# INNOVATIVE ENTREPRENEURSHIP

# How to avoid cash flow problems?

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# Avoiding Cash Flow Problems

*This factsheet looks at the situations that can lead to cash flow problems and how you can avoid running into trouble. It outlines the practical steps you can take to build and maintain your cash flow.*

## WHY CASH IS IMPORTANT

A business can only continue to trade if it has the cash available to pay its bills when they fall due. To ensure this, it is necessary to understand how cash flows into and out of a business.

- Cash flows into a business from money that is invested in it by its owners and any shareholders, and from the money that is paid by customers when a sale is made.
- Cash flows out of a business when it pays suppliers, staff wages, overhead costs and taxes.

Problems can arise when outflows of cash are greater than inflows and ultimately at the critical point where all the cash available to the business has been spent. It is essential to address any cash flow problems in good time, well before this stage.

## THE MAIN CAUSES OF CASH FLOW PROBLEMS

### Late payment by customers

A sale is completed only when an invoice has been paid in full. Many business owners concentrate on generating new sales, and fail to set up adequate procedures to ensure that customers pay on time. As a result, they experience cash flow problems.

### A key customer becomes insolvent

If your business is dependent on a few major customers, you are exposed to the risk of one of them having financial problems that could result in non-payment of an invoice. This can be disastrous if the income from that client makes up a large proportion of overall revenue, and is needed for your business to pay its own creditors or employees.

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## Insufficient working capital

Working capital is the money that finances the day-to-day operations of your business. When you first set up your business you are likely to face significant costs. You then have to pay suppliers and staff regularly before you actually receive any money from your customers. If enough money is not invested in your business when you set it up, you can quickly encounter cash flow problems once you start to trade as the cash flows out much faster than it is received.

You can also run into problems with working capital if your business grows very quickly. This is because as sales grow working capital requirement also grows. Money becomes tied up in stock and an increasing amount of money is owed by customers, who may pay more slowly than is needed for the business to pay its suppliers. This situation is commonly called over-trading.

## Focusing on turnover instead of profit

Everyone wants to see their sales grow as quickly as possible but long-term sustainable cash flow into a business is generated only through making profits. Products that thebusiness sells, and services that it delivers, should therefore be costed carefully to ensure that they generate a profit for the business at their expected selling prices. Focusing on high-volume but low-profit-margin sales can quickly lead to a position of over-trading if the working capital needs of your business have been underestimated.

## Poor financial planning

Problems can occur if you do not make plans to ensure that you have cash to cover major expenses such as Value Added Tax (VAT), and rent. You must take account of these payments in your cash flow forecast and ensure that sufficient funds will be available at these key times. It is also important to purchase any costly equipment when cash flow is stronger, or consider buying second hand, outsourcing, leasing equipment over a longer period to reduce the impact on cash reserves.

## Over-committing with stock purchases

Wholesalers and other suppliers often offer discount incentives for bulk purchases, to encourage you to buy larger volumes of their goods. This may appear attractive at first, but careful thought is necessary before committing to large orders of stock, particularly for a new start up. A bulk order for items that quickly go out of fashion or have a short shelf life might mean being left with unsaleable stock that still has to be paid for.

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## Practical steps for maintaining cash flow

A cash flow forecast is an important tool for avoiding cash flow problems. The forecast makes it possible for you to anticipate most cash flow issues that could occur during the normal course of running your business. It also allows you to work out what effect lower sales or slower payments would have on cash movements.

**SOME KEY METHODS TO REDUCE CASH FLOW PROBLEMS ARE**

## Adopt tight credit control procedures

Only provide credit to approved customers. To decide whether or not to approve a customer for credit, set up procedures that allow you to obtain all the information you need to make a credit decision. For example, ask customers to complete a credit application form.
Check when their accounts are due for payment and ensure that they pay according to agreed terms. It is important to have efficient administrative procedures for preparing invoices promptly and sending statements to customers.

## Check that customers are creditworthy

Credit checks can be performed through a variety of third-party services including credit agencies (international), bank references and trade references.

- Credit agencies provide status reports on customers. Available in most countries like Turkey, UK etc. These agencies are important at an international trade level.

- Bank references involve asking a customer's bank its opinion on the customer's ability to meet payment demands.

- Trade references come from referees who have dealt with that customer before. Referees should be asked questions regarding the customer's payment habits, sales and payment terms.

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## Offer incentives for early payment

Consider offering customers a discount if they pay either on delivery or within a certain number of days (typically 7-14 days) of the invoice date. Common levels of discount are 2%-5%, but the exact level will depend on the effect on the business's profit margins and how important early payment is.

## Make it easy for customers to pay

Offer customers a range of different payment methods including, for example, secure online payment via a payment services provider such as PayPal and credit/debit card payments through Chip and PIN, smartphone payment apps or over the telephone.

## Part-payment

If you have a large order to fulfil or a big project to complete for a client, it is advisable to consider negotiating part-payment in advance. For example, you could ask to be paid half the total amount of the bill at the outset, or for completing half the order or achieving a particular deliverable in a project. The outstanding amount would be payable on completion of the project/order. This guarantees some cash income for the business upfront and it means payment for the full amount won't have to be pursued once the project/order is fulfilled.

## Negotiate better credit terms with suppliers

As your business grows, it may be possible to negotiate better credit terms with suppliers. If the majority of your customers expect to have 30-day credit accounts, your business will benefit from 30-day payment terms with its own suppliers.

## Set up a bank overdraft facility

An overdraft makes it possible to borrow money as and when required from the bank, up to an agreed limit. It can be a helpful way to finance working capital for businesses with large variations in cash flow during the course of a month, or large seasonal variations, because interest is only paid on the amount actually borrowed.

On the other hand, continued reliance on an overdraft can become expensive. More importantly, it may also highlight that a business needs additional working capital, or a longer term form of finance. With an overdraft, a business is also exposed to 'repayment on demand', which means that the lender can ask for full repayment at any time. A 'term loan' with fixed monthly instalments can be a better option as the lender can only demand full repayment if the borrower defaults on instalments.

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