

How To Avoid A Decrease In Cash Flow From An Increase In Operations



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Operating cash flow refers to the cash flow your business generates from its regular activities. It begins with net income from your income statement, adds back in the cash, and then incorporates changes in working capital.

On a basic level, if you have the balance on asset increase, cash flow from operations decreases. If the balance on an asset decreases, you'll have an increased cash flow.

If you have a net increase in balance on a liability, cash flow from operations increases. If the balance on the liability decreases, your cash flow decreases as well.

Ideally, your business should develop a strategy that avoids declines in cash from business operations. To do this, you must focus on maximizing your net income

and optimizing efficiency ratios.

What Factors Decrease Cash Flow from Operating Activities?

Net Income Decrease

The cash flow statement (CFS) is a financial statement that provides a summary of how your business has moved its cash and cash equivalents (CCE) over an accounting period. You may also hear it referred to as a statement of cash flows. It is a statement accepted by the Generally Accepted Accounting Principles (GAAP) standards for financial reporting in accrual accounting.

The CFS indicates how well a business manages its cash position. in layman's terms, this refers to how well the company generates revenue to pay its debts and fund its operations. It is one of three main financial statements and it complements the income statement and balance sheet.

The cash flow statement starts with net income which is equal to all revenue minus cost including income taxes. The operating cash flow on the other hand begins with net income and any changes in that income that would affect cash flow from operating activities. If your revenues decrease or your costs increase and cause your net income to decline, you will see a decrease in cash flow from operating activities.

Changes to Working Capital

The biggest part of the cash from operating activities is the changes in working capital which include your current assets and current liabilities. Changes in your current assets and liabilities are shown in the cash flow statement. Growth in assets or a reduction in liabilities from one period to another constitutes the use of cash and reduces your cash flow from operations.

Evaluate your working capital management with efficiency ratios like inventory turnover, days sales outstanding, and days payable outstanding, so you can see how your company's operations influence the actual cash available.

Low Inventory Turnover Rates

Calculate your inventory turnover rate by finding the ratio of sales to the inventory available at the end of the same period. If you find a lower inventory turnover, this indicates less effective Inventory management. Improper inventory management increase is the level of inventory shown on the balance sheet at any given time, meaning that you're not selling your inventory. This is a cash use that decreases cash flow from operations.

Inventory Changes

Whenever you have inventory changes, you're affecting your cash flow. If you have an increase in inventory, you're changing your current assets and, you're damaging your cash flow. If you can decrease your inventory, you'll have more cash flow. Inventory is typically the largest short-term asset of businesses that sell products rather than services.

Increase in Days Sales Outstanding

Days sales outstanding is a metric that measures how quickly your organization collects cash from its customers. Calculate this much work by multiplying the number of days in a period By the ratio of accounts receivable to credit sales across the same period. If you see the number increase, it indicates poor receivable collection practices so your company isn't getting paid for items it has sold. Ultimately, you end up with higher current assets with a use of cash that decreases cash flow from operating activities.

Decrease in Days Payable Outstanding

Your accounts payable, or notes payable, are the amounts you owed to vendors that are payable within the next 30 to 90 days. Without payables and credit, you have to pay for all goods and services at the time of purchase. For optimal cash flow management, you need to take a closer look at your payable schedule.

Days payable outstanding measures how quickly your business pays your suppliers. To calculate it, multiply the days in the period by the ratio of accounts payable to the cost of revenues within the same period.

If you find a decrease in the days payable outstanding, your business is paying suppliers faster and money is going out the door sooner. It reduces accounts payable on your balance sheet. Reducing your current liabilities is the use of cash that decreases cash flow from operations.

Changes in Prepaid Expenses

If you encounter an increase in prepaid expenditures, your cash flow suffers. But if you encounter a decrease in prepaid expenses, you'll improve your overall cash flow.

Net Changes in Accounts Receivable

Increasing accounts receivable hurts cash flow but decreasing helps it. Your accounts receivable asset indicates how much money customers who bought products on credit still owe your business. This asset is a promise of cash that your organization will receive but the cash will not increase until you collect money from customers.

Changes in Operating Liabilities

If you have an increase in short-term operating liability, you will see an improvement in cash flow. If you have a decrease in operating liabilities, your cash flow will decline.

Depreciation

When you record appreciation expenses, you'll decrease the book value of your long-term operating assets. There is no cash outlay when recording the depreciation expense, such as when a piece of equipment has reached the end of its useful life. Every year, your business will convert part of the total cost invested and its fixed assets into cash. You'll recover this amount through cash collections from sales so depreciation is a positive cash flow factor.

Credit Terms

Your credit terms are the time limits you set for your customer's promise to pay for what they purchased from you. Your credit terms affect the timing of how

often you receive revenue. Offering trade discounts is one way to improve cash flow. Giving your customers discounts for cash payments or cash transactions is a great way to boost your cash flow and keep things running smoothly.

Credit Policy

A credit policy is the guideline used when you decide whether or not to extend credit to a customer. A correct credit policy is crucial to ensuring that your cash flow doesn't suffer because it is too strict or too generous.

By understanding the factors that influence changes in cash flow, you can build a strategy that keeps you in the black.

A Closer Look at Accounts Receivable and Cash Flow

Accounts receivable record sales that you have not yet collected revenue from. You sell goods or services in exchange for a customer's promise to pay you within a certain time frame in the future. If your organization typically extends credit to customers, then the payment for accounts receivable is most likely the main source of cash.

Worst case, unpaid accounts receivable leave your business without the cash flow you need to pay your own bills. More commonly, slow-paying or late-paying customers create cash shortages which leave your business without the necessary cash flow to cover your outflow obligations.

Accounts receivable also represent Investments. Money in accounts receivable isn't available to pay back loans, pay bills, or expand your business. The payoff from the investment in accounts receivable won't occur until your customer pays, which influences the amount of cash you have on hand and the liquidity of your business. It's important to understand the concept of accounts receivable as an investment if you want to consider its impact on your cash flow and free cash balance.

Use the following financial ratios to determine how your accounts receivable are impacting your cash inflows:

- Average collection period
- Accounts receivable to sales ratio
- Accounts receivable aging schedule

Average Collection Period

Your average collection period is the amount of time it takes to convert your average sales into cash. Using this measurement, you can define the relationship between accounts receivable and cash flow for any period of time. If you have a longer average collection period, you'll have a higher investment in your accounts receivable. It also means there's less cash available to cover your expenses when other cash outflows.

Calculate your average collection period by dividing your annual sales by 360. you can use the annual sales amount and accounts receivable balance from the prior year as it is typically accurate enough to analyze and manage your cash flow. But if more recent information is available use that instead. Calculate the average daily sales correctly by using the number of days reflected in the sales figure. If you used data from the last quarter, divide the total by 90 rather than 360.

For instance, Sandra owns and operates a crafting business. Sandra's total annual sales from the previous year were \$50,000. The total balance of his accounts receivable at the end of the same year was \$3,000. Sandra's average collection period is calculated like this.

- $\$50,000/360 = \138.89 average daily sales volume
- $\$3,000/138.89 = 21.6$ (rounded up to the nearest whole number for total days) = 22 days average collection period.

For Sandra's previous year, each dollar of sales was invested in accounts receivable for 22 days. Assuming that her business hasn't changed drastically from the last year, cash flows from sales on account won't be available for use for 22 days.

Accounts Receivable to Sales Ratio

The accounts receivable to sales ratio is a metric that measures the rate at which your business is selling its invoices to customers. This ratio gives you an idea of how quickly your company converts invoice sales into cash in hand, and it can

also give you insight into what might be slowing down that process. The higher the ratio, the faster your business converts its invoices into cash in hand, which can mean that you can rely on sales from invoices even if you're not getting paid immediately by customers.

The ratio looks at your accounts receivable investment and how it relates to your monthly sales amount. It helps you to spot recent increases in your accounts receivable. With monthly sales information, this ratio serves as a quick and easy way to look at changes in accounts receivable. The more recent information you use, the easier it will be to find cash flow problems.

Calculate your accounts receivable to sales ratio by dividing your accounts receivable balance at the end of the month by your total sales for the month.

For example, Sandra's accounts receivable balance at the end of the month was \$2,000 and the total sales from the same month were \$4,000. Sandra's accounts receivable to sales ratio is 2.

Accounts Receivable Aging Schedule

The aging schedule is a table where each row shows daily credit sales, debits, and days of credit terms. The aging schedule provides an at-a-glance snapshot of which invoices are overdue, as well as how much money you're owed. Aging schedules are an important accounting tool that shows how quickly your accounts receivable turn over.

When comparing two different businesses, a business with shorter accounts receivable aging schedule would have faster cash flow than a business with a longer accounts receivable aging schedule. Keep in mind that it's not just about days past due; accounts receivable turnover measures both your outstanding debt balance and how fast you collect on your invoices.

Final Thoughts

Cash flow from operations is a crucial metric that tells you how much cash your organization is generating from business activities. Much of its function comes from the income statement and the balance sheet statement including net income and working capital. Any change in the factors that make up the line items such

as inventory, accounts receivable, accounts payable, sales and costs, can all influence cash flow from operations.

Your net cash flow is a key indicator of your company's financial health. While it's okay for financing activities and investing activities to periodically and temporarily put you in a negative cash flow, you must operate with a positive cash flow overall.

When your business is spending more than it's bringing in, you run a negative cash flow. In other words, your sales are not enough to cover your expenses. If it continues indefinitely, you risk going out of business because you won't be able to pay your bills.

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