

Liquidity Management: How To Maintain Good Cash Flow and Mitigate Risk



Why liquidity management is important

Liquidity management is used to determine how financially stable your business is by calculating the amount of cash or other liquid assets you have available to cover upcoming business expenses. If your business has enough cash or assets that can be converted to cash quickly, it's said to be liquid. However, if the amount of cash and other assets do not exceed the amount of money you owe vendors and others, you have liquidity issues.

To avoid being surprised, you must be aware of any possible liquidity issues before they can negatively impact your business. The best way to do that is to calculate liquidity ratios regularly, with several to choose from, including the following.

- **Current Ratio:** The current ratio measures the ability to meet short-term obligations due within a year. The formula to calculate the current ratio is $\text{Current Assets} / \text{Current Liabilities} = \text{Current Ratio}$

- **Quick Ratio:** The quick ratio is similar to the current ratio, except it only includes a business' most liquid assets which include cash, marketable securities, and accounts receivable. The formula to calculate the quick ratio is $\text{Cash} + \text{Securities} + \text{Accounts Receivable} / \text{Current Liabilities} = \text{Quick Ratio}$.
- **Cash Ratio:** The cash ratio provides the most conservative estimate of liquidity, using only cash. The formula to calculate the cash ratio is $\text{Cash} / \text{Current Liabilities} = \text{Cash Ratio}$.

Calculating these ratios at regular intervals can help keep you on track and provide you with both cash position and liquidity risk. Liquidity is particularly important for businesses that are applying for a loan or additional outside funding, as both lenders and investors closely examine liquidity to determine whether a business is a good investment or risk.

In all cases, a higher liquidity ratio is better, indicating that your business can meet all current financial obligations.

Because cash is the most liquid asset available to businesses, calculating the cash ratio may be the most beneficial. While the other two ratios can be useful, the assets included in the calculation will need to be converted to cash before use. For example, you'll have to collect on any outstanding accounts receivable balances from your customers or convert existing inventory into cash before that cash can be utilized.

Maintaining good cash flow is the only way to become and remain liquid. Luckily, there are numerous liquidity management solutions you can implement in your business, starting with the following cash management processes that can directly assist with boosting cash flow.

1. **Don't pay supplier payables immediately.** Instead, see if you can negotiate payment terms with your vendors that are better suited for your business. For example, if you have to pay \$5,000 to your vendor upon delivery of products, but you currently offer your customers Net 30 terms, you will always have cash flow problems since more cash will be leaving the business than flowing in. If your vendor already provides you with 30 days to pay the invoice, take the entire 30 days to pay.
2. **Consider offering discounts to your customers.** If you have problems

getting your customers to pay on time, you may want to consider offering an incentive for early payment. For example, many companies will offer their customers a small 1% or 2% discount if the invoice is paid in ten days or less. Giving your customers a reason to pay earlier will cost you a little upfront but may help with any cash flow issues you may be having. Not only that, but it eliminates the need to follow up on any late-paying customers later in the month.

3. **Ask your supplier/vendor about payment incentives.** Incentives can work both ways. It's likely that your vendor is just as appreciative of early payments as you are. If vendors are actively competing for your business, they may be open to offering a discount for bulk orders or early payment. This is particularly true if you have a long-term relationship with your vendor.
4. **Send an invoice immediately.** If you offer your customers credit terms, don't wait to send an invoice. Instead, send the invoice when the product is delivered or the service rendered. Waiting to send an invoice can add up to 30 additional days to your accounts receivable balances. While not all of your customers may pay you immediately, others may.
5. **Ask for a deposit.** Depending on the goods or services you provide, you may want to ask your customer for a deposit. This is particularly important when providing custom or one-of-a-kind merchandise to your customers, or undertaking a big job that requires a lot of up-front costs. Most customers will not even balk at being asked for a deposit upfront, and those that do may have financial issues you need to be aware of.

Maintaining good cash flow is the only way to become and remain liquid. Following good cash management processes can directly assist with boosting cash flow and improving liquidity.

6. **Create and adhere to a credit policy.** One of the best ways to grow your business is to extend credit terms to customers. But before you do, be sure you have an established process in place, starting with the completion of a credit application. Don't feel obligated to offer credit terms to everyone. And when you do offer terms, make sure the terms are spelled out in a written disclosure agreement that you provide your customers.
7. **Periodically reexamine current credit and billing processes.** If your

business has grown in recent years, be sure to take some time to reexamine your current billing processes. Chances are what worked for you as a startup does not work now. This is particularly true if you started your business with a few customers and now have hundreds or thousands. Another thing you can do is send an annual reminder to all of your credit customers of what their credit terms are and the repercussions of not abiding by those terms.

8. **Closely track accounts receivable.** One of the best ways to get an idea of who's paying and when is to keep a close eye on your accounts receivable activity. Reviewing your A/R balances regularly allows you to see who's paying early, who regularly pays on time, and who the chronic late-payers are. To help mitigate late payments, start sending payment reminders as the due date approaches. You may also want to offer multiple ways to pay an invoice. For example, many customers prefer the convenience of paying a bill online rather than cutting a check. Allowing them to do so can increase your collection time considerably. For late accounts, have staff follow-up with late-paying customers immediately, and stop the further shipment of products until all past-due amounts have been collected. You may also want to revise terms to include a late-payment clause that will automatically charge your late-paying customers a penalty for any late payment.
9. **Reduce your expenses.** One of the quickest ways to improve cash flow (and liquidity) is to reduce your expenses. While fixed expenses are a little harder to reduce, other expenses such as business travel, employee overtime, unused subscriptions, even phone usage can usually be trimmed. Do you still have an expensive telephone system when all of your employees use cell phones to connect with customers? If so, get rid of it. The same goes for subscriptions to business journals, magazines, and newspapers that no one reads. If overtime is an issue, make sure that department managers know that all overtime expenses need to be approved ahead of time. And while it may be difficult to reduce rent or insurance costs, if you're paying for more space than you need, consider looking for something smaller (and cheaper). The same goes for insurance. Insurance agents are always happy to talk to potential customers, and can even be of assistance in switching over all of your

accounts, should you decide to change your insurance provider.

10. **Manage your inventory properly.** Managing inventory is much more than simply reordering more products or materials when they run low. Proper inventory management requires you to keep a close eye on inventory turnover and performance. What products are selling? What products are slow to move? Knowing the answer to both of those questions will do two things; first, it will allow you to purchase more of the product that is selling, and it will prevent you from purchasing too much of the product that isn't selling. By eliminating or reducing the amount of slow-moving inventory, you'll free up more cash. You may also want to consider using a drop-shipper, which eliminates the need to purchase large amounts of inventory for resale. Instead, your customer purchases an item, and it is shipped from your contracted drop-shipper. This method can improve cash flow immediately, and works particularly well for businesses that don't have a lot of space available to store large amounts of inventory.
11. **Open a line of credit.** It's difficult to obtain needed cash from a bank or other lender if your business is suffering financially. Remember, even if you're doing everything right, you may run into a situation that causes your available cash to drop. But arranging for an available line of credit from a bank, financial institution, or other financial services company before cash becomes tight can help you out should you need it in the future.
12. **Consider raising prices.** Raising prices is not the best solution for a one-time cash flow problem, but if you find your business is always short of cash, consider adjusting your pricing levels. Of course, if supplier costs rise, you'll have to raise prices or absorb the cost, which is usually difficult for small businesses with tight profit margins. If you do decide to raise prices, make sure to give your customers plenty of notice and explain the hike in price as best you can.

Healthy cash flow is the path to sustained

liquidity

Chances are you can pinpoint exactly where your cash flow gets bogged down. Perhaps your sales have dropped in the last year due to the pandemic, or supply chain expenses have increased. In either case, you'll want to implement a cash management solution for your business.

It can be helpful to spend a few moments preparing a cash flow forecast. You'll also want to run a cash flow statement that details cash inflows and outflows in real-time. In many cases, small businesses with very limited cash flow may want to track their cash flow daily to ensure that the business can continue to operate uninterrupted.

By reviewing the statement regularly, you can pinpoint the source of your cash flow problems, and address those problems immediately. Did your suppliers raise their prices? Do your customers pay their invoices late? Whatever the reason, addressing the issue is the only way to get your cash flow back on track, since the longer your cash flow remains low, the harder it becomes to find a way back to liquidity.

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