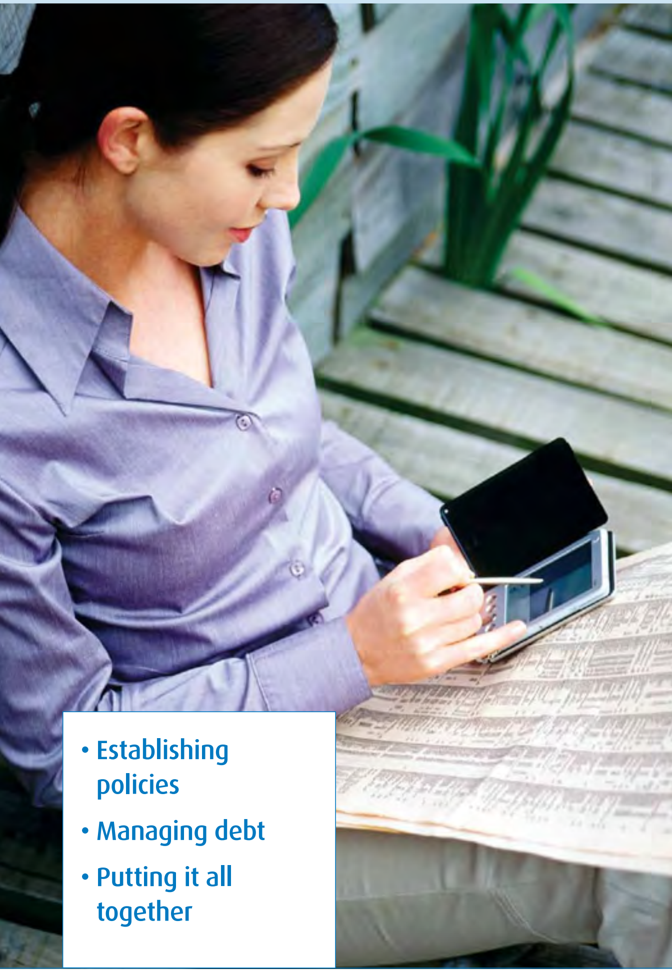
Managing your cash

BUSINESS COACH SERIES



- Establishing policies
- Managing debt
- Putting it all together

BMO Bank of Montreal

Staying liquid

The situation

Your business is generally sound. But it seems that, by the end of every month, your company is running short of cash. Your short-term borrowing is costing you a lot of money, and you're concerned that your company's cash management is making a poor impression on your bank.

The solution

At BMO Bank of Montreal®, we are committed to helping Canadian businesses develop and succeed. The purpose of this Business Coach is to help you use your bank's money less — and therefore save money. Although banks make money by lending money to businesses, we are pleased when businesses such as yours can profit from our knowledge.

The fact is, the cheapest money you can find is already right there in your own business. To access it simply requires self-discipline and good management. In good times and bad, it's always sound business practice to manage for cash — what accountants refer to as liquidity. This Business Coach is focused on liquidity, on squeezing the last cent out of your operation. It will help improve your profits and reduce your risks.

Look at the Business Operations wheel below. You are at the centre, so managing for cash starts with you. Now check those areas that require greater control, where dollars are escaping needlessly. This Business Coach will help you by providing a comprehensive checklist.

1. Cash

Speed up the flow of cash in, and slow down the flow out. Make full use of tools that are available to you.

- Speed up deposits by:
  - leveraging your bank's cash management services
  - using electronic transfers
  - depositing cheques daily
  - monitoring overdue receivables daily

Tips

Lowering your taxes always makes sense.

- Control/slow down the outflow by:
  - watching petty cash and advances
  - using credit cards for employee expenses (helps record-keeping/reduces cash advances)
  - paying taxes and bills only when due
  - examining prepaids — consider paying insurance, etc., as you go
- Make use of cash available by:
  - using cash management services to consolidate your balances, where appropriate
  - putting cash into short-term, interest-bearing deposit instruments

2. Tax planning

While tax evasion is illegal, tax reduction is a sound business practice.

Sensible planning with your accountant and possibly your lawyer can help you avoid, reduce or defer taxes. However, don't become preoccupied with taxes. Your primary challenge is to earn a profit.

Since tax rules change constantly, review your situation once a year with your accountant or after a new provincial or federal budget. Carefully weigh the benefits of incorporation versus sole proprietorship. As the owner of a business, you may have more flexibility than you realize. Check out the following with your professional adviser with the goal of preserving cash.

- For tax reduction and avoidance, consider:
  - small business deduction
  - income splitting
  - wholesaler/manufacturer — determine best level at which to "transfer" goods
  - point at which tax is to be levied
  - assets: examine policies concerning leasing; availability of investment tax credits; accelerated depreciation; timing of disposal or purchase of depreciable assets
- For tax deferrals (timing), consider:
  - deferred profit sharing
  - RRSPs
  - estate freezing
  - registered pension plans
  - accounting methods and choice of year-end

3. Credit practices

Few businesses can operate demanding cash only — that is, offering no credit. However, in the granting of credit, there is a fine balance between providing an incentive to close a sale and losing control of your assets.

- Establish limits for each category of customer and stick to them.
- Tighten the limits when times are tough and for customers in weak industries.
- Beware of the long-established company that suddenly wants to become a customer; has the company been cut off by someone else?
- Use credit rating agencies, information from banks, and other sources of credit information.
- Ensure the person responsible for credit granting is a member of a credit manager's association/trade association.
- Consider insuring your receivables.
- Retain title, where possible, on major items; check with your lawyer, since there must be a written acceptance of terms by your customer.
- Charge interest on overdue accounts.
- Consider accepting a MasterCard®* credit card or other credit cards.

4. Accounts receivable

Once you've decided on your credit policy, make sure you monitor your accounts. Don't be frightened to be tough. Good customers respect others who manage their businesses well.

Invoicing and statements

- Invoice the same day you ship goods.
- Issue statements at least once a month (if you have many accounts, consider issuing statements on a cyclical basis, not just at the end of the month).
- To those who honour statements only, issue statements faster.

Monitoring

- Always monitor receivables by dividing them into categories: 30 days and less; 30 to 60 days; 60 to 90 days; 90 days and more.
- Monitor "long" accounts frequently, even daily.
- Cut off and do not ship to overdue accounts. But consider: progress or partial payments; postdated cheques; COD (Cash on Delivery) next order; extended terms, which you must get in writing.
- Are customers taking discounts after the discount date? If so, debit them back with the next invoice.
- Consider "factoring" or "current asset financing" using a third party to manage all credits and receivables for you (see the companion Business Coach booklet *Finding Sources of Capital* on this topic).

Tips

Failing customers often provide many clues before leaving you holding a bad debt.

Collecting

- Be alert for signals of future problems. Have the following brought to your attention: postdated cheques; stale-dated or incorrectly written cheques; late returns/excessive warranty claims; lump sum payments.

- Have a good system of collection or "dunning" letters. Also use email and the phone.
- Consider using a collection agency. Annual fee includes use of agency letters and advice on credit procedures; collection fees only apply when money is collected.
- Move quickly with liens.

5. Sales and distribution policy

Selling a product or service that is grossly underpriced is easy. And it's simple to attract customers when you overservice or accept all returns without question. Before you establish costly policies, consider the following.

- Know the gross margin on all your products.
- Reward sales personnel on the basis of the gross profit received, not on volume invoiced. Why reward a sale where the customer does not intend to pay?
- Be cautious with warranty/return and service policies; monitor accounts and cut off abusers, if necessary.
- Maintain a minimum order/delivery policy; have customers group or block their orders.
- Beware of a single large order, especially one-time sales to governments or very big institutions. If the customer is slow paying, you may find yourself in a cash crunch; negotiate progress payments whenever possible.
- Know which 20% of your customers account for 80% of your sales.

Decide where you fit in the distribution network and stay with it. A manufacturer has a high gross margin, but also has a high investment in fixed assets such as plant and equipment. A wholesaler has a lower gross and less tied up in fixed assets, but more in inventory. And for a retailer who looks at gross as a markup, the biggest investment is in inventory, often with no fixed assets at all.

Tips!

In times of trouble it's easier and safer to lower overheads than to increase sales.

Crossing two types of business often leads to a company that is only half as effective.

- Test different price levels and maintain prices consistent with your quality and image. Survey customers.
- Check your industry statistics to see how you compare against the norm. Ask your banker for information. Also, check with provincial and federal government information offices and the Business Development Bank of Canada (BDC).
- Watch your breakeven (see the companion Business Coach booklets *Making Sense of Financial Terms and Jargon* and *Measuring Performance* on this topic). If your gross margin is 33.3%, $1 saved in overhead is worth $3 in sales.

6. Purchasing policy

Purchasing is the start of cash outflow, so watch it carefully. Overzealous purchasing is an easy way to lose control of cash, so consider the following.

- Do you have a simple reorder policy based on past inventory levels and future targeted inventory turnover?

- Under whose authority does your purchasing function?
- Do you know the cost of carrying inventory (warehousing, handling, interest costs, and so on)?
- If you had a three-month supply of a product and the manufacturer offered you a discount of 10% to take another three-month supply, would it be to your advantage to accept? (The answer is probably no. Work it out.)
- When ordering large quantities from a major supplier, can you arrange staggered release and shipment?
- Do you have alternative sources of supply?
- Get quotes from major suppliers; shop around.
- If a supplier lets you down, can you charge back the cost of the delay?
- Is help in planning and control of inventory available from any of your suppliers?
- Are cash flow planning services available through the supplier, a bank or other financial source?
- Which suppliers have a return policy?
- Make sure cost increases can be passed on quickly with price increases.

7. Payables

Your payables represent actual cash flowing out from your bank account. Make your payables more cost-effective by preparing for them in advance.

- Break payables into 30, 60, 90, and more than 90 days.
- Segregate all accounts payable by type: those offering discounts; those that are demanding; those that allow you to run long; those charging on overdue accounts.
- Find out if extended terms are available from key suppliers at a critical time in the year, or at any time.
- In extreme circumstances, will a supplier take postdated cheques, accept COD on new shipments, give extended terms at reasonable rates?

Tips!

Consider a Just In Time inventory replacement system.

8. Inventory

For many businesses, inventory is needed. But excessive inventory can mean the difference between profit and loss. Don't tie up money in assets that don't earn money.

- Analyze your business by each product and each product by raw material, finished goods, and so on.
- Track the number of times each major item turns in a year.

- Compare your figures to the industry average (available from industry associations, Dun & Bradstreet, public company annual reports, and possibly Statistics Canada).
- Set targets that are realistic, and then set up a reorder system.
- Sell off or return any outdated or slow-moving materials and merchandise; they will only get more difficult to sell with time.
- Is warehouse receipts financing available? (See the companion Business Coach booklet *Finding Sources of Capital* on this topic.)
- Consider having some of your product manufactured under licence rather than making it yourself.
- Are you demanding too much in the way of quality control?
- Is your security preventing theft?
- Use the ABC system; and use perpetual inventory on all the important A items.

9. Production/operations

Ensure your employees are aware of your costs so they can better participate in cash management.

- Keep fixed costs low; wherever possible, turn fixed costs into variable ones (see the companion Business Coach booklet *Measuring Performance* on this topic).
- Have regular meetings to review scheduling (sales, production, and so on).
- Ensure your bookkeeper is aware of, and monitors fees negotiated with your suppliers and service providers (e.g. : the discount rate charged on credit card transactions).
- Always retain some flexibility for the future such as unused borrowing capacity and sufficient cash to meet increases in costs.

10. Debt management

Other people's money is fine, if you use it wisely.

- Borrow long term for long-term needs, short term for short-term needs.
- Try to match the term of the loan with the useful life of the asset, i.e., a five-year life requires a five-year debt.
- Lenders look at the stability of your company, so they consider retained earnings as well as historic profit and cash flow performance along with the security you can offer.
- Keep total debt to equity in line: preferably 1:1 and never more than 3:1.
- Be sure you have a comfort margin in your cash flow to service debt, say two to two-and-a-half times. Example: debt service is $25,000 per annum; profit before depreciation but after taxes at $50,000 equals two times margin.
- Explore various sources of capital; expect the best treatment from those who know you and/or know your industry.
- If you foresee problems, discuss them with your banker or other major creditors before disaster strikes.
- In deciding on what type of financing and how much, remember the bottom line is profit on your total invested capital.

Tips !

Keep an up-to-date business plan and cash flow plan to make borrowing easier.

11. Fixed assets

The primary goal of a successful owner-manager is to manage assets effectively, not to own them. Assets do not necessarily generate profits.

- If you have unused or under-utilized assets such as a building or equipment, consider leasing them out, selling them or sub-contracting the under-utilized time.
- Consider sale and leaseback, with option to buy the assets when you have more cash.
- If your assets have gone up in value over the depreciated value shown on your books, you may have some unused borrowing capacity; use it wisely.
- The value of your assets requires that you keep them in good order; ensure you have proper maintenance and service schedules.
- Before purchasing an asset, be sure you are getting a good return on your new investment – that means, after taking into account all related costs including interest, labor, overhead, property taxes, and so on.
- All purchase decisions need to be sound from a cash flow point of view; even if you can make a profit on the investment, it's still an unsound purchase if you don't have the cash to service the investment.

Putting it all together

Look at the Business Operations wheel at the front of this Business Coach. In the centre is you. Around you are people and physical assets.

- People, your employees, are your most valuable asset through whom all your plans and objectives are carried out. Involve them; they can't help you if they don't know or understand.
- Ensure you use the physical assets fully and wisely; if you can't use them, sell them or let others use them by contracting them out.

Your job is to manage, to get your people and your assets working together effectively.

- Set objectives and targets: short-term, one-year, and up to five years. Express in dollars sales, gross profit, selling costs, overhead including interest costs, and pretax profits.
- Create a plan, a road map and make sure you involve your people so it's their plan as well (see the companion Business Coach booklet *Developing Your Business Plan* on this topic).
- State your budget targets in specific dollar amounts and periods of time.
- Managers must control and measure. Since you cannot watch everything all the time, use the "hot button" system described in the companion Business Coach booklet *Measuring Performance.*
- Provide feedback to let people know what's happening; if you have to make changes, keep employees in the loop and involve them in setting the revised objectives and plans.
- Management doesn't stop; it's continuous and dynamic, and your success depends on how well you involve and utilize all your assets.

Cash is your most easily measured asset. Keep track of it and use it wisely.

Tips

A good manager doesn't keep his/her stakeholders in the dark.

At BMO Bank of Montreal, we are committed to helping Canadian businesses develop and succeed. To this end, we've created a Business Coach Series that provides information and knowledge that can optimize the value of your company's financial resources. The booklets that make up the Series focus on essential areas of financial management allowing you to focus on operating your business more effectively.

For more information on how BMO Bank of Montreal can help your business:

- talk to your Commercial Account Manager
- call us directly at **1-877-262-5907** or
- log on to **bmo.com/business-resources**

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