Cash May be King, but
The Coronation Could Get Ugly

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Distributors always seem to think they are somewhat short of the desired level of cash. In reality, they probably have more than enough cash to operate successfully even in a slow-growth economy. The challenge is that if another serious economic downturn takes place, their cash balances could disintegrate.

Because of this lack of cash, many firms made significant moves over the last decade in an attempt to generate cash. Those moves were only occasionally geared towards improving profitability to increase cash. Instead, they were more likely centered on reducing inventory and accounts receivable at the existing profit level. Such actions have created as many problems as they have solved.

This report considers how cash might be enhanced through different management actions. It does so by examining two specific issues:

- **Alternative Approaches for Increasing Cash**—An review of the strengths and weaknesses of the two major cash-increasing strategies.
- **Cash and Profitability**—An analysis of the financial impact of different approaches for increasing cash.

Alternative Approaches for Increasing Cash

Fundamentally, there are two very different approaches to increasing cash for distributors. The first is to systematically increase profit and reinvest the after-tax profit back into the business. The second is to reduce what are commonly called cash traps, with the most conspicuous cash traps in distribution being inventory and accounts receivable. These two approaches—profit and cash traps—have mirror-image strengths and weaknesses.

Increasing profitability requires focusing on a number of profit drivers in the firm. This route has a slow payoff. The strong advantage is that the profit improvements tend to become permanent events. The improved profit helps increase cash balances every year as long as the results are maintained.

In contrast, reducing inventory and/or accounts receivable causes cash to increase sharply and quickly. The down side is that such reductions might lead to a decline in sales if the changes are not made precisely.

Too often the asset reductions are ham handed. The firm may cut back on the line of credit provided, even to good customers. Further it may lower the inventory investment in key items, leading to severe out-of-stock situations.

The reality is that a lot of firms see only the upside—the quick-hit increase in cash from reducing inventory and accounts receivable. Any subsequent decline in sales often leads to a sad surprise regarding profitability that can be agonizingly difficult to overcome.

Cash and Profitability

Exhibit 1 provides an analysis of the alternative approaches to increasing cash. Given the complexity of some of the possible actions, the exhibit is a little detailed. However, it provides some critical insights if reviewed carefully.

The first column of numbers (Current Results) presents information for an illustrative distributor. As can be seen, the typical firm generates $20,000,000 in sales, resulting in a pre-tax profit of $500,000. It pays a 30% tax rate, so it produces $350,000 in after-tax profit to reinvest in the business.

On the investment side, total assets are $7,500,000. These are heavily weighted towards accounts receivable and inventory. Cash is $500,000, which represents 6,7% of total assets. This is probably adequate, but more is always wanted. On the last line Return on Assets (pre-tax profit divided by total assets) is 6.7%.

The next three columns present some options for improving the firm's cash position. The first of the three scenarios is to systematically improve its profit position. In this profit scenario, four very realistic (but arbitrary) actions have been taken. Sales have increased by 5.0%; gross margin dollars have increased by 6.0% reflecting a modest margin improvement; payroll has been controlled and increases by 3.0%; and all other expenses are leveraged so that they only increase by 2.0%. The result is an after-tax profit of %476,000 which is reinvested in the firm to enhance the cash position.

With this approach both inventory and accounts receivable increase by the same 5.0% as sales. The result is that not all of the increased profit ends up in cash. A proportion is invested in more inventory and accounts receivable. The most significant impact is that ROA rises to 8.5%. The firm has a new profit base.

In the Cash-Increasing Scenario labeled Asset Transfer One, the firm merely duplicates the profit results from the base year as all of the emphasis is on asset redeployment. As a result of this emphasis, both accounts receivable and inventory are reduced by 10.0%.

With this scenario both the reductions in inventory and accounts receivable are transferred to cash along with the after-tax profit. The result is that the firm's cash position literally explodes. Cash increases by 155.7% to $1,278,500. It is a wonderful scenario, but typically proves unrealistic.

The final scenario presented, Asset Transfer Two reflects the result if the reduction in inventory and accounts receivable also produces a sales decline. Research by the author suggests that a sharp 10.0% decrease in inventory and accounts receivable will typically lower sales by around 7.5%. There is wide variation in this result, of course, but that figure is fairly typical.

Gross margin dollars fall by the same 7.5% which creates a serious profit challenge. This is acerbated by the fact that expenses tend to stay the same. The net result is that after-tax profit falls to $87,500.

Although the firm's cash position is enhanced, with the reduction in inventory and accounts receivable, ROA plummets to 1.6% at the same time. The firm has also set a lower profit base that will continue to be a problem in the long term.

All of this simply means that extreme care must be exercised in any asset-redeployment strategy. The siren song of more cash may prove to create unanticipated consequences that erode the benefits.

Moving Forward

Investment reduction strategies are extremely popular in distribution today. If implemented properly, they can help the firm improve its cash position. However, in far too may instances the investment reduction leads to serious sales volume problems. In the preponderance of cases the firm would be better served to focus on the slow-but-steady approach of profit improvement to eventually produce more cash.

About the Author:
Dr. Albert D. Bates is Director of Research at the Profit Planning Group and a principal at the Distribution Performance Project. That organization's web site: distperf.com has numerous free tools that distributors can use to improve profitability. His recent book, Breaking Down the Profit Barriers in Distribution is the basis for this report. It is a book that every manager should read. It is available in trade-paper format from Amazon and Barnes & Noble.

Exhibit 1
Three Alternative Scenarios for Generating Cash
For an Illustrative Distributor

Income Statement	**Current Results**	**Cash-Increasing Scenario** Profit Enhancement	Asset Transfer One	Asset Transfer Two
Net Sales	$20,000,000	$21,000,000	$20,000,000	$18,500,000
Cost of Goods Sold	15,000,000	15,700,000	15,000,000	13,875,000
Gross Margin	5,000,000	5,300,000	5,000,000	4,625,000
Expenses				
Payroll and Fringe Benefits	3,000,000	3,090,000	3,000,000	3,000,000
All Other Expenses	1,500,000	1,530,000	1,500,000	1,500,000
Total Expenses	4,500,000	4,620,000	4,500,000	4,500,000
Profit Before Taxes	500,000	680,000	500,000	125,000
Income Taxes (30%)	150,000	204,000	150,000	37,500
Profit After Taxes	$350,000	$476,000	$350,000	$87,500
Balance Sheet				
Cash	$500,000	$701,000	$1,278,500	$890,000
Accounts Receivable	2,500,000	2,625,000	2,362,500	2,362,500
Inventory	3,000,000	3,150,000	2,835,000	2,835,000
All Other Assets	1,500,000	1,500,000	1,500,000	1,500,000
Total Assets	$7,500,000	$7,976,000	$7,976,000	$7,587,500
Return on Assets	6.7%	8.5%	6.3%	1.6%