Cash Management Practices in Small Companies

Of all the disciplines that a small company must master to grow and succeed, none may be more important than cash management. While a strong cash management system can ensure that a company maintains adequate cash levels to meet its operating and investment requirements, an inadequate cash management system can lead to a company's failure to meet its financial commitments. All too often, poor cash management systems have led small business managers to liquidate or reorganize under Chapter 7 or 11 of the Bankruptcy Code.

Most small business managers claim that cash management is their leading concern. Often walking a tightrope between growth and illiquidity, small business managers face different cash management challenges than their counterparts in larger companies. Compared to larger firms, small businesses often have under-staffed and under-trained accounting staffs, volatile cash flows dependent on a single product line, limited access to new capital, and a significant share of their net worth tied up in working capital. These limitations are often compounded by management's focus on growth, which can put additional pressure on the cash management system by increasing net working capital requirements.

Yet, despite its importance, few small business managers can dedicate significant time managing cash. Most develop a set of techniques to avoid cash crises, but many of these "systems" are as basic as matching receivables to payables. Most cash management systems in small companies employ a fraction of the tools available to them, as small business managers rarely have a forum to transfer knowledge about management practices. While each company has certain strategies that are more appropriate for it depending on the type or size of its business at a given time, the goal of this Note is to provide managers with a broader universe of specific techniques used by small businesses to manage cash.

This Note uses the following three-part model of cash management systems to provide a framework for a discussion of best practices.

1) ***Cash Cycle Policies and Tactics.*** Managing the cash cycle through active management of accounts payable, inventory, and accounts receivable.

2) ***Forecasting and Review Processes.*** Short-term and long-term efforts to understand the current cash position, anticipate cash requirements, prioritize uses of cash, identify variances, and reinforce a culture of prudent cash management within the organization.

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3) ***Organizational Design and Incentive Systems.*** The allocation of decision rights among employees to ensure effective execution of the cash management and incentive systems, which help focus the organization and its management team on meeting its cash objectives.

Cash Cycle Policies and Tactics

Managing the cash cycle is at the center of a cash management system. Broadly, the cash cycle refers to the outflows and inflows of cash associated with the conversion of raw materials into finished goods and later into accounts receivable. The longer the cash cycle, the more days the company must finance the purchase of raw materials, inventory and receivables. A company's proficiency in this discipline allows it to meet its cash commitments, retain operating flexibility, and lower financing costs. For a small, stable company, the logistics of cash cycle management can be quite simple. Often when a company has limited suppliers and customers, a single manager or bookkeeper can monitor sales and track invoices. However, as the firm grows, competing demands for cash increase and decision rights for cash management become highly decentralized. As a result, high growth companies often find the details of cash management quite elusive and their cash management systems must become more sophisticated to adequately meet the needs of the organization.

Accounts Payable

Paying for supplies via cash on delivery (C.O.D) is a costly way to finance payables and can be an inefficient use of cash. Often suppliers will extend standard industry credit to new customers to gain new business. Over time, however, small businesses employ a variety of strategies to manage their accounts payable more effectively. Depending upon the cash position of the firm, companies may try to extend—or "stretch"—their payables terms to reduce the period of time during which they must finance receivables. Alternatively, the company may try to prepay payables to take advantage of available discounts. The following techniques are often practiced to optimize payables performance:

- **Pay first deliveries C.O.D**. Without an established credit rating, this technique develops goodwill with suppliers. By agreeing to pay the first several bills from a new supplier C.O.D., a company may be able to leverage this goodwill at a later time to receive more favorable payment terms.

- **Initially, pay bills on time.** The first objective is to establish a good credit rating. The most common way for a company to receive favorable payment terms is to establish trust by paying bills on time. After establishing an attractive credit history with a given supplier, that supplier is often willing to extend terms as a service to retain a reliable customer's business.

- **Maintain perfect credit with several suppliers.** Even with modest or unproven credit history, a company can secure favorable credit terms by referencing select supplier relationships. By maintaining at least three favorable credit references, companies can receive beneficial terms when applying for credit with new vendors.

- **Test suppliers' terms**. By testing suppliers' payment terms, companies can identify the limits of each supplier's credit. Many suppliers have collection processes, which do not spotlight accounts until they become 20 days past due. Thus, customers can often fly beneath the "past due" radar by paying within 20 days of the stated due date. Companies should test suppliers' payment terms to understand the maximum time in which they can pay their bills without disrupting healthy relationships.

- **Prioritize vendors**. Not all suppliers are equal. Some may be more important to a company's business than others. For example, some suppliers may double as customers or may be the only potential source of supplies. As a result, payment to these suppliers should be prioritized and paid within agreed terms. During significant cash crises, some managers find it helpful to prioritize vendors based upon the strategic importance of the service to their business. For instance, a manufacturing company in Massachusetts conducted this type of review and prioritized as follows: 1) employees, 2) telephone, 3) utilities, 4) transportation, 5) raw materials, 6) bank, and 7) all others.

- **Manage supplier base.** A small business should actively manage its suppliers individually, based upon each supplier's industry structure. In highly fragmented supplier industries, a small business might consider consolidating its suppliers in order to leverage its buying position and obtain more favorable payment terms. However, in highly consolidated supplier industries for which there are few substitutes, consolidating purchases can expose managers to unfavorable terms. In these industries, it may be more helpful to diversify the supplier base as much as is possible.

- **Purchase on consignment**. By purchasing on consignment, small companies can reduce exposure to inventory obsolescence as well as automatically match payables with receivables. Consignment tends to be practiced only in select industries, and therefore may not be an option for some businesses.

- **Pay early when possible**. Suppliers will often offer significant discounts for prepayment or early payment. Terms such as 2% Net 10 refer to a 2% discount for prepayment in 10 days. For normal 30 day terms, this discount equals 36.5% per annum [2% * (365 days / 20 days)]. When companies have excess cash on hand, or when short term financing terms are more favorable, it often makes sense for a small business to take advantage of these terms when offered.

- **Sign all checks.** Many small business managers find it necessary to spend several hours each month personally signing checks. Many managers say that there is no more important responsibility than personally signing all checks. Through this process, they stay in touch with purchasing volumes, identify potential fraud, and identify any significant changes which might effect their cash position.

Accounts Payable Crisis Management Techniques

- **Suspend management salaries.** At times, a small company will suspend senior management salaries and expense reimbursements while it awaits collection of accounts.

- **Pay part of invoice**. A company might pay half an invoice within agreed terms and delay payment on the balance. By actively communicating with suppliers about expected payment dates, suppliers may be willing to accommodate partial late payments.

Inventory

A goal of a finely tuned cash management system is to minimize average inventories of raw materials, work in process, and finished goods. Excess inventory can pose cash problems for companies by tying up cash which otherwise might be invested in more productive projects. Of course, balancing inventory levels requires significant coordination of sales, purchasing, and production as well as an advanced understanding of production processes and sales cycles. Empirical evidence indicates that small companies carry higher inventory levels than larger companies, reflecting a small company's less sophisticated production and inventory management systems.[1] The following are some observed methods for reducing inventory buildups.

- **Off-load buffer inventory levels**. By encouraging customers to carry buffer inventory, a company can reduce inventory levels it carries in its own facility. This practice reduces working capital financing needs and lowers costs associated with storage, obsolescence, and perishability. To encourage customers' adoption of this policy, a company may pass along a fraction of the cost savings to its customers. Smaller companies are more able to compel larger companies to accept this arrangement when the smaller company is offering the larger company a service/value that is hard to secure elsewhere.

[1] U.S. Small Business Administration – Office of Advocacy. "Facts About Small Business," 1996.

- **Adjust production shifts in peak and non-peak seasons**. Rather than increase inventory levels to meet cyclical demands, a company can increase short-term capacity by adding staff and/or production shifts during peak season. Though this strategy increases staffing and operating costs, it shortens the period during which the company must finance inventory levels. This approach works best in low skilled operations for which little training is required and supply of workers is abundant. Alternatively, during non-peak seasons or cash crunches, the company may try to reduce the average work week, which would allow it to retain its entire staff throughout the year.

- **Add sales and inventory forecasting systems**. By forecasting and reviewing orders and shipments regularly, managers can identify variances quickly and adjust purchasing and production accordingly. Armed with this system, a small business manager can quickly spot potential overstock of costly inventory and cut back on purchasing and production. While sales and inventory forecasting is important for all businesses, companies selling products with a high variable cost component are likely to benefit most.

- **Discount excess inventory**. During periods of excess inventory, a company can offer discounts to customers to reduce inventory levels. While discounting may accelerate the conversion of inventory to cash, it will also reduce gross margins. Many managers consider this "fire sale" strategy a draconian measure, but companies with highly perishable products or technology-based products with rapid obsolescence cycles often use it.

- **Perform regular inventory audits**. Inventory audits are necessary to verify that reported inventory levels on financial statements match actual inventory on hand. Semi-annual audits can reveal discrepancies caused by inaccurate reporting, theft, damage, or perishability.

Accounts Receivable

One company's receivables are another company's payables. While an aggressive cash management system requires active management of payables, it also requires active collections policies. Often, the quickest and best source of cash for many small companies is their accounts receivable. An intelligent analysis of customer payment histories and collections processes can significantly improve a company's cash position. The following are some frequently used methods to improve collections performance:

- **Create rigorous credit review process**. While extending credit may be an industry practice, small companies must develop a comprehensive credit review process for prospective customers in order to identify non-credit-worthy customers. By identifying high-risk customers up-front, a company can avoid future collections problems. Before granting credit, the company should review the customer's financial statements, check at least three vendor references for payment history and authorized level of credit, contact bank references, and consult customer references. Additionally, national agencies, such as Dun and Bradstreet, can provide credit history and identify outstanding claims against a company. These formal checks should be supplemented by informally monitoring rumors about the company's financial performance. Prepayment should be required for those customers who fail to meet adequate credit requirements.

- **Actively monitor aging reports**. An aging report that monitors the payment status of each account can help manager's track and prioritize overdue accounts. A weekly aging report shows all accounts by invoice number and customer number divided into categories by age of invoice (less than 30 days, 30 to 60 days, 60 to 90 days, and over 90 days). At a glance, an aging report shows where problems exist so that appropriate actions can be taken to remedy delinquent accounts.

- **Establish and enforce collections policy.** By establishing and enforcing a distinct, consistent, and widely communicated compliance system for delinquent accounts, a company can facilitate the collection of receivables. Inconsistent enforcement of collections policies can lead to abuse by customers. For example, a security system manufacturer in Massachusetts has instituted a policy that requires action only on accounts that are 20 days past due (i.e., at 50 days). At 50 days, a courtesy call is placed to the delinquent customer's accounts payable clerk. At 60 days, a more stern call is placed to the accounts payable clerk and a call is placed to the buyer. Beginning at 70 days, calls are placed every seven days to the accounts payable clerk and buyer. At 90 days, the company's CFO assumes responsibility for the account and calls the most senior executive he/she knows in the customer's organization. At 120 days, the CFO forwards the account to a collection agency and notifies the customer's CFO in writing.

- **Make noise**. Once the account is past due, it often helps to contact the customer. Often in collections, "the squeaky wheel gets the grease." A delinquent customer may be testing the collection policy to identify flex, or may be experiencing cash problems and paying only those vendors that contact them. Alternatively, customers may believe they have a reason to postpone payment, such as an incomplete delivery. Regardless of the reason, customers will often remit to those who shout the loudest.[2]

- **Offer discounts for pre-payment**. A company can encourage payment of accounts by offering prepayment discounts. In some industries, 2% Net 10 are incentives for prepayment. However, companies often avoid these policies because they offer an expensive form of financing. On an annualized basis, 2% discounts for Net 10 prepayments on Net 30 accounts equal raising capital at a cost of 36.5%. Many managers prefer to raise capital at lower cost through revolving bank credit. Additionally, some companies find that prepayment discounts rarely are effective in collecting delinquent accounts. Only those customers who otherwise pay on time accept the discount.

- **Hire capable collection clerks**. Collection of delinquent accounts is challenging, and some people's personal strengths and interpersonal skills are better suited to collections than others. Staffing the collections department with capable, personable, unflappable, and persistent individuals is as important as developing a rigorous collections process.

- **Establish relationships with customers**. It is important for collections clerks to establish a rapport with their customers' payables clerks so that the company's receivables are prioritized. Companies should encourage collections clerks to strengthen these relationships (i.e., find conversation points, occasionally treat to lunch, send holiday cards, etc.)

- **"Fire" bad customers**. There is no rule that a company has to retain all of its customers. Just as companies will change vendors if service is inadequate, so too should companies drop customers when payment is consistently delinquent. Accurate aging reports and rigorous collections policies can help identify those customers that should be "fired."

- **Review credit lines annually**. Annual reviews of customers' financial statements can provide an early indication of those customers that may have difficult meeting payment terms. Since annual reviews can be time-consuming, many small businesses only perform reviews for large customers.

- **Know the customer's business.** By knowing the customer's market, the small business manager can anticipate collections problems and distinguish cyclical problems from business downturns. This information allows the manager to tailor a collections program to the customer which optimizes both the company's and the customer's interests.

- **"Factor" receivables.** A drastic measure to shorten collections periods is to "factor" receivables, or sell receivables to a third party (i.e., a collections agency) at a discount. While factoring converts receivables into cash, it requires accepting a significant write-down, sometimes up to 50%. Many managers view this measure as extreme and use it only in cases in which successful collection is unlikely.

[2] Some managers claim that "nagging" important customers who represent a significant component of sales can threaten the sales relationship. Systems must be in place for collections clerks to identify important customers and follow pre-specified procedures.

Alternative Sources of Cash

Many small companies have little excess cash available to meet the demands of a highly cyclical business or the needs of rapid business growth or contraction. Most small business managers either invest excess cash in additional productive resources or distribute it to owners and managers. As a result, many small companies need to finance the difference between their payables and receivables cycles through alternate means. The following are common alternate sources for short-term cash needs.

- **Establish bank revolver.** Often, the first source of cash tapped by a small company is a line of revolving credit with a local bank from which the company can draw up to an agreed-upon limit. Frequently, secured by a company's receivables, a "revolver" is an inexpensive and flexible means of external financing, though it must be paid down at least once a year to demonstrate to the bank that the revolver is not part of the company's permanent capital structure. Often, banks will require that the owner/president secure a line of credit with a personal guarantee.

- **Use personal credit card for financing.** Many entrepreneurs tell stories about using credit cards as a means of short-term financing. Credit cards, while expensive forms of financing, can also serve as a stopgap during periods of short-term cash crises. Most managers are highly reluctant to use personal credit cards because they put their personal assets and credit record at risk.

Forecasting and Review Processes

Regular forecasting and review sessions help managers identify cash problems before they reach crisis stages and enable senior management to communicate the importance of cash management to the organization. In many small companies, this cash forecasting and review process is the weakest link in their cash management system. In fact, many small businesses miss this cash forecasting process completely or limit their analysis to quarterly reviews of performance.

There are at least four reasons why smaller companies lack more formal and sophisticated forecasting and review processes. First, some small company managers lack the training and experience to understand the importance of this process. Second, some small companies have no immediate need for such formal systems because the organization has a small management team and few employees. Third, some small business managers substitute senior management experience for formal forecasting and review processes. Finally, many smaller companies historically have not needed these processes because the business was easily managed by simple controls.

During periods of rapid growth or contraction, rigorous cash forecasting systems can help senior management monitor the company's cash position while the review process can force senior management to plan and prioritize future investments. Additionally, forecasting and review processes can help mitigate the effects of unexpected senior management turnover by distributing knowledge among the entire senior management team and documenting forecasts on paper.

While there are various cash forecasting strategies companies can adopt (depending in large part on the size and type of business), small company cash forecasting typically begins with annual financial forecasts developed by the CFO with detailed input from department managers. These forecasts, which include monthly sources and uses of cash, balance sheet and income statement projections, are approved by senior management the Board of Directors, and all lending institutions. Thereafter, on a weekly basis, departmental cash reports (weekly and year-to-date) are generated by the Controller and distributed to appropriate division heads. On a semi-monthly basis, revised cash projections (30 days, 60 days, 90 days, and yearly) are generated by the CFO and reviewed with the entire management team in staff meetings.

To highlight the importance of cash in the organization, some companies begin each staff meeting by reviewing the company's current cash position. At this point, the senior management team discusses any variances, new large cash requirements (i.e. investment, staffing), and how to prioritize future cash needs. One quick, early indicator of cash trouble is when the senior management team notices abnormalities in the volume of orders in the queue. A red flag goes up when either there is too high a backlog of outstanding orders or continually lower order volumes than in the previous months.

While cash forecasting and review processes in smaller companies resemble those of larger companies, there are at least two notable distinctions. First, larger companies have more automated, computer-based systems which generate forecasts on a monthly basis. In smaller, growing companies, the cash forecasting process is more subjective and imperfect. Second, while cash allocations in larger companies are made by the corporate executives, the entire senior management team (which includes division and/or department heads) in a smaller company works closely together to review and allocate cash. Cash forecasting in a smaller company requires significant collaboration among managers in balancing competing cash needs. As a result, some smaller companies send their senior managers to classes to teach them how to read and interpret financial statements.

Organizational Design and Incentives

To complement a company's cash management tactics and forecasting/review system, a company must also implement an organizational design that appropriately allocates decision rights and motivates members of the organization to manage cash flow. There are at least four organizational design issues which smaller companies should address to help manage their cash flow:

- **Select an active and knowledgeable board of directors**. Despite crafting the most well-conceived cash cycle tactics and forecasting systems, a small business manager can lose perspective on the company's cash position because he/she loses objectivity about his/her business or industry. At these times, it is necessary to have a board of directors that is objective and experienced in financial management. Often, small companies fill their boards with friends and family members out of convenience and friendship. However, small business managers often find it extremely helpful to have other small business CEOs as well as bankers and management consultants on its board of directors.

- **Assign overall cash management responsibilities**. While many employees may be involved in the cash management system, one individual in the organization must have final responsibility for cash management. Typically, the small business owner or manager assumes this responsibility. However, if the CEO does not have confidence in his/her ability or believes that his/her time can be better used on other initiatives, then a trusted controller needs to be hired to assume control of cash flow management. This person should assume responsibility for designing the system and monitoring the company's cash position.

- **Assign collections responsibilities.** A company must decide how it wishes its salespeople to be involved in the account collections process. Most small companies have at least one accounts receivable clerk whose sole responsibility is to manage receivables. This responsibility entails maintaining, monitoring, and distributing the Customer Aging Report, making phone calls to delinquent accounts, printing and mailing bills and reminder notices, managing the credit check process, and fielding questions. This organizational structure is designed to shield salespeople from alienating their customers by pressing them for payment. Accordingly, incentive systems are developed to reward salespeople on sales volume.

  Alternatively, some small companies prefer to make salespeople responsible not only for sales but also for ensuring that their customers pay their bills. As such, salespeople are not paid commission until their client has paid its bill. Thus, salespeople are encouraged both to assist in the collection process and to make only sales for which they know money will be collected.

- **Assign purchasing approval responsibilities**. In small companies, it is necessary to make sure that the people who are spending cash are doing so with intimate knowledge of the company's cash position. However, as the number of customers, suppliers, and employees grow, decision-making often becomes more decentralized. Thus, people who make purchasing decisions often have less of an understanding of the company's overall cash position. While budgeting and forecasting are helpful in setting spending expectations, a company can get into trouble if it does not carefully monitor its purchases.

As a result, many small companies require purchase authorization by executives who have knowledge of the company's cash position and can balance conflicting cash demands. For example, companies may require that employees run every purchase order over $250 by its CEO. Companies must be careful in setting the approval minimums, as high benchmarks can allow too much flexibility and excessively low minimums can constrain effective operations.

Small companies experiment with different incentives to encourage managers and employees to focus part of their attention on cash flow. Generally, small companies create annual incentives for managers based on some mixture of sales and profits to encourage attention to cash flow. Though cash flow is important to the company's heath, it is usually unwise to reward employees exclusively for maximizing cash flow; employees with only cash flow incentives will often under-invest in resources affecting the long-term viability of the company. The goal of these incentives is not only to improve a company's cash management, but also to send a message throughout the organization that maximizing cash is of paramount importance and an area that requires careful attention to reap both financial and non-financial rewards.

Conclusion

Managers in small companies who do not take the time to think about how they will manage their cash cycle are headed for trouble in the long term. When a business is small and not complex, cash management seems relatively straightforward. But, as the firm grows, the need for well-conceived and communicated cash cycle procedures and systems is essential. Furthermore, managers who wish to manage cash effectively in the long-term must understand that cash management does not start and end with balancing accounts payable with receivables, and maintaining low inventories. A sustainable cash management model will also provide for an appropriate forecasting and review system as well as an organizational design that both places the cash decision rights in the appropriate people's control and motivates everyone in the company to meet the firm's cash objectives.