Question 1.

In July 2007, Kwik Save the supermarket chain, collapsed after it ran out of cash. Most of its workers had not been paid for up to six weeks. Kwik Save was founded in 1959 as one shop in Rhyl, north Wales, and floated on the stock exchange in 1970. By the 1990s it had more than 1,000 stores and recently became part of Somerfield. However, it was sold on to a new firm, BTTF, headed by Mr Niklas, in February 2007. Some new cash was injected into the business but it was not enough to save the chain.

The firm collapsed due to a combination of tough competition from the big supermarkets which have slashed prices, foreign low-cost rivals such as Aldi and Lidl, and bad management. In May suppliers halted bread and milk deliveries saying that there were considerable difficulties getting paid by Kwik Save. Just before the company collapsed 81 stores were closed and 700 people lost their jobs. A further 90 stores were closed on the day it collapsed with around 1,100 people being laid off. However, it was hoped that some of the stores would be bought by other retailers and that some people would be kept on. Amanda Higgins, the former deputy manager of a store in Ellesmere Port that has been closed down, heard the news on television, while the company remained silent. 'It's diabolical,' she said. 'I just don't know what to do.'

She phoned the Little Sutton store near her home and was told by staff there that the shop had been shut down. Staff were also told that if they came in and handed over the store in a rational manner they would be paid a week's wages, but Ms Higgins could not believe it.

Source: adapted from *The Guardian*, 6.7.2007 and www.a2mediagroup.com

(a) Using this case as an example, explain the importance of cash when running a business.

(b) Explain how: (i) employees and (ii) the owner will be affected by the collapse of Kwik Save.

(c) Analyse the possible causes of the collapse of Kwik Save.

flowing into a company. Travel companies in the UK have faced this problem in the past. Companies have to 'buy' holidays before they are sold. External factors, including a recession, may have led to many of these holidays remaining unsold as consumers changed their holiday buying patterns. Firms may also have lost revenue if holidays were discounted in an attempt to sell them.

Seasonal factors Sometimes trade fluctuates for seasonal reasons. In the agriculture industry, cereal farmers have a large cash inflow when their harvest is sold. For much of the year,

though, they have to pay expenses without any cash flowing This situation requires careful management, although it is possible to predict these changes.

Poor financial management Inexperience in managing cas a poor understanding of the way cash flows into and out of business may lead to cash flow problems. For example, if a business plans to spend heavily just before it receives large amounts of cash from customers who have bought on credi is likely to face problems. It is not prudent to spend cash wh is not definitely there.

Methods of improving cash flow

Cash flow problems can be prevented by keeping a tight con on financial resources. The use of budgets and cash flow forecasts will improve the financial management of the busi Inevitably, though, there will be occasions when firms run s of cash. When this does happen the firm's main aim will be survival rather than profit. The following measures might b used to either generate cash or save it.

Use of overdraft facilities If a business is not able, or does n wish, to use the options listed above, an obvious option is to borrow money. Most businesses have an overdraft facility wi their banks. An overdraft is a type of flexible loan. The borr can choose to borrow up to a certain sum of money agreed the bank, called the overdraft limit. But they are free to pay part of the money borrowed at any time and do not have to borrowing money to have an overdraft facility. A business ca increase its cash by borrowing more money on its overdraft. example, it might have an overdraft limit of £5,000. It is currently borrowing £3,000. So it could borrow up to £2,00 extra.

There is more of a problem if a business is already borro up to its overdraft limit. Then it has to negotiate with its ba that limit. There is no guarantee that the bank will do this. business experiencing cash flow problems could well be a business in difficulties. The bank will not want to increase lending to a business which could cease trading in the immediate future. The bank is likely to want to see a cash fl forecast to judge whether or not the business will be able to the interest on the overdraft and the overdraft itself in the future.

Negotiate additional short-term or long-term loans A busi may be able obtain a short-term loan from a bank to inject extra cash. If a business feels that extra money will be neede a longer period of time a long-term loan might be conside business could pay back smaller installments over a longer period of time to help cash flow. However, once it is known a business is short of cash, banks and other money lenders be reluctant to provide cash for fear of the business collapsi

Sell off or reduce stocks Sometimes it may be possible to se stocks of raw materials, components or semi-finished goods

cash. To generate cash quickly they can be sold cheaply in a sale or below cost if necessary. Some stocks may be quite specialised and prove difficult to sell quickly.

A business might simply reduce the amount of stocks it holds. A machine manufacturer may buy in fewer stocks of components to make machines. Stocks cost money to hold. So fewer stocks can increase cash in the business. The danger is that stocks will not be available to make products that are required for sale.

Use a factoring company An alternative to pressurising customers for money is to sell the debts to a specialist **debt factor**. A factor is a business that will provide finance to another business against its debts for a fee. It often pays a certain amount to the business 'up front' and the remainder once debts are collected. Debt factors give businesses cash immediately and take the responsibility for collecting the debt. However, they make a charge for this and the debts must be good.

Sell off unwanted or non-vital fixed assets A business may be able to sell off unwanted or non-vital fixed assets like vehicles, machines and property. Unfortunately, to sell assets like these quickly they are likely to be sold at auctions and they may be sold below their true value.

Use of sale and leaseback Businesses are increasingly using sale and leaseback to raise cash. Assets like property and machinery can be sold to specialists in the market, such as Arnold Clark and Lease Direct. The assets are then leased back to the seller. This means that cash can be raised and the business can continue to use the assets. However, it may take a while to set up such agreements and can be an expensive way to fund assets in the long term.

Question 2.

Adrian Talbot owns and runs a small garment manufacturing business. He employs 12 workers, using rented premises in London. Cash flow is always a problem for him. The businesses that buy from him often pay late while the profit margins he earns are wafer thin in an industry notorious for cut throat competition. At least finished stock is never a problem. He makes a sample and wins orders based on that. As soon as an order is complete, it is sent out to the purchaser.

(a) **Suggest and explain THREE ways in which Adrian Talbot could possibly improve his cash flow situation.**

Stimulate sales for cash Many businesses, retailers for example, can generate cash by offering large discounts for customers who pay in cash. In the example at the beginning of this unit, Fopp tried to generate cash in this way by selling records, CDs and other stock for cash only. Unfortunately, the measure was not enough to save the business.

Mount a rigorous drive on overdue accounts This involves a business putting pressure on its customers to pay back what they owe more quickly. Allowing customers to receive products and pay for them at a later date is called TRADE CREDIT. The DEBTORS of a business are those customers (individuals or businesses) that owe a business money. However, pressurising customers in this way may mean that they find other suppliers.

Only make essential purchases It obviously makes sense during a cash crisis to postpone or cancel all unnecessary spending. A business should only buy resources for cash when it absolutely has to.

Delaying payments A business may simply delay payments. It then keeps this cash in the business for a longer period of time. It will only make payments when it is put under pressure to do so by CREDITORS – businesses that are owed money.

Extend credit with selected suppliers It will help a business to save cash if it can delay paying suppliers for goods and services that have already been bought. It may be able to extend its credit payment period from 30 to 60 days, for example. However, delaying for too long could mean that suppliers withdraw their credit facilities or refuse to deliver goods in the future.

Reduce personal drawings from the business Owners who regularly take cash from the business for their own personal use could attempt to take less. Obviously some cash might be needed for living expenses, but making a reduction in drawings is a quick way to stop cash leaving the business.

Introduce fresh capital Owners may be able to provide some new capital to improve cash flow. For example, small businesses may be able to use savings or take out loans using personal possessions as security. A small business may be able to persuade friends or relatives to invest in it – new partners might be taken on for example. Larger companies may be able to sell shares to raise fresh capital. However, attracting fresh capital might be very difficult if the business is struggling. It is likely to be up to the current owners to provide more capital.

In all the above cases, action must be taken quickly. If the business survives the cash crisis, it is important to identify the causes and to make sure it does not happen again. It is also

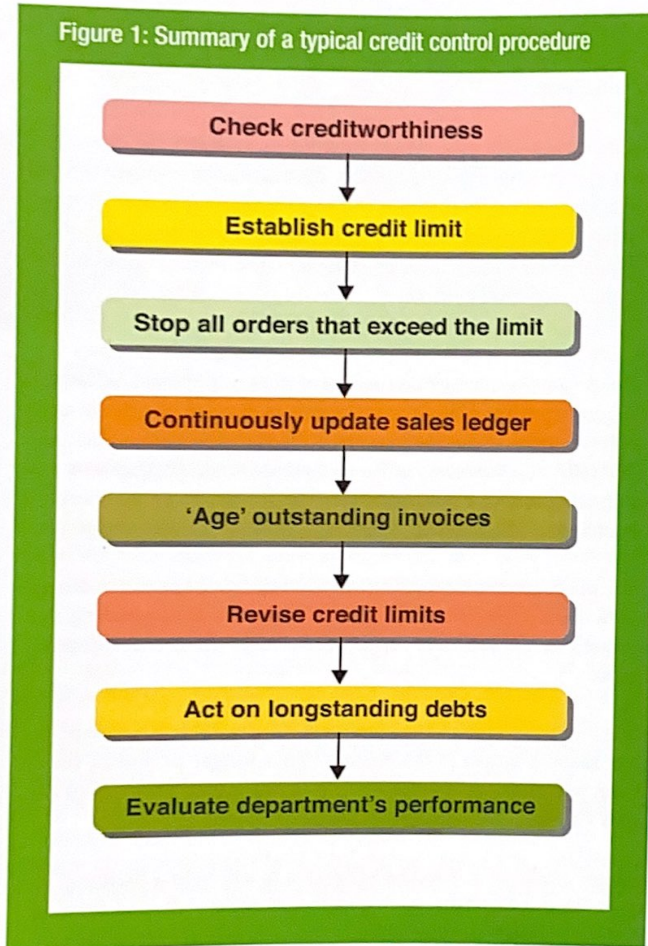

Figure 1: Summary of a typical credit control procedure

evident that measures taken to alleviate a cash crisis are likely to reduce profits. For example, selling goods at a discount to raise cash will reduce profit margins; selling off assets and leasing them back can reduce profit in the long term; borrowing money from banks will incur interest charges; inviting new members to provide capital will dilute ownership.

Credit control

Most businesses have some sort of CREDIT CONTROL system, so that cash that is owed can be collected quickly and easily. A 'tight' or 'easy' credit policy may be adopted. Tight credit terms may be used to improve liquidity, reduce the risk of bad debts, exploit a seller's market or maintain slender profit margins. Easy credit terms may be designed to clear old stocks, enter a new market or perhaps help a regular customer with financial difficulties.

The company accountant and the sales manager often work closely with the credit controller, since credit policy will affect the financial position of the firm and its sales. Between them they set targets for the credit control department, such as the maximum value of bad debts or the length of time it takes to collect debts.

Firms have procedures to help credit control. Figure 1 shows an example.

- Many firms will not do business with new customers until their creditworthiness has been checked. This can be done by asking for references from a supplier, a banker's reference or a credit-rating agency's report. From this information the credit controller can set a credit limit based on the risk involved.
- When an order exceeds the credit limit, the credit controller should investigate. This may result in a stop being placed on the order, requesting the customer to pay any outstanding debt or simply allowing the order to go ahead.
- Credit control records, which show customer orders and payments, must be up to date. Every month, outstanding invoices must be 'aged' to identify customers who owe money over 30, 60 and 90 days.
- If there are persistent debts, the credit controller must take action. A statement of the account should be sent, followed by a second one with a letter. Next, a telephone call to the debtor should be followed by a personal visit. Finally, as a last resort, it may be necessary to take legal action to recover the debt.
- Some firms use an independent **debt factor** to assist in credit control. There has been quite a growth in this type of business in recent years. A factor is a business that will provide finance to a business against its debts for a fee. It often pays a certain amount to a business' up front' and the remainder as debts are collected.

KEYTERMS

Creditors – those to whom a business owes money for goods or services delivered but not yet paid for.
Credit control – the process of monitoring and collecting the money owed to a business.
Debtors – those who owe a business money for goods or services delivered but for which they have not yet paid.
Overtrading – a situation where a business does not have enough cash and other liquid resources to support its production and sales.
Trade credit – given when a supplier allows a customer to receive goods or services but pay for them at a later point in time. Typically, trade credit is given for 30 days.