VAT increase – Cash flow implications for Barristers Chambers

The tune has been called and it's time to face the music. In order to balance the books, business has to take some of the pain of the UK's financial recovery and the Chancellor has indicated that savings will be made on an 80/20 ratio. This equates to 80 per cent spending cuts and 20 per cent increased taxes. So the increased VAT rate to 20 per cent was no real surprise.

But the VAT increase poses a change and requires us to take the time for a little inward reflection and ask ourselves how well prepared our specific area of commerce is, to face the coming change. Are you confident that your Chambers will be in a position to manage the increase in outgoings without experiencing a temporary cash shortfall shortly after the increase takes effect in January next year?

Those with a VAT quarter ending 31st January 2011 will need to account the new tax rate on sales made in January in the January return. The VAT will need to be paid by the end of February but will previous months bills have been paid by then? Clearly, some will find themselves with a cash shortfall as a result of this 2.5per cent increase in outgoings. The most noticeable impact will be felt by growing sets showing a greater volume of sales in January than previous months.

So what preparation should be considered to lessen the impact?

Primarily, a review of cash forecasts to ensure that the VAT increase has been included in calculations should be undertaken. This should be followed with an appropriate revision to plans for the interim and for the period immediately following the VAT rise, due to the potential for adversely affecting cash flow. It should be remembered that all businesses will experience the same pressure at the same time. Deferred payments by your clients may be experienced as they attempt to manage their finances.

It's important to ensure that all personnel throughout the business are informed of the situation and start planning now to reduce the impact of the increased outgoings. Some members may be affected more than others, based on their current work profile and aged debt. They need to be made aware of what can be done and how they can help to manage their forward cash position.

Whilst increasing the volume of sales might help finances generally, an increase in sales in the month of January itself will in fact exacerbate the problem as the VAT payable on those sales will be higher and unless bills from previous months have been paid, cash in-flow will remain unchanged. A price increase is another consideration but will clients stand such a move at present? This solution may lead to a reduction in sales volume.

A team effort of action encompassing sales and marketing and cash flow management techniques is the most effective approach.

Let's take a closer look at what can be done to improve cash flow management.

Begin by revising cash flow forecasts and then put together a plan based on what you find. It should include the following:

Payment terms

Consider reducing payment periods for some risk categories but be aware of the potential impact on sales volume of this action. Detailed communication with clients should take place should this be one of the chosen solutions.

Credit Risk

Be aware of the risk being taken when opening new accounts, or extending further credit to existing clients, especially those with slow payment patterns. Ensure that due diligence procedures include a measure on financial risk and use credit checking and referencing to enable an informed decision to be made. Unnecessary credit risk taking will affect financial performance generally and cash flow specifically. It is well known that a high proportion of bad debt write-offs result from first transactions. Deposits on account should be requested whenever possible, at least to cover disbursements.

Time should be taken to find out which commercial and government department clients have signed up to the Prompt Payment Code - some Government Departments such as the Legal Services Commission are not yet signatories, despite this being a Government initiative.

Performance Management

Set targets for increased cash in-flow and engage all personnel in this initiative. Publish performance against the target monthly and produce monthly briefings which should be given face to face rather than in written form.

Monitor cash flow and Days Sales Outstanding (DSO or debtor days) and consider the use of graphs and charts to have an immediate impact, at a glance. Ensure that they are easily understood.

Billing

Review the billing process and talk to clients to find out how you can make it easier for them to pay more promptly. Smaller more regular bills with easily understood supporting documents may get paid quicker by some organisations, whilst others prefer a single monthly transaction, creating less administration. Some clients prefer invoices to fees notes. If so, adapt wherever possible to speed cash-flow.

Ensure that all bills are raised promptly and most importantly on a ‘right first time’ basis. Errors lead to payment delays.

Work in progress

Manage Work In Progress (WIP) closely - on a monthly basis ideally and have a process in place to communicate with individuals that do not apply billing best practice. Some of the larger organisations have begun to employ a WIP Manager as this is crucial to healthy cash flow. Consider creating a billing report for this purpose. Whilst publishing this in a name and shame manner would not be considered acceptable, removing names and providing all individuals with their own personal performance information, compared with their colleagues, in individual meetings can make a big difference to performance.

Review the fees recovery strategy. Removing delays in communication with debtors and ensuring tenacious follow up can shave days off the DSO. It is important to remember the impact that can be made in the initial stages of client contact, normally viewed as ‘relationship management’. These conversations are normally originated by either the person handling the case or sales/marketing personnel, as opposed to those involved in credit control and cash flow management, and are not seen as negative communications. They are extremely effective in reducing payment hurdles.

Fees recovery

Refresh fees recovery skills. Effective actions save man hours as well as speed up cash flow. It may be appropriate to increase the hours spent on fees recovery, temporarily, in order to avert a cash shortfall in February. The expense of this will be far less than having to use a bank overdraft or obtain other external funding.

External finance

Finally, if cash forecasts show that the 2.5% increase in outgoings, coupled with falling instructions and price pressure, despite your best efforts, will still result in a cash shortfall, start talking to potential providers of funding now. Leaving relationship building out and making a last minute request will not demonstrate that you are a good financial risk.

Ensure that the cash forecast model and data provided to your lender is accurate, complete and stands up to scrutiny and be prepared to shop around for the most economic solution to a temporary cash flow problem.

Internal reporting

When making performance comparisons, take into account the known variance. When comparing data for the first month or quarter in which the change occurs, point out the reason for the variance in the explanatory narrative.

Be aware of the impact of the change when using VAT inclusive figures When calculating DSO, separate the sales value and VAT to show an accurate trend. Failure to do so will show a worsening DSO. See the example below.

The calculation for the Days sales outstanding (DSO) is:

$$\frac{\text{Trade debtors (VAT inclusive at 17.5\% \& 20\% x 365 days}}{\text{Credit sales x (1.175 or 1.20)}} = \text{DSO in days}$$

Examples showing the effect of the VAT increase

Debtors (17.5% VAT inclusive)	1,000,000	x		365	=	365,000,000.00	**60.91**	**DSO**
Total sales YTD at 17.5% VAT only	5,100,000	x		1.175	=	5,992,500.00		

Debtors (17.5% & 20% VAT inclusive)	1,010,638	x		365	=	368,882,870.00	**61.45**	**DSO**
Total sales YTD at 17.5% and 20% VAT rates	5,100,000	X	(1/12x 1.2 + 11/12 x 1.175)		=	6,003,125.00		

Some businesses will see a reduction in profitability as a result of the increase in outgoings resulting from the VAT increase. Ensuring that a plan is in place to reduce the effect on your organisation is in your hands.

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