

# Improving Cash Flow: What's Your Prompt Payment Strategy?

By Keith Girard , [Allbusiness.com](http://Allbusiness.com)

Donald Trump once famously proclaimed that "Cash is king." But as most small business owners know all too well, what he really should have said is "Cash flow is king."

Failing to understand and manage cash flow is the most frequently cited reason that a small business goes out of business. But a business doesn't have to be failing to encounter problems. Even profitable firms can fall into a cash flow trap, and fast-growing firms are particularly vulnerable because their cash demands are that much higher.

So it should go without saying that managing cash flow should be a top priority. Yet one survey found that 46 percent of small business owners failed to list cash flow management as a major preoccupation or said they delegated the task to others — big mistake, according to experts.

## **A Common Business Quandary**

At its most basic, cash flow is simply the amount of money that comes into a business versus the amount that flows out the door to pay bills. The problems arise because the two cash streams rarely match.

The dislocation can be as small as a few days, or it can be a question of months. A retail store, for example, may ring up most of its sales on Friday and Saturday. The rest of the week, it's starved for cash. And most retailers, regardless of size, typically do 45 percent of their sales during the weeks between Thanksgiving and Christmas. The huge cash surplus must carry them for months — or at least until President's Day.

In the meantime, they must continue to purchase inventory and meet payroll along with every other bill, from basic utilities to debt service. The same goes for most other businesses, from construction to plumbing contractors to computer services.

The simple solution, of course, is to have enough cash reserve on hand to get through periods of low cash flow. But the overwhelming majority of small businesses, especially startups, are typically undercapitalized.

To compound the problem, most banks still adhere to that old truism: They only want to lend you money when you don't need it. Without cash reserves or a hefty line of credit at the local bank, the only other solution is to closely manage cash flow. And that process usually begins with a cash flow analysis.

## **Measuring and Managing Cash Flow**

At its most basic, a cash flow analysis begins with cash on hand; that cash is used to create inventory and the inventory is sold to create receivables. Then more cash is created when the customer pays. Expenses can be projected against cash flow to yield an operating cash flow (OCF) ratio. The OCF ratio is important because it's a measure of a company's liquidity, or its ability to pay its bills.

After determining cash flow, the next step is to manage it. In real estate, as the saying goes, the three most important factors are location, location, location. The same goes for cash flow management. Except the three most important factors are organize, organize, organize!

It's critical, experts say, to map out expenses in as much detail as possible. That starts with listing recurring expenses — insurance, utilities, lease payments, rent, payroll, capital goods, inventory — and, just as importantly, noting when they are due. The next step is to prioritize. Payroll, for example, must be met without fail. But most other payments are flexible. Vendors, for example, are often willing to accept terms.

## **The Cash Flow Contradiction**

In real estate it's also a truism that sellers always want top dollar for their properties while buyers always want to pay next to nothing. By the same token, Les Masonson, the widely quoted author of *Cash, Cash, Cash: The Three Principles of Business Survival and Success*, says cash flow is all about "getting the money from customers sooner [and] paying bills at the last possible moment."

Therein lies the fundamental contradiction of cash flow management. This is where the fun begins. A cottage industry of experts offers reams of advice on tricks of the trade to even out payables and receivables.

## **Pursue a Prompt Payment Strategy**

Joseph Anthony, a tax professional in Portland, Ore., who writes about finance and tax issues, suggests one of the most common strategies for small businesses — encourage prompt bill payment. Create incentives, such as discounts, if bills are paid before the due date, he advises. Others suggest speeding up the ordering, shipping, and billing process. For example, have customers fax orders or create them electronically. Ship and bill the next day, and deposit checks as soon as they arrive.

Still other experts suggest charging delinquent accounts hefty late fees (say 2 percent a month) and writing dunning letters as soon as the payment date passes. They also suggest withholding new merchandise or services if bills remain unpaid. If all else fails, try to get a least a partial payment. But beware — such harsh measures could send your customers across the street if you are in a competitive industry.

Some experts also advise to look beyond the stated terms for payment and find out the actual norm for payment in a particular industry. Often the two can vary widely and

knowing the latter can at least help create a more accurate projection of cash flow. In other words, be realistic about cash flow.

Of course, the best way to avoid cash flow problems is simply to avoid customers that fail to pay promptly, says Anthony. That means checking credit references, obtaining credit reports, or conducting other due diligence.

Turning away business, however, especially for startup firms, may not always be the best policy. Unless they are total deadbeats, the better strategy may be to simply factor in a customer's payment history when you perform your cash flow analysis. That way you aren't caught off guard by late payments and your analysis isn't skewed.

### **Using Float to Your Advantage**

The problem with the prompt payment strategy for receivables is that it directly clashes with the most recommended strategy for handling accounts payable — proceed *slowly*. The goal is to conserve as much cash as possible on hand at all times. Thus, most experts suggest only paying bills on the due date to avoid late charges, and never paying early without a discount.

Because of the tug-of-war between the two strategies, balancing cash flow is a never-ending process. But external factors often create an unanticipated cash shortfall. A snow storm on a high-volume sales day can dent receivables, a big customer can go out of business, or an emergency expenditure may zap cash reserves.

That requires a different strategy: buying time to allow cash flow to catch up to payables. There are various ways to do that. For example, it can take up to several days for transactions to be processed after money changes hands. That time period is known as "float," and it's possible for a business to use it to its advantage. One simple strategy, for example, is to make payments on Thursday or Friday to take advantage of the delay in mail delivery over the weekend.

By far the most common strategy for small businesses, however, is to make payments by credit card. That's because most cards include a 25-day interest-free float. By rolling payments among several credit cards, the float can be extended even longer. Some experts recommend going so far as to set up an out-of-state checking account to pay bills; it typically extends the float — the time it takes for the check to clear — by at least a day.

### **The Pros and Cons of Factoring**

Beyond taking advantage of float, experts recommend other strategies to manage cash flow. It's possible, for example, to sell or "factor" future receivables, including credit card receipts. Typically, companies buy them at a discount for cash upfront. Some factoring companies also offer accounts receivable management services. Another strategy is to borrow against receivables, but both have downsides.

Factoring often places a business's most valuable asset — customer relations — in the hands of another company. Aggressive collection tactics, for example, can sour relations

and drive away customers. Factoring may also be interpreted by customers as a red flag, signaling that your business is struggling and may not be a reliable long-term supplier of goods or services. Borrowing against receivables, on the other hand, piles debt on your balance sheet; this also may be interpreted as a red flag.

### **Additional Cash Flow Strategies**

Inventory management is another common tool to manage cash flow. Businesses typically sell down inventory to raise cash. Or they develop "just-in-time" inventory, which typically ties up less cash in the stockroom. Inventory turnover is also a cash flow management tool. Some businesses will exclude slow-moving items, even if they have high profit margins, in favor of items that sell quickly.

Another strategy to improve cash flow is known as *continuity of sales*. Essentially, a business agrees to provide goods or services on an installment basis over a fixed period of time. Instead of spreading out payments over, say, the course of a year, customers pay upfront usually in exchange for a discount.

The flip side to that strategy is leasing, or buying on installment credit. While it costs more in the long run, paying in installments means less cash upfront, which preserves cash reserves and improves cash flow. A variation of that strategy is a sale, lease back deal. That turns an asset, such as real estate, into cash without a creating a big drain on cash flow.

Of course, it was William Shakespeare who wrote in *Hamlet* "Neither a borrower nor lender be." That may be good advice, but it's pretty obvious that he never ran a business — or managed cash flow.

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