Cash is King
A guide on working capital Management.

Exclusive Business Insight from M. Simpson.

1. INTRODUCTION TO WORKING CAPITAL MANAGEMENT.
2. WHAT IS WORKING CAPITAL?
3. WORKING CAPITAL CYCLE.
4. ESSENTIALS OF GOOD WORKING CAPITAL MANAGEMENT.
5. REQUIREMENTS OF THE BOARD & THE SENIOR MANAGEMENT.
6. CONCLUSIONS.
7. EXPLANATIONS “DISCONNECT P&L & CASH”.

You can lose money over a long period of time but you only run out of cash ONCE.

Understand the disconnect between your accounting profit and cash.

Accounting policies IMPACT on the disconnect, they can flatter your operational performance yet often hide a serious deterioration in cash.

M Simpson Associates will review the DETAIL of your Business and advise on best practice Working Capital Management.
• Are you concerned about lack of cash?
• Do your management understand the difference between accounting profit and cash?
• Are “Profit Centre Managers” aware of the importance of cash management?

Most businesses spend a disproportionate amount of time worrying about cash at the expense of their business and the opportunities available to them.

Cash management and planning for growth are essential to a company’s survival, as Benjamin Franklin stated “Failure to plan is planning to fail” an old adage more relevant today than ever!


As a Small Business Owner, Managing Director, Finance Director & Consultant I have witnessed periods of great & enjoyable success and unfortunate failure. MSAL appreciate the difficulties of both the SME owner and the CEO of an International Group.

Working Capital Management is the “prevention” that many businesses fail to appreciate until it is too late. It is possible to correct poor working capital management practices at any stage in a company’s life cycle but the sooner the better. Solutions adopted too late are costly and may not be enough to allow a sustainable solution.

For a company to succeed in the vital area of Working Capital Management the Owner(s) / Board must adopt a clear strategy for Working Capital, Managers need Training, Targets need to be set, Results (KPI’s) must be communicated, Reviews should be undertaken of all Business activities that impact on Cash and the Visibility and Focus must be maintained.

Cash Management should be of Strategic Importance to all Businesses and the Management need to understand how their decisions may impact on efficient Cash Management.

With over 30 years’ experience managing working capital in varied industries with multiple income streams both in the UK and Internationally I hope this publication helps your organisation.
All businesses need cash to survive.

Cash is needed to:
- Invest in fixed assets
- Pay suppliers and employees
- Fund overheads and other fixed costs
- Pay tax due to the Government

Nearly all businesses use much of their cash resources to finance investment in “working capital” Managing working capital effectively is, therefore, a vital part of making sure the business has enough cash to continue.

Working capital is the cash needed to pay for the day to day operation of the business.

**Definition of Working Capital:**

\[
\text{Current assets} = \text{Assets of the business held in cash form (e.g. at the bank) or that can quickly be turned into cash (Stocks, Debtors, Cash, Investments)}
\]

\[
\text{Less Current liabilities} = \text{Money owed by a business which will need to be paid in the next 12 months (Trade Creditors, Taxation, Dividends, Short-term Loans)}.
\]

**The working capital cycle is:**

The period of time between the points at which cash is first spent on the production of a product and the final collection of cash from a customer.

*The Key to Managing Working Capital is to reduce the time between first expending cash and receiving payment for Goods and Services provided*

**Warning:** a profitable business can fail if it runs out of cash.

It is often said, you can lose money for some time, but **you can only run out of cash once.**

Overtrading happens when a business tries to do too much, too quickly with too little long-term capital

Those that ignore the signs of overtrading do so at their peril.
The Key to Managing Working Capital is to reduce the time between first expending cash and receiving payment for Goods and Services supplied.

WORKING CAPITAL CYCLE

Cash flows in a cycle into, around and out of a business. It is the business's lifeblood and every manager's primary task is to help keep it flowing and to use the cashflow to generate profits. If a business is operating profitably, then it should, in theory, generate cash surpluses. If it doesn't generate surpluses, the business will eventually run out of cash and eventually failure is inevitable.

The faster a business expands the more cash it will need for working capital and investment. The cheapest and best sources of cash exist as working capital right within business. Good management of working capital will generate cash, will help improve profits and reduce risks. Bear in mind that the cost of providing credit to customers and holding stocks can represent a substantial proportion of a firm's total profits.

There are two elements in the business cycle that absorb cash - Inventory (stocks and work-in-progress) and Receivables (debtors owing you money). The main sources of cash are Payables (your creditors) and Equity and Loans.
Each component of working capital (namely inventory, receivables and payables) has two dimensions TIME and MONEY.

When it comes to managing working capital - **TIME IS MONEY**. If you can get money to move faster around the cycle (e.g. *collect monies due from debtors more quickly*) or reduce the amount of money tied up (e.g. *reduce inventory levels relative to sales*), the business will generate more cash or it will need to borrow less money to fund working capital. As a consequence, you could reduce the cost of bank interest or you'll have additional free money available to support additional sales growth or investment. Similarly, if you can **negotiate improved terms with suppliers** e.g. get longer credit or an increased credit limit; you effectively create free finance to help fund future sales.

It can be tempting to pay cash, if available, for fixed assets e.g. computers, plant, vehicles etc. If you do pay cash, remember that this is no longer available for working capital. Therefore, if cash is tight, consider other ways of financing capital investment - loans, equity, leasing etc. Similarly, if you pay dividends or increase drawings, liquidity will be removed from the business.

**More businesses fail for lack of cash than for want of profit.**

Sources of additional working capital include the following:

- Existing cash reserves
- Profits (when you secure it as cash!)
- Payables (credit from suppliers)
- New equity or loans from shareholders
- Bank overdrafts or lines of credit
- Long-term loans

If you have insufficient working capital and try to increase sales, you can easily overstretch the financial resources of the business. This is called **overtrading**. Early warning signs include:

- Pressure on existing cash
- Exceptional cash generating activities e.g. offering high discounts for early cash payment
- Bank overdraft exceeds authorized limit
- Seeking greater overdrafts or lines of credit
- Part-paying suppliers or other creditors
- Paying bills in cash to secure additional supplies
- Management pre-occupation with surviving rather than managing
- Frequent short-term emergency requests to the bank (to help pay wages, pending receipt of a cheque).
• It does not matter how much Revenue you recognise or how many assets you have on your books at “Historic” costs, the only businesses that survive are those that generate enough cash to keep their operations going.

• Cash management is NOT about accounting policies & unlike revenue recognition it is REAL and harder to “manipulate”

• It is relatively easy to obtain short term savings in Working Capital by:-
  • Slowing down payments to Suppliers
  • Speeding up Collections from Customers
  • Starving Inventory

It will seriously harm your reputation if accountants simply “manipulate” supplier payments to manage cash over long periods of time, similarly starving inventory will eventually harm your customer service, managing working capital efficiently impacts on the entire organisation & policies adopted need the cooperation of all concerned (both operational & finance)

• Good training, processes & procedures and Good KPI’S will deliver long term improvements

• Contract negotiation including terms for payment, Inventory management, invoicing & credit control all need to be robust

• Long term gains demand a “sustained” effort & “systematic” approach

• Effective working capital management requires the cooperation of every part of the organisation including Sales, Finance, Operations and in particular the “Operational Directors”

• World class businesses will have their decision makers in every department not simply achieving excellence in the area they control but acting wisely as a steward of company cash

• A cash focus involves the transformation of mind-sets at every level of the organisation (“Culture Change”), this cultural change will take time to achieve and will require a constant management.
• Senior Management need to focus on Working Capital & make it a Priority
• Improving Working Capital requires a “Cultural” shift and a change of focus & accountability that begins at the top and cascades down
• A Root & Branch review of all processes required (Credit Control, Contract billing, Supply Chain & Inventory management)
• **While Management interest is not enough to succeed a lack of interest will make it fail**
• Management incentives should be linked with meeting certain Working Capital targets on a sustained basis
• It is Essential targets exist for all business units(profit centres) & central functions (Finance, Supply Chain etc), they need to be understood, measured and reported upon
• Employees should be rewarded based on their efficiency of Working Capital use where possible, incentives designed to reduce the working capital cycle will have a positive impact on cash flows and train key management the importance of managing their respective component of working capital for the greater good of the business.
• It is not acceptable to exclude Creditors & Inventory from Working Capital management simply because of a weak supply chain – All areas of working capital require measurement in order to better manage cash and ensure a cash culture exists throughout, effective management of Inventory & better negotiation of supplier terms can relieve pressure on short term cash requirements.
• In companies with weak working capital practices customers may be given the same terms regardless of their strategic importance. Credit may be granted to low value / high risk customers, a review of customer terms and the enforcement of a strict credit control policy can lead to significant release of “free cash”
• Working Capital Management requires a day to day focus; a business must ensure visibility & Good KPI measures exist & are communicated throughout the senior management team.
• The key to success is **FOCUS** by the senior management, **TARGETS** must be set and agreed, **VISIBILITY** through relevant timely reporting, **COMMUNICATION** of results to all involved, **TRAINING** throughout the entire organisation, **GOOD PROCEDURES** set in place to control the elements of Working Capital
• Negotiate terms, get invoicing right, improve invoice phasing, ensure credit control procedures and credit risk management is robust
• Repeat the process and **REMAIN FOCUSED**
• Departments will have conflicting goals (eg. Sales & Finance over Credit) and a company’s policies need to be clear & consistent to prevent harmful “in-fighting”.
• Excellent Working Capital Management is not a trick of accounting; it is a process that demands on-going FOCUS, it is REAL & bad practice will result in BUSINESS FAILURE.
• Working Capital Management requires a DAILY FOCUS, it is not a strategic decision you take once, to be effective the cooperation of the entire organisation is required and the CONSISTANT support of the BOARD of Directors.
• Companies that strive to improve their Working Capital Management are those that take a structured “root and branch” approach, ensuring departments work closely & cooperate to achieve strategic goals, they will work closely with key customers and suppliers to achieve ever greater efficiency, and have robust risk management policies in place.
• Improving Working Capital Management can generate significant operating cost reductions, reduce provisions / write-offs of receivables & inventories and reduce the finance costs of short term finance.
• Improving Working Capital requires a Cultural shift and a change of focus & accountability that begins at the top and cascades down.

EXPLANATIONS “DISCONNECT P&L & CASH”

• Cash – v – Accruals – Accounting policies for Revenue Recognition; POC*/ WIP*/ LTC’s* can create a “disconnect” between recorded profit and cash.
• The Accruals Concept – attempts to match costs with revenues for profit calculation but ignores the cash position, for example you cannot pay bills with “accrued sales”!
• Revenue Recognition (POC etc) allow room for “manipulation” & a further “disconnect”.
• EBITDA - should approximate to the cash generated from “current” operations but may be significantly different due to methods of Revenue Recognition and other Accounting Policies adopted by a business.
• Businesses that have a strong EBITDA may still be “burning” cash if Debtors or Inventory are allowed to increase beyond acceptable levels.
• Businesses showing healthy EBITDA can still FAIL due to not managing its working capital and OVERTRADING.

T: 01234 954191 E: info@msimpsonassociates.com
Businesses may “hide” problems in WIP / POC; They recognise Revenue by Accruing Sales but the failure to actually Invoice / collect cash can result in significant “Negative” cash-flows

- Financing Costs – Interest payments are excluded from the EBITDA measure
- CAPEX EXPENDITURE is not reflected in the EBITDA figure
- Capital Repayments on Loans are not included in the EBITDA calculation

**EBITDA** is the result of accounting policies and does not take account of Financing Costs /taxation or Capex and as a result cannot be used as a true measure of how much cash has been generated in a period of time.

Cash Management and Working Capital Management are essential to ensure the business is able to meet its obligations and grow safely.

A business should understand and reconcile any differences in reported profits and cash movements

- POC - % of completion for longer term manufacturing of items for sale
- WIP – Work In Progress or “unbilled sales”
- LTC – Long Term Contracts only partially billed

In all cases Revenue & Profit may have been recognised but actual invoicing to customers remains outstanding, these “accrued sales” can seriously distort the reported EBITDA and the actual Operational Cash movements. It is therefore essential to reconcile the actual movement in cash which will consist of EBITDA & the movement in Working Capital; Capital Expenditure / Capital Sales; Financing movements (new finance / finance repaid); Finance costs (Interest) & Taxation

**A focus on EBITDA is not very useful if a business runs out of cash to keep going.**

M Simpson Associates can help with a review of your working capital management and offer real help in releasing the “free cash” available, we can work alongside your staff on a part-time or interim basis, we can train / mentor your staff, assist with a cultural change offering recommendations for targets / KPI’s / Reporting . We can assist with the introduction of cash forecasts and budgeting to allow your business plans for growth to be monitored facilitating safe growth and the delivery of your strategic targets.