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Are your cash-flow tools recession ready?

John Mullins

London Business School, Sussex Place, Regent’s Park, London, NW1 4SA, U.K.

Abstract  In good times like those most businesses have enjoyed for the past decade, business owners have typically watched their income statements with pleasure, as year-to-year performance gains have fattened their dividend payouts and increased the valuation of the companies they own and run. All too often in such times, scant attention is paid to what’s between the top line and the bottom line of the income statement. Worse, most business owners, in my experience, give little more than a cursory nod to the balance sheet. Why does this matter? When a recession lands on their doorstep with a sudden thud, as it apparently just has, many of these same people will find themselves having sailed too close to the wind, with cash running out and a dearth of tools to help them weather the storm and understand what has gone wrong. But it need not be so, for there are four simple tools to help any business owner answer these four important questions: (1) Where is cash going in my business, and where is it coming from? (2) To what extent are my profit margins improving or declining, and why? (3) To what extent am I effectively managing the cash-flow relationships with my customers and my suppliers? (4) What, if anything, can I do to better manage the cash that flows into and out of my business? If your business is threatened by the COVID-19 pandemic, here are some tools to help it survive.

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1. Is a recession upon us?

Paul Samuelson, the Nobel Prize-winning economist, quipped decades ago that the markets had predicted “nine of the last five recessions” (Kennedy & Coy, 2019). As the accepted definition of a recession is two consecutive quarters of negative growth in GDP (BBC News, 2008), it’s not entirely clear, as I write, whether that test will be met in the coming months. But one fact is clear, a fact amplified by the COVID-19 pandemic that’s now upon us with a vengeance: Another recession will arrive someday—mostly likely sooner, perhaps later. It is probably—at least undeniably—already here.

Despite today’s foreboding, though, for the past decade or so all over the world, most business owners have been watching their income statements with glee, as year-on-year improvements in...
profit performance have fueled their dividend payouts and increased the valuation of the companies they own and run. I’ve observed two things: First, most business owners devote little rigorous attention to what’s between the top line and the bottom line of the income statement; second, and worse, in heady times like those we’ve experienced in recent years, most give only a cursory glance—if at all—to their balance sheets (Higson, 2012). This should not come as surprising news, because many business owners are not formally business-educated. Most never were exposed to Accounting 101!

When a recession hits, however, as it almost surely has, many such businesses will find themselves having sailed too close to the wind, with insufficient cash in the bank to weather the storm and a dearth of tools to help them understand in clear and simple terms what has gone wrong and what to do about their cash-strapped predicament.

2. Be prepared

In 1907, Robert Baden-Powell, an English soldier, devised the scouting motto: “Be Prepared” (Wendell, 2017). In any business, preparing for an impending recession—or reacting to one when it unexpectedly lands with a thud—means having a clear understanding of what’s happening with cash flow, as when cash flow turns negative or cash runs out, unpleasant things are likely to happen. Managers lose sleep over how they are going to make payroll on Friday. Banks call their loans as covenants are breached. In far too many cases, sadly, when a recession hits, the business goes bust. With the right tools, however, business owners stand a fighting chance of avoiding that outcome.

In my work with hundreds of business owners running fast-growing companies over nearly two decades, I find that their aforementioned focus on the bottom line of the income statement, accompanied by little more than a cursory glance at the rest of it and all-but-complete ignorance of the balance sheet, is all too common. In fact, it’s the norm. What they need, I have found, to better manage their companies’ performance and fund their growth when times are good, and to survive when times suddenly get tough, is a set of tools that can help them answer four crucial questions:

1. Where is cash going in my business, and where is it coming from?
2. To what extent are my profit margins improving or declining, and why?

Figure 1. Four cash-flow management tools

SUCA: Sources and uses of cash analysis
LBLMA: Line-by-line margin analysis
CDA: Cash-days analysis
HCA: Hidden-cash analysis
3. To what extent am I effectively managing the cash-flow relationships with my customers and my suppliers?

4. What, if anything, can I do to better manage the cash that flows into and out of my business?

Happily, there are four simple, corresponding tools available to enable any business owner or CEO to quickly answer these questions at any moment—or for any period—in time. By “simple,” I mean three things:

1. Easy for a financially untrained business owner to understand: no arcane language, complicated mathematical formulas, or abstract ratios required;

2. Easy to communicate to others in the business who shoulder the real day-to-day responsibility for managing cash and delivering performance in good times and bad; and

3. Doable with a hand calculator or in a rudimentary spreadsheet.

The four cash-flow management tools are illustrated graphically in Figure 1. Ideally, of course, every business owner would have already prepared for today’s crisis by putting such tools in place, deploying them in good times to help find cash for growth, and preparing for any cash crunch that comes along when times get tough (Blair, du Preez, & Le, 2020; Churchill & Mullins, 2001). Alas, my experience tells me that rarely occurs, so for many business owners it’s already too late to prepare. But it’s never too late to act. So, a business owner slammed with the COVID-19-induced downturn might ask: “What should I do now?”

3. Four tools for understanding cash and cash flow

To be clear, the four tools, at least in concept, aren’t brand new. They aren’t rocket science, either. Similar tools appeared—in principle, at least—in the 14th and 15th centuries, and over time, the accounting profession, which originated in Scotland in the 19th century, developed similar tools (Lee, 2013). Most accounting software packages, in fact, could easily generate such tools. But many don’t (QuickBooks Support, 2020), or they provide them in such an arcane fashion that simplicity is lost. Unfortunately, rarely do I find an owner-managed company that uses more than one of the four tools—if any at all!—on a regular basis:

- Tool 1: Sources and uses of cash analysis
- Tool 2: Line-by-line margin analysis of the income statement
- Tool 3: Cash-days analysis of the balance sheet
- Tool 4: Hidden-cash analysis

### Table 1. ACME Widget Works financial statements

| Income statement (dollars in thousands) | Actual 2018 | Actual 2019 | What if? 2020 |
|----------------------------------------|------------|------------|---------------|
| Sales                                  | 2,000      | 2,400      | 1,800         |
| Cost of sales                          | 1,200      | 1,380      | 1,080         |
| Gross margin                           | 800        | 1,020      | 720           |
| Operating expenses                     | 700        | 840        | 770           |
| Net profit after tax                   | 100        | 180        | (50)          |

| Balance sheet (dollars in thousands)   | EOY 2018   | EOY 2019   | EOY 2020   |
|----------------------------------------|------------|------------|------------|
| Cash                                   | 20         | 3          | (36)       |
| Accounts receivable                    | 165        | 198        | 222        |
| Inventory                              | 263        | 302        | 296        |
| Total current assets                   | 448        | 503        | 482        |
| Plant and equipment                    | 25         | 25         | 30         |
| Total assets                           | 473        | 528        | 512        |
| Accounts payable                       | 99         | 114        | 118        |
| Revolving loan payable                 | 50         | 50         | 50         |
| Total current liabilities              | 149        | 164        | 168        |
| Owners’ equity                         | 100        | 100        | 130        |
| Contributed capital                    | 100        | 100        | 130        |
| Retained earnings start of year        | 204        | 224        | 264        |
| Current-year profit after tax          | 100        | 180        | (50)       |
| Dividend paid out                      | (80)       | (140)      | 0          |
| Retained earnings end of year          | 224        | 264        | 214        |
| Total owners’ equity                   | 324        | 364        | 344        |
| Total liabilities and shareholders’ equity | 473        | 528        | 512        |
By “regular basis,” I mean not less than quarterly, and ideally monthly. After all, if you want your business to be responsive to changes in its performance, whether caused by internal or external factors, suitable warning signals must be seen, interpreted, and reacted to more frequently than not. But OK, you’ve not done that, you say, so let’s move on. We’ll first examine the four tools one at a time, after which I’ll suggest some concrete, real-world steps that can be taken now to apply them. Finally, I’ll close with a brief story of how one business owner did just that and survived the Great Recession of 2007-2009.

3.1. Tool 1: Sources and uses of cash analysis

Tool 1 answers the first of the three questions posed earlier: Where is cash going in my business, and where is it coming from? (We’ll call the cash’s destinations “uses of cash” and its origins “sources of cash.”) Why is this question important? A refrain I often hear goes something like this: “If we only had more cash, my company could grow faster.” Conversely, in a downturn: “If I can’t unlock some cash quickly, my business—not to mention the jobs I provide for my employees—may not survive.” Determining where the company’s cash has been going and whence it’s been sourced is the first step on the path to addressing these issues. And in times like these, when the world has turned upside down, knowing where the cash has been going and where it is likely to go in the weeks and months ahead is Step 1 in halting the cash burn.

With Tool 1, this important two-part question can be addressed for any period of time for which beginning and ending balance sheets are available: monthly, quarterly, yearly, or even longer. As we’ll now see, the procedure is straightforward.

| A | B | C | D | E | F | G | H | I | J | K | L | M |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Balance sheet (dollars in thousands) | EOY 2018 | EOY 2019 | EOY 2020 | 2019 Operating year | Changes | Sources | Uses | Changes | Sources | Uses | 2020 Operating year |
| Cash | 20 | 3 | (36) | 17 | 17 | 39 | 39 |
| Accounts receivable | 165 | 198 | 222 | (33) | 33 | (24) | 24 |
| Inventory | 263 | 302 | 296 | (39) | 39 | 6 | 6 |
| Total current assets | 448 | 503 | 482 |
| Plant and equipment | 25 | 25 | 30 |
| Total assets | 473 | 528 | 512 |
| Accounts payable | 99 | 114 | 118 | (15) | 15 | (4) | 4 |
| Revolving loan payable | 50 | 50 | 50 |
| Total current liabilities | 149 | 164 | 168 |
| Owners’ equity | 100 | 100 | 130 | (30) | 30 |
| Contributed capital | 204 | 224 | 264 |
| Retained earnings start of year | 100 | 180 | (50) |
| Current-year profit after tax | (80) | (140) | 0 |
| Dividend paid out | 224 | 264 | 214 | (40) | 40 | 50 | 50 |
| Retained earnings end of year | 324 | 364 | 344 |
| Total owners’ equity | 473 | 528 | 512 | 72 | 72 | 79 | 79 |
| Total liabilities and shareholders’ equity | 473 | 528 | 512 |

Table 2. Tool 1: Sources and uses of cash analysis
Let’s consider the hypothetical Acme Widget Works, whose simplified financial statements are shown in Table 1. In order to run Tool 1, an analysis of Acme’s sources and uses of cash, first (Step 1), simply take any two balance sheets, place them side by side, and calculate (via subtraction) the changes in each account (i.e., calculate the change, whether positive or negative, on each row of the balance sheet). Here we’ll run this analysis for Acme’s 2019 and 2020 years—from the year-end balance sheet for 2018 to that for the end of 2019—and similarly from year-end 2019 to Acme’s hypothetical “What if?” performance through year-end 2020 (see Table 2). For now, we’ll set aside any discussion of Acme’s 2020 year and focus on 2019.

To check your work, add up the numbers in the Sources and Uses columns. They should be equal (i.e., they should balance; hence, accountants call it a balance sheet!). If they don’t balance, you’ve posted something in the wrong column. If that’s the case, find your error and fix it.

Next (Step 2), take each of the change figures in Column G and copy it to either the Sources column or the Uses column (Columns H and I in Table 2). If you are using a spreadsheet, as we are here, the plus or minus signs in the Changes column indicate the proper columns into which to place them: in the Assets portion of the balance sheet, the pluses are Sources and the minuses are Uses; and vice versa in the Liabilities and Equities portion of the balance sheet. But you can also simply rely on your good sense, and doing so will aid your understanding. When inventory goes up, for example, that ties up more cash, so it’s a use of cash. When accounts payable to your suppliers increase, your suppliers are letting you use their money until you pay them. Thus, that’s a source of cash. And so on.

The tricky figure to treat properly is the change in the cash account. To get it right, use the arithmetic sign in a spreadsheet as your guide: plus indicates a source, minus a use. The results may seem counterintuitive, but consider this. When the cash balance decreases from one balance-sheet date to another, it means some cash has been taken from the company’s bank account. Thus, such a change is a source of cash. Wherever that cash went will show up as a use. And the converse will hold, of course, when the cash balance (i.e., the company’s bank account) increases. Topping up one’s bank account “uses” cash that could have been used or deployed elsewhere.

Once your analysis is complete, it’s time to interpret what it means. For Acme in 2019, the figures in the Uses column (Table 2, Column I) show that the uses of cash were for inventory ($39,000) and accounts receivable ($33,000), for total Uses of $72,000. We can see in the income statement (see Table 1) that sales grew nicely that year, up 20% to $2.4 million. That means more inventory was required to support the additional volume, and more credit was granted to Acme’s customers. Whether the changes in inventory and accounts receivable were appropriate amounts, we don’t yet know. But stay tuned: Tool 3 will tell us.

Where was the cash sourced in 2019 to fund these increases in inventory and accounts receivable? The Sources column (Table 2, Column H) tells us that the largest portion of the funding came from retained earnings ($40,000), the difference between the year’s profit after tax and the dividend that was paid out. Another $15,000 came from Acme’s suppliers, to whom Acme now owes more in accounts payable; the remaining $17,000 was funded by nearly depleting the company’s cash balance. Note that had Acme’s owners wanted Acme to pay out (as dividends) its entire profit after tax of $180,000, it would not have had adequate cash to do so.

We’ll get to the 2020 “downturn” numbers a bit later, but for now, there’s an important lesson.

Table 3.  Tool 2: Line-by-line margin analysis

| A | B | C | D | E | F | G | H | I |
|---|---|---|---|---|---|---|---|---|
| **Income statement (dollars in thousands)** | **Actual** | **Actual** | **What if?** | **% of Sales** | **% of Sales** | **% of Sales** | **% of Sales** | **% of Sales** |
| Sales | 2018 | 2019 | 2020 | 2018 | 2019 | 2020 |
| 2,000 | 2,400 | 1,800 | 100.0% | 100.0% | 100.0% |
| Cost of sales | 1,200 | 1,380 | 1,080 | 60.0% | 57.5% | 60.0% |
| Gross margin | 800 | 1,020 | 720 | 40.0% | 42.5% | 40.0% |
| Operating expenses | 700 | 840 | 770 | 35.0% | 35.0% | 42.8% |
| Net profit after tax | 100 | 180 | (50) | 5.0% | 7.5% | -2.8% |
here: Rapid growth eats cash, at least in many kinds of companies, including those that give their customers credit and those that have inventory to fund (Harnish, 2014). Though Acme’s owners might have been pleased with their company’s 2019 performance as measured by its income statement, they might well be concerned about its appetite for burning cash as it grows. As we’ll soon see, such concerns are magnified when growth turns unexpectedly negative. Given these concerns, they might wish to apply Tools 2 and 3 to better understand what’s driving the company’s cash-flow pattern.

3.2. Tool 2: Line-by-line margin analysis of the income statement

Tool 2 answers the second of the three questions posed earlier: To what extent are my profit margins improving or declining, and why? This question is important because in a company with a growing top line, it’s not necessarily the case that profit will grow in commensurate fashion. When a relative change in profitability varies from a change in top-line revenue, that discrepancy serves as a warning signal that something may have changed, for better or worse. It’s important to understand the nature of any such change and deal with it quickly, whether advantageously or defensively (Higson, 2012). As we’ll soon see, in a downturn, such changes can be sudden and painful.

For Acme, we know from a cursory glance at the income statements for 2018 and 2019 (see Table 3, Columns C and D) that bottom-line profits were up a whopping 80% year-over-year (from $100,000 to $180,000) on a sales increase of just 20% (from $2 million to $2.4 million). Why was it such a good year, profitability-wise?

Tool 2, which we’ll call a line-by-line margin analysis of the income statement, enables us to understand how well expenses were managed relative to the level of sales achieved during any period of time: a month, a quarter, a year, whatever. If sales increase, as they did for Acme in 2019, it’s likely that expenses will rise as well, in support of the greater sales volume. The key question that Tool 2 answers is whether the extent of such increases (or decreases, perhaps) is appropriate or efficient when viewed in light of the increase in sales.

To run a line-by-line margin analysis for each of Acme’s operating years, simply set the year’s sales at 100% and then calculate the percentage of sales that each line item on the income statement represents. Crucially, we want to know whether Acme was relatively more efficient, or less so, in managing its costs (e.g., cost of sales, operating expenses) and the resulting gross margins and profit margins that were delivered. Such efficiency is only meaningful, however, when compared to something else. To what might we compare?

- Acme’s history is one useful comparison. Is Acme getting better at managing, say, cost of sales, or worse? Is it achieving any economies of scale with regard to operating expenses as it grows?

- Comparing Acme to others in its industry is also instructive (Higson, 2012). Is Acme more efficient than others in some expense categories? Less so in others? One source of such information for American companies is the Risk Management Association’s Annual Statement Studies (Risk Management Association, 2020). Industry trade magazines are another.

Table 3 provides a line-by-line margin analysis of Acme’s 2018 and 2019 (and prospective 2020, set aside for now) income statements, so that we can compare its 2019 performance with that of 2018. The Tool 2 procedure is straightforward, as was that for Tool 1. Sales for each year are set at 100%, as noted above, and the expense categories that follow are expressed as percentages (see Columns G and H) of the top-line sales figure.

What do we see? Cost of sales declined by 2.5 percentage points—good news!—resulting in a corresponding increase in gross margin. Apparently, Acme was able to buy better or smarter, perhaps due to the higher quantities it bought, in order to meet higher demand, or it was able to increase its pricing, or some combination of the two. Operating expenses held steady at 35% of sales. The results on the bottom line? A 2.5 percentage-point increase in profitability, from 5% of sales in 2018 to 7.5% in 2019.

How might Acme’s owners interpret these results? Absent any information to provide an industry comparison, the increase in gross margin, especially when combined with rising sales, is salutary. And what about the flat percentage of operating expenses? The owners should hope that some of the operating costs might be largely fixed over at least some range of sales, thereby reducing the percentage of operating expenses, even if only slightly, as sales grow. That did not happen here, which is perhaps a cause for concern.

Thus Acme’s sharp increase in profitability was driven by just two factors: the 20% increase in sales plus the 2.5 percentage-point increase in
gross margin during 2019. If Acme’s owners believe sales are likely to continue to grow, they might elect to use some of its additional gross-margin dollars to make certain that the company’s operating infrastructure—people, fixed assets, and more—is likely to be able to support higher levels of sales.

On the other hand, if Acme’s owners see a recession on the horizon, they might want to try to lock in the changes that improved the gross margin percentage, in order to buffer a possible future downturn in sales. If they are not able to do so, and if the gross-margin percentage reverts to its earlier 40%, amid plummeting sales and an insufficient cut in operating expenses as sales fall (see Table 3, Columns E and I), profitability can disappear in a heartbeat.

Tool 2 has enabled us to better understand Acme’s key source of cash for 2020, its profit-driven increase in retained earnings, as we saw from Tool 1. We now know the increased profitability was driven by the increase in sales and an

| Table 4. Tool 3: Cash-days analysis |
|------------------------------------|
| **Income statement (dollars in thousands)** | B | C | D | E | F | G | H | I |
| Actual | Actual | What if? | Daily rate | Daily rate | Daily rate |
| 2018 | 2019 | 2020 | 2018 | 2019 | 2020 |
| Sales | 2,000 | 2,400 | 1,800 | 5,479 | 6,575 | 4,932 |
| Cost of sales | 1,200 | 1,380 | 1,080 | 3,288 | 3,781 | 2,959 |
| Gross margin | 800 | 1,020 | 720 |
| Operating expenses | 700 | 840 | 770 |
| Net profit after tax | 100 | 180 | (50) |

| **Balance sheet (dollars in thousands)** | EOY | EOY | EOY | Cash days | Cash days | Cash days |
| | 2018 | 2019 | 2020 | 2018 | 2019 | 2020 |
| Cash | 20 | 3 | (36) |
| Accounts receivable | 165 | 198 | 222 | 30 | 30 | 45 |
| Inventory | 263 | 302 | 296 | 80 | 80 | 100 |
| Total current assets | 448 | 503 | 482 |
| Plant and equipment | 25 | 25 | 30 |
| Total assets | 473 | 528 | 512 |
| Accounts payable | 99 | 114 | 118 | 30 | 30 | 40 |
| Revolving loan payable | 50 | 50 | 50 |
| Total current liabilities | 149 | 164 | 168 |
| Owners’ equity |
| Contributed capital | 100 | 100 | 130 |
| Retained earnings start of year | 204 | 224 | 264 |
| Current-year profit after tax | 100 | 180 | (50) |
| Dividend paid out | (80) | (140) | 0 |
| Retained earnings end of year | 224 | 264 | 214 |
| Total liabilities and shareholders’ equity | 324 | 364 | 344 |
| Total equities | 473 | 528 | 512 |
improved gross margin percentage. But our analysis does not yet address Acme’s other sources and uses of cash that we also saw using Tool 1, namely the changes in its key working-capital counts: accounts receivable, inventory, and accounts payable. To understand whether the changes that led to these sources and uses of cash were appropriate, in a commensurate sense and given Acme’s growth in sales, we need to apply Tool 3.

3.3. Tool 3: Cash-days analysis of the balance sheet

Tool 3 enables us to answer the third of the four questions raised at the outset of this article: To what extent am I effectively managing the cash-flow relationships with my customers and my suppliers? Why does this question matter? As we’ve seen in the analysis of sources and uses of cash using Tool 1, when a business grows its topline sales, its key working-capital accounts—for Acme, its inventory, accounts receivable, and accounts payable—are likely to grow too (and conversely, when sales decline, so will working-capital accounts). But if the changes in working capital are not effectively managed, they can starve a growing and profitable company of cash that it needs to pay its bills, whether on the way up or on the way down.

Let’s examine how well Acme has been managing its working-capital accounts through the lens of Tool 3, a cash-days analysis of its balance sheet. Tool 3 brings together key figures from both the income statement and the balance sheet. In doing so, it enables us to report the key working-capital accounts in terms of “days,” a notion that everyone in the company can understand. For Acme, there are three such figures, plus a crucial consideration that depends on them:

- In how many days, on average, do our customers pay us?
- How many days’ worth of inventory do we have on hand at any moment in time?
- In how many days, on average, are we paying our suppliers?
- And, crucially, how do the above figures compare with industry averages or with our past performance? Are we getting better at managing our working capital, or worse?

To run Tool 3, we first calculate two crucial pieces of information from Acme’s income statement: the average daily rate of top-line sales Acme generates over a period a time (here, one year), and the average daily rate of cost of sales that accompanied those sales. If we’re doing this for a year, we simply divide the year’s total sales by 365, the number of days in a year. And similarly, dividing the year’s cost of sales by 365 yields the daily rate of cost of sales. The resulting figures are shown in Table 4, Daily rate, Columns G, H, and I. If we were to consider just one quarter, we’d divide the quarter’s sales and cost-of-sales figures by 91, the approximate number of days in a quarter. Let’s set aside the figures for 2020 for now.

| A | B | C | D | E |
|---|---|---|---|---|
| Before looking for hidden cash | Balance sheet (dollars in thousands) | EOY 2020 | Cash days |
| Cash | (36) | |
| Accounts receivable | 222 | 45 |
| Inventory | 296 | 100 |
| Total current assets | 482 | |
| Plant and equipment | 30 | |
| Total assets | 512 | |
| Accounts payable | 118 | 40 |
| Revolving loan payable | 50 | |
| Total current liabilities | 168 | |

| After finding hidden cash | Balance sheet (dollars in thousands) | EOY 2020 | Cash days |
| Cash | 32 | |
| Accounts receivable | 197 | 40 |
| Inventory | 266 | 90 |
| Total current assets | 496 | |
| Plant and equipment | 30 | |
| Total assets | 526 | |
| Accounts payable | 133 | 45 |
| Revolving loan payable | 50 | |
| Total current liabilities | 183 | |

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Once we have the daily rate figures, the Tool 3 procedure is straightforward. To know how fast our customers have been paying us, we simply divide the year-end accounts-payable figure by the average daily rate of sales for the year just ended. For both 2018 and 2019, Acme has been collecting its accounts receivable in a consistent 30 days (Table 4, Cash days, Columns G and H).

Since the inventory balance always represents the cost we paid for the goods we then sell, we use the daily rate of cost of sales to determine how many days’ worth of inventory we have on hand at a particular point in time for which a balance sheet is available. The resulting figures for Acme show us that the company held, on average at year-end, some 80 days in inventory in 2018 and 2019 (Table 4, Cash days, Columns G and H).

Similarly, since accounts payable represent the cost we pay for the goods we then sell, we use the cost-of-sales daily-rate figure for accounts payable too. The results tell us that Acme was being given 30 days’ credit by its suppliers in 2018 and 2019 (Table 4, Cash days, Columns G and H).

What does all this mean? Acme has managed its key working-capital accounts in consistent fashion for both 2018 and 2019. In the absence of any industry data suggesting Acme should do better, we can conclude that the increases in all three working-capital accounts, when compared to the increase in sales, are commensurate, as its cash days have remained stable.

But what if an unexpected recession rears its ugly head, as seems to be the case today? As the winds of economic change are blowing, let’s imagine what might happen in 2020. Some customers, perhaps short of cash, are likely to pay Acme more slowly than they have in the past, pushing Acme’s cash days of accounts receivable out to, say, 45 days. Acme’s inventory may also balloon as its sales level declines, say, to 100 days, especially if the downturn is unforeseen. Acme, now worrying about a cash shortage itself, may start paying its own suppliers more slowly, stretching its cash days of accounts payable to, say, 40 days. These figures are shown in Table 4, Cash days, Column I. These are the drivers we used to construct the “What if?” balance sheet for 2020, as previously shown in Table 1, which we did not discuss. We’ll discuss it now.

3.4. Tool 4: Finding hidden cash

The result of the combined effects of both the income statement changes brought on by a likely 2020 recession (Acme’s top-line sales tumble from $2.4 million to $1.8 million) and the likely balance sheet changes we’ve discussed (lengthened cash days for accounts receivable, inventory, and accounts payable) generate a $36,000 cash shortfall in Acme’s balance sheet (Table 4, Column E). A company not well armed with tools to analyze what might happen in 2020 may well conclude that someone—a banker, an investor, or the owner—will have to step up with $36,000 of cash to fill this troubling and perhaps unexpected hole.

Fortunately, however, armed with our new understanding of cash days from Tool 3, we’re able to run a few more simple calculations to find “hidden cash” on Acme’s own balance sheet. What if Acme can better manage the slippage in its accounts receivable, perhaps by no longer doing business with marginally solvent or slow-paying customers, by being more diligent in collecting from those who are paying slowly, or by getting some customers to pay faster—or even in advance? If Acme could hold the slippage in the accounts receivable cash-days figure to 40 days instead of 45, that would free up 5 days’ worth of hidden cash, or 5/45ths of the projected 2020 accounts receivable balance, which is nearly $25,000. That’s a good start toward filling the $36,000 cash shortfall in its 2020 balance sheet!

If Acme can get better control of its inventory and get it halfway back to its past 80 cash-days standard (i.e., to 90 cash-days), that would free up 10/100ths of the projected year-end 2020 inventory balance, or nearly $30,000. Acme could also, with its suppliers’ forbearance, try stretching its accounts payable to 45 days, generating another 5/40ths of the projected 2020 accounts-payable figure, or another almost $15,000.

We could examine other cash-days scenarios as well. Taken together, though (about $25,000 + $30,000 + $15,000 = nearly $70,000 in all), these proposed cash-days changes can more than offset the projected 2020 year-end cash hole and keep the company from running out of cash. (See Table 5, in which the relevant portions of the “before” and “after” balance sheets are shown). Very simply, these hypothetical changes move the company’s hidden cash amounts from their respective working-capital accounts to cash.

Similar sensitivity analyses, changing the percentage of sales figures on the income statement by a point or two each, can generate cash as well (Harnish, 2014; Miltz, 2020). For example, one additional percentage point of gross margin (from 40% to 41% in 2020) would generate an extra 1/40th of the projected gross margin (another $18,000). And the same is true for a one-point reduction in
operating expenses, a $18,000 reduction in the projected operating expense amount (another $18,000).

It’s easy, of course, to provide examples of what might happen in a hypothetical company when a recession hits. But what exactly should business owners do now that a recession appears to have arrived? What concrete actions are necessary?

4. Applying tools 1, 2, 3 and 4 in a real-world recession

Achieving improvements in cash days and margins is never easy, especially in the face of a downturn, given the strain that recessions inevitably place on both customer and supplier relationships. The good news is that we now have at our disposal four tools to apply, which give us levers to pull when a rapid response is critical (Churchill & Mullins, 2001). Having worked through multiple economic downturns, here are some tips I’ve found helpful in making such changes happen for real.

4.1. Improve gross margin percentage

- I’ll wager that, in the broad array of goods or services your business sells, there are some items that are simply not very price sensitive. Try raising prices on these items alone.

- In a recession, your suppliers are likely to be worried about falling demand and slow-paying customers. Ask for price concessions in return for agreeing to pay on time, or if your cash permits, in advance. Even better, offer your key suppliers long-term contracts for delivery when sales turn up, even paid in advance if your cash position permits (Tully, 2020). A recession is a good time to cut great deals!

4.2. Cut operating costs

- We’re all learning how to work from home these days. Shrink (or eliminate) your office or facility, and negotiate a rent reduction from your landlord. Better yet, move to a nearby vacant space, and negotiate several months of free rent.

- Eliminate “indirect” overhead that you can do without, at least temporarily. This can include office supplies and services, computers, some IT support, and so on. Honeywell cut its indirect burden from 13% of sales to 7% in the Great Recession (Tully, 2020).

- Do less. Focus your strategy on what’s going to work now and what needs to be ready when things get better. Dump the rest.

- Furlough people instead of firing them, or reduce them to part-time or pay them on commission, instead of on salary.

4.3. Collect accounts receivable more quickly

- If yours is a B2B business, make a list of your customers and ask yourself which are unlikely to be cash-strapped. Ask them to prepay in return for a small discount.

- Make sure your invoices are sent out promptly upon shipment or delivery. Then, a few days before each invoice is due, call key customers (hire the most charming person you can for this role!) and confirm that they have the invoice, that it’s correct, and that they’re going to pay it on time (Harnish, 2014).

- Not all your customers will be slow to pay in a recession. Identify those who are laggards, and either pursue them or stop doing business with them.

4.4. Manage inventory more tightly

- Consider foregoing quantity discounts to keep your inventory level down. Using Tools 2 and 3, you can measure the extent to which such a trade-off (less inventory to hold, but reduced gross margins) will be worthwhile.

- Consider dropping some slow-moving items or selling them on only a special-order basis.

- Identify stale, obsolete, or seasonal inventory that’s not moving, and discount it to sell it and turn it into cash. Tools 2 and 3 can measure the likely effect of this trade-off against gross margin as well.
4.5. Pay your suppliers more slowly

- I recommend against doing this if you can make things work by better managing your other working-capital accounts in the ways noted above. Why? In a recession, your suppliers will surely be happy if you pay on time when many others don’t. As we’ve seen, Acme has options for finding the hidden cash it needs. So will you. If you gain a reputation for paying on time through thick and thin, you’ll get better deliveries, better service, and better responsiveness to your needs when the recession comes to an end.

- Pay what you can with a credit card, and take advantage of the float.

4.6. The good news

The good news in times like these is this: Tools 1, 2, 3, and 4 don’t just give us a way to think about the combination of changes that would keep your company solvent when times are tough; they also serve as key performance indicators that can be used to measure and report progress (quarterly or monthly) toward achieving that goal, whether in good times or bad. Simply measuring—and reporting!—your company’s line-by-line margin and cash-days figures on a monthly or quarterly basis will help keep your team’s minds focused on cash. As the saying goes: “What gets measured gets done.”

5. If Rud Browne did it, so can you

Rud Browne, a Canadian entrepreneur, had built a thriving business selling used and refurbished mobile computing equipment to companies that needed old units to avoid having to upgrade their entire systems to the latest technology. Recalling the fourth quarter of 2007, Browne said, “The canary in the coal mine is computer hardware sales. It’s the first thing a company can stop spending money on” (Mullins, 2014, p. 7). In early 2008, his company, Ryzex, found itself with falling revenues (down 25%), declining profit margins (margin dollars down 50%), and $3 million in debt. Browne made managing cash everybody’s job, personally training each of his 360 employees on the importance of cash flow and teaching them the tools (those outlined in this article) to manage it.

In the downturn, customers wanted discounts. Ryzex allowed his sales team to grant them but required pay-in-advance or seven-day terms. Service and maintenance agreements went from being paid monthly in arrears to being paid annually in advance. Customers were encouraged to lease new equipment (by this time, Ryzex sold new equipment as well as refurbished) rather than buy it, which meant Ryzex would get paid in 72 hours while not having to pay its vendors for 45 to 60 days (within agreed terms). As a result of these and many other such steps, Ryzex’s cash days were transformed. Over the next 17 months, the company went from being $3 million in debt to having a $6.5 million cash surplus (Mullins, 2014).

6. The time is now

I hope I’ve convinced you that these four tools are useful additions to your managerial toolkit and sufficiently straightforward to put into practice immediately. And even better than the survival that the effective use of these tools is likely to bring are the opportunities that recessions always provide.

As Warren Buffett recommends: “Be fearful when others are greedy, and be greedy only when others are fearful” (Roberge, 2020). Recessions can be an opportune time to pick up new customers (from your competitors) as well as new employees (who may see nothing but a stagnant few years ahead in their current roles elsewhere). If your cash flow is well managed and your pockets are full, you’ll be well positioned to do these things and to weather the current economic storm, whether it develops into a full-fledged and long-lasting recession or not. If Rud Browne did it, so can you!

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