Cash flow problems

Many businesses experience cash flow problems. The difficulties they have to cope with from time to time include:

- Being unable to pay suppliers' accounts on time
- Being unable to gain the usual discounts from suppliers, due to small orders being placed and settling accounts late
- Customers not settling their accounts on time; and not
- Staying within an agreed overdraft facility.

In order to overcome these difficulties it is necessary to manage working capital effectively.

What Is working capital and why Is It Important?

Working capital

Working capital is the difference between the current assets and the current liabilities of an organisation. In order to calculate this figure it is necessary to look at the Balance Sheet to find the current assets and current liabilities totals. In essence, working capital is the term used to describe a firm's short-term use of funds. A proportion of the organisation's capital will be tied up in fixed assets but a certain amount will be allocated to financing the day-to-day business expenditure. For example, money is required by the Croeso Hotel to purchase food and beverages, to pay wages, and to finance credit sales. If the firm does not possess enough working capital to meet its short-term obligations, it will be unable to continue trading.
Working capital management

The aim of working capital management is, therefore, to strike a balance between having too much or too little. Too much working capital means that a firm will earn a lower return on capital employed. Too little working capital, however, means that the business is in danger of ceasing to function altogether because it cannot generate the cash needed to finance its day-to-day trading.

Controlling working capital

In order to control the working capital of their business, managers need to analyse each element of their current assets and liabilities and decide what measures can be introduced to improve their overall working capital management. Within the current assets section of a Balance Sheet, the following items will usually appear:

- Stock
- Debtors
- Cash at bank
- Cash in hand

The current liabilities usually consist of the following elements:

- Trade creditors
- Taxation
- Dividends payable
- Bank overdraft

In order to improve the management of working capital it is essential to understand how each element of current assets listed above should be controlled; we shall take each in turn and then look at current liabilities.

Stock

Stock can take three different forms: