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Controlling Costs & Cash Flow

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Controlling Costs and Cash Flow

⇨ Strengthening your business's financial performance

Overview

Whether or not businesses generate income, they generate costs. Whatever your objectives, you will be expected to achieve them with a limited amount of cash and, sometimes, urgent cost reductions will be needed if the business is encountering problems. You will also be expected to reduce costs as far as possible, as a matter of course. Despite its central importance to profitability, cost reduction is often done carelessly, even in desperation, rather than effectively and rationally.

Linked to the issue of profitability is the need to manage cash. Cash and profit are the twin, related financial pillars on which a business survives. Leadership, customers, talented people, ideas and competitive products are also essential, but no more than cash and cost control.

Many businesses make the fatal mistake of focusing solely on profit, ignoring the fact that *cash* is the life-blood of the business. The most fundamental of all financial statements, particularly for small and medium-sized businesses but also highly relevant to large companies, is the cash flow forecast.

Benefits of cost control and cash management

> Financial decisions should not be left entirely to experts. Financial issues and techniques – such as cost and cash flow management –
>
> How Effective Are Your Managers?

The business is more competitive, flexible and stronger if costs are being actively controlled and, above all, if there is a culture within the organisation of cost control. In particular, cost control and cash management means the business is better able to make acquisitions, drive increases in revenue, take customers from competitors, enter new markets, develop new products and weather potential problems. What matters is not simply having 'low' costs (or relatively low costs compared to competitors), but having the *right* cost structure to generate profit, compete and build the value of the business.

Action checklist: controlling costs and cash

Prepare to control costs

- ✓ **Know what costs you control,** by understanding what you have budgeted to spend under all cost headings. The major areas of business expenditure include employment, materials, fixed and variable costs, overheads, production, administration, marketing, sales and professional fees.
- ✓ **Establish information systems, develop key performance indicators and actively monitor costs**. Make sure that you receive detailed information about costs, and especially the relationship between costs and profitability. What matters is not always having low costs; it is about having the *right* cost structure to take the business forward. You need to have quick access to the right information under each cost heading. Also, decide how frequently you will monitor costs.
- ✓ **Check understanding** – make sure that members of your team know the areas of cost that they influence and how much is available to spend.

Encourage people to find savings

This should be done without weakening the operation. Ask for those closest to the expenditure (those actually spending the money) for suggestions about how costs might be reduced. Gain commitment from your people to reduce costs, either by linking cost reductions to things that they want or by structuring reward systems to encourage cost reduction.

Find out why costs rise

If costs have risen beyond budget, find out why and take action – if only to explain why the cost overrun is unique and essential.

Decide how to treat the least profitable products

The least profitable products often drift, with dwindling profitability. Decisive action is needed to turn around a poor performer – by reducing costs, raising prices, altering discounts or changing the product (or abandoning it altogether, to prevent a drain on resources and reputation).

Avoid weak budgetary control

Often budgets are used merely to assess performance, whereas their real value is being an active tool to inform financial decisions. Budgets should not be cut without giving sufficient thought to how this will affect other decisions.

Manage debtors

The whole process of invoicing and receiving prompt payment from customers is vital for effective cash management. This can be a complex area linked with many other aspects of the business – notably sales. Some of the key elements include:

Ensure effective invoicing. Invoices need to be dispatched as soon as possible; they must be clear to the recipient, accurate and state when payment is expected. Ensure that all the relevant information is included on the invoice, notably customer order reference, supplier's VAT number and delivery address. Also, consider *interim invoicing*, agreed from the outset, whereby a business charges for work done to date, even if the whole project is not completed. This is particularly useful when selling professional services (such as legal and accountancy fees), where the nature of the work is prolonged or ongoing.

Encourage prompt payment. In the future, legislation may be introduced forcing businesses to settle their debts within a fixed period; otherwise the supplier is legally entitled to charge interest. At the moment, this seems some time away; in the meantime, suppliers can encourage prompt payment by offering a discount off the current invoice – or a reduction off the next invoice – if payment is received quickly (within seven days). Clearly, the level of discount needs to be matched with the size of order and an awareness of the time value of money.

Verify credit risk. It is essential to avoid bad debts or businesses that are likely to require a nuclear detonation in order for them to eventually pay. Checking creditworthiness is one way of doing this and it can involve, as a minimum when dealing with *any* business for the first time, getting a bank and trade reference. For major accounts, consider checking the financial health of the customer, perhaps using an on-line service or simply reviewing the organisation's last set of audited accounts.

Use credit limits. It is prudent to agree with sales staff a sensible level of credit that will be granted to customers and then to extend (or reduce) this as the relationship with the customer develops (or deteriorates!). Clearly, a simple, effective system needs to be put in place by finance staff alerting relevant personnel (perhaps in sales or production) to the fact that a customer has reached their credit limit. A call to the customer resulting in payment can then easily remove the obstacle to progress - the unpaid invoice.

Consider advance payment/deposit with order. For expensive or custom-made products or services, or for first-time customers, it is worth considering a policy of cash with order. This clearly needs to be offset against other commercial considerations, including the likelihood of achieving the sale.

Use an effective process for collecting overdue payments. There needs to be one individual with the clear responsibility for collecting overdue payments and they need an effective process for doing this. This might involve a letter on the day that payment is due clearly sent to the named individual that placed the order, including all relevant information from the outstanding invoice. A telephone call seven days later is often the next step. If either of these yield any queries then these need to be addressed and resolved immediately. Should both of these fail to achieve a satisfactory result the next step is a final letter, warning of the consequences of failure to pay – impending legal action. This final letter should state a date after which legal action will be taken.

Another approach is simply to factor out the debt, so that another company pays you a percentage and then undertakes to recover the debt themselves. Clearly this is effective in gaining cash, although at a reduced level once the factoring agent is paid.

Consider matching your financial systems to your markets – it can help to decide who you do *not* want to sell to, and then organise your systems to effectively prohibit these groups. For example, direct selling overseas is often expensive for certain businesses once costs of carriage and exchange rates have been accounted for, together with the element of risk and the difficulties in recovering overdue payment. The solution might be to insist that overseas customers pay in advance at a fixed exchange rate, and are responsible for the costs of delivery. This is one method of avoiding bad debts – although it can also be one method of avoiding sales! This approach usually works for occasional orders to markets that are neither the core of the business nor presenting any immediate opportunity.

Manage inventory levels

Recent surveys estimate that the cost of holding goods in stock can be anything up to 35% of the value of the goods themselves. So, *£100,000 worth of stock can cost an additional £35,000 to hold in stock for a year*. These additional costs include: interest to pay for the goods and their storage; insurance; theft and wastage; staff and equipment costs to handle the stock, and occupancy costs (for example, warehousing or rental) for storage. This can be avoided by establishing an efficient process for just-in-time production, perhaps passing some of the risk on to other businesses in the supply chain. Also, it is necessary to ensure effective communication between staff in production, purchasing, sales, marketing and finance. For example, sales and marketing personnel need to warn production and purchasing of likely campaigns and potential increases in business.

Manage purchasing and creditors

This needs to be completed efficiently, without incurring any direct or indirect penalties. It is worth considering the following techniques:

- ✓ **Maximise your purchasing power,** by planning the likely volume of business and by using a select band of suppliers. In this way, lower prices or extended payment terms may be agreed.
- ✓ **Establish secure and efficient procedures for authorising expenditure and payment.**
- ✓ **Monitor the time taken to pay creditors** – never assume that they are much less important than customers and can be treated poorly. If they are, then they can take action that may reduce the success of your organisation.

Use discounted cash flow for investment appraisal

Discounted cash flow (DCF) is based on one key principle: that the value of money changes, effectively reducing, with time. Cash today is worth more than cash promised in the future. There are five key steps in DCF analysis:

1. Develop an accurate projection of the future operations in which the money is going to be used, taking into account sales, costs and other relevant financial aspects. Typically, the projection should be broken down for each year of the period of the investment.
2. Quantify positive and negative cash flows for each year of the projection and quantify the annual net totals of cash inflow or outflow.
3. Estimate the value of the cash flow for the final year of the projection. A conservative and prudent approach that is widely adopted is to assume that the final year's cash flow will continue in perpetuity.

4. Decide the discount factor – the percentage amount that will be applied to each year's cash flow. Determining this factor is central to the whole exercise. A higher discount factor will generate a lower overall valuation. Typically, two factors influence the level of the discount factor; the first of these is the level of business risk. If the risk is high (with investment unlikely to meet projections), then the discount factor should also be high. Second, the discount factor is often a compromise between the cost of borrowed money (such as 5% interest) and the return expected by the investors (for example, 15%); in this case, the discount factor would be 10%. It may be desirable to select a range of discount factors – providing optimistic, realistic and worst case scenarios.
5. Apply the discount factor to the net cash flow for each year of the projection and for the terminal value. The figures resulting from these calculations are the present value contribution of each year's future cash flow; adding these values provides a total estimate for the value of the investment.

Discounted cash flow analysis is used to help value the potential of an organisation and to make other investment decisions. The discounted cash flow method assesses the projected stream of economic benefits (such as cash flow, net sale proceeds, value of intangible assets) and it calculates the maximum investment that should be made. This is known as net present value analysis. It also enables comparison of an investment amount with a stream of economic benefits and it provides an overall rate of return. This is internal rate of return analysis and it enables analysts to assess the rate of return provided by a particular investment. Many consider discounted cash flow analysis as more useful than other valuation methods, such as price-earnings ratios. If an investment case is sound, then discounted cash flow will highlight this.

Avoiding problems

- ✓ Ensure that customers pay as soon as possible.
- ✓ Pay creditors quickly enough so that they neither raise their prices in future nor levy a financial penalty for late payment.
- ✓ Control fixed, overhead costs at a level that can be routinely sustained by the business.
- ✓ Manage inventory levels and work-in-progress to avoid cash being tied up in stock.
- ✓ Keep open lines of credit: this means maintaining a dialogue with financial backers (especially banks), keeping them informed of your plans and situation, and having adequate sources of finance available (for example, overdraft and loan facilities).
- ✓ Regularly forecast cash flow – during good times and bad – and improve cash flow forecasting.
- ✓ Create an awareness of the importance of cash flow and cost control throughout the organisation.
- ✓ Rigorously analyze major expenditure decisions and understand the cash flow implications.

Key questions

- ✓ Do you know the biggest areas of cost for your business, both in real terms and percentage growth? **Contact @accountancy for advice**
- ✓ Where are costs escalating, where *might* they escalate and what is causing this? **Contact @accountancy for advice**
- ✓ Are people rewarded and incentivised for actively reducing costs?
- ✓ Who are your major suppliers? Have you discussed with them how your costs (their prices) might be controlled or reduced? Is it time for a change?
- ✓ Do you review your budget regularly and take corrective action? Do you review cost-profit ratio and other relevant performance indicators? **Contact @accountancy for advice**
- ✓ Have you prepared a cash flow forecast? **Contact @accountancy for advice**
- ✓ Do you monitor how much cash is in the business, striking a balance between keeping and investing cash? **Contact @accountancy for advice**
- ✓ When investing cash, is the business aware of the time value of money? **Contact @accountancy for advice**

Dos and don'ts

Do:

- ✓ Find out why costs have risen above budget.
- ✓ Take prompt, corrective action wherever possible to curb unplanned cost increases.
- ✓ Compensate for overspend by taking action in other areas if you are unable to reduce rising costs.
- ✓ Keep people informed of costs: whether they are rising, falling or stable; what action is being taken to keep costs on target.
- ✓ Encourage people to reduce costs and eliminate waste.
- ✓ Ensure that your team members appreciate the time value of money – the fact that money now is worth more than the same sum of money in the future. This is an important aspect of controlling costs and managing cash.
- ✓ Prepare and monitor two financial statements: the budget and cash flow forecast.

Do not:

- ✓ Ignore cost overruns.
- ✓ Fail to raise awareness of cost issues.
- ✓ Assume that because sales are being generated then cash is flowing. Understand your debtors and their capacity to pay on time. A sale is not made until the cash is received.
- ✓ Ignore debtors, creditors or suppliers – they all need to be carefully managed and monitored.

Things you can do

Control costs

Focus on major items of expenditure. Costs should be categorised as major or peripheral items. Often, undue emphasis is given to the 80% of activities accounting for 20% of costs, rather than focusing on the priorities – those generating the majority of costs. **Contact @accountancy for advice**

Increase cost awareness. Casualness is one of the pitfalls of cost control. While focusing on major items of expenditure it may also be possible to reduce the overall level of cost of peripheral items. Costs can be reduced over the medium to long-term by influencing people's attitudes towards cost and wastage. In particular, managers' attitudes to cost control and reduction and the effects of expenses on cash flow and profitability should be examined.

Maintain a balance between costs and quality. Commercial management and cost control means getting the best value possible. This requires a balance between price paid and quality received.

Use budgets for dynamic financial management. Budget early so financial requirements are known as soon as possible. Consider the best time-period for the budget – normally a year but it depends on the type of business. Budgets can be of interest to others outside the normal running of the business, as well as providing a starting point for cash flow forecasts. They are also useful in monitoring costs. **Contact @accountancy for advice**

Eliminate wastage. For decades, leading Japanese companies have directed much of their cost management efforts toward 'muda' or waste elimination. This involves techniques such as process analysis, mapping and re-engineering – important parts of operational decision-making. The value of process analysis is that it enables waste to be identified and eliminated and costs to be reduced, by thinking of activities as a chain of events from the beginning of the process to the end, with each part of the chain comprising discrete, identifiable tasks. The idea of thinking about everything that goes on in a business in terms of processes and in terms of waste elimination is fundamental. In a Japanese factory you can see how processes have been laid out and the continuing search for better ways to do things, in the least wasteful way.

Manage overhead expenditure. Planning overhead expenditure based on budgets is prudent, but incurring expenditure *too soon*, in anticipation of increased activity, is one of the most common causes of cash flow problems. Caution and timing are essential, and the key to success is to delay new costs for as long as possible without jeopardising the business.

Prepare and use a cash flow forecast

Forecasting the cash-needs of a business is essential: you need to have a clear idea of how much cash will be needed to run the business in order to develop, evaluate and implement the most effective strategies. There are a number of vital points that should be remembered when preparing and using a cash flow forecast: **Contact @accountancy for advice**

Prepare the forecast. When you prepare the forecast you will probably need to prepare a budget for the business for the year ahead. The first step is to fill in your predictable payments (such as staff, advertising). The next step is to estimate likely sales revenues; include the time that the cash will be *received*, not when it will be invoiced. From the sales forecast you can then calculate and include the costs of sale and the direct costs (such as raw materials) that are related to the levels of sales and production. Finally, remember to include figures for the month in which they will *actually* be received or paid. **Contact @accountancy for advice**

Sample cash flow forecast (for a small business):

	Month 1		**Month 2**		**Month 3**		**Total:**	**Qtr.1**
	Budget	**Actual**	**Budget**	**Actual**	**Budget**	**Actual**	**Budget**	**Actual**
Receipts: capital								
Cash from sales								
Cash from debtors								
Total Receipts (A)								
Payments: creditors								
Salaries								
Rent, rates, water								
Insurance								
Repairs, renewals								
Heat, light, power								
Postage								
Printing, stationery								
Transport								
Telephone								
Fees and services								
Capital payments								
Interest charges								
Other expenses								
Value Added Tax (VAT) payable								
Total payment (B)								
Net cash flow (A-B)								
Opening bank balance								
Closing bank balance								

Further action

Use the following table to identify areas for further development.

Issue	Response	Further Action
Could your business benefit from increasing awareness of financial issues?		
How are costs actively managed, measured and how frequently are they reviewed?		
Do you view costs as a 'bad' that must be eliminated, or a necessary component of sustainable business growth?		
How sophisticated and accurate is your measurement of, and strategy for improving, cash flow? Does everyone understand issues concerning the time value of money and		

the risks involved (liabilities)?		
How flexible are your credit terms and how do you use it to create opportunities by relieving some of the pressures created by cash flow?		
Does your budget highlight areas of wastage and help you to focus on improving profitability in ways that can be communicated to key stakeholders?		

For Further Information or to Arrange a Consultation

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