OPERATING EXCELLENCE

Accounting Best Practices: Cash Management

BY BRUCE MAYER, PEG NOLAN, AND STEVE WOLFE

Our vision for this accounting best practices series is to examine fundamental financial tools and best practices for co-ops that promote overall financial health and the ability to improve. In previous articles, we reviewed best practices for the balance sheet (*Cooperative Grocer* Nov.–Dec. 2011), the income statement Jan.–Feb. 2012), and internal controls (March–April 2012).

This final installment covers cash management. Understanding cash flow keeps the doors of your co-op open and is essential if you want to build your co-op's future. It can answer the question: "If the income statement says we are making money, why don't we have any cash?"

Note: Please don't guess! A qualified accountant or experienced co-op consultant can be an important resource for you in analyzing your cash management practices and needs.

ILLUSTRATION BY MHJ

Cash management is big

Cash management is multifaceted in that it involves every aspect of your co-op's organization and requires you to understand and develop sources of cash, know how cash is generated by your business, learn how to structure debt capital, and, in a crisis, how to generate cash in a hurry. Together your **balance sheet**, **income statement**, and **cash flow statement** are a map that you can use to understand how to be successful and make money and profit for your members.

How does your cash flow?

It is not unusual to have a circumstance where the co-op has a cash shortage at the same time as its income statement shows a positive net income. How can this be? A cash flow statement (see template, page 22) narrates the story of where cash came from and where it was spent. It summarizes all cash received or paid out by the co-op within a specified period of time.

In business, cash is generally invested to support the increase of non-cash assets such as inventory or fixed assets or to decrease liabilities such as payables or principal payments on long-term debt. Note: interest payments on your debt are expensed as "other expenses" on your income statement.)

Usually there are only two entries from your income statement that appear on a cash flow statement. They are **net income** (positive or negative) and **depreciation and amortization** (a non-cash expense). All other items are reflections of changes made to your balance sheet over the time period specified.

Always know your cash needs

Grocery operations require a significant amount of cash to operate smoothly. To avoid cash shortages, a co-op general manager (GM) needs to assess how much cash is needed at any given time. It is a best practice for GMs to know their co-op's cash needs well enough to anticipate and plan for cash shortfalls.

Co-ops that are managing their cash closely must develop a budgeting process that allows them to anticipate cash shortfalls. A best practice is a weekly cash budget that should then be monitored against the actual bank balances. Doing this ensures that you know that there is enough cash available to keep the doors open.

Evaluating sources of cash

Once you know your cash needs, you can put together a long- and short-term plan for generating cash in advance of running out. If you can anticipate your needs well enough in advance, equity or debt issuance are good options. Shorter-term, useful strategies for generating cash quickly include slowing cash outflows through delaying payment of invoices and reducing inventory.

Following the opening of one expanded co-op, the GM sat down to reconcile the **sources and uses budget** with the actual project costs and calculated that when it opened they had about $200,000 remaining in the project budget to sustain them until operations were generating enough cash to cover costs. This was more available cash than they had anticipated because their construction costs had come in under budget. Since opening, however, gross sales had leveled off to a weekly average of $55,000 instead of the $65,000 budgeted in the proformas. Additionally, labor expenses were higher than budgeted, and monthly inventories showed that the gross margin was too low. Though gross sales, margin, and labor had been steadily improving, the amount of cash they were spending to cover initial losses ▶

◀ following the opening (their "burn rate") was averaging $10,000/week. It was during week eight that the GM conducted this analysis, which indicated that the co-op had about 12 weeks to get operations to a "cash-neutral" position (burn rate of zero dollars), or they would need to get an infusion of cash. While dollars were coming in as planned through additional member loans and new member equity, clearly that wasn't going to be enough. A plan was needed to secure additional cash, as well as to improve operational performance more quickly. He calculated that they would likely need an additional $100,000 to bridge them to a cash-neutral position.

Banking relationships

Good cash management includes establishing and maintaining a good relationship with the banking institution that holds your cash. Many co-ops have been able to obtain needed capital at critical moments based on their rapport with lenders and others.

Two important notes: One, do not underestimate the value of your business to a bank. Having the high volume of transactions, large cash balances, and the need for loans and other banking services makes your co-op attractive to a bank. Two, when evaluating a bank, make sure that you will have the ability to review bank transactions online. This is critical for cash management and is also important in allowing for the segregation of duties for internal control over cash.

TEMPLATE OF A CASH FLOW STATEMENT

My Food Cooperative: Statement of Cash Flows

Year ended June 30, 2012

CASH FLOWS FROM OPERATING ACTIVITIES	
Net income	$250,000
Adjustments to reconcile net income (loss) to net cash provided by operating activities	
Depreciation and amortization	150,000
Loss on sale of property and equipment	1,000
Deferred income taxes (Use a CPA to calculate)	15,000
(Increase) decrease in assets	
Accounts receivable (most often coupons/rebates)	(2,000)
Income tax receivable (Use a CPA to calculate)	(7,000)
Inventory	(40,000)
Prepaid expenses	(5,000)
Long-term deposits (Lease or escrow)	(2,000)
Equity in cooperatives	(2,000)
Increase in liabilities	
Accounts payable	50,000
Accrued expenses	(100,000)
Net cash provided by operating activities	**308,000**
CASH FLOWS FROM INVESTING ACTIVITIES	
Purchases of property and equipment	(700,000)
Proceeds from sales of property and equipment	2,000
Net cash used in investing activities	**(698,000)**
CASH FLOWS FROM FINANCING ACTIVITIES	
Proceeds from long-term debt	500,000
Proceeds from owner equity	100,000
Patronage dividends paid	(50,000)
Owner shares refunded	(10,000)
Payments on long-term debt	(200,000)
Net cash provided by financing activities	**340,000**
Net change in cash (Total of the three bolded "Net cash" items above)	*(50,000)*
Cash—beginning of period	300,000
Cash—end of period	**$250,000**

Line of credit

Having a line of credit available is a best practice and is important to be able to cover any temporary shortfalls without causing disruption to your operations. It is especially important to have arranged this well in advance of your need since it will be difficult to negotiate one if you are in the midst of cash flow issues. These lines of credit typically have requirements to pay them off annually, so you should not plan to use them for long periods of time. In our co-op expansion story above, if a line of credit for $100,000 had been established as a part of their expansion plan, they could have used it to bridge their cash gap, effectively "buying" more time to steady their operations and develop other capital if needed to ensure cash flow.

Accounts payable management

When cash flow is tight, slowing payment of accounts payable and other liabilities can help immediately. Some things must be paid on time, such as taxes, especially payroll taxes, and invoices with early payment discounts or late payment penalties. Keeping communications open with vendors is critical to avoiding disruptions in delivery or sudden COD requirements.

Reviewing your accounts payable list may generate additional ideas that you can include in your cash plan strategy. Are there stakeholders in your co-op that may be willing and are positioned to assist you in your plan to bridge a cash gap? Banks, landlords, vendors, members, your community, and local government and businesses all have a vested interest in your co-op's continued success. Having a good plan is key in being able to engage them properly.

Inventory management

One of the largest assets on your balance sheet is inventory. There are a few different ways to generate cash quickly from your inventory.

Extend your terms. If you can defer payment of vendor invoices by extending your invoice terms from, say, 10 days to 21 days, your cash should go up by the average dollar amount of 11 days' worth of invoices. In essence, your vendor becomes a partner in financing your inventory. ▶

Internal Controls Best Practices

At all times, it is important to maintain and strengthen internal controls. Transparency, accountability, and checks and balances must be high priorities, especially in difficult times. One thing that we have personally observed more than once is the damage that can be done by a well-meaning bookkeeper who keeps the bad news from other staff and the GM. This can take the form of transferring funds from savings and covering up that draw down, hiding invoices and not recording them in the payables system, or preparing checks but not sending them.

Knowing your bank balances is important. You must be able to check online or call the bank and get your bank balances. If you do this on the same day each week, you will learn about the normal weekly and seasonal cycles of your cash.

Standard hiring practices should include a background check on key employees. In one case, a co-op hired a bookkeeper and later fired him for theft, only to discover that he had a police record that included stealing from prior employers.

Irregular practices and missing money can be detected by an audit. Many co-op boards of directors require that an audit be completed when there is a change in finance or general management and may require an audit every year once the co-op has reached a significant sales volume. Some governmental lending instruments and banks require an annual audit as a covenant to their loan.

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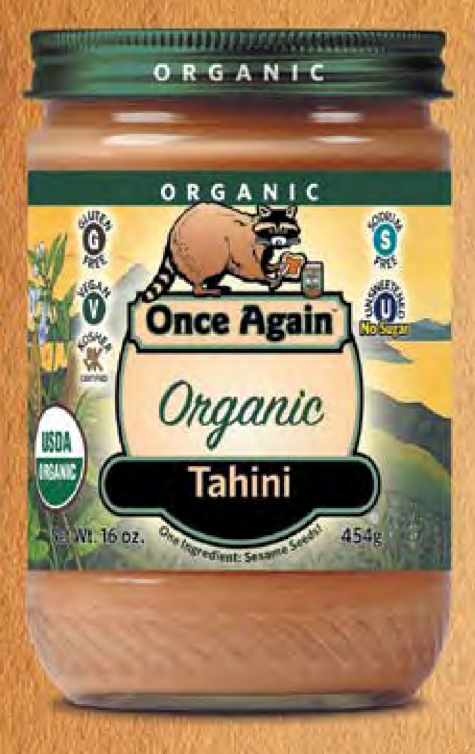

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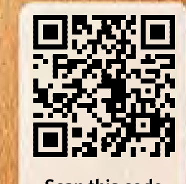

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Since it is such a large asset, reducing inventory can be another way of generating cash quickly. This is generally accomplished by carefully decreasing the amount of back stock that you keep on hand without causing unnecessary out of stocks. A ratio you can use over time to monitor progress is **inventory days** (aka **days of inventory**), which is the average number of days that inventory is owned by the store before it is sold. The greater the number, the longer the inventory sits in the backroom or on the shelf before it is sold.

If your back stock is already lean, you could consider intensifying your category management efforts for ways to generate cash, but this would likely take longer.

A new wellness manager was hired in one co-op, and after six months the store manager discovered that wellness department inventory had gradually increased by $50,000. The GM was furious, but upon reflection recognized that the department manager was new to management and did not have proper training, plus there were no policies in place to prevent such a mishap.

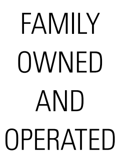
Capital structure and debt management

In general, every business needs to understand its own capital structure and how it can be managed to optimize return on investment for your members. You can evaluate it by looking at your debt-to-equity ratio, which shows the ratio between capital invested by the owners and the funds provided by lenders and other creditors, i.e., how much of your business is financed through debt and how much is financed through equity. Note: A best practice is to annually review your debt and interest terms for opportunities that optimize your debt structure to meet your cash needs.

In conversation recently one GM was questioned by her peers about the interest rate their co-op was paying on their primary loan. Prompted to analyze it, they found that with little work and no cash they could easily refinance this source of capital, resulting in lower monthly payments and savings to the co-op of over $10,000 in reduced interest expense over the life of the loan.

Good capital structure does not mean that your co-op has no debt. It means that you are managing the risks and benefits of available capital and optimizing member benefit. Any time the debt-to-equity ratio is less than 1:1, there will almost always be a large cash balance. Is there a way for you to invest excess working capital in your growth, your future, and/or your mission? How much can you invest without putting your current co-op business at risk? These are only some of the important questions you will want to ask yourself. Engaging with your peers and experts can assist you in detecting and answering questions that facilitate your understanding of risk so that you can protect and leverage your co-op's assets with more confidence.

Members have a role in investing in their co-op's future. Developing



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Ratios for Cash Management

Debt-to-equity formula:
debt / equity

Definition: Shows the ratio between capital invested by the owners and the funds provided by lenders and other creditors.

Analysis: Compares how much of the business was financed through debt and how much was financed through equity. A higher debt/equity ratio generally means that a company has been aggressive in financing its growth with debt. Too much debt can put your business at risk, but too little debt may mean you are not realizing the full potential of your business and may actually hurt your overall profitability.

Current ratio formula:
current assets / current liabilities

Definition: Measures short-term debt-paying ability. Current assets are the sum of assets that typically convert to cash within 12 months. Current liabilities are the sum of amounts owed by the company and due within 12 months.

Analysis: 1.0 ratio means the company has $1.00 in current assets to cover each $1.00 in current liabilities. Look for a current ratio above 1.0. Note: Any current ratio number over 2.0 (2:1) often indicates excess working capital.

Debt service coverage ratio:
net operating income / total debt service

Definition: Measures the ability of your business to generate enough net operating income to cover debt.

Analysis: Greater than 1 is good. A ratio of, say, .90 indicates that the business is only generating enough cash to cover 90 percent of its debt. The ratio is often a covenant included by lenders.

Inventory days formula:
365 days / inventory turns

Definition: The average number of days that inventory is owned by the store before it is sold.

Analysis: The greater the number, the longer the inventory sits in the backroom or on the shelf before it is sold.

Inventory turns formula:
cost of goods sold (annualized) / average inventory

Definition: Number of times that you turn over (or sell) inventory during the year. Measures inventory liquidity.

Thanks to CoopMetrics: www.coopmetrics.coop/CM_User_Support/Other_Users/Ratio_Definitions/NF_Ratios

ways for them to invest in the co-op can build less-expensive sources of capital for the co-op. It can also contribute to co-op profitability by decreasing the amount of interest paid through higher loan rates. And it can deliver interest to co-op members instead of outside lenders. Larger net profits for the co-op can deliver larger patronage dividends to members in good years.

In years when the board of directors declares a patronage dividend, it is important to know your working capital needs before you declare what portion will be delivered to member owners in cash. An analysis of paying taxes or paying patronage dividends often shows the advantage of paying patronage dividends, especially if only a portion is paid out in cash. The maximum a co-op can retain is 80 percent. This serves to reward members who shop at the co-op, and it builds your balance sheet (member equity) while reducing your tax obligation. Designing the patronage dividend cash portion so that it can be redeemed as a store coupon can also help to keep more of the cash portion in the co-op.

Got cash? How can you leverage it well?

Many co-ops maintain very high cash balances. Cash levels should be reviewed regularly to determine that the co-op is fully leveraging this asset. Since current interest rates on short-term deposits are low, the use of sweep accounts and transfers to money market accounts or certificates of deposit will yield very little income.

Investing your excess cash in debt repayment, a co-op loan fund or local community development organization, or another co-op project may be a way for the co-op to achieve its mission. Since all co-ops benefit from a stronger co-op community, the use of excess cash to support other co-ops has multiple benefits. We caution co-ops to conduct a rigorous evaluation of the risks and benefits before making direct investments. In general, investing in areas associated with your core expertise is less risky, but we know that there are additional opportunities for investment that support your mission (e.g. farm, vendor, or community venture). All should be evaluated carefully.

Conclusion

Cash management is critical to the success of your co-op. We have discussed ways to evaluate the liquidity needs and capital structure of your co-op, as well as some of the options for managing your cash. Running a successful co-op requires expertise in so many areas that it is critical that you consult with experienced advisors when the stakes are high and knowledge of the options may not be readily available on staff or with your board. ■

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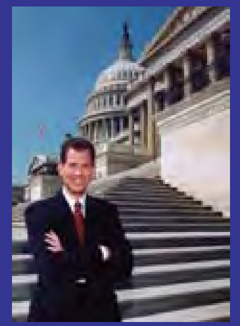

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