

GROWTHFORCE

White Paper

Cash Flow Best Practices

The 5 Rules of Cash Flow Best Practices for Small Businesses

*A White Paper by Stephen King
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The more you grow, the more cash flow problems you are likely to have. Cash flow is the reason **85% of all businesses don't make it to their fifth year.** This paper¹ discusses how to avoid cash flow problems by outlining the best back office practices that the Fortune 500 companies implement to improve their cash flow and how you can apply them to your business. Specifically we are going to focus on credit policies, billing practices, collections procedures and payment policies.

For small businesses, the key to improving cash flow is managing receivables. Usually it's the biggest asset of a service business. Most service businesses have a lot more in receivables than cash or any other asset.

- Collections of A/R is usually the **biggest contributor to cash flow.**
- With a minimum effort you get a relatively high-value payback.
- Interest expense on borrowings affects profit.
- Analyzing A/R also helps identify underlying business issues



Customer Feedback

Customers will tell you what's wrong with your business when you are trying to separate cash from their wallet. If you focus on those issues, it will help you understand underlying business issues which contribute to improved cash flow.

¹ This white paper is the result of a study of Fortune 500 best practices done in preparation for a presentation at the Inc 500 National Conference in 2000.

Rule #1: Control Cash Flow Problems

Don't let your **customer's cash flow problems** create cash flow problems for you.

The key is deciding who gets credit. How do you decide who to give services or products to without first getting their money? What should be in your credit policy?

Step 1

Be smart about who can establish credit

When you give a customer a product or a service without getting cash, it's a loan, which entitles you to determine how creditworthy their business is. Take a look at their cash balance, call trade references that they do business with and ask, "Is this a good customer to have?"

Once you've paid payroll on a job and paid all your expenses, it's too late to find that out your client has cash flow problems and can't pay your bill. You need to take the time up front to decide whether or not this is a good sale.

If it's a large amount you should use the trade services. The top three credit bureaus are Dun & Bradstreet, Equifax, and Transunion. (TRW Credit).

Step 2

Create a written credit policy

Your credit policy should be in the fine print in every one of your contracts. A credit policy defines who is creditworthy and your terms.

What should be in a credit policy?

Terms – to whom and when will you provide the credit? For example,

- Does anyone who pays a 50% deposit get credit?
- If the amount is over \$10K it may require a credit report that has no balances > 45 days.

What is your **collection period**?

- When is the customer's bill due?
 - upon receipt/10 days/30 days
- What is the standard collection period?
 - Typically terms range from immediately upon completion of services to net 30 days.

Discounts

- 1-5% incentives for early payment
 - We recommend not offering early payment discounts. This concept has lost favor as the Fortune 500 have found that too many customers take the discount even when paying late. This ends up doubling your billing and collection cost to follow up on unauthorized discounts. Instead include a late payment charge (see below).

Payment terms must be expressly defined in every sale/contract

- This eliminates confusion for the client.
- Clear payment terms improve your position in case of a legal problem.
- However they must be fair & consistently enforced, or you face potential discrimination charges

Late Charges

- Standard late payment charges for most service businesses are rate 1.5% per month (18% per annum) after 30 days.

Security Deposit

- Request a deposit up front to cover your cost whenever possible. This serves as collateral to minimize your exposure in case a customer won't pay.

Personal Guarantees

- If the amount is large or length of the contract is long, you can ask for a personal guarantee, however this should be from one of the officers of company.

Collection and Attorney **Fees**

- Make sure you spell out who will pay legal fees if you sue.

Best practices in many industries are to get a 50% deposit so you know you've at least got your costs covered. Also, in your contracts, define what your collection period is. When is the bill due? It is a lot easier to deal with a customer's credit problems if they know what the expectations are in advance. These payment terms need to be expressly defined in your contract.

We also suggest that your policy include late charges. If you're not enforcing late charges you've effectively given clients an "interest free" loan. Any good Controller

knows when cash is tight, the bills that go to the bottom of the pile are the ones that have no late penalty.

Also make sure your policy states that if you do have to go to small claims court and you have to hire a lawyer to collect your fees, the client is liable for those legal fees.

Rule #2: Get Cash Upfront

Get enough **cash upfront** to cover payroll and expenses.

As a service business, labor costs are your biggest expense. The goal here is to get your billing out and payment in before you have to pay payroll.

Design a billing process

Design a billing process that is so simple that everyone knows what to do after they complete a job. If you can wait to pay your bills out until after you have been paid for a job you will eliminate your cash flow problems (assuming that you have priced the jobs right).

If you're paying payroll today for services delivered yesterday, and you're getting paid 45 days from now, you will need outside capital to support your working capital requirements. You can't make it up in volume. Time the delivery of your invoice as closely as possible to the delivery of services, and time the payment of those services as closely as possible to the payment of payroll.

1. Start with a review of your billing process

- Map it out. How many steps does it take to create an invoice

2. Review your invoice form

- Make it very easy for your client to understand so that there are not questions about what they are paying for.
- Tie invoice details to the payment terms outlined in the contract

3. Review timing of invoices

- Invoices should arrive a minimum of 20 days before payment date. Most well run businesses only cut checks once a week and this allows your bill to cover two check processing periods.
- Process invoices often – definitely not only at end of month! You should send an invoice immediately upon completion of a milestone or project.

4. Take any **emotions or insecurity** out of the process

- Delegate responsibility for creating the invoice to someone independent of the billing process.
- Service providers often wait to send an invoice because everything is not perfect. It's better to get it out than it is to wait for it to be perfect. That's easier when someone else does the billing.

Retainers

If you're a service business and you're dealing with the same customers every year, take their annual spend and spread it over a 12 month period. Ask the customer to put you on retainer for the base-level services you provide. This way you and your client don't have the ups and downs of monthly cycles.

Setting up a retainer agreement has **numerous advantages**:

- You can record these transactions easily by setting up a recurring bill in QuickBooks.
- You can debit the client's bank account on the 1st for the amount on your bill. This eliminates the time that you have to chase your client for money and the hassles for the client in writing a check.
- This keeps your processing costs down for you and your client.

Credit Cards

Credit cards significantly improve cash flow unless the client would have paid you just as quickly with a check. Usually it is well worth the cost of the credit card processing fee. We recommend Intuit's merchant account because the rates are highly competitive (we compared Intuit against other well known service and found no material difference in fees) and you just have to click a button on the invoice screen inside QuickBooks and it automatically processes the transaction and applies it against the invoice. You don't need a card swiper or any other tools, and it makes the accounting really simple.

Rule #3: Implement Collections Procedures

Implement collections procedures that allow you to spend as little time as possible chasing your money.

Why don't people pay you? There are **four reasons** clients don't pay:

- 1.** They are dissatisfied.

2. They set their own pay timetable.
3. There is a short-term cash shortage.
4. The client can't pay. A bankruptcy is pending.

There are many ways to attack collections. We recommend the following procedures be religiously followed.

Step 1

Run an aged A/R report every week

- The aged A/R should be in order of amount owed, not alphabetical by client. (Very simple in QuickBooks).
- Attack past due accounts amounts in dollar order.

Step 2

Start calling clients before the balance is due

Don't wait until the balance is 30 days past due.

Your first call is a customer service call taking place 3 to 5 days before the due date.

- Was everything okay?
- Were you highly satisfied with our service?
- Is there anything we should know or need to improve in our service?
- We see your invoice is due in 4 days; do you have a copy of invoice?
Are there any questions about our bill?

Step 3

Take action every week

Take action a minimum of every week; preferably every 3 days. The squeaky wheel gets oiled...make sure you get your oil.

If you call for payment before the bill is due you are showing the client you are serious about collections. But to be a good collector you need to follow these guidelines.

To be a good collector you need to follow these guidelines:

- Be a **good listener**. Customers will tell you why they are holding checks. The best run Fortune 500 companies carefully monitor collection callers to learn trends

- **Follow-up immediately** on customer service questions to show you are serious. If you get feedback and act on it right away you have eliminated the reasons to hold a check. Is there anything we should know or need to improve?
- Train all staff who make collection calls on good collection skills. **Follow the “3 F’s”:** Be friendly, firm and focused.
 - Never end conversation without securing check or commitment. Otherwise it’s a failed phone call.
 - Call a day before a check is expected to confirm. Ask what time you can pick it up.
 - Get post-dated checks – a bird in hand is worth...
- If you can’t do it right and have cash flow problems, outsource it: One collector should handle 400-600 A/C’s.

Step 4

Anticipate each response a collector might face

Response 1. Check is in the mail.

- Get a check number, the date mailed and amount for your records Small business credit policies.

Response 2. Partial Payments

- Why did they only make a partial payment?
- When can we expect full payment?

Response 3. A promise, but no current payment

- When can we expect/pick up a check?

Response 4. Disputed amounts or unhappy with the quality of service

- What do we need to do to make you happy and close out this balance?
- FYI – This is critical because if you don’t have happy clients the best practices won’t do you any good.

Response 5. Request for additional information

- What other information do you need?

Response 6. Inability to make payment – this is the most difficult issue

- Need to understand the severity of the situation.
- When can you make a payment on account?
- Review current status of service – are we shutting them down?
- Confirm they understand that a late payment carries an interest penalty
- Review your standard collection practices (when do the lawyers need to get involved?)

Step 5

Measure your success

The only way to ensure cash flow success is to monitor results. The old adage “What management measures then gets done” is very true for collections.

The most common Accounts Receivable management tool is DSO – **Days Sales Outstanding**. DSO is a simple formula that results in a powerful figure.

$$DSO = \frac{\text{Accounts Receivables}}{\text{Sales}} \times 360$$

The answer will be in number of days it takes you to collect on your sales. Your goal depends on your industry & your payment terms. The most common goal is to get your DSO below 30 days.

Example

Let’s say you’ve got \$40,000 in accounts receivable, and you’ve got \$450,000 in annual sales. Multiply that times 360, and you’ve got 32 days outstanding. Typically any number over 30 means you not doing a good job. If that number is fewer than 30, then you’re ahead of your peers.

Every week (assuming you bill weekly) take that report and see if that number going down. If not, go back to the basic collection steps to identify why your collection efforts are slipping.

Rule #4: Pay Your Bills

Pay your bills after you've been paid by the client.

This is the corollary of Rule #2 – get cash for a job before you have to pay payroll on that job. There are two steps to follow to manage your expense flow most effectively:

Step 1

Institute a waiting period before paying payroll

The best run companies don't pay payroll immediately after the work period, they wait two weeks before staff get paid for their work. This way you have a chance to bill and collect from the client before you have to pay payroll.

Step 2

Pay payroll semi-monthly

GrowthForce recommends paying payroll semi-monthly. This way your salaried payroll is exactly the same every month. Bi-weekly means you have two months with three payrolls, which is very difficult to do for many small businesses. Weekly payroll processing should be avoided at all costs as it significantly increases the cost to process payroll and creates constant cash flow pressures.

Step 3

Institute a "pay slowly" rule

Many office managers or untrained payable clerks follow a "clean desk" rule which gets bills out the door quickly. Bills should be paid when they are due, and no earlier.

Rule #5: Manage Your Debt

Manage your debt – be informed.

The two largest investors in American small business are Master Card and Visa. Many small businesses get started with zero-percent credit cards, but forget to pay attention to the interest rates after the initial introductory period. They also don't make sure they pay off expensive money with cheaper sources of funds.

Step 1

Check your interest rates

Check the interest rate on every credit card and make sure you are not paying 18+% interest. Most credit card companies will give you 0% on balance transfers for up to a year.

Be careful to note the credit card issuer. MBNA is often the bank behind many trade association or non-profit credit cards. The banks won't let you transfer funds from one of their cards to another on the same bank. You can tell by looking at the small print on the application or the back of your existing credit card.

Step 2

Get a line of credit from the bank

Use it to pay off your credit card balance and pay lower interest.

You'll save because:

- The bank offers lower interest rates than credit card companies (outside of the introductory rates)
- You can pay back your credit line as soon as you have cash available. If you pay off a credit card between periods you often only get credit at the statement date.

If you can't get a big credit line, ask for a small one. Then use it, pay it back, use it, pack it back, and keep on using it. The banks will extend you more credit once you establish a credit history with the bank. If you are trying to establish credit its better to use it and make timely payments than to let it sit unused. You only build credit when you use your credit.



For More Information

Please email info@growthforce.com or call **281-358-2007**.

GrowthForce would be happy to review your current processes and make recommendations or provide outsourced services to help you improve your cash flow.