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More Money at the End of the Month: Strategic Ways to Improve Cash Flow

By David Peters, CPA, MST, CLU, CPCU

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About your instructor

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Learning Objectives

- State the relationship between sustainable growth, core earnings, and company cash flow
- Recognize how time assessments and customer segmentation can be used to identify cash flow negative clients.
- Identify common behavioral biases which influence how a company spends money

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How do I optimize cash flow?

- Optimizing cash flow really is just a combination of two things:
  - Increasing and getting cashflows in sooner
  - Decreasing and paying cash outflows later

- Identifying a cash flow optimization problem can be done:
  - Qualitatively – Cash inflow is not optimized from the core product/service.
  - Quantitatively – Ratio analysis shows that liquidity is not optimized.

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Qualitative Evaluations - Core Earnings and Sustainable Growth

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- **Core Earnings** – The idea that a company creating cash through selling its main product or service is more valuable more valuable to long-term company viability than one-time cash flows (like the sale of a building).

- **Sustainable Growth** – The idea that there is an ideal level of productivity for a given level of capacity. Cash flow will not be stretched or cash wasted, as long as the ideal level of productivity is maintained.

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Example

Brenda serves on the board of ABC Company, a start-up company. ABC management is pleased to announce that the company has had positive cash-flow during each of the last three months. They point to the positive cash flow increase on the statement of cash flows. While everyone seems pleased with this result, Brenda is not so sure. She knows the company sold a large piece of equipment 3 months ago, sold off some of its investment portfolio two months ago, and received a large investment from the company owner last month. She hasn't looked at the financial statements in-depth, but she wonders if the celebration may be premature.

The company could have a core earnings problem, if it is only cash flow positive as a result of these one-time events. It may have a sustainable growth problem, if the company is growing quickly, yet does not have the staff, processes, or equipment to accommodate it.

Question: Is it possible to have negative cash flow from operating activities on the statement of cash flows and NOT have a core earnings problem?

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Example

Yes. While not necessarily likely, it is possible to have negative cash from operating activities and not have a core earnings issue. If the company received a large, one-time cash inflow from investing or financing activities and decided to extinguish some accounts payable sooner than normal, this could create a net cash outflow from operating activities - but the negative cash would be the result of a purposeful company decision. Other evidence regarding the timing of operating inflows and outflows would need to be examined before a definitive conclusion could be reached – payment terms, what prompted the decision to pay down accounts payable ahead of normal, etc.

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Regulatory Sustainable Growth – NAIC P&C IRIS Ratios

	Ratio	Unusual Values Equal to or Over	Unusual Values Equal to or Under
1.	Gross Premiums Written to Policyholders' Surplus	900	---
2.	Net Premiums Written to Policyholders' Surplus	300	---
3.	Change in Net Premiums Written	33	-33
4.	Surplus Aid to Policyholders' Surplus	15	---
5.	Two-Year Overall Operating Ratio	100	---
6.	Investment Yield	6.5	3.0
7.	Gross Change in Policyholders' Surplus	50	-10
8.	Change in Adjusted Policyholders' Surplus	25	-10
9.	Adjusted Liabilities to Liquid Assets	100	---
10.	Gross Agents' Balances (in collection) to Policyholders' Surplus	40	---
11.	One-Year Reserve Development to Policyholders' Surplus	20	---
12.	Two-Year Reserve Development to Policyholders' Surplus	20	---
13.	Estimated Current Reserve Deficiency to Policyholders' Surplus	25	---

(NAIC, 2024)

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Quantitative Evaluation – Liquidity Ratios

- Current Ratio = Current Assets / Current Liab.
- Quick Ratio = Quick Assets / Current Liab.
- Quick Assets = Cash, Accts. Receivable, Marketable Securities

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Liquidity – Operational Measures

$$\text{Defensive Interval} = \frac{\text{Quick Assets}}{\text{Daily Cash Operating Expenses}}$$

$$\text{Cash Conversion Cycle} = 365\left[\frac{\text{inventory}}{\text{cost of good sold}}\right] + 365\left[\frac{\text{receivables}}{\text{sales}}\right] - 365\left[\frac{\text{accounts payables} + \text{accruals}}{\text{daily cash operating expenses}}\right]$$

For what type of businesses/industries would these ratios be useful?

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Liquidity – Quality Measures

- **Inventory / Working Capital**
- **Receivables / Working Capital**

Why are these considered measures of "quality"?

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A word about all of these measures....

- All of these items are just indicators. There really is no such thing as a definitively good or bad liquidity ratio.

- If any of these indicators seem to be trending in a negative direction, we should look into them more to see why. We should look for corroborating evidence.

- Paying attention to what is going on within the company can help make sense of the numbers. Financial statements should never be looked at in a vacuum!

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So how do we fix a cash flow problem?

- Getting cash in the door faster:
  - Increasing the potential customer base
  - Fixing payment terms
  - Getting rid of problem customers

- Slowing cash out the door:
  - Adjusting to the business cycle
  - Fully utilizing credit
  - Streamlining company operational expenditures

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Increasing Customer Base vs. Payment Terms

- Increasing a potential customer base generally involves getting into a new market or offering a new product. Considerations may include:
  - Existing knowledge of the new product/market
  - Regulatory and business costs involved
  - Existing customer perception of your business – Are you known for one thing?

- Extending time for customers to pay generally increases customers, but may result in higher bad debts.

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Example

An insurance company is concerned that its payment terms may be deterring customers from purchasing its auto insurance product. Currently, new customers must make a down payment of at least 1 ½ months of the total policy premium up-front. The rest may be paid on a monthly basis over time.

The company decides to make their down payment equal to only 1 month of the premium, in an effort to get more customers. While this results in a 20% increase in premiums written, bad debts also increase by 30%. The company is finding more and more of its customers are having trouble making the second installment payment on their policy. While the company may have gotten more customers, the overall customer quality has probably gone down.

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Identifying Problem Customers

- Rank customers based on a rating system. For example, customers may be ranked on three dimensions: current revenue, potential for future revenue, and revenue per time spent.

- Revenue versus expenses broken down by customer. For example, an accounting firm might evaluate clients based on revenue received minus expenses (staff time, printing costs, etc.). This one requires close tracking to be effective!

- Average days to payment by customer. Get rid of customers that take too long to pay.

- More qualitatively…. Which customers are difficult to deal with and drive your staff nuts?

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Business Cycle & Cash

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- It is rare for a business to not experience any cyclicality. Most businesses have some ebb and flow. (Example: Retail stores tend to better at holiday time)

- Not surprisingly, companies tend to be more cash plentiful at the hot times during the year.

- Long-term investing of excess cash can allow for expenditures to stay steady, even if revenue is bumpy (pull from investments when cash inflows are lean, and invest more in the portfolio when cash inflows are good)

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Considerations in Investing Company Cash

- **Risk** – How comfortable are owners/Board with fluctuations in the market?
- **Rate of Return** – What type of return does the company want to achieve with the portfolio?
- **Liquidity** – How soon will the company need cash from the portfolio?
- **Legal** – Are there any legal or regulatory constraints on how cash is invested?
- **Taxes** – What are the tax implications to the company (owner, if a flow-through)?
- **Timing** – When during the year will cash be needed?
- **Other** – Are there things that the company may or may not want to invest in? Any other constraints on the portfolio?

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Stretching AP & Financial Stress

- Financial stress is the concept that as debt increases, there is a psychological cost associated with it.

- Theoretically, there is a point at which the benefit of stretching AP (waiting till the last day to pay invoices) is no longer beneficial.

- Stretching AP may result in hidden cost – Requires a system or excellent organization (which may result in increased staff time).

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What keeps our companies from being streamlined?

- It doesn't take an accountant to figure out that more spending than money coming in is a bad business plan!

- So if the logic isn't the problem, what is?
  - Not being aware of the company's financial position
  - Bad habits/Bad Prioritization - not understanding what is necessary vs. what isn't

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Creating Better Awareness of a Company's Financial Position

- All-Hands Meetings
- Roundtable Discussions with Executives
- Email Blasts
- Is there a way to turn it into a friendly competition?

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How do we form bad habits?

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- **We get so used to things that we cannot think of it any other way.**
  - “We always cater this meeting!”
  - “We have to take the client out to this restaurant. They expect it!”
  - “Our staff is underwater constantly. We have to hire someone!”

- **Behavioral finance is based in investing concepts but may provide some clues on this issue as well….**

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Behavioral Finance Biases

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Information-Processing Biases

- Anchoring and Adjustment
- Mental Accounting
- Framing
- Availability

Emotional Biases

- Loss Aversion
- Overconfidence
- Status Quo
- Endowment
- Regret Aversion

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Information Processing Biases

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- **Anchoring and Adjustment** – We have a number in our head of what our spending “should be” in a particular area.

- **Mental Accounting** – Too much emphasis on where the amounts are spent (sales budget vs marketing budget), as opposed to just realizing that additional spending affects the entire company.

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Information Processing Biases

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- **Framing** – Making decisions based on whether they are presented positively or negatively.

- **Availability** – Making decisions on immediately available information that may not be representative of reality.

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Emotional Bias

- **Loss Aversion** – Not giving up on a project that should be abandoned, because then they would have to declare the project a failure.

- **Overconfidence** – Unlikely belief that we always control our own destiny.

- **Status Quo** – Fear of moving away from items that we have always spent money on.

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Emotional Bias

- **Endowment** – Too comfortable because things have always been good.

- **Regret Aversion** – Fear of making a bad decision.

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Case Study

You are the CFO of a small electronics distributor company in your hometown. The company has been expanding revenues over the last few years, but profit has stayed the same. This is largely due to a new product that the company has been producing, the widget. While everyone had high hopes for the product a few years ago, your company has consistently lost money on the widget every year with no real signs of improvement.

Sam Smith, who is in-charge of the widget line, comes to you after a budget meeting. He asks how much money the company will be putting towards his product this year. He says, "We can't quit now on the widget. Otherwise it will be a failure – and we just can't have that! I know we can turn it around!"

What bias is Sam exemplifying? How would you address Sam in this instance?

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Dealing with Behavioral Biases

- **Information Processing Biases** – Errors in logic or how the information is processed. It is a lack of understanding. *(Generally corrected through education.)*

- **Emotional Biases** – Erroneously reacting to a view based on one's feelings. *(Generally cannot be corrected, so it needs to be accommodated.)*

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Dealing with Behavioral Biases

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- In investing, we generally want to evaluate:
  - Standard of Living Risk
  - Cognitive vs. Emotional Bias
- If standard of living risk is low, deal with cognitive biases through education. Emotional biases can be accommodated.
- If standard of living risk is high, deal with cognitive biases through education. Emotional biases must be confronted.

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How does this apply to cost cutting?

- Companies may be hanging on to views based on information processing errors or emotional biases

- If the problem is based on information processing, we need to make employees and other stakeholders more aware of the problem and educate.

- If the problem is emotional:
  - And the expense item is immaterial → May need to accommodate
  - And the expense item is material → May need to consider personnel changes

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Rules of Thumb for Cost Cutting

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- The biggest expense line items generally present the biggest opportunities for cost cutting *(for most companies, people costs are the biggest expense)*

- Breaking expenses into revenue producing and non-revenue producing expenses can help identify opportunities

- Delaying cost where possible can improve cash flow, help companies think about what is necessary, and maximize productivity *(Ex: delayed hiring)*

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Managing Headcount

- Before you can evaluate headcount, you need to be able to measure productivity. Examples:
  - Sales or Revenue per Head for Sales Staff
  - Tickets Serviced per Head for IT Help Desk
  - Calls Handled per Head for Customer Service

- Need to figure out a baseline for productivity metrics.

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Managing Headcount

- **Hiring decisions should be made with the big picture of the company in mind**
  - You want employees to feel a bit stretched, but not burned out.
- **Hiring should be delayed wherever possible**
  - Generally, if there is doubt as to whether an additional person is needed, delaying the decision can help make it clear

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Managing Headcount

- **Things to Consider:**
  - Younger talent is generally cheaper, but more experienced professionals may be more productive. What level of person do you need?
  - In a bad economy, talent is generally cheaper
  - Certain positions are more difficult to hire for and the hiring process may take longer
  - Hiring locally is generally cheaper than paying for someone to move

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Discussion

The IT Manager comes to you saying that she needs one more additional person for her team. You mention to her that this is one more person than the company had budgeted for her team this year. She says it would be a disaster not to hire another person. "The company's network security would be in danger!" she exclaims. How do you respond? Do you take her word for it? Push back? If so, how?

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Potential Areas of Excess Cost

- Rental/Office Space
- Travel Costs
- Business Meals
- Desktop Computers only used at the office
- Client Entertainment
- Physical Storage Space

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Day-To-Day Ways to Improve Cash Flow

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- **Challenge company norms** – Do we really need this? If we do, do we need it now?
- **Challenge departments to look for alternatives** – Is there a cheaper way?
- **Don't be afraid to say NO!** – Part of being a finance leader in a company is protecting the company's assets. Don't let them go out the door, if you don't need to.

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Summing It Up

- Spotting cash flow problems can be done a number of ways, but no method should be done in isolation. All methods need corroborating evidence.

- Improving cash flow is conceptually simple, but difficult to implement – because it often involves changing company behavior (getting new customers, changing employee habits, and the like).

- It often falls to the finance leader to become a change leader to really make cash flow improve.

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Thank you!

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