



Improving Liquidity

How to meet pressures to improve liquidity in today's economy

In the difficult economic times we are operating in today, never has there been more focus and pressure to release liquidity from working capital. Cash, as the saying goes, is King.

Put simply, without cash a company will close down. However big or small. So to ensure survival through this period, companies are placing increased focus on cash flow and liquidity.

Some statistics for you;

The leading 2000 corporations in Europe and the US have an aggregate total of US\$1 trillion of cash tied up in working capital¹

Around 60% of failed businesses put this failing down wholly or in part to cash flow problems²

73% of C-level executives mentioned conducting top-down reviews of cash management and cash flows³

There is pressure to manage cash, liquidity, and also risk more effectively; to optimise liquidity like never before.

*"Companies are now scrutinising their balance sheets and actively seeking out ways to release cash, both to support operational cash flow demands and to underpin committed or essential capital expenditure."*⁴

Liquidity is essential in driving forward company growth and innovation.

The basics

Before going any further we need to be clear about the basic definitions.

A liquid asset is something that can easily be converted into cash. Liquidity is the measure of whether a firm can pay its current debt with its current assets. If a company has adequate liquidity it can meet its current liabilities.

Much attention is paid within companies to profit, the measure of what you have billed. A sale is immediately recognised on your income statement. However, you don't receive this money immediately. You cannot show that credit transaction in your cash budget and statement of cash flows until you actually receive payment. This is cash flow, and this is where the attention needs to be paid.



How to measure liquidity

There are a number of calculations of varying accuracy that you can perform to assess the liquidity of your company, such as;

Current ratio

Current ratio determines the ratio of your current assets to your current liabilities. Current assets include cash, accounts receivable, inventory etc.

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

(Target ratio of 2 to 3)

This measures if a firm has liquid funds to pay its current obligations.

Quick ratio

Quick ratio determines if you can pay your short term debt obligations, or current liabilities, without having to sell any inventory.

$$\text{Quick ratio} = \frac{\text{Current assets} - \text{Inventory}}{\text{Current liabilities}}$$

(Target ratio of 1 to 2)

This indicates a firm's liquid funds without selling inventory.

But, however you chose to measure it the key must be to properly manage your cash flow. This is essential to avoid running out of operating cash.

Manage liquidity and increase your cash flow

So we have seen cash and liquidity management are critical functions to any business, but how can improvements be made? Thankfully there are many measures, large and small, that you can consider.

This section outlines a top line view of the elements you can look at to improve liquidity management, the following section takes some of these elements in more detail and covers potential pitfalls and considerations you need to make before making changes.

To start with, of primary importance is data. Having visibility and transparency of data enables better control. This applies to both the quality of data and the accessibility of data.



Importance of good data

Accurate data enables better forecasting and therefore better decision making.

Information needs to be accurate if effective decisions are to be made with confidence.

If the quality of data is not good, decisions are based on little more than educated guesswork.

Accessible data

Forecasting cash flow and liquidity is often complicated by the sheer quantity of data required, and the need to analyse and sometimes merge numerous spreadsheets and data sources.

Only once you can forecast cash flow accurately can you manage cash requirements properly. And to forecast cash flow accurately you need all relevant data in the right place at any given point.

Not to mention the fact that disparate spreadsheets and data sources take a significant amount of time to manage and maintain.

Take stock

Review your inventory levels and ensure you do not stock too much. The economic climate may well have affected buying patterns of your customers. Analyse these and ensure your stock levels are sufficient but not unnecessarily heavy.

Costs and prices

When was the last time you reviewed your costs or increased your prices? Appraise your profitability and readjust as necessary.

Diversify your suppliers

Buying all your supplies in one place is unlikely to guarantee the best costs. Using a range of suppliers can often help you to negotiate lower, more competitive prices.

Reduce your fixed capital

Review your fixed capital and identify where cuts can be made, e.g. buildings/offices, staff, equipment, vehicles etc. Getting rid of any unproductive assets will release cash.

Don't overlook your overheads

Assess the firm's overheads, can you lower them? Look at rent, advertising, professional fees etc.

**Earn extra interest**

When cash is not needed elsewhere, move cash balances in to an interest-accruing account. When these funds are required you can shift them back to your main operating account but you will be gaining maximum interest on your money in the interim. This is also known as 'sweeping' or using 'sweep accounts'.

Negotiate longer payment terms

You will keep money in your bank account for longer and gain interest on it.

Improve accounts receivable

Improve your collections and ensure you are getting money that is owed to you on time.

Minimise billing disputes

This will help your accounts receivable function, but will also help lower days sales outstanding and to accelerate operating cash flow.

Pay attention to owners draws

Do not draw too much money out of the business if you can help it.

Make better use of existing credit lines

Making maximum use of existing credit lines, such as P-Cards, will benefit your liquidity.

Prevent fraudulent attempts

During a tough economic climate, fraud has been found to increase. Financial pressures on individuals increase, and some succumb to the temptation. To limit these attempts within your own business you need to ensure you have stringent checks and balances in place, and in particular maintain a strict control on spend.

Cash discount system

Using a cash discount system can encourage debtors to pay sales invoices faster.

Make proper credit checks

Credit check all new customers and make trade credit risk decisions accordingly.



Minimise transactions costs

By reducing administration you can reduce costs, thereby helping working capital.
Focus on eliminating duplicate efforts, data re-keying, and human errors.

Better collaboration

Improve collaboration between finance, line-of-business managers, and operating units.

Putting things in to practice

The previous section gave an overview of elements to consider when improving the liquidity of a business. However in a number of instances there are potential drawbacks of making changes (such as the time to make the changes or costs involved) or other considerations you need to be aware of. For each of the elements we cover in this section, we will look at the considerations in more detail and also look at a potential solution to some of these.

There is a common solution that can aid the elements we will cover. Invapay is a trading and payment system that allows businesses to order from and pay any vendor. Invapay acts as a simple but data-rich intermediary - accepting buyer orders and payments (of all types) on behalf of suppliers, and automatically transferring funds to the supplier's bank account within five days from invoice submission (subject to terms established with the buyer).

Invapay can help with many of the elements covered regarding better liquidity management to make improved cash flow and liquidity a reality.

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If the quality of data is not good, decisions are based on little more than educated guesswork".

Of course accurate data is a must, but unfortunately the quality of data provided by suppliers for purchases is not always to the level you need. For many suppliers, especially smaller suppliers, the cost of providing level 3 line item detail is simply too high.

Invapay provides level3 line item detail for every single transaction, providing accurate data and full visibility.



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Managing multiple spreadsheets and data sources takes a lot of resource and also increases the chances of errors. Gathering together data from various sources, reconciling data, and identifying and resolving mistakes creates a huge burden on resource.

Using an ERP system as the central hub of your relevant financial information ensures that all data is recorded in the same place, providing easier reporting, visibility, and accuracy.

The details of all transactions made through Invapay are delivered back to you in a format to integrate to whichever ERP system you use.

The combination of accurate and accessible data enables proper analysis of liquidity, including the review and management of intraday liquidity which otherwise is unachievable.

Diversify your suppliers

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There is a drawback to diversifying your suppliers. To set up numerous suppliers on your systems can create a significant drain on resource, and you also need to take account of the time required to maintain those additional suppliers' details on your systems.

In addition more suppliers can mean more phone calls chasing for payments, querying invoices etc. So you may decrease the cost of goods, but in doing so can increase the costs of the finance department's work.



Using a system like Invapay allows you to diversify your suppliers without the extra paperwork or administration costs of setting them all up on the system. All purchases are made through Invapay, so there is just this one master supplier to set up and maintain on your system. The supplier paperwork and administration is dealt with by Invapay.

Make better use of existing credit lines

"Making maximum use of existing credit lines, such as P-Cards, will benefit your liquidity".

Many firms have credit lines that they are not using as much as they could. P-Card programmes for example have been notoriously underused. Suppliers can only be part of a P-Card programme if they are able to accept credit card payments. Many however do not, and the cost of implementing this can be prohibitively high.

Invapay helps improve liquidity by helping you make better use of your existing P-Card credit lines. All purchases are made through Invapay, and this can be done by whatever method you choose, including P-Cards. However suppliers are paid directly by Invapay, so there is no need for them to be part of your P-Card programme for you to purchase from them.

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Having accurate data will help with your checks and balances, but controlling spend can be a challenge, and when spend is not fully controlled fraud becomes easier. Maverick spend is often rife within companies, as those making purchases find any controls imposed inconvenient, restrictive, and time consuming. Control measures can be put in place but compliance can be a challenge.

When all purchases are made through the Invapay system you can easily control which suppliers are available to purchasers, as well as spend limits and defining purchase types. Level 3 line item detail for every transaction also means any potentially fraudulent attempts are easy to identify. For purchasers, the system is quick and easy to use, so compliance tends not to be the problem it was in the past.



Minimise transactions costs

"By reducing administration you can reduce costs, thereby helping working capital."

"Focus on eliminating duplicate efforts, data re-keying, and human errors".

High levels of administration and resource associated with purchases, including approvals and dispute resolution, add to the cost of each and every transaction. In addition, for finance professionals working within a multi-national corporation, administration relating to cross-border payments and reconciliation provide a further burden.

Many of the costs are hidden, in the sense that it takes away people's time to spend on added-value activities. However the costs are real and removing them can have a positive impact on the business.

With Invapay, the cost per transaction is significantly reduced. Required administration levels are significantly lower, and because purchasing rules can be automatically applied, the resource required for approvals or to resolve disputes is removed.

Better collaboration

"Improve collaboration between finance, line-of-business managers, and operating units".

Finance professionals do not work in a silo. Changes made in the finance department will often impact on other lines of business, so to make improvements requires the backing and cooperation of all business units.

A system such as Invapay will usually gain the backing of other business units quickly. The system is simple to use and provides a quick and easy way to procure goods from a wide range of suppliers without causing additional administration for users.



Summary

We have seen that there are many elements to consider when looking to improve cash flow and liquidity. For many of the initiatives that can impact upon liquidity there are also possible drawbacks that need to be overcome.

This whitepaper has shown how businesses can overcome many of these potential drawbacks through the implementation of one simple system. And if implemented in conjunction with all or even some of the measures we have discussed, will bring significant benefits to a business and to achieve the aim of improving the liquidity and cash flow of the business.

References

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- ¹ Ernst & Young, All tied up, 2009
 - ² Rosemary Peavler, about.com
 - ³ Ernst & Young, Opportunities in adversity survey, 2009
 - ⁴ Ernst & Young, All tied up, 2009