Tips for Companies to Improve Cash Flow

Your company's books show an increase in sales and net profits but cash flow remains tight. You ask yourself… How can we keep making a profit and have no money in our bank account? Your inventory levels are increasing to supply customer demand, your vendors want to be paid within 30 days, your employees need to be paid every two weeks, and your customers want to stretch you out for 75 days to pay your invoices. This situation is a very common occurrence for companies. Here are several tips to improve your cash flow:

Inventory Management - Companies use various methods to determine when and how much inventory to order. The methods range from someone walking through their warehouse, plant, or store once a month to evaluate inventory levels to elaborate systems that analyze efficient order points on a daily basis. Companies carrying more inventory than needed are directly reducing the amount of money in their bank accounts. For example, if a company reduced inventory levels by $250,000 it would fairly quickly have these funds available to pay down its line of credit or deposit in a money market account. The key is "how low can you go" while still being able to meet customer needs. Other factors that should be considered include the lead time suppliers require to deliver product, quantity discounts offered by suppliers, the cost to order inventory, unpredictable customer demand, the time needed to manufacture or convert the product, and warehousing costs. Some companies use a mathematical equation to assist in the determination of their economic order points. This equation is the square root of ((2 x D x P) / C) where D is the demand in units for a specified time period, P is the ordering costs per purchase order, and C is the carrying costs of one unit in stock for the time period used for D. The most efficient companies don't carry any inventory at all but rather have all products dropped shipped directly from their suppliers to their customers. Others have suppliers carry their inventory on consignment.

Accounts Receivable Management – The faster companies can complete the sales cycle the better their cash flow. The most efficient companies bill their customers on a daily basis, send monthly account statements, review aged accounts receivable reports weekly, and call customers directly after due dates. The old adage "the squeaky wheel gets paid first" is very true. COD (cash on delivery) terms may be used for customers past due on their bills. Delinquent accounts should be promptly turned over to a collection agency. Discounts can be offered to customers to encourage early payment or late charges can be assessed for past due payment. Industry average comparisons can also be a helpful tool in evaluating accounts receivable levels. Receipts should be deposited daily. Some companies use a lockbox at their bank to ensure receipts are deposited daily. Companies should make the most of their funds once they have been deposited by paying down their line of credit or transferring the funds to a money market account.

Capital Budgeting – Special consideration should be made before investing in fixed assets. Companies should determine all of the costs involved in acquiring capital items as well as all the related benefits. A few simple calculations can be made to determine if the acquisition makes sound economic sense. The three most commonly used methods to analyze fixed asset purchases are the payback period, the net present value (NPV), and the internal rate of return (IRR) methods. The payback period method is the number of years needed to return the initial investment. The NPV method is the present value of future cash flows, discounted at the applicable cost of capital, minus the cost of the investment. The IRR method is the discount rate that equates to the present value of future cash flows of the investment. Not all fixed assets will increase revenues or reduce costs. These types of items include office furnishings, a parking lot, etc. Alternatives should also be considered, including buying used items versus new items, leasing versus buying, or postponing the purchase for a year or two. If cash flow is already a concern, long term debt should be considered to finance the investment.

Payables Management – In general, vendors do not charge interest on outstanding invoices. The longer you can take to pay your vendors and still keep them happy, the better your cash flow. Some vendors will grant you longer payment terms, if you just ask, while others may ask for collateral or say no. Companies should take advantage of early payment discounts only if it makes sense to do so. You may be better off paying down your line of credit or leaving the funds in a money market account. Other ways to improve cash flow is waiting to pay sales commissions until payment is received from the customer, paying insurance premiums monthly instead of semi-annually, and changing payroll periods from weekly to bi-weekly.

Companies interested in increasing their cash flows should set realistic goals in changing their processes. Open discussion with all of the stakeholders can be enlightening. Too much money in your bank account is a good problem to have.