Cash Flow for Manufacturing and Wholesale Companies

Do you know your breakeven cash flow?

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Cash flow is one of the most commonly used terms in business -- and is also one of the most often misunderstood concepts. Many managers and business owners believe that generating more sales is the way to fix cash flow problems. However, increased sales may not increase cash flow. Other costs associated with sales, such as selling expenses or variable costs may even require more cash. Understanding the cash cycle of your company may assist you in making sound business decisions. Increasing inventory or accounts receivable may improve your balance sheet, but it does not generate cash to pay bills. The chairman of Citibank stated "The first question I would ask any borrower these days is 'Do you know your break-even cash flow?'"

When your company is short on cash, borrowing money may seem like the quick fix, and sometimes it is; however, you must keep in mind that the borrowed funds will have to be paid back sometime in the future. This will reduce the cash available to pay future bills.

The tools to analyze cash flow are available and relatively simple to use. Tools that are available and easy to use include: 1) financial statement cash flow statements, 2) cash cycle ratios, and 3) other financial ratios.

Cash Flow Statement

Often managers and business owners ignore the cash flow statement because they don't understand the way the information is presented. This statement can answer the question: "Where did our profit go?"

Cash Cycle

A manufacturing or wholesale company's cash cycle consists of accounts receivable, inventory and accounts payable. It is easy to calculate. Below is a simplified example of how to analyze cash flow for a company.

Sample Company:

- $5,000,000 sales
- Average accounts receivable is 60 days, balance at 12/31 = $833,333
- Inventory turns every 75 days, balance at 12/31 = $787,500
- Average accounts payable is 50 days, balance at 12/31 = $525,000

Cash cycle is 85 days (60 days accounts receivable + 75 days inventory - 50 days accounts payable). For each 1% increase in annual sales, the company would need approximately $11,806 of debt or equity to finance the related increases in accounts receivable and inventory, net of accounts payable ($50,000 / 360 days x 85 days). The impact of changes in the number of days ratios on your company's cash should influence how you manage these different areas.

Accounts Receivable

For accounts receivable, each day that receivables remain uncollected costs the company $13,888 in cash flow. By reducing the days in accounts receivable from 50 to 45, the company could provide

an additional $69,440 in cash [(50-45) *$13,888].
This increase in cash is not generated by additional sales, but by improving collections.

To reduce days in accounts receivable:

- Establish credit limits for customers
- Time billings so that customers receive bills before their payment cycles
- Establish internal accountability for delinquent accounts receivable

Inventory

Each day that inventory ages costs the company $10,500 ($787,500 / 75 days) in cash flow. This does not include the costs of storage, overhead and labor that are also affected by holding inventory. Reducing the days in inventory from 75 to 70 will generate an additional $52,500 in cash flow [(75-70)*$10,500].

To reduce days in inventory:

- Analyze optimal levels for each product or type of product
- Improve purchasing procedures
- Analyze obsolescence of inventory, and
- Install a system for tracking inventory more efficiently

Many wholesalers and manufacturers have experienced cash flow problems due to excess investments in accounts receivable and inventory. In today's fast paced business environment, improved cash flow management is essential to remain competitive. Once you have a good understanding of your company's cash cycle, you can focus your efforts on improving the components of the cash flows.

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