Sobel & Co., LLC
CERTIFIED PUBLIC ACCOUNTANTS AND CONSULTANTS

Retail Practice Group

CASH IS KING: EFFECTIVELY MANAGING CASH FLOW FOR RETAILERS

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Abstract

The goals of the authors of this white paper are to define cash flow and then specifically address its impact on retailers of all sizes. Using accounting principles as a basis for the discussion, they use real world examples and relevant situations to demonstrate the importance of predicting and managing the flow of cash, most specifically for retailers.

Table of Contents

1. What is Cash Flow and Why Does It Matter?.................................1-2
2. How Do You Measure and Manage Cash Flow?..............................3-7
3. Three Types of Cash Flow 8-10
4. What are the Implications of Cash Flow on Retailers? 11-12
5. Citations 13-14
6. About the Retail Team 15-17
7. About Sobel & Co.'s Retail Practice Group 18

1. What is Cash flow and why does it matter?

"Cash is king" – we have all heard this maxim many times. But what does it mean, and how does it apply to modern retailers? In short, it means that the most important financial questions about a business all start and end with cash.

Cash in a business is considered in the framework of three questions: 1) how much cash do we have, 2) where is our cash coming from, and 3) where is our cash going. The answer to each of these questions underpins the financial management of a retail business. A retail operator will ignore the firm's cash position at his peril.

The first question, how much cash do we have, is more properly phrased "how much cash is on hand?" The answer is very straightforward: $100, $20,000, etc. We all intrinsically understand this from our personal lives – we check our wallets and bank accounts to see if we can afford to buy something or if we are able to pay our mortgage this month. A business must go through much the same process, instead considering whether there is sufficient cash on hand to cover payroll, vendor payments, and other obligations.

The second two questions consider "cash flow" – that is, the movement of funds into and out of the business. In a retail setting, "Where is our cash coming from" is really asking about customer payments – are they paying with cash or credit card, and when are they paying on their accounts. In other words, when do revenues become cash on hand? In certain other settings, it can also mean draws on a revolving line of credit, equity investments, or mortgages to buy equipment or property. These are alternatively termed "cash inflows." "Where is our cash going" looks at the payments that the business makes. There are many types of payments – purchasing inventory, paying employees, maintaining common areas, paying down debt, tax payments, and distributions to owners, for example. These payments are also called "cash outflows." At the intersection of cash inflows and cash outflows lies the business's cash on hand – what is left after all monies are collected and obligations are paid.

Cash flow can be very different from profit, and as such, measuring the success or financial position of a firm solely on profits and losses can be misleading. For example, consider a business that is profitable, collects from its customers in 90 days, and has to pay its vendors in 30 days. This company could earn a profit, but may find it unable to meet its liabilities because of a long cash collection cycle. Therefore, the information in a profit and loss statement doesn't portray the entire picture, even though many owners prefer to measure their success by their profits.

Academic studies over the years support what common sense tells us: insufficient cash flow can be one of the leading causes of a business' failure. Equifax, the credit-reporting agency, found that bankruptcies among the nation's 27 million small businesses leaped by a whopping 81% between June 2008 and June 2009 when the economy plunged and cash dried up. Similarly, the U.S. Small Business Administrations' (SBA) statistics indicate that although about 600,000 new small businesses are launched, on average, every year, only about 66% will survive the first two years, 44% will survive four years and 31% are likely to survive for seven years or more. The management and ownership of a business can work to effectively and efficiently manage the company's cash position and project its future cash flows; doing so is a highly effective management tool that can act as a leading indicator of a liquidity crunch, allowing for time to address the situation before it becomes dire.

2. How Do you measure and manage cash flow?

Understanding the definition of cash flow is the first step in recognizing how essential it is to any business. The good news is that there are many measures that can be implemented to anticipate, address, and ultimately plan and manage for positive cash flow.

For a retail business owner or CEO, the most important advice on how to properly management cash flow is to engage in upfront planning. Failure to plan is a leading cause of any business' demise. You not only need to know how much you will be spending, but on what. It is no surprise that statistics from the SBA show that a high percentage of small businesses that file for bankruptcy have engaged in poor, or no, cash flow planning. You need cash to meet the demands of the company – so it is little wonder that preparation and planning can make a major difference in success rates for entrepreneurs.

This is especially true when a business is in a robust growth mode. A company requires positive cash flow when it expands capacity, increases inventory, extends its product line or penetrates additional markets. The results of these new efforts, in the form of more sales, will most likely not be felt immediately, so there needs to be sufficient cash on hand – based on credible forecasting – to sustain the company while these initiatives gain momentum.

Another word of caution as you begin measuring and managing your cash flow: don't be unrealistic in your predictions. If you plan for unreachable sales goals, or minimize your expenses and other liabilities, you will find yourself caught in a dangerous situation. Be honest with yourself. Hiding from reality will not improve your cash flow, but understanding it will help you when dealing with your vendors, customers and employees.

Here are some ideas that can have an important influence on the availability of cash in the business:

- *Follow a budget*. If you do not have a clear and complete understanding of every expense you need to address, you cannot manage your cash flow. To assist with this, write and adhere to a budget. This process keeps you focused and structured regarding the true costs of operating the company. If the budget is complete and accurate it enables you to account for everything, with few surprises, so you won't be caught saying, "where's my cash?" at the end of the month. Seasonality adjustments should be considered, especially in the retail world. Cyclical purchasing (brought on by holidays, for example) is expected, but you must also realize there will be situations beyond your control. Unpredictable weather, catastrophic emergencies, even economic downturns may be beyond your purview to anticipate, but with good planning you can soften the impact.

- *Encourage repeat business by rewarding loyalty.* In the retail world, customer loyalty is one key way to ensure positive cash flow. To start, review your customer service policies. Next, invest in training your staff, particularly the employees on the front line who must be customer-centric. Finally, reward repeat buyers with added value. The more you can provide incentives for them to return, the more often they will be back and the more often they will tell their friends about you as they help spread your reputation by word of mouth.

- *Collect receivables promptly.* You do not have cash until your customers pay you. Few reports are as discouraging as an aging analysis that demonstrates 90-150 days of receivables on your books. Georgia Solotoff, owner of PIP Printing in Livingston bills her customers twice monthly. In addition to attaching the invoice to the finished product on delivery, she sends a copy of the invoice two weeks later. This not only has really accelerated collections but it keeps the company name in front of customers with more frequency. What started as a way to improve cash flow also has a marketing component to it. As the business matured, Georgia worried about how long it was taking to collect on her credit sales. Today she reviews the accounts receivable aging twice per month so she has a better handle on the details and is able to stay on top of her collections. Unlike most business owners who are uncomfortable making collections calls, Georgia knows she needs to be proactive on the phone, keeping after the customers who are holding up her cash flow. If this is difficult for you, there are reputable companies that specialize in handling collections calls professionally and sensitively on your behalf.

While not all retailers maintain customer accounts in this day and age, many retailers maintain a different type of account receivable: credit/debit cards. Electronic payments are a great tool to accelerate cash collection, but like any other facet of a business, they must be reviewed periodically. Because not all credit card processors are the same, it is important to ensure that your business has the best agreement possible with the vendor. The most crucial features of a credit card processing agreement are the fees charged on each transaction (which can range from 1% to 4%) and how quickly after the transaction occurs the business receives its cash. Some payment processors offer deposits as quickly as the next day.

Despite the emphasis on generating cash, your customers may ask you to extend payment terms to them in much the same way that you may attempt to work with your suppliers to defer your payments. When this occurs, spend time with the customers who you trust and value; help them, if you can, by agreeing to make arrangements for delayed payments. The problem with these types of accommodations is that it slows down the flow of cash into your company. But just as some of your vendors will make special arrangements for you – because it is a sensible business decision – you can offer special terms to your customers under the appropriate conditions. However, overall, your goal is to encourage customers to pay as quickly as possible. One popular idea is to offer discounts to reward early payment or offer prepay terms on preordered products, thereby giving them a discount that you can afford in order to increase cash on hand.

- *Manage inventory carefully.* As the retired CEO of a grocery store chain noted recently, “Imagine the impact on our cash flow when the goods we’ve paid the supplier for remain sitting on the shelves.” In other words, understanding and managing your inventory is critical to your cash flow and, ultimately, to your company’s profitability. When all is said and done, you need to invest in products that your customers want to purchase. With perhaps 70% or more of your cash tied up in inventory, you need to make careful choices about how to stock your shelves. There is always a new product, an exciting innovative offering, and a broader assortment, but, if you are not careful, you will quickly acquire excess inventory. This can lead to markdowns and deep discounts as you struggle to clear the shelves, regardless of the cost to you, to make room for the next shipment and to generate some cash flow.

Accurate and insightful planning is an important ingredient for good inventory control as is studying reports on inventory movement from previous months or years and remaining alert to trends in the industry by attending trade association meetings or reading trade publications. All these can help you make educated decisions. Paying attention to evolving changes in your niche can keep you at the cutting edge and keep your cash flow healthy.

- *Manage payables.* To use your cash wisely, you may want to take advantage of payment terms offered by your vendors, as long as they make sense for your company. However, use caution. Don't make decisions in a vacuum; don't let the immediate benefit of deferring payments be your only concern. Take into consideration the impact of missing out on quick-pay discounts if you choose to delay payments. Make decisions that will be most beneficial for the short- and long-run whenever possible.

  No matter what, talk to your vendors, concentrating your efforts on building meaningful relationships rather than being caught up in the details of the transaction. Ask them what they are seeing in the industry, talk to them about your situation. Don't consider their pricing as the only factor in using their products. Identify ways that you can help each other as 'partners' and explore flexible and innovative options that make sense for both of you.

- *Encourage electronic payments.* Consider encouraging your customers to pay using a credit card. This benefits you by dramatically reducing cash collection time (sometimes as quickly as the next business day) while still allowing your customer time before their bill comes due. Technology has made accepting credit cards trivial; some of the new credit card readers, which easily attach to iPhones and iPads, enable customers to quickly and effortlessly pay for items without requiring a significant, upfront investment from your business. However, be cognizant of the cost of accepting credit cards before making this decision; processing fees can range from 1% to 4% of the transaction.

- *Understand financing needs.* It is nearly impossible to run a retail operation without some form of financing arrangement in place. A typical financing arrangement that many retailers maintain is a credit line. There are going to be times when there are seasonal dips where direct cash flow from collections may not be enough. And in order to cover payroll and other related operational costs, it is necessary to have short-term debt arrangement in place. But drawing on a credit line should generally be a short-term need. Businesses need to be careful about financing growth and consider interest rates and bank fees when forecasting both short- and long-term cash flow positions. This leads into the next types of financing arrangements - mortgage and notes payable. Generally speaking, businesses do not have the upfront cash to purchase inventory as well as the equipment and fixed assets needed to run the operation. As a result, entering into mortgage and note payable arrangements, due to purchases of fixed assets, is almost a necessity to sustain operations and/or continue increased growth.

The message here is clear: the ability to manage cash flow is significantly improved when you have a plan. The more accurately you can predict your circumstances, the more prepared you will be and the better your position for success. By having timely access to financial reports, you will quickly be made aware of any problems or trouble areas. This allows you to put procedures in place that can avert trouble or, at the very least, have time to react before the situation gets completely out of hand.

All of the suggestions listed here are based on implementing them in tandem with other critical information you have available. You need to work closely with your business advisors, talk to trusted suppliers and other business colleagues as well so that you can create the best solutions and implement those initiatives that will be effective for your unique situation given your company's life cycle phase, resources, philosophy and history. Seamlessly integrating all the data should help you arrive at good business decisions regarding positive cash flow.

3. Three types of cash flow

There are three different types of cash flow: operating, investing, and financing. Operating cash flow represents the cash generated or expended in pursuit of a business's mission; for a retailer, it is the amount of cash flow that comes from buying and selling inventory. Investing cash flow is the amount of cash spent to support the business; the largest component for a retailer is the purchase of equipment. Finally, financing cash flow is the cash flow result of borrowing arrangements or transactions with owners; that is, the receipt of cash from a loan, payments on a loan, or distributions to ownership.

When managing cash flow, it is important to recognize the difference between the different types of cash flow. For instance, while it may be feasible to improve the cash position by delaying expenditures for new equipment, it may not be feasible to delay payment to vendors to accomplish the same goal.

The financial statements of a business reflect the company's cash flows through the cash flows statement. The cash flows statement is broken into operating, investing, and financing sections and shows, in detail, what occurred that affected the company's cash position.

The statement itself is only as helpful as the interpretation behind the numbers. While the cash flow statement provides an overview of the changes in cash for a specified period, there are many cash flow factors that will not be immediately discernable through its review. Keep in mind that it is a historical overview and not a forecast of future cash flows. The review of the cash flows statement may show key indicators of cash flow factors to focus on when taking a proactive approach for a better future. Some of the following factors typically need to be addressed when looking to improve cash flows:

- *Fixed and variable costs*. Fixed costs are those not associated with the sales or production of the products. These typically include rent, utilities, insurance, real estate taxes, and administrative salaries. Variable costs include those costs directly associated with the sales and production of the products. These typically include costs directly related to inventory, shipping, and direct labor. When looking to improve overall cash flow, questions can be raised in order to control these costs including:

- Are we maximizing capacity at our locations? Do we need all of the space that we currently own/rent? There may be opportunity to renegotiate lease terms and/or downsize based on the current needs of the company.
- Are all of the functions of each employee being utilized productively? Are multiple employees performing the job that one employee can complete?

- *Equipment purchasing*. Depending upon the type of retail operation that you are running, equipment purchasing may be a significant part of your business. This is especially evident in the supermarket arena. While making large capital purchases to invest in the business may seem like a necessary step, it takes careful consideration in analyzing the return on investment that is expected to be generated from the purchase. Major considerations include the following:

  - How much financing will I need, if any?
  - What are future cash flow implications based on the length of the financing agreement and applicable interest rate?
  - If financed, will there be covenants that the company will need to comply with?

  Depreciation is another critical factor to consider. Over the past several years, there have been several changes to allowable depreciation that have been favorable to the taxpayer. These include allowable bonus depreciation and higher IRS section 179 deduction limits.

  If you know that tax rates are going up in the following year, it may make sense to delay a large purchase in order to apply the related depreciation expense against a higher tax rate, effectively resulting in a better benefit. The same is true for taking advantage of allowable bonus depreciation and section 179 deduction limits. If there are expiring provisions in the following year, it may make sense to make the purchase in the current year. Each and every scenario is going to be unique, and current cash flow will be the critical driver. Timing your capital purchases can translate into very significant tax savings and positive future cash flows.

Money float. As noted previously, the overall strategy for nearly all companies is to effectively delay payments on your payables and speed up collections on your receivables. By extending these two periods out, you are not only able to maintain more cash on hand, but continue to earn interest on that money as well. We all know that this is not always an easy task, but when you consider the significant dollars being collected and paid on a regular basis, the interest that can be accumulated by extending payables and speeding up receivables by a few days on a consistent basis throughout a given year can become substantial.

4. What are the implication of cash flow on retailers?

Retailers, whether brick and mortar or online, know that cash is king. Cash flow is at the heart of the retail world. Without cash, there can be nothing on the shelves, no advertising, no facility, and no employees. Without cash, as Ted Hurlbut wrote in his blog, *Cash Flow, the Lifeblood of Every Independent Retailer*, "When cash flow is positive, there is a tomorrow. When cash flow is negative there's an abyss."

Cash flow is essential to any business. But it is even more important for retailers because of their reliance on major expenditures, such as inventory, employees and operations as well as the impact of both planned and unexpected fluctuations. For instance, a building contractor can prepare for a decrease in cash flow during the winter months when construction slows, finding other ways to manage and spread out expenses. But an unusual and unexpected warm spell during Christmas when the stores are stocked with cashmere sweaters can all but destroy the retailer who has no chance to react. The same thing can happen if a sudden prolonged cold snap forces people indoors and, therefore, out of restaurants, malls and movie theaters. Or maybe the retailer did not have the vision to purchase enough of that new product that is suddenly in high demand. Unsatisfied customers may go elsewhere to make the purchase. Any of these things can, and do, happen with great frequency, creating cash flow challenges for every retailer.

Retail owners need to recognize that 80% of sales generate from 20% of inventory. It is great to experience high sales volume that occurs from the 20% of inventory that is "hot" today. But the important question is, why is the remaining 80% of inventory, which is clogging the shelves and racks, only producing 20% of the store's sales? In "Talking Cash Flow Blues," *Inc. Magazine* warns retailers to avoid what it calls assortment creep, the desire to offer every possible product that the customer might want. Instead, the experts say, guard your cash – buy and ship inventory as close to the time of sale as possible - and keep a close eye on your own sales forecast. This quantitative report can make or break you, so be sure the forecast is realistic and relevant. Gather data by listening carefully to your sales staff and to your customers before you build up your inventory.

Inc. Magazine also reminds readers how important it is to stay focused. You know your core mission. Do not be tempted to stray too far from what you do well, from what you are known for, and from doing what is most profitable for you.

Financial discipline is of great importance to retailers. Successful owners and managers rely on return on investment (ROI) to remain healthy, and expansion is a component of growth, as is return on total assets and return on invested capital. But positive cash flow is the foundation that supports and sustains the retailer. If the business runs out of cash and cannot secure new financing, it will dissolve.

5. Citations

Some of the information shared in this white paper was drawn from information researched at the following sites:

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Special thanks to Georgia Solotoff, owner, PIP Printing and Eileen Scott for sharing their insights and ideas.

6. About the retail team members

John R. Mellage, CPA, Audit Manager

John Mellage, an Audit Manager at Sobel & Co., brings extensive experience working with middle market family owned and privately held businesses in the areas of audit, taxation, financial statement analysis, as well as business consulting. While specializing in the areas of retail, manufacturing and distribution and not-for-profit, John has expertise across a variety of industries. His real-world knowledge helps clients ensure they are in compliance with related industry requirements. He also performs highly specialized not-for-profit engagements including Yellowbook and A-133 audits

Over the years John's clients have valued his guidance and counsel as he has assumed the role of their trusted business advisor. As such, he is actively involved in helping his clients with short and long term strategic business planning, tax planning and compliance, succession and transition planning cash flow management, and budgeting to name a few areas where his insights are most needed.

John is a Certified Public Accountant in New Jersey, and holds a Bachelor of Science of degree from Fordham University. He is also a member of the American Institute of Certified Public Accountants (AICPA) and the New Jersey Society of Certified Public Accountants (NJCPA).

David Calotta, CPA, Manager

David Calotta joined Sobel & Co. in July 2011, after graduating from Ramapo College in New Jersey in 2008 where he earned a Bachelor of Science degree in Accounting. He went through the ranks at the firm, quickly advancing from senior level to manager because of his knowledge and technical competencies, his values, and his strong sense of responsibility and accountability. His proactive approach to client care and his technical skills in accounting make him a favorite at the firm and with the clients.

Dave works across a range of industry sectors but has begun to develop a specialty in the retail sector, serving as one of the mentors in this practice group while working to educate other staff members on the constantly changing and evolving trends in this niche.

He draws on his industry experience to add value for Sobel & Co.'s retail clients in areas including financial statement audits, tax return preparation, cash flow projections, tax projections, and internal controls. Dave leads the firm's new hire training program and he is actively building meaningful relationships in the New Jersey business community.

A member of the New Jersey CPA Society (NJSCPA) and the American Institute of CPAs, Dave earned his CPA license in May 2011. He has written articles for the NJSCPA Newsletter, Tomorrows CPA, and over the last five years his contributions to the firm and to the business community have been recognized, resulting in his being included on the prestigious NJSCPA "30 under 30" list in 2011.

Outside of work, Dave enjoys spending time training for endurance events as well as hiking and kayaking with his wife, Danielle, and his dog, Tucker.

Harold R. Sobel, CPA, Member of Firm

Harold Sobel, Member of the Firm of Sobel & Co., is highly regarded for his skills as a business advisor. Harold has developed expertise in the area of closely held business planning, including budgeting, cash flow management, forecasting and succession planning. Harold also has considerable experience advising clients on personal financial planning.

Harold is actively involved in consulting to the retail industry, especially to retail chains in the supermarket niche on cash management, inventory management, budgeting, LIFO Accounting, and special depreciation issues.

Harold Sobel is a Certified Public Accountant in the State of New Jersey. He is a member of the American Institute of Certified Public Accountants and the New Jersey Society of Certified Public Accountants. Harold is an active member of the New Jersey Retail Merchants Association and the New Jersey Food Council. He is also a frequent speaker on various aspects of financial reporting and has been interviewed several times for national supermarket magazines.

In addition, Harold serves as treasurer of Hilltop Country Day School, a non-profit independent school.

Harold is a graduate of Bentley University in Massachusetts, where he received a Bachelor of Science Degree in Accountancy.

7. About Sobel & Co.'s Retail Practice Group

Sobel & Co., a regional public accounting and consulting firm located in Livingston, NJ, has been adding value to the area's business community since 1956! Our retail clients benefit from the depth of experience of the professionals in the Retail Industry Services Group. This team offers real world experience gained from working with clients who's assets range from $5 million to $350 million, across a range of sub-niches from grocery store chains to drug store chains to apparel stores.

This expertise enables us to work closely with clients, earning their trust and delivering exactly the scope of services that they find most relevant. Our team is involved in several industry trade associations and is knowledgeable about the trends and changes that are impacting our clients in this sector.

At our clients' suggestion, and working in tandem with them, our Retail Industry Services Group offers traditional auditing, accounting, tax and business consulting along with:

- Cash flow management
- Consulting services
- Financing alternatives
- Forensic accounting/Litigation support
- Fraud vulnerability studies
- LIFO inventory
- New site valuation
- Cost segregation analyses

For more than 55 years Sobel & Co. has served the retail sector with experience, business acumen, technical skills and a dedication to understanding the unique situations facing retailers in a constantly changing business climate.