CASH MANAGEMENT – A RECOVERY TOOLKIT FOR BUSINESSES

JEFFREY D. SHERMAN, FCPA, FCA

JANUARY 2021

Ontario Small Business Series

The CPA Financial Literacy Program makes resources available to Ontario's small-business owner-operators to help them manage their finances. This free, comprehensive series will enable the province's small businesses to navigate through today's uncertainty and plan for the future. These resources are made possible by the generous support of the Government of Ontario. For more information, please visit www.cpacanada.ca/ontariosmallbusiness.

Table of Contents

1. **Your Roadmap to Successful Cash Management** 2
2. **Controlling Cash** 5
3. **Banks and Banking** 15
4. **Sales and Receivables** 21
5. **Expenses and Inventory** 26
6. **Debt and Equity** 31
7. **Running Out of Cash: Dealing With a Crisis** 33
8. **Resources to Help You Recover** 35

CPA CHARTERED PROFESSIONAL ACCOUNTANTS CANADA COMPTABLES PROFESSIONNELS AGRÉÉS CANADA

Ontario

1. Your Roadmap to Successful Cash Management

> "This planet has – or rather had – a problem, which was this: most of the people living on it were unhappy for pretty much all of the time. Many solutions were suggested for this problem, but most of these were largely concerned with the movements of small green pieces of paper, which is odd because on the whole it wasn't the small green pieces of paper that were unhappy."
>
> Douglas Adams, *The Hitchhiker's Guide to the Galaxy*

A Time for Recovery

The COVID-19 pandemic has created many challenges for all of us. It is the most disruptive event since the Second World War that ended three-quarters of a century ago. The challenges for small businesses are particularly severe.

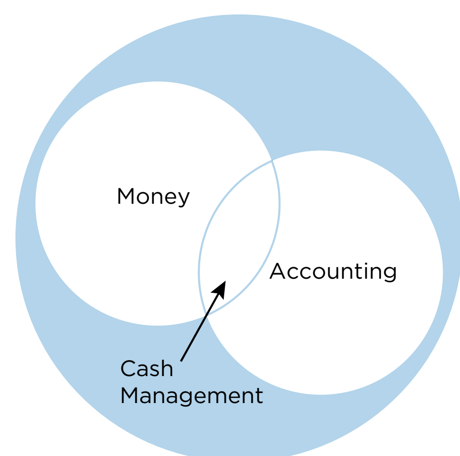
Through the support of the Government of Ontario, CPA Canada has developed a series of concise toolkits to provide resources to owner-operators of small- and medium-sized businesses.

From a business perspective, a major challenge has been cash – or lack of it. This guide will give you advice on traditional cash management techniques as well as guidance geared to the pandemic to help you recover from the disruption and, we hope, to prosper afterwards.

> Two other *Toolkits* in this series should help you as well: *Strategy and Planning – A Recovery Toolkit for Businesses, and Financing – A Recovery Toolkit for Businesses*. They are available as a free download at **www.cpacanada.ca/ontariosmallbusiness**.

Money and Accounting

Cash management focuses on the movement of cash. It is at the intersection of two important topics: money and accounting. While almost everybody is interested in money, I have been told (by my children, and frequently) that not many people share my fascination with accounting. That is a pity, because accounting is an extraordinarily useful and practical subject.



Accounting is fundamentally a practical discipline. There is usually no reason to do it unless it affects decisions that result in better outcomes.

Cash management is the ultimate practical application for accounting because it deals with an element of the business that is both excruciatingly simple and surprisingly complex. If this book gives you some fresh insights into cash management and helps you to apply them in recovering from the pandemic, then it will have achieved its purpose.

The term "cash management" sounds straightforward and obvious, but it can mean different things to different people.

What is Cash Management?

As an owner-manager running a small- or medium-sized business, you already know the importance of cash. While your accountant may help you measure success by going through some calculations and analysis to report profit, you know that cash on hand and access to cash when you need it are vital to the success (and even the very survival) of your business.

In fact, profit is primarily a measurement for reviewing results over periods measured in months, quarters or years. The calculation of profit is necessary for dealing with amounts that accrue across accounting periods. Ultimately, a business is successful if it produces much more cash over its lifetime than it consumes. (The meaning of "much more" is another topic, but we will touch on elements of it later.)

To the banker, cash management is similar to treasury management and refers to a suite of products designed to report, transfer, invest and borrow cash.

To a treasurer or controller, cash management describes the process of anticipating and planning for cash receipts and disbursements. Recently, cash management has emphasized the relative safety and security of holding cash or cash equivalents such as GICs rather than riskier assets.

This description of the meaning of cash to persons with different responsibilities echoes the oft-cited tale of the three blind men who imagined the shape of a whole elephant based on the part they touched. The trunk, the tusk, the legs, and the back are all different parts of the same elephant yet insufficient in themselves to define the entire elephant. Similarly, these different views of cash management show us different aspects of the same process.

Definition

> "Cash management is the process of managing the short-term liquid resources of the business to optimize its results."

This definition can be examined in more detail:

"Process of managing"

Cash management is not a policy, rule, device or technique; it is the entire process, including funds coming in, funds going out, and the planning, control and measurement of the funds themselves. It is one of the core elements of running your business efficiently and effectively.

"Short-term liquid resources"

Such resources are anything that can be readily converted into money without relying on collections from customers or the sale of goods or services. It includes cash itself, short-term investments (i.e., "near cash") that can be readily liquidated and denominated in money (such as government of Canada treasury bills) and various types of deposits (such as term deposits) in banks. But – and here's a critical concept – the level of cash and near cash is

influenced by many other factors: borrowings, speed of collections, disbursements, the amount spent to buy long-term assets, and so on.

"To optimize its results"

If you strip your business down to its essentials, you need to do two things well: Do the right thing and do it in the right way. Doing the right thing depends upon having the right strategy, which is covered in a companion book in this series: *Strategy and Planning: A Recovery Toolkit for Businesses*. Doing it in the right way, or executing well, is the other essential element of success and it is here that effective cash management will help.

Why Manage Cash?

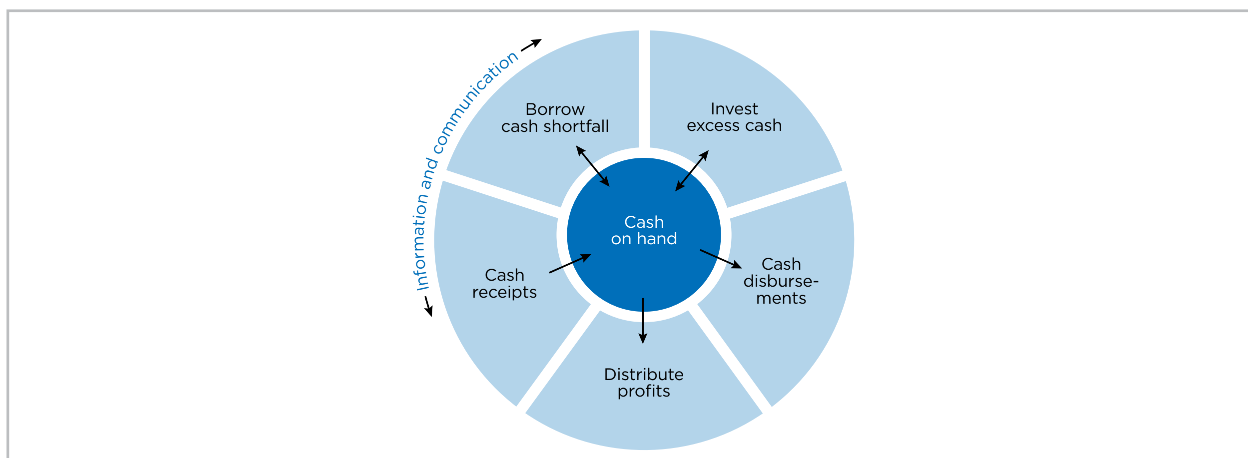
Cash is at the centre of all business activity. You need cash to start and expand the business, and cash to run it. You need to generate cash from business activity. The business is successful if the excess of the cash it generates over the cash it disburses is a sufficient reward for the efforts and risks taken in starting and running the business. The pandemic, for example, has created particular challenges that can be met by continuing to apply traditional cash management techniques. What these are and the way to apply them are the focus of this publication.

Effective cash management can help you survive these challenging times. It does this by forcing you to:

- measure and monitor
- manage
- achieve cost savings
- ensure financial stability
- anticipate problems
- maximize results

The central role of cash management in any business is the reason that the definitions presented earlier are so varied: It depends on who is defining it. And that also means that cash management forces you to consider operational issues and not just the numbers.

Cash is central to any organization's operations, as shown in the diagram below.



2. Controlling Cash

> The controller said excitedly: “Mr. Forbes, the ledger shows a slight profit this month!”
>
> My father turned to him and said: “Young man, I don’t give a damn what your books show. Do we have any money in the bank?”
>
> *Malcolm Forbes*

Budgets and Forecasts – and Cash

Many owner-managers pay little attention to budgets because they simply do not find them useful. Indeed, particularly in larger corporations, the budget process can be a massive and dysfunctional game-playing exercise. The traditional approach to the budget rewards negotiation, not performance. The manager who budgets for 10% sales growth and achieves 12% is a success, while the manager who budgets for 20% growth but achieves 18% is a failure.

Too often, the focus is on the process and the annual budget, rather than on the importance of updating a rolling forecast every month (or even every week) to anticipate and manage changes to the environment and the business.

Jack Welch, former CEO of General Electric during a period when it was wildly successful, is well known for criticizing budgets, with such assertions as, “the budget is the bane of corporate America.” The budget process has been blamed for planning processes being “hijacked” by financial types who then proceed to “manage by the numbers” rather than taking a more integrated approach. The budget is blamed for many related problems such as an undue focus on financial issues rather than customers, employees, quality, service and so on. Of course, some of this criticism is misplaced since no reasonable manager would expect the budget process to replace other elements of good management.

In the context of cash management, however, budgets and forecasts are actually powerful and useful tools. They provide an opportunity to learn from variations in forecasts by analyzing and studying the reasons for them.

The normal objections to the budgetary process do not apply to cash management for several reasons:

- Due to the nature of receipts and disbursements in most businesses, some statistical variation will always occur. Small variances may not always matter.
- “Negative variances” are not necessarily negative. For example, if profit is 30% below plan, that is presumed to be bad; if cash is 30% below plan, that may be good or bad, depending upon the circumstances and impact. If sales are booming (good), the need to carry more inventory or extra accounts receivable may result in less cash than expected (not necessarily bad).
- The analysis often occurs within the finance area, so interdepartmental issues do not (or should not) arise.

- Since cash balances and their variations do not carry the same consequences as declining sales, rising expenses or smaller profit, they can be reviewed and discussed more productively and dispassionately.
- Unlike profit, changes to cash match external data (i.e., the transactions going through your bank accounts). Therefore, they require continued attention and proactive monitoring.

Owner-managers know intuitively that cash is very important; they thus often want to sign all cheques and see all deposits. If you watch the cash, you get a fairly accurate view of what is really going on in the business.

You should have monthly reporting that compares actual results to the budget, and you should expect key metrics and brief analysis to accompany that reporting. Even smaller companies should do this. The discipline of writing down reasons for variances is excellent training for your staff and will be useful when you sit down with your managers, investors or bankers to try to understand what happened.

Defining Some Terms

Budget

Budget refers to the "official" accepted forecast for the financial results and financial position of the company anticipated at the end of a defined period. It is official because it is accepted by the board of directors as the benchmark against which to measure results. In an owner-operated business, the owner-manager may be the one to approve it. In this role, the owner-manager is effectively the board of directors overseeing the budget, as distinct from managing the day-to-day operations.

Projection and forecast

Projection means the expected results based on certain assumptions, which may not be the most likely assumptions. Forecast means the expected results, based on the most likely assumptions.

Balance sheet forecasts

Almost all businesses of any size budget their operating results one year in advance to provide a means of assessing the actual results as they occur and then taking appropriate action. Most businesses also update the budget monthly or quarterly by making rolling forecasts representing the expected results for the following 12 months. But it is less common in smaller businesses to budget and forecast the balance sheet.

It is not unusual for the owner-manager and other managers in a smaller business to focus on operations, not the balance sheet, and for their eyes to glaze over if someone suggests forecasting the balance sheet. After all, if it is hard enough to forecast operations, then to spend valuable time forecasting balance sheets would be even more futile!

But smart businesses know they need to forecast the balance sheet; this involves preparing a cash flow forecast as well. (You will find examples of cash flow statements later in this section.)

Here is an example of a forecast for a small business:

Example Inc. STATEMENT OF OPERATIONS

(Condensed)

	Actual Year ended Dec. 31, 2019	Actual Year ended Dec. 31, 2020	Budget Year ended Dec. 31, 2021
Sales	$ 1,756,832	$ 2,350,000	$ 3,290,000
Cost of sales	987,522	1,269,633	1,777,486
Gross margin	769,310	1,080,367	1,512,514
Research and engineering	98,752	126,963	177,749
Selling and marketing	263,525	352,500	493,500
Administration and general	316,230	423,000	592,200
Total expenses	678,507	902,463	1,263,449
Profit before the following	90,803	177,904	249,065
Interest expense	14,400	13,020	11,640
Income taxes	21,393	46,167	66,479
Net income	$ 55,010	$ 118,716	$ 170,946

This shows a successful enterprise: Sales increased by more than 33% from 2019 to 2020 and net income more than doubled. The budget anticipates sales increasing by 40% in 2021 and the bottom line increasing by a similar percentage.

Many small- and medium-sized businesses only budget their income. In this case, if a budgeted balance sheet were to be prepared based on the operating statement above, the balance sheet might look like this:

Example Inc. BALANCE SHEET

(Condensed)

	Actual Year ended Dec. 31, 2019	Actual Year ended Dec. 31, 2020	Budget Year ended Dec. 31, 2021
Cash and cash equivalents	$ 87,000	$ 25,213	$ (69,756)
Accounts receivable	292,805	470,000	731,111
Prepaid expenses	67,000	65,000	74,000
Inventory	197,504	253,927	355,497
Total current assets	644,310	814,140	1,090,853
Fixed assets, net	345,842	355,842	365,842
Total assets	990,152	1,169,982	1,456,695
Accounts payable and accrued liabilities	262,803	346,917	485,684
Total current liabilities	262,803	346,917	485,684
Mortgage payable	240,000	217,000	194,000
Total liabilities	502,803	563,917	679,684
Share capital	200,000	200,000	200,000
Retained earnings	287,349	406,065	577,011
Total shareholders' equity	487,349	606,065	777,011
Total liabilities and shareholders' equity	$ 990,152	$ 1,169,982	$ 1,456,695

This is interesting. Despite operations budgeted to be very successful, the cash at the end of 2021 is forecast to be negative. With this information, you as the owner-manager now have two key factors to consider: First, understand what could cause the negative balance, and second, ascertain whether something can be done to prevent it. (In this case, receivables and inventory have climbed without a similar increase in accounts payable.)

Next, if a negative cash position is likely, focus on arranging for an overdraft with the bank or bringing in another source of cash (financing). Finally, if the business is seasonal, you will need to review the expected balance sheet during the year as well.

Different Approaches for Different Purposes

There are two completely different approaches and formats used to monitor and forecast cash balances; which one to use depends upon its purpose. Most businesses should use both methods.

Your monitoring of cash can have different goals depending upon the timeframe.

1. **Short-term goal:** Ensure there is enough cash available in your bank account tomorrow and next month.

   If a problem is expected, you want to take the appropriate action (i.e., to increase the funds available, arrange an overdraft facility or loan, or otherwise advise the bank that a problem may be coming up). Do this now, not after it happens.

2. **Medium- and longer-term goal:** Plan your cash requirements for the next quarter, year and several years.

   Cash available over longer time periods depends on operating results, collection of receivables, disbursements to suppliers, and hundreds of other factors some of which you can influence, some of which you cannot.

These goals correspond to two different methods of monitoring and forecasting cash:

1. **Direct** (or receipts and disbursements) method is used for short-term objectives such as monitoring your bank accounts and ensuring funds are available to meet the company's immediate needs.
2. **Indirect** (or sources and uses) method is used for most other purposes.

Short-Term: Direct Method

The direct method is used for short-term cash flow monitoring and forecasting. It is based on forecast receipts and disbursements. In effect, it ignores the timing differences, accruals and deferrals that generally accepted accounting principles require, and only considers cash in and cash out. As such, it does not tie in directly to the financial reporting system. Even the cash balance it records is really the bank's record of cash (i.e., your actual cash in the bank).

This differs from your "book balance" of cash in the company's financial records, which deducts cheques as they are issued and adds any bank deposits not yet recorded in the company's records. For example, a merchant credit card payment may be deposited in the bank before it is recognized in the company's accounting records.

A major limitation of the direct method is that it does not easily reconcile directly to the financial records. For example, assume sales are $200,000 in January. To use the direct method, you need to create a model to predict how many of those sales will be collected in January, how many in February, and so on. This can be worthwhile for short periods but can be tough to do with a reasonable level of accuracy for longer periods.

Here is an example of the direct method:

Example Inc. STATEMENT OF CASH FLOWS

Receipts and disbursements method (direct method)

	Actual Month ended Dec. 31, 2020	Forecast Month ended Jan. 31, 2021	Forecast Month ended Feb. 28, 2021	Forecast Month ended Mar. 31, 2021
Receipts				
Cash sales	–	–	–	–
Collections of accounts receivable	$ 244,832	$ 260,000	$ 240,000	$ 220,000
Sales of fixed assets	–	1,000	–	–
Total cash receipts	244,832	261,000	240,000	220,000
Disbursements				
Suppliers and payables paid	187,322	120,000	70,000	145,000
Payroll and related taxes	89,554	90,000	90,000	90,000
Occupancy costs	46,081	42,000	44,000	42,000
Mortgage and related interest	3,215	3,000	3,000	3,000
Capital expenditures	4,538	–	20,000	–
HST, net paid (received)	6,543	7,000	7,000	6,000
Income tax instalments	4,000	4,000	4,000	4,000
Other	–	15,000	–	–
Total disbursements	341,253	281,000	238,000	290,000
Increase (decrease in cash)	(96,421)	(20,000)	2,000	(70,000)
Cash, beginning of period	121,634	25,213	5,213	7,213
Cash, end of period	$ 25,213	$ 5,213	$ 7,213	$ (62,787)

This method yields an interesting and important insight. Based on the assumptions used, it appears that during March the company's cash disbursements will exceed receipts by $70,000 to produce a negative cash balance of over $62,000. It also shows that the cash balances will be very low at the end of January and February; if any collections are delayed, the result will be a negative balance.

If arranged beforehand with the bank, the forecasted negative cash balance may well be settled with overdrafts or loans. Certainly, the business wants to avoid bounced cheques or a payroll or tax transfer being declined by the bank because of insufficient funds. This short-term forecast allows the company to anticipate such adverse consequences ahead of time, and to take appropriate actions to prevent them from happening.

Medium Term: Indirect Method

The indirect method is used for most cash flow forecasting other than for very short periods. It starts with net income calculated on the same basis as the company's annual financial statements and then adds and subtracts various items to convert that number to a cash flow basis.

Since this method ties into the financial statements, it is easier to model and follow. For example, predicting cash receipts from collection of accounts receivables in two years' time is quite difficult – and sometimes almost impossible. However, forecasting net income, then adjusting it for the various items, may still be very challenging but at least somewhat feasible (as we will see in Example Inc.'s statement that follows).

Below, you can see that in following the indirect method, the information presented in the cash flow statement is divided into three categories:

- operating activities
- investment activities
- financing activities

Operating activities start with net income from the statement of operations. Non-cash items normally consisting of depreciation and amortization of fixed assets and intangible assets are added to net income. Then, the change in working capital is added or subtracted because such items as accounts receivable, inventory and accounts payable increase or decrease due to the operations of the company and the usual fluctuations in activities that will provide or consume cash.

The aggregate change of all the working capital items is a source or a use of cash. For example, if accounts receivable increases by $50,000, that reduces the cash that would otherwise be available because the increase is a use of cash.

To put it another way, $50,000 will be required to finance the increase in accounts receivable. Conversely, an increase in accounts payable is a source of financing. Similarly, the reverse is true: A reduction in accounts receivable is a source of cash and a decrease in accounts payable is a use of cash.

Example Inc. STATEMENT OF CASH FLOWS

Sources and uses method (indirect method)

	Actual Year ended Dec. 31, 2019	Actual Year ended Dec. 31, 2020	Budget Year ended Dec. 31, 2021
Cash provided by (used in):			
Operating activities			
Net income	$ 55,010	$ 118,716	$ 170,946
Add (deduct) items not involving cash:			
Depreciation	40,000	40,000	40,000
Changes in working capital			
Accounts receivable	17,433	(177,195)	(261,111)
Prepaid expenses	3,655	2,000	(9,000)
Inventory	21,000	(56,422)	(101,571)
Accounts payable and accrued liabilities	(34,732)	84,114	138,767
Cash provided by (used in) operating activities	102,366	11,213	(21,969)
Investing activities			
Capital expenditures	(50,000)	(50,000)	(50,000)
Cash (used by) investing activities	(50,000)	(50,000)	(50,000)
Financing activities			
Repayment of mortgage	(23,000)	(23,000)	(23,000)
Cash (used by) financing activities	(23,000)	(23,000)	(23,000)
Increase (decrease) in cash and cash equivalents	29,366	(61,787)	(94,969)
Cash and cash equivalents, beginning of year	57,634	87,000	25,213
Cash and cash equivalents, end of year	$ 87,000	$ 25,213	$ (69,756)

Note that the balance of cash on hand forecast for December 31, 2021, is ($69,756) – the same figure that appeared on the budgeted balance sheet earlier. This demonstrates a strength of this method (i.e., that it ties into the income statement and balance sheet as well as the financial systems of the company).

Examining the larger numbers in the 2021 forecast, you can see that the increase in accounts receivable uses up $261,111 of cash, which by itself is almost $100,000 greater than the cash provided by the income for the year. The increase in accounts payable provides $138,767 of cash, most of which is used by the increase in inventory, which consumes $101,571 of cash.

This result suggests that various approaches could be used separately or in combination to address the cash shortfall (e.g., reducing receivables by speeding up collections, reducing inventory by operating more efficiently, and increasing accounts payable by slowing down payments to suppliers).

Longer-Term: Integrating Into the Budget Process

One of the strengths of the indirect method of preparing cash flow statements is that they can be derived from the financial statements that are produced as part of the reporting and budgeting processes. Because owner-managers are usually much more comfortable with forecasting and projecting sales and expenses than they are with forecasting and projecting cash receipts and cash disbursements, the results they get from the former forecasts and projections are usually more accurate.

Of course, no forecasting process will be completely accurate; sometimes forecasts can be spectacularly wrong. It is important to learn from mistakes by understanding the reasons for the differences (called “variances”) and then take appropriate actions to address them.

One important tool for effective cash management is comparing actual operating results (i.e., sales, cost of sales, expenses, and net income) to budget and then analyzing and identifying the reasons for any differences. It is important to follow up this analysis of the variances so the reasons can be understood, and appropriate corrective measures taken.

Corrective measures may pertain to improving operations, or to improving the forecasting process itself. So, think about implementing a routine process for comparing forecast or budgeted cash flows with actual results. That process then provides a very powerful tool for analyzing changes and may help you readily identify areas where you can quickly and effectively apply corrective measures.

Finally, over a period, look for trends in cash flows. For example, perhaps your business has historically shown increases in accounts payable lower than those budgeted for because your staff are paying suppliers too quickly.

The checklist below will help you quickly identify areas requiring follow-up or improvement. For questions for which the answer is “yes,” you should be able to identify reports or examples of behaviour that support that response. Otherwise, you may have identified an area where you can improve operations and cash flow management.

TABLE 1 – PLANNING AND MONITORING CASH CHECKLIST

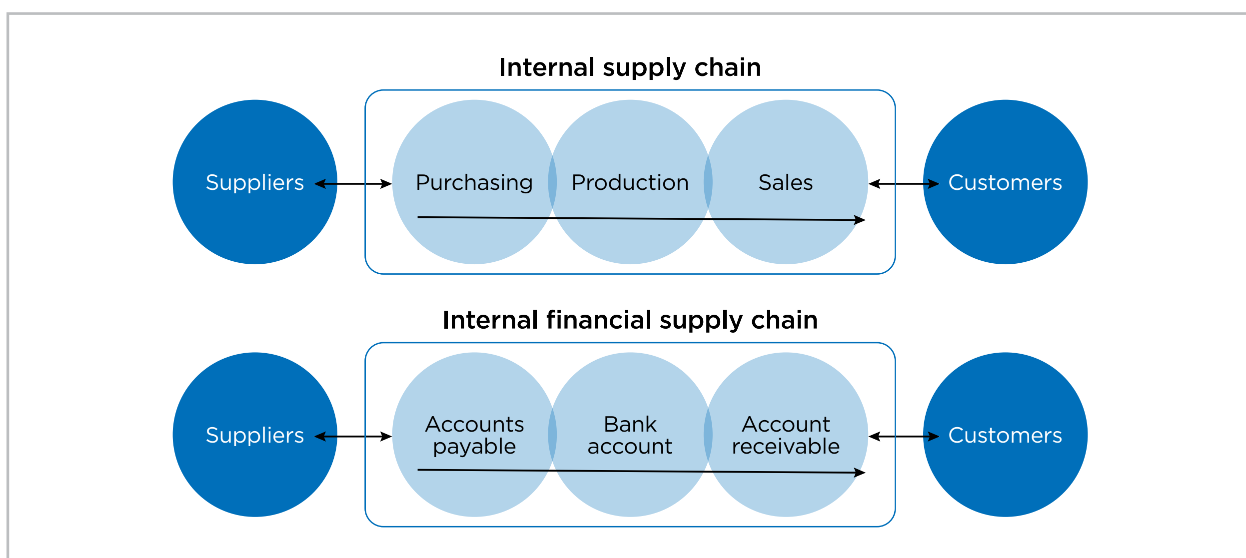
Consideration point	Yes	No	Not applicable	Comments / Follow-up
1. Do we forecast short-term cash flows using the direct (receipts and disbursements) method?				
2. Do we follow up variances between actual and forecast using the direct method?				
3. Do we forecast medium-term cash flows using the indirect (sources and uses) method?				
4. Do we follow up variances between the actual results and the budget results using the indirect method?				
5. Do the operating managers understand how their actions affect cash flows and cash balances?				
6. Can we identify three actions taken in the last six months that resulted from our analyzing cash flows and identifying variances?				
7. Is the analysis of cash flows comparing actuals to forecast prepared on a timely basis?				
8. Is a cash flow statement prepared as part of the monthly package of financial statements?				
9. Are cash flow statements prepared for individual business segments or groups (where these have their own operating or profit statements)?				
10. Are cash flow impacts taken into account when setting performance objectives for managers and when evaluating their performances?				

3. Banks and Banking

The Financial Supply Chain

The bank is usually a major link in a company's financial supply chain. The concept of a supply chain is normally applied to the operations of a business: It is the system of processes, people, technology, information, and resources that moves goods and services from your suppliers to you and from you to your customers.

Supply chain management, in this context, refers to the need to integrate business processes, and exchange information with suppliers and customers to optimize the process. Products and services flow from suppliers, through to production and on to customers; cash, on the other hand, flows in the opposite direction. The concept of the supply chain reminds us that information flows in both directions – and of the importance of information flow.



Supply chain management refers to exchanging information with suppliers and customers so that all companies involved can optimize their processes by considering demand from the ultimate customer or consumer. Many banking services are similar in that they focus on providing you with information in addition to the mundane function of paying cheques or recording deposits.

There are different ways of using the supply-chain concept. Here are a few:

- Some larger businesses (perhaps some of your customers) have fully automated their payment process to enable automated matching of purchase orders, contracts, sales orders, invoices and receiving reports, with little or no human intervention when issuing a cheque or electronic funds transfer (EFT) payment.
- If you deal with multiple banks, it may be possible for your primary bank to access data from the other banks so that your staff can access integrated banking information on one platform.

- The online banking services described later in this chapter can give you extensive information in a "soft" machine-readable format that may be useful for planning, bookkeeping or other purposes.

Dealing With Your Bank and Banker

Banks occupy a unique position of trust and authority. You can deal effectively with your bank by thinking of it as another supplier – albeit an important one. As is the case with any service provider, you want to be proactive and try to understand things from their perspective. (Of course, you may have more than one supplier for financial services, or deal primarily or solely with one bank.)

Because the major chartered banks in Canada are very large and complex organizations, it requires some finesse and skill by both the banker and the client to ensure a company selects and uses the right products.

Think of Your Bank as Another Supplier

Your bank may play several different roles. It may provide:

- routine processing and related services for bank accounts
- credit (borrowing)
- investment services for excess funds (investing)

Bank services are delivered through a relationship manager who may have a title ranging from customer service officer to manager to senior vice-president, and who performs the traditional functions of the "bank manager."

From the bank's perspective, a team services the customer: A senior banker handles much of the relationship with the customer's more senior management, while a junior person usually looks after day-to-day banking. Often a cash management services expert is assigned to help the client with new requirements and new services. Other specialized individuals may be involved in such areas as treasury (i.e., foreign exchange transactions, money market investments, interest rate or foreign exchange options, etc.), letters of credit, merchant credit card services, etc. If the customer borrows, then individuals in the risk management department will be involved as well. Even non-borrowing customers have a limited involvement with the bank's risk managers (e.g., when dealing with credit card accounts or foreign exchange transactions).

From your point of view, the key is a good working relationship with the banker servicing your account. Your administrator or bookkeeper probably deals with another person on the bank's team. Often, a judgment as to how "good" your bank is depends on the working relationship with the individuals involved with your account. Nonetheless, there are differences between the services offered by the various banks, and each bank changes the products it offers over time.

Stephen Leacock captured the mystique of banking in 1910 when he published his humorous short story “My Financial Career” about making deposits:

> The manager got up and opened the door. He called to the accountant. “Mr. Montgomery,” he said unkindly loud, “this gentleman is opening an account; he will deposit fifty-six dollars. Good morning.”
>
> I rose. A big iron door stood open at the side of the room. “Good morning,” I said, and stepped into the safe.
>
> “Come out,” said the manager coldly, and showed me the other way.
>
> I went up to the accountant’s wicket and poked the ball of money at him with a quick convulsive movement as if I were doing a conjuring trick. My face was ghastly pale. “Here,” I said, “deposit it.” The tone of the words seemed to mean, “Let us do this painful thing while the fit is on us.” He took the money and gave it to another clerk. He made me write the sum on a slip and sign my name in a book. I no longer knew what I was doing. The bank swam before my eyes.
>
> “Is it deposited?” I asked in a hollow, vibrating voice. “It is,” said the accountant.

The mystique vanished as banks began to position themselves as retail stores and consultants. They now focus on strengthening their client relationships by trying to become advisors as much as custodians. Many banking services have changed, and new ones have been introduced to keep pace with the evolving business environment.

It is important for owner-managers to understand the bank’s relationship with its customers from the bank’s perspective. It is not unusual to hear business owners lamenting that their bank refuses to finance some new activity. Remember: Banks lend money to earn interest. Because the returns from that activity are relatively modest, so are the risks. The banks are not in the business of financing risky ventures. If you need to finance greater risks, you will need equity, which you can get by retaining earnings (instead of distributing them through dividends or bonuses) or by raising new equity, or you can raise new debt by borrowing from a different source. These options for obtaining financing are further discussed below.

There is a connection between the business risk inherent in the operations of your company, and the amount of financial risk the banks will tolerate. Financial risk is measured by leverage: the ratio of loans and debt to equity. Banks themselves can have high financial leverage because they keep their business risk very low.

The banking disasters in the United States and Europe in 2007- 2008 resulted from banks with high leverage assuming excessive business risk – in many cases, risk they did not realize they had. At the other end of the scale, a start-up with no track record has high business risk, usually no debt and thus no financial leverage.

Managing Your Bank Accounts

A small business could have several accounts with its primary bank, such as:

- an operating account (sometimes called a current account) for day-to-day deposits and cheques
- an interest-bearing account for short-term idle funds
- a U.S.-dollar chequing account (discussed in "Foreign Currencies" below).

In addition, you may have separate accounts for a large payroll (if not paid through a payroll service), cheques issued to consumers or the public, or a high volume of low-value cheques such as rebates. The reason for separate accounts is to isolate errors or frauds so that you can identify and deal with them quickly.

Depending on the size of your business and whether you have a full-time bookkeeper, you should reconcile your bank accounts daily or weekly by accessing your bank records online. A formal bank reconciliation may be prepared once a month and duly reviewed by management. Anything that appears as a reconciling item in one month should be cleared the following month.

In addition, online information should be reviewed as often as practicable, to detect errors or fraudulent activity quickly. Your financial reporting should never be delayed because the accountant is waiting for the bank statement. If there is an effective ongoing reconciliation process, the account can be viewed online one day after the end of the month, and there should be no surprises.

There are many services to help reconcile and provide day-to-day management of the operating account. They add varying degrees of security, assurance and timesaving but, of course, have differing service charges and other requirements. The banks normally call these "cash management" services.

Almost all banking services can now be accessed electronically through web browsers on the Internet. Because the banks change their offerings frequently, it is important to routinely review which services you access, and how. You also need to assess whether some new product is available that provides better or cheaper functionality. For example, the following are some typical bank services that can support your cash management:

- **EFT, direct deposit, direct debit, preauthorized payments:** There are multiple ways to pay employees or suppliers electronically. You will want to review the many different EFT products carefully to ensure you have the right one for a particular type of disbursement.
- **Merchant EFT:** This type of EFT allows customers to pay you electronically.
- **Automated reconciliation:** With your general ledger package, paid items can be downloaded and reconciled automatically in your accounting system. In a variation of this, the bank will track issued and paid items and do the reconciliation for you.
- **Daily clearing, also called "negative pay":** Paid cheques are reported daily by electronic capture of critical information and/or cheque images. You would notify the bank if any items should not be paid because of alteration, forgery or other fraud.

- **Positive pay:** With this service, you advise the bank about released cheques. If a cheque is presented for payment that does not match the information provided, the bank contacts you before paying it. The matching may be based on serial number and amount or other fields such as date and payee name.
- **Deposit services:** This type of service co-ordinates and centralizes recording of deposits made remotely, at other branches or at other financial institutions.
- **Cash concentration, mirroring, centralized cash:** These services provide net balances in different bank accounts so you manage the net balance only (as a net overdraft or to invest).
- **Credit card services:** Not strictly part of your bank account services, but also important, these include both corporate credit cards and merchant credit card services if you accept payments by credit card.

To maintain the relationship, you should meet with your banking team at least once a year. It can be a good opportunity for your team to get together with the bank staff with whom they otherwise only communicate by email or phone. Such a meeting also provides a forum to consider whether you have the right services given any changes in your business and changes to the bank's offerings. A meeting is important even if you have a "non-borrowing" relationship.

Foreign Currencies

Many Canadian businesses are financially "bilingual" (or even "multilingual"), as it is routine to bill and pay for goods and services in other currencies, often U.S. dollars but also euros, British pounds sterling, Japanese yen, Hong Kong dollars, and so on. When you deal in foreign currencies, a small amount of effort can save a lot.

Tips for managing costs while managing currency

If you have not made prior arrangements with your bank for buying or selling a foreign currency, you will incur more costs for these transactions. While they won't charge an overt commission, the rate you pay will be up to 3% higher than the wholesale "midmarket" rate. (This foreign exchange rate is called the branch rate or "bulletin" rate, and normally only changes once a day.)

The spread works both when you buy and when you sell, so if you convert $1,000 to euros then convert it back, you will have about $60, or 6%, less than what you started with, even though there is no commission. The bank will reduce this spread – but only if you ask. The amount of the reduction will depend on the expected volume of business you will give the bank and the competitive situation.

Depending on the volumes, frequency of transactions, and currencies, you may be able to deal with the banks' foreign currency dealers by phone or through an automated online foreign exchange system. The exchange rate will be better than the bulletin rate – sometimes much better – and is based on the current wholesale rates.

For example, the additional "spread" over the mid-market wholesale rate can be as little as one-tenth of one percent – one dollar on $1,000, instead of $30. By talking to the dealer, you can also get a sense about what they expect to happen in the markets, as well as enter into more sophisticated trades.

Canadian and U.S. dollars

Canada is unique in having separate clearing systems for Canadian- and U.S.-dollar items. If you buy or sell anything priced in U.S. dollars, it is cost-effective to have an account denominated in U.S. dollars; this will reduce the cost and the volume of currency conversions.

There are several different types of U.S.-dollar-denominated accounts. The least expensive type may work well for U.S.-dollar payments in Canada, but suppliers in the U.S. may have to pay substantial fees and wait several weeks for cheques to clear. Another type is paid through (normally) a New York bank or trust company affiliate or branch of your bank and it clears through the American clearing system. Yet another option is an account through a U.S. bank (that may be an affiliate of your primary Canadian bank) that then looks exactly like a domestic U.S. cheque.

International transactions

For international activity, your bank will have specialists who can help set up various specialized services. These include:

- correspondent banking services to help with international transactions, receipts, and payments
- electronic payments (similar to EFT) including international wire payments and access to the U.S. payment systems
- import documentary credits, letters of credit to finance payments for imports and inventory in transit
- export documentary credits, letters of credit to reduce your receivable risk for export sales
- standby letters of credit, payment guarantees or documentary collections to reduce risk for you or your counterparties
- other trade finance services which may include providing advice and putting you in touch with service providers in other countries

There are often several ways of achieving a particular objective. For international business activities, it is especially important to ensure you speak to the right experts at your bank when assessing your company's needs.

4. Sales and Receivables

> What is efficiency? It is doing things – not wishing you could do them, dreaming about doing them, or wondering if you can do them.
>
> *Frank Crane*

Optimizing Cash

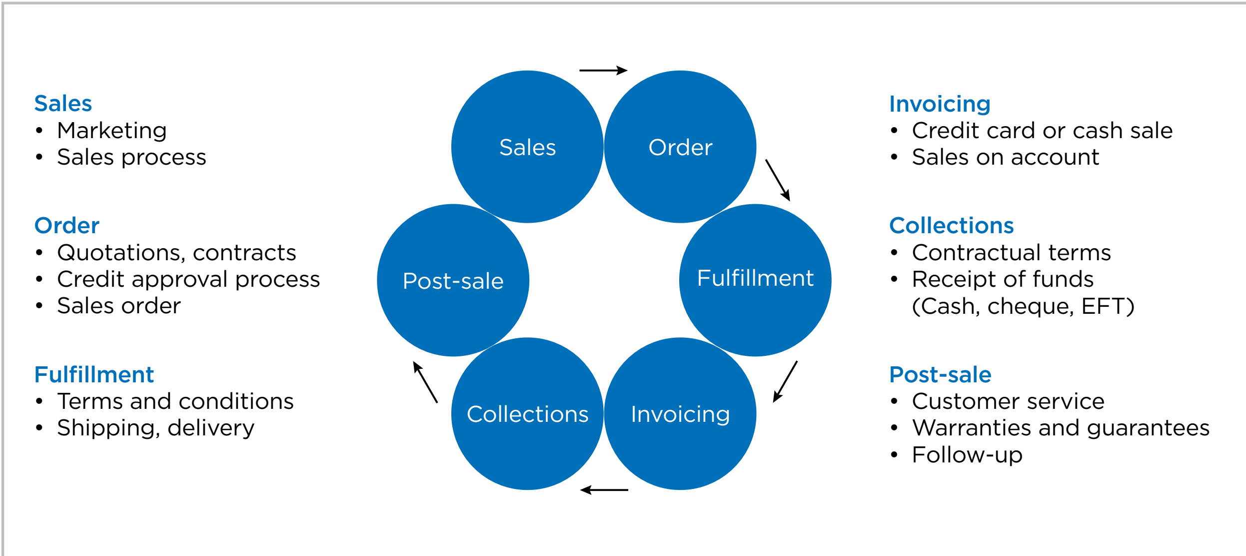
An essential aspect of cash management is to maximize the amount of cash available, both by operating efficiently and by effectively managing working capital as well as other assets and liabilities.

Multiple benefits arise from operating well: improved controls, more effective management, excellent quality, better customer service – even better morale, and hence performance by staff is enhanced.

A well-run operation sets up numerous "virtuous circles" and generates a positive feedback loop on many levels. Every step in the cycle shown here will increase cash flows; each step provides positive reinforcement to the other steps.

Sales, Receivables, and Receipts Cycle

It can be useful to divide operations into separate financial cycles. The revenue cycle is also called the "sales, receivables and receipts" cycle because those are the major elements that ultimately result in cash coming in. The sales-receivables-receipts cycle involves all aspects of selling the goods or services, billing, and following up accounts receivable and collections.



Do not forget the importance of collections. Sales result in an eventual cash inflow while receivables represent a delay in that cash inflow. Therefore, a reduction in that delay means an increase in your cash. Some further points to consider:

- If you do not collect the cash, there was not much point to the sale in the first place.

- Collections problems might give you early warning that the customer is dissatisfied due to problems with your products or services, or that the customer has cash-flow issues themselves.
- As receivables become older, they often become more difficult to collect.
- Accounts receivable can be a significant number on your balance sheet; thus, reducing them can be an important source of cash.

Here are some ratios from the results for Example Inc. presented earlier.

Sales, Receivables and Receipts Cycle	Actual Year ended Dec. 31, 2019	Actual Year ended Dec. 31, 2020	Budget Year ended Dec. 31, 2021
Sales	$ 1,756,832	$ 2,350,000	$ 3,290,000
Accounts receivable (end of year)	$ 292,805	$ 470,000	$ 731,111

If sales are spread evenly throughout the year, you can calculate how quickly receivables are collected:

$$\text{Accounts receivable turnover} = \frac{\text{Sales}}{\text{Accounts receivable}}$$

$$\text{For 2019:} \quad \frac{1{,}756{,}832}{292{,}805} = \text{six times per year}$$

$$\text{Days' sales in accounts receivable*} = \frac{365}{\text{Accounts receivable turnover (= six times per year)}} = 61 \text{ days}$$

* The average number of days to collect accounts receivable.

Turnover and days' sales are two ways of looking at the same measurement. (Note that if sales fluctuate significantly during the year, this calculation should be based on the preceding quarterly or monthly sales.) Calculating accounts receivable turnover and days' sales results in the following:

Metrics	Actual Year ended Dec. 31, 2019	Actual Year ended Dec. 31, 2020	Budget Year ended Dec. 31, 2021
Accounts receivable turnover (× per year)	6	5	4.5
Days' sales in accounts receivable (days)	60.8	73.0	81.1

As can be seen, efficiency (i.e., speed of collection) has been deteriorating: Receivables turnover has been declining while days' sales has increased. The budget for 2021 assumed this trend would worsen and days' sales would increase from the actual 73 days at the end of 2020 to 81 days at the end of 2021. Based on this, it is now possible to do some "what if" analysis. What if, at the end of 2020 and 2021, the company was as efficient at collecting accounts receivable as it had been in 2019? In other words, what if turnover in 2020 and 2021 were also at six times per year?

Metrics	Actual Year ended Dec. 31, 2019	Actual Year ended Dec. 31, 2020	Budget Year ended Dec. 31, 2021
Sales	$ 1,756,832	$ 2,350,000	$ 3,290,000
Accounts receivable	292,805	470,000	731,111
Accounts receivable as if at 2019 actual turnover	292,805	391,667	548,333
Reduction in accounts receivable		78,333	182,778

This balance sheet shows that the company could expect the accounts receivable balance at the end of 2021 to go down by $182,778 or 25% if it achieved the same turnover in 2021 as in 2019.

Turnover at 6x per year (61 days' sales) is actually not very efficient if the terms are, say, net 30 days. So, the next step is to model what would happen if the company collected receivables in 45 days instead of 61 days.

Metrics	Actual Year ended Dec. 31, 2019	Actual Year ended Dec. 31, 2020	Budget Year ended Dec. 31, 2021
Sales	$ 1,756,832	$ 2,350,000	$ 3,290,000
Accounts receivable	292,805	470,000	731,111
Accounts receivable as if collected in 45 days	216,596	289,726	405,616
Reduction in accounts receivable	76,209	180,274	325,495

This is an astonishing improvement! Recall that, in the original budget, the cash shortfall at the end of 2021 was budgeted at $69,756. By improving how efficiently it collects accounts receivable, the company can change this to a cash surplus of $255,739 instead ($182,778 + $69,756). Even by improving efficiency to actual 2020 levels, it would produce a cash surplus of $113,022.

Credit and Collections

One of the keys to controlling accounts receivable balances is to have very clear payment terms and to follow up with aggressive action if they are missed. It is always important to remain in touch with customers and understand their issues. Regular phone calls, emails, or visits can have the dual objective of both offering unexpected customer service ("Is everything all right with the order?") and a collections subtext ("Our accounts receivable department tells me your payment is still outstanding – is there a problem with our service?")

The checklist below can help you quickly identify areas for improvement in your credit, sales, and collections processes. Only answer "yes" if you can think of a report or example to support the response; otherwise, you have identified an area warranting further follow-up.

Credit and Collections Checklist	Yes	No	Not applicable	Comments / Follow-up
CREDIT				
1. Do we have a written credit policy?				
2. Do we evaluate each customer and assign a credit limit?				
3. Do we review customer credit limits annually?				
4. Do we have mechanisms in place for an exchange of information between sales and finance regarding changes that might affect customer credit?				
SALES				
5. Do we invoice promptly? • mail • courier • email • online invoicing (web-based) • automated matching by customer				
6. Do we follow up sales with a phone call, email or visit to ensure customer issues are being dealt with?				
COLLECTIONS				
7. Is our shipping and fulfillment process accurate and efficient?				
8. Do our customers understand the terms and conditions?				

Credit and Collections Checklist	Yes	No	Not applicable	Comments / Follow-up
9. Are terms and conditions up to date and in writing?				
10. Are changes to terms and conditions approved by management (for example, continuing to provide credit where there is a history of late payments)?				
11. Are customer records up to date? Are all requests for quotes (RFQs), contracts, correspondence, etc., maintained on file and available?				
12. Is management aware of customer complaints or other issues?				
13. Do we offer customers alternative payment channels (as appropriate)? • credit card • cheque • cash • direct debit • EFT transfer • bank transfer				
14. Are late payments followed up quickly? • email • phone call • visit				
15. Are late payments escalated to management for further action?				
16. Is appropriate additional action taken for late payments? • restrict further sales • restrict customer service • flag credit problems in file • report to credit agencies • use third-party collection services				
17. Is the aged accounts receivable listing followed up frequently, and unallocated payments resolved?				
18. Is the aged accounts receivable listing used for management review?				

5. Expenses and Inventory

Budgets and Expenses

The budget is the primary device used to monitor and control expenses during the year. It refers both to the detailed list of planned expenditures and to the entire plan for achieving the company's objectives during the year. The budget constitutes an important element of the control system. However, the budget's role in the control system only works if the budget-setting process is adequate, if you monitor and compare it to actual expenditures and if you review and analyze the differences.

A mistake smaller companies often make is to focus on the expense categories (e.g., office supplies) rather than on the allocation of expenses by departments (e.g., sales). Yes, you need to look at the detail, but you also need to focus on the big-picture numbers: "How much did our sales department expense increase from last year?" (and not just "How much did our office supplies expense increase from last year?").

You need to "drill down" and explore the budget presented earlier in more detail. You would do this by performing both horizontal and vertical analysis:

Vertical analysis	Actual Year ended Dec. 31, 2020		Budget Year ended Dec. 31, 2021	
Sales	$ 2,350,000	100.0%	$ 3,290,000	100.0%
Research and engineering	126,963	5.4	177,749	5.4
Selling and marketing	352,500	15.0	493,500	15.0
Administration and general	423,000	18.0	592,200	18.0
	$ 902,463	38.4%	$ 1,263,449	38.4%

Vertical analysis means considering each number as a percentage of a base number – in this case, sales. By undertaking vertical analysis, you can see that each department had budgeted the same percentage of sales for 2021 as the actual results for 2020. This analysis raised a red flag: Why should the percentage used be the same?

Horizontal analysis	Actual Year ended Dec. 31, 2020	Budget Year ended Dec. 31, 2021	Increase
Sales	$ 2,350,000	$ 3,290,000	40.0%
Research and engineering	126,963	177,749	40.0
Selling and marketing	352,500	493,500	40.0
Administration and general	423,000	592,200	40.0
	$ 902,463	$ 1,263,449	40.0%

Horizontal analysis means considering each number as a percentage change from the previous period – in this case, the change from actual 2020 to budget 2021. This analysis shows the same information in a different way; since sales were budgeted to increase 40%, each department was budgeted for the same percentage increase. Again, this analysis raises questions as to why you would budget expenses to increase at the same rate as sales.

Consider this in another way. If the company could achieve the same level of sales with no increase in expenses in the three departments, its pre-tax profit would increase by $360,986 ($1,263,449 – $902,463). That may not be a reasonable expectation but, then again, budgeting for an increase in the departmental expenses at the same rate as the sales increase is not necessarily reasonable either.

Salaries and Wages

Salaries and wages often represent the largest expense items in a business. As with all expenses, they should be broken down by department so that changes from the previous period can be analyzed. The individual employee positions (including vacant or new positions) may then be listed and summed up to provide a total for each department.

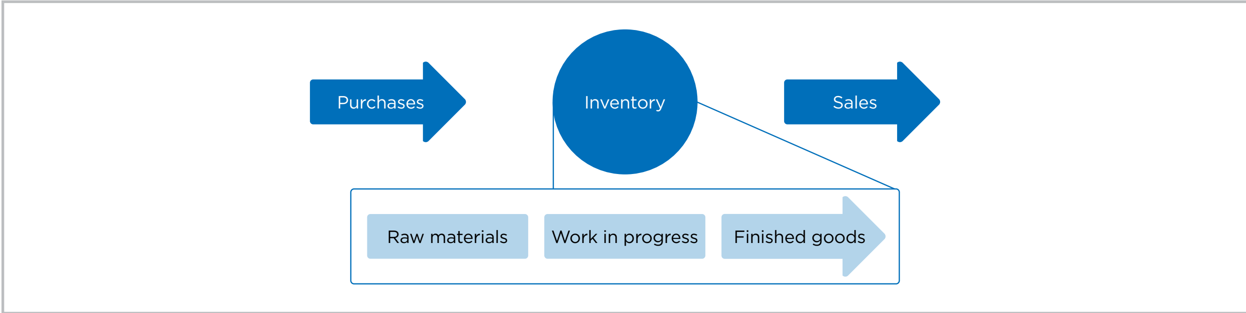
By looking at departmental totals and changes over time, you can assess reasonability and trends and ensure that some overall perspective is applied, rather than becoming bogged down in the minutiae of individual employees. Be sure to do both horizontal and vertical analysis: changes in salaries and wages in each department compared to the previous year, and salaries and wages in each department as a percentage of sales.

This might also be the time to take a step back and consider other management issues such as:

- assessing the impact of government programs during and after the pandemic
- reviewing the creation of new positions, vacancies, and variations in responsibilities as a result of growth, contraction and other changes in the business, etc.
- deciding what to do about underperforming employees
- reviewing (re)training, education and related issues as a result of observing problems and deficiencies over the year
- talking to your insurance agent or benefits consultant at least once a year about what might need changing around employee benefits, and how to control costs
- confronting unresolved human resources problems

Inventory

Inventory may be purchased for resale, or there may be a production process that converts inventory received into another type of inventory for subsequent sale.



A reseller such as a retailer or wholesaler does not have a production process, although there may be some repackaging or other conversion of inventory to make it available for sale. Companies that sell services instead of (or in addition to) tangible goods also have inventory such as a labour input that produces the services.

In some cases, there is an obvious inventory element since billing occurs after a large amount of services has accumulated (e.g., professional services firms such as lawyers, engineers or accountants). In other cases, the services are billed shortly after they are rendered (e.g., medical services, gardeners and consultants), so there is little inventory recorded.

Manage Inventory

It is not unusual for 80% of the sales volume to result from 20% of the line items. An important element of optimizing inventory levels involves identifying where inventory levels may be reduced without impairing customer service or production efficiency. In some cases, businesses find that slow-moving items are sold to unprofitable customers, which suggests the need for a more complete analysis to consider eliminating not just inventory items but also unprofitable customers. On the other hand, if you need to supply a wide range of inventory for strategic reasons, then you need to find other ways to make the process more cost effective.

Lessons can be learned from appliance and automobile manufacturers. They provide a wide range of parts for products that are no longer sold, but they charge very substantial markups for them. A piece of rubber trim that costs $1 to manufacture might sell for $100 or even more to the consumer.

Using the earlier budget, you can calculate the efficiency of using inventory to determine turnover:

Metrics	Actual Year ended Dec. 31, 2019	Actual Year ended Dec. 31, 2020	Budget Year ended Dec. 31, 2021
Cost of sales	$ 987,522	$ 1,269,633	$ 1,777,486
Inventory (end of year)	197,504	253,927	355,497

If sales are spread evenly throughout the year, you can calculate:

$$\text{Inventory turnover} = \frac{\text{Cost of sales}}{\text{Inventory}}$$

$$\text{For 2019:} \quad \frac{\$\,987{,}522}{\$\,197{,}504} = \text{five times per year}$$

$$\text{Days cost of sales in inventory} = \frac{365}{\text{Inventory turnover}} = 73 \text{ days}$$

Turnover and days' sales are two ways of looking at the same measurement. (Note that if sales fluctuate significantly during the year, this calculation should be based on the preceding quarterly or monthly cost of sales.)

Metrics	Actual Year ended Dec. 31, 2019	Actual Year ended Dec. 31, 2020	Budget Year ended Dec. 31, 2021
Inventory turnover (× per year)	5	5	5
Days' sales in inventory (days)	73	73	73

This shows that inventory turnover was low in 2019 and 2020, and that the budget assumes the same level of turnover will continue in 2021. Turning over inventory five times per year, or every 73 days, is not very impressive. With some focus on the production process and the identification of bottlenecks or high levels of raw materials or finished goods inventory, it is likely that this turnover rate could be improved. If turnover increased from five times per year to six times per year, here is what would happen:

Metrics	Actual Year ended Dec. 31, 2019	Actual Year ended Dec. 31, 2020	Budget Year ended Dec. 31, 2021
Cost of sales	$ 987,522	$ 1,269,633	$ 1,777,486
Inventory at actual 5× turnover	197,504	253,927	355,497
Inventory if at 6× turnover	**164,587**	**211,606**	**296,248**
Reduction in inventory	**32,917**	**42,321**	**59,249**

Six inventory turns a year is still only fair for many industries and, in many cases, would not require much of a stretch. Even so, it would free up $59,249 of cash in 2021. If the company were able to achieve eight inventory turns a year, then inventory at the end of 2021 would amount to $222,186 and would free up $133,331 of cash compared to the base case.

To put these figures in context, recall that in the original budget there was a cash shortfall at the end of 2021 budgeted at $69,756. By improving the efficiency of inventory, this shortfall could be changed to a cash surplus.

Contracts and Purchase Orders

Many smaller businesses follow an informal process when ordering inventory. If possible, at a minimum try to get competitive bids. It may be better still to make the purchasing process more formal and ensure the key terms are in writing. This may be done by entering into a supply contract or by ensuring that everything is clearly set out on your purchase order.

By putting all the important items in writing, you reduce the chance of a current misunderstanding growing into a future conflict. Investing the time to enter into written agreements may save much more time down the road by reducing disagreements and clarifying the terms, pricing and conditions.

Typical terms to consider including in a contract or purchase order are:

- exact legal names of seller and buyer
- detailed list of what is being purchased
- specifications and quality parameters
- delivery terms
- price
- HST/GST registration number
- provincial sales tax included, exempt or not applicable
- payment terms and conditions
- warranty terms
- other representations
- mechanism for resolving disputes

You do not need a complex contract to protect yourself; just deal with these issues on the purchase order or sales order, or in a short letter. In more complex situations, there may be a contract or standing purchase order detailed purchases are made within the terms and conditions specified.

6. Debt and Equity

> Neither a borrower nor a lender be,
> For loan oft loses both itself and friend,
> And borrowing dulls the edge of husbandry.
>
> William Shakespeare, *Hamlet*

Capital Structure

Capital structure refers to the mix of debt and equity used to finance the business. In theory, the amount of debt and equity in the balance sheet results from a careful analysis based on minimizing the total cost of debt and equity (called the "cost of capital").

If debt accounts for a small proportion of the total funding, then debt is much cheaper than equity because it represents a more secure claim and because the cost of debt (interest) is deductible for income tax purposes. However, as the amount of debt increases relative to the total, the interest rate will increase due to the risks associated with greater financial leverage.

In theory, there is an optimum level of debt, and your debt levels should be based on that.

Reality, however, is different. Debt levels are usually based upon several pragmatic factors:

- amount of debt financing available through banks or other lenders
- amount of debt financing necessary after the owners have distributed earnings through bonuses or dividends
- bank covenants that dictate the required amount of equity

These factors may well result in a debt level similar to the theoretical optimum, but the focus is more on availability of funding and the lenders' requirements, rather than on minimizing the total cost and optimizing the position of the owners.

A company's capital structure often just evolves over time without the owner-manager giving it a great deal of deliberate thought. However, you should approach your capital structure strategically: Think about what makes sense for you and the company. You may have various constraints, such as wanting to avoid new equity issuances because you do not wish to cede any control. Or your lenders may have indicated to you that it is time to find sources of fresh equity to grow the business.

Leverage and Business Risk

In the example balance sheet presented earlier, debt (represented by a mortgage) seems fairly small and almost incidental to the analysis. Look at the company's debt levels from a strategic perspective.

Metrics		Actual Year ended Dec. 31, 2019		Actual Year ended Dec. 31, 2020		Budget Year ended Dec. 31, 2021
Profit before interest and income taxes	$	90,803	$	177,904	$	249,065
Interest expense		14,400		13,020		11,640
Interest coverage ratio		**6.3 to 1**		**13.6 to 1**		**21.3 to 1**

The interest coverage ratio is profit before interest expense and income taxes divided by interest expense. A ratio of 1 – 2 to 1, for example, would suggest that a company's operations are barely covering its interest obligation. However, in this case, the ratios are very high and trending higher. This suggests that greater borrowing capacity is available should it be needed.

Metrics		Actual Year ended Dec. 31, 2019		Actual Year ended Dec. 31, 2020		Budget Year ended Dec. 31, 2021
Mortgage payable	$	240,000	$	217,000	$	194,000
Total shareholders' equity		487,349		606,065		777,011
Debt to equity ratio		**0.49**		**0.36**		**0.25**
Debt to debt + equity ratio		**0.33**		**0.26**		**0.20**

Accessing debt and equity at the right time and in the right amounts is a vital component of cash management. You can read about this topic in more detail in a companion publication, *Financing – A Recovery Toolkit for Business Owners*.

7. Running Out of Cash: Dealing With a Crisis

> "Annual income twenty pounds, annual expenditure nineteen, nineteen and six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery."
>
> Mr. Micawber in Charles Dickens' *David Copperfield*

The pandemic has caused successful businesses to suddenly face situations of no revenue or significantly reduced revenue, resulting in serious cash flow issues. Here is a summary of things to consider when facing a cash crisis.

Talk to All Key Suppliers

Talk to your bank, to your landlord, to your other key suppliers. Keep them informed. If they understand you are trying to deal with the crisis logically and systematically, perhaps they will "cut you some slack." Perhaps they will offer a discount or accept a promise to pay much later, rather than writing off the debt. At least, if they are co-operative, you can have a productive discussion and maybe reach a solution.

Cut Expenses

You have likely done this already. But, even if you have, take another look. What can you still cut out? Look at everything going through your bank account. Eliminate everything that is not necessary.

For example, during the pandemic, retail stores have carefully reviewed staffing to ensure every hour of employee time is essential to the current level of business. Customer service may not be at optimal levels, but customers will no doubt understand, given the situation, that you are going through crisis times.

Another example is automatic monthly payments that should be reviewed. A small grocery store found that it was paying every month for access to an unnecessary human resource information system that could be replaced by manual recordkeeping.

Focus on Profit Margins

Review the information you get from your accounting systems. Where can you make operations more efficient? For example, during the pandemic, restaurants have focused on menus without premium ingredients so that they can reduce waste if sales suddenly do not materialize because of a new lockdown. Others have quickly altered their strategies by reconfiguring their space to offer retail supplies and take-home pre-cooked meals.

Review Government Programs

Canada and Ontario offer a variety of programs to assist small businesses, and the programs are updated frequently. Section 8 below "Resources to Help You Recover", provides links to resources and ideas that might be useful to you.

Accelerate Receivable Collections

There are multiple techniques for speeding up the collection of receivables. Not all apply to every business, but here are some ideas:

- Make it easy for customers to pay with electronic payments through your bank or by using their credit cards.
- Ask for deposits or prepayments.
- Send out invoices promptly and frequently – do not wait for month-end.
- Follow up slow-paying accounts.

Alter Payment Schedule

The flip side of accelerating collections is slowing down payments. Here are some ideas; again, every one will not apply to every business:

- Did you build up credibility by paying quickly in the past? If so, take advantage of your good reputation and engage your suppliers in a discussion.
- If you have paid following regular terms in the past, perhaps you can increase the payment period by a week or two.
- Many businesses are now having severe cash crunches. Talking to suppliers might identify solutions that yield win-win outcomes, such as discounts for prompt payment, extended terms, etc.

Creative Sources of Cash

Factoring (i.e., borrowing against) receivables, accepting inventory on consignment (i.e., you pay for it after you sell it), are among the ways you can free up cash. Can you sell off any assets to raise cash to tide the business over? As noted above, there is a companion publication from CPA Canada, *Financing – A Recovery Toolkit for Business Owners*, that covers where to find financing.

Talk to an Expert

Your CPA or lawyer might be able to give you a fresh perspective. Insolvency specialists (many of whom are CPAs) also handle restructurings and may have novel ideas as to how you can keep your business going through the pandemic.

8. Resources to Help You Recover

The Plan

To cope with and recover from a crisis, you need to be systematic and have a plan. The checklist below provides a series of steps to follow. The plan does not need to be complicated; just list the steps you need to take to meet the expected deadlines. Then you revisit it and start again.

1. Determine your cash flows for the next three months
   - Prepare a cash flow statement using the receipts and disbursements method (Section 2).
   - Consider the ideas presented throughout this *Toolkit*, but especially from Section 7.
   - Revisit the forecast and make any necessary changes.
   - Consider how to change your strategy or business plan in light of the pandemic: See the companion publication – *Strategy and Planning: A Recovery Toolkit for Businesses*.
2. Review your available resources
   - What does the cash flow forecast tell you?
   - Consider novel sources of cash: See the companion publication *Financing – A Recovery Toolkit for Businesses*.
   - Investigate government programs and rules (more on that below).
   - Skim through some of the web resources listed below for new ideas you might consider.
3. Develop a plan
   - Put it all together. Can you get some "quick wins"?
   - Involve your business partners, managers and employees in the plan, as appropriate.
   - Write the plan down as a list of steps and deadlines.
4. Go back to step 1 and do it again.

Go through this process systematically and document your plan. Monitor implementation of the plan to evaluate your progress. Update the plan from time to time, as necessary.

Government Resources

The rules are constantly changing, and you need to be up to date. You should consult current links on the Internet to be sure you are current on government requirements and on programs that provide assistance to businesses.

Many programs are available from both the federal and provincial governments. For example, at the time of writing (December 2020) there were several programs ranging from the federal Canada Emergency Business Account (CEBA) interest-free loans, the Canada Emergency Rent Subsidy (CERS) and the Large Employer Emergency Financing Facility (LEEFF), to various relief measures for specific sectors.

Every province has its own programs, and municipalities offer various types of support as well. Since all these programs change constantly, you should monitor them regularly to get updated information. The links below are a starting point: They will direct you to specific links for businesses, but those specific links frequently change. Your starting point should always be the websites from Canada and your province(s) of business.

Government of Ontario: COVID-19 pandemic information and links to specific information:

- COVID-19 (coronavirus) in Ontario (covid-19.ontario.ca)
- Ministry of Economic Development, Job Creation and Trade (www.ontario.ca/page/ministry-economic-development-job-creation-trade)

Government of Canada: COVID-19 pandemic information and links to specific information:

- Coronavirus disease (COVID-19) (www.canada.ca/en/public-health/services/diseases/coronavirus-disease-covid-19.html)
- Canada's COVID-19 Economic Response Plan (www.canada.ca/en/department-finance/economic-response-plan.html)

CPA Canada is monitoring the COVID-19 pandemic for any new developments related to its economic impact:

- COVID-19 information resources (www.cpacanada.ca/en/members-area/covid-19-resources)
- COVID-19 financial literacy resources (www.cpacanada.ca/en/the-cpa-profession/financial-literacy/financial-literacy-resources/covid-19-financial-literacy-resources)
- Ontario small business financial literacy resources (www.cpacanada.ca/ontariosmallbusiness)

Many municipalities have COVID-19 web pages as well, although they are often geared more to the public than to businesses. Here are a few:

Brampton: (letsconnect.brampton.ca/general)

Hamilton: (www.hamilton.ca/coronavirus)

Kitchener: (www.kitchener.ca/en/city-services/storm-and-emergency-updates.aspx#)

London: (london.ca/covid-19-coronavirus-information)

Mississauga: (web.mississauga.ca/city-of-mississauga-news/covid-19-recovery)

Ottawa: (www.ottawapublichealth.ca/en/public-health-topics/novel-coronavirus.aspx)

Peel Region: (www.peelregion.ca/coronavirus)

Toronto: (www.toronto.ca/home/covid-19)

Vaughan: (www.vaughan.ca/news/COVID19/Pages/default.aspx)

Waterloo: (www.waterloo.ca/en/living/covid-19-response.aspx)

York Region: (www.york.ca/wps/portal/yorkhome/health/yr/covid-19/covid19/)

Other Resources

Up-to-date information is available from the websites of professional services firms, law firms and others. The following are a few examples; all are Canadian sites or reference Canadian information. Of course, you should ensure the information is current and should cross-check it with other advice before acting on it.

CPA firms

Bakertilly: (www.bakertilly.ca/en/btc/covid-19-business-guidance)

BDO: (www.bdo.ca/en-ca/covid-19/home)

Deloitte: (www2.deloitte.com/global/en/pages/about-deloitte/topics/combating-covid-19-with-resilience.html)

Ernst & Young: (www.ey.com/en_ca/covid-19)

Grant Thornton: (www.grantthornton.ca/insights)

KPMG: (home.kpmg/ca/en/home/insights/2020/03/the-business-implications-of-coronavirus.html)

MNP: (www.mnp.ca/en/covid-19)

PwC: (www.pwc.com/ca/en/covid-19.html)

Welch LLP: (www.welchllp.com/covid-19/)

Many other CPA firms have guidance as well.

Law firms

Canadian law firms have excellent online resources. Below are some places to start. Many other law firms have resources available. Those listed below have a COVID-19 landing page to get you started:

Blakes: (www.blakes.com/covid-19/articles)

BLG: (www.blg.com/en/insights/2020/03/covid-19-breaking-developments-and-essential-resources)

Gowling WLG: (gowlingwlg.com/en/topics/covid-19-how-will-coronavirus-impact-your-busines/)

Miller Thomson: (www.millerthomson.com/en/covid-19-resources)

Stikeman Elliott: (www.stikeman.com/en-ca/kh/guides/COVID-19-Canadian-Legal-Resources)

Torys: (www.torys.com/covid19)

For more information visit:
www.cpacanada.ca/ontariosmallbusiness

DISCLAIMER

The views expressed in this series are non-authoritative and have not been formally endorsed by CPA Canada, or the Government of Ontario. The information included in this publication is for general information purposes only and should not be used as a substitute for consultation with professional advisors.

CPA Canada, the Government of Ontario and the authors do not accept any responsibility or liability that might occur directly or indirectly as a consequence of the use or application of or reliance on this material.

Copyright © 2021 Chartered Professional Accountants of Canada.

All rights reserved. This publication is protected by copyright and written permission is required to reproduce, store in a retrieval system or transmit in any form or by any means (electronic, mechanical, photocopying, recording, or otherwise).

For information regarding permission, please contact financialliteracy@cpacanada.ca.