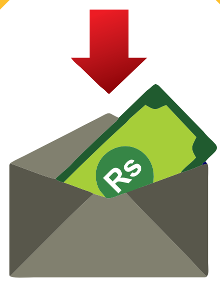
Information Booklet

Accounting & Finance

6

MANAGING BUSINESS CASH FLOWS

for SMEs



SMEDA

National Business Development Program for SMEs

Introduction

Small and Medium Enterprises Development Authority (SMEDA) works under the Ministry of Industries and Production, Government of Pakistan and was established in 1998 with the objective to propel economic growth through development of SMEs. SMEDA serves as an SME strategy-advisory body for the Government of Pakistan and facilitates partners in meeting their SME development agendas.

SMEDA envisions growth of a globally competitive SME sector, through creating an enabling environment and support services for increase in the national economy. SMEDA strives to achieve this vision by providing assistance in employment generation and value addition to the national income, through development of the SME Sector, by helping increase the number, scale and competitiveness of SMEs.

National Business Development Program for SMEs (NBDP) is a project of SMEDA which intends to provide hands-on support services to SMEs. The aim of this business development support provided by NBDP is to advance new businesses and improve efficiencies in existing SME value chains to empower them to contend in global market. NBDP expects to facilitate around 314,000 SME beneficiaries over the period of five years.

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Objectives

- To highlight the concept, importance and need of cash flow management.
- To explain effective methods of cash flow management in small and medium enterprises.

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a | Managing Cash Flow – Concept and Importance

Cash flow refers to the increase or decrease in the total cash amount of a business. It describes the amount of cash that is generated or consumed in a given time period. Cash flow management is the process of monitoring, analyzing and optimizing the net amount of cash receipts minus cash expenses. The net cash flow is an important measure of the financial health for any business.

Types of cash flows:

Cash Inflow

Cash inflow is the transfer of funds to a business from another party as a result of core operations, investments or financing. Cash inflow includes payments to a business by customers and banks and contribution of equity by investors.

Cash Outflow

Cash outflow is the transfer of funds to another party by a business. This could be from paying staff wages, cost of renting an office or from paying dividends to shareholders. A business is considered unhealthy if its cash outflow is greater than its cash inflow.

Importance of Cash Flow Management:

Cash flow management is the most important aspect of every business. A healthy cash flow ensures that:

- A business can pay salaries on time and have funds for growth and expansion of the business.
- A business can pay vendor bills, loan installments, service charges and taxes on time.
- A business can project the future cash flow with accuracy and take necessary action.

Research indicates that one of the main reasons why businesses fail is because of poor cash flow management. If a business constantly spends more than it earns, it indicates that the business has cash flow problems. For medium and small businesses, the most important aspect of cash flow management is avoiding extended cash shortages, caused by an overly large gap between cash inflows and outflows. A business would not be able to stay in market if it cannot pay bills for an extended period of time.

b | Assessing the Need of Cash Flow Management

- Cash flow management basically depends on financing and not on measuring profits. The positive result of operating activities reflects how the business is doing in terms of its operations.
- Rate of cash flow helps in making effective decisions such as investing back into the business for expansion, whether the business has enough cash funds for its expenses and/or to sustain a loss.
- A business has to pay special attention to its cash cycle to cover the gap between receivables and payables.

C | Cash Flow Management through Operating, Financing and Investing Activities[1]

Cash flow is categorized as operating, investing or financing activities on the cash flow statement, depending on the nature of transaction. Following are the details of three ways of cash flow management:

1

Operating Activities

Operating activities include cash activities related to net income. It includes activities that generate profit and activities that lead to expenses.

2

Investing Activities

Investing activities include cash activities related to noncurrent assets (long-term investments, property, plant, equipment and the principal amount of loans made to other entities). Cash generated from sale of land and cash paid for an investment in another business are included in this category. (Note that interest received from loans is included in operating activities.)

3

Financing Activities

Financing activities involve cash activities regarding noncurrent responsibilities and owners' equity (the principal amount of long-term debt, stock sales and repurchases, and dividend payments) Interest paid on long-term debt is included in operating activities.

d | Concept of Financial Leverage and Operating Leverage

In a business, leverage refers to the funds that are either debt or borrowed to purchase equipment, inventory or some other assets of a business. It is choice of a business owners whether to use either debt or equity to finance or purchase the required assets. Debt or leverage increases the risk of becoming bankrupt but it also increases the profits and returns; specifically return on equity.

There are two types of leverage:

1

Operating Leverage

Operating leverage is the ratio of fixed costs to variable costs. If a business firm has more fixed costs in comparison to variable costs, then the firm is said to have high operating leverage. Such businesses require healthy cash flow management and monetary cycle to ensure fixed costs are met. For example, businesses with a high operating leverage have heavy machinery and equipment which requires regular maintenance and monetary funds for ensuring its operations. A labor-intensive firm, in comparison, will have lower operating leverage since it has less fixed costs.

2

Financial Leverage

The amount of debt in the business is referred to as financial leverage. If a business has financial leverage, it gets exposed to a higher risk of default and bankruptcy since debt is a loan which will need to be paid off eventually. However, it also allows opportunities for growth and expansion of the business.

Saylor, 2019. Available at:
https://saylordotorg.github.io/text_managerial-accounting/s16-02-three-types-of-cash-flow-activ.html [Accessed 18th August 2019]

e | Methods of Cash Flow Management[2]

Following are some techniques to improve the cash position of a business. Not all of these methods are appropriate for all businesses, however, a combination of these methods can be used by any business.

1. Proper management of accounts
2. Maintaining cash reserves
3. Collecting receivables
4. Making financial projections
5. Encouraging customers to pay faster
6. Determining the breakeven point
7. Using cash flow worksheets
8. Reviewing cost
9. Avoiding falling behind on invoicing
10. Extending payables

1 Proper Management of Accounts

The following two actions are required for cash flow management:

Cash budgeting

Making a cash flow budget should be the first step in managing the business's cash flow. For this purpose, a bookkeeper, accountant, accounting software and spreadsheets can be used to help calculate inflow and outflows of money. Budgeting helps in predicting when a shortage of cash is likely to occur and prepare of such a situation to avoid default and bankruptcy. The following example describes the format of a cash budget. Business 'A' maintains a minimum cash balance of PKR 5,000 in case of a deficiency, loan is obtained at 8% annual interest rate on the first day of the period.

Business A					
Cash Budget					
For the Year Ending June 30, 2019					
	Quarter				
	1	2	3	4	Year
Beginning Cash Balance	PKR 5,200	PKR 5,000	PKR 5,000	PKR 11,740	PKR 5,200
Add: Budgeted Cash Receipts	37,150	54,190	53,730	62,300	207,370
Total Cash Available for Use	PKR 42,350	PKR 59,190	PKR 58,730	PKR 74,040	PKR 212,570
Less: Cash Disbursements					
Direct Material	14,960	16,550	16,810	19,410	67,730
Direct Labor	8,830	9,610	9,750	11,900	40,090
Factory Overhead	10,020	10,400	11,000	11,780	43,200
Selling and Admin. Expenses	7,640	8,360	8,500	9,610	34,110
Equipment Purchases		6,000		14,000	20,000
Total Disbursements	PKR 41,450	PKR 50,920	PKR 46,060	PKR 66,700	PKR 205,130
Cash Surplus/(Deficit)	PKR 900	PKR 8,270	PKR 12,670	PKR 7,340	PKR 7,440
Financing					
Borrowing	4,100				4,000
Repayments		−3,188	−912		−4,000
Interest		−82	−18		−100
Net Cash from Financing	PKR 4,100	PKR -3,270	PKR -930		−100
Budgeted Ending Cash Balance	PKR 5,000	PKR 5,000	PKR 11,740	PKR 7,340	PKR 7,340

[2] https://www.firmofthefuture.com/content/10-effective-cash-flow-management-strategies-for-small-businesses/

Cash Flow Forecast:

A cash flow forecast is a projection of future financial position of a business based on expected payments and receivables. Sometimes there are a number of reasons why businesses set up a cash flow forecasting process, which include:

Covenant forecasting

Interest and debt reduction

Short term liquidity planning

Long term planning/budgeting purposes (e.g. 3-year plan)

Determining the Break-even Points

Breakeven Point refers to the point at which total cost and total revenue are equal. A breakeven point is used to determine the number of units or rupees of revenue needed to cover total costs (fixed and variable costs).

Number of Units or Revenue = Variable Cost + Fixed Cost

The formula for breakeven analysis is as follows:

Break even quantity = Fixed costs / (Sales price per unit – Variable cost per unit)

Fixed Cost	Fixed cost is the cost that does not change with varying output (i.e. salary, rent, building machinery).
Sales Price	Sales price is the amount that a customer pays to purchase a product.
Variable Cost	Variable cost is the cost that varies with change in the activity level of a business. Examples of variable costs are direct materials, piece rate labor and commission charges etc.

It is also helpful to note that sales price per unit minus variable cost per unit is the contribution margin per unit. For example, if a book's selling price is PKR 900 and its variable costs are PKR 750 to make the book, PKR 150 is the contribution margin per unit and contributes to offsetting the fixed costs.

Example of Break-Even Analysis:

Business 'A' sells water bottles. Fixed costs of Business 'A' consist of taxes, rent, and staff salaries, which add up to PKR 100,000. The variable costs associated with producing one water bottle are PKR 2 per unit. The water bottle is sold at a premium price of PKR 12. To determine the break-even point of Business A's premium water bottle:

Break even quantity = PKR 100,000 / (PKR 12 – PKR 2) = 10,000

Therefore, given the fixed costs, variable costs and selling price of the water bottles, business 'A' would need to sell 10,000 units of water bottles to break even.

3 Maintaing Cash Reserves – What?

Notable cash reserves give a person, a group or a business the ability to maintain cash reserves that have the ability to make a large purchase. It, likewise, guarantees that the business has the financial resources to sustain challenging circumstances.

4 Using Cash Flow Worksheets

Another way to manage cash flow is the worksheet, which examines the change in each balance sheet account and relates it to any cash flow statement impacts.

5 Collecting Receivables

Accounts receivable helps in managing cash flow. It is not possible to maintain cash flow when customers do not make payments when due.

6 Reviewing Cost

Reviewing the costs associated with a business can help in managing cash flow. Any business should perform a cost review once in a month, however, if the business is in a highly unstable industry or experiencing cash issues, it is recommended that a cash flow analysis would be done on weekly or even daily basis.

7 Making Financial Projections

Financial projections are crucial when a business needs additional funding. There are three components of a cash flow projection:

- Cash Revenues – This is an overview of estimated sales for a given time period. Only account for cash sales will be considered not credit.
- Cash Disbursements – This is ledger cash expenditure that is expected to be paid in a specific month.
- Reconciliation of Cash Revenues to Cash Disbursements – It is the transfer of cash amount that a business has to pay to merchants within a specific period of time.

8 Avoiding Slack on Invoicing

Invoicing also helps in managing cash flow by maintaining good records of the income received and due to the business. Here are few benefits of frequent invoicing:

- Improves cash inflow
- Speed up payments or receivables
- Reduces time spent for chasing payment
- Automates payment processes of the business
- Improves customer relationships and trust
- Saves time

Encouraging Customers to Pay Faster

The simplest method to encourage customers to pay faster is to give vendor discounts, where 2/10, Net 30 terms would entail giving customers a 2% discount if the invoice is paid within 10 days. Otherwise, the full amount has to be paid in 30 days. This can be an attractive offer for customers of a business, as it allows them to make the equivalent of a 73% APR in ten days just by paying their bills faster.

Extending Payables

A business can extend its payables to net-60 or net-90. Some suppliers charge late fees, so there is a need to make payments on time.

COMPANY NAME	MANAGER NAME		COMPLETED BY		DATE COMPLETED
	CURRENT PERIOD		PREVIOUS PERIOD		INCREASE (or DECREASE)
	BEGIN	END	BEGIN	END	
BEGINNING BALANCE | CASH ON HAND					
(+) CASH RECEIPTS					
CASH SALES					
CUSTOMER ACCOUNT COLLECTIONS					
LOAN / CASH INJECTION					
INTEREST INCOME					
TAX REFUND					
OTHER CASH RECEIPTS					
OTHER					
OTHER					
OTHER					
TOTAL CASH RECEIPTS					
(–) CASH PAYMENTS					
(–) COST OF GOODS SOLD					
DIRECT PRODUCT / SERVICE COSTS					
PAYROLL TAXES / BENEFITS - DIRECT					
SALARIES - DIRECT					
SUPPLIES					
OTHER					
TOTAL COST OF GOODS SOLD					
(–) OPERATING EXPENSES					
ACCOUNT FEES					
ADVERTISING					
BANK FEES					
CONTINUING EDUCATION					
DUES / SUBSCRIPTIONS					
INSURANCE					
INTERNET					
LICENSES / PERMITS					
MEALS / ENTERTAINMENT					
OFFICE SUPPLIES					
PAYROLL PROCESSING					
PAYROLL TAXES / BENEFITS - INDIRECT					
POSTAGE / SHIPPING					
PRINTING					
PROFESSIONAL SVCS					

COMPANY NAME	MANAGER NAME		COMPLETED BY		DATE COMPLETED
	CURRENT PERIOD		PREVIOUS PERIOD		INCREASE (or DECREASE)
	BEGIN	END	BEGIN	END	
OCCUPANCY					
RENTAL FEES					
SALARIES - INDIRECT					
SUBCONTRACTORS					
TELEPHONE					
TRANSPORTATION					
TRAVEL					
UTILITIES					
WEB DEVELOPMENT					
WEB DOMAIN AND HOSTING					
OTHER					
TOTAL OPERATING EXPENSES					
(–) ADDITIONAL EXPENSES					
CASH DISBURSEMENTS TO OWNERS					
CHARITABLE CONTRIBUTIONS					
INTEREST EXPENSE					
INCOME TAX EXPENSE					
OTHER					
TOTAL ADDITIONAL EXPENSES					
TOTAL CASH PAYMENTS					
NET CASH CHANGE (CASH RECEIPTS – CASH PAYMENTS)					
MONTH ENDING CASH POSITION (CASH ON HAND + CASH RECEIPTS – CASH PAYMENTS)					

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