Financial training
For non financial staff

ATTAINMENT TRAINING

The financial training specialists

Managing growth

Introduction

They say that more businesses go bust coming out of recession, than going into recession.

This article looks at some of the reasons why this happens, and how you can help protect your business.

Do stay with me in the numerical examples (I know numbers aren't everyone's thing), but this is an important area to understand.

Cashflow: the most common cause of insolvency

A cashflow crisis can trigger the insolvency of a profitable business. There is a hidden danger here – businesses set budgets for the year, but these measure profit, not cashflow. So the cashflow crisis can sneak up unexpectedly.

The cashflow crisis is often initiated by working capital problems

Working capital

In business we spend money so we can make profitable sales. Money is tied up long term in fixed assets (the things we mean to keep – equipment, property, vehicles etc) that we need.

Working capital is all the "unfinished business": the stock of raw materials that has not yet been used; the unfinished work in progress (WIP); stocks of unsold goods; and debtors, the customers who have not yet paid. This working capital locks up cash that would otherwise be in the bank.

As the business grows extra sales means more working capital, which soaks up more cash.

How working capital may have compounded the recession

As we went into recession, many businesses reduced their stock levels to save cash.

Imagine a business selling 100 units a week, each of which needs 1 unit of raw material. They want to hold a week's worth of raw materials in stock – 100 units. Suppose the recession halves their sales. Now they are only buying 50 units a week. As they have 100 units in stock, they don't need to buy any stock for a week, which means their supplier goes from selling 100 units a week to nothing for a week, then 50 a week thereafter.

Suppose our example company also decides to half stockholding levels, so they only hold half a week's stock – 25 units. Now they buy nothing in the first week, 25 in the second week, then 50 a week thereafter. This hits the supplier still harder, and hits their suppliers in turn.

Working capital and the end of recession

As we return to growth this situation reverses. Our example company wants to go back to holding a week's worth of stock to be able to produce much more. Sales are expected to go back to 100 units a week. So how big is the first week's order to the supplier as it moves from producing 50 a week to 100?

The first order will be 175. That's 100 units for that week's production and another 75 to bring stock up from 25 to 100. Then 100 units a week thereafter. So now the supplier grows still faster, and passes that growth down the supply chain.

The financial impact of working capital

Let's imagine our example company buys materials at £300/unit, and production labour costs are £400/unit. It sells the finished product at £1,000/unit. We know it held half a week's worth of raw materials, but it also held 2 weeks of finished goods, and sold on 4 weeks credit.

Whilst it sold 50 units a week working capital was £277,500:

• 25 units raw material @ £300	7,500
• 100 units finished goods @ £700	70,000
• 200 units unpaid @ £1,000	200,000

Then sales return to 100 units a week. We would expect working capital to double to £555,000. This gives the business problems – where does the extra £227,500 come from?

It probably comes out of the overdraft. If the business holds finished stock for two weeks before selling it, and customers take 4 weeks to sell, the business is paying out for the increased level of production for 6 weeks before the extra money comes in.

But it gets worse than this.

Working capital can increase more quickly than the business grows

As we move from recession back into growth we can be desperate for the increased sales. Because we don't want to miss the sales, we increase stock levels to insure we can satisfy every customer. As our business customers have cashflow problems because of their own increased working capital requirements, they pay their suppliers more slowly.

Now our example business has working capital of £740,000:

• 100 units raw material @ £300	30,000

- 300 units finished goods @ £700 210,000
- 500 units unpaid @ £1,000 500,000

Over a period of just a few weeks working capital has risen by nearly £½m (from £227k to £740k). This is for a business with sales of about £5m pa.

And it gets worse!

The tragedy for our example business is that this expansion happens at the end of the recession.

Well obviously – recovery always follows the recession, it doesn't precede it.

But that means the business is already in a weak state, and is probably near its borrowing limits before expansion begins. An extra £½m on the overdraft at this stage is just too much.

And so the business fails.

Managing growth successfully

We want sales to recover, but we need to survive the recovery. This means controlling growth so that the cash from increased sales comes in as quickly as possible.

This means keeping stocks of raw materials and finished goods under control until customers are paying. It means tight credit control in the early stage of recovery.

The sales department may be opposed to this. Lower stock levels means some sales might be missed, and new customers will be looking for longer credit terms initially. Production may be opposed to keeping stocks of raw materials low, as production cannot then be increased quickly, which might mean to more sales being lost.

Managing growth will be a delicate balancing act between winning the increased business, but not taking on so much so quickly that it brings your business down.

But what can the HR department do?

Managing working capital may seem to be the responsibility of the Finance department. But the working capital problems are caused by people right across the business – it is a people issue.

In the next management meeting, listen to sales and production people discussing sales, production, ordering, and stock levels. What impact will they have on working capital, and how will this be financed?

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The HR department can be a voice of financial prudence that will help ensure your business survives the recovery.

In addition your department can provide training that will help as many people as possible understand how they impact this issue.

Sales people need to sell, whilst thinking carefully about credit terms, the ability to deliver within reasonable stock levels, and how they can be part of the collection process themselves.

Production people need to think about how they schedule production and order materials to meet sales, whilst keeping stock levels as low as possible.

Credit control staff need to keep on top of customers, even though those customers may be looking for every possible reason to put off payment.

Learning more about this

This is a new way of thinking about business for many people. To learn more about the subject look on the Resources page of our website for the exercise *"Overtrading"*. This looks at the cashflow implications of a rapidly growing company (and is also one of the post course development resources we provide after our courses).

In the Book Reviews on the same page, look at "The Genghis Khan guide to business", a lucid and well written guide to business finance. Also try "Managing Cashflow" in the Management Pocketbooks series.

Contact us

Phone us on 0121 276 0040, or email us at alex@attainmenttraining.co.uk, and we can arrange a visit to discuss these issues further.