

## Improve Cash Flow Management through 5 Steps

By John Formento Jr., Analyst, Sageworks, Inc.

The financial health of any company is determined, in part, by the status of collections and aging accounts receivables. Cash flow management is an important part of any CFO's job. Strong cash flow management practices often mean the difference between the success and failure of a company. In order to improve cash flow management, financial leaders should adhere to these five tips:

- 1. Thoroughly examine [accounts receivable](#):** It is very easy for cash to be tied up in accounts receivable (AR). The AR days financial ratio is a metric that is useful to better understand a business's accounts receivable. Reducing the number of AR days is a great place to start when trying to free up cash flows. One way to decrease collection time for accounts receivable days is to give customers an incentive to pay early, such as offering a 2% discount for payments received within 10 days of invoicing. Another way to decrease accounts receivable days is to examine the payment history of all customers and identify which customers are taking the longest to pay. Then, contact the slow paying customers and try to work out better payment arrangements or, if necessary, decline further credit offerings to them.
- 2. Diligently manage accounts payable:** One of the easiest ways to free up cash flows is to make payments on the due date, not early (unless the vendor offers a discount for early payment) and not late. This will keep cash on the balance sheet as long as possible, while still ensuring that bills are paid. Another way to lower accounts payable is to procure inventory, supplies, and equipment from a single vendor and arrange a volume discount. Increasing your purchasing power increases your negotiating power.
- 3. Prepare for growth:** Growth is one of the biggest expenses a business will incur. Properly forecasting expenses that are needed for growth (IT equipment, travel expenses, inventory costs, etc.) will make cash flow management an easier task. In most cases, it costs money to make money and an understanding of the difference between future cash inflows and current cash outflows is a key part of cash flow management. Paying careful attention to the cash flow statement, accurately forecasting when payments from customers will be received, and understanding operating costs are key steps in preparing for growth and managing cash flow.
- 4. Implement inventory management best practices:** Holding excess inventory is a great way to starve a company of needed cash. Understanding the business cycle is important in determining inventory levels, which is a key to better cash flow management. One way to better manage cash flow is to forecast sales as accurately as possible. This can be done by looking at previous sales over the last 12 months and finding sales trends month-by-month. Another option is to use a just-in-time inventory (JIT) management system. "Make sure your inventory practices are more 'just in time' than 'just in case'," said John Blasingame, Florence, Ala.-based President of Small Business Network and host of the Small Business Advocate radio show. The main idea behind JIT inventory management is to procure inventory right before it's needed. This will reduce inventory holding costs and create more free cash flows.
- 5. Forecast [cash flow](#):** According to Jeff Hipshman and Curtus Campbell at the Orange Country Business Journal, "In the current economic situation, it is often vital for companies to manage their business on a 13-week cash flow forecast." There are two main categories of cash flow forecasting, direct and indirect. The direct method consists of forecasting using the company's cash receipts and disbursements (R&D). Receipts

include the collection of account receivable and sales of assets. Disbursements consist of payroll, account payable payments, interest on debt, and dividend payment. The R&D method is good for forecasting cash flows within a 30 day period. There are three indirect methods of forecasting cash flows. The first is the adjusted net income method (ANI) and involves subtracting changes in balance sheet accounts from EBIT, which is earning before interest and taxes. The second indirect method is the pro-forma balance sheet method (PBS), which looks right at the projected cash account and, assuming all balance sheet accounts have been accurately forecasted, cash should be correct too. The final indirect method is accrual reversal method (ARM), which uses statistical distribution models and algorithms to reverse large accruals and cash effects. Both the ANI and PBS methods are good for medium-and long-term forecasting, while the ARM is good for medium term forecasting.

Monitoring cash flow and taking the appropriate steps to shorten receivables is extremely important in creating a successful financial environment. The combination of these five steps creates a significant, positive impact on your business and profits. Continual cash flow management by an informed leader is critical in the long-term financial success of your company.

**About John Formento Jr.:** John Formento Jr. is an Analyst at [Sageworks](#), a financial information company and Inc. 500 honoree. Formento is responsible for marketing and product development activities to improve the brand awareness and customer retention for Sageworks financial software applications. Prior to Sageworks, he founded Eye-Tee LLC, a company that provided IT and marketing services to small businesses. Formento graduated with honors in Business from the Schreyer Honors College at The Pennsylvania State University.

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