Invest Northern Ireland

Cash Flow Tutorial

1. Managing cash flow

Welcome to this Invest NI tutorial on managing cash flow.

It will take around ten minutes to complete and includes tips and useful exercises to help you manage your cash flow. The tutorial is broken into three short sections which you can complete at your own pace.

At the end, you should have a good idea about:

- effectively managing cash within your business
- understanding the difference between cash and profit
- the consequences of poor cash flow and how to remedy this.

What is cash flow?

Cash flow is the movement of money in and out of your business. It's not profit and loss. Effective management of cash flow enables the business to grow. Cash is king!

Effective management of cash flow is key to business success. To speed up cash coming in you should:

- issue invoices promptly and chase your debts
- you can also ask customers to pay sooner, use deposits, staged payments, or factoring
- you should consider charging penalty interest for late payments.

Some of these, like issuing invoices promptly, should be a standard procedure. Others, such as chasing debt, should be done in a way that maintains good relationships with your customers. However, you should remember that if you allow customers too long to pay, they are effectively banking with you.

You can also slow down your expenditure by:

- getting flexible credit terms
- ordering less stock
- using just in time purchasing
- reviewing fixed overheads

In the next section, we'll do a cash flow forecast using a spreadsheet. You can download here **https://secure.investni.com/static/library/invest-ni/v2/cashflow-management/cash-flow-sheet-for-exercise.xlsx**.

2. Cash flow forecast

Welcome back to our cash flow tutorial. In this section, we will do a cash flow forecast using a spreadsheet. You can download the spreadsheet from the tutorial video webpage.

When you're ready, take a look at the wages row on the spreadsheet. Let's imagine that you want to increase wages by 15%. What happens to your cash in hand? Take a couple of minutes and do the calculations.

	April	May	June	July	August	September
Opening Balance	0		414	696		
Plus Income	2,200	3,600	3,000	1,800	1,800	3,600
Less Expenditure	2,268	3,118	2,718	2,868	2,218	3,118
Closing Bal at month end		414	696			

This is what you should get:

	April	May	June	July	August	September
Opening Balance	0	**-68**	414	696	**-372**	**-790**
Plus Income	2,200	3,600	3,000	1,800	1,800	3,600
Less Expenditure	2,268	3,118	2,718	2,868	2,218	3,118
Closing Bal at month end	**-68**	414	696	**-372**	**-790**	**-308**

As you can see from July's closing balance your opening and closing balances go negative.

To avoid this situation, you need to prepare a yearly forecast and update and review it each month ensuring that your projections are as accurate as possible.

So, how can a business making a profit fail? Simple. It runs out of cash.

Let's look at the position of these two companies – Company A and Company B. Assume business has just started up, so there's no opening stock and no balances on any of the accounts.

	COMPANY A		COMPANY B	
Revenue				
Cash Sales		10,000		2,000
Credit Sales (Ref 1)		nil		8,000
Total Revenue		10,000		10,000
Cash Purchases	6,000		9,000	
Closing Stock	(£1,000)		(£4,000)	
Cost of Goods Sold		5,000		5,000
GROSS PROFIT		5,000		5,000
Less Expenses				
Depreciation	1,500		1,500	
Rent (Ref 2)	500		500	
Other Expenses	500		500	
Total Expenses		2,500		2,500
NET PROFIT		2,500		2,500

Looking at the spreadsheet, you'll see that most of the key figures are comparable. Revenue is £10,000, gross profit is £5,000, and net profit is £2,500. In terms of profitability, the performance of the businesses is similar. However, if we look at their transactions, we'll see that only one of the businesses is managing their cash flow.

At end of month, the cash balance of Company A is £3,000 – made up of sales of £10,000, less purchases of £6,000, and £1,000 in expenses (£500 in rent and £500 in other expenses).

The cash in Company B is nil. Due to £6,000 of sales to credit customers, it now has an overdraft of £1,750, and still owes £250 for rent.

Put simply, if your overheads are £75,000, you need to earn £75,000 in cash to break even. Ideally, you'd like to make sales of £85,000 to make a profit of £10,000.

To understand cash flow, you need to understand working capital.

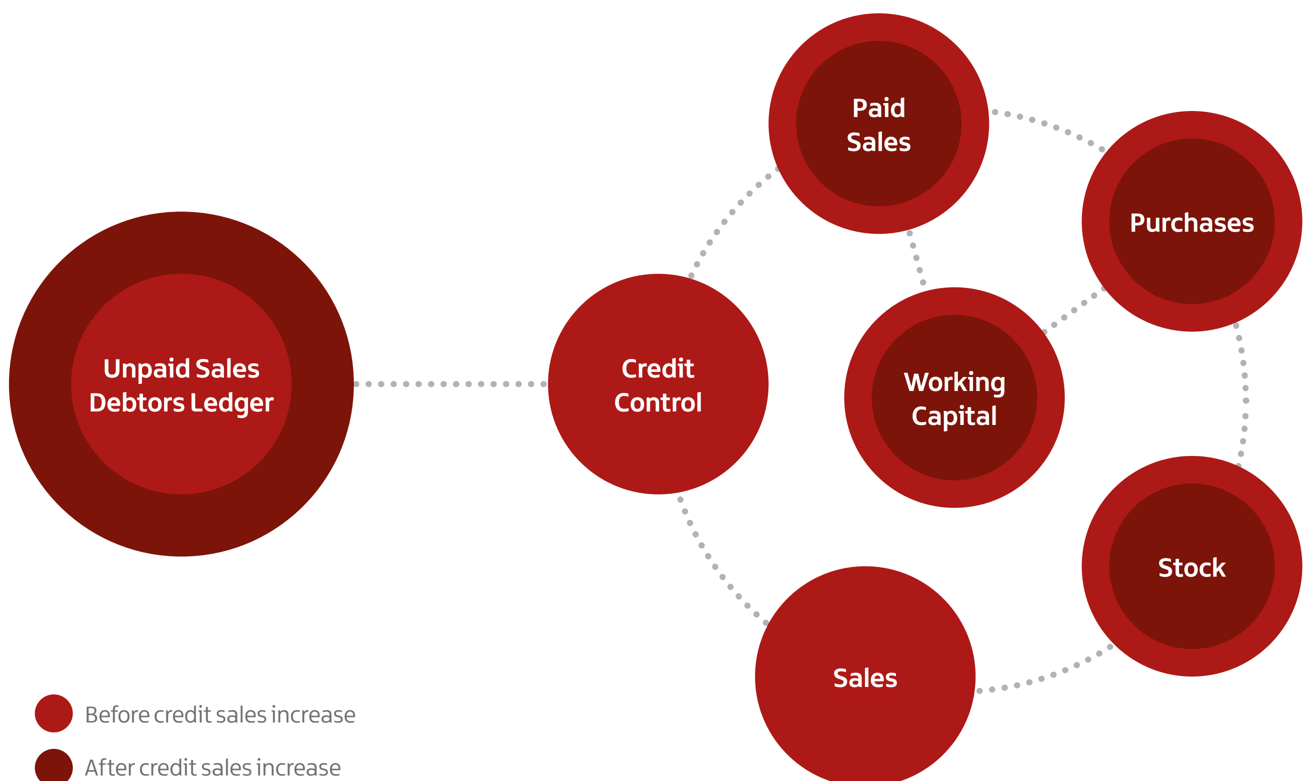
Working capital

Working capital is cash tied up in the assets of the business, and the cash available to do business. It indicates your ability to meet your short-term obligations.

Look at this illustration. The bigger the sphere, the bigger the amount. The company has plenty of working capital to operate because it's getting paid cash for sales.

Now look at what happens when credit sales increase.

The working capital for the business is significantly reduced, and may affect the company's ability to operate.



3. Effective credit on cash flow

There are advantages and disadvantages with credit. You may have the goods before you pay for them, but you need to make sales to pay on the due date. For the seller, it can increase sales, but credit needs to be well managed. There is the danger of non-payment and lack of liquidity due to slow payment.

Due diligence

We all want new customers, but if you want to stay in business you need to do certain things when you start dealing with them. This is called due diligence. Make sure that you check their credit ratings, and take up trade and bank references.

Once you have the information, communicate your credit terms and limits to your customer in a professional and friendly manner. You are now trading with your customers, so make sure you manage their accounts. Keep all records – such as invoices – up to date and tracked.

Giving credit

The three most important things when giving credit are:

- know your customers
- manage their accounts regularly
- chase debt and manage non-payment promptly

Taking legal action to recover debt is never a good thing, but can be necessary. You can minimise the need for this by having an effective credit policy.

Cash flow management is essential to your business. Remember these five key things and you won't go far wrong.

1. Always prepare a cash flow forecast and monitor it on a regular basis.
2. Ensure you have a good working capital.
3. Have a credit policy.
4. Manage credit customer accounts.
5. When chasing debt, select the most appropriate approach.

If you would like more information, visit **investni.com**.