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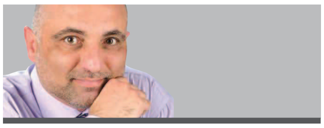
Tackling cash flow problems: Prevention is better than cure



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Clichés describing the importance of cash flow in managing a business are numerous. A cash flow problem can easily lead to business failure and a poor cash flow situation can happen to a business with sales bursting through its roof.

In Malta, we have experienced bankruptcies of businesses with high sales turnover who were nevertheless unable to meet their bills and pay their suppliers. Some of these cases are still fresh in the minds of suppliers who have never been paid and whose saga is still echoing in our courtrooms.

Poor cash flow management should not be taken frivolously because it can cause liquidity problems for the business community with a negative effect on the economy at large. Poor cash flow leads to late payment which very often has a domino effect in the economy.

"Businesses cannot pay their suppliers because they are not paid by their customers" – this vicious circle is commonly found in various sectors of the local business environment.

"The small size, fragmented and generally saturated Maltese market tends to force suppliers to oversell to gain a bigger share of the market"

Investing in resources to chase long-overdue bills and spending good money to take debtors to court may only serve to cure the symptoms of this problem, if ever!

In today's business world, businesses should take a proactive approach and put time and resources into knowing your customers, looking for any market trends and finding ways to gain and sustain competitive advantage in their market arenas.

For the success of a firm, commercial information and business intelligence are becoming more critical than ever before, irrespective of the size of the business or its economic sector. The more information a firm can get, the better strategic decisions it can make, as long as the management team knows what to do with the information.

Firms need up-to-date and cost-effective information to act proactively. They need efficient tools by which they can identify potential profitable sales.

Firms need easy-to-use systems to regularly monitor their existing customers. They cannot afford to lose money due to lack of information or due to information which does not assist them to take appropriate business action in a proactive manner.

Companies should seek information about prospective customers in order to avoid risks related to clients suffering cash flow difficulties. They should also monitor their existing customers on a regular basis and, if a cash flow problem is identified, the firm should take the necessary steps to assist the customer and protect its interests promptly.

But what causes cash flow problems in a business?

There are many possible reasons. Studies, supported by the people in business, suggest that the most common factors leading to cash flow and liquidity problems are:

- Undercapitalisation and overtrading: this happens when a business grows rapidly with inadequate working capital.
- Stockpiling: stock is an important element of business but it has to be properly managed because money may be unproductively tied up in unnecessary stock.
- High investment in fixed assets: very often, it is wiser to lease fixed assets so that the resources and working capital will not be drained.
- Too much gearing: Money costs money. Loans and interest have to be paid. Business growth should be appropriately funded by striking a balance between loans and shareholders' capital.
- Poor management: a firm can never be successful if it is managed by unskilled, inexperienced and unprofessional people.
- Unforeseen expenses: unexpected expenses do occur to all businesses. Provisions should be made for any emergencies.
- Changes in demands: markets are constantly changing. Unnoticed market changes may result in less sales and a high level of idle stock.

Nevertheless, the most common cause of cash flow problem in Malta often occurs from improper management of credit customers, commonly referred to as debtors.

Lacking the management skills to deploy good credit management practices could result in late payments and bad debts which could also have a negative effect on the bottom line of the business.

Our competitive market and trade culture do not help proper cash flow management. The small size, fragmented and generally saturated Maltese market tends to force suppliers to oversell to gain a bigger share of the market. Sometimes suppliers go beyond their means when granting credit to their customers. More often than not, trade credit is still being extended verbally with no documented credit terms and conditions, let alone signed credit agreements.

This culture should definitely be changed. Trade creditors should be more proactive and professional when granting credit, to the benefit of the business organisation itself which would then reflect on the wider economy in which it operates.

Poor cash flow can be the death of an otherwise healthy business!

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A quick guide to credit management

Credit management is a critical business function which should focus its resources on its major components, consisting of:

Credit sales approval: the efficiency and effectiveness of the internal processes used to approve new credit sales; how proficient a credit function is in analysing the credit worthiness of a prospective customer to manage risk and in the way of saying "yes" to profitable sales that would otherwise be lost.

Invoicing: the efficiency and accuracy of the credit function in billing its customers accurately, completely and in a timely manner.

Managing overdue accounts: the effectiveness of the methods used to monitor and manage past due A/R (overdue accounts); how skilled the credit function is in completing the sales (i.e. getting paid from overdue customers).

Communication: the effectiveness and efficiency of the communication processes deployed with the various stakeholders of the credit function; how capable the credit team is at working as one team with other business functions such as sales, distribution and finance to make sure synergy is maintained; and having the same approach towards building and sustaining long-term customer relationship. Communication also refers to what factors are being monitored for the purpose of performance measurement and how the results are being presented to the top management team for their approval and, or for any corrective action.