

Two Common Cash Flow Mistakes: (extracted from Evergrow newsletter)

Cash flow constraints are often exacerbated by two common mistakes.

#1: Focus on Sales:

Attracting more customers and making more sales may seem like an obvious solution to one's cash flow problems. After all, if your business makes more money, then it won't run out of cash, right?

Wrong! Why? Because sales aren't cash – they are *potential* cash. If your debtor, creditor and stock management are crippled by inefficiencies, then that potential; will go to waste.

It's like trying to make more sausages by forcing more ingredients into your sausage making machine. There is a limit to how many sausages your business machine can churn out, regardless of your input. The only way to overcome that limit is *by building a better machine*.

#2: Over-prioritising debtors:

Unlike more sales, better debtor management will yield cash flow benefits. As important as it is to be paid as quickly as possible, this is just one of three pivotal cash flow forces. The other two, creditor and stock management, often don't receive nearly as much attention.

Consider the following hypothetical scenario: on average, a company takes 30 days to sell stock, 40 days to be paid and 20 days to settle suppliers accounts. That equates to a cash cycle of 50 days (30 days + 40 days – 20 days = 50 days). In other words it takes 50 days for the company to cycle its cash.

If our goal is to bring the cash cycle down to 30 days, then focussing solely on debtor management will necessitate improving the average debtor days by 50%. Not impossible, but very challenging.

Alternatively, we could opt for a balanced approach: improve stock turnover by 20% (i.e. 6 days), cut debtors days by 25% (i.e. 10 days), and extend creditors days by 20% (i.e. 4 days). This has the same net benefit (i.e. improving the cash cycle by 20 days) but is much more achievable.

Healthy cash flow isn't rocket science. If you're running out of cash, then it's either entering your business too slowly, exiting too quickly, or staying tied up for too long. The key is striking the right balance.