

Cash Flow Management for Small Businesses



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What is cash flow management and why does it matter?

Your business can continue trading and operating for a long time without making any profit, but it doesn't have a chance of survival if it lacks the cash to pay employee salaries, suppliers and creditors.

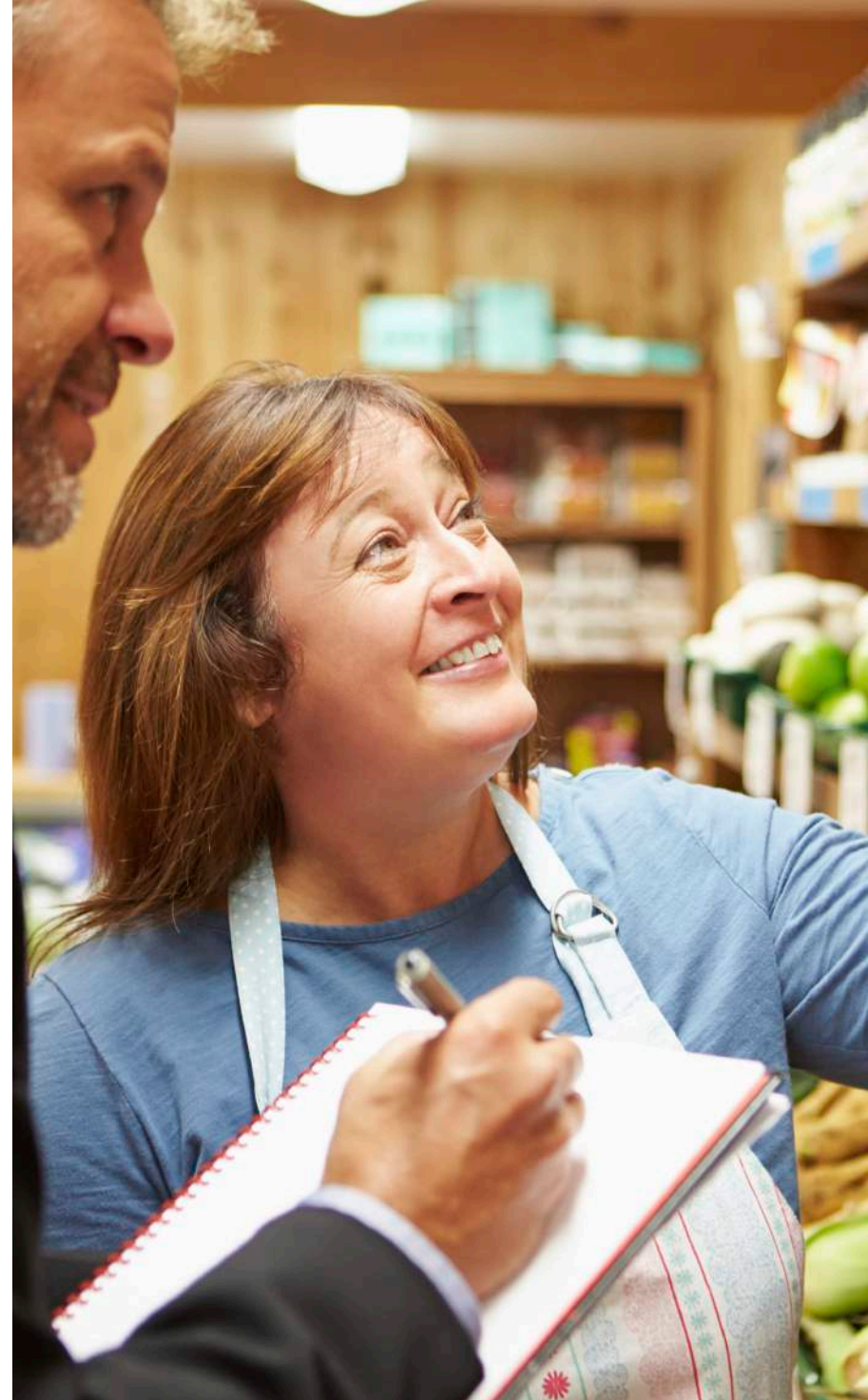


Good cash flow management is essential to maintain a healthy company that can trade and even extend credit to customers if need be.

Why managing your cash flow matters

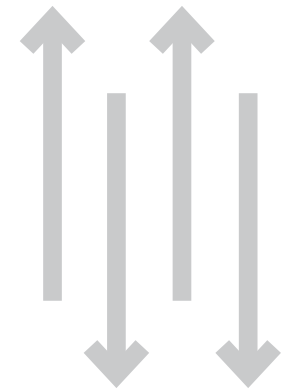
The cash flow of your business is not only defined by the general income and outgoing of cash but also by the timing of every transaction – your payments in have to match the payments out, so a good alignment of the two is crucial.

Many small businesses fail within the first year of operation, and a good number of these put their failure down to poor cash flow management. If a company consistently has more money going out than coming in, then it cannot continue to operate because it will not be able to meet expenses, pay for new stock or cover employee salaries.





Thinking about your cash flow



Inflows and outflows

A cash flow is comprised of a number of streams, moving both in and out of the business:

- The main inflow will be whatever is made from sales and/or service fees.
- This is supplemented from time to time by new finance, such as a bank loan.
- The main outflow will be business expenditure – this includes salaries, overheads and stock and supply purchases.
- Other outflows include VAT and tax payments, which come out in lump sums on a regular basis and should be scheduled into finance management systems so they don't take you by surprise.

The inflow and outflow of cash equals the overall cash flow for the business, and they have to be carefully regulated to ensure that there is always enough cash available to cover the company's needs. If the outflow exceeds the inflow, the company will begin to falter.

It's important to distinguish between positive cash flow and profit. A company can have a positive cash flow but not be profitable, and it can be profitable but have a negative cash flow.

Cash flow gap

The cash flow gap occurs when inflow and outflow payments are not aligned, resulting in time periods when the business is left short of cash. It's a common issue for small businesses where outflows outstrip inflows – for example, materials and other resources may have to be paid for before the customer pays for the completed job.

The outflow timescale will help ensure that the cash flow gap is closed as soon as possible because business owners are able to see where potential problems will occur before they do. Steps can also be taken to cut the cash flow conversion period so that inflows are received as soon as possible.



Common cash flow killers

1 Seasonal sales fluctuations

Seasonal drop-offs in sales and revenues are common across many businesses. If not planned for, not only will the fall in sales mean that less cash is coming in, but the inventory that hasn't been sold will be sitting around taking up money – every pound spent on it is a pound that cannot be used in other areas of the business.

2 Late payments

Late payments are an inevitable part of running a business, as suppliers and customers have their own cash flow requirements to meet. This will impact negatively on operations as a whole and means that the invoicing process should be made as simple and clear as possible for customers in order to ensure that they pay their bills more quickly. It's also essential that you have procedures in place for chasing payments in order to avoid late payments turning into bad debts.

3 Unexpected expenses

There will always be moments when money has to be paid out unexpectedly – they can't be predicted or planned for because the amount of expenditure on the organisation's part won't be known until the problem occurs. It will always be worth having backup cash reserves (see 5 below) but they may not be enough to deal with the issue, so every effort should be made to recover costs owed and/or secure extra short-term finance in order to cover the shortfall.

4 Out-of-date accounts

How can a cash flow be defined as either positive or negative if accurate and up-to-date records aren't kept? If they're not kept updated, a cash flow can very easily become negative, and it will be difficult to turn things around when the accounts first have to be brought up-to-date. Keeping records clear and sorted by date is the first step in maintaining a positive cash flow.

5 Not having backup cash reserves

When things do take a downhill turn, it can be extremely beneficial to have a reserve of cash that can be called upon to help keep the company afloat until things can be turned around. If this means borrowing from the bank as opposed to being able to withdraw cash from a reserve bank account, then so be it. This makes forming a good relationship with your business bank essential.

6 Faster-than-anticipated growth

The faster an organisation grows, the more cash has to be made available for higher staff numbers, bigger office space, more product choices, etc. When these are upfront costs (for instance, a new office will require the first and last month's rent in advance as well as a deposit), revenue streams usually cannot keep up and this creates a cash flow gap which can quickly cripple a business.

7 Not wanting to offend

As already noted, late payments can be a particular problem when it comes to maintaining a healthy cash flow, so organisations need to learn that it is alright to ask for payment if it doesn't look like it is forthcoming. Conversely, extensions can be granted as long as the organisation won't subsequently be thought of as a pushover.

8 Not forecasting outflows

There are far too many outgoings than any business owner can manage in his or her head – not only is it difficult to remember them all, but there's no chance of anyone being able to mentally organise them well enough to see where potential shortfalls might occur down the line. Make sure you have a system for tracking your expenses and when payment is due.

Cash flow forecasting



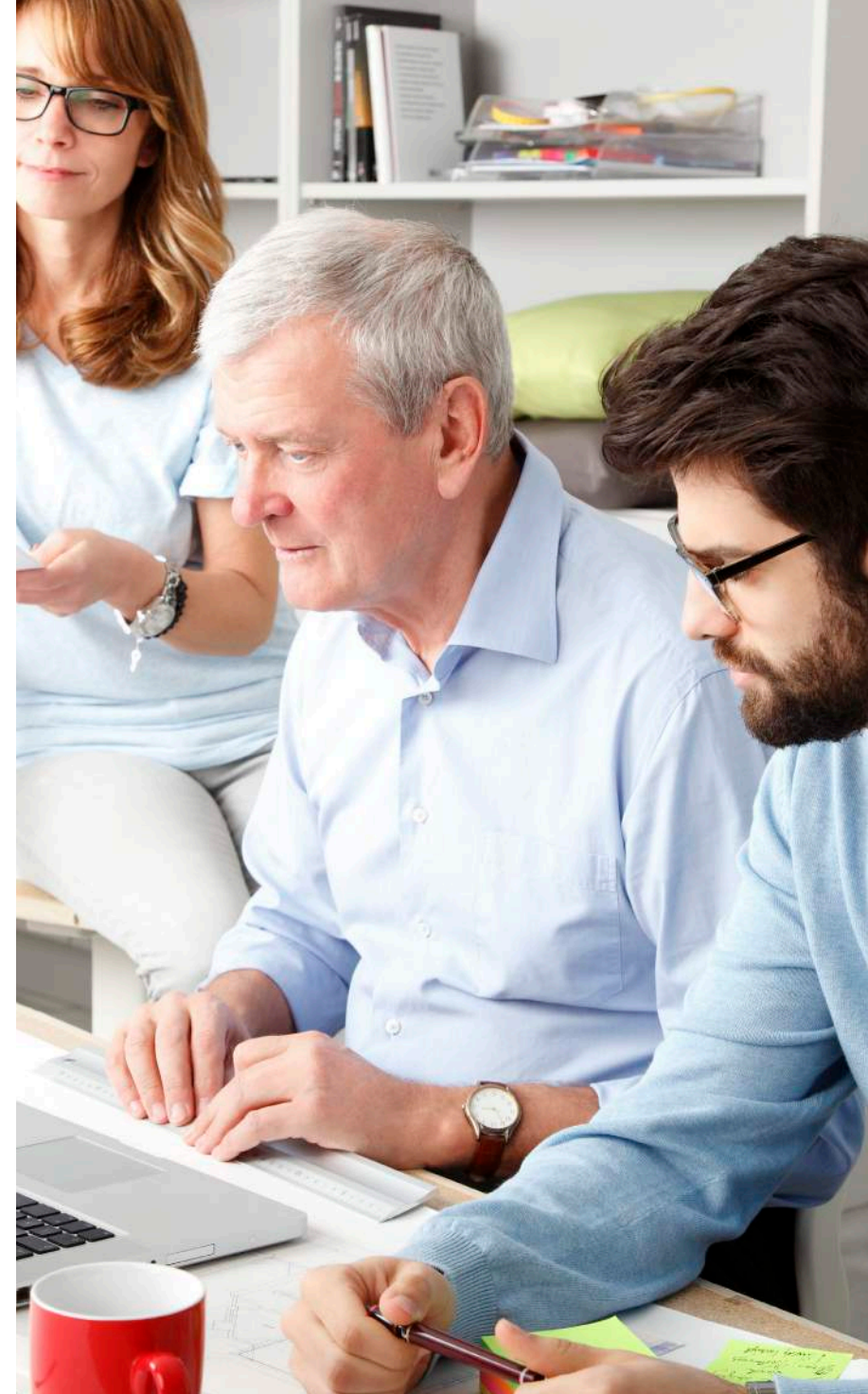
What is cash flow forecasting?

One of the most important things you can do to stay on top of your cash flow is to maintain a month-to-month (or week-to-week or day-to-day, if needed) projection of your outflow timescales and amounts. This covers absolutely everything, from amounts paid to suppliers to salaries and electricity bills.

An outflow projection document should:

- show users where potential shortfalls will occur
- ensure that payments to vendors and creditors can be made at the correct times
- identify any issues that might exist with regard to payments being received
- be suitable for external stakeholders, such as banks, to examine so that they are satisfied about the business's solvency. This makes them more likely to extend credit or provide new finance as and when it is needed.

Accounting software can be used to project cash outflows, but a well ordered Excel spreadsheet can be just as effective. The figures can then be used to compare projections against actual results, assess whether you can take on any new major projects and flag up areas that need attention such as sales figures dropping or profit margins diminishing.



Golden rules for cash flow forecasting

Be realistic

There's no point making unrealistic predictions about expected income over six months or a year because it will completely skew the forecast and could end up with a company spending much more because of what it thinks is coming in. When that doesn't happen, the outflow doesn't match the inflow and the business begins to suffer.

Remember the definitions of income and cost

Submitting an invoice does not mean that that money is suddenly sitting in the bank waiting to be spent – until it is paid, it shouldn't be touched. Similarly, a cost is money that has physically come out of the account. If payment can be rescheduled, this will help to balance the accounts and offer some breathing space if cash flow problems develop in the interim.

Include every aspect of outflow

Even if something seems too small (like a postage fee) to include in the forecast, it should be included to be on the safe side. Those small fees can add up and if a business is on a knife-edge in financial terms, they can be the death of it. The responsible thing is to keep track of them, even if they don't seem significant in the short term.

Plan multiple scenarios

Your cash flow forecast should always be flexible and that means planning for multiple scenarios. As already discussed, unexpected expenses will always occur and sales and revenue can easily come up short. Although you can't predict everything you can plan based on different potential outcomes.

For example, a sales cash flow forecast might have three versions: one that forecasts what will happen if the expected inflow is raised; one that forecasts what will happen if the inflow is 15% (for example) higher than what was expected; and one that forecasts what will happen if the inflow is 15% lower.

Factor in fixed and variable costs

Some costs, such as broadband, will be classed as fixed and not change from month to month, while other costs, such as electricity, will be classed as variable. Other costs will be tied to the overall successes or failures of the business – for instance, a strong selling period will necessitate buying more stock than usual. The forecast should be regularly tweaked to allow for the variable costs as and when they arise.

Plan for seasonality

One of the benefits of a cash flow forecast is that it can help to plan expenditure during slow times when income isn't as readily forthcoming – for instance, a business that sells beachwear will need to make sure that outgoings are carefully managed during winter or that cash reserves are built up during the summer season.



Getting paid

Tips for invoicing

1 Alter payment terms

Many invoices are still paid an average of two weeks late despite stating clear payment terms. With this in mind, terms could be renegotiated so that payment is due within a fortnight, a reasonable amount of time. Then, if payment is made two weeks late, it is equal to the original credit terms of 30 days.

4 Use invoice numbers

Splitting payments across multiple invoices so payments can be dealt with over different billing periods can be difficult to reconcile and keep track of. Clearly numbering every invoice will be a vital way of ensuring that the right payments are being made at the right time.

2 Remember VAT information

VAT numbers are often forgotten when a VAT-registered company is invoicing someone who is also VAT-registered. An invoice that contains the originator's VAT number, the rate of VAT and a unique invoice number must be submitted in order to satisfy HMRC's requirements.

5 Send reminder emails

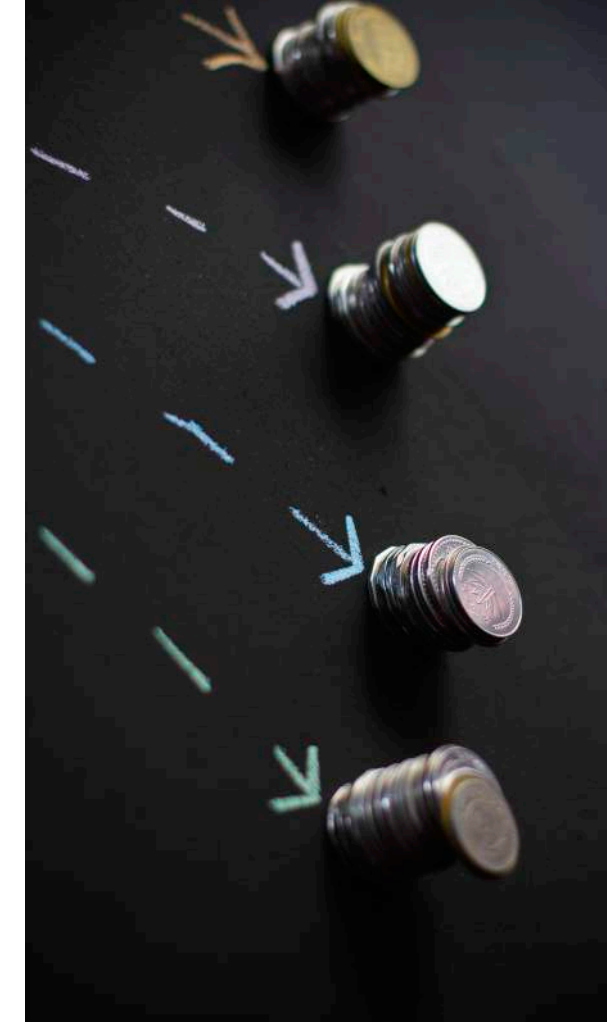
It can be beneficial if reminder emails are sent out when payment is due or nearly due, as invoices can be left at the bottom of a pile of paperwork (whether inadvertently or deliberately) and forgotten about. Gentle reminders will jog the memories of those who deal with accounts and payments.

3 Keep things concise

Keeping records of completed work is essential if invoices are not going to be submitted immediately – this ensures the amounts specified are correct. Invoices should be kept simple and concise so that recipients can clearly see how much they owe, what for and when it should be paid by. The clearer the information is, the quicker payment will be made.

6 Include clear late payment terms and conditions

All businesses have a statutory right to claim interest and costs on late payments, as defined by the Late Payment of Commercial Debts Regulations 2013. Make use of this legislation (see page 11) and encourage buyers to pay on time. You don't have to tell your customers that you will claim Late Payment interest, compensation



or costs if they fail to pay on time before they have actually breached your payment terms. However, it may be beneficial for your cash flow to tell them in advance of your intentions, should payment be made late. You could put warnings to this effect on your invoices; your statements and in your terms of business.

Late payments

Companies and businesses are often left with no other choice than to ask for customers who haven't paid within the time limit set out by the sale terms of agreement to pay them. This is one of the factors that can contribute to the cash flow suffering, and it's important that you are able to ask for payment in a respectful but firm way, especially when the customer has missed the deadline to send payment through.

It's important to always set clear terms of sale, as much to protect the company as anything else – if things get as far as court, these will be vital evidence that the non-payer is the party in the wrong. However, there will always be some customers who can't pay on time.

There are four types of late-paying customers:

Chronic late payers

These customers pay eventually, but they drain cash flows so it's worth setting up automatic invoice reminders to be sent out to try and prompt them into paying sooner.

Clients who can't afford to pay yet

Other people have cash flow issues as well, so they may simply be unable to pay by the agreed-upon date. In cases like these, it's important to pick up the phone and find

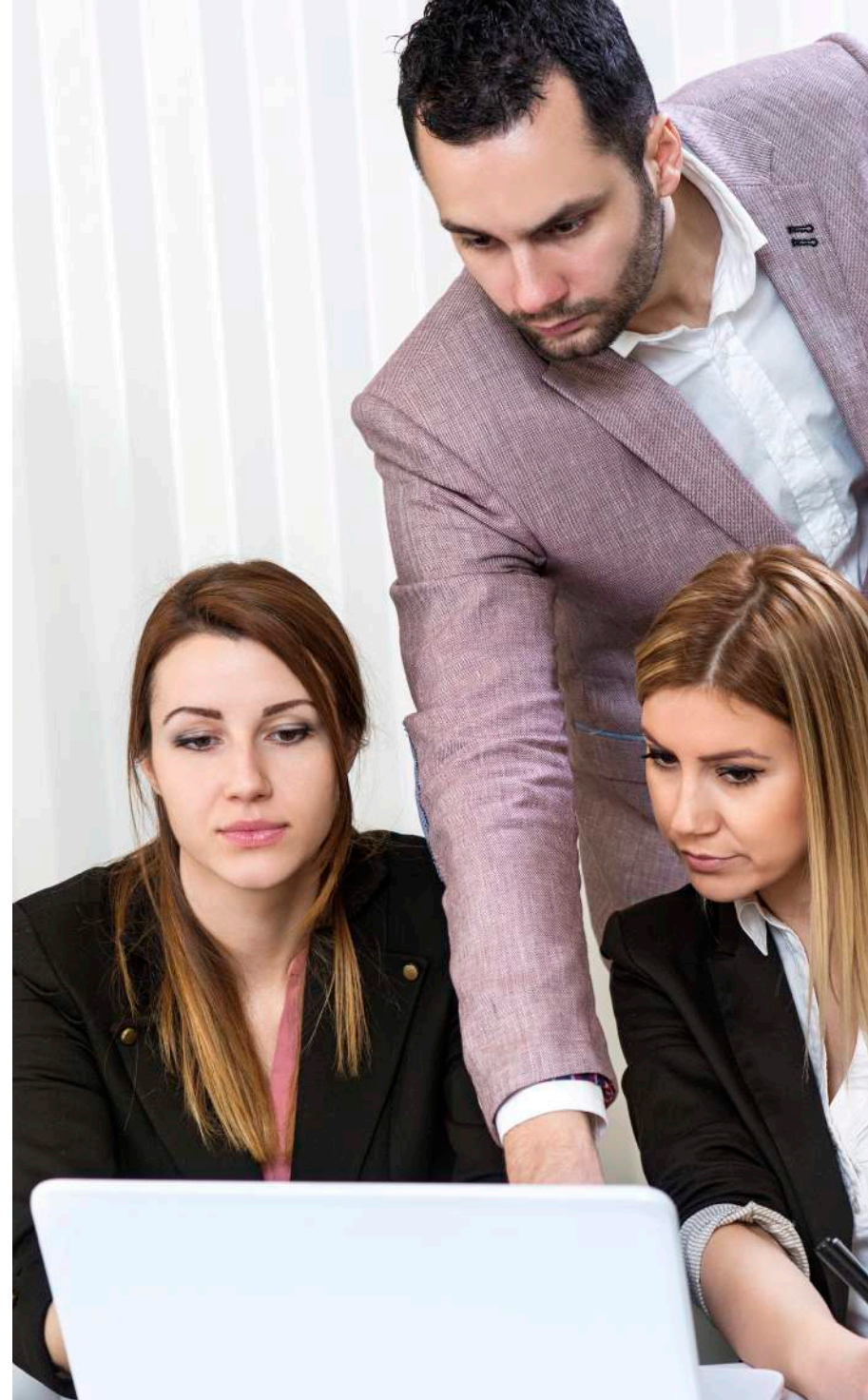
out what's going on – they can be offered extensions if it will help to maintain a good relationship.

Clients for whom your invoice isn't a pressing one

Some customers may have a lot of bills to pay before they get to this one, so issuing late fees or demanding immediate full payment won't work. Consider arranging a payment plan that allows them to pay in instalments.

Clients who disappear

Unfortunately, some customers simply disappear before paying their bill and can't be found again. While collection agencies could trace them and obtain payment from them eventually, the extra time, effort and cost required may make this option uneconomic. If it is decided not to pursue them, the invoice should be written off and the customer added to a blacklist.





Step by step guide to getting paid

- 1 Send an email or make a phone call to the customer to ensure that the invoice has been received and that there are no issues with the work that is being invoiced for.
- 2 If payment hasn't been received by the specified date, send a statement of the account (NOT a request for payment) to the customer.
- 3 When a week past the payment due date has been reached without anything being received, send a polite reminder email or letter.
- 4 At some point between 7 and 14 days overdue, call the accounts department and find out what has happened with payment. Write down any promise of payment and follow up via email.
- 5 At 14 days past the payment due date, send a stronger reminder email or letter that brings up the possibility of late payment charges.
- 6 From day 15 to day 30, stay in contact with the customer until payment has been resolved – if your contract allows you to stop working for reasons of non-payment, inform them of that.
- 7 If no payment has been received by day 30, it's time to consider instructing a Debt Collection Agency or Solicitor – can you afford to continue working for them when they haven't paid? Would your relationship survive taking the dispute to the next level, and does it matter?

Late payment legislation

All businesses have the statutory right to take advantage of the late payment legislation, first introduced as the **Late Payment of Commercial Debts (Interest) Act 1998** and modified in 2013 by **The Late Payment of Commercial Debts Regulations**.

This legislation entitles businesses to:

- claim interest for late payment
- claim reasonable debt recovery costs, unless the supplier has acted unreasonably
- challenge contractual terms that do not provide a substantial remedy against late payment
- have “representative bodies” challenge contractual terms that are grossly unfair on behalf of SMEs.

Specified payment amounts can be anywhere from a penny to amounts in excess of £10,000, with claimants also able to charge 8% interest above the base rate in addition to fixed costs to cover any collection costs they might have incurred, see table opposite.

The legislation’s aim, in addition to giving claimants protection against companies who don’t pay on time, is to encourage those companies to pay on time in the first place and resolve these issues before they occur. The legislation should be treated as a standard part of payment terms and contracts so that customers are aware that they could face legal action if it is required.

Invoice amount	Fixed costs
£0.01 - £999.99	£40
£1,000 - £9,999.99	£70
£10,000 +	£100

A Debt Collection Agency can charge its collection costs to late paying customers and this provides a free-of-charge collection service when they are successful.

Claimants have up to six years after the dispute to make a legal claim for late payment in England, Wales and Northern Ireland, and up to five years in Scotland. It can be beneficial to clearly state as part of a company’s payment terms that this is an option available for them to take.



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