

**The
Economist**

GUIDE TO CASH MANAGEMENT

How to avoid a business credit crunch

John Tennent

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Introduction

Cash management

To run a successful business requires effective management of a variety of resources that include all or some of the following: people, equipment, property, cash, a brand, products, services and inventory. Of all these resources cash is probably the most important. With sufficient cash a business has the ability to buy almost any of the other resources in which it may be deficient. Whether the purchase of that resource is worthwhile at the price required is another matter, but the purchase can still be made. All the resources other than cash have a value to a business that is dependent on their availability, utilisation, market demand and the prevailing economic climate. It is cash and only cash that maintains a constant value and can easily be turned into other assets or resources. This book explores the effective management of this most precious resource.

At a personal level we learn by experience the fundamentals of managing cash. We have a bank account and a monthly statement that tells us our cash balance and itemises all the receipts and payments. Intuitively we know that we must have more cash coming in than going out if we are to avoid debt. A cash crisis occurs when we have to make payments from a depleted bank account and find our borrowing limits have already been reached. In a business, few people have access to the type of cash information that we have at home. Therefore cash flow may appear to be an activity that can be forecast, analysed, monitored and managed by “someone in finance”. However, there is both a legal and an operational responsibility for managing cash that extends across the whole of a business’s management.

In some countries there is a legal responsibility based in insolvency law. For example in the UK it is an offence for directors to continue to trade if their company cannot pay its debts when they fall due. Directors have a duty to their staff and to their creditors to acknowledge when a business is in financial difficulty. Failure to act when evidence is available can lead to directors becoming personally liable for certain debts.

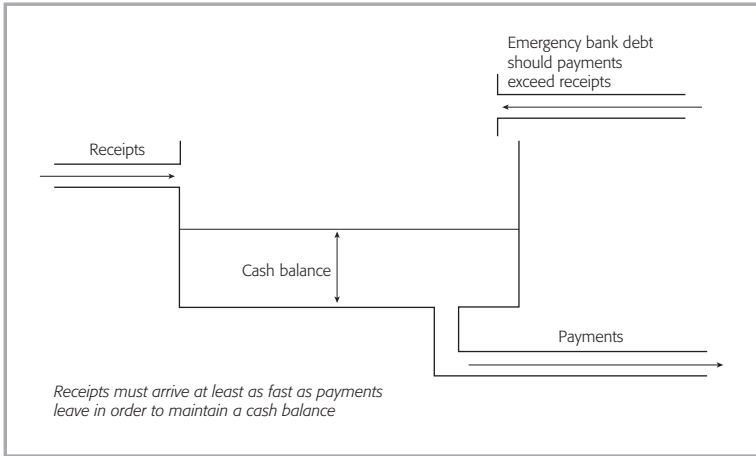
The operational responsibility requires everyone in a business to understand how their individual actions affect cash and to take responsibility for making changes that can improve its flow. However, many managers have a poor understanding of cash flow and any performance incentives often direct their energy to other aspects of the business such as sales volume or new business generation. Consequently, many businesses can become inefficient in their use of cash by tying up huge amounts in working capital and poorly utilised assets. The challenge is to raise awareness, responsibility and reward for improvements.

The starting point for surmounting this challenge is for managers and staff alike to have a sound knowledge of cash management. This includes an awareness of the signs of a looming cash crisis in both their own business and those of others with which they trade, as well as the skills to deal with the crisis before it becomes a disaster.

Cash and cash flow

It is not the amount of cash that a business has in its bank accounts that will make it successful; the role of management is to generate a financial return on the business activities that is substantially greater than an investor can achieve from other less risky investments such as a deposit account. Holding cash will not help achieve this objective. The focus of management is therefore to build a business that can generate a sustainable cash flow and deliver a superior return on investment for investors.

The difference between cash and cash flow can be illustrated by an analogy to the way water supplies are managed. A water company has an unpredictable supply of rain and thus holds a reservoir of water to meet demand. The size of the reservoir depends on the

FIG 1 **Cash and cash flow**

water company's ability to forecast two things: the supply of rain and customer demand. If daily supplies of rain consistently exceed daily demands for water, almost no reservoir is required.

If water represents cash, the amount of cash required in a business depends on the predictability of both the “supply” or receipts of cash from trading activities and the “demand” or payments of cash to suppliers and staff. Cash flow is the ability to generate a sufficient supply of cash so that a business is able to meet its demand for cash. The alternative is to have external investors who are prepared to fund any shortfall; but to encourage external investment, the management must demonstrate that the business can achieve a positive cash flow that will be sufficient to pay interest and ultimately enable repayment.

An example of a business with a highly predictable cash flow is a supermarket chain, where every day its customers pay over a vast amount of cash (or cash equivalents such as cheques and credit cards). The volume of the core food products that are sold is little affected by the economic climate and therefore the daily receipts from sales are easy to forecast. Payments to suppliers will usually be made after the cash has been received from customers, which could be up to two months or more after the goods were supplied. In these circumstances, the business needs to hold little cash. Contrast this with a house builder that makes a few irregular sales of large

amounts yet may have almost daily invoices to pay for construction materials and subcontractor wages. To manage this type of business requires either a much more substantial cash balance to act as a “buffer” against unpredictable receipts or a flexible bank borrowing facility that will enable trade to continue.

Cash does not equal profit

Although a positive cash flow is critical to a business it is not necessarily a sign of profitability. More important is that the opposite is also true: profitability is not necessarily a sign of a positive cash flow. The concepts of profit and cash are quite different. Revenues and costs for calculating profit are recognised at the point that the benefit of goods or services is delivered. Receipts and payments of cash are recorded when money is transferred. Although the difference is in timing, the gap between when an event is recognised for profit purposes and when it is recognised for cash purposes can be long, as the following examples illustrate:

- A customer buys goods on March 1st but pays for them on July 31st by taking five months’ credit. For profit purposes the business would show the sale of the goods when they are delivered in March, but the bank account would not show the cash receipt until July. In the intervening period the business may well need to pay suppliers, staff and overhead costs, thus putting a strain on cash resources.
- An example of an event when cash flow can be positive yet loss-making is a clothing retailer’s end-of-season sale. The event may generate a lot of cash from customers, yet the items may be sold below cost and hence realise a loss.
- A more extreme example is the purchase of production equipment that is expected to last ten years. The impact on cash will be substantial and negative at the point the equipment is purchased, yet the cost of this equipment for profit purposes will be spread over ten years using the process of depreciation. The cash to pay for the machine will ultimately come from the sale of the goods it produces. In this case, a long-term loan may be

required to fund the purchase. The investors will be reliant on a sustainable business that can generate a positive cash flow from the equipment that will enable repayment.

These examples show that profit effects can differ from cash flow effects. Ultimately, in achieving a superior return on investment for its investors, a business will need to operate profitably and with a sustainable cash flow. If it cannot forecast both these attributes confidently, it will be difficult to attract external investment to carry the business through the mismatch in the timing of events.

A guide to cash management

The examples illustrate that the effective management of cash and more importantly cash flow depends on six critical factors:

- Cash flow forecasting of likely cash receipts and payments to ensure a business can meet its payment obligations as they fall due.
- Treasury management to establish funding lines with investors and banks (including effective control of borrowing facilities to enable the drawing down of cash for either a substantial asset purchase or working capital when short-term cash demand exceeds short-term cash supply).
- Efficiently managing day-to-day operations to minimise the amount of cash required to maintain and grow activities.
- Selecting appropriate investment opportunities that will result in an overall positive cash flow for the business.
- Monitoring the portfolio of products and services to ensure they are cash generative and not cash consuming, thereby managing the future viability of the business.
- Having a plan for managing surplus cash.

This book starts with an explanation of concepts and principles that are essential to understanding the way cash is used within a business and then looks at each of these factors.

1 Key concepts

WHATEVER THE FASHIONABLE BUSINESS topic of the day – globalisation, outsourcing, carbon emissions – the most enduring focus of all businesses is cash. Cash is probably the most important resource in running a successful business, and cash flow is crucial for sustaining the business activities. However, investors will measure and monitor a much wider range of attributes of the business in assessing its performance. These include indicators such as revenue, income (or profits), earnings, EBITDA (earnings before interest, tax, depreciation and amortisation), assets, working capital and leverage. Some of these have an indirect link to cash flow, but their effective management is no less important to the overall running of a successful business. When the results of an international company are reported in the media it is normally the profits or losses for the last 12 months that are the main focus. Debts, revenue and even executive pay will typically receive more coverage than either cash or cash flow. Therefore as cash flow management is developed in this book it is necessary to understand the ripple effects that actions will have on all aspects of the business. The main ingredient for achieving a strong cash flow is the effective management of all the other business resources being deployed, so a clear understanding of those resources is an integral part of understanding how to develop an effective cash flow.

This chapter covers a range of concepts and principles that define a successful business, identifies the main attributes of financial reporting and illustrates the way performance is measured by a range of stakeholders. See also *The Economist Guide to Financial Management*, which covers all these concepts and principles as well as others in more detail.

Business success

The goal of many businesses is to deliver a sustainable, superior return on investment (ROI). The return is the investors' reward for risking their money in the business. The concept is similar to a savings account where an amount of money is placed on deposit with a bank and the investor earns interest on it. A savings account is seen as low risk and consequently the return that the investor will make is similarly low.

$$\text{ROI for a savings account} = \frac{\text{Interest}}{\text{Investment}} \%$$

Thus if a deposit of \$1,000 is placed in a bank and the gross interest earned over a year is \$30, the ROI is 3%.

For a business to be successful it needs to reward investors with a return higher than that of a savings account. The higher return is compensation for the greater investment risk as a consequence of the uncertainty in running a business. The return required might range from double to several times that from a savings account depending on the perceived level of risk, which will be related to factors such as the nature and maturity of the business.

The return in a business is derived from the profit it generates compared with the money invested to achieve that profit.

$$\text{ROI for a business} = \frac{\text{Profit}}{\text{Investment}} \%$$

Thus if investors place \$1,000 in a business and the operating profit over a year is \$200, the ROI is 20%.

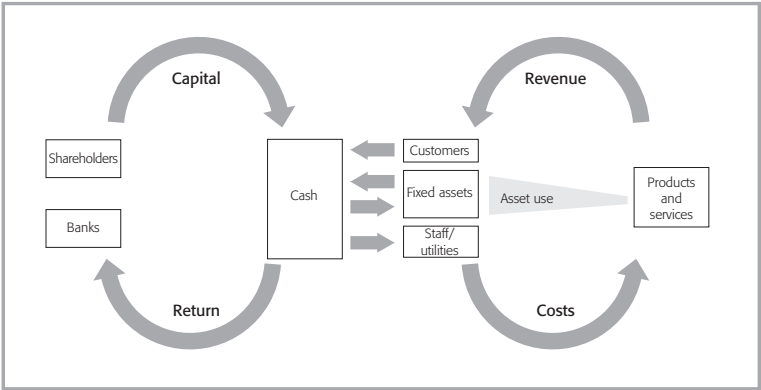
The business model

The business model in Figure 1.1 illustrates the financial structure of a business and the way cash flows around its various parts.

When a business is first established investors and others such as banks provide the initial capital in the form of cash to fund the business. There are then two main ways in which the cash can be spent:

- Capital expenditure (often abbreviated to capex) on items that are known as fixed assets, which are intended to be used in

FIG 1.1 A business model



the business (rather than sold) and thus are typically in use for several years. Examples are buildings, machines and vehicles.

- Operating expenditure (often abbreviated to opex) on items that will be consumed, used or sold in providing the products or services for customers or will be spent on administering these activities. Examples are utilities, staff costs and components.

Through expenditure on a mix of capital and operating resources and human endeavour, a business can provide the products and services that are sold to customers. Sales will either be on credit terms (as is usually the case with sales to other businesses) or for immediate payment (as is usually the case for sales to consumers). Credit sales will take time to turn into cash, even though the revenue will be recognised on the income statement at the point of sale.

A manufacturing business is likely to hold inventory of both raw materials and finished products. There may also be work in progress (products at various stages of construction or completion). Inventory and work in progress tie up cash, so keeping the levels of these items under control is an important part of cash efficiency.

For a business to be profitable, the cash received from selling products or services must, in the end, be greater than the cash required for their provision. This surplus can then be reinvested back in the business to fund its growth or returned to the investors.

Over time a business may accumulate fixed assets that are no longer required, become obsolete or are poorly utilised. In such cases they can be turned back into cash and perhaps provide some of the money required to fund new assets.

This business model provides the basis for all transactions that take place and therefore the basis on which they can be recorded, measured and monitored in order to achieve effective financial management. The most significant item in the process is cash, which has to be managed in conjunction with everything else and not in isolation. For example, understanding the inventory levels required for achieving good customer service or knowing the economic order quantities for achieving low-cost purchasing are advantageous to optimise profits, but an increase in inventory is potentially a drain on cash. There has to be a balance between these conflicts of optimising cash and optimising profit depending on the business situation and the prevailing operating environment.

Financial statements

There are three primary financial statements that are used to present the financial situation of a business covering the assets, liabilities, trading and cash flow:

- **The balance sheet or statement of financial position.** This is a snapshot of a business at a moment in time showing the assets that it owns, the liabilities that are owed and the money put in by investors. A balance sheet represents the items that should either provide a future benefit or have a future claim on the business. An alternative is to consider the balance sheet as a list of all the assets that investors' cash has been used to purchase and the liabilities incurred in running the business.
- **The income statement.** This is a statement of trading activity – also known as the profit and loss statement – that summarises the revenue earned and the costs incurred for a period. The costs comprise all the items that have been consumed or have been spent in earning the revenue and running the business. Ultimately, trading surpluses (or profits) will increase cash and any trading deficits (or losses) will reduce cash. However, the

impact on cash will not necessarily arise at the same time as the surplus or deficit is recognised as, for example, revenue may be tied up in receivables, costs in payables and so on. In the long term, a profitable business will generate cash.

- **The cash flow statement.** A summary of the cash received and paid over a period. This is effectively a summarised bank statement showing money in and money out.

When these three statements are reported they are normally historic, reporting what has happened in the past rather than what may happen in the future. Although this historic analysis may portray typical performance and be indicative of the future, creating a cash flow forecast, and understanding its alignment to budgets and business plans, is a far more useful management tool in avoiding a cash crisis (see Chapter 2). Clearly, it is easier to manage the future of a business by looking ahead rather than behind.

The three statements link together, with the balance sheet being a statement at a point in time and the income statement and cash flow summarising the activity over a period of time, typically a year.

Table 1.1 summarises the balance sheet and income statement; the cash flow statement is discussed in Chapter 2.

TABLE 1.1 **The balance sheet and income statement**

US term	UK term	Amount	Explanation
Balance sheet or statement of financial position			
Property, plant and equipment	Tangible fixed assets	150	Items that are owned and used in the business such as premises, vehicles and machines. These assets are depreciated to reflect their wearing out over time. The value in the balance sheet is known as the net book value after depreciation
Intangible assets	Intangible assets	100	Similar to tangible fixed assets except they are valuable rights and are usually paper-based, such as patents, trademarks and brands

US term	UK term	Amount	Explanation
Goodwill	Goodwill	50	A type of intangible asset that arises on the acquisition of a business. It represents the value of the acquisition over and above its specific net assets and covers items such as brand, reputation, customer base and employees
Current assets	Current assets		A collective term for the short-term assets that are likely to be converted into cash within one year
Inventory	Stock	50	Items ready or being constructed for sale, consisting of raw materials, work in progress and finished products
Receivables	Debtors	40	Amounts owed to the business from customers for sales it made on credit
Cash	Cash	10	The bank balance (and any physical cash held)
Total assets		<u>400</u>	
Current liabilities	Current liabilities		A collective term for the short-term liabilities that must be settled within one year
Payables	Creditors	30	Amounts owed to suppliers for products purchased on credit
Loans	Loans	120	Money borrowed from banks
Provisions	Provisions	60	A future obligation that is uncertain in amount and timing, such as the funding of a shortfall in a company pension fund
Common stock	Ordinary shares	100	The money raised by the business when it issued its shares
Reserves (retained earnings)	Reserves (retained profit)	90	Profits made by the business that have not been distributed to shareholders by way of dividends
Total liabilities		<u>400</u>	
Income statement			
Revenue	Sales	300	The value of all products and services sold and delivered to customers

US term	UK term	Amount	Explanation
Cost of sales	Cost of sales	(260)	The costs involved in making and producing the products that have been sold, sometimes known as the cost of goods sold
Gross profit	Gross profit	40	Revenue less cost of sales gives gross profit
Selling, general and administration	Expenses	(15)	The overheads of the business that do not specifically relate to making or producing the products, such as rent, IT, accounting and other head-office costs
Operating income	Operating profit	25	Gross profit less expenses gives operating income
Interest	Interest	(5)	Interest charged on the business's borrowings
Income tax	Tax	(5)	Tax charged on the business's profits
Earnings	Earnings	15	The profit available for shareholders once all costs have been met

Financial principles

There are many financial principles underpinning the way business activities are accounted for in the two statements discussed above. This section focuses on the ones that will help in understanding the most important numbers and how they can be affected by management actions.

Revenue recognition

Revenue is recognised on the income statement when products or services are delivered to the customer. Importantly, this is not necessarily the same time that the cash is received. If a transaction takes place between two businesses, it is likely that the buyer will take a period of credit on the purchase so the cash will reach the seller 30–90 days after the products or services were provided. Sales made, for which cash has not been received, represent the receivables or debtors figure on the balance sheet.

For businesses that provide services such as travel (airlines and tour operators, for instance) or insurance, it is normal for the cash to be received in advance of customers receiving the benefits of their purchase. This is advantageous to cash flow, but it makes no difference to the timing of when revenue is recognised, as this is still based on the date that the products or services are delivered to the customer. In the case of insurance, the revenue is recognised in equal amounts over the period that cover is provided.

Another example of the way cash recognition is different from revenue recognition is in a mobile telecommunications business where a customer switches from a prepaid “pay as you go” deal to a post-paid contract. From a revenue-recognition perspective there would be no effect as connection revenue is recognised at the point a call is made (specifically when a call is terminated) or a text sent. However, from a cash perspective the effect is very different. In a prepaid deal the cash is received perhaps a month or two before a call is made. For a post-paid contract the cash will arrive perhaps a month or two after the call is made. This change in timing of the cash receipt of up to four months makes the consequences of a customer switching highly significant to cash management.

Cost recognition

Cost is recognised on the income statement in exactly the same way as revenue. A cost is incurred when the benefit of products or services is received. The benefit may not necessarily arise at the moment the items physically arrive in a business: for example, manufacturing components will go straight into inventory until they are required. On the income statement there is a principle of “matching” whereby the costs of providing products and services to customers are matched with the income derived from their sale. Hence the benefit of components used in producing products arises at the point of sale not the point of manufacture.

Regardless of whether components are used immediately or are held as inventory, they are likely to be paid for 30–90 days after they have been delivered. Costs incurred but not yet paid for are the payables or creditors on the balance sheet, representing supplier accounts waiting to be settled.

As well as the liability of payables there is the liability of accruals. Accruals are an estimate of the cost of products or services where the benefit has been received, or partly received, and for which an invoice has not yet formalised the amount owed: for example, electricity consumption that is invoiced in arrears once a meter has been read. An accrual is therefore an estimated payable that is used as a way of ensuring that all costs are correctly included in reporting profitability. Accruals are likely to be settled after payables, but both are imminent cash outflows.

Interpreting an income statement

An income statement represents activity done and not cash movements. It reflects how profitable or not a business is, but not the business's cash position. The timing effect of the various events in a manufacturing business is shown in Figure 1.2.

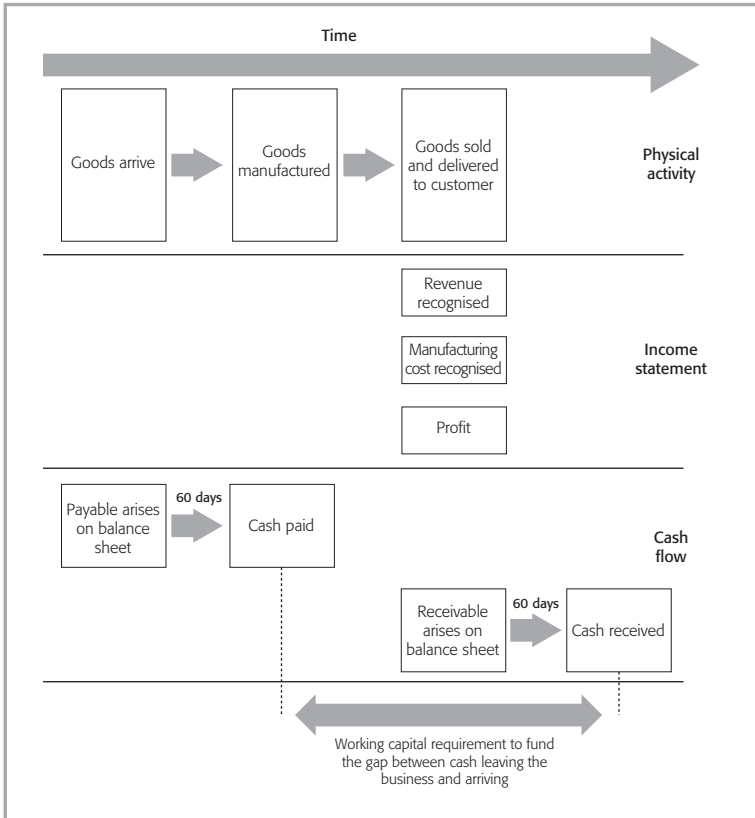
In many businesses the only financial information that is given to operational managers is an income-statement style budget report. With no information on the cash flow, these managers have little incentive or ability to monitor or manage it.

Asset values

The balance-sheet item that usually consumes the most amount of cash is fixed assets, which includes land, buildings, machines and vehicles. It follows that fixed assets may also have the potential for raising the most cash should it be required. However, the amount shown on the balance sheet will not reflect the current market value of the fixed assets. Instead it will be based on the following principles:

- **Historical cost.** Assets are recorded at their original cost less any depreciation (see below). Where an asset may have increased in value it is not usual (though it is possible) to revalue it upwards. This is partly because of the fickle nature of the market, but more importantly the value is only indicative until a transaction is concluded. This is particularly relevant for bespoke assets for which there may be either a limited or no resale market.

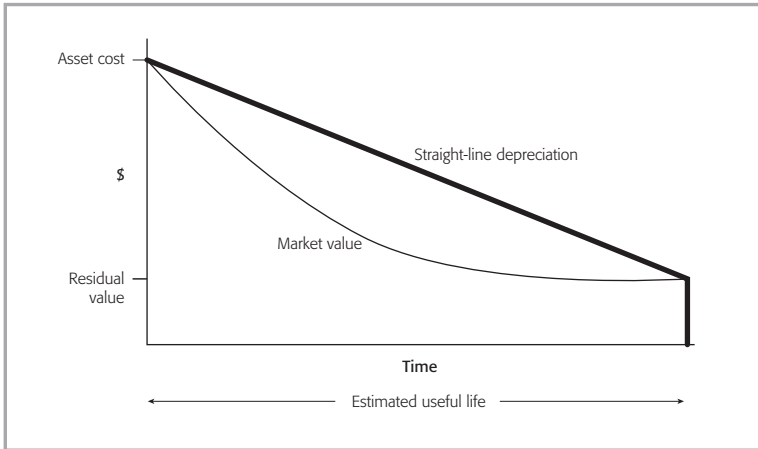
FIG 1.2 Timing effect of events in a manufacturing business



- **Impairment review.** The directors are required to review the portfolio of assets each year and assess whether there is any permanent diminution of value or impairment in any of them. Write-downs should then be made to adjust for any overstatement.

The effect of these principles, if they have been prudently applied, is that in the case of assets such as buildings, where market prices may have appreciated, there can be latent value that is not evident from the balance sheet.

FIG 1.3 Straight-line depreciation



Depreciation

Depreciation is the process of spreading the cost of a fixed asset over its useful life.

The cost of an asset is its purchase price and, where appropriate, the costs of delivering and installing it. The useful life of an asset is based on management judgment. Some assets, such as computers, have short lives because of technical obsolescence; others, such as buildings, have useful lives of many years. Therefore businesses pool similar types of assets and set a standard period for their expected useful life: for example, for freehold buildings it might be 50 years, whereas for computers or cars it might be only three or four.

Several methods can be used to spread the cost of owning an asset. Most businesses use straight-line depreciation, which effectively spreads the cost evenly over an asset's useful life.

If an asset is to be scrapped at the end of its useful life, the cost of ownership is the purchase cost. Should an asset, such as a motor vehicle, be disposed of before its value reaches zero, the total amount of depreciation to be spread over its useful life will be its cost less any potential residual value.

Figure 1.3 shows that straight-line depreciation will result in a potentially higher than market value being shown on the balance

sheet for assets, such as computers, whose market values can drop fast after purchase.

Making sense of balance-sheet assets

Where a business is trading successfully with good cash flow the mismatch between the market value of fixed assets and the value shown on the balance sheet is unlikely to be a problem. These assets are being held for their use not their market value, and the mismatch will disappear over time and be inconsequential. Only when an asset is no longer needed or there is a cash crisis that requires it to be sold would its market value become relevant. The management of assets is covered in Chapter 5.

In contrast to fixed assets, many of the other assets on the balance sheet are shown at values that are a reasonable indication of their actual value. Management is responsible for regularly reviewing inventory to write off surplus or unsaleable stock and receivables to write off bad debts. Inevitably, the judgments management make on what to write off may be wrong – more or less stock may prove unsaleable or some bad debts may turn good and be paid.

Provisions

The main operating liabilities are payables and provisions. Payables, as stated above, consist of specific short-term liabilities that are usually settled within a few weeks. Provisions are future obligations that are uncertain in both amount and timing. The amount of a provision is based on the concept of prudence, which requires that all liabilities and potential liabilities should be included on the balance sheet or disclosed. Conversely, the concept requires that revenues and profits should only be included once their realisation is reasonably certain.

Examples of provisions include the funding of a shortfall in a company pension fund, potential warranty responsibilities for a manufacturing business, or commitments to restore sites after mining activities are completed. Provisions will only become payables once a liability is formalised by one or more future events. For as long as they remain provisions rather than payables, there is not normally a need to have cash immediately available to meet them.

Making sense of balance-sheet liabilities

Although a balance sheet differentiates between short-term (less than a year) and long-term (more than a year) liabilities, the difference is of little help in identifying how much cash is needed to meet imminent liabilities, let alone what is due to be paid and when in the longer term.

To really understand a business's cash payment obligations, a cash flow forecast is required, providing details of what cash receipts are expected to come in and when, and what cash payments are required or expected to go out and when. From this detail, likely shortfalls or surpluses of cash can be identified and action taken to make sure there are funds in place to cover shortfalls or make productive use of any surpluses. The development of a cash flow forecast is covered in the next chapter.

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