BUSINESS FINANCE

SELLING OR LENDING?

For convenience, most businesses provide payment terms to their customers. This allows your customers to get instant access to your products and/or services while avoiding the delay of them paying you upfront. Typically, businesses allow a customer to pay an invoice 15 or 30 or 60 days after delivery (you will often see this represented as payment terms of "net 15", "net 30", "net 60"). What most business owners do not realize is that when they provide payment terms to their customers, they become a bank to their customers whereby they finance purchases and they lend this money to their customers for FREE! This is something no bank would ever offer its borrowers.

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Banks are very meticulous about collecting payments from their customers in a timely basis. They send out payment reminders and have staff to make calls and collect money. For most businesses, there is some level of auto-pilot of this function. They do not have any regimen setup to actively collect payments. If someone is late, they may call to ask about when payment should be expected. "I need a week" is often an acceptable answer.

Some time ago, a client of mine (who shall remain nameless) was looking over their financial statements and asked me why, if they were profitable, they did not have more cash in the bank? They were indeed making a profit, but failed to understand the interworking's of their financial statements. When they sold something on "terms", they invoiced their customer which increased their revenue and increased their accounts receivable (the amounts owed to the business). When a customer paid them, they reduced their accounts receivable and increased the cash in their bank (they deposited the payment they received). For the business in question, they had been increasing revenue as they made sales, but a lot of customers were not paying their bills so their accounts receivable was also increasing. This is why they were profitable on paper but did not have more cash in their bank account.

Accounts Receivable sits in the top section of the Balance Sheet under Assets, which is often overlooked by most business owners. It represents the amount of "lending" you are providing to your customer base. The best practice is to review this number at least monthly, if not weekly, and look at it comparatively. You should be curious as to whether this number is increasing month to month and, if so, why is that the case? If your business is growing, a reasonable amount of increase is the be expected. The monthly increase of Accounts Receivable is one of the items you should be reviewing in order to properly manage your business. By doing this, you will ensure that you are staying in your chosen industry and not accidentally going into the banking business.

Jeff Solomon is the founder and owner of CFO On The Go, a fractional CFO practice. CFO On The Go provides affordable, part-time CFO services to multiple companies allowing business owners and decision makers access to high level, financial leadership and knowledge. This provides them peace of mind that their business is being run efficiently and effectively.