3.7 Cash flow

Strategies for dealing with cash flow problems

Cash flow problems stem from the inability to either increase cash inflows or control cash outflows. As you have seen, this is critical to the survival of the business; without cash, the business cannot purchase raw materials or pay its bills for the day-to-day running of the business.

Concept

Sustainability (economic)

When businesses aim to be sustainable, it also means that they should aim to manage their cash flow in a sustainable manner. Extreme cash flow volatility may either leave a company with excessive cash flow or leave the company short of cash at different moments. This can threaten the solvency of the business and put the stakeholders who rely on the business at risk.

To have a healthy net cash flow, the business must either increase its cash inflows, reduce its outflows or find additional finance. This section outlines some of the ways this can be achieved.

Reasons for poor cash flow

When discussing poor cash flow, it is important to refer to both cash inflow (payments received) and cash outflow (payments made). Cash flow problems may result from either and may include:

- **Poor stock management.** The company could hold too much stock, having spent much of its cash purchasing the inventory. This might result in inadequate cash in the business.
- **Poor pricing strategy or low sales.** In a bid to penetrate the market or increase sales, the business may have priced the product too low, resulting in lower revenues and inadequate cash inflows.

- **Expanding too fast.** A business may invest and spend on expansion too quickly. Heavy investments in capital or other resources for expansion can result in large debts that need to be paid by the business. These large debt payments can cause cash flow problems. One example of quick expansion that brought cash flow problems was an Icelandic airline company called WOW Air. WOW Air took on significant debt for expansion. Once the terms of debt repayment became harsher, the company found itself with insufficient cash to continue operating.

Figure 1. Icelandic airline WOW Air expanded too quickly and ran into cash flow problems.

Credit: Jonathan Barton, Getty Images

- **High expenses.** If expenses are high then the business cash outflow is much higher than its inflows, resulting in a negative net cash flow figure.
- **Seasonal demand.** Some products, such as ice cream, thrive in the summer and sales are therefore likely to plummet in winter, resulting in low cash inflows.

Making connections

In Subtopic 5.3 (/study/app/y12-business-management-a-hl-may-2024/sid-351-cid-174702/book/the-big-picture-id-39339), higher level students will learn how a just-in-time (JIT) inventory management strategy allows a business to efficiently manage its inventory by ordering raw materials immediately before use. In addition to being an efficient operating principle, this strategy allows the business to manage its cash flow more efficiently, as expenses (cash outflows) are not incurred until close to the production and delivery date.

Non-profit social enterprises may also be vulnerable to cash flow problems, as they often rely on grants and donations for their financing. Grants and donations can come with a degree of instability, and the amounts may not be the same each year.

Increasing cash inflow

Effective debt collection

A company must put an effective debt collection system in place that ensures that monies owed to the company are paid in time. This could mean frequent phone calls or emails reminding debtors to pay on time. Although this could discourage further credit purchases by these customers, resulting in a loss of clients. The company must also conduct thorough credit checks on customers to reduce the incidence of slow payment or bad debts in the future.

Cash transactions only

A company could require that all goods or services are paid for in cash. While this would reduce credit transactions and the possibility of default, the company may lose some good customers who can only buy on credit.

Figure 2. Payments in cash may reduce cash flow problems.

Credit: Kwanchai Khammuean / EyeEm, Getty Images

Increased promotion

In a bid to increase sales, the company could implement new promotion strategies, such as reducing its prices through promotional pricing or increased advertising. These efforts could increase sales. However the drawback is that advertising could be costly and therefore increase the company's cash outflows, while reducing prices will both lower the company's profit margin and probably only lead to a marginal increase in the cash inflow.

Expanding product portfolio

Expanding the product portfolio diversifies risk and increases the revenue or cash inflow streams from a wider variety of products, which is advantageous in the long term. It must, however, be noted that investing in new products will require cash outflows in the short term, with the hope of more sales and therefore higher cash inflows in the future.

Figure 3. A larger product portfolio may help diversify risk.

Source: "Faced products on a supermarket shelf (https://commons.wikimedia.org/wiki/File:Faced_products_on_a_supermarket_shelf.JPG)" by Amnesiac86 is licensed under CC BY-SA 3.0 (https://creativecommons.org/licenses/by-sa/3.0/)

Going public

Becoming a publicly held company allows a business to sell a portion of its ownership to outside investors through the sale of shares. This method can be effective in raising funds. However, it is a one-time solution and involves additional compliance and reporting.

Overdrafts

Taking out a bank overdraft is probably the quickest way to increase cash inflow. An overdraft is a facility that allows a business to draw more money than it has in its bank account. It can be fairly easily arranged with the bank, especially if the business has banked with them for a long time. This is particularly useful to pay wages or buy crucial raw materials. The disadvantage of this, however, is that interest on overdrafts can be higher than the usual rate.

Loans

Borrowing can be an effective way to pay for immediate expenses. Long-term loans are generally more advantageous than short-term loans, as they imply a predictable and often smaller monthly outflow. To address cash flow problems, a business can restructure short-term bank loans as long-term loans. Disadvantages of taking out a loan are that interest payments will need to be made, and that the bank could change the terms of the loan at some point in the future.

Government assistance

In some countries, the government gives grants and subsidies to companies that produce essential goods and services or provide employment. The government can also provide low-interest loans for entrepreneurs needing financial assistance. This boosts the company's cash inflow and may help to alleviate the cash flow problems.

Governments often extend preferential tax treatment to non-profit social enterprises, which should be taken advantage of. An advantage of grants, taxes and subsidies are that they do not need to be repaid. A disadvantage is that government assistance is subject to political change and the business cycle.

Sale of non-current (fixed) assets

A company could increase cash inflow by selling some of its disused non-current assets, such as old machinery or vehicles. While this would increase the cash inflow and help solve the cash flow crisis, care must be taken not to sell assets that may be difficult to replace, thus inhibiting the company's future operations.

Disadvantages of the strategies above could be that these methods do not guarantee a stable cash inflow and are often subject to seasonal (for tax reasons) fluctuations.
In addition to these strategies, non-profit social enterprises may use the following strategies to increase cash inflow:

- campaign to increase one-time donations
- promote subscription-based donations – where donors are charged a fee every month – to increase the predictability of cash inflows
- research and apply for additional grants
- use crowdfunding – where many contributors help fundraise for a project

Figure 4. Many non-profit social enterprises rely on donations.

Credit: Peter Dazeley, Getty Images

Reducing cash outflow

Better stock management

Slow-moving stock items tie up the company's funds; the company must ensure that only goods that are popular with customers are stocked. Manufacturing companies could use a just-in-time (JIT) stock management system (covered in HL Subtopic 5.3 (/study/app/y12-business-management-a-hl-may-2024/sid-351-cid-174702/book/the-big-picture-id-39339)). Using this system, stocks of inputs are only delivered when they are needed in production, thereby reducing the amount of cash tied up in stock. A disadvantage of this strategy is that the business becomes over reliant on the speed with which suppliers fill the orders.

Renegotiate credit terms

The business could renegotiate an extension for payment of its trade credit. This would give the company a temporary reprieve and reduce its cash outflows. However, there is a limit to how much this can be done and suppliers may refuse to extend credit to the company in the future. Note that a company should always try to negotiate longer creditor days than debtor days to ensure somehow that cash would be received (from debtors) to pay to creditors.

Switch to cheaper suppliers

The company could find alternative cheaper suppliers for its raw materials, thereby reducing the cash outflow on inputs. This, however, has the disadvantage that the new supplier's inputs could be cheap due to lower quality, which would eventually be passed on to the company's final products. This could damage the reputation of the company and reduce future sales.

Reduce expenses

The company could cut unnecessary expenses, such as staff parties, or use its electricity, phones and fuel more conservatively. However, while this would reduce the cash outflows on these items, it could hinder the effective operations of the company, ultimately resulting in lower productivity and sales.

Lease rather than purchase equipment

A one-off cash payment for a new machine or equipment usually requires a large cash outflow. Leasing, on the other hand, requires smaller monthly payments while the company has use of the machine. This frees up some of the funds from the outright purchase and reduces the cash outflow. The drawback, however, is that the company does not get to own the machine at the end of the lease period.

Activity

Learner profile: Inquirers
Approaches to learning: Research skills (information literacy)

Read this article on liquidity problems (https://www.pwc.com/us/en/industries/health-industries/library/covid-hospital-liquidity-crisis.html) faced by hospitals in the US.

- Identify the source of the liquidity problems experienced by these hospitals.
- Identify three ways hospitals can address cash flow problems in the wake of the COVID-19 pandemic.

Exam tip

In Paper 2 you may be asked to make a recommendation to a company based on a cash flow forecast and other financial statements.

The command term **recommend** requires you to ‘present an advisable course of action with appropriate supporting evidence/reason in relation to a given situation, problem or issue’ (IBDP Business Management guide).

This means that you will need to select and interpret financial information presented to you and use it to support your arguments. You may need to combine this with non-financial information presented in the exam. Finally, you should be familiar with the limitations of each financial statement in order to evaluate your recommendation.

Some limitations of financial statements are listed below:

- **Profit and loss account**. This gives an accurate description of annual profits but may be of limited predictive value.
- **Balance sheet**. This is a snapshot of a given point in time. A company’s balance sheet may change rapidly if the company sells assets or takes on debt.
- **Cash flow forecast**. Since it is a forecast, it includes assumptions about the future that may not hold true.