Cash Flow Management – The Most Common Mistakes

Cash is King.

Insolvency is about the inability to pay bills, not about profit. Thousands of profitable businesses fail – and not only in recessions – due to an inability to manage cash well enough. If you can't pay your bills, you are in trouble, no matter how good next year's profits will be.

When things are getting tight, firms often take drastic measures to improve their cash flow, but not all of these make sense. Here are some cash flow management mistakes to avoid.

Cutting the Wrong Costs.

Keeping costs low should always be part of your strategy. However, there are costs to cut and costs not to cut. If your success depends on having a successful image, beware of cutting costs which will be noticed by your customers.

Effective marketing is an investment in new business generation, not an expense. Think carefully about trimming the costs that bring in tomorrow's business.

Also, avoid concentrating on trivia. The cost structures of most businesses are dominated by just a few costs, so start by looking at the big costs. To be seen to be slashing the paper clip order will just look petty minded: don't be distracted by unimportant things – concentrate on the big issues.

Asset Finance

Don't assume that you will have to stop replacing assets just because there is a downturn. Paying heavily to repair assets which are inefficient in the first place is normally a false economy.

Consider leasing, as opposed to buying, replacement assets (manufacturers of equipment and vehicles are still offering attractive leasing terms) and if cash is very tight, consider selling your existing assets to a finance company and leasing them back. You may also be able to renegotiate loans over a longer payment period or get a repayment holiday.

Borrowing From the Wrong People.

Look at the cost of borrowing from all sources. Most suppliers will accept a reasonable increase in the time you take to pay them and, despite recent changes in the law, most will not normally charge interest; so they are in effect supplying working capital to you free.

Make a list of the sources of credit available to you and the effective cost of borrowing from each and try to use the cheapest sources first.

Don't forget that losing settlement discounts by delaying payment is usually a false economy.

Also, remember that if a payment goes out by cheque, you control when it leaves your account – the timing of payments made by direct debit is effectively out of your hands.

Two sources of borrowing can be particularly expensive: credit cards, where the interest rates can be very high, and borrowing from HM Revenue and Customs, who levy heavy penalties on late payers.

Overtrading

Overtrading is what happens when you are growing too fast and your financial resources can't keep up. For example, if you sell something for £100 that gives you a profit of £20, you will have to finance the cost (£80) between the time you incur it and the time you get paid by your customer.

The longer that time difference is, the bigger your borrowing will have to be. You also have to finance your normal trading expenses as well. When businesses run short of cash as they expand, this is called 'overtrading'.

Many business people try to overcome the problem by increasing sales, on the grounds that increasing sales produces more profit. Unless you get paid by your customers before you have to pay for the goods you sell to them, this is likely to be a mistake. All increasing your turnover will do in these circumstances is increase the rate at which you run out of money.

You might wish to consider factoring (a system whereby the bank lends a proportion of sales value to the company on sight of sales invoices) your debts.

Discounting

There are ways of discounting that work and those that don't. When your temptation is to slash prices, remember that every £1 knocked off the selling price is one less pound in your pocket. Say you sell an item for £10, which you buy for £5. Giving a 25 per cent discount means the profit per sale will be half what it was before. Will you sell twice as many?

Other forms of discount (such as a '3 for 2' offer) may be better. In this example, such an offer may clear the stock faster, generate more cash and the same profit (£5) per sale as before.
Before cutting prices, think through the likely results. If you supply on credit, consider offering extra special prices for cash sales only.

Managing cash flow is an essential skill for any business. Business decisions need to be thought over carefully from the points of view of their effects on both profit and cash flow.

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