Managing Cash Flow

Introduction

Managing cash flow can be a challenge for many small businesses. There are lots of reasons why your business may face a cash crisis, and it's vital to pinpoint the factors that can cause cash flow problems.

In this guide, we explore some of the situations that can lead to cash flow problems, along with the steps you can take to avoid running into trouble.

The main causes of cash flow problems

Late payment by customers

If you concentrate on generating new sales but don’t set up procedures to make sure customers pay on time, this can lead to cash flow problems.

A key customer becomes insolvent

If your business is dependent on a few major customers, you face 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 part of your revenue, and is needed to pay your creditors or employees.

Insufficient working capital

Working capital is the money that finances the day-to-day operations of your business. If you don’t invest enough money in your business when you set it up, you can quickly run into 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, your working capital requirement also grows.

Focusing on turnover instead of profit

Everyone wants to see their sales grow as quickly as possible. Still, long-term sustainable cash flow into a business is generated only by making profits. Products that you sell, and services that you deliver, should be costed carefully to make sure that they create a profit.

Poor financial planning

You are likely to face problems if you don't make plans to ensure that you have cash to cover major expenses such as wages, business rates and rent. You must take account of these payments in your cash flow forecast and make sure that sufficient funds will be available for these critical expenses.

Practical steps for maintaining cash flow

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

There are lots of ways to prevent cash flow issues. Here are some examples.

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 get all the information you need to make a credit decision.

The Small Business Commissioner provides ten 'top tips' for ensuring that customers pay their invoices on the agreed terms.

Check that customers are creditworthy

You can access credit checks through a variety of third-party services including credit agencies, bank references and trade references.

The Better Payment Practice Campaign has useful guidance on the various ways to check customers' creditworthiness.

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. Typical levels of discount are 2%-5%, but the exact level will depend on the effect on your profit margins and how vital early payment is.

Make it easy for customers to pay

Offer customers a range of different payment methods including, for example, secure online payment, credit/debit card payments and payments over the telephone.

Factoring and invoice discounting

If your business is growing rapidly, it may be helpful to use an invoice discounting or factoring service. These provide an advance (usually 70%-85%) on the value of invoices as soon as you raise them. Interest is charged on the advance and there is a service charge.

Part-payment

If you have a large order to fulfil or a big project to complete for a client, you should consider negotiating part-payment in advance. For example, you could ask to be paid half the total amount of the bill upfront, or for completing half the order or achieving a particular goal in a project. The outstanding amount would be payable on completion of the project/order. This guarantees some cash income for your business throughout the process.

Negotiate better credit terms with suppliers

As your business grows, it may be possible to negotiate better credit terms with suppliers. For example, could your business benefit from 30-day payment terms with your suppliers?

Set up a bank overdraft facility

An overdraft makes it possible to borrow money from the bank as and when you need it, up to an agreed limit. It can be a helpful way to finance working capital if your business has large variations in cash flow, because interest is only paid on the amount borrowed. However, if you rely too much on an overdraft it can become expensive.

Asset financing

If your business needs to invest in new equipment but doesn't have the cash, you can fund the purchase with a loan, a hire purchase loan or a leasing deal. These arrangements allow fixed regular repayments over a set period, usually two to five years.

Hints and tips

- Regularly monitor customers who owe you money and pursue them promptly for payment of overdue invoices. Analyse their payment patterns to help spot any potential problems early on in the process.
- Plan ahead for expenses such as utility bills and tax payments. The earlier you catch cash flow problems, the more time there is to respond.
- Act quickly when you expect a shortage of cash. Contact your bank and suppliers as soon as a problem arises. If you delay, you risk harming relationships with your bank, suppliers and customers. Banks are far more understanding about cash flow problems when they are tackled in advance.
- Remember that your business has a legal right to charge interest on late payments.