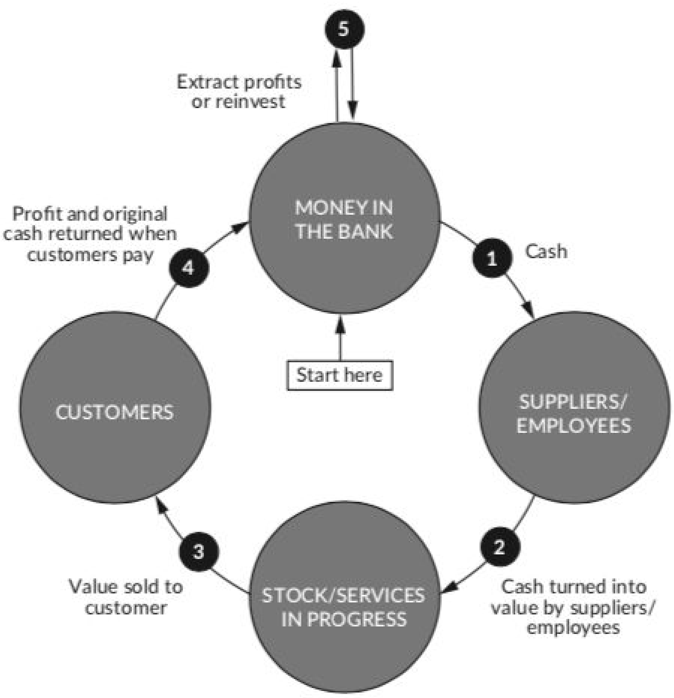
The Importance of Cashflow Control

Once you've raised your capital, the next step is to manage your day-to-day cashflow. You've probably heard the phrase 'cash is king'. There is some truth in that statement, but we prefer the analogy that cash is the lifeblood of all business. If a human runs out of blood, all their organs cease to function. If a business runs out of cash, the business will cease to function.

The cashflow cycle

The diagram below shows an overview of the cash flow cycle. As a general rule, the faster the cycle, the less cash is required. If the cycle is slow, more cash will be required.



It's important to be able to visualise the cycle and understand the time involved in each step. It all starts with value creation.

Step one

You commit to paying for production and labour. Payment can be made in advance or in arrears. Many employees and subcontractors can be paid monthly in arrears. Suppliers often give credit, though this is dependent on credit history and credit checks.

Step two

Your suppliers and employees create the value. This could take a significant time (building a house) or be instantaneous (a download in the app store).

Step three

The customer decides to buy the service/product. The time involved here could be significant (eg, furniture, holidays, cars).

Step four

The customer pays.

Annual turnover	£ 1,000,000
Gross margin	30%
Annual cost of production/sales	£ 769,231
Annual cost of overheads	£ 130,769
Anticipated annual profit	£ 100,000
Daily turnover	£ 2,740
Daily cost of production/sales including overheads	£ 2,466

		Days	Cash	
Average days it takes customers to pay	X	60	£ 164,384	
Average days it takes before customers buy your stock/service once complete	Y	30	£ 73,973	
Average days it takes to produce your stock/service	Z	30	£ 73,973	
Less				
Number of days from delivery to pay suppliers/employees	B	120	£ 295,890	
Length of cash/value cycle	X+Y+Z-B	0	£ 16,438	Average cash finance required
Maximum cash required	(X+Y+Z)/B		£ 295,890	Total cash funding requirement
Days of profit to fund business			1080.00	

The cash flow predictor diagram above shows that it will take 1,080 days of retaining profits (excluding business taxes) to build enough cash reserves to run the business within these parameters. With this in mind, you can understand why managing X, Y and Z, and B is worth some effort.

So what can be done to manage the cash flow cycle? First, get rid of any preconceptions of what is and isn't possible.

Let's start with the customer payment days (X). In the UK, many businesses are accustomed to a cash flow cycle of sixty days. We have visited many businesses where they discuss customer payment days (X) being reduced from eighty days down to seventy days. While a reduction from eighty to seventy customer payment days certainly is an improvement, seventy days still creates massive headaches for whoever is managing the cash flow.

Strategies to reduce customer payment days (X)

Customer payment days are also commonly known as debtor days. It is often the longest part of a cash flow cycle. Below are several strategies to help reduce customer payment days.

- Establish your terms *at the outset*
    - Explain that you pay your bills on time and you only work with similarly minded customers
    - Consider whether instalments or a deposit could be appropriate
    - Add a breach of payment terms penalty
- Make it easy to collect your amounts due
    - Offer payment by direct debit. If you use a cloud accounting system, you can automate collection via direct debit on your agreed due date for little more than your current bank charges
    - Offer payment by credit card
    - Provide your bank details on every invoice/ statement
- Use an automated chasing system
    - Ensure every invoice is chased, without fail. Several cloud accounting systems can do this for you.
- Reward businesses that pay within your terms
    - Perhaps offer a prize draw for customers that pay on time
- Consider prompt payment discounts
    - Think about raising your prices and then discounting heavily for prompt payment

By building a system from the beginning that minimises payment delays and manages customer payments, it's possible to have negative debtor days (ie, customers paying in advance).

Strategies to reduce the sales cycle (stock days)

Stock days (Y) is the value of goods/services that have been completed but not yet sold expressed in days.

The time it takes customers to buy your product or service once it's made available is a key factor in cash flow. Let's use a shoe shop as an example. This type of business has a high stock level requirement. For each style of shoe, a multitude of sizes is required. If the shop has 100 styles, it immediately needs at least 700 pairs of shoes in stock; if it sold 7 pairs a day, it would have 100 days' worth.

Twenty years ago, stock management options were limited. Today, many options exist, all centred on just-in-time stock management and creating demand in advance of service/stock production. Online businesses can now pass orders directly to their suppliers and then manage customers' expectations (clarify expected delivery dates). For example, Nike now delivers custom trainers in a few weeks; the customer pays on order and is told when to expect delivery. Nike has no cash tied up in the deal.

Commerce is ultimately the point at which supply meets demand. It's no good creating supply if there's no demand, and it's equally pointless creating demand if you can't supply. The key is to manage the intersection of supply and demand; doing so drives price and sales.

- Generate demand before your service/product is ready. Use marketing strategies to pre-sell your value (launch discounts, limited editions, waiting lists etc.)
- Set up a marketing system to do this systematically for each iteration of your ideas. Consider focused niche marketing, with the power of the internet you can specialise in very niche markets but sell right across the world in your chosen niche.
- Use an automated marketing and sales tracking system that integrates points of contact, and builds and hones your prospects' demands; Amazon is very good at this, letting you know that customers like you who have bought whatever you have just bought also bought this item – simple but effective.
- Ensure your conversion system, from prospect to customer, is simple and customer transparent: Netflix uses a simple FAQ system that answers many questions and leads a prospect to become a customer through linking to a sign-up process.
- Use a pricing system that maximises your value to the customer and explains that value to your customer: find out as much as possible about your customers to ensure that you are selling at the correct price point for them.
- Make it easy for the customer to buy your product: after all the effort to make the sale, ensure you can accept the transaction in as many forms as are appropriate for your customer.

Strategies to reduce the production cycle (production days)

The most effective tool to minimise the production cycle (Z) is automation. Why?

- It reduces human error
- It allows products and services to be delivered consistently, which ultimately creates a more favourable impression on the customer
- It allows you to objectively plan the production process

You could improve your bank by £386,000

If all the above strategies were used, the transformation would be monumental; for example, if the debtor days were converted to −15 (ie, payment two weeks in advance), the stock days were reduced to seven (one week), and value creation took three days. Leaving our payment days at thirty, which would be normal for a salaried service business, we would transform the cash flow requirement to an overall average of −35 days, which leads to a healthy bank balance averaging £90K, compared to an overdraft requirement for the same business of £296K, a £386K swing. The bad-debt risk would also be significantly lowered. What could you achieve in your business?

Get control of your cashflow with your cloud accounting software

The entrepreneurs of today are in such a fortunate position with respect to the resources available to them. The plethora of cloud software resources has made an expensive and complex task (managing your business) much more straightforward and much less costly.

The last ten years have seen a comprehensive advancement of financial tools, marketing tools, and the ability to reach customers anywhere in the world 24/7. This period has also seen remarkable change in the accessibility and productivity of accounting systems. The modern-day entrepreneur can now collaborate much more effectively with suppliers, customers, advisers and financiers than ever before.

Imagine a world where your bank is integrated with your accounts system, which is integrated with your payment processing system, which is integrated with your collections system, which is integrated with your cloud reporting system, which is integrated with a desktop/tablet control system – and all in real time. You no longer have to imagine. The technology is available now.

Where do you start?

The first task is to establish the core of your business: the accounting system.

In the UK, options include Xero, QuickBooks, FreeAgent and Sage. These are the main market leaders, but this list isn't exhaustive. Although all of the aforementioned are relatively easy to use, they are also relatively easy to set up incorrectly. I always advise speaking to a qualified accountant who is well versed in the system you choose.

So, what do you need to think about when setting up your accounting system?

- What types of reports are you expecting to generate? This will drive the design of the accounting core structure.
- Have you set up the appropriate shortcuts to make input quick, easy and accurate?
- If you sell products, have you set them up in the system correctly so that you know how much stock you have on hand and have sold?
- Is your bank cloud friendly? Most are, but a few still don't integrate. You need to be able to connect to your bank.
- Can you connect to other forms of payment systems (eg, direct debit systems, debtor-chasing systems)?

After establishing your core accounting system, you need to consider the add-on tools in the cloud ecosystem that surrounds this core. Not all apps are the same quality, and it's certainly useful to speak to existing users before utilising any of them.

Must-have apps

An app for invoice processing

Manually entering invoices into an accounting system and then filing the source document piece of paper should be a thing of the past. Instead, you can either scan or take a photograph of the invoice and process it with an accounting app. The app uses optical character recognition to translate the invoice and enter the details into the accounting system for you. Then it attaches a copy of the invoice to the transaction and files it within the accounting system.

This type of app will transform your recordkeeping and allow you to take another step closer to a paperless system. Having electronically filed records is especially useful if you have a visit from tax inspectors.

An app or direct feed that connects you to your bank

Once you're properly tracking your invoices, the next step is to link your bank to your accounting system. As noted, most major banks have a direct feed from their online banking systems into the main cloud accounting systems. This produces a number of advantages for entrepreneurs.

Time saving – You don't have to spend time organising statements and entering the details into your accounting systems

Accuracy – All transactions come into your accounting system directly from the bank; no input errors

Completeness – When you do things manually, it's easy to miss something, which then leads to time wasted trying to spot the difference

Quality improvements – Instead of spending hours putting the numbers in, you can spend time overviewing your position in real time and consulting with advisers in a meaningful way, which ultimately improves your ability to manage the business and make relevant decisions; you have key information at your fingertips

An app to automate credit control

Many businesses spend vast amounts of time and effort chasing payments from customers. A short invoice-to-payment period is essential to maintaining positive cash flow and reducing funding requirements. Several applications can also be utilised in conjunction with your cloud accounting program to enable the automated chasing of debt.

Clients who use these kinds of apps often go from overdraft to cash in the bank in a short space of time. Initially some are put off by the thought of losing customers as a result of chasing amounts outstanding. The key is to chase professionally. You will not lose a good customer if you chase in a business-like way with appropriate language at the appropriate time. After all, you're only chasing amounts which are contractually due to you.

With the tools outlined above in place, you can deal confidently with your numbers and manage your taxes.

Your Next Steps:

- Consider any changes in your contracts with suppliers/creditors that can positively affect your cashflow.
- Establish your core accounting system - consider a cloud accounting software
- Make the most of cloud accounting and stay on top of your finances with must-have apps
- Get a third party business adviser that can keep you accountable and provide expert advice on Cashflow Management.

Have considered all of the above but still don't have enough cash in the bank? Want to find out what your **Funding Options** are?
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