

Possible solutions to solve cash flow problems

[Economics](#), [Money](#)



Cash flow is the movement of money in and out of a business. It is of vital importance for a company continually monitoring and controlling its cash flow. A shortage of cash may lead to insolvency while an excess of cash is wasteful because it is not a productive asset. Therefore, various sources of finance should be combined to help maintain a sound record of cash flow. However, ' The problem is not just to find the money but to find it from the right sources at the right price and at the right time. (Woodcock. C 1982, p120)

That means the theory of business finance may be described as being based upon an efficient choice between those sources and uses of funds which are available to the firm. This essay will first identify the possible causes for an expanding firm that faces the cash flow crisis and then propose feasible solutions to solve it. There are perhaps three main elements in controlling cash flow: debtors, stock and credit.

It is possible to achieve rapid improvements in cash flow by ensuring that debtors pay more promptly, that stocks are cut to the minimum required to provide an efficient service, and that full benefits of the credit terms offered by suppliers is taken. Alternatively, failure in achieving these will be the reason that results in the company's struggling in the cash flow. Firstly, the cash flow crisis may be caused by an increase in the level of bad debts that come with the growth of credit sale in conjunction with the failure in reviewing the average age of debtors and unproportionate distribution of credit by customers.

An expansion may be brought about by increasing customer credit limits and extending the period of credit. Though debtors are one of a firm's most liquid

assets, the expected revenue is only transformed into cash receipts when customers pay. Therefore, the promptness of payment is important because credit requires financing and is costly, while lengthening delays in payment are a sign of bad debts and an increasing of working capital tied up in credit. Moreover, the default of one particular customer that has been given too much credit may also expose the firm unnecessary risk.

Secondly, the ignorance of the importance of stock holding is also likely to lead to cash flow crisis. The firm may fail to balance the advantages of flexibility which occur with increased stock levels with the additional cost. Stocks cost money to maintain because they need to be stored in expensive warehouses, have to be insured against hazards such as fire and theft, and they are in danger of deteriorating or becoming obsolete as time passes. Furthermore, the level of inflation and high interest rates to be paid on the money borrowed to buy or manufacture the stock means the value of cash tied up on the stock is being lost.

However, the cost of understocking or stockout is also severe for the firm. Apart from the lost of revenue, there is always a problem of the intangible cost of not being able to meet customers' orders. Last but not least, failure in deciding when to pay credit and how much credit to take can result in cash flow crisis. It is important for the firm to weight up the advantages of delaying payment of creditors with the benefits that can be derived from prompt payment and the discount thus available. It means comparing different credit policies in a rational way.

If, for example, the firm refuses the discount without comparing with the figure for return on investment, it should not be seen as rational since such

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discounts may be viewed as entailing no risk. Alternatively, discounts are not necessarily all that they appear to be if the firm can make productive use of its money during the whole credit period. While taking credit might appear to help a firm's cash position, taking too much credit might result in higher prices, lost discounts and difficulties in obtaining future suppliers. Credit might even be withdrawn at the worst situation.

There are various methods that can help the firm to cover the cash shortage and thus prevent further deterioration of its cash flow situation. Speeding up cash inflow, delaying cash outflow, cutting down expenditure and funding additional finance are all very effective methods if applied properly according to the firm's circumstance at that time. The firm that is faced with deteriorating debtors situation can improve its cash flow position by managing debts efficiently. The firm, for example, may grant discounts for early payment, exact a charge on overdue accounts, or enforce more rigorous collection procedures.

However, before undertaking a new credit policy, it is essential for the firm to weigh up the benefits of the new credit policy against the cost of greater control because a more stringent credit policy cannot be implemented without cost. After assessing the relative cost and benefit of the new credit policy, it is better for the firm to start with computing the average age of the debtors if it decides to undertake a new credit policy. If the average age of debtors rises over time, a more detailed breakdown of the age of debtors is required in order to classify debtors by their quality, liquidity or the age of sale. The calculation of the average age and the classification of debtors help the firm to focus on the bad debts and decide on the period that it is going to

allow after the due date or whether to withdraw the credit and claim immediate payment.

Moreover, the calculation of the average age and the classification of debtors, combined with the sensitivity analysis, can also be employed to help the firm determine whether it is worthwhile to offer a discount. Because the profit and loss of a discount policy depend on three factors: 1. the term offered (discount and period); 2. the opportunity investment rate; 3. the customer response rate. (Davis, E 1984, p75) Factor 1 is determined by the firm and factor 2 is known; so the uncertainty of the risk involved in the discount policy is up to the customer response rate. With the help of the figure obtained by the methods mentioned above, a reasonable estimate of who are likely to respond as well as the numbers involved will be provided as a foundation that the decision whether to undertake a discount policy is based on.

Leasing, which is another way of improving cash flow position, is a contract which gives a company possession and use of a particular asset in return for payment of a rental charge over a period of time. This method of financing the acquisition of goods, plant and equipment are of value to the growing business in that they enable the firm to plan cash flow with a greater degree of certainty and conserve working capital resources for use in meeting more immediate demands on the company's funds. It also provides the flexibility with which companies need to take advantage of trading opportunities when they arise.

By leasing, a company can have the use of equipment while paying for it out of revenue and the payments are charged against revenue for tax purposes;

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it brings new working capital into the company and can release the funds which would otherwise remain locked up in a piece of machinery brought outright. Another benefit of leasing is the lessor may lower rentals at the start of the leasing contract, a factor which can be of particular advantage to a rapidly expanding firm because earnings would not initially be sufficient. Moreover, holding on equipment brought outright after its economic life costs both opportunities and profits.

Leasing, however, will replace obsolete equipment automatically at the end of its contract. Therefore, it is especially desirable for those goods where technological or other changes mean that the company using the asset does not want the asset for its whole working life such as cars and computers. Although leasing is usually charged a higher rate of interest than the rate that the company would effectively pay were it to borrow the money to purchase the equipment and the costs such as maintenance and insurance may steadily rise every year, it absorbs part or all of the risk of equipment obsolescence and grants credit to the lessee.

For a company that is experiencing a shortage of funds, leasing is a useful method of acquiring assets without making any capital outlays, especially when the firm is at or near its debt limit. However, lease may be useful if the firm's main aim is to survive or short term profit rather than long term development. If the firm is over-committed to leasing, it reduces the company's ability to borrow at a later stage because an asset which could otherwise be used as collateral for loans has been lost (Franks.

J and Scholefield. H 1974, p38). The firm commits itself to a particular building for a considerable length of time and problems can arise, for <https://assignbuster.com/possible-solutions-to-solve-cash-flow-problems/>

example, if the firm wants to make alterations to the building because of the development of the business. Therefore, leasing should be used after a careful calculation and as part of a properly balanced mixture of finance. In conclusion, the decision about the firm's appropriate mix of borrowing must consist with the circumstances and the firm's financial strategy at that time.

Apart from covering cash shortage, for a firm that is struggling for its cash flow position, it is necessary to focus on long term growth as well if possible. Careful and realistic sale forecasts as well as reasonable assessment about the risk and opportunity involved are both of great importance in choosing financial alternatives. Consequencely, the concept of the balance between risk and return, short-term and long-term and advantages and disadvantages may be in the central of modern finance, and continues to do so.