Routes to success 3: the importance of cash

No matter how great the product or how full the order book, any business can fail if it runs short of its most important commodity

You have a great plan. Business is underway; the product is right, you have recruited the people you need and orders are booming. Then you run out of money, and it's all over almost before its started.

It may be a depressing thought, and you may not want to hear bad news - but over 80 percent of businesses fail in their first five years. And the major reason is not that they don't have enough orders, it's that they have too many. They have failed to manage their finances and overlooked the costly truth - growth costs money.

To stay afloat, then, you must prepare for all likely eventualities and cash flow planning is one of the most important steps you must take. Failure to keep track of cash flow and to respond to impending cash famines will bring your dream to a premature end.

It always puzzles us that so many business owners don't take the time needed to gain an understanding of basic accounting principles - surprising given the importance of financial control to the success of any enterprise. Knowing the basics makes it far easier to manage cash flow. There are, of course, plenty of books that give an introduction to accounting for non-specialists.

> The costly truth is that growth Costs money

Within any business, there is an operating cycle through which cash flows, from the purchase of trading stocks through the collection of cash from debtors. The cycle ('cash gap') measures the rate of flow of assets into cash. If your operating cycle from the purchase of supplies through the collection of debtors totals 180 days, this is the amount of time for which you have to find finance.

Since all lenders look for a return on their investment, this financing will, of course, cost you money. The longer your operating cycle, the higher your financing cost will be. It is important to analyse your operations and forecast your cash needs to minimise the amount which must be borrowed without running the risk of becoming short of cash.

Cash flow projections should show whether your business generates enough cash to meet its obligations and how payments due to suppliers and staff can be related to cash inflows from sales. As a result, you can tell if inflows and outflows from your operation combine to result in a positive cash flow. Any significant changes over time will also be apparent. Understanding this will allow for better control of your cash position and allow room to plan for the extra financing that growth in your business will call for.

When cash-flow deficits are identified, plans must be altered to bring in more cash. When excess cash is revealed, it might indicate too much borrowing or simply that you have idle money that could be better used. The purpose is to develop a plan that will provide a well-balanced cash flow.

When problems appear, how can they be overcome?

Collecting debtors has to be first on the list of areas to look at. Your customers must be actively and consistently managed so that overdue accounts are promptly identified and collected. Money is lost when a firm's collection policies are too soft. The longer your customer's balance remains unpaid, the less likely it is that you will ever receive full payment. Conversely, the faster you collect on your debtors, the less your cash gap will be.

Control of what you owe is just as important - but this is best dealt with not by delaying payments beyond their due date, but by planning what you need and negotiating extended terms with your suppliers.

And do not overlook the prices you charge for your products and services. Pricing is critical in achieving a profit and maintaining positive cash flow. Always lowering prices in response to competitive pressures is a natural but often inappropriate action.

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