Capital Source Solutions

3115 S. Grand Blvd, Suite 350E
St. Louis, MO 63118
Phone: 314-226-3663 Fax: 314-584-2085
Web: www.capitalsolutionsstl.com

Working Capital Best Practices

If you are in business for yourself, or work for a small to medium sized business, you don't need to be convinced of the importance of increasing cash flow and cash balances. There are few things in business as comforting as high balances in company bank accounts.

Over time in a growing business the majority of its cash is tied up in working capital, and it can be helpful to think of it as the money people owe you in the form of accounts receivable, plus the money you may have invested in inventory, less the money you owe vendors in accounts payable. That is roughly how much working capital your business possesses today.

By effectively managing the accounts that make up working capital, companies can sharply reduce the amount of money tied up in its sales cycle, carry higher cash balances, and reduce its dependency on owner's capital or lines of credit to fund the business.

From direct experience working directly with small to medium sized business owners since the 1980s, we put together this review of Working Capital Best Practices.

Know your **Key Performance Indicators (KPI's)** for working capital.

1. Days between Service Delivery and Invoice Delivery:
   Ideally this is 0, but should be no more than 7 days.

2. Days Sales Outstanding (**DSO**):
   Average number of days from delivered invoice to payment collection.

3. Days Inventory Outstanding **(DIO):**
   If applicable to your business, average number of days inventory is carried until invoiced.

4. Days Payables Outstanding: **(DPO):**
   Average number of days from receipt of vendor invoices to time of payment of vendor invoices.

5. Cash Conversion Cycle (CCC): = DSO + DIO - DPO.

You should be familiar with your company's Cash Conversion Cycle number, expressed in days. And you should be looking for ways to reduce that number each budget period.

6. Monthly Working Capital Cash Burn or WC Cash Contribution Rate:

How much net cash is the business absorbing or contributing from working capital on a monthly basis? If revenue is up, chances are your need for cash is up too, and your working capital accounts are consuming more cash.

7. Months to Zero:

How many months would current cash support business obligations if no new funds came in. The goal should be to accumulate at least 3-9 months of expenses in either cash and/or a line of credit that can be accessed to support a major disruption.

How it all works

Here is an example on how to calculate a few simple statistics on a business to come up with its **Cash Conversion Cycle**.

ABC Company
2014 Select Financial Highlights

Sales	$1,000,000	Cash	$75,000
COGS	$750,000	Accounts Receivable	$100,000
Gross Profit	$250,000	Inventory	$110,000
Operating Expenses	$125,000	Accounts Payable	$120,000
Net Income	$125,000		

Assume a business with $1 million in annual sales. The first number you need is the daily sales outstanding (DSO) $1 million /365 days = $2,700 daily sales.

Assume that you had $750,000 of material costs (COGS) on that $1 million in sales. Daily cost of goods sold expense or Daily Inventory sales (DIO) would be $750,000/365 days = $2,000 per day.

Assume $100,000 in accounts receivable, $110,000 in Inventory and $120,000 in accounts payable.

To calculate how many days it is taking to collect ABC invoices: $100,000 (A/R) /$2,700 (Daily Sales Outstanding) = 33 days to collect accounts receivable, on average.

To calculate how many days it takes to sell your inventory (if you carry any): $110,000 (Inventory)/$2,000 (Daily COGS) = 55 days to sell inventory.

Finally, calculate how many days ABC Company is taking to pay suppliers and vendors: $120,000 (Accounts Payable)/$2,000 (Daily COGS) = 60 days to pay suppliers.

In this example, the business has a Cash Conversion Cycle of **28 days**.

33 days to collect invoices + 55 days to sell inventory – 60 days to pay vendors = **28 days**.

Your mission, now that you know your Cash Conversion Cycle number is through these calculations, is to look for ways to reduce it, without jeopardizing important business relationships. Faster collection of invoices, more deposits or progress billing, and slower payments, where possible, with vendors.

Your number now might be 15 days (which would be excellent), 40 days, or 90 days. Your industry has a lot to do with it. But once you know that number, you have a great yardstick to use to measure how efficiently you are operating and if you are losing cash to working capital or increasing cash from working capital over time. It could be what you need to know to foresee a cash crunch before it comes.

Ways to improve your Cash Conversion Cycle.

1. Have specific policies and practices in place for the handling of accounts receivable and collection, accounts payables and inventory purchasing. Verify the **timeliness** and **accuracy** of invoicing. Reduce the sets of eyes

and pairs of hands needed to prepare and deliver invoices at the time of service completion.

The clock on receipt of payment does not start until there is an invoice in your customer's hand. Most businesses, regardless of current practices, can improve cash flow meaningfully by getting better with the accuracy, delivery and collection of invoices.

2. Do you send timely payment reminders for past due clients? Better, do you send out payment reminders *before* the due date, or in anticipation of a due date? Companies that do report dramatically better results in the timeliness of client payments.

3. Consistent courtesy calls on clients with outstanding invoices works. Have procedures firmly in place and followed consistently with all clients that dictate what happens 10 days prior to due date, 1 day after due day, 10 days after, etc.

4. Ask clients for retainers or deposits on large projects, or progress billing if the work will take place over several months. Align the deposits as much as possible to the costs of the work performed.

5. Find out if clients *prefer* electronic invoicing, and save cost and mail time by emailing invoices. Have it that the day it gets sent is the day it gets delivered.

6. Offer a broader array of payment options to your clients, including credit card and some of the myriad of online electronic payment options. Communicate these options regularly to clients.

If they know calls and letters are going to come at set points they will work hard to avoid them by paying as soon as possible.

7. Offer a small discount to certain clients who agree to improve the timing of their payments, provided your margin is healthy enough and the influx of cash important enough.

8. For customers routinely late with payment, price your service or product to compensate for their slow payment, or use it as a reason to request a deposit or progress payments on new orders.

9. Determine which suppliers are critical and which are interchangeable, and work on getting longer payment terms from those vendors not deemed strategic or critical.

10. Are there opportunities to barter with clients or suppliers? Your services may be needed by a vendor or you may need a client's services but in either case cash can be preserved and value delivered to both sides. Marketing companies often get creative with bartering to accomplish a wide range of needs from printing to financial advice.

11. Pay for long-term assets with long-term money. The cash rich small business owner who pays cash for everything is the exception to the rule. When investing in company assets that will serve you for many years, finance them and pay over a like number of years, preserving valuable cash today for the business. This can be a quick way to go from liquid to a cash crunch, by using cash to buy long-term assets before realizing that more cash would be needed for working capital.

12. Have a bank line of credit**,** even if you don't use it**.** If you have two or more years of recent profitable historical results, your business would likely qualify for a line of credit. The time to secure outside funding is when things are going well and the cash position of the business is healthy. In other words, secure it before you need it.

Formulas

Day Sales Outstanding **(DSO)** = Accounts Receivable/(One day revenue)
Days Inventory Outstanding: **(DIO)** = Inventory/(One Day COGS)
Days Payables Outstanding **(DPO)** = Accounts Payable/(One Day COGS)
Cash Conversion Cycle **(CCC) = (DSO + DIO - DPO)**

Capital Source Solutions

3115 S. Grand Blvd, Suite 350E
St. Louis, MO 63118
Phone: 314-226-3663 Fax: 314-584-2085
Web: www.CapitalSolutionsSTL.com