

Part IV

Managing Your Business with Cash Flow in Mind

The 5th Wave

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"I'm not familiar with auditing terms. What do you think that means?"

In this part . . .

The chapters in this part of the book get down to day-to-day cash-flow matters that business managers have to deal with (or make sure that other employees in the business are doing well). Chapter 12 leads off with an in-depth discussion of fundamentals of bank accounts and the key features you should pay attention to. The chapter also provides valuable advice for managing cash in the digital, electronic-funds-transfer age and explains the importance of cash budgeting.

Chapter 13 discusses an unpleasant but necessary topic: preventing and minimizing cash losses from many kinds of embezzlement and fraud. Unfortunately, some customers, vendors, employees, and managers may seize any opportunity to steal from the business or otherwise take advantage of their positions for their personal benefit at a high cost to the business.

In Chapters 14 and 15, we shift to more positive topics. These two chapters explain improving cash flow in the basic cycles of selling and disbursements. These two fundamental business operations are often overlooked from the cash-flow point of view.

Chapter 12

Covering the Basics of Cash and Cash Activity

In This Chapter

- ▶ Understanding uses of cash and how much you need
 - ▶ Finding out how to manage your business's cash
 - ▶ Managing and controlling cash digitally
 - ▶ Checking cash levels and keeping them level
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You've probably heard the following clichés a thousand times over: “Cash is king,” “He who has the gold makes the rules,” and, in the infamous words of Warren Buffett, “When the tide goes out, we'll see who's left standing naked on the beach.” But all these sayings are 100 percent accurate, because most businesses spend the better part of their lives either attempting to secure and create as much cash as possible (hopefully from the ability of generating real profits) or, after this goal is achieved, turning their attention to managing and protecting this invaluable and unique asset.

Looking at the uniqueness of cash from another perspective, a business works its tail off to increase and improve its cash levels, but after it does so, the business is going to then have to work its tail off attempting to keep other parties from grabbing it. Whether shareowners are looking for increased dividends, the government is looking for its share of tax receipts, vendors are wanting to be paid quicker, employees are feeling underappreciated (that is, underpaid), or management simply feels like all that cash is burning a hole in its pocket, the list of uses for perceived excess cash balances is endless.

Cash, just like every other business asset, must be properly managed, protected, and controlled by management. However, given the extremely liquid nature of this asset and the fact that cash can easily “disappear” without a trace, the types of controls required to properly manage and protect this asset take on an entirely different level of thinking and attention.

One theme that we hope to drive home in this chapter is that minding, controlling, and managing cash is basically a real-time event that requires active, timely, and appropriate (that is, senior-level) management involvement. Given the speed at which business moves in today's economy, gone are the good old days of evaluating a business's performance on a monthly basis. That system must be supplemented by very timely and highly relevant information reporting. And as part of that reporting, cash availability represents an invaluable internal management data point to evaluate a company's overall health and performance.

Managing the Unique Characteristics of Cash

When cash is evaluated from the perspective of reviewing the balance sheet, it really just looks like another business asset listed before trade receivables, inventory, and other assets. But when cash is really understood, its uniqueness begins to stand out based on the following characteristics. First, cash is very liquid and transportable (not to mention highly susceptible to fraud or theft). Second, cash really does represent the circle of life in a business as basically all business transactions either start or end with cash. Third, cash can be exchanged for basically any good or service required by a business. And fourth, cash not only represents the circle of life of a business but, more importantly, is also the lifeblood of all businesses, because it is imperative to maintain proper amounts of cash to support ongoing operations.

Understanding that cash ends up being one side of almost every transaction

One of the unique elements of cash (unlike trade accounts receivable or inventory) is that eventually it ends up being on one side of almost every business transaction executed. The following two examples explain how cash becomes a side of any transaction:

- ✓ **Sales cycle:** ACME Distribution, Inc., sells \$10,000 worth of widgets to a customer on credit. The customer eventually remits payment. The series of entries shown in Figure 12-1 would occur in the accounting system.
- ✓ **Payables cycle:** ACME Distribution, Inc., purchases \$6,000 of raw material to manufacture its widgets, initially receiving 30-day payment terms and then eventually pays the vendor in cash for the product (see Figure 12-2).

ACME Distribution, Inc. — The Trail of Cash

	<u>Account Description</u>	<u>Debit</u>	<u>Credit</u>
Figure 12-1: Recording the trail of cash for sales.	To record the initial sale of products to a customer:		
	Trade Accounts Receivable	\$10,000	
	Sales - Widgets		\$10,000
	To record receipt of the customer payment for the sale of widgets:		
	Cash	\$10,000	
	Trade Accounts Receivable		\$10,000

ACME Distribution, Inc. — The Trail of Cash

	<u>Account Description</u>	<u>Debit</u>	<u>Credit</u>
Figure 12-2: Recording the trail of cash for payables.	To record the purchase of raw material to manufacture widgets:		
	Inventory - Raw Material	\$6,000	
	Trade Accounts Payable		\$6,000
	To record the payment of the vendor invoice for the purchase of raw material:		
	Trade Accounts Payable	\$6,000	
	Cash		\$6,000

Although both of the examples are relatively simple, the point is that for most businesses cash represents the end game (either in the form of an eventual receipt or disbursement). In fact, when cash flows and balances are properly understood, they are the best management assessment tools available to capture the essence of a business's performance, and they offer a great benchmark on which to assess a company's health.



Certain transactions do not involve cash, such as recording depreciation expense on owned equipment or having to write off a trade receivable as bad debt that's uncollectable. However, these transactions tend to be less frequent in nature, are for lower dollar amounts (in total), and are generally accounted for at a specific point in time (for example, monthly or quarterly), so they tend to have a reduced role in the business's overall health. This is not to say that these types of transactions are not important to recognize in the financial statements, because full accrual-based financial statements produced by using GAAP require these types of transactions to be recorded. But the real economic value and "meat" of a business's viability should be based in transactions that eventually produce or consume cash.

Tuning in to the constant cash hum

Because basically all company transactions, in one form or another, end up in cash, cash creates a somewhat unique flow and rhythm depending on the specific attributes associated with your business. No two businesses are exactly the same, so the hum and rhythm of cash flows differ between businesses, but, as unique as businesses may be, most have to manage and understand three primary types of cash flows: routine, nonroutine, and shocks:

- ✔ **Routine cash flows:** Routine cash flows are generally driven from a company's internal normal operating cycle of selling products or services, collecting cash, purchasing materials or incurring expenses, and paying for these purchases or expenses (which includes the company's payroll). This type of cash flow tends to be very frequent (or routine, if you like, such as the restaurant serving the lunch crowd each day), highly predictable (the restaurant has a solid understanding of what the average ticket for each customer should be) and transacted in much higher volumes with a relatively low average transaction level. McDonalds offers a perfect example of routine cash flows because they have great data on when customers will make purchases, what they will buy, how much they will spend, and the volume of customers expected.
- ✔ **Nonroutine cash flows:** Nonroutine cash flows tend to be driven by a number of factors, including seasonal business trends, extraordinary events (such as acquiring a business), and/or timing-related events associated with the fiscal year-end of a business (like making estimated tax payments). For the most part, nonroutine cash flows can be anticipated and incorporated into the budgeting and forecasting process because though they're far less frequent in occurrence, they tend to occur in the same period during a given fiscal operating year. (For example, the final estimated tax payment for a regular C corporation using a fiscal year-end of December 31 falls in the last month of the year).
- ✔ **Shocks:** Even less routine than nonroutine cash flow is the occasional and cruel need for most businesses to manage sudden shocks to cash resources. Events that would fall into this category are natural disasters, potential adverse litigation outcomes, and a large and long-standing customer terminating a contract without warning. The good news associated with these events is that they are fairly rare. However, these events also tend to be very large and can significantly impact a company's cash position with little or no warning.



Having a properly structured and available lending facility to assist with managing the periodic uncertainties of cash flows is an extremely important tool (to have readily available) for most businesses. Unless you're the likes

of Apple or IBM, sitting on literally billions of dollars of excess cash, you should always make sure your company has a rainy-day fund to tap in case of unexpected events. Working with financing sources (such as a bank or other lender) to make sure ample cash backs your rainy-day fund availability is a prudent management decision.

Deciding what a normal cash balance should be

It's the \$10 million question: What should a normal cash balance be? Well, the answer to this question varies significantly based on the following four key operating issues.

Stage of business

Businesses just launching or starting up need a lot of available cash in order to cover projected operating expenses during the period prior to revenue being generated and converted to cash. For mature businesses with highly predictable revenue/sales patterns, cash availability can be lower because management has a much greater level of confidence related to periodic cash inflows and cash outflows.

The business stage also affects cash flow related to growth. For slower growth in more mature businesses (for example, a utility company), again, lower cash levels are needed. For rapidly expanding businesses (typically newer companies or businesses operating in highly competitive, rapidly changing, and/or innovative environments), higher cash availability is needed to support the anticipated growth.



Newly launched businesses must understand two key operating issues in order to determine how much cash is needed.

- ✓ First, the monthly cash burn rate (discussed in Chapter 7) indicates how fast the business is using up cash. For example, if your business generates \$25,000 revenue and cash receipts but spends \$100,000 a month to cover base operating expenses, your burn rate is \$75,000 per month.
- ✓ Second, the revenue or selling cycle must be understood and managed to find out when cash will be received from eventual product or service sales. For some start-ups, this amount of time may be a little as six months, while for others (such as a biotechnology company developing a new drug), it may be ten years. Chapter 14 delves into the revenue cycle and how it can be managed to improve cash flows.



The selling cycle almost always takes longer than a company thinks. Business owners and entrepreneurs (who are often sales and marketing driven) are by nature optimistic and almost always think the market will accept their products or services in a very efficient and timely manner. So although optimism is welcome and encouraged, business plans should always double any best-case scenario time estimates for implementation to actual sales being realized.

By understanding these two critical issues, managers can determine the amount of cash needed to support the business operations over a set period of time. This number represents a base minimum level of cash the company needs to operate.

Type of business

Your business type has a significant impact on what's considered a normal cash balance. The cash resources needed for a retail business that sells directly to customers and generally doesn't generate trade receivables is very different from the cash resources needed for a construction company that builds bridges, highways, and other massive projects. For companies that are more affected by large projects, lengthy business decisions and operating cycles, and downstream influences (for example, a defense contractor waiting for Congress to approve a new military program), higher levels of cash are generally required to manage the ebb and flow of expenses versus receipts. For a long-standing fast food restaurant that deals only in cash, credit cards, and debit cards, the need for readily available cash tends to be reduced.

Access to cash

Although having available cash on the balance sheet is always important, having access to cash *when needed* is often far more valuable to a business. This access may come in the form of an established relationship with a lending facility you can tap when needed, or you may be able to access funds from investors who have committed funds to be released over a period of time. For companies with access to external available cash resources, lower levels of cash are required. For companies that don't have this luxury, higher levels of cash are needed.



Securing funding or cash for a business to operate is one of the most time-consuming, intensive, frustrating, and lengthy processes senior management undertakes. Planning for cash needs well in advance is absolutely critical to ensure that cash is available when needed. Prior to the Great Recession, which started in December 2007 (per the National Bureau of Economic Research), you could assume that planning three to six months in advance was sufficient (depending on where the cash was going to be secured from). Now you should double that estimate. With fewer sources of funding/cash available, more competition, and more stringent underwriting criteria, securing funding takes much longer in today's market.

Market stability

A company must always be evaluating its market and customer base to execute its business plan. In markets that are very stable and display a high level of predictability (for instance, we know X customers will purchase our products and pay in Y days, regardless of the state of the economy), operating risks are lower and thus cash balances can be kept lower. A good example of this market is liquor stores — whether times are good or bad, people tend to drink. On the opposite end of this spectrum are companies operating in markets that are highly competitive and fluid. For example, a video game manufacturer may have the best-selling title in the current year but miss the mark altogether in the next year. Ensuring that ample cash resources are available to adapt to rapidly changing market conditions is essential to a business's long-term strategic plan.

Your operating conditions

After you have a sense of where your business falls in the preceding four categories, you can go back to the original question of what a normal cash balance is. Obviously, the answer still varies on a business-by-business basis, but you can use the following three operating scenarios as general rules of thumb:

- ✓ **Mature/highly predictable business with stable markets and access to alternative sources of cash:** In this scenario, available cash balances can be lowered given the highly stable nature of the business. Many such companies use a three- to six-month operating expense metric to determine how much cash should be available. For example, if a company incurs \$100,000 a month in operating expenses and always wants to have three months of cash on hand to cover every expense in the event that not one dime comes in from sale (highly unlikely), then the cash balance needed would be \$300,000. Business types that fall into this scenario include grocery stores, gas stations, utility companies, larger retail operations (such as Walmart and McDonald's).
- ✓ **Older business operating in an unstable and evolving market with limited access to alternative sources of cash:** In this scenario, cash resources need to be increased to address a multitude of issues, including potentially having to support operating losses during a turnaround period, adapt marketing and sales strategies to changing markets and customers, and account for the fact that during the business turnaround phase, access to financing and cash will be limited. In this environment and using the operating expense metric, a minimum of 12 months of cash availability should be available and most likely more. The reason more money is better is that company turnarounds
 - Usually take longer to implement than planned
 - Cost more than anticipated

- Tend to be met with a large amount of skepticism from financing sources (that is, the source wants proof before it will provide financing, whereas you need financing in order to prove it)

So having extra cash available when operating in this environment is always recommended to help absorb the unforeseen roadblocks and speed bumps that will inevitably appear. If the monthly operating expense level is \$100,000, then at least \$1.2 million would be needed. A perfect example of a business operating in this environment was General Motors — and for that matter, the auto industry in its entirety. This industry underwent a major restructuring since 2008 and, if it wasn't for the United States Government, was going to fail due to large losses combined with limited access to capital.

- ✓ **Start-up or newly formed business penetrating a new market with no current revenue or real customers:** In this scenario, the operating expense metric needs to be at least 12 months, and in a number of circumstances should be closer to 2 years. So if a start-up company incurs \$100,000 a month in operating expenses, it should have at least \$1.2 million and maybe up to \$2.4 million in available cash. The reason for this high level should be clearly evident — no real revenue is being generated (so no inflow of cash is occurring), and securing financing or cash from third parties often takes a long time (based in the fact that bank loans aren't available while a company is losing money, so equity needs to be secured, a much more time-consuming process).



The bottom line with cash availability is simple and straightforward: The higher the risk and business uncertainty, the higher level of available cash needed to support operations. One of the single biggest reasons small businesses fail is the lack of capital or, more specifically, the failure to develop a realistic business plan (ensuring that enough capital is available to execute the plan given multiple operating scenarios).



Can having too much cash be a problem?

The answer is yes, because too much cash indicates that the company isn't deploying assets in the most profitable manner possible. In today's economic environment, excess cash has limited earnings potential. Whether a company invests the cash in a bank CD (earning 1 to 2 percent) or United States T-bills or bonds (earning from less than 1 to 4 percent), the ability to generate any type of real earnings is limited, which is why you see shareowners of

corporations always placing pressure on management with excess cash to either "use it or lose it." The goal is to redeploy internal earnings that sit in cash into business opportunities that can achieve much higher returns than 1 to 4 percent. And if that growth isn't possible, then management can at least increase dividends to return the excess cash to the shareowners (the rightful owners of the cash).

And one final thought that needs to be considered is that the available cash balances presented in this section are based on ideal levels. In today's economy, ideal is often far different from actual. Most strong, stable companies tend to have more cash than is needed, whereas most new and struggling companies tend to have far less cash than needed. The balance of this book is geared toward helping manage available cash to these ideal targets to ensure that your company has the necessary resources to prosper.

Implementing Fundamental Cash Management Practices

In one sense, cash is just like every other company asset. Similar to inventory, fixed assets, or patents, it needs to be proactively managed, controlled, and evaluated on a periodic basis to protect the economic interests of a company. On the other hand, cash represents a very unique and extremely liquid asset that requires additional management attention, not just from the standpoint that cash can quickly disappear due to fraud but, more important, because it truly represents the lifeblood of a business. This section focuses on the fundamental management issues associated with cash, from the beginning (setting up cash accounts) to the end (assessing and evaluating cash as an asset).



The same concept that applies with all other company assets also applies to cash. The goal is to utilize each company asset as efficiently as possible to improve operating results and increase the enterprise's economic value.

Establishing cash and bank accounts

When a business is initially formed, the first step usually undertaken (after the legal formation) is setting up bank and cash accounts. For the purposes of our discussion, bank and cash accounts are generally assumed to mean the same thing because for most companies the majority of business in cash is usually maintained in bank accounts. Even for businesses that maintain active on-hand cash balances (such as retail stores that need to have cash available to transact with consumers), the original source of this cash and the eventual destination are bank accounts.

In order to establish company bank accounts, you need to consider the type of bank accounts required, get approval for those accounts from the company's owners or governing board, and then determine who has signing authority (to make withdrawals and deposits). These subjects are discussed in the following sections.

Bank account types

First, a company must decide what types of bank accounts it requires to conduct business. The following types are most commonly used:



- ✓ **General operating account:** This account is used to process the majority of a business's normal and customary transactions, such as paying vendors and receiving customer payments. Thus the name *general*.

Some companies establish a master general operating account and then establish smaller operating accounts for a business division or segment that needs to have ready access to a bank account to conduct business. For example, a recycling company that buys large amounts of material probably doesn't want to have cash on hand to purchase the items but yet needs to pay third parties on the spot. This company establishes a smaller operating account for this division, funded with lower cash levels, which can be used to pay third parties as needed. The account is then replenished periodically (in some cases, daily) based on the actual or anticipated needs. This type of structure represents a control procedure at two levels. First, it limits the amount of cash in an account that may be more susceptible to fraud (because normally this account has numerous check signers). Second, the division is forced to produce management information frequently in order to ensure that the bank account is properly funded.

- ✓ **Payroll account:** Quite often, businesses establish a separate bank account to process periodic payroll activity. Payroll-related activity is usually reviewed by a number of additional parties (like the human resource department, outside payroll processing services, and others). So to limit access to potentially confidential information, such as total company-wide cash levels, a payroll account is only funded with just enough cash to cover the next payroll.
- ✓ **Investment account:** Various names are used for this type of bank account, including *savings*, *money market*, *interest bearing*, and others, but the idea is always that when a company has excess cash balances, the cash is parked in an account that can generate interest earnings.
- ✓ **Restricted cash accounts:** A restricted cash account can be any number of different, unique bank accounts that hold cash for a particular use. It can be a certificate of deposit used as collateral (for example, a landlord may require a deposit on leased space, so instead of giving the landlord cash, the lessee makes a deposit with the bank and pledges it as collateral). It may be a trust account set up to segregate cash that can only be used for a specific purpose. For instance, a business was sold with 25 percent of the purchase price held back for one year to ensure that the company's performance met predetermined targets. When the company met those targets, the funds were released to the seller. The reason for the trust account was that the seller wanted to make sure the funds would be available.



The general rule of thumb is that the smaller the company, the fewer bank accounts needed. In some cases, the company may be so small (for instance, a one-location retail store with four employees) that all its banking needs can be addressed with one general bank account. However, managers at companies of all sizes should remember that the more cash is consolidated into fewer bank accounts, the higher the risk for large losses to occur. Thus, internal policies, procedures, and controls need to be that much tighter and stronger when fewer bank accounts are used.



Currently, the FDIC (Federal Deposit Insurance Corporation) insures bank accounts for up to \$250,000. If your business has \$400,000 in a bank account and the bank fails, your business is at risk for \$150,000. Although cash losses such as these from failed banks are rare, all business owners need to understand that this risk does exist. Companies with large amounts of cash often diversify it across multiple banks and account types to help manage this concentration risk.

Bank account approval

After the number and type of bank accounts have been determined, the actual process of legally establishing the bank accounts must be undertaken. Companies are required to obtain proper approval from their governing board or membership group to legally open and operate a bank account. For a corporation with a board of directors, board authorization must be obtained in order to open and begin to use the bank account. Similar authorizations are also required for other business legal forms, such as LLCs, partnerships, and nonprofits. You can usually get a boilerplate form (for each legal entity type) from the bank to ensure that the proper language is used and documentation is prepared to establish a bank account.

Bank account signers

The following statement may seem unusual or even out of place coming from authors who are both accountants/financial professionals by training and trait, but we hope you will remember it above all else in this chapter:



The first and foremost control that needs to be placed on cash is that your senior-most accounting and financial personnel or staff *should not* be granted check-signing authority (or the ability to transfer funds outside of the company).

Why not, you ask? Well, in just about every business, the party most adept and qualified to commit fraud is the same party that's responsible for preparing the financial statements, reports, and/or other financial-based management tools used. So who is better situated and has the knowledge to commit fraud and hide it in the financial statements? The senior accounting and finance personnel! Don't allow the coyote to guard the hen house.

Of course, not all accounting and financial personnel are coyotes, and the intent of this statement is not to implicate them as being the primary source of fraud in a business. But we do want to reinforce a key financial control, segregation of duties, in which the objective is to separate the parties that prepare information from the parties that control/manage company assets to implement a simple yet very effective check and balance. The goal is to avoid being a victim of one of those classic stories we've all heard too often where the accountant of 20 years (you know, the little old bookkeeper), as reliable and dedicated as you could ever hope, has just made off with tens of thousands of your hard-earned dollars.

The last issue that needs to be addressed before opening an account is determining who in the business will have check-signing authority. Consider two key concepts when making this decision. First, the signers on the accounts should be independent from the parties preparing and processing the documentation requiring payments. The accounting department usually prepares and processes the documentation, so personnel in that department (the bookkeeper, controller, CFO, and others) should *not* have check-signing authority. This separation is an internal control to help protect company assets by reducing the opportunity for fraud. Second, the signers on the account should be in senior roles to ensure that proper review and approval are being completed before checks are signed.



Most companies employ a dual check-signing requirement when payments are above a certain level. For example, when payments exceed \$10,000, two signatures are required to ensure that the expense is properly reviewed and approved. Getting two sets of eyes on large payments provides an additional level of control to safeguard company assets against large or material errors or irregularities.



Being a signer on a bank account represents a significant responsibility that carries with it additional exposure and potential liabilities. For example, if a company fails to remit payroll taxes, the IRS will look to all parties who were responsible for remitting the taxes to pursue collection efforts, which includes company officers, senior management, and potentially all signers on bank accounts. So before you choose parties to act as signers or accept this responsibility, think carefully, because this function is best left to the owners, officers, and/or senior management team (the parties within the business with the most to gain, the most at risk, and the most business experience).

Controlling cash and bank accounts

After the bank accounts have been established, the next order of business is to make sure proper controls have been established to protect and safeguard this business asset. The following list of basic cash and bank account controls outline the bare minimum of controls needed:

- ✔ **Securing bank instruments and documentation:** At all times, all bank instruments — account numbers, blank checks, facsimile signature stamps, statements, original agreements, and/or any other type of documentation — should be kept under lock and key, accessible only by authorized company personnel.
- ✔ **Performing periodic bank reconciliations:** On a periodic basis (usually monthly), an independent party should reconcile all bank account statements against the general ledger. In addition, a member of senior management should then review and approve the reconciliation.
- ✔ **Auditing and balancing cash activity:** In situations where cash is actively used in the business (like a retail business), a daily balancing of cash on hand against a sales report can control the physical handling of cash. The party handling the cash (for instance, a checkout employee) balances the cash in her drawer against a computer report generated for the period of time she worked to make sure that the cash sales reported agree with the cash in the draw (accounting for beginning balances and other adjustments). By implementing a frequent balancing procedure, any discrepancies can be quickly identified and addressed.
- ✔ **Monitoring petty cash:** Most companies have a small petty cash fund for use on discretionary purchases (like if the office manager wants to buy everyone lunch for a job well done). Although petty cash balances tend to be small, parties that have access to them tend to use the petty cash as their own personal slush fund. To manage this misuse, first, give access to petty cash only to responsible parties. Second, require that all disbursements from petty cash be supported by a receipt. And third, order a periodic audit/reconciliation of petty cash to make sure that leakage is not occurring.
- ✔ **Implementing flash reports:** *Flash reports*, high-frequency reports that provide a quick snapshot or summary of critical business information and results, are a very effective tool for managing and controlling cash. A simple example of flash reporting is having a sequenced bank report setup whereby all activity for a period of time (say, a week) is reported to management, independent of the accounting function. Managers can then review the report and, if needed, compare it against internal company information to determine if it's reasonable. Before the digital age, this type of control wasn't efficient to implement, but today pushing critical information out in a real-time fashion is easy and encouraged by banks to help prevent and detect fraud.
- ✔ **Limiting access to bank accounts and information:** In the digital era we all live and operate within, bank accounts and information are available at the touch of a button (just like about everything else). Keeping tight control on who has access to the bank account information and requiring passwords to be changed on a frequent basis are necessary controls.

✔ **Using other basic controls as relevant:** Other basic controls may be appropriate for your company, depending on what kind of business you engage in. For instance, many companies use lock-box accounts through which customers remit payments directly to a bank, which then receives the check, deposits it, and reports the payment information back to the company (to update the accounting records). This control prevents company personnel from handling (or mishandling) customer checks. Also, stop payments are basically used by most companies at one time or another to request that the bank stop payment on an issued check before it is cashed (or relieved from the bank account). These occur for various reasons (for example, a customer never received payment for invoices that were lost in the mail, so a new check is issued) but should be administered by the appropriate personnel.



The digital age has pushed banking into real time. Gone are the days of issuing checks and knowing that you have seven business days before they clear (to use the float or retain the luxury of issuing a stop-payment request on the check). Today, check information is captured and processed extremely quickly, so businesses must establish controls to make sure that when a check or payment is made, it is valid and has little or no chance of needing to be changed. These days, after the check or money has left the house, it isn't coming back.

Maximizing your business's cash

Generally, most businesses don't sit on large stockpiles of cash wondering what to do with their vast riches. But when excess cash does become available, you can use a number of strategies, including the four that follow, to help improve and enhance operating results:

✔ **Compensating balances:** Just about every business incurs bank fees in one fashion or another. One way to help reduce bank fees is by maintaining what's called a *compensating balance*. That is, if a general operating account (that doesn't earn any interest) is kept at a certain level, the bank calculates what the cash in the account would have earned and then credits your bank fees by this amount. These compensating balances can help reduce bank fees when slightly higher balances are kept in non-interest-bearing accounts (such as a general operating account or payroll account). To determine if a compensating balance agreement for your business makes sense, you should approach your bank and request that an analysis be completed. If it looks like it will save you money, then ask your friendly banker to set this service up.



Banks are constantly looking for new revenue sources, and bank fees have been a prime tool over the past three years. Today, banks charge for just about everything, ranging from issuing fees for online banking and electronic payments to charging for each check that clears. But remember, these fees are often negotiable, so don't be bashful about

approaching the bank about reducing the fees. For strong customers, the banks make a significant amount of money from managing your cash and bank accounts, so requesting discounts on fees is reasonable.

- ✔ **Implementing sweep accounts/ZBAs (zero balance accounts):** Sweep accounts and ZBAs are often used by larger, slightly more sophisticated companies with multiple locations and bank accounts. A sweep account allows a business to “sweep” excess cash from multiple operating accounts into a centralized account. This sweeping event then usually produces excess cash, which can be used to either pay down borrowings on a line of credit (to reduce interest expense) or invested in a money-market account (to earn interest). In coordination with using a sweep account, ZBAs are frequently used as well. A ZBA basically keeps the balance of the account at zero per the bank. Any time a check or payment clears the account, money is swept in from the central account to cover the obligation. ZBAs provide the dual assistance of using internal cash as efficiently as possible and providing an additional internal control: Fraud and theft are less likely when the account appears to have zero cash available.
- ✔ **Leveraging the float:** A *cash float* occurs when a business issues checks on Friday that don’t clear until the next Friday. In theory, the business has the use of these funds for a short period of time until the recipient actually cashes the checks. If \$20,000 of checks have been issued but not yet cleared the bank, cash float explains why the company’s cash balance per its books may state that \$15,000 is available whereas the bank balance shows \$35,000 available. Years ago, numerous businesses used this strategy to help finance their operations — they had using the float down to an art form. Today, using the float is more difficult. Given the advent of digital technology, check information is now captured much quicker and clears the issuing company’s bank account must faster. However, in certain industries the float is alive and well and used actively to help finance business operations.
- ✔ **Using lock boxes:** As discussed in “Controlling cash and bank accounts,” companies can use bank-provided lockboxes to process checks paid to the company and eliminate internal handling. Lockboxes also provide another advantage in that they can often result in customer’s payments being received and processed more quickly (thus providing your business with the use of cash sooner). Although the processing may be only a day or two sooner, for larger companies, having access to the extra cash quicker can result in improved operating performances.

Understanding Cash in the Digital Age

The digital age has truly transformed how businesses operate in today’s highly competitive business environment. The practice in the good old days of calling your accounting department to prepare a report and then providing a fax

number to send the information has been replaced by accessing an *app* (or application) on your 4G cellphone or tablet computer that lets you obtain and manage critical business data (in as close to real time as possible). Okay, this example may be a slight exaggeration, as most businesses still operate by using the old brick-and-mortar method of e-mailing reports or files over the Internet for access in a computing environment. But the evolution and innovation of technology will without question push the distribution of accounting and financial information to an entirely new level over the next decade.

And yes, digital advances will have a profound impact on cash, both in terms of how cash payments and transactions are processed and, more important, in how cash and bank accounts need to be managed and controlled. In the digital age, when an electronic payment is processed, it basically is gone from your account at that moment, so if it is incorrect, you've just given cash to a third party (and out of your control). In the olden days, if a check was cut on Friday and did not clear the bank until the middle of the next week, you still had 72 hours to react and potentially place a stop payment on the check. If you let your guard down, just for a moment, cash can, per the words of Warden Norton in *The Shawshank Redemption*, "Vanish like a fart in the wind."



Most businesses rely on external professionals to support, maintain, and manage complex business issues (for example, taxation issues are usually best supported by a qualified and experienced CPA firm). Understanding cash in the digital age is one of those complex issues. The complexities surrounding electronic cash transactions are numerous. One of the best sources of advice and support for managing electronic cash transactions are banks, given their experience with and knowledge about processing just about every type of cash-based transaction used by businesses today. Your company should work closely with its primary bank to ensure that cash is both protected and managed as effectively as possible.

Moving and processing cash transactions electronically

With the exception of using cold, hard cash in a business transaction, the first thing to remember about cash is that basically every other type or form of cash payment, from wires to credit cards, represents an electronic transaction. Even the use of checks has moved into the electronic age; the critical information provided on a check, such as the payee, payer, amount, check number, date, and bank account information, is now often captured electronically by various parties involved in the process (from the end recipient to the banks processing the check).

Checking out forms of electronic payments

Table 12-1 summarizes the different types of electronic payments your business may use. In addition, various pros/uses and cons associated with each type of electronic payment are listed.

<i>Type of Payment</i>	<i>Pros/Uses</i>	<i>Cons</i>
ACH (auto-mated clearing house)	Most commonly used to support bulk or batch payment processing. Best suited for larger organizations with high volumes of payment transactions to process (like government-initiated payments for Social Security, which process millions of payments each month without actually issuing a check but uses ACH to credit the recipient's bank account).	A somewhat more-complicated system, basically administered by Federal Reserve Banks. Not well suited to individual electronic payments for infrequent or one-time payments, because it takes a little more effort to set up and establish the payment logistics.
EFT (electronic funds transfer), including direct deposits and electronic checks	Efficient, easy to use after established with the bank, and reduces expenses with traditional check writing. Often used with recurring disbursements (such as direct deposit for the weekly payroll).	Debits or reduces the payer's account immediately, reducing the ability to use the float. Added controls required to ensure that access is limited to appropriate personnel.
Wires (a form of electronic funds transfer)	Offers increased controls because each transaction tends to be individualized. Generally used for nonrecurring transactions and foreign-payment processing.	Same as the cons for EFT. In addition, extra fees are usually charged.

(continued)

Table 12-1 (continued)

<i>Type of Payment</i>	<i>Pros/Uses</i>	<i>Cons</i>
Credit cards	Offer ease of processing, an easy way to finance purchases, fraud protection and payment return services, and a chance to earn “points” (for example, for travel). They’re widely accepted, and, on the receipt side, they accelerate customer payments.	For businesses that accept credit card payments: Fees range from 2 to 4 percent, liability is increased due to the need to keep information (like card numbers) confidential, establishing merchant accounts with financial institutions can be time consuming, and personal guarantees are required to protect against fraudulent charges.
Debit cards	Easy to use and, unlike credit cards, limit purchasers to spending only what’s available in their checking account. Ideally suited to companies that sell to consumers and need to accept debit cards as an alternative form of payment.	Same as the cons for credit cards. In addition, has increased risks associated with giving other parties direct access to bank account. Generally not used extensively in the business community to process payments.

A number of new and innovative types of electronic payment processing are becoming imbedded in the mainstream including using PayPal and pre-paid (and rechargeable) debit cards, and, soon to be appearing at a store near you, swiping your cellphone to process payment. These forms of electronic payment are still emerging and tend to be based more in the BtoC e-commerce market (business to consumer) rather than BtoB (business to business). However, there can be no doubt that these forms of electronic payments will continue to grow in popularity, so adapting your business to accept these types of payments should be undertaken. (But be sure to work with only the most reputable third-party clearing companies and have a clear understanding of the fees charged.)



If your business hasn’t already done so, now is the time to fully embrace the use of electronic cash. Developing and implementing the systems, controls, policies, and procedures to handle any form of electronic cash carries the following three critical advantages:

- ✓ **Reduced expenses:** Internal costs associated with security, supplies, mailings, and so on can be reduced.
- ✓ **Improved performance and efficiency:** Cash can generally be received and put to use quicker when electronic payment systems are properly implemented and utilized.
- ✓ **Lowering fraud:** When properly implemented and managed, electronic payments can reduce fraud by limiting the number of parties handling cash and by utilizing advanced fraud protection features available in the electronic environment.



Banks are starting to require businesses to implement fraud prevention tools to lower overall risks. Businesses may be held liable for fraudulent transactions if the bank has provided the tools necessary to prevent fraud but the business either doesn't elect to incorporate the tools or doesn't properly use the tools. Granted, this type of legal action is rare, but business owners need to be aware of the risks associated with not evolving with the market.

Considering the use of checks

The trend in business is definitely away from checks and toward electronic cash as a means to improve business efficiencies, reduce fraud, and lower business risks. In Corporate America, electronic cash has become the norm, so if you're looking to conduct any type of significant business with the Fortune 500 companies, be prepared to accept and remit by using electronic methods.

Even in the general population, the use of checks has greatly diminished over the past decade, with more customers using online electronic checks, debit cards, credit cards, and other forms of electronic cash (like PayPal) to process payments. Most small- to medium-size businesses will have to continue processing payments by check for the foreseeable future because some customers are still paying with checks. But the message is loud and clear: You'd better already be on the electronic-cash train, 'cause it has left the station.

Establishing cash controls in electronic-based accounting systems

Ten years ago, I would have titled this section of the book "Establishing cash controls in computer-based accounting systems," because the concepts of cloud computing, virtual companies, freely portable accounting systems, and the like really didn't exist. At the turn of the millennium, the world was really just being introduced to the dot-com boom-and-bust cycle and was busy working through Y2K issues, while social media, mobile networking, and

cloud computing were concepts left for science fiction writers. What a difference ten years makes. Today, the dot-com era represents a distant memory (or for some, a forgettable nightmare) replaced by the world of instant mobile communication, cloud computing, and highly portable/on-demand information.



To begin this discussion on establishing controls over cash in an electronic environment, you need to understand that the same fundamentals of controls apply whether you're controlling cash in a traditional manual environment or in an electronic environment. (Refer to the earlier section "Controlling cash and bank accounts" for an overview of the fundamental practices.) Beyond these basic fundamentals, companies actively use the following additional controls, policies, and procedures to manage and protect cash in an electronic environment:

- ✓ **Access to and use of passwords:** Password protection in the digital age is absolutely critical to ensure that vital/confidential information is properly protected. Passwords should also limit who can access and manipulate company bank accounts and process payments. Require frequent password updates. In addition, your business should also set up logs or run reports that track logins, implementation of positive confirmation on password changes, and the location of the accessing computer or mobile source. Banks and financial institutions aggressively use algorithms to monitor and track unusual activity in bank accounts and credit cards, and your business should tap that source when the situation warrants.
- ✓ **Flash and exception reports (testing the system):** Various reporting tools are available to help manage and control bank accounts and cash levels. Just like a weekly sales flash report is generated to report on how the company performed during the past week, the same type of report can be generated to monitor cash levels (focusing on activity out of the norm). In addition, exception reporting can be used to identify any trends or activity that may indicate a problem. For example, management may want to be informed of any changes in employee compensation levels from the prior period (as provided by a payroll service) to ensure all changes were approved. With bank accounts, reports can be generated and provided that list any check over, say, \$5,000 that cleared the bank account. Needless to say, these reports are unique to each business in terms of what information is critical and/or at the highest risk for fraud or mismanagement. Management should determine what information is needed and then develop and implement proactive tools to prevent problems from arising.
- ✓ **Positive pay and other bank tools:** Banks offer a number of tools and resources to help manage electronic cash transactions. One such tool that a number of companies use is most commonly referred to as *positive pay*. Positive pay reports to the bank all checks a company generated from its system in real time. Software sits on top of your company's accounting system and captures any check and payment information

processed (so the bank has a record of what you approved). When checks or payments are presented to the bank for payment, the check is matched against the positive pay report to ensure that the check is valid. If not, the bank notifies your company of the discrepancy and the company indicates whether the check should be accepted or rejected. Other examples of bank management tools include using “push” reports (reports generated by the bank and pushed out to the customers) to notify customers of the latest electronic scams and fraud schemes and developing complex algorithms which track customer payment trends and credit card charges habits (to identify anything out of the ordinary which may indicate that fraud has been committed).

- ✔ **Advanced controls for checks:** While the electronic age continues to transform the movement of cash, the tried-and-true method of using checks isn’t going away anytime soon. However, generating checks has evolved in the electronic age. Formerly, businesses would order preprinted checks from a supplier or the bank and then insert them into the printer when checks needed to be processed. Today, blank check stock is received from the supplier, and when checks are printed, all the vital information is printed at the same time (such as the bank routing and account numbers, payee, payer, and check number). The check is printed with special MICR toner (that is, magnetically readable toner that the bank’s computers can read and process) on special fraud-prevention paper (using watermarks and other distinctive features). Not only do these steps help with fraud prevention (because now a pre-printed check can’t be stolen and filled out with fraudulent information), but they also improve the bank’s efficiency in reading and processing checks (because all the information has been magnetically encoded).

An even further advancement in the check printing world is to use remote check printing. This feature allows a company to pay its vendor by processing a check payment that actually prints at the customer’s site (on their printer), using a computer generated signature or facsimile. This strategy is best used for larger relationships where frequent payments are made and carries numerous advantages including reducing costs (no mailing required) and handling risks.

- ✔ **Using prepaid debit cards:** Prepaid debit cards are a growing form of control over electronic cash. One of their most common uses is for employee paychecks in cases where the employee doesn’t have a bank account. Surprisingly, roughly 20 percent of the population doesn’t use regular bank accounts and direct deposit but rather receives a live check, cashes it, and then pays bills with either cash or by purchasing money orders. Prepaid debit cards allow the employee to have his card “recharged” on the pay date so that the card carries a balance that can be spent. The card is safer than carrying cash because if the card is lost or stolen, it can be cancelled and another card issued (as long as the PIN is protected). Prepaid cards can also be used in a number of other areas, such as parents providing a set level of spending for their college student (usually quickly reached).

What should be clear from these bullet points is that working with your bank is very important in terms of implementing the proper controls, policies, and procedures to protect cash in an electronic environment. Fraud (including bad checks and credit card theft) remains a significant expense for banks and financial institutions, resulting in billions of dollars of losses over the years. And if fraud is costing the bank money, then it's costing you money, because the bank makes up for these losses or expenses by either charging your business higher fees or paying lower interest rates (on investable cash balances).



Managing and controlling cash in the electronic age requires a partnership between you, your bank, and critical customers and creditors. Your business needs to be proactive in implementing necessary controls because you can't assume that a bank is going to protect your interests at all times. The banks are smart, but the crooks are usually smarter (and often one step ahead when committing theft and fraud). Assuming that a third party is going to protect your business interests is often the source of unnecessary heartburn and the mother of all headaches.

Working with Cash as a Key Business Indicator

Chapters 8 and 9 of this book provide an in-depth discussion and overview of the business-planning process, including developing financial projection models — which, of course, includes forecasting critical cash information (that is, sources, uses, and available balances). Keep in mind that when budgeting cash, it tends to become a “forced” number in the financial forecasts. That is, after all other assumptions have been built into company projections and forecasts — items such as how long it will take to collect receivables, how much needs to be invested in fixed assets, whether the business will need to borrow from a bank this year, and so on — cash levels or balances are forced into the balance sheet so that it can balance. For example, a jewelry retailer will ramp inventory levels and gear up promotional efforts to support the holiday selling season which starts in mid to late November and runs through the end of the year. So cash balances tend to be very low at the end of October as the company has deployed cash for the benefit of the holiday season (so a low cash balance is expected or forced into the balance sheet). However, by the end of December, cash balances should reach extremely healthy levels as inventory has been reduced via high holiday sales levels (thus the high cash balance is forced into the balance sheet). The key isn't so much that cash balances went from extremely low levels in late October to the highest level of the year in late December but rather did the cash perform as expected against management's internal forecasts.

Of course, the forced cash balance may or may not be a desirable outcome; it may be too low or even negative (relative to the desired cash levels needed to operate a business). If cash levels are too low, your business should immediately view it as a red flag in terms of making sure management has a plan developed to address any potential cash squeezes that may occur.



Think ahead, very far ahead, when developing a plan to make sure that plenty of cash or access to cash will be available to support your business. In today's unsettled and competitive capital markets, securing cash from external sources (such as banks and investors) to support your business operations is a very time-consuming and lengthy process that can easily take three to six months or longer, depending on the source of the cash.

Knowing the seasonal ebb and flow of cash

Most financial projections prepared by businesses tend to follow a fairly similar pattern. Unless the economy is crashing (a la 2009), the goal for most businesses is to increase sales and improve profits. For example, a business unit may set a target of increasing sales by 15 percent for the year and profits by 20 percent in order to meet senior management's expectations. Instead of diving into all the fundamentals and strategies associated with preparing financial forecasts (covered extensively in Chapters 8 and 9), this section focuses on various seasonal factors and events (when viewed on an annual basis) that can significantly impact short-term cash flows and availability. Or looking at it from another perspective, if proper planning is not completed and adequate cash resources are not available to build inventory and promote sales (during a busy season), then sales will be negatively impacted (by not having the proper inventory available), which in turn will result in lower profits.

Very few if any businesses experience linear increases (or, for that matter, decreases) in sales, profitability, and cash flows over a 12-month period. This perfect world just doesn't exist for 99 percent of businesses, because they are always encountering events, transactions, external influences, and so on that have a material effect on cash flows and cash availability on a quarterly, monthly, or in some cases weekly basis. So because cash levels can vary significantly in a very short period of time, your business should always be prepared for trouble.

Recognizing the events that cause cash-flow variation

Although a number of factors and events can impact cash flows and availability over a year, most fall into one of the following three categories:

✔ **The four seasons:** A large number of companies build their business models around the four seasons of the calendar year, and changes in the season can significantly impact cash levels. For a jewelry company, the Christmas holiday rush, which lasts about six weeks a year, can produce as much as 35 percent of the entire sales for the year. In late October, just prior to the Christmas holiday season, cash levels decrease because cash has been spent on inventory that needs to be on the shelves for consumers to buy. However, in late December or early January, cash balances skyrocket due to the Christmas buying binge. To an uneducated party evaluating cash positions at these two points in time, the company looks to be in trouble in October, whereas at the end of December, the company looks to be very strong.

✔ **The government:** Rules and regulations established by the government can often create significant short-term impacts on cash flows and availability. A perfect example is the timing of quarterly estimated income tax payments. For regular C corporations, these tax payments fall on the 15th of the 4th, 6th, 9th, and 12th month of the corporation's fiscal year end. (For example, a calendar-year-ending fiscal year would make estimated payments on 4/15, 6/15, 9/15, and 12/15.) So for two months during the quarter, no estimated income tax payments are due, but in the third month, a large payment is made. Other examples of how the government can impact short-term cash flows and availability include unemployment insurance (due on the last day of the month following each calendar quarter end), remittances for sales and use taxes collected (which may vary from monthly to annually, depending on how much is due), and paying for licenses and permits in advance.



A very distinct trend is taking hold in states, cities, counties, and local municipalities in the United States. If you haven't heard, most of these entities are out of money. So not only are they looking for ways to increase revenues (for example, by raising sales tax rates), they are also looking for ways to accelerate payments (from businesses to governments). Paying more and quicker is a trend that you should anticipate to continue for years to come, so when creating a financial forecast, incorporate events that will accelerate the flow of cash from your business to the government.

✔ **The company itself:** Most businesses over a period of time develop specific policies, procedures, and operating structures that create peaks and valleys of cash flows and availability. Some companies may look to retool with new equipment during a particularly slow period. Other companies may accrue employee bonuses during the year and then pay them in a lump sum around Christmas of each year. Some companies may have a significant loan payment due as a result of a note payable executed three years earlier. The list of company-specific influences on cash are endless, but the same basic management concept applies to all: Managers who prepare the budget must have a clear understanding of these influences and must account for them in the annual budgeting process.

Staggering cash flow

Staggering is a practice that attempts to budget cash needs on a more even basis during the year. Staggering cash inflows and outflows to smooth them out on an annual basis can be a very effective management tool.

For example, if a business has to commit cash for new equipment purchases, it should plan to do it at a time when business won't be disrupted by the cash drain. The business can even out cash flows by budgeting for the purchase in a month that doesn't require other significant cash outlays (for example, not when the business has to build inventory levels to support seasonal sales and pay estimated taxes).

Business can also stagger cash flows when paying commissions. Rather than pay commissions when the sale has occurred, a number of companies pay commissions when the cash is actually received from the customer. Not only does this staggering help match the cash outflow with the cash inflow, but it also gives sales representatives an incentive to make sure that customers pay in a timely fashion.

Setting periodic cash level benchmarks

A very simple cycle to remember is that starting a business takes cash. The cash, when secured, is then deployed in the business via realizing expenses, investing in assets, generating sales, paying obligations, and hopefully producing net earnings or profit. The goal is to have the profits eventually turned back into cash so the cycle can start all over again. This cycle confirms the discussion at the beginning of this chapter about how basically all business transactions eventually end up in cash (either increasing or decreasing). So cash is a logical critical internal management benchmark on which to evaluate a company's performance. However, like most benchmarks, this one should be used with other critical benchmarks to properly evaluate a business's performance.



Businesses use all kinds of operating metrics as benchmarks to evaluate their performance. Classic examples include comparing a weekly sales report trending the last four weeks to a report from the like period for the prior year, calculating inventory turnover ratios for each company product and comparing the turns to the prior year, and so on. However, most small companies don't use cash benchmarks to help evaluate and manage their businesses. Seeing that most small businesses struggle with even putting together a statement of cash flows, it's no wonder that using cash as a critical benchmark is quite often overlooked.

When using cash as a benchmark, two underlying concepts are important to understand to extract the most value from this benchmark to assist in managing your business:



- ✔ **Use cash as a canary in the coal mine.** Cash is a great tool to use in the capacity of a canary in the coal mine (that is, as an early warning system), because if cash levels are significantly different than expected, it almost always indicates that a more significant issue or problem exists with the performance of other assets, liabilities, or the company's profitability.

When cash benchmarks are established, they're generally based on either internal or external data points. External benchmarks (that is, comparing your business's cash to that of other businesses in the same industry) should be used with an abundance of caution. Even with companies operating in the same industry, capital structures, strategic business plans, and internal policies can differ greatly, having a significant impact on cash flows and cash availability. So although "best-in-class" external benchmarks for cash can be informative, avoid drawing conclusions based on this benchmark alone. Internal benchmarks are often much more informative. Cash benchmarks have the most value when they're driven from asking why cash balances or internal cash flows may be varying so significantly from budgeted levels.

- ✔ **Implement cash flash reporting at all costs.** Every business owner and manager needs to monitor operating performances with the use of information provided through reports. Traditional reports such as monthly financial statements or sales by product lines are helpful but incomplete. The implementation of high-frequency flash reporting is becoming more and more important for businesses so that key operating metrics can be monitored very closely. Cash is especially important to monitor frequently because having a solid handle on weekly (or in some cases, daily) cash inflows and outflows can highlight a problem much quicker (allowing management to respond faster) than waiting until the end of the month.

Chapter 13

Preventing Cash Losses from Embezzlement and Fraud

In This Chapter

- ▶ Putting business controls in context
 - ▶ Checking out the internal control checklist
 - ▶ Realizing the limits of internal controls
-

When the infamous bank robber Willie Sutton was asked why he robbed banks, he's reputed to have said, "Because that's where the money is!" The cash flows of a business are a natural target for schemers who see an opportunity to siphon off some cash from these streams of money. The grandfather and father-in-law of the authors — who was a very successful businessman — told us that there's a little bit of larceny in everyone's heart. Well, perhaps not everybody — but enough people that a business should be worried.

Making a profit is hard enough as it is. There's no excuse for letting some of your profit slip away because you didn't take appropriate precautions. You don't leave the keys in your car, do you? You lock your car and make it difficult to steal. Likewise, you shouldn't leave the keys to your business's cash flow lying around. This chapter discusses controls and preventive measures that a business should consider adopting in order to prevent and mitigate cash losses from dishonest schemes by employees, customers, and other parties it deals with.



This chapter is directed to business managers; it is not a detailed reference for accountants. The chapter takes the broader management view, whereas accountants take a narrower view. Accountants focus on preventing errors that may creep into the accounting system of the business and quickly detecting errors if they get by the first line of controls. In addition to these internal accounting controls, the accounting department typically has responsibility for many of the other controls discussed in this chapter, as we cover in the sections that deal with particular controls.

Setting the Stage for Protection

We start with the reasonable premise that the large majority of people are honest most of the time. You can argue that some people are entirely honest all the time, but realistically this assumption is too risky when running a business. In short, a business has to deal with the dishonesty of the few. A business cannot afford to assume that all the people it deals with are trustworthy all the time. Fraud against business is a fact of life. One function of business managers is to prevent fraud against their business, and it should go without saying that managers should not commit fraud on behalf of the business. (But some do, of course.)

A business is vulnerable to many kinds of fraud from many directions — customers who shoplift, employees who steal money and other assets from the business, vendors who overcharge, managers who accept kickbacks and bribes, and so on. The threat of fraud is ever present for all businesses, large and small. No one tells a business in advance that they intend to engage in fraud against the business, and compounding the problem is that many people who commit fraud are pretty good at concealing it.

So every business should institute and enforce internal controls that are effective in preventing fraud. An ounce of prevention is worth a pound of cure. Keep in mind the difference between controls designed primarily to stop fraud (such as employee theft) versus procedures designed to prevent errors from creeping into the accounting system. Both types of precautions are important. Even if it prevents theft, a business may lose money if it doesn't have accounting controls to ensure that its financial records are accurate, timely, and complete.

On the police TV series *Hill Street Blues*, the last thing the desk sergeant would tell the patrol officers before they went out to their beats each night was, "Be careful out there." Good advice too for a business and its internal controls!

Preventing loss with internal controls

The procedures and processes that a business uses to prevent cash losses from embezzlement, fraud, and other kinds of dishonesty go under the general term *internal controls*. *Internal* means that the controls are instituted and implemented by the business. Many internal controls are directed toward the business's own employees to discourage them from taking advantage of their positions of trust and authority in the business to embezzle money or to help others cheat the business.



Many internal controls are directed toward the outside parties that the business deals with, including customers (some who may shoplift) and vendors (some who may double bill the business for one purchase). In short, the term *internal controls* includes the whole range of preventive tactics and procedures used by a business to protect its cash flows and other assets.

Some businesses put the risk of cash losses from fraud near the bottom of their risk ranking. They downgrade these potential cash seepages to a low priority. Accordingly, they are likely to think that internal controls take too much time and cost too much. Most businesses, however, take the middle road and assume that certain basic internal controls are necessary and cost effective — because without the controls, the business would suffer far greater losses than the cost of the internal controls.



Some companies boldly assume that the company's internal controls are 100 percent effective in preventing all embezzlement and fraud. A more realistic approach is to assume that some theft or fraud can slip by the first line of internal controls. Therefore, a business should install an additional layer of internal controls that come into play after transactions and activities have taken place. These after-the-fact internal controls serve as safety valves to catch a problem before it gets too far out of hand. The principle of having both kinds of controls is to *deter and detect*.



Certain internal controls are designed such that two or more persons would have to collude to commit and conceal the fraud. Collusion may or may not be an effective deterrent. The deterrent value of collusion may be compromised when two persons have a personal relationship unbeknownst to the business — for example, the two may be in a sexual relationship, or one may be buying drugs from the other, or one may be a cousin of the other. The ultimate deterrent to fraud is knowing that you will be caught if you do it. Even so, desperate people still take their chances of being caught, so if the collusion requirement doesn't derail their plans, you can still try to detect them.

Recognizing the dual purpose of internal accounting controls

Many internal accounting controls consist of required forms that must be used and procedures that should be followed in authorizing and executing transactions and operations. A business's accounting department records the financial activities and transactions. So, naturally, the accounting department is put in charge of designing and enforcing many core internal controls. The accounting profession has a long history of involvement with internal controls.



Many accounting internal controls have both an accounting reliability purpose and an antifraud purpose. The business gets two for the price of one from these particular controls. For example, employees can be required to punch their timecards on a work clock as they start and end each day, or they can have their hours entered in a payroll log signed by their supervisor. This sort of internal control helps prevent employees from being paid for time they didn't work. Also, the procedure tells the accountant which expense account to charge for their work and produces a record of the transaction that helps eliminate (or at least minimize) errors in capturing, processing, storing, and retrieving wage data needed for financial records. The accounting system of a business keeps track of the large amount of information needed in operating a business, and these internal controls are designed to ensure the accuracy, completeness, and timeliness of information held in the accounting system.

Internal accounting controls need to be kept up-to-date with changes in a business's accounting system and procedures. For example, an entirely new set of internal controls had to be developed and installed as businesses converted to computer-based accounting systems. Before then, the word *hacker* referred to a poor golfer, or duffer, not software code breakers who pose very sinister threats to companies' computer systems. The transition to computer and Internet-based accounting systems brought about a whole new set of internal accounting controls, to say nothing of all the other internal controls a business had to install to protect its databases and communications.

Struggling with fraud committed by the business

There's fraud against a business, and then there's fraud *by* a business. The first type of fraud can be classified by who does it, and unfortunately, a business is vulnerable to all kinds of fraud attacks from virtually everyone it deals with. This side of the coin includes all kinds of schemes and scams by vendors, employees, customers, and even one or more of the business's own mid-level managers. The other side of the coin is the conscious behavior of the business itself that is sanctioned by top-level owner/managers.

Frankly, most discussions of business internal controls skirt around this sensitive issue. Most articles and books assume that the business is as honest as the day is long. The discussion frames the business as an innocent target of employees, customers, and others who want to steal its money or other assets. But the truth of the matter is that some companies carry on unethical practices as their normal course of business, including bribing government and regulatory officials, knowingly violating laws covering product and employee safety, failing to report information that is required to be disclosed, misleading employees regarding changes in their retirement plans, conspiring with competitors to fix prices and divide territories, advertising falsely, treating employees with discrimination, and so on.

Frauds perpetrated by businesses may very well be illegal under state and federal statutes and common law. Restitution for damages suffered from the fraud can be sought under the tort law system. The evidence is clear that many businesses deliberately and knowingly engage in fraudulent practices, and that their managers do not take action to stop it. Basically, managers are complicit in the fraud if they see fraud going on in the business but look the other way. The managers may not like it and not approve of it, but they often live with it due to unspoken pressure to follow the “three monkey” policy — see no evil, hear no evil, speak no evil.

The lenders and shareowners of a business should keep aware of the possibility of *financial reporting fraud*. The managers of a business may cook the books, resulting in seriously misleading financial reports. Independent CPA auditors test a company’s internal accounting controls that are designed to prevent financial reporting fraud. However, audits don’t catch all incidents of financial reporting fraud. This issue is beyond the scope of this chapter. For more on financial reporting fraud, refer to John A. Tracy’s *How to Read a Financial Report*, 7th Edition (John Wiley & Sons, Inc.).



If you ask a CPA to audit your financial statements, the CPA may have to refuse you as a new client (or dump you if you’re already a client) if your internal controls are inadequate. If your internal controls are too weak, the CPA auditor can’t rely on your accounting records, from which your financial statements are prepared. And the CPA may have to withdraw from the engagement if the auditor discovers high-level management fraud. Both authors have worked on audits in which serious management fraud was discovered. Our CPA firm walked off the audit (and immediately sent a bill to the ex-client). CPAs cannot knowingly be associated with crooks and businesses that operate with seriously weak internal controls.



Even businesses that routinely engage in shady practices should implement internal controls. In fact, operating on the wrong side of the road may make the business more aware of the need for internal controls, and it makes the business more vulnerable to fraud. Employees, customers, and others the business deals with are not fools; they’re generally aware of what’s going on. And fraud begets fraud. If employees or people doing business with the company see fraudulent practices sanctioned by top-level managers, the natural inclination is to respond in kind, adopting an attitude of entitlement and doing some fraud of their own. And they may be very good at it.

In the following discussion of internal controls, we assume that the business is behaving ethically, that the people it conducts business with (employees, customers, and so on) are treated fairly, and that the managers have not cooked the books. We assume that the business is not facing a generally hostile or “let’s get even” attitude on the part of its employees, customers, vendors, and so on. In other words, we assume that the business faces the normal sort of risks of cash losses from fraud that every business encounters. We don’t discuss extraordinary safety measures that a business operating in a high-crime area may have to use (like armed guards at doors).

Putting Internal Controls to Work

In this section we discuss important steps and guideposts that apply to virtually all businesses in establishing and managing internal controls. You find out both what kinds of tools are available to protect your business and what particulars you need to consider when choosing and using them.

Because this chapter is directed to business managers, not accountants, we don't delve into the details of internal accounting controls. If you or your accountant wants to find out more about internal controls, we recommend that you go to the websites of the Institute of Internal Auditors (www.theiia.org) and the American Institute of Certified Public Accountants (www.aicpa.org). Both of these professional associations publish an extensive number of books on internal controls.



In this chapter, we use the term *fraud* in its most comprehensive sense; the word covers the waterfront. It includes all types of cheating, stealing, and dishonest behavior by anyone inside the business and by anyone outside that the business deals with. Examples range from petty theft and pilferage to diverting millions of dollars into the pockets of high-level executives. Fraud includes shoplifting by customers, kickbacks from vendors to a company's purchasing managers, embezzlements by trusted employees, padded expense reports submitted by salespersons, deliberate overcharging of customers, and so on. A comprehensive list of business fraud examples would fill an encyclopedia.

Going down the internal controls checklist

Businesses have a large and diverse toolbox of internal controls to choose from. The following sections provide a checklist for managers in deciding on internal controls for their business.

Watching over high-risk areas

Strong and tight controls are needed in high-risk areas. Managers should identify which areas of the business are the most vulnerable to fraud against the business. The most likely fraud points in a business usually include the following areas (some businesses have other high-risk areas, of course):

- ✓ Cash receipts and disbursements
- ✓ Payroll (including workers' compensation insurance fraud)
- ✓ Customer credit and collections, and writing off bad debts
- ✓ Purchasing and storage of inventory

Separating duties

Where practicable, two or more independent employees should be involved in the authorization, documentation, execution, and recording of transactions — especially in the high-risk areas. This arrangement is called *separation of duties*, and the idea is to force collusion of two or more persons to carry out and conceal a fraud. For instance, two or more signatures should be required on checks over a certain amount. For another example, the employee preparing the receiving reports for goods and materials delivered to the company should not have any authority for issuing a purchase order and should not make the accounting entries for purchases. Concentration of duties in the hands of one person invites trouble. Duties should be divided among two or more employees, even if it causes some loss of efficiency.

Performing surprise audits

Making surprise counts, inspections, and reconciliations that employees cannot anticipate or plan for is very effective. Of course, the person or group doing these surprise audits should be independent of the employees who have responsibility for complying with the internal controls. For instance, a surprise count and inspection of products held in inventory may reveal missing products, unrecorded breakage and damage, products stored in the wrong locations, mislabeled products, or other problems. Such problems tend to get overlooked by busy employees, but inventory errors can also be evidence of theft. Many of these errors should be recorded as inventory losses but may not be if surprise audits are not done.

Letting employees blow the whistle

Encourage employees to report suspicions of fraud by anyone in the business (which has to be done anonymously in most situations). Admittedly, this policy is tricky. You're asking people to be whistle-blowers. Employees may not trust upper management; they may fear that they will face retaliation instead of being rewarded for revealing fraud. Employees generally don't like being spies on each other, but on the other hand they want the business to take action against any employees who are committing fraud.



The business has to adopt procedures to safeguard anonymity that are convincing to potential whistle-blowers. It also has to convince employees that they will not be ostracized if they report their suspicions. Frankly, a business may have to offer financial incentives to whistle-blowers to get them to take such a drastic action that could have serious repercussions over their future career with the company.

Leaving audit trails

Insist that good audit trails be created for all transactions. The documentation and recording of transactions should leave a clear path that can be followed back in time when necessary. Supporting documents should be organized in good order and should be retained for a reasonable period of

time. The Internal Revenue Service (www.irs.gov) publishes recommended guidelines for records retention, which are a good point of reference for a business.

Limiting access to accounting records and end-of-year entries

Access to all accounting records should be strictly limited to accounting personnel, and no one other than the accounting staff should be allowed to make entries or changes in the accounting records of the business. Of course, managers and other employees may ask questions of the accounting staff, and they may ask for special reports on occasion. The accounting department can provide photocopies or scanned images of documents (purchase orders, sales invoices, and so on) in response to questions, but the accounting department should not let original source documents out of its possession.

Checking the background of new employees

Before any new employee is hired, management should have a thorough background check done on him, especially if he will be handling money and working in the high-fraud-risk areas of the business. Letters of reference from previous employers may not be enough. Databases are available to check on a person's credit history, driving record, criminal record, workers' compensation insurance claims, and life insurance rejection record, but private investigators may have to be used for a thorough background check.



A business should consider doing more extensive background and character checks when hiring mid- and high-level managers. Studies have found that many manager applicants falsify their résumés and list college degrees that they in fact have not earned, and any dishonesty could very well be a bad omen about future conduct.

Periodically reviewing internal controls

Consider having an independent assessment done on your internal controls by a CPA or other professional specialist. This step may reveal that certain critical controls are missing, or, conversely, that you're wasting money on ineffectual controls. If your business has an annual financial-report audit, the CPA auditor evaluates and tests your business's internal controls. But you may need a more extensive and critical evaluation of your internal controls that looks beyond the internal accounting controls. See the earlier section "Struggling with fraud committed by the business" for more on the benefits and possible consequences of hiring an outside CPA.

Appraising key assets regularly

You should schedule regular "checkups" of your business's receivables, inventory, and fixed assets. Generally speaking, over time these assets develop problems that are not dealt with in the daily hustle and bustle of activities and the time pressures on managers and other employees. Receivables may include seriously past-due balances, but these customers'

credit may not have been suspended or terminated. Some products in inventory may not have had a sale in months or years. Some items in fixed assets may have been abandoned or sold off for scrap value, yet the assets are still on the books and being depreciated.

One principle of accounting is that losses from asset impairments (damage, aging, salability, abandonment, and so on) should be recorded as soon as the diminishment in value occurs. The affected assets should be written off or the recorded (book) value of the assets should be written down to recognize the loss of economic value to the business. The decrease in asset value is recorded as a loss, which reduces profit for the period, of course. Generally, fraud isn't lurking behind asset impairments — although it can be. In any case, high-level managers should approve and sign off on asset write-downs.

Implementing computer controls

Computer hardware and software controls are extremely important, but most managers don't have the time or expertise to get into this area of internal controls. Obviously, passwords and firewalls should be used, and managers know about the possibility of hackers breaking into their computers, as well as the damage that viruses can cause. Every business should adopt strict internal controls over e-mail, downloading attachments, updating software, and so on.

If the business isn't large enough for its own IT (information technology) department, it has to bring in outside consultants. The business accounting and enterprise software packages available today generally have strong security features, but you can't be too careful. Extra precautions help deter fraud.

Curbing indifference to internal controls

Internal controls may look good on paper. However, the effectiveness of internal controls depends on how judiciously employees execute the controls day in and day out. Internal controls may be carried out in a slipshod and perfunctory manner. Managers often let it slide until something serious happens, but they should never tolerate a lackadaisical attitude regarding the performance of internal controls by employees.



Sometimes a manager may be tempted to intervene and override an internal control, not out of indifference but because bypassing the control will be more efficient or serve another purpose. This break in procedure, however well meant, sets an extremely bad example. And in fact in some cases it may be evidence of fraud by the manager.

Special rules for small businesses

The lament of many small business owners/managers is, "We're too small for internal controls." But even a relatively small business can enforce certain internal controls that are very effective. Here are basic guidelines for small business owners/managers:

- ✔ **Sign all checks:** The owner/manager should sign all checks, including payroll checks. This precaution forces the owner/manager to keep a close watch on the expenditures of the business. Under no conditions should the accountant, bookkeeper, or controller (chief accountant) of the business be given check-signing authority. These people can easily conceal fraud if they have check-writing authority.
- ✔ **Mandate long vacations:** The owner/manager should require that employees working in the high-risk areas (generally cash receipts and disbursements, receivables, and inventory) take vacations of two weeks or more and, furthermore, make sure that another employee carries out their duties while they're on vacation. To conceal many types of fraud, the guilty employee needs to maintain sole control and access over the accounts and other paperwork used in carrying out the fraud. Another person who fills in for the employee on vacation may spot something suspicious.
- ✔ **Get two sets of eyes on things:** Although separation of duties may not be practicable, owners/managers should consider implementing job sharing in which two or more employees are regularly assigned to one area of the business on alternate weeks or some other schedule. With this arrangement, the employees may notice if the other is committing fraud.
- ✔ **Watch out for questionable spending:** Without violating their privacy, owners/managers should keep watch on the lifestyles of employees. If the bookkeeper buys a new Mercedes every year and frequently is off to Las Vegas, you may ask where the money is coming from. The owners/managers know the employees' salaries, so they should be able to estimate what sort of lifestyles the employees can afford.

Considering some important details of internal control

Even when you know what internal controls you want to use, you must take care to implement them in ways that are legal, practical for the company, and effective. And you also need to know what to do if the controls fail and you have a case of fraud on your hands. The following sections address these important details that you may overlook in your eagerness to place controls and get back to business.

Considering legal implications

Pay careful attention to the legal aspects of internal controls and the enforcement of them. For example, controls should not violate the privacy rights of employees or customers (for example, no strip searches), and a business should be very careful in making accusations against an employee suspected of fraud. At the other extreme, the absence of basic controls can possibly

expose a manager to legal responsibility on grounds of reckless disregard for protecting the company's assets. For example, a business may not have instituted controls that limit access to its inventory warehouse to authorized personnel only, with the result that almost anyone can enter the building and steal products without notice. The manager could be accused of neglecting to enforce a fundamental internal control for inventory. You may need to get a legal opinion on your internal controls, just to be safe.

Evaluating cost effectiveness

One obvious disadvantage of internal controls is their costs — not just in money but also in the time it takes employees to perform the internal controls. Internal controls are an example of “managing the negative,” which means preventing bad things from happening as opposed to making good things happen. Rather than spending time on internal controls, employees could be making sales or doing productive activities. But putting it a more palatable way, internal controls are needed to manage certain unavoidable risks of doing business.



The mantra you often hear is that internal controls should be *cost effective*, meaning that the collective benefits of a company's internal controls should be greater than the sum of their costs. But measuring the cost of a particular internal control or the total cost of all internal controls isn't very practical, and the benefits of internal controls are difficult to estimate in any quantitative manner. In general, basic internal controls are absolutely necessary and worth the cost. In the last analysis, the manager has to make a judgment call on what level of internal controls to implement to achieve a reasonable balance between the costs and the benefits.

Hiding internal controls

Generally, internal controls should be as unobtrusive as possible to the outside parties the business deals with. Ideally, your customers and vendors should not take notice of them. If you're not very careful, internal controls can give the impression that you don't trust your employees, customers, or vendors. People are sensitive about accusations (real or imagined) that you think they may be crooks. Then again, people accept all kinds of internal controls, probably because they have become used to them. For example, bookstore customers hardly notice the small electronic chip placed in books, which is deactivated at the point of sale. On the other hand, bookstore customers probably would object to having to show a detailed receipt as they leave the store for all the books they have in their bag.

The exception to this rule is when a business wants to make an internal control obvious to help deter crime or to remind employees and customers that the business is watching them to help prevent fraud. For example, surveillance cameras may be positioned to make them clearly visible to customers at check-out counters. If you've been to Las Vegas, you probably noticed several internal controls in the casinos. But these controls are only the ones you can see. Casinos use many other internal controls they don't want you to see.

Don't forget about security measures

In addition to internal controls, most businesses need what are generally referred to as *security measures*. Some of these are obvious, such as locking the doors when the business is closed and limiting access to areas where products are stored. Other measures may or not be needed, such as security guards, surveillance cameras,

motion detectors, ID cards for employees, security tags and devices on products, and so on. Generally, these controls are not under the authority of the accounting department. Larger businesses employ a director or chief of security. In a smaller business, the general manager may have to take on this duty.

Following procedure when fraud is discovered

The main advice offered in the professional literature on fraud against a business is to establish and vigilantly enforce preventive controls. The literature has considerably less advice to offer regarding what course of action managers should take when an instance of fraud is discovered, other than recommending that the manager plug the hole that allowed the fraud to happen. The range of options facing managers upon the discovery of fraud, assuming that the facts are indisputable, include

- ✓ Beginning an investigation, which may require legal advice regarding what you can and cannot do
- ✓ Immediately dismissing employees who commit fraud or putting the person on paid leave until a final decision is made
- ✓ Starting legal action, at least the preliminary steps
- ✓ If applicable, notifying the relevant government regulatory agency or law enforcement

Recognizing Limitations of Internal Controls

A good deal of business is done on the basis of trust. Internal controls can be looked at as a contradiction to this principle. On the other hand, in a game of poker among friends, no one takes offense at the custom of cutting the deck before dealing the cards. Most people see the need for internal controls by a business, at least up to a point. The previous sections of this chapter discuss the need for and various aspects of internal controls. In conclusion, this final section offers two final thoughts for managers: the need to maintain management control over internal controls, and ways of finding fraud that is not detected by the internal controls of the business.

Keeping internal controls under control

Many businesses, especially smaller companies, adopt the policy that some amount of fraud has to be absorbed as a cost of doing business and that instituting and enforcing an elaborate set of internal controls isn't worth the time or money. This mind-set reflects the fact that business by its very nature is a risky venture. Despite taking precautions, you can't protect against every risk a business faces. But on the other hand, a business invites trouble and becomes an attractive target if it doesn't have basic internal controls. Deciding how many different internal controls to put into effect is a tough call.

Internal controls aren't free. They take time and money to design, install, and use. Furthermore, some internal controls have serious side effects. Customers may resent certain internal controls, such as checking backpacks before entering a store, and take their business elsewhere. Employees may deeply resent entry and exit searches, which may contribute to low morale.

So even if your business can afford to implement every internal control you know of, remember that more is not always better. Limiting the business to a select number of most effective controls may provide a good balance of protection and customer and employee tolerance.

Finding fraud that slips through the net



Internal controls are not 100 percent foolproof. A disturbing amount of fraud still slips through these preventive measures. In part, these breakdowns in internal controls are the outcome of taking a calculated risk. A business may decide that certain controls are not worth the cost, which leaves the business vulnerable to certain types of fraud. Clever fraudsters can defeat even seemingly tight controls used by a business.



Internal controls should be designed to quickly detect a fraud if the first line of internal controls fails to prevent it. Of course, responding to this detection is like closing the barn door after the horse has escaped. Still, discovering what happened is critical in order to close the loophole.

In any case, how can you find out if fraud is taking place? Well, the managers or owners of the business may not discover it. Frauds are discovered in many ways, including the following:

- ✓ Alarms that call attention to suspicious activities may be raised in the normal internal reports to managers, such as unusually high inventory shrinkage for the period that has no obvious cause.
- ✓ An internal audit may find evidence of fraud.
- ✓ Employees may blow the whistle to expose fraud.

- ✓ Customers may give anonymous tips pointing out something wrong.
- ✓ Customer complaints may lead back to discovery of fraud.
- ✓ A vendor may notify someone that they have been asked for a kickback or some other under-the-table payment for selling to the business.



In financial statement audits, the CPA tests internal controls of the business. The auditor may find serious weaknesses in the internal controls system of the business, or instances of material fraud. In this situation, the CPA auditor is duty bound to communicate the findings to the audit committee or to other high-level executives of the business.

Large businesses have one tool of internal control that is not practical for smaller businesses — *internal auditing*. Most large businesses, and for that matter most large nonprofit organizations and governmental units, have internal auditing departments with broad powers to investigate any of the organization's operations and activities and report their findings to the highest levels in the organization. Small businesses can't afford to hire a full-time internal auditor. On the other hand, even a relatively small business should consider hiring a CPA to do an assessment of its internal controls and make suggestions for improvement. In fact, hiring a CPA for this job may even be of more value than having an independent CPA audit the business's financial statements.

Chapter 14

Managing the Selling Cycle to Improve Cash Flows

In This Chapter

- ▶ Looking at the big picture of the selling cycle
 - ▶ Protecting cash in the sales cycle through basic controls
 - ▶ Finding out some unconventional methods for improving cash flows from sales
 - ▶ Seeing how lending agreements affect your selling cycle
-

For most businesses, cash inflows are derived from two primary sources. First, as discussed in Chapters 10 and 11, cash or capital can be secured from external sources including investors, banks, and/or other lending sources. Transactions to secure this type of cash tend to be nonrecurring and focused on special needs or events (for example, securing seed capital when a business is first formed and launched or taking new loans to support a significant business expansion).

The second and more important source of cash is what's generated internally from the selling cycle. Unlike during the dot-com era of the late 1990s (when, for the briefest of moments, the markets discounted the importance of actually generating sales), businesses today do in fact need to generate real sales that can be quickly and efficiently turned into cash. This chapter focuses on how you can use the selling cycle to maximize cash inflows.



Generating cash from the selling cycle can and should be actively controlled and managed with internal resources. External sources of cash, which still must be managed, are often unpredictable and influenced by unforeseen or uncontrollable forces and events (which make them more difficult to manage and, thus, the predictability of securing cash from external sources is more challenging). Remember, proactive management of the selling cycle is a function that can be controlled internally and often can produce more-reliable sources of cash (than finding yourself always waiting on the decision of another party).

Understanding the Entire Selling Cycle: Start to Finish

The concept of the selling cycle can be looked at from many perspectives but basically boils down into one of two views: the accounting/financial perspective versus the strategic view. In this section we give you an overview of both.

The accounting/financial view

The accounting/financial perspective of the selling cycle is generally fairly narrow. In this view, the selling cycle typically starts when a “hard” transaction is executed — that is, when an actual sales order or contract is received from the customer and an agreement has been entered that stipulates terms and conditions of when the requested goods or services will be delivered and the need for any credit review and approval. After these items have been addressed, this accounting sales cycle continues through delivery of the goods or services and eventually collection of the balance due. In some cases, the accounting cycle can be as quick as less than one hour (just think of a customer purchasing products in Walmart) or may last six months or longer (say, in the case of a defense contractor such as Boeing building and delivering planes).



The key point with the accounting selling cycle is that it is very narrow in scope and doesn't properly capture the true or real amount of cash required to support the entire selling cycle (from customer identification through to customer retention).

The strategic view

The alter ego of the accounting/financial selling cycle is the strategic point of view, which looks at how a business operates and generates sales from the very beginning (conducting market research on target customers and developing a sales pipeline) to the very end (managing customers' expectations and providing additional support and service well after the sale).

Customers just don't magically appear when a business opens its doors and begin ordering goods and services. Instead, the process of identifying, courting, securing, managing, and retaining customers is a far more complex and management-intensive process than some people realize. For example, for a company like Boeing, the process of actually securing a contract from the Department of Defense to build planes can take years to finalize and will undoubtedly involve multiple parties within Boeing, including engineers (to

support design requirements), legal personnel (to support contractual obligations), manufacturing employees (to address production capabilities), and even accountants (to quote and support overhead rate calculations).

Even a small retail business that opens in the local strip mall must develop an economically viable business model that ensures a product or service of value is offered at a competitive price to its target customers, reached via efficient marketing, promotional, and advertising efforts. So although a customer may enter this retail business, browse, and spend \$100 on a product, all within a half hour, the time and effort required to actually bring that customer into the store more than likely took months and multiple times the amount of money spent during the first visit.

Why the sales cycle is the biggest consumer of cash

An old but very true saying in the restaurant business is that you always lose money on a customer's first visit because the profit generated off the first visit in no way even comes close to covering the costs of the entire selling cycle — accounting for all the costs incurred to get the customer in the door (the first time). This axiom really holds true for almost all businesses, because without repeat customers, failure is almost always guaranteed. Therefore, when a company develops its strategic business plan, it must understand the concept of the entire selling cycle to ensure that adequate cash resources are secured and managed from start to finish.

The sales cycle is a big consumer of cash because of the concept of *compounding*: the accumulation of all efforts of the sales cycle that must be completed in sequential steps, throughout which any delay in one element of the sales cycle slows down the entire sales cycle. The advertising campaign must wait until the product or service is developed into a commercially viable status. And this wait for the advertising campaign delays the point at which customers can be reached, which causes a lag to work its way through the entire sales cycle by delaying quotes, sales orders, goods or services delivery, invoicing, customer payments, and eventually, being able to generate repeat business from the customer. And all along the way and with basically every step, cash is being consumed, until that magical day when the first dollar is actually received (which is immediately framed and placed on display for everyone to see).

So when managing the sales cycle, utilize the following three strategies to help maximize cash flows derived from the selling cycle:

- ✓ Develop, implement, and manage proper policies, procedures, and controls throughout the entire selling cycle.
- ✓ Know your customers and your selling cycle inside and out.

- ✓ Remaining adaptable, flexible, and retaining some creativity when working with customers can go a long way to improve cash flows.
- ✓ Understand how cash can be generated or “manufactured” during the selling cycle through the windows and opportunities that present themselves.

You may wonder why we focus on the entire selling cycle so intently. Well, for almost every business we’ve ever worked with, the selling cycle always takes longer than the business’s managers think it will. And mishandling the selling cycle and running out of cash is a good way to go belly up in a hurry. So with this warning in mind, the remainder of this chapter focuses on bringing in cash from the selling cycle quickly and possibly driving sales higher by turning your accounting function into a sales resource and tool.

Implementing Basic Controls in the Selling Process to Manage Cash

Every business has a selling cycle that’s unique to that company. Some companies, such as retail stores or ecommerce sites, rely heavily on point-of-sale customer purchases (via accepting cash, credit cards, debit cards, or other forms of electronic payments) to realize the end of the selling cycle (at least from a cash perspective). Others, such as manufacturing companies or distributors, generally invoice or bill their customers, who then remit payments via checks or by using electronic forms of payments. But no matter the specifics of each sales cycle, all businesses must establish a standard set of basic sales controls to ensure that the entire selling cycle is optimized both from the net-profit and cash-flow-generation perspectives. In this section we walk you through these typical and necessary controls.

Qualifying the customer

The concept of qualifying customers goes well beyond simply identifying customers who will be able to pay for goods and services purchased. Rather, customers need to be evaluated from the broad perspective of how much profit they generate in relation to the amount of capital your company must invest to support them. For example, if you have a relatively small customer who demands frequent support and service, takes 60 days or more to pay, and is constantly looking for price discounts and/or other sales perks, the actual profitability from this customer may be quite low. Your business may prefer to work with other customers who generate you more earnings.

Another example of properly qualifying a customer is looking at the “reputation” risk associated with doing business with a specific customer (and the damage your business’s image may sustain). Enron was considered one of the most successful businesses through the early 2000s, but when the company imploded, not only did a number of vendors lose money from not collecting receivables, but they also had to deal with the Enron association factor (was your business aware of and a party to the fraud?).



Businesses need to understand that the amount of invested capital required to support customers goes well beyond the simple calculation of determining how long it takes for the customer to pay (which we discuss in Chapter 5). The profitability of a customer encompasses numerous factors, which range from how the customer was initially obtained to what efforts are required to ensure that a repeat customer is present. Businesses really need to complete a more thorough review on potential customers by completing a number of steps as follows:

- 1. After a customer has been identified, management should focus on whether the customer fits into the ideal business target or profile (established in the business plan) in terms of potential annual revenue levels, specialized product or service requests, and similar subjective factors.** Experience and industry knowledge are critical to supporting this process because, while the numbers are important, there’s no replacing extensive experience (when qualifying customers).
- 2. Management needs to evaluate the financial strength of the customer to assess whether they can even pay (by reviewing their financial statements and credit reports), and if they can, how long payment will take.** Also, establishing customer credit limits should be considered at this stage as well.
- 3. With the customer identified as being valid and quantified as being viable, ongoing assessments of the customer’s real economic return need to be completed.** For example, customers may play the partnership and “win-win” game at the start of the relationship, but if they are simply short-term, price-sensitive customers that will move to a new supplier at the drop of a hat (versus long-term, value-orientated customers), then the termination of the relationship needs to be considered.

These three steps are not meant to be all-inclusive of every step a business can take to qualify a customer, but the steps do highlight the basic logic in the qualification process. First, is the customer a proper fit in relation to the business plan? Second, is the customer’s financial strength adequate to ensure that your business is paid? Third, does the customer really represent a valued long-term relationship or a pain in the butt who eats into operating margins (which usually can’t be determined until the relationship has developed over a period of time)?



Customers can be disqualified for any number of reasons specific to a situation. For example, a large staffing company supported numerous customers from a wide variety of industries. As part of its business model, the staffing company paid workers' compensation insurance for all the workers it sent out to fill open positions at customer companies. Workers' compensation insurance is determined by numerous factors, one of which is a company's specific experience with losses. One of this staffing company's customers had a particularly bad safety record, which caused injuries to the temporary employees provided to the customer, impacting the workers' compensation rate for the entire company and increasing premiums for all employees. The staffing company had to terminate this customer, because its negative impact on the overall business was far greater than the profit generated from the single account.

Being prudent with credit review and approval

All businesses should implement proper policies, procedures, and controls for extending credit. Even retail businesses, which derive most of their sales from POS (point-of-sale) transactions, make sure to obtain proper credit approval by getting authorization for electronic forms of payments (credit and debit cards, PayPal, and sometimes even checks) before the sale is completed. However, for most businesses, a more formal and proactive credit review and approval process is required to ensure that after you make a sale, you actually get paid.



Establishing initial credit is one thing, but applying proper credit review and approval processes on an ongoing basis is something completely different. Credit defaults occur more often from a failure to continuously apply credit policies and procedures than from poor initial efforts. Remember, economic conditions can change quickly at both the macro and micro levels, so constant revisions and evaluations of customer credit are essential to limiting future losses.

The following sections cover basic credit review and approval policies and procedures that your business should use to prevent losses. We present the simpler efforts first and then move to more-extreme measures you may want to take.

Utilizing credit agencies and other external reporting/informational bureaus

A number of credit reporting agencies, such as Dun & Bradstreet, provide credit reports and other information on potential customers (for a price, of course). These sources are easily accessible and provide solid information and credit ratings on potential customers. The downside to these sources is that sometimes the data being provided can become stale, or outdated,

because getting timely information from businesses can be a challenge and business conditions can change quickly. Credit agencies are an important tool, but they should be used as part of the entire credit process and not as a stand-alone resource.



Leveraging a network of local contacts and professional references is a great way not only to generate business but also, more importantly, to obtain market financial information on potential customers. Joining a trade organization in your business's region or niche with a specific market interest can be a great way to secure information on potential customers, because a number of trade organizations offer credit and business referral data. Better Business Bureaus are another external resource that can be tapped to support the credit review and approval process.

Processing internal credit applications and references

Businesses often utilize internal credit applications that request numerous pieces of information from customers, ranging from where they bank to how they're performing to who their largest creditors are. Whether this data is obtained from an actual credit application or through other means (customer websites, publicly reported financial data on file with government organizations, or other sources), your business should accumulate it for all customers and keep it up-to-date. Not only is this info essential to have in the event a customer defaults on payment obligations (to track down the customer and pursue collection efforts), but it can also provide vital information on the customer that your business may be able to mine to generate additional sales.

Your customers should always be willing to provide references, including banks or financial institutions they utilize or other suppliers they conduct business with, which your business can use as needed. References are not designed to obtain actual financial information but rather are geared more toward securing information on the nature of the relationship (such as easy to work with, professional, communicate well, and so on). When customers balk at providing references, the red flags should go up.



A customer data sheet can gather the same information as a credit application and may be viewed in a less hostile manner by the customer. Some customers view the process of applying for credit as an insult or waste of time, so rather than battling with the customer, developing a customer data sheet that's structured in a manner that emphasizes the long-term relationship and future sales potential may be received more favorably (and may help generate additional sales). It should be noted that the final decision to extend credit can be based on the credit application, the data sheet, both, or neither, because the final credit decision may take into account other considerations that are not disclosed in these documents. The idea with these documents is to support or enhance the credit decision process rather than to be used as the only source of information to make a credit decision.

Implementing the use of electronic forms of payments

When your business has concerns about a customer's creditworthiness, establishing multiple forms of electronic payment functionality is often very prudent. For instance, you may want to accept credit cards (including having a customer's credit card on file to charge if needed) and also set up ACH (automated clearing house) or EFT (electronic funds transfer) options such as PayPal to allow for processing payments in the new digital age. In some cases, credit card payments may not work given the size of the transaction being processed or the type of card the customer uses (for example, American Express is not accepted by your company), so having backup or alternative forms of receiving electronic payments is prudent. Even though your company may have to pay fees to process electronic payments, the fees pale in comparison to the time, effort, and losses realized from customers not paying.



The ability to process payments electronically not only assists with collection efforts and reduces bad debts but in addition may potentially increase sales. Larger corporations now basically insist that all their vendors accept electronic forms of payments. These payments may still take a while to receive (large corporations are notorious for slow payments), but by being able to accept electronic payments, your company may have the opportunity to expand business with certain customers.

Completing more-detailed financial reviews

In some situations you may require a more thorough credit evaluation of a customer, including a complete review of the customer's financial statements and operating performance. These types of efforts are generally reserved for customers who will be engaging in very large transactions and that in a sense may be more of a partner than a customer. Of course, each situation varies, but consider completing more-comprehensive financial reviews for customers who drive 10 percent or more of your annual revenue. The trade-off is the time, effort, and cost associated with completing a detailed review in relation to the value gained (or loss prevented) from undertaking this type of effort.

Obtaining collateral or guarantees (corporate or personal)

A credit-review and approval policy being used more and more by businesses is obtaining collateral and/or guarantees in exchange for extending credit. A very common form of guarantee relates to parent-subsidiary business structures where the parent company is financially solid with ample resources, but the subsidiary (the parent owns) is relatively young with a limited operating history. Under this scenario, a supplier to the subsidiary may request a parent guarantee for a year or two until the subsidiary's financial strength and operating history improves.

The Great Recession has changed the environment related to requesting collateral or guarantees, making them a more acceptable control against potential bad debts, especially for customers who have experienced financial difficulties, who demonstrate slow payment patterns, and/or who request a significant increase in credit. The good news with using this type of strategy is that payment is all but guaranteed (in one form or another) and your customer displays a commitment to the business relationship. The bad news is that this control is still considered an extreme measure, and to be quite honest, not many of your customers will happily provide collateral or offer a guarantee to receive credit. These types of requests can often rub the customer the wrong way. Another downside is that you'll generally require the involvement of professional counsel to make sure that the proper documentation is prepared and executed.



One strategy to consider when requesting collateral or guarantees is to allow the customer to remove these requirements when certain milestones are met. For instance, if a customer needs increased credit for only a 90-day period, the guarantee or collateral may only be required during this period. After the customer returns to normal credit and payment patterns, the collateral and/or guarantees can be removed. Displaying a willingness to work with customers provides the dual benefit of gaining loyalty and sending a message to your customer of being an astute business person.

Setting proper terms and conditions

While conducting the credit review and approval process, you want to simultaneously establish customer terms and conditions. For each customer, consider the following key questions and then clearly communicate your answers to the customer if you approve the credit request:

- ✓ **How much credit will your business extend?** The answer to this question depends on the credit review and approval process discussed in the preceding section and varies by company and with each customer. So a better way to skin this cat is to ask yourself another question: How much can my business afford to lose on a bad debt without damaging operations significantly? If your credit review and approval efforts were limited to the first two strategies noted in the previous section (relying on reports from credit agencies and internal credit applications and references), then a safe range of credit may be no more than 1 percent to 2 percent of your total sales. So if your business generates \$10,000,000 a year in revenue, extending credit of \$200,000 to a single customer would be reasonable.



For most businesses, diversifying the customer base so no more than one customer accounts for 2 percent to 3 percent of total revenue is difficult. Businesses tend to observe the 80/20 rule, which says that 80 percent of sales come from 20 percent of customers. With this reality

in mind, businesses often extend credit levels well in excess of 5 percent of total company annual sales to support larger customers. If your business engages in significant credit extensions, be sure to undertake added credit review and approval processes to support and assess the added risks associated from potential large defaults.

- ✔ **What are the payment terms?** After the amount of credit has been determined, the actual payment terms need to be set. Probably the most common payment term utilized by businesses extending credit is *net 30*, which means that the customer has 30 days from the invoice date to pay. The variety of payment terms are extensive and are often tailored to the tendencies of a specific industry. However, the general rule of thumb is that for higher-credit-risk customers, payment terms are shorter and monitored very closely to limit potential losses. (In other words, keep these customers on a short leash.) For stronger, more-established customers, payment terms can be extended.



When establishing payment terms, make sure you understand the customer's paying habits and cycles to properly manage cash flows. Extremely large companies, including the biggest corporations operating in America, often leverage their supplier's payment terms. If you offer net 30, they will pay in net 60. If you offer a discount if they pay in 10 days, they will still take the discount if they don't pay for 45 days. Be prepared to make allowances for big customers. Of course, by stretching or changing the payment terms, you could easily assume that they have defaulted. Well, good luck in pursuing any action, because in the end, they will use their size and deep pockets to leverage payment terms to their liking. You may not consider it fair, but "it is what it is," and large corporations are going to leverage the relationship to their advantage.

- ✔ **Where will the customer take possession of the products sold?** Your business must determine which party is responsible for transporting products from your location to the customer. If you opt for *FOB (free on board)* at your company's dock, then the customer is responsible for either picking up the product from your dock/location or arranging for a common carrier to transport the goods. If you use the terms *FOB [the customer's dock/location]*, then your business is responsible for shipping the goods to the customer. Although your business would probably like to determine the FOB status, in a number of cases (and especially with large customers), the customer will dictate this term.

Both strategies have pros and cons:

- For FOB your dock, you pass the shipping responsibility, risk of loss, fees, and so on to the customer at your dock. In addition, your business can invoice the customer earlier (rather than wait until receipt by the customer). The downside to this strategy is the customer service aspect, because this requirement may irritate the customer with having to manage additional tasks (for example, coordinating shipment).

- FOB customer's dock is a much more attractive proposition for the customer but requires more effort on your part to coordinate the shipment. Your business also assumes additional risk of loss (if something were to happen during the shipment) and must wait to invoice until the shipment has been received. In addition, the cost of shipment or freight may become an issue, because if the customer doesn't want to pay for the freight, you will most likely have to eat this expense.

✓ **What legal matters need to be disclosed?** Clearly stating all critical legal terms and conditions is very important in the terms of credit extension. Legal matters to address include when the risk of loss is transferred (for example, upon delivery or at final customer acceptance), any warranty information, return policies (including any restocking fees), and various other matters (which tend to be driven by the unique or specific issues associated with different industries).

Supplying CART — complete, accurate, reliable, and timely — invoices

One of the most tried-and-proven strategies resulting in improved cash flows from the selling cycle is as basic and as simple as it sounds: Apply the concept of *CART* by producing complete, accurate, reliable, and timely invoices. When invoices properly agree with and match the terms and conditions established in the original customer purchase orders (which represent your sales orders), you reduce the risk of customers rejecting the invoices for payment.



If the invoice isn't complete, accurate, and reliable, the customer's payable system kicks out the invoice and cycles it through an exception process within their accounting system to resolve the discrepancies. Customers that are experiencing financial difficulties may be eager to use inaccurate invoices as an opportunity to delay payments. In the end, the invoice will probably be approved and paid, but the delay may range from a couple of days to months (slowing down your cash flows).

As for the timely aspect, quickly producing and forwarding your invoice to your customer for processing should result in your business receiving speedier payments. So if you can process monthly invoices on the first of the following month and not wait until the fifth business day of the following month, then cash receipts should accelerate as well. To help the system run smoothly, develop a billing system that ensures the required information needed to bill customers in a timely manner is readily available (and doesn't take days to accumulate).



Reviewing the basic accounting and operational controls, policies, and procedures to ensure that your business produces CART invoices is beyond the scope of this chapter. However, you can take a big step in the right direction by making every effort to ensure that the terms and conditions set in the customer's purchase order, sales contract, or internal sales order generated are consistent with the invoice generated.

Managing past-due accounts and collection efforts

The final basic procedure of the selling cycle is management of the sale after it has occurred. Up to this point, the customer has been qualified, subjected to a credit review and approval process, given sale terms and conditions, and provided with a CART invoice. All these events occur prior to and at the point of actual sale — and, in some cases, after the point of sale (for example, a customer may be billed once a month for a number of purchases made during the month, which are accumulated on one invoice for easier reading and processing). Now we turn our attention to how past-due accounts can be managed to improve cash flows and limit losses.

Managing collection efforts is an ongoing and critical function that should be addressed on a periodic basis. A number of companies implement weekly reporting requirements that highlight all collection efforts, provide updates on how receivables are performing or trending, and note any significant problems that may be brewing. Building management discipline (periodic and timely review of receivable reports by the appropriate management team members) into your collection processes will enhance future results.

When customers delay payments, management needs to implement proactive efforts to collect the outstanding receivable. You can implement two strategies for collecting the balance due: internal efforts and external efforts.

Internal collection efforts

Internal collection efforts vary by company and situation, but all businesses should use the same basic steps to improve the collection results without impairing or damaging a customer relationship:

- 1. Positive confirmation: Check that the customer received the invoice and verify all information, terms, and conditions.** If the customer claims not to have received the invoice, forward a copy via certified mail or e-mail. (If you e-mail, ask for positive confirmation of receipt by the customer.) When the customer has received the invoice, immediately confirm when it will be paid.

Keeping open lines of communications and a professional and positive approach are very important. At the same time, firmly and clearly let the

customer know that past-due invoices will not be tolerated. As the old saying goes, if you give an inch, they'll take a mile, so you must condition your customers to pay on time. To stay on top of potential problems, we recommend that you undertake positive confirmation efforts within seven days of the invoice becoming past due.

2. **Secondary contact: If the initial positive confirmation efforts are not fruitful, make an effort to work with the customer by establishing a payment plan, confirming when payments will be made, offering alternative methods for payment, and/or looking to resolve the outstanding balance due with other creative strategies (such as collateral).** You may attempt these more forceful and direct collection efforts from as soon as 14 days past due to as late as 60 days past due (depending on the customer). Regardless of when you begin offering various options, keep up constant customer contact. Remember, sometimes the best collection strategy is simply being a pest — but keep your pestering friendly and positive.



Get the sales representative who consummated the initial sale actively involved in the collection effort. This strategy can be very helpful for a couple of reasons. First, the sales representative has an established relationship with the customer and therefore can speak to contacts in a manner that may be more effective. Second, if the sales representative earns a commission based on when cash is received from the sale, then he or she has a vested financial interest to collect and will make collection a priority.

3. **Final contact: If payment still doesn't arrive, present the customer with an ultimatum to pay or suffer the consequences.** Consequences may include placing the customer on COD (cash on delivery) terms for future transactions, restricting future sales, turning over the account to a collection agency, and/or threatening legal action (a threat can sometimes be as fruitful as actually pursuing legal action). The idea with these consequences is to strongly encourage payment instead of pursuing a course that actually forces a payment.

When the point of final contact is reached, document your company's position and clearly relay it, with positive receipt confirmation, to the customer. If the customer begins to default on previously agreed-to payment plans (generally structured during the secondary contact stage), ceases communications, and/or undertakes a disinformation campaign, then it's time to raise the red flag and consider more-aggressive collection tactics (including moving from threatened legal action to actual legal action or turning the account over to a third-party collection agency to secure payment).

In summary, the consequences are really used as the first option in the final contact stage and is designed to strongly encourage payment (but not force payment). The second option then really becomes forced collection action, which is usually pursued in the form of retaining collection agencies (for smaller and more-routine matters) or attorneys (for larger and more-complex matters).

What if your customer goes bankrupt?

Most businesses that extend credit do so in an unsecured fashion, meaning that they don't obtain security in the customer's assets or take collateral. An unsecured position is generally the worst spot to be in when the customer experiences financial problems and can't pay everyone. The secured creditors and priority credits get paid first, and then whatever cash is left over gets divided up between the unsecured creditors. In bankruptcy proceedings, the unsecured creditors usually get hammered and receive (if they're lucky) 25 percent of the balance owed. So the trick to improving collection results is finding a way to move your claim from unsecured to priority.

One example of how a creditor was able to move up the priority ladder is a staffing company that provided staff and paid payroll of the staff to the company. The staffing company was able to move up the priority ladder by successfully claiming that 70 percent of their invoices

to the company were for payroll and payroll taxes (and not general services). In bankruptcy proceedings, unpaid payroll and payroll taxes represent priority obligations that need to be paid before unsecured creditors are paid. So by moving up the priority ladder, the staffing company received 70 percent of their claim rather than the 10 percent it would have gotten otherwise from the trust of assets set aside for allocation to the various creditors (from liquidating the bankrupt company's assets). Although this example is somewhat unique, the primary point we want to drive home is that in order to move up the priority ladder, you must have a very strong case and set of circumstances to support why your claim should receive preference. Clearly, the dangers of being an unsecured creditor are significant in a bankruptcy proceeding, but options do exist (although limited) to improve your chances of collection outstanding balances due.



Document all collection efforts in writing with letters, e-mail, collection effort notes in an electronic system, or whatever other means available. Having a documented trail of collection efforts can greatly assist in the recovery effort, especially when third parties are secured to help resolve a dispute (because the party that is better prepared with quality supporting documentation generally receives more-favorable outcomes).

External collection efforts

Every company must determine at what point the collection effort must be turned over to external resources. That point may be 30 days past due, 60 days past due, or even longer (and is really dictated on a case-by-case basis, depending on the industry you operate within and potential unique issues with the customer). Be aware, though, that when external resources are used, the relationship with the customer will be damaged. In fact, when you employ external collection resources, you can pretty much kiss the customer goodbye.

External collection efforts are outside professional services and resources used to secure payment. Basically, external efforts boil down to the two following options:



✔ **Collection agencies:** Countless collection services are available to choose from when you need to retain a third party to secure payment. Most collection agencies work on a commission; if you don't get paid, they don't get paid. The good news with collection services is that they're very knowledgeable about their trade and have a wide range of resources available to help secure payment. Plus, the collection service takes care of the dirty work of playing the bad guy to collect money due. The bad news with collection services is that their fees can often exceed 25 percent of the amount collected, and their tactics tend not to be customer friendly.

Collection agencies offer a full range of services and are very competitive, so we recommend that you do some comparison shopping. Certain agencies may offer a broader range of services, including providing support on pursuing collections through taking actions to small claims court. When evaluating the effectiveness of collection agencies, consider the trade-off between price and range of collection tools.

✔ **Professional resources:** For larger or more-complex collection issues, securing professional resources in the form of legal and/or financial advice generally becomes a necessary step. Missteps with large or complex issues can often prove to be very costly, so protecting your business and financial interests with professional counsel needs to be evaluated from a cost-versus-benefit standpoint.

1. **The first step with securing professional resources is to determine if the cost of retaining professional counsel (such as an attorney) is reasonable compared to the expected payout from the customer.** If an attorney is going to cost \$25,000 and the expected customer payment is, at best, \$15,000, there's not much point in pursuing this course of action.
2. **The second step is to determine if the matter is better resolved through an independent third-party settlement or arbitration proceeding (a qualified and independent third party agreed to by both parties to settle a matter) versus actually pursuing legal action in the form of a lawsuit.** Arbitration proceedings are commonly used in today's environment to avoid the added time, effort, and money it takes to actually take a collection case to court.
3. **The last step is to pursue a collection matter with an actual lawsuit (whether processed in small claims court or through regular court channels).** Needless to say, the lawsuit or "court" route should only be used with very large and complex collection matters (and really represents the exception rather than the rule).

When applying a cost-versus-benefit analysis on a collection issue, remember to incorporate all critical facts and data. For instance, if you're owed \$100,000 but professional legal counsel is going to cost \$25,000 to secure payment (in the form of representing your company in a settlement proceeding or lawsuit), you may quickly conclude that the \$75,000 of net receipts is more than

enough to pursue legal action and cover the \$25,000 of costs. However, if you estimate that your company only has a 33 percent chance of collecting the balance due and that internal management resources will be consumed to support the process, the expected net receipts begin to drop considerably and may not be worth it.

Getting Creative to Improve Sales-Related Cash Flows

After you get a solid handle on the basics of cash flow in the sales cycle, addressed in previous sections of this chapter, you're ready to turn your attention to utilizing more-creative sales-cycle policies and procedures. On one hand, these procedures can accelerate or improve cash flow, but on the other hand, they do come with a price (usually in the form of added interest costs or one-time fees or charges). The list of ideas in this section is by no means complete, but it does provide a sampling of the types of strategies your company can use to accelerate the receipt of cash from the sales cycle.

Using discounts: The double-edged sword

A very commonly used payment term, net 30, gives customers 30 days from the invoice date to pay. This payment term is often expanded by providing the customer a discount such as *2 percent 10, net 30*. What this payment term means is that payment is due in 30 days but a 2 percent discount will be provided if it is paid within 10 days. This offer sounds great and can really improve cash flows, because if all invoices are paid within 10 days, receivable balances can be kept to a minimum. Another popular tactic is to offer *3 percent on receipt, net 30*, in which a 3 percent discount is offered if customers pay as soon as they receive the invoice (with payment otherwise due in full in 30 days).

But you can't have your cake and eat it too: Offering discounts brings two significant risks. First, larger customers may simply take the discount but still pay you in 30 to 45 days. They can use their leverage (banking on the fact that you don't want to lose a large customer) to extract the discount from your company even if they technically aren't abiding by the terms. Second, as highlighted in Table 14-1, offering discounts when translated into an effective interest rate can be very expensive indeed.

Table 14-1 **The Cost of Providing Discounts**

<i>Discount Terms Provided</i>	<i>Discount Amount on Invoice of \$1,000</i>	<i>Implicit Interest Rate If Customer Pays in 30 Days</i>	<i>Implicit Interest Rate If Customer Pays in 45 Days</i>
1% 10, net 30	\$10	18.00%	10.29%
2% 10, net 30	\$20	36.00%	20.57%
3% on receipt, net 30	\$30	36.00%	24.00%

So before you jump headfirst into using discounts, think closely about the trade-offs that will be realized. Although the discounts are not reflected as interest expense in the financial statements, your business will need to reflect the customer discounts taken as a reduction from gross sales to reflect a net sales figure earned. In the above example, if a customer took a \$20 discount for paying within ten days, then the company's net sales would be \$980 (and not \$1,000) so in effect, the company has realized a \$20 expense to accelerate the receipt of cash.

Offering creative payment terms

Payment terms come in all shapes, sizes, and forms and may range from requiring prepayments or deposits (to cover a portion of a large project) to extending payment terms to two years or more (for example, in the case of payments made when a lawsuit is finally settled). The real battle with becoming creative with payment terms is the balancing act you must undertake between using these terms to improve cash flows while at the same time structuring terms to improve customer satisfaction and increase sales opportunities (which generally require longer payment terms).

The following three examples of creative payment strategies highlight various alternatives that address both objectives:

- ✓ **Covering out-of-pocket “hard costs” first:** When companies sell goods or services, the invoice to the customer should cover both the cost of providing the goods or services and a profit (if not, you're not going to be in business very long!). So one strategy to help manage risks is to structure dual payment terms that ensure your hard costs are paid within 30 days while letting your profit be paid with slightly more-favorable terms. This type of strategy is not appropriate to use for the masses, (such as a business that cannot separate hard costs from profits easily, or a high-volume, low-selling-price business such as a retailer),

but it can be effective with larger or unique situations. Floating the profits can help manage your company's cash needs, while at the same time providing some flexibility to your customers.

An example of when this strategy may be appropriate is for a research and development project. The project may require additional external costs to be incurred as well as increasing the number of employees to support the project. These added hard costs can be quantified and billed to the customer in advance or early in the project, whereas the overhead and profit component of the project can be billed later.

- ✓ **Letting your customers pay when they get paid:** In some industries, such as construction, customers pay invoices from creditors when their own invoices are paid. In other words, "When I get paid, you get paid." So instead of extending an actual grace period for customers to pay (such as net 30 days), you may want to select a date for payment that you know relates to when your customer is getting paid (which generally you would obtain directly from your customer via verbal confirmation or in some cases, documentation in an executed contract noting when payments will be received). Proper coordination of payments should be pursued to avoid getting bumped to the next month.
- ✓ **Adjusting when the customer gets the products (and pays the bill):** A number of customers place blanket purchase orders to secure products over a period of time. In some cases, the purchase order requests the majority of the products be delivered over a short period of time (for example, by November 10 to support the holiday season). Although this arrangement may be ideal for the customer, the supplier can get trapped into delivering products in an unlevel manner. A strategy to help manage this requirement is requesting level loading delivery schedules with associated invoicing occurring at the same time. Instead of delivering 9,000 units of a 10,000-unit order over a 30-day period, a request could be made to deliver 2,000 units over five like periods and bill accordingly. This proposal can be further expanded by offering free storage and shipping in the event the customer doesn't have the capacity to accept the products until a specific date.



The variety of payment terms available for use are endless and often are heavily influenced by industry trends and norms. For example, consigned inventory programs are actively utilized in the jewelry industry in order to make sure that adequate product levels are on the store shelves for the critical shopping seasons. When the product is sold, then the supplier looks for payment within seven days. But remember, if your business uses creative payment terms, make sure that any lending facility established that advances funds against customer invoices is properly structured to account for these terms. For further information on this topic, refer to the section "Managing the Lending Agreement in Relation to Your Sales Cycle" later in this chapter.

Using deposits, advances, and prepayments

Companies have been using deposits, advances, and prepayment requirements for decades as a means to accelerate the receipt of cash and have the customers share in the risk (so to speak). Pre–Great Recession, this type of strategy worked well for a number of industries, including construction, defense, and research, in which it made perfect sense to receive a portion of the costs upfront to support a large project with a relatively long delivery timeline. The classic approach of requesting 30 percent down, 30 percent on achieving the first milestone, 30 percent on the second milestone, and 10 percent upon completion is a tried-and-proven business strategy that continues to be used successfully throughout the economy.

But since the Great Recession of 2007 through 2009, the use of deposits, advances, and prepayments has taken on an entirely new meaning that goes well beyond the classic purpose of these payment tools. The reason for the increase in popularity is centered in the fact that traditional sources of credit from banks and other lenders have decreased as a result of tightened and much stricter underwriting standards (so businesses must look elsewhere for credit).

Arrangements these days offer new benefits, both for the customer and your business:

- ✔ **Benefits to the customer:** The largest and strongest corporations sit on mounds of cash — Apple alone has over \$60 billion of cash, cash equivalents, and short-term investments. And these companies are probably earning no more than 2 percent on their cash balances. So one significant benefit to these companies is that by providing a substantial prepayment to a vendor (that is, your business), they may be able to secure a discount (say 5 to 10 percent). This return is higher than they'd get investing the cash, and with corporations always looking to reduce expenses, what better solution is available?
- ✔ **Benefits to your business:** Let's face it; America was spoiled rotten prior to the Great Recession, as credit was readily available and free flowing. That credit situation changed dramatically when the financial industry melted down in 2008 and 2009 as a result of the real estate market collapse. Today (contrary to what media is reporting), credit is still very tight and expensive for small businesses. So tapping a strong customer for cash upfront by providing a reasonable discount can not only strengthen the relationship with the customer but also provide a relatively cheap source of financing for your business.



If you're going to approach customers with this type of strategy, do so with the utmost caution in order to avoid the perception that your company is struggling financially. This strategy can quickly backfire if the customer's perception of the request is one of financial weakness (thus the customer needs to find another supplier) versus strategic value. Packaging the request or offer is of critical importance when using large prepayment requests. Proper packaging ideas tend to center around highlighting the benefit the customer will receive with committing upfront or prepayments including guaranteeing timely delivery, clearly noting how much upfront costs your business will be required to cover to support a project (which they did not have to initially cover), and related "benefits." The customer must be sold on the fact that providing a prepayment is truly in their best interests.



Prepayments, deposits, and advances can greatly improve a customer's "buy-in" and commitment to your business, because when customers have "skin in the game" (or in other words, have committed real money or capital to a specific endeavor or project), their interest and commitment levels tend to increase rather quickly. A very effective spin that businesses use to secure prepayments is the concept of sharing the risk. The point to make to your customer is very straightforward: "We're putting forth significant efforts and committing resources to meet your demands, so receiving a like commitment from you is more than reasonable".

Accepting alternative forms of payment

Over the past decade, electronic payment has clearly established itself as the new norm, so accepting electronic forms of payment is important for improving cash flows. Following is a review of the most common (and not so common) forms of payments your business may want to accept:

- ✓ **Checks:** Checks are still widely used today to process payments, but they continue to diminish in popularity. If your business still accepts checks (which most do), you can use two strategies to accelerate the speed at which your bank clears the check to your bank accounts (thus improving cash flows):
 - If volumes are large enough, you can use a bank lockbox, which allows customer payments to be made directly to the bank, which can then process them sooner than if your company had to receive, process, and deposit the payments first. This strategy also provides an additional control procedure in that your internal staff doesn't handle vital financial documents, which could be lost, damaged, and/or stolen.
 - Banks now support a very effective service that allows your business to scan customer checks on a special printer and automatically deposit them via electronic transmission of the key data. This strategy also improves speed, accuracy, and safety.

- ✔ **ACH (automated clearing house), EFT (electronic funds transfer), and wires:** Companies both small and large are using these types of electronic payments to conduct business (refer to Chapter 12 for a further discussion). Most companies rely on a “push” strategy in which the customer initiates the request to remit payment electronically and then pushes the payment to the vendor. A strategy that can improve cash flows is to request that your customers provide you the right to initiate and “pull” a payment from their bank accounts on a specific date and/or according to other predetermined criteria). Granted, most customers aren’t overly receptive to this type of arrangement, but in certain cases (for example, if they have poor credit), it can be used to improve cash flows.
- ✔ **Credit, debit, and prepaid cards:** The use of credit, debit, and prepaid cards as a form of payment continues to expand throughout the country. If a business is operating in the retail industry, acceptance of credit, debit, and prepaid cards is absolutely essential (and these businesses should have a merchant account set up from day one).

Businesses whose customers traditionally don’t rely on cards to process payments are also looking at setting up merchant accounts to accept customer payments, because the customers’ financing sources are changing these days. Small-business financing requirements ranging from \$25,000 to \$250,000 are now actively supported by credit card companies that base credit decisions on electronic credit scores, as opposed to being supported by the old brick-and-mortar method of obtaining a loan from a small community bank. Because your customers are likely to use a business credit card instead of cash obtained through a loan, your business needs to accept those credit cards. Even though a fee of between 2 to 3 percent must be absorbed to process a credit card transaction (by your business, because the party accepting credit card payments absorbs the fee), it beats having to track down the customer and pester them for payment.



Being sensitive to your customer’s billing cutoff dates on credit cards can pay off. For example, if your customer’s credit card has a billing cutoff date of the 24th of each month, charging the customer’s card on the 25th can give the customer an extra 20 to 30 days to pay. Using this scenario, if a charge is made on the 24th, the customer is required to pay it by the 20th of the following month (or roughly 25 days in a normal grace period). By charging it on the 25th, the charge doesn’t post to the credit card and appear on the statement until the next billing cycle, requiring payment 25 days after that. The benefit to the customer is that she receives an extra 25 days to pay the balance due basically interest free (assuming that the entire balance on the credit card is paid). The benefit to you as a business owner is that you can receive payment for the outstanding invoice (improving cash flow) before the end of the month to keep the trade accounts receivable aging in good shape (because it helps prevent invoices from getting older and increasing the days sales outstanding calculation).

- ✔ **Evolving electronic forms of payment:** The speed at which technology is moving in today's economy is nothing short of breathtaking. Seemingly just yesterday, PayPal established itself as a new and innovative method of processing payments; \$71 billion total payment was processed in 2009. Today, the largest financial service companies in the country are teaming with Google and other technology companies to turn your cellphone into a payment-processing tool. Staying on top of these trends is extremely important to capture the benefit of both improved cash flows (by being able to accept every type of payment a customer is offering) and increased sales (because nobody wants to turn down a sale because a specific type of payment is not accepted).
- ✔ **Trades, offsets, and barter:** Due to the economic upheaval experienced in recent years, the use of trades, account offsets, and even barter transactions is expanding.
 - *Trades* may be utilized when a customer has a specific asset of value and wants to exchange it for a balance due. As long as the asset is deemed valuable to your company, then getting something is better than nothing.
 - *Account offsets* apply to customers and suppliers that conduct business back and forth. A customer may purchase goods or services from your business but at the same time also sell other items back to your business. In this case, account offsets can be used to simply net a balance due against a balance owed (avoiding the need to exchange cash).

Unlike trades or account offsets (which tend to occur after the fact), *bartering* tends to occur before the transaction, with both parties agreeing to a predetermined deliverable. For example, a CPA firm may offer to complete an advertising company's annual income tax reporting requirements in exchange for the advertising company developing and launching a promotional campaign for the CPA firm. If barter transactions are used, just make sure that they are completed as an arm's-length transaction (a transaction completed at fair market value between two independent parties without any undue duress or coercion) and properly documented.



Utilizing trade, offset, and barter agreements can be effective, but remember to watch out for the tax man. In the eyes of the taxing authorities, these types of agreement represent arm's-length transactions that generate taxable sales and expenses. But unlike your business, the tax man does not like to accept alternative forms of payment, so be careful not to get trapped by accepting too many assets that can't be efficiently converted into cash.

Accepting other forms of currency, including gold and silver

Companies should be fully prepared to accept payment in the form of different world currencies ranging from the Japanese yen to the Chinese yuan to the European euro. Establish a proper banking relationship to facilitate the acceptance and conversion of global currencies into the almighty U.S. dollar.

Some companies are also finding that they may need to be prepared to accept payment in gold and silver. In 2011, Utah began allowing gold and silver to be legally recognized as a form of currency. Gold and silver have been out of favor over the past 100 or more years because

they have been viewed as being an inefficient method to conduct business. But the economic turmoil since 2007 has shaken the faith of people, business, and governments, and as a result, gold and silver have regained favor in terms of supporting transactions.

Although we're not prophesying a return to gold- and silver-based currency (highly unlikely), the development in Utah illustrates how important it is to remain flexible and adaptable in accepting different forms of payments to improve sales, your business results, and cash flows.

Managing seasonality in the selling cycle

Almost all companies, in one form or another, have to manage seasonal selling issues with customers. If your business targets the youth clothing market, then be prepared to ramp up before the back-to-school selling season. For outdoor furniture, you need to gear up early in the calendar year so large customers have products on the floor in the spring for their customers to use in the summer.

The ebb and flow of seasonal selling cycles is a fact of life most companies simply have to live with, so rather than attempt to significantly influence or alter your customer's buying and paying habits (just to improve your internal cash flow), the burden on managing cash flows during the seasons really falls on your business. The following strategies can assist with managing impacts on cash flows from seasonal factors:

- ✔ **Securing additional financial support:** A widely used strategy in numerous industries is leveraging financing sources through the busy season to improve liquidity and cash availability. Whether your business has a lending agreement with built-in features to extend additional credit during the peak selling season or you secure and use specialized lending sources only during the peak season, working with lending sources is one of the most effective ways to support cash needs during this period. Factoring groups (see Chapter 11) can offer a flexible financial resource

to support operations by structuring specialized seasonal lending programs to support your business (for example, predetermined customer accounts are targeted for factoring at set rates). The next section of this chapter delves into this issue in more detail.

- ✔ **Leveraging your vendors and employees:** Chapter 15 dives into this subject in more detail, but the general concept is that if your business has to manage seasonal peaks and valleys, so should your vendors and your employees. For example, you can request extended payment terms for a 90-day period from your vendors, and you can pay employee commissions on a cash-received-plus-15-days basis.
- ✔ **Business planning:** Cash and management resources tend to be stretched very thin running up to and during the seasonal sales crush. After the season ends and business returns to normal operating levels, with cash receipts at a peak (from collecting on seasonal sales), the opposite tends to occur. As such, business-planning efforts and associated infrastructure improvements or capital investments are best scheduled during this off-peak period in order to help smooth annual cash flows and to ensure that management has time to give those improvement and investments the proper amount of attention. Really, how many companies in the midst of a seasonal sales crunch want to implement a new computer information system?

Managing the Lending Agreement in Relation to Your Sales Cycle

A critical concept often overlooked by companies is the way your lending agreement is structured in relation to your sales cycle. Your setup can have a profound impact on improving cash availability and liquidity.



Lending agreements need to be structured in anticipation of the selling cycle and not adapted or adjusted during the selling cycle. Financing sources are notoriously more difficult to work with when a change is needed mid-stream and on short notice, because banks and other lending sources don't like surprises. So be a good Boy Scout by being prepared and planning well ahead to get the most out of your lending agreement. In this section we tell you how to prepare in advance and what to look for in a lending agreement.

Defining eligible receivables

Banks define *eligible receivables* as customer receivables that are available to borrow against, not the total receivables owed to a company. Following are the most common types of *ineligible* receivables:

- ✔ Receivables over 90 days past due (because the bank may think they're uncollectable)
- ✔ Foreign receivables
- ✔ Certain governmental receivables (for example, receivables generated from the federal government, which lending sources may not be able to legally obtain a secured interest in)
- ✔ Customer receivables with excess concentration levels
- ✔ Related or affiliated party receivables
- ✔ Cross-aged receivables (explained in the "Watching for hidden time bombs in your lending agreement" section of this chapter)

The goal for most businesses is to maximize the number of eligible receivables to maximize the amount of borrowing capacity. Of course, from a lender's perspective, the opposite holds true, as they tend to be more conservative (imagine that) and look to reduce eligible receivables.



In the context of receivables, the term *concentration* means that an inordinately high level of sales or receivables is associated with few customers or a single customer. Financing sources generally get nervous about high levels of concentration because if that customer encounters a problem, the risk of non-payment and defaulting on the lending agreement increases. Thus, you often see a provision in a lending agreement that states that any amount of receivables above 10 percent of the total receivables associated with one customer will be ineligible. So if total receivables are \$1,500,000 and one customer comprises \$300,000 of the balance (or 20 percent), \$150,000 (the 10 percent over the 10 percent limit) is ineligible to borrow against.



Referring to the discussion on the credit review and approval process in "Implementing Basic Controls in the Selling Process to Manage Cash," the benefits of completing a more-thorough credit review flow through to the lending agreement. If the financing source can document and support that a large customer is financially sound, you can negotiate with the financing source to increase the concentration limit for the best and strongest customers (thus reducing ineligible receivables and increasing access to liquidity or cash) from say 10 percent to 15 or 20 percent. So the extra credit review and approval efforts has the dual benefit of providing more confidence in getting paid as well as structuring a strong lending arrangement.

Understanding advance rates and dilution

After you determine eligible receivables (and, hopefully, maximize them for your company), you next need to manage advance rates. The advance rate represents the maximum amount of borrowings that can be secured against the eligible receivables. A very typical advance rate is 80 percent, but this rate can be negotiated for your business needs or, conversely, may be

lowered by the financing source if adverse trends develop, such as increasing levels of dilution or deteriorating collection rates. (In the later section “Driving a lending agreement to improve liquidity and access to cash,” Figure 14-1 provides an example of how the advance rate works and how important it is to manage both eligible receivables and the advance rate to increase liquidity and access to cash.)



Dilution is a relatively simple ratio calculation all financing sources utilize to help determine advance rates. The denominator in the equation is sales figures over a period of time (such as a year). The numerator is the sum of all billing or invoice adjustments made during the same period for transactions such as sales returns, discounts offered, bad debts, billing adjustments, and other items. For example, if annual sales amount to \$6,000,000 and the total of all returns, discounts, bad debts, and/or other adjustments is \$400,000, the dilution rate is 6.67 percent ($\$400,000 \div \$6,000,000 \times 100$). The general rule of thumb is that for each 5 percent increase in dilution, the advance rate is decreased by 5 percent (from a base rate of 80 percent). So in this situation, the advance rate is reduced to 75 percent because 6.67 percent is above the first 5 percent dilution increment.



Producing CART invoices is critical to getting the most out of your lending agreement. (If you need a reminder about CART, refer to the earlier section “Supplying CART — complete, accurate, reliable, and timely — invoices.”). Lending sources don’t like to see numerous adjustments and changes made to invoices after issuance. Changes make them nervous and raise questions about the strength of your internal policies and procedures. Something as simple as a billing address error (which requires the original invoice to be voided and a new invoice to be issued) increases the amount of adjustments as calculated by the bank, which in turn drives the numerator higher and the dilution rate higher (thus lowering the advance rate). Even if all other information is correct, this one simple adjustment shows up as a billing correction, which can influence the lending agreement.

Watching for hidden time bombs in your lending agreement

A number of other terms and conditions within your lending agreement need to be understood, and probably managed, to improve available liquidity. Following are some of the more common terms and conditions to be sensitive to and manage:

- ✓ **Cross-aging factor:** A term and condition usually buried within lending agreements that can be very nasty is a *cross-aging factor*. In its simplest form, a cross-aging factor is applied on a customer basis and states that if X percent of a customer’s balance due is more than Y days old (60 or 90 days are common), then the entire receivable is ineligible to borrow against. Common cross-aging factors range from 20 to 25 percent, but



note that if the test is applied and fails by even the slightest amount (20.1 percent past 60 days with the limit of 20 percent established), you get no margin for error (and the total of the receivable will be deemed ineligible).

You can probably see where we're going with this tip: Managing your slow-paying customers to somehow always having a cross-aging factor calculation of just below the limit established (say 18 percent compared to a 20-percent limit as set by the bank) can keep your eligible receivable levels higher and thus access to cash higher. By working closely with customers to make sure that just enough older invoices are paid and processing adjustments to older invoices in a timely fashion, you can meet the target. Just double check that the calculations are accurate and supportable, because the last thing your business needs is for a bank auditor to challenge your reporting.

✓ **Financial covenants:** Lending sources use financial covenants to ensure that the borrower's financial strength remains above predetermined levels to support the ability to repay the loan. These covenants come in all sizes, shapes, and forms and are generally based on the financial information presented by the borrower to secure the loan. Understand two key concepts about financial covenants:

- **If you violate a financial covenant, the lending relationship will become strained.** The normal reaction from the lending source is to tighten up your ability to borrow (restricting liquidity and cash availability).
- **You don't want to let the lending source dictate the financial covenants according to generic standards applied by banks and other lending sources.** Every business has a unique selling and operating cycle, which can result in widely varying financial performances between different times of the year. Lending sources tend to be relatively conservative and narrow minded when establishing financial covenants, so you need to educate them on expected business operating performances.



A bank wanted to establish a minimum quarterly profitability financial covenant for a staffing company requiring that a positive profit be realized each quarter. Given the seasonality of the staffing industry, with the first and fourth quarters being relatively poor and the second and third quarters being stronger, the covenant was changed to generating a positive profit on a rolling four-quarter basis. With these terms, a weaker quarter that produced a loss would not cause a violation of the covenant.

✓ **Reporting requirements:** Financing sources normally place a significant amount of reporting requirements in the primary loan agreement, including providing annual tax returns, monthly or quarterly financial statements, monthly borrowing base certificates, annual personal financial statements (for the owners of the business), trade receivable and payable agings, and other reports as deemed necessary. Complying with



all reporting requirements is important to ensure that you maintain a healthy relationship with your lending sources.

In recent years, banks and other financing companies have come under increasing pressure from external auditors, examiners, the government, and/or other parties to improve the quality of the loans extended. One surefire way to cause problems and damage your ability to borrow is to fail to comply with all reporting requirements.

- ✔ **Other borrowing restrictions:** Quite often, financing sources place restrictions on the maximum amount of other loans that can be obtained while the current lending facility is in force. For example, a company may want to secure a loan (from another financing source) to purchase additional property and equipment that's not part of the lending agreement with the primary financing source. Assuming that this loan is below the amount established in the lending agreement, the company can secure the loan with no ramifications. If the loan is greater than the maximum amount established, a waiver from the primary lender needs to be obtained (to avoid defaulting on the agreement).

The problem with this type restriction is that it can limit the ability for a company to secure cash from other sources of nontrade debt (thus impairing a potential source of cash). Give careful consideration to structuring this term in the primary lending agreement.

- ✔ **Hidden fees and charges:** The list of additional fees and charges financing sources can think up is endless. To start, a loan-origination fee may be charged, which is nothing more than a percentage charge the financing source earns to originate the loan. A 1 percent loan-origination fee is very common — but remember that you can negotiate, so countering with 0.5 percent would not be unreasonable. Then be prepared to pay for a collateral exam completed by either the financing source or an external third party. In order to confirm the assets you intend to use as collateral are sound, they must be audited. Also be prepared to pay the legal fees incurred by the financing source to draft the agreement. So even before the loan is accessible, substantial expenses have already been racked up.

After you've closed, you may still incur fees. Say you're using 65 percent of the loan on average for the year. That's not bad, but be careful, because some loans incorporate an unused loan charge for the average amount of the loan not used during the year. Imagine that; you've done a great job minimizing the use of the loan and lower interest charges, but you still get stung with a fee to the financing source for just providing the commitment. And finally, to add insult to injury, if you secure a better lending facility before the initial term of the original loan expires, you can most likely expect an early termination or prepayment fee to be charged.



Financing sources have to compete for your business like everyone else, so when securing financing, get competitive bids. The hidden fees and charges are negotiable, so take advantage of opportunities to push back on pricing when presented. Remember, financing sources are going to get you coming and going, so any terms and conditions that can be structured to lower the overall cost of the loan should be pursued.

As the saying goes, the devil is in the details, especially for lending agreements. If you don't make an effort to read and understand all the terms and conditions (the fine print), something in the agreement will undoubtedly come back to bite you in the rear end.

Driving a lending agreement to improve liquidity and access to cash

Figure 14-1 displays a typical lending agreement, with limited-active management compared to a proactively managed and structured lending agreement in relation to a company's selling cycle. The impact on available borrowings and access to cash are significant, both in added cash available (\$162,000) and as a percentage increase (15.76 percent).

For the purposes of Figure 14-1, limited-active management equates into the column titled standard bank terms, which basically means that the bank is setting the terms of the lending agreement based on their boilerplate offerings. The proactively managed column is headed by the description of company structured terms and basically indicates that the company has actively and aggressively negotiated with the bank to establish the terms and conditions of the lending agreement. This document would most likely be prepared by the company securing the financing to properly evaluate and compare what the bank is offering versus what the company needs (and has hopefully, successfully structured) and to evaluate if the added availability of cash would come at any additional costs.

The last section of the figure shows a simple analysis on the impact hidden fees and charges may have on the transaction. In this example, the company was able to reduce the loan origination fee from 1 percent to 0.5 percent, place a cap on examination and legal fees of \$5,000 (versus higher actual), and remove the unused loan-commitment fee (which the financing source was attempting to charge at a rate of 0.25 percent for the year). These more-favorable terms helped reduce the hidden fees and charges by almost half, from roughly \$21,000 to \$11,000.

ACME Distribution, Inc. — Available Borrowing Capacity Comparison		
Description of Loan Provision	Standard Bank Terms	Company Structured Terms
Total Loan Facility	1,250,000	1,250,000
Total Accounts Receivables	1,500,000	1,500,000
Ineligible Receivables:		
Concentration Limitation, Bank 10% Company 15%	150,000	75,000
Cross-Aging Receivables, Bank 20% Company 30%	65,000	25,000
Total Ineligible Receivables	215,000	100,000
Advance Rate, During Peak Season	80.00%	85.00%
Borrowing Capacity	1,028,000	1,190,000
Increase in Borrowing Capacity, \$	N/A	162,000
Increase in Borrowing Capacity, %	N/A	15.76%
Fees and Charges:		
Loan Origination Fee	12,500	6,250
Collateral Examination and Legal Fees	7,750	5,000
Unused Loan Commitment Fee	1,094	0
Early Termination Fee	0	0
Total Added Fees and Charges	21,344	11,250
Increase in Effective Loan Interest Rate	1.42%	0.75%

Figure 14-1:
Available
borrowing
capacity
comparison.

Chapter 15

Managing the Disbursement Cycle to Improve Cash Flows

In This Chapter

- ▶ Taking a look at what the disbursement cycle involves
 - ▶ Using basic techniques to improve cash flow from the disbursement cycle
 - ▶ Evaluating additional approaches to managing the disbursement cycle
 - ▶ Hanging on to cash while compensating employees
-

Chapter 14 evaluates how a business can manage its relationship with customers throughout the selling cycle to improve cash flows and liquidity. In this chapter, we evaluate the exact opposite of the selling cycle — the disbursement (that is, expenditure) cycle. We explore how a business working with creditors can squeeze cash from the disbursement cycle. Throughout, we note numerous similarities between the two chapters, which of course is logical, because a business paying money from its disbursement cycle represents a part of someone else's selling cycle (in terms of receiving cash).



To gain a better understanding of the disbursement cycle in terms of how cash flows can be improved, first read Chapter 14 on the selling cycle so that you can simply think about those points from a different perspective. If discounts are offered to customers to accelerate payments, think of how your business can utilize any discounts being offered from suppliers to improve operating results. Or if a supplier is placing pressure on your business to pay obligations, confirm lending agreement terms to see how making just enough payments at the right time keeps their lending facility maximized.

Tracing the Entire Disbursement Cycle

The concept of the disbursement cycle can be looked at from the same two perspectives as the selling cycle: the accounting/financial view versus the strategic view.

The accounting/financial disbursement cycle generally starts when a commitment is made to purchase goods or services. For larger companies, the commitment is supported by the generation of a purchase order, which identifies the type, quantity, price, technical specifications, delivery dates, and other terms and conditions of the goods or services to be purchased.

For smaller companies without a formal purchase order system, another form of positive confirmation (such as an e-mail, fax, or even a simple phone call) is generally used to support the purchase request. The accounting/financial cycle then proceeds with the receipt of the goods or services purchased and then finishes when final payment is made. Similar to the sales accounting/financial cycle, the disbursement accounting/financial cycle is fairly narrow in scope and is based on “hard” transactional documentation.

From a strategic perspective, the disbursement cycle is much broader in scope and starts from the initial point of planning, running all the way through managing vendors and suppliers well after payments have been made. For example, a technology company that has developed a new accessory for a personal computer must develop a production plan that starts well before the first purchase order is ever issued. Suppliers must be identified and qualified as part of the overall production plan to ensure that forecast commitments can be satisfied (as the accessory is rolled out to the market). These suppliers may range from a manufacturer of a key component to an advertising firm retained to market the accessory.

On the tail end of the disbursement cycle, the management of vendors and suppliers continues well after their last invoice is paid, as invaluable business information is generated from managing the follow-up process proactively. Even after the primary thrust of the advertising and promotional campaign has been undertaken and the bills paid, the company can mine data related to customer purchasing trends, feedback, what worked, and what didn't work. Accumulating valuable business intelligence from vendors and suppliers is part of the ongoing and management-intensive disbursement process that extends well past the last invoice payment.



Looking at the disbursement cycle through the strategic view emphasizes how much cash is required and consumed well before the first purchase order is executed and well after the vendor/supplier is paid. If these cash requirements are not properly planned for, then you will most likely experience the pain and suffering of not securing enough cash (or capital) to properly operate your business.

Taking Critical Steps in the Disbursement Cycle to Manage Cash

The most important difference between managing the selling cycle to improve cash flows compared to working the disbursement cycle for cash is also the simplest to understand: You control cash in the disbursements cycle, whereas your customer controls the cash in the selling cycle. This difference is no doubt significant, but in most other ways the cycles are very similar in the way they relate to establishing basic accounting policies, procedures, and controls to protect all business assets (including cash). The three critical steps explained in the following section — qualifying suppliers and vendors, establishing proper controls, and managing creditors — provide you with a better understanding of the basics of the disbursement cycle.

Qualifying suppliers and vendors

Good vendors and suppliers are essential to the ongoing profitable operations of your business. In fact, qualifying suppliers and vendors is just as important, if not more so, than qualifying customers. Whether a vendor provides a critical raw material component in the final finished good or simply sells your company the proper insurance coverage, you want that vendor to be reliable and provide the highest quality product or service.

Numerous resources and procedures are available to help you properly qualify suppliers and vendors. Following are some of the more popular strategies:

- ✔ **Request sample or trial runs.** Before a significant commitment is made with a vendor or supplier, companies often request a trial period, during which a reduced level of business is conducted so that both parties can properly evaluate the feasibility of a larger and longer relationship. The old saying of learning to walk before you run can definitely apply to new vendor relationships.
- ✔ **Tap industry and third-party references.** Countless resources are available for access from both trade and regional sources to obtain references on vendors and suppliers. From contacting the local Better Business Bureau (BBB) to reading online reviews to attending industry trade events, the basic concept always remains the same. Use available public and private resources to do your homework and follow through on references.
- ✔ **Put it in writing.** Making sure that clear and concise terms, conditions, and relationship expectations are established in advance serves a couple of purposes. First, both parties will be able to set expectations on which to operate and support the relationship. Second, you'll get a red flag if a vendor or supplier remains vague and noncommittal about relationship expectations.

- ✔ **Trust your instinct.** Successful business owners usually have a great instinct when it comes to establishing relationships with third parties, so always taking a moment to step back to assess a vendor or supplier is usually very helpful.



Don't be consumed with using price as the only decision point. Sure, a vendor or supplier may offer the best price, but if the product or service quality is substandard and delivery times are unreliable, the ultimate price your business may pay will be far greater than saving a few percentage points.

Establishing proper disbursement cycle controls

When establishing proper disbursement cycle controls, keep in mind the concept of CART (complete, accurate, reliable, and timely). Just like in the selling cycle, disbursement cycle failures, inefficiencies, and/or errors will ultimately have a negative impact on cash flows and cash availability (over the long run). Management should make the same effort in establishing proper disbursement-cycle controls, policies, and procedures as with the selling cycle, because cash leakage potential represents an even greater risk.

Establishing, implementing, and maintaining proper accounting policies, procedures, and controls varies by company and industry but should encompass the following basics:

- ✔ **Utilize a purchase-order system.** Although implementing a formal purchase-order system isn't practical for every business, using some sort of system that ensures proper review, approval, and authorizations for purchases of goods and services are made prior to making a firm commitment should be adhered to. The idea is to avoid errors and mistakes before they happen (which are often very costly) by making sure that the appropriate management team members approve and authorize transactions.



Smaller businesses generally don't have resources available to implement a formal purchase-order system. But the lack of resources should not prevent even the smallest business from making sure that purchases or goods and/or services are properly approved and authorized. Senior management, and quite often the founder, president, and CEO, should explicitly instruct both internal employees and external vendors and suppliers that they (that is, senior management and others) are the only parties who can authorize purchases. Always establish and utilize a very simple internal policy that clearly relays authority levels.



- ✔ **Implement proper approval and authorization procedures.** Proper approval and authorization levels among the senior management team should be established and reviewed/updated on a periodic basis. For example, a purchasing manager may be given the authority to purchase \$20,000 worth of raw materials, but if the order exceeds this level, then the manufacturing general manager's approval is required. Further, if the order exceeds \$100,000, then the company's president would be required to approve the purchase. The greater the risk to the company, the higher the level of authorization that should be required.

Business contracts related to real property leases, lending agreements, credit card processing, bank account access, and the like should almost always be executed by a legal officer of the company, because most third parties require an officer's signature to properly bind the contract. These types of financing-based agreements differ from more-traditional purchase agreements because the risks to both the company and third parties is far greater, which in turn requires the need for actual officer approvals and signatures.

- ✔ **Match, check, and verify.** Businesses should always make a concerted effort to match vendor and supplier invoices against original issued purchase orders (if utilized), receiving reports, executed contracts, and/or any other information available to ensure that the vendor invoice is correct. If you assume that every vendor or supplier invoice received is accurate, then you are going to be in for a rude awakening. Various sources estimate that two to four percent of all invoices contain errors, and in some industries such as healthcare, the error rate is closer to 30 to 40 percent.
- ✔ **Segregate duties.** If your business has the resources available, segregate different disbursement cycle functions among different employees. For instance, if material is received in the warehouse, have the warehouse staff be responsible for verifying the amount, quality, specifications, and so on of the material against the original purchase order. If correct, this information should then pass to the accounting department, which can verify the price on the vendor's invoice against the original purchase order and, if accurate, proceed to process the vendor invoice.

Smaller businesses may not have the luxury of having multiple departments that can assume different duties, so making sure that at least a couple of relatively independent parties are reviewing and approving vendor invoices will help improve accuracy, reduce errors, and avoid processing incorrect payments. For instance, an accounting manager may receive, review, and input a vendor invoice in the accounting system (for subsequent payment processing). When the invoice is selected for payment, a senior management team member with payment authority should review the invoice again prior to finalizing the payment.

✔ **Control the last line of defense — payment authorization.** Finally, the last line of defense for most businesses in the disbursement cycle is at the final check-signing stage (or, in this electronic age, before the send button is hit). A final review and approval of all disbursements should be undertaken by only the most senior management team members to ensure that when payments are processed, they are as accurate as possible.



One final thought we want to share, and a statement that may surprise you, is a warning to never allow your senior accounting and finance personnel to process payments. The reason why not is very logical when you ask yourself one simple question: “Who is best able to commit and conceal fraud in a business?” Everyone’s heard the story about the bookkeeper of 30 years, so dedicated to the company and always so reliable and trustworthy until the unthinkable is discovered — the bookkeeper has been bilking the company over the years. By implementing a simple segregation of duty policy of requiring a senior manager independent of the accounting and finance group to review and process final payments, you can often be very effective in preventing your business from becoming a poster child for this kind of theft.

Managing external creditors

The overview of the accounting-based perspective of the disbursement cycle ends in the previous section, because after the vendor has been paid, the cycle is for the most part complete. But strategically, the management of external creditors, ranging from vendors and suppliers to lending sources such as banks, is an ongoing process with a direct impact on cash flows and cash availability.

Probably the most important component of managing external creditors is keeping lines of communication open. Speaking from experience, nothing is worse than failing to communicate with a bank and then delivering a very unwelcome financial or operating performance “surprise.” The same can hold true for critical vendors as well, because if they are blindsided by unexpected events or requests, not only will they become nervous about getting paid but they also may feel somewhat slighted and change their attitude toward your business, shifting from being a partner (and willing to work with you) to being nothing more than another creditor. Be sure to communicate clearly and proactively about both good and bad news because creditors want to have an opportunity to proactively manage a potential problem, as well as to participate in your success.

But even with a solid communication plan in place, not all business information should be provided to the creditor, because the vast majority of the info is either irrelevant or confidential. Make sure that just the most appropriate

and relevant business information is provided to the creditor. In addition, smaller and less-important creditors don't require the same type of communication effort and plan as key creditors do. For example, you're not going to provide the same information to the company watering the office plants as you do to the bank providing your financing.



Make a concerted effort to properly edit, cleanse, scrub, package, and/or prepare business information that will be distributed externally. There is a significant difference between financial and operational information used for internal management purposes and information distributed to external parties for review and evaluation. Externally provided information is usually presented in a more summarized format, focused on more general/macro-level issues, and avoids disclosing confidential data. Furthermore, a notice that the information is proprietary and confidential should always accompany it.



In the business world you often hear *NDA*, which stands for a nondisclosure agreement, and *CA*, which stands for confidentiality agreement. These agreements are used when confidential business information must be shared between parties in order to support a specific transaction or relationship. The basic idea with these agreements is to ensure that any information being shared between the parties remains confidential, and if one party violates the agreement, then damages may result. We recommend that you work with professional counsel (such as lawyers) to draft these agreements when critical and confidential business information is shared.

Establishing open lines of communications between your business and its vendors and suppliers is a great way to harvest invaluable and, to a certain extent, nonpublic market and industry information. Chances are, one of your suppliers also supports one of your competitors, so although the supplier may not intentionally disclose useful information, it never hurts to keep your ears and eyes open to information that may be of keen interest.



Communication with and management of creditors is often critical to your own business's health. In one situation, a large contractor relied on multiple suppliers and vendors to source products for an end product sold to the government. One supplier of critical importance (this supplier provided a highly technical component that could not be readily provided by other parties) experienced financial difficulties and began to experience delivery problems. By having strong communications between the parties, delivery problems were averted because the contractor was able to step in and provide additional financial support (to ensure no disruption to the supply chain). If the contractor had not stepped forward, a single component, comprising less than 2 percent of the total end product, would have caused significant delivery delays and resulted in reduced cash flows (as without product delivery, no customer payments would be received).

Getting Creative to Improve Cash Flows from the Disbursement Cycle

Most businesses don't have the luxury of General Motors (having Uncle Sam available with billions of dollars of emergency cash) and banks (structuring TARP, or Troubled Asset Relief Program, to provide emergency liquidity during the financial crisis of the Great Recession) or of being too big to fail (we just had to make reference to that term at least once in the book). Rather, most businesses have to operate under the context of TSTC — too small to care. The government really never came running to the thousands of struggling small businesses with any type of financial rescue program. When faced with economic difficulty, the majority of businesses have to buckle down and return to their entrepreneurial roots not only to develop a survival strategy but also to identify new and creative ways to generate cash. Within these cases, a primary target is squarely placed on the disbursement cycle. Honestly, if your sales have decreased and your customers are taking longer to pay, then what better way to generate cash than turning about and taking longer to pay your own vendors?



When utilizing more-creative strategies to improve cash flows from the disbursement cycle, understand the following two key concepts:

- ✓ First, being creative *does not* mean being dishonest or manipulative. In fact, when creative strategies are used to improve cash flow from the disbursement cycle, just the opposite occurs, as working with vendors and suppliers (to improve cash flows) requires the utmost management and business credibility.
- ✓ Second, using creative disbursement-cycle strategies to improve cash flows almost always comes at a cost. It may be an outright interest charge from the vendor, a higher lease payment, increased material costs, or something else, but in one form or another, an added cost is going to be present. The key is understanding the trade-off between improving cash flows and the increased cost.

Leaning on vendors and suppliers

When looking for ways to generate additional cash from the disbursement cycle, the starting point is with your vendors and suppliers that have provided goods or services to your business and are now looking for payment. Vendors and suppliers are in business, too, have most likely experienced some form of past cash-flow problems (and have felt your pain), and they don't want to lose you as a customer. Therefore, you should have some room for negotiation.



Using staffing companies

Employees are expensive (which we're sure is not news to anyone). On top of their base compensation, employers have to pay benefits galore. And to add insult to injury, employees don't offer payment terms — they must be paid regularly and on time. An entire section of this chapter is dedicated to leveraging employees for cash, but the first tip or strategy that businesses can use to help manage the cash requirements associated with employees is to use personnel staffing companies (or temps) when the opportunity is right.

For a fee, the personnel staffing company will handle all the employment issues associated with an employee and bill your company as agreed. Using personnel staffing companies not only transfers the risks and management responsibilities of the employees to the staffing company but also may give you the opportunity to secure payment terms of net 15 to net 30 (meaning that you have 15 or 30 days to pay the staffing company from the date of the invoice). By basically turning the personnel staffing company into a bank, you can increase cash flows.

Leaning on vendors and suppliers is widely used when a little extra support is needed and can be particularly effective when critical vendors are leveraged. Every business has both critical and noncritical vendors and suppliers. Critical vendors and suppliers tend to be deeply engrained in your business by providing large amounts of goods or services that are essential to the selling cycle. In addition, critical vendors also tend to have very strong and long-lasting business relationships that can be leveraged from time to time based on past trust, business volumes, and friendships.



A word of caution, however: Looking to critical vendors for a break should really be the exception rather than the rule. Constantly going back to the well for support will eventually lead to deeper concerns by the critical vendor about your business, and this strategy could eventually backfire if the vendor restricts credit. So when you absolutely need to rely on this strategy, make sure to stay proactively engaged with the critical vendors and keep communication lines open and clear.

Another vendor strategy that businesses often look to utilize is to establish relationships with multiple like suppliers. By doing this, multiple benefits may be realized, including increasing total available credit (because if you get \$50,000 in credit from each of four suppliers as opposed to two, the amount of potential credit is doubled), ensuring price competition, and maintaining a reliable supply chain. However, downsides exist as well in terms of realizing lost purchase-volume discounts (because if you split your orders among four vendors instead of using just one, you may lose pricing leverage), added administrative and management time requirements to support multiple vendors, and so on.

Using JIT payment strategies

You can hold on to cash as long as possible by relying on JIT payment strategies. *JIT* stands for *just in time*. In Chapter 14 we discuss how you can work with your customers to ensure that payments are received just at the right time to maximize available liquidity from a lending facility. In the disbursement cycle, the same logic holds (but in reverse): By understanding your vendor's financing programs, you know when they require your payments or face liquidity issues or problems on their end. Needless to say, your vendors are going to continue to keep the pressure on you to adhere to the payment terms extended, but if your business experiences a tight period of cash flow, having the knowledge of just how far you can push your vendors without creating any management headaches is often a very helpful piece of data.

Of course getting your vendors to cough up this information is much easier said than done because most would prefer to keep this piece of data confidential. So a few strategies can be used to obtain the information:

- ✓ First, if your business has a strong relationship with the vendor's senior management team, then asking about the vendor's financing terms, at a general level, is not unreasonable.
- ✓ Second, having good contacts and industry resources that your business can leverage about what current market terms and conditions are for financing agreements can be used as a general reference point.
- ✓ Finally, look to your company's financing relationship for a reference point. Chances are, if they are tightening your terms based on economic conditions, the same will hold for other financing companies.



Originally, the concept of *JIT* was applied to the inventory supply chain. In order to improve efficiencies and reduce costs, waste, and losses, supply chains were structured to ensure the right amount and type of inventory was always available to support downstream sales. The use of *JIT* business strategies has been expanded to other areas as well, including *JIT* financing (for start-ups that receive funding just in time) and *JIT* employees (working aggressively with temporary staffing companies to make sure that the right amount and type of employees are needed just at the right time).

Grading your vendors and suppliers

When times are tight (translation: cash resources are very limited), knowing which vendors have to be paid and which vendors can wait may mean the difference between survival and failure. When your business experiences a cash crunch, you can determine which vendors and suppliers get paid first by assigning a "grade" to identify their relative importance to the ongoing operations of a business. The higher the grade, the more critical a vendor or

supplier is to the business. The lower the grade, well, those vendors and suppliers will get paid when cash becomes available.

Here we present a simple A-through-D grading system, but companies may use number schemes, color-coding, and/or other measurement systems as preferred.

- ✔ **Grade A:** These vendors represent the highest level of importance in terms of keeping the lights on, the doors open, and ensuring that sales continue to be made. In addition, these vendors tend to retain leverage on your business in one fashion or another. A critical product component supplier, bank or financing company, and landlord tend to fall into this group.
- ✔ **Grade B:** Grade B vendors tend to have a number of similarities to the grade A vendors but can be pushed around a little bit (for example, you can ask for another 15 to 30 days to pay) and don't have quite as much leverage (because replacement vendors are available, for instance). Noncritical product component suppliers and some professional service providers tend to fall into this group.
- ✔ **Grade C:** The grade C vendors are the first group that can really be stretched on the payment front, because they don't provide essential and/or critical goods or services to the company (that is, they aren't needed on a daily basis to operate). An example of a grade C vendor is a temporary staffing company that your business no longer needs but that has past-due bills outstanding.
- ✔ **Grade D or F (if you like):** At the bottom of the barrel are the grade D or F vendors. These vendors tend to have no leverage, provide goods and services that are not needed, and really have no long-term strategic importance to the business. As much as these vendors would hate to admit it, they fall into the prime category of potentially receiving a "haircut" or "cram down" when payments are made. An example of these vendors is an advertising agency (supporting a terminated promotional campaign) or a material supplier for a discontinued product line.



The terms *haircut* and *cram down* essentially mean that the vendor, supplier, or even a creditor is not going to receive 100 percent of the balance they're owed. Haircuts are usually voluntary, in that the creditor understands that a loss will be realized and works toward achieving the best outcome possible (for example, 70 percent on the dollar). A cram down tends to be delivered in a harsher context via the debtor "cramming down" a settlement to the creditor. Call it what you may, if you believe that your business is graded as a D or F by one of your customers, be prepared to settle for what you can and move on with life. Although you will most likely never know what "grade" your business has been assigned, astute business owners can usually quickly figure out where they fall on the food chain in terms of determining just how valuable they are to their customer.



The grading of vendors and suppliers is highly confidential information that should be guarded very closely internally. Nothing is worse than letting this information slip out to vendors and suppliers and then having to respond to the angry C and D rated vendors and suppliers.

Floating along

Years ago, in the good old business days when most payments were processed via check and the banks hadn't fully embraced digital technology, a tried-and-proven method of improving cash flow was to use the *float*. For example, a company would process vendor payments on Friday of each week and drop the checks in the mail (of course, after the last post office pickup of the day). Vendors would then receive payment early the following week, deposit the funds in their bank accounts, and wait for the banks to clear the checks, which could result in a payment taking as long as a week to transfer from the business to vendors. The issuing company therefore had a little extra time (a week) to work on customer payments to cover outstanding checks. This strategy truly defined the old saying, "The check's in the mail."

Now welcome to the 21st century. Between the advances in technology and the adoption of electronic payment processing, the float has almost entirely disappeared in terms of having any type of material impact on cash flows. A week of float has now turned into a day of float as modern technology greatly improves payment-processing efficiency as well as helping to reduce fraud.

But float strategies are still available for creative companies, just in a different capacity. A prime example of using the float relates to processing payments with credit cards. If your business regularly pays certain vendors by using credit cards, you can realize benefits by setting payments to occur one day after the billing cutoff date. If your business's credit card has a cutoff date on the 20th of each month (due on the 15th of the next month), processing a vendor payment on the 22nd rolls this charge into the next billing cycle and provides another 30+ days to pay.



Utilizing the credit card payment cutoff date doesn't mean that a higher credit balance is available. Rather, the goal is to simply buy an extra 30 to 40 days of interest-free financing to support your business operations. Of course, this strategy assumes (and it's a big assumption) that discipline is maintained and credit card balances are paid in full each month. If not, the interest charges on the outstanding credit card balances can quickly turn this strategy into a money-losing event.



This tip may be overkill, but we recommend getting to know your vendor payment-processing habits and trends in order to try to identify which vendors still are slow to deposit/process payments and which utilize the most advanced techniques to quickly process payments. For some businesses, every little bit of cash flow helps.

Creating cash from inventory

Manufacturing, stocking, maintaining, purchasing, and managing inventory is often one of the worst offending areas within a business in terms of consuming excess cash. Left unattended, inventory quickly becomes the ultimate black hole in terms of sucking cash right off the balance sheet. Proactive management of inventory (that is, actively managing inventory product lines to identify and reduce or eliminate slow-moving, obsolete, and/or poor-performing items to improve inventory turnover rates) is without question the best strategy available to avoid incurring additional risk of loss with both obsolete inventory and tied-up cash. However, alternative strategies are also available to help turn inventory into cash (as described in the following two real-world examples).



A manufacturer of high technology products required fairly expensive raw materials and chemicals in the production process. In order to improve availability and reliability of certain key products, a primary vendor agreed to store the inventory on the manufacturer's site, which was accessed on an "as needed" basis. When the raw material was accessed and used, a report was generated once a week, invoices produced, and the manufacturer was provided net 30 days to pay. This strategy worked well for the vendor because the manufacturer was a large customer that it wanted to provide the highest value service to. In addition, the vendor had excess financial resources available to support this strategy. For the manufacturer, not having to purchase, warehouse, and manage this raw material provided the ultimate opportunity to utilize a JIT inventory strategy. (If you missed it, the earlier section "Using JIT payment strategies" describes the JIT concept.)



Here's another helpful example: A jewelry retailer required a large amount of inventory in the form of precious metals and stones to ensure that enough products were on the store shelves for the all-important holiday selling season. A primary supplier of precious stones agreed to consign the stones over half a karat and accept 14-day payment terms after the consigned inventory was sold. By consigning the inventory, the supplier technically remained the legal owner of the large stones but, at the same time, made sure that its large stones were available for sale (improving operating results). For the jewelry retailer, having the right product available at the right time improved its operating results as well.

These inventory strategies by no means represent a complete listing of all the options available. However, when using these types of strategies, remember the key point: There's no such thing as a free lunch. If your business is going to use these types of strategies, somewhere and somehow, your vendors or suppliers will build in added costs in the price of the materials to compensate for your business using their cash and assets.

Tapping vendor-provided financing

Probably the most common type of credit extended from vendors and suppliers is *net 30*, which means that the payment is due within 30 days of the invoice date. Countless other vendor credit terms are available and range from due in advance (for rent payments) to net 90 days or more (to support seasonal sales). Following are two more opportunities available to tap vendor-provided financing to improve cash flows:

- ✔ **Insurance:** Insurance premiums for general liability, umbrella, auto, directors and officers, and other forms of annual coverage requirements are usually billed 100 percent in advance (for the entire year). Inquiring with the broker or insurance company about financing options is worthwhile, though, because for financial strong companies, very attractive payment plans are often available. (For example, you may get 20 percent down with the balance due in nine equal installments at 4 percent per annum).
- ✔ **Leasehold improvements:** Most businesses at one point or another lease real property to support their operations. As the business evolves, expands, and/or market conditions change, updates to the leased space may be required. If the landlord doesn't want to make these leasehold improvements or updates on his nickel (which is most often the case), you will be responsible for paying for the leasehold improvements. One strategy to consider is to go back to the landlord and ask whether he will absorb the leasehold improvement costs and then adjust the rental rate moving forward. If the increase is reasonable, then instead of coming out of pocket from day one to cover the leasehold improvement costs, the costs can be amortized over the life of the lease.



For larger and more-infrequent transactions, it never hurts to ask about financing options. Most larger, astute, and savvy vendors and suppliers will already be working with third-party financing sources to make your life (as their customer) as easy as possible.

Leveraging Your Employees for Cash

The majority of this chapter has been focused on managing the disbursement cycle to improve cash flows from the perspective of external third parties such as material suppliers, corporate vendors, and professional service providers. At this point, we want to explore how companies leverage their employees and manage the payroll and compensation cycle to improve cash flows without violating the plethora of rules, regulations, and laws designed to protect employees.



Federal and state laws alike have been designed to protect employees and ensure that they are paid in a timely manner (in addition to ensuring that all payroll taxes and other payroll associated obligations are paid in a timely manner as well). Although opportunities are present to leverage the payroll and compensation cycle to improve cash flows, they aren't numerous given the relatively stringent regulatory environment.

Timing commissions and bonuses

One of the most effective and legitimate strategies used by businesses to properly match cash receipts with disbursements is to structure commission and bonus plans in a consistent manner with the receipt of cash from sales.

✓ **Commissions:** The simplest strategy to use with commissions is to defer the payment of any sales commission earned until the cash has been received from the customer. For instance, if a sales representative generated \$100,000 in sales in April and earns a 5 percent commission on all sales, the commission of \$5,000 would be recognized as an expense in April by accruing the obligation due. However, if the customer doesn't pay until June, then the commission of \$5,000 isn't paid until June as well (to match the cash receipt with the payment of the commission). This strategy can be further leveraged to improve cash flows by implementing a policy such as paying all commissions on the 10th day of the month following customer payment. So if the customer doesn't pay until June, the commission could actually be delayed until July 10.



Structuring a commission plan that remits commissions when the customer pays encourages the sales representatives to stay actively engaged with the customer to ensure that payments are received (because if the customer doesn't get paid, the sales representative doesn't either).

✓ **Bonuses:** Bonus plans are generally tied to specific business goals and objectives established for a company's operating performance overall (as opposed to a commission paid on sales). To maximize cash flows, the ideal scenario is to pay bonuses during a period of the year when cash balances are usually higher (for example, 90 days after the company's primary selling season so that sales can turn into cash from customer payments) and/or to pay the bonuses after the operating period on which the bonus is based has been properly evaluated (to ensure that an accurate bonus is calculated and paid).



All compensation plans that include bonuses, commissions, and/or other similar types of payouts should be properly structured and approved by either an internal human resources department or by external professional counsel. The last thing any business needs is to run afoul of state or federal laws pertaining to employee compensation.

Connecting compensation to performance

It should go without saying that all compensation plans need to be structured with a clear correlation between objectives and rewards. A perfect example of this link is the classic sales compensation and commission plan whereby a sales representative earns 5 percent of all sales generated up to \$1,000,000 and then 6 percent on all sales above \$1,000,000. The company's objective is to drive sales, and the reward is a higher commission for the sales representative. But this type of simple compensation structure has gotten more than a few businesses in trouble because although sales were being driven, the company forgot to ask whether the sales were profitable and collections were being received.

A more relevant and worthwhile sales representative compensation and commission plan expands on the above base program by adding the following features:

- ✓ All sales commissions are paid when cash is received, for cash received within 90 days of the invoice date. Commission payment is then matched with the actual receipt of cash and also ensures that customers pay within a timely manner (by keeping the sales representative engaged).
- ✓ The base minimum gross margin required on all sales is 20 percent. For sales that generate a gross margin of less than 20 percent, no commission is earned (unless approved by management). The goal with this requirement is to keep the sales representative focused on selling profitable goods or services and avoiding the trap of “buying” sales by offering deep discounts or special deals.



This sales commission example is very basic and is offered merely to highlight the types of compensation plan features and structuring options that can be utilized to achieve desired results (which for a business is generating profits and for an employee is earning fair and reasonable compensation). The key issue is that compensation plans need to be properly aligned with business operating objectives to produce the desired results.

The sales compensation and commission plan example provided is based on a *top-line approach*, which looks at the top line of the income statement (which is first revenue or sales) and then the next critical line of gross profit.

The top line — in this case, net revenue — can be used as the basis to calculate a commission for an individual sales representative that produced \$2 million in sales and earns a 5 percent commission, or \$100,000. The top line can also be used to calculate a bonus for the sales and marketing team, such as paying a bonus of 3 percent if the company's top line exceeds \$10 million for the year (thus providing \$300,000 to be split between the team in the form of a bonus). Top-line compensation programs represent only a portion of most businesses' employee compensation because in addition to top-line commissions, bottom-line bonuses — that focus on the last lines of the income statement, which are typically net profits — are also widely used by businesses.

The same logic applied to structuring commission programs also applies to structuring bonus programs, as a clear correlation between the reward being offered and the desired business objective needs to be developed. In addition, identifying what method will be used to measure the bottom line should be incorporated into the bonus program (for the benefit of all parties). One of the most common methods employed is to simply structure the financial measurements based on GAAP (generally accepted accounting principles). It's both reliable and independent.



Don't be consumed with structuring bonus programs strictly on the income statement alone. For senior management, keeping the business on sound financial footing with a solid balance sheet and strong cash flows is just as important as generating high profit levels. The higher the level of senior management, the more broad-based the objectives should be, factoring in data from all financial statements, including both quantitative and qualitative targets. Remember, one of senior management's primary responsibilities is to think strategically, which usually involves developing and implementing long-term business plans. So senior management should be incentivized appropriately for achieving critical objectives that don't necessarily contribute to current-year profits but lay the foundation for higher profits three years down the road.

Utilizing noncash forms of equity compensation for employees

A number of noncash forms of compensation are available for use by employers that can supplement the employee's earning potential over the long run. One of the most widely used forms of a noncash-compensation program is an incentive stock-option plan. Diving into the details of stock-option plans is well beyond the scope of this book, but the general idea is to provide employees with a grant of stock options (which represent equity ownership in the company) that they can earn or vest over a period of time.

Start-up companies often use stock-option plans for a number of reasons, including to attract high-quality employees. Because the start-up company doesn't have the resources to match cash-compensation programs of larger businesses, they sweeten the pot with offers of equity. Start-ups may also use stock-option plans as a means to conserve cash (trading cash compensation for potential equity appreciation at a later date) and to make sure that the employee stays committed to the company for an extended period (as the stock-option grant is earned over a period of, say, three to five years). For employees, the trade-off is usually straightforward in that lower near-term compensation is earned with the hope that the start-up becomes the next Google and stockholders will exit with millions.



If your company is considering implementing an incentive stock-option plan, obtain proper legal counsel to ensure that it's structured and managed correctly. The technicalities with these types of plans are significant and best left to the experts.

Another type of noncash equity compensation is often referred to as *phantom equity*. Under these plans, an employee is provided upside earnings potential upon a future event being achieved (and is compensated at that time). For example, a key employee may be provided a phantom-equity incentive of 2 percent of the company's value when it is sold. The advantage to the business owners is that they don't actually have to give up any equity (thus having another shareowner with voting and other rights to account for). The advantage to the employee is that she has an incentive plan with significant upside when the event is realized (although some tax disadvantages are present). The variety of colors and flavors with phantom-equity plans are extensive, but they all provide the employee with significant earnings potential upside (like an incentive stock-option plan) but without actually issuing equity. Withholding equity may be particularly favorable for businesses that are family owned, tightly controlled, structured as subchapter S corporations, and/or have other ownership structures that limit the ability to issue equity.



Providing equity in lieu of cash compensation can be expensive. Companies need to understand that although cash can be conserved, giving up equity represents a real cost of conducting business. The trade-offs of giving up ownership interests in exchange for securing the employee need to be carefully evaluated.

Checking out other benefit strategies and ideas

Finally, a couple of other employee-compensation strategies may be relevant in terms of improving cash flows, controlling expenses, and reducing the risk of fraud.

- ✔ **Use it or lose it vacation policies:** Encouraging all employees to use accrued vacation within a certain time period or lose it can help improve cash flow by limiting the potential of having to actually pay accrued vacation balances if the employee leaves. The idea is to avoid building up multiple years of accrued vacation by strongly encouraging employees to take vacation (thus reducing outstanding balances). In addition, having employees take vacation achieves a significant internal control by providing an opportunity to have another independent employee cover the workload of the employee on vacation. This employee brings a fresh set of eyes to the job, which can uncover fraud, waste, and/or other inefficiencies.
- ✔ **Employee allowances versus expense reports:** Employers for years have used allowances as an additional form of employee compensation to cover directly incurred expenses for such items as mileage, auto, travel, phones, and so on. Although relatively easy to administer, using allowances also creates problems for the employee and employer alike. Employees are generally required to report allowances as earned income on their tax returns, because the IRS tends to view allowances as additional compensation. For the employer, allowances tend to be paid at the same time as payroll (thus accelerated) and may be inflating expenses (because employees may be taking advantage of the allowance if their actual direct costs are much lower).

To manage this issue, requiring employees to prepare and submit expense reports not only keeps the employee honest with expenses but also can buy the employer a little time in remitting payment (for instance, employees must submit expense reports within 10 days after the month end and will be paid on the 25th of the following month). Furthermore, direct reimbursements of employee expenses from an expense report is generally not considered additional income to the employee by the IRS.

