What causes cash flow problems?
Allowing customers too much credit
Overtrading

How can cash flow be improved?
Review trade credit with suppliers
Review credit offered to customers
Overdrafts and short-term loans
Debt factoring
Sale and leaseback

Self Check Questions
What causes cash flow problems?

Businesses often run into financial difficulties because they have cash flow problems. In simple terms, cash outflows are greater than cash inflows. It is often true to say that cash flow problems can be avoided through better financial planning. It may be all too easy for the busy owners of a business to create a cash flow forecast at the start-up phase and then forget about it. The original forecast can only be based on educated half guesses so it should be revisited and revised regularly in the light of experience. In other words, actual cash flow should be compared with forecast cash flow. If this is done, entrepreneurs may receive “early warning” of cash flow problems in time to take action. Two specific causes of cash flow problems are outlined below.

Allowing customers too much credit

With business-to-business sales, credit is often expected. Whether it is expected or not, allowing customers time to pay this can help to make a sales. However, if the firm has to pay for major expenses well before receiving payment from customers, it can quickly be drained of cash. If a firm does not actively seek payment from late payers there could be a cash flow crisis.

Overtrading

Young businesses that have rapid sales growth but limited capital can become victims of their own success. Planning how to manage cashflow is especially important for a business in this position.

Cash can be flowing out of the business faster than it is coming in. For example, a manufacturer may be tempted to take on a big lucrative order that means buying in a lot more stock, new machines and staff. These cash outflows occur well before cash inflows from the extra sales. This can lead to the business collapsing as cash runs out and bills are not paid.

How can cash flow be improved?

Improving cash flow is fundamentally about improving the management of working capital. What is working capital? It is the money a business uses within its day-to-day trading (buying and selling). It is not the capital that is tied up in fixed assets such as machinery and buildings. It. Working capital is used to pay outgoings such as wages and stock for re-sale. If a business does not have enough working capital it will struggle to stay afloat, even if it is a profitable business. The key to managing working
capital is the timing of cash movements: delay cash outflows for as long as possible and receive cash inflows as quickly as possible. What follows is a summary of techniques for doing this.

**Review trade credit with suppliers**
It may be possible to negotiate with suppliers to be allowed credit instead of paying cash, or be allowed a longer credit period. For example, a supplier may recognise that giving 60 days credit instead of a standard 30 days could help a fairly young business survive the “growing pains” of early cash flow difficulties.

**Review credit offered to customers**
In the same way, reducing the length of the credit period offered to customers, or even asking for cash instead, helps speed up cash inflows. The problem with this tactic is that it might lead to a fall in sales if competitors routinely offer credit. One way around this is to offer a small discount to customers who pay cash. Where credit is made available it is important to have a credit control system for monitoring whether customers are paying on time and contacting those who are not.

**Overdrafts and short-term loans**
If you have an arranged overdraft with your bank you are able to have a negative bank balance (up to a certain amount). In the short term, this is very helpful when cash outflows exceed inflows. However, banks will not usually allow a business to be overdrawn for long periods without feeling confident that the business will be able to get a positive balance again.

There is always a cost to being overdrawn. Banks charge interest on the overdrawn balance for as long as it is there. So management should plan to use an overdraft as little as possible and for as short a time as possible.

Sometimes it may be better to seek a short-term loan from your bank rather than an overdraft. The rate of interest will be lower and the repayments can be spread over a longer period. Whether an overdraft or a short-term loan is the best way of making cash available depends on individual circumstances.
Debt factoring

A debt factoring company is a business that gives immediate cash to its business customers in return for the legal right to collect payment from a debtor. How does this work exactly? Suppose that company X is a manufacturer who is owed £10,000 each by three separate customers. These customers made purchases on 60 days credit a few days ago. Company X could get most of the money it is owed straight away by transferring the debts to a factoring company. The debt factoring company immediately gives X up to 80% of the value of the debt. In due course it will collect the money from the customers and pay the balance still owing to X, less a 5% charge.

The customers of X are happy because they have received credit from company X. The manufacturer, X, is happy because it has received an early cash payment. The debt factoring company is happy because it has made a little money on the deal.

From the viewpoint of the original creditor (in this case, X) the need to pay interest on an overdraft has been avoided. On the other hand, the commission paid to the factoring company reduces profit margin. (Profit margin is profit as a percentage of sales).

Sale and leaseback

Working capital is not the same as capital tied up in fixed assets. Nevertheless, it may be possible to find ways of reducing the need for fixed capital and use the money freed up to provide working capital. There are two ways of doing this.

A business may identify fixed assets that are not essential to the business and sell them. For example, suppose a business has land at the rear of its premises that is not used for anything much. It might be possible to generate cash by selling the land as a building plot.

Alternatively it may be possible to sell assets to create cash and then lease them back. For instance, sometimes organisations sell buildings to investors and then continue to use the same assets by leasing them back. Vehicles and machinery that are owned outright can also be sold and immediately replaced with equivalents, supplied under a contract with a leasing company.
Self Check Questions

1. Give two possible causes of cash flow problems.
2. What is working capital?
3. State three methods of improving working capital.
4. What is a debt factoring company?
5. Explain why sale and leaseback helps cash flow.