credit is so easy to get, entrepreneurs must be careful not to overuse and abuse it, putting their businesses in a precarious financial position.

Favorable credit terms can make a tremendous difference in a company's cash flow. Table 9.7 shows the same most likely cash budget from Table 9.2 with one exception: Instead of purchasing on C.O.D. terms (Table 9.2), the owner has negotiated net 30 payment terms (Table 9.7). Notice the drastic improvement in the company's cash flow resulting from improved credit terms.

If owners do find themselves financially strapped when payment to a vendor is due, they should avoid making empty promises that "the check is in the mail" or sending unsigned checks. Instead, they should openly discuss the situation with the vendor. Most vendors will

TABLE 9.7

Cash Budget,[a] Most Likely Sales Forecast

	Jan.	Feb.	Mar.	Apr.
Cash Receipts:				
Sales	$150,000	$200,000	$200,000	$300,000
Credit Sales	112,500	150,000	150,000	225,000
Collections:				
60%—1st month after sale	$180,000	$67,500	$90,000	$90,000
30%—2nd month after sale	78,750	90,000	33,750	45,000
5%—3rd month after sale	11,250	13,125	15,000	5,625
Cash Sales	37,500	50,000	50,000	75,000
Interest	0	200	0	9
Total Cash Receipts	$307,500	$220,825	$188,750	$215,625
Cash Disbursements:				
Purchases[a]	$105,000	$140,000	$140,000	$210,000
Rent	2,000	2,000	2,000	2,000
Utilities	850	850	850	850
Interest	0	0	7,500	0
Tax Prepayment	0	0	50,000	0
Capital Addition	0	130,000	3	0
Miscellaneous	70	70	70	70
Wage/Salaries	30,000	40,000	45,000	50,000
Total Cash Disbursements[a]	$137,920	$312,920	$245,420	$262,920
End-of-Month Balance:				
Cash (beginning of month)[a]	$12,000	$181,580	$89,485	$32,815
+ Cash Receipts	307,500	220,825	188,750	215,625
– Cash Disbursements[a]	137,920	312,920	245,420	262,920
Cash (end of month)[a]	181,580	89,485	32,815	(14,480)
Borrowing	0	0	0	24,480
Cash (end of month [after borrowing])[a]	$181,580	$89,485	$32,815	$10,000

[a] After negotiating "net 30" trade credit terms.

work out payment terms for extended credit. One small business owner who was experiencing a cash crisis claims:

> One day things got so bad I just called up a supplier and said, "I need your stuff, but I'm going through a tough period and simply can't pay you right now." They said they wanted to keep me as a customer, and they asked if it was okay to bill me in three months. I was dumbfounded: *They didn't even charge me interest.*[31]

Small business owners also can improve their firms' cash flow by scheduling controllable cash disbursements so that they do not come due at the same time. For example, paying employees every two weeks (or every month) rather than every week reduces administrative costs and gives the business more time to use its cash. Owners of fledgling businesses may be able to conserve cash by hiring part-time employees or by using freelance workers rather than full-time, permanent workers. Scheduling insurance premiums monthly or quarterly rather than annually also improves cash flows.

Wise use of business credit cards is another way to stretch the firm's cash balance. However, entrepreneurs should avoid cards that charge transaction fees. Credit cards differ in their interest-charging policies; many begin charging interest from the date of purchase, but some charge interest only from the invoice date.

Inventory

Inventory is a significant investment for many small businesses and can create a severe strain on cash flow. The typical grocery store now stocks more than 49,000 items, three times as many as it did 20 years ago, and many other types of businesses are following this pattern.[32] Offering customers a wider variety of products is one way a business can outshine its competitors, but product proliferation increases the need for tight inventory control to avoid a cash crisis. Although inventory represents the largest capital investment for most businesses, few owners use any formal methods for managing it. As a result, the typical small business not only has too much inventory but also too much of the *wrong* kind of inventory! Because inventory is illiquid, it can quickly siphon off a company's pool of available cash. "Small companies need cash to grow," says one consultant. "They've got to be able to turn [cash] over quickly. That's difficult to do if a lot of money is tied up in excess inventory."[33]

Surplus inventory yields a zero rate of return and unnecessarily ties up the firm's cash. "The cost of carrying inventory is expensive," says one small business consultant. "A typical manufacturing company pays 25 percent to 30 percent of the value of the inventory for the cost of borrowed money, warehouse space, materials handling, staff, lift-truck expenses, and fixed costs. This shocks a lot of people. Once they realize it, they look at inventory differently."[34] Marking down items that don't sell will keep inventory lean and allow it to turn over frequently. Even though volume discounts lower inventory costs, large purchases may tie up the company's valuable cash. Wise business owners avoid overbuying inventory, recognizing that excess inventory ties up valuable cash unproductively. In fact, only 20 percent of a typical business's inventory turns over quickly, so owners must watch constantly for stale items. If a small business must pay suppliers within 30 days of receiving an inventory shipment and then the merchandise sits on the shelf for another 30 to 60 days, the pressure on its cash flow intensifies.

Carrying too little inventory is not desirable because companies with excessive "stockouts" lose sales (and eventually customers if the problem persists). However, carrying too much inventory usually results in slow-moving inventory and a low inventory turnover ratio. Experienced business owners understand the importance of shedding slow-moving inventory, even if the price they get is below their normal markup.

A Company Example

Recognizing the high cost of holding inventory, Cindy Revenaugh, vice president of sales at ***Channeled Resources****, a company that sells recycled paper products, gives her sales force the power to sell slow-moving items at any price that is not below the company's cost. "We just want to move the stuff and get cash for it," says Revenaugh. "Even if they sell it at cost, it's better than letting it sit here."*[35]

Carrying too much inventory increases the chances that a business will run out of cash. "The cash that pays for goods is channeled into inventory," says one business writer, "where its flow is dead-ended until the inventory is sold and the cash is set free again. The cash flow trick is to commit just enough cash to inventory to meet demand."[36] Scheduling inventory deliveries at the latest possible date will prevent premature payment of invoices. Finally, given goods of comparable quality and price, an entrepreneur should purchase goods from the fastest supplier to keep inventory levels low.

Monitoring the "big three" of cash management can help every business owner avoid a cash crisis while making the best use of available cash. According to one expert, maximizing cash flow involves "getting money from customers sooner; paying bills at the last moment possible; consolidating money in a single bank account; managing accounts payable, accounts receivable, and inventory more effectively; and squeezing every penny out of your daily business."[37]

AVOIDING THE CASH CRUNCH

Learning Objective

5. Explain the techniques for avoiding a cash crunch in a small company.

Nearly every small business has the potential to improve its cash position with little or no investment. The key is to make an objective evaluation of the company's financial policies, searching for inefficiency in its cash flow. Young firms cannot afford to waste resources, especially one as vital as cash. By utilizing the following techniques, entrepreneurs can get maximum benefit from their companies' pool of available cash.

Barter

bartering—*the exchange of goods and services for other goods and services rather than for cash.*

Bartering, the exchange of goods and services for other goods and services rather than for cash, is an effective way to conserve cash. An ancient concept, bartering regained popularity during recent recessions. Over the last decade, more than 700 barter exchanges have cropped up, catering primarily to small- and medium-sized businesses looking to conserve cash. More than 500,000 companies—most of them small—engage in more than $16.1 billion worth of barter each year.[38] Every day, entrepreneurs across the nation use bartering to buy much needed materials, services, equipment, and supplies—*without* using cash.

A Company Example

When Jerry Trombo relocated his printing business, ***Litho Graphics****, he traded printing services for moving services, painting, carpeting, furnishings, a computer, and a newly paved driveway. For the year, Litho Graphics conducted more than $50,000 worth of bartering, an amount representing 8 percent of the company's sales—and involving no cash! "I don't buy anything unless I pick up the barter catalogue," says Trombo, who has been bartering through an exchange for more than 11 years. "I'll do anything to avoid spending cash."*[39]

In addition to conserving cash, companies that use barter also have the opportunity to transform slow-moving inventory into much-needed products and services. Barter companies pay, on average, trade credits equal to three times the amount inventory liquidators would pay for the same merchandise.[40] Buying goods and services with barter also offers the benefit of a built-in discount. Although a company gets credit for the retail value of the goods or services it offers, the real cost to the company is less and depends on its gross profit margin. For instance, the owner of an Italian restaurant bartered $1,000 worth of meals for some new furniture, but his actual cost of the meals was only $680, given his gross profit margin of 32 percent. Business owners who barter also say that joining a barter exchange brings in customers who normally would not buy from them.

In a typical barter exchange, businesses accumulate trade credits when they offer goods or services through the exchange. Then they can use their trade credits to purchase other goods and services from other members of the exchange. The typical exchange charges a $500 membership fee and a 10 percent transaction fee (5 percent from the buyer and 5 percent from the seller) on every deal. The exchange tracks the balance in each member's account and typically sends a monthly statement summarizing account activity.

Online barter exchanges such as Intagio.com, International Trade Exchange, and Ubarter.com have become extremely popular because of their convenience and the wide variety of items they list on their exchanges. A business owner can barter for advertising time and space, hotel stays, catering services, car rentals, airline tickets, office supplies, printing services, photography, carpet, cell phones, and many other products and services. Online barter exchanges usually charge lower membership and transaction fees than their off-line counterparts. Before joining a barter exchange, business owners should investigate the fee structure, the selection and the prices of its goods and services, and its geographical coverage.

Trim Overhead Costs

High overhead expenses can strain a small firm's cash supply to the breaking point; simple cost-cutting measures can save big money. Frugal small business owners can trim their overhead in a number of ways.

PERIODICALLY EVALUATE EXPENSES. Business owners not only should attempt to keep their operating costs low, but they also should evaluate them periodically to make sure they have not gotten out of line. Comparing current expenses with past levels is helpful and so is comparing a company's expenses against industry standards. Useful resources for determining typical expenses in an industry include *Robert Morris Associates' Annual Statement Studies*, *Dun & Bradstreet's Industry Norms and Key Business Ratios*, and *Prentice Hall's Almanac of Business and Industrial Financial Ratios*. We will describe these resources in more detail in the next chapter.

A Company Example

Linda Nespole, a manager at ***Hi-Shear Technology****, an aerospace subcontractor, used this technique to cut thousands of dollars from her company's operating expenses each year. When Hi-Shear's cash flow was squeezed recently, Nespole began tracking some of the company's largest operating expenses, mostly utility bills, and discovered some unusually large increases. Basic repairs, preventive maintenance, and more efficient fixtures cut costs and generated enough savings to pay for themselves within just a few months. Nespole expanded her list and began charting company expenses and acting on trends she saw. The result was major cost savings in everything from telephone charges to retirement plan costs. Tracking and controlling expenses has become a priority for Hi-Shear's 125 employees, and the company's cash flow has never been better!*[41]

WHEN PRACTICAL, LEASE INSTEAD OF BUY. By leasing automobiles, computers, office equipment, machinery, and other assets rather than buying them, an entrepreneur can conserve valuable cash. The value of such assets is not in *owning* them but in *using* them. Businesses can lease practically any kind of equipment—from office furniture and computers to construction equipment and manufacturing machinery. According to a recent survey, 73 percent of small companies use leasing as a cash management strategy.[42] "These companies are long on ideas, short on capital, and in need of flexibility as they grow and change," says Suzanne Jackson of the Equipment Leasing Association of America. "They lease for efficiency and convenience."[43]

Although total lease payments typically are greater than those for a conventional loan, most leases offer 100 percent financing, which means the owner avoids the large capital outlays required as down payments on most loans. Also, leasing is an "off-the-balance-sheet" method of financing and requires no collateral. A lease is considered an operating expense on the income statement, not a liability on the balance sheet. Thus, leasing conserves a company's borrowing capacity. Lease agreements also are flexible. Leasing companies typically offer a variety of terms and allow businesses to stretch payments over a longer time period than those of a conventional loan. "There are so many ways to tailor a lease agreement to a company's individual equipment and financial needs that you might call it a personalized rental agreement," says the owner of a small construction firm.[44]

Leasing also protects a business against obsolescence, especially when it comes to equipment such as computer hardware and software, whose technological life is limited to perhaps three years.

A Company Example

When Kai Adams, Brad Monarch, and Tim Haines opened the ***Sebago Brewing Company****, a restaurant-pub in South Portland, Maine, they borrowed $175,000 through a Small Business Administration loan and invested an equal amount of their own money. Installing beer brewing equipment, outfitting the kitchen, and furnishing the dining room (plus holding some cash in reserve for working capital) took most of their start-up funds. Still, the partners knew that they needed one more crucial ingredient to make their restaurant a success: a sophisticated computer system that would track every aspect of its operation minute by minute and give them the control they needed. The only catch was the system cost $30,000 that they did not have! So Adams, Monarch, and Haines decided to lease the computer setup. "It took a lot of money to open this restaurant," says Adams, "and we really had to be selective about what we spent our capital on. Leasing the computer system freed up cash flow for our opening." Having since opened two more outlets, the entrepreneurs continue to lease everything from computers to dishwashers. The benefits include lower initial capital outlays, flexibility in updating equipment, and, in many cases, transferring the cost of maintenance to the lessor.*[45]

AVOID NONESSENTIAL OUTLAYS. By forgoing costly ego indulgences like ostentatious office equipment, first-class travel, and flashy company cars, entrepreneurs can make the most efficient use of a company's cash. Before putting scarce cash into an asset, every business owner should put the decision to the acid test: "What will this purchase add to my company's ability to compete and to become more successful?" Making across-the-board spending cuts to conserve cash is dangerous, however, because the owner runs the risk of cutting expenditures that literally drive the business. One common mistake during business slowdowns is cutting marketing and advertising expenditures. Economic slowdowns present a prime opportunity for smart business owners to bring increased attention to their products and services and to gain market share if they hold the line on their marketing and advertising budgets as their competitors cut back. The secret to successful cost saving is cutting *nonessential* expenditures. "If the lifeblood of your company is marketing, cut it less," advises one advertising executive. "If it is customer service, that is the last thing you want to cut back on. Cut from areas that are not essential to business growth."[46]

NEGOTIATE FIXED LOAN PAYMENTS TO COINCIDE WITH YOUR COMPANY'S CASH FLOW CYCLE. Many banks allow businesses to structure loans so that they can skip specific payments when their cash flow ebbs to its lowest point. Negotiating such terms gives businesses the opportunity to customize their loan repayments to their cash flow cycles.

A Company Example

For example, Ted Zoli, president of ***Torrington Industries****, a construction-materials supplier and contracting business, consistently uses "skipped payment loans" in his highly seasonal business. "Every time we buy a piece of construction machinery," he says, "we set it up so that we're making payments for eight or nine months, and then skipping three or four months during the winter."*[47]

BUY USED OR RECONDITIONED EQUIPMENT, ESPECIALLY IF IT IS "BEHIND-THE-SCENES" MACHINERY. One restaurateur saved thousands of dollars in the start-up phase of his business by buying used equipment from a restaurant equipment broker.

HIRE PART-TIME EMPLOYEES AND FREELANCE SPECIALISTS WHENEVER POSSIBLE. Hiring part-time workers and freelancers rather than full-time employees saves on the cost of both salaries and benefits.

CONTROL EMPLOYEE ADVANCES AND LOANS. An entrepreneur should grant only those advances and loans that are necessary and should keep accurate records on payments and balances.

DEVELOP A SYSTEM TO BATTLE CHECK FRAUD. Consumers and businesses in the United States write more than 42 billion checks a year for retail payments, totaling some $39.5 trillion! Of those checks, about 251 million are returned because of insufficient funds, a closed account, or some other problem.[48] About 70 percent of all "bounced" checks occur because nine out of ten customers fail to keep their checkbooks balanced; the remaining 30 percent of bad checks are the result of fraud.[49] Simple techniques for minimizing losses from bad checks include requesting proper identification (preferably with a photograph) from customers, recording customers' telephone numbers, and training cashiers to watch for forged or counterfeit checks. Perhaps the most effective way to battle bad checks is to subscribe to an electronic check approval service. The service works at the cash register, and approval takes only a minute or less. The fee a small business pays to use the service depends on the volume of checks. For most small companies, charges amount to 1 to 2 percent of the cleared checks' value.

CHANGE YOUR SHIPPING TERMS. Changing the firm's shipping terms from "F.O.B (free on board) buyer," in which the *seller* pays the cost of freight, to "F.O.B seller," in which the *buyer* absorbs all shipping costs, can improve cash flow.

SWITCH TO ZERO-BASED BUDGETING. Zero-based budgeting (ZBB) primarily is a shift in the philosophy of budgeting. Rather than build the current year budget on *increases* from the previous year's budget, ZBB starts from a budget of zero and evaluates the necessity of every item. "Start with zero and review all expenses, asking yourself whether each one is necessary," says one business consultant.[50]

Be on the Lookout for Employee Theft

Companies lose billions of dollars each year to employee theft. Because they often rely on informal procedures for managing cash (or no procedures at all), small business owners are most likely to become victims of embezzlement and fraud by their employees. One source of the problem is the entrepreneur's attitude that "we're all family here; no one would steal from family." Although establishing a "police state" environment and trusting no one is not conducive to a positive work environment, putting in place adequate financial control systems is essential. Separating among at least two employees key cash management duties such as writing checks and handling bank statements and conducting regular financial audits can be effective deterrents to employee theft.

Keep Your Business Plan Current

Before approaching any potential lender or investor, a business owner must prepare a solid business plan. Smart owners keep their plans up-to-date in case an unexpected cash crisis forces them to seek emergency financing. Revising the plan annually also forces the owner to focus on managing the business more effectively.

YOU Be the Consultant . . .

The Trusted Employee

Lloyd and Jim Graff, co-owners of Graff-Pinkert, a company in Oak Forest, Illinois, that buys and sells machines that make metal components, ran the family-owned business the way their father, who founded the company, had: on trust and a handshake. After all, they were still doing business with many of the same companies their father had done business with over the years. The Graffs extended that same level of trust to their family of 18 employees. If an employee needed money for a deposit on a home or for a family medical emergency, the Graffs would extend a loan—interest free. Many employees and their families were friends outside of work and spent recreational time together.

That's why the Graffs were shocked and dismayed when they discovered that one of their workers, Patty Preston (not her real name), had been embezzling money from the business for more than four years. An 11-year employee and a mother of three children, Preston was a bookkeeper for Graff-Pinkert. Her illicit activities came to light while Preston was on vacation. Preston had neglected to deposit Jim Graff's last few payroll checks into his personal bank account. When he mentioned it in front of several workers, one of them grew concerned and revealed that she believed Preston had charged several Rugrats videotapes for her kids on the company's account at Home Depot. Another employee said that Preston also had purchased a storage shed for her home on a company account.

Jim immediately began to investigate the employees' allegations and discovered that they were true; Preston had been using company funds to purchase personal items. He contacted his brother, who was on vacation at the time. "I fired her for being a petty crook," Lloyd says. It didn't take long for the Graffs to discover that Preston's crime was anything but petty. To finance a gambling habit and a luxurious lifestyle, she had embezzled more than $200,000 from Graff-Pinkert, a huge amount for a company whose annual sales were between $8 and $10 million. "Jim and I walked around punch-drunk as the enormity of the crime mounted up," recalls Lloyd. "It was a real blow to our confidence. The people who worked with her were horrified, even angrier than Jim and me. This was a co-worker they trusted. They felt violated."

Preston's duties included, among other things, writing checks and reconciling the company bank statement. Her embezzlement scheme was simple. She would write a check to a legitimate vendor or supplier and have one of the Graffs sign it. Then she would go to her typewriter and, using correction tape, change the name on the check, making it payable to her own credit card company. Because she also handled the bank statement, she could cover her tracks, and no one else saw what she was doing. Because they were focused on managing the company's rapid growth and because they saw their employees as part of an extended family, the Graffs never noticed the crime that was taking place right before their eyes. The small accounting firm, the same one their father had hired decades before, somehow never caught the embezzlement in their annual audits.

Graff-Pinkert had no fidelity insurance protecting them against employee theft, and they wanted to recover at least some of the money Preston had stolen. Because Preston had mailed fraudulent checks across state lines, she had committed a federal crime. The Graffs contacted the FBI and filed a lawsuit against Preston in federal court. In a settlement, Preston relinquished to Graff-Pinkert $72,000 she had accumulated in her profit-sharing plan. Because she had blown most of the money gambling in nearby casinos, Preston had few assets from which to make restitution to the company. At her sentencing, Preston said nothing, not even uttering an apology to the Graffs or to the handful of employees who showed up. The judge sentenced her to 24 months in a federal penitentiary and ordered her to continue to pay restitution to the company upon her release. The Graffs receive checks for small amounts, sometimes just $25, irregularly from Preston, who now works as a hotel maid. Although they scrutinize their bank statements more carefully now, the Graffs' business philosophy hasn't changed. "We're more skeptical but not cynical," says Lloyd. "We still approach it as a family business. If we couldn't run it that way, I'd hang it up."

1. Identify some of the factors that led Graff-Pinkert to become a victim of embezzlement. What impact does this crime have on a company's cash flow?

2. What recommendations would you make to the Graffs about protecting their business from embezzlement in the future?

3. Working with several of your classmates, use the resources of the Web to develop a list of steps entrepreneurs should take to prevent their businesses from becoming victims of employee theft and embezzlement.

Source: Adapted from John Grossmann, "A Thief Within," *Inc.*, May 2003, pp. 42–44.

Invest Surplus Cash

Because of the uneven flow of receipts and disbursements, a company will often temporarily have more cash than it needs—for a week, month, quarter, or even longer. When this happens, most small business owners simply ignore the surplus because they are not sure how soon they will need it. They believe that relatively small amounts of cash sitting around for just a few days or weeks are not worth investing. However, this is not the case. Small business owners who put surplus cash to work *immediately* rather than allowing it to sit idle soon discover that the yield adds up to a significant amount over time. This money can help ease the daily cash crunch during business troughs. "Your

Check fraud costs businesses billions of dollars a year.

Courtesy of Corbis/Stock Market. © Chuck Savage/Corbis.

goal . . . should be to identify every dollar you don't need to pay today's bills and to keep that money invested to improve your cash flow," explains a consultant.[51]

However, when investing surplus cash, an entrepreneur's primary objective should *not* be to earn the maximum yield (which usually carries with it maximum risk); instead, the focus should be on the safety and the liquidity of the investments. Making high-risk investments with a company's cash cushion makes no sense and could jeopardize its future. The need to minimize risk and to have ready access to the cash restricts an entrepreneur's investment options to just a few such as money market accounts, zero balance accounts, and sweep accounts. A **money market account** is an interest-bearing account offered by a variety of financial institutions ranging from banks to mutual funds. Money market accounts pay interest while allowing depositors to write checks (most have minimum check amounts) without tying their money up for a specific period of time. A **zero balance account** is a checking account that technically never has any funds in it but is tied to a master account. The company keeps its money in the master account where it earns interest, but it writes checks on the ZBA. At the end of the day, the bank pays all of the checks drawn on the ZBA; then it withdraws enough money from the master account to cover them. ZBAs allow a company to keep more cash working during the float period, the time between a check being issued and its being cashed. A **sweep account** automatically "sweeps" all funds in a company's checking account above a predetermined minimum into an interest-bearing account, enabling it to keep otherwise idle cash invested until it is needed to cover checks.

money market account—*an interest bearing account that allows depositors to write checks without tying up their money for a specific period of time.*

zero balance account (ZBA)—*a checking account that never has any funds in it. A company keeps its money in an interest-bearing master account tied to the ZBA; when a check is drawn on the ZBA, the bank withdraws enough money from the master account to cover it.*

sweep account—*a checking account that automatically sweeps all funds in a company's checking account above a predetermined minimum into an interest-bearing account.*

CONCLUSION

Successful owners run their businesses "lean and mean." Trimming wasteful expenditures, investing surplus funds, and carefully planning and managing the company's cash flow enable them to compete effectively. The simple but effective techniques covered in this chapter can improve every small company's cash position. One business writer says, "In the day-to-day course of running a company, other people's capital flows past an imaginative CEO as opportunity. By looking forward and keeping an analytical eye on your cash account as events unfold (remembering that if there's no real cash there when you need it, you're history), you can generate leverage as surely as if that capital were yours to keep."[52]

CHAPTER SUMMARY

1. Explain the importance of cash management to a small business's success.

- Cash is the most important but least productive asset the small business has. The manager must maintain enough cash to meet the firm's normal requirements (plus a reserve for emergencies) without retaining excessively large, unproductive cash balances.
- Without adequate cash, a small business will fail.

2. Differentiate between cash and profits.

- Cash and profits are *not* the same. More businesses fail for lack of cash than for lack of profits.
- Profits, the difference between total revenue and total expenses, are an accounting concept. Cash flow represents the flow of actual cash (the only thing businesses can use to pay bills) through a business in a continuous cycle. A business can be earning a profit and be forced out of business because it runs out of cash.

3. Understand the five steps in creating a cash budget and use them to create a cash budget.

- The cash budgeting procedure outlined in this chapter tracks the flow of cash through the business and enables the owner to project cash surpluses and cash deficits at specific intervals.
- The five steps in creating a cash budget are as follows: determining an adequate minimum cash balance, forecasting sales, forecasting cash receipts, forecasting cash disbursements, and determining the end-of-month cash balance.

4. Describe fundamental principles involved in managing the "big three" of cash management: accounts receivable, accounts payable, and inventory.

- Controlling accounts receivable requires business owners to establish clear, firm credit and collection policies and to screen customers *before* granting them credit. Sending invoices promptly and acting on past-due accounts quickly also improve cash flow. The goal is to collect cash from receivables as quickly as possible.
- When managing accounts payable, a manager's goal is to stretch out payables as long as possible without damaging the company's credit rating. Other techniques include verifying invoices before paying them, taking advantage of cash discounts, and negotiating the best possible credit terms.
- Inventory frequently causes cash headaches for small business managers. Excess inventory earns a zero rate of return and ties up a company's cash unnecessarily. Owners must watch for stale merchandise.

5. Explain the techniques for avoiding a cash crunch in a small company.

- Trimming overhead costs by bartering, leasing assets, avoiding nonessential outlays, using zero-based budgeting, and implementing an internal control system boost a firm's cash flow position.
- Investing surplus cash also maximizes the firm's earning power. The primary criteria for investing surplus cash are security and liquidity.

DISCUSSION QUESTIONS

1. Why must entrepreneurs concentrate on effective cash flow management?
2. Explain the difference between cash and profit.
3. Outline the steps involved in developing a cash budget.
4. How can an entrepreneur launching a new business forecast sales?
5. What are the "big three" of cash management? What effect do they have on a company's cash flow?
6. Outline the basic principles of managing a small firm's receivables, payables, and inventory.
7. How can bartering improve a company's cash position?
8. What steps can entrepreneurs take to conserve the cash within their companies?
9. What should be a small business owner's primary concern when investing surplus cash?

THE BUSINESS DISC

Launch *The Business Disc* and return to the section where Harry describes the cash flow statement. If you have passed that point in the program, you can easily return to it. From the "Go To" menu, select "Events from PART 1 - B," and click on "Harry Introduces: Cash-Flow Statement." If you haven't reached that point, continue from where you left off. What does a cash-flow statement track? Why does Harry suggest that you add 10 percent of the total to your estimated disbursements? How does the sales forecast affect your company's cash-flow statement?

Develop a list of all of the costs you expect to incur as you operate your business. If you have not done so already, complete the disbursement section of the cash flow statement using this information. Now that you have read Chapter 9, do you see any cost estimates you want to change? Explain. How accurate did your initial estimates prove to be?

BUSINESS PLAN PRO

Business PlanPro

Section 7.1 of the Business PlanPro, "Important Assumptions," includes financial assumptions you must make to as part of your business plan.

Section 7.4 "Project Cash Flow" will allow you to conduct a proforma cash flow analysis or, if this is an acquisition of an existing business, assess the capability of the business to generate "free cash".

BEYOND THE CLASSROOM . . .

1. Interview several local small business owners about their cash management policies. Do they know how much cash their businesses have during the month? How do they track their cash flows? Do they use some type of cash budget? If not, ask if you can help the owner develop one. Does the owner invest surplus cash? If so, where?
2. Volunteer to help a small business owner develop a cash budget for his or her company. What patterns do you detect? What recommendations can you make for improving the company's cash management system?
3. Contact the International Reciprocal Trade Association (www.irta.net) and get a list of the barter exchanges in your state. Interview the manager of one of the exchanges and prepare a report on how barter exchanges work and how they benefit small businesses. Ask the manager to refer you to a small business owner who benefits from the barter exchange and interview him or her. How does the owner use the exchange? How much cash has bartering saved? What other benefits has the owner discovered?
4. Use the resources of the World Wide Web to research leasing options for small companies. The Equipment Leasing Association of America (www.elaonline.com) and its Lease Assistant site (www.leaseassistant.org) are good places to start. What advantages does leasing offer? Disadvantages? Identify and explain the various types of leases.
5. Contact a local small business owner who sells on credit. Is collecting accounts receivable on time a problem? What steps does the owner take to manage the company's accounts receivable? Do late payers strain the company's cash flow? How does the owner deal with customers who pay late?