**TRAINING IN FINANCIAL AND BUSINESS MANAGEMENT FOR ROAD CONTRACTORS**

**MODULE ONE SESSION EIGHT PARTICIPANTS’**

**LIQUIDITY MANAGEMENT**

**1.0 Purpose of session:**

The purpose of this session is to assist trainees:

1. To appreciate the importance of cash flow in business
2. To be able to relate profits to cash flow using a funds flow statement
3. To acquire knowledge on the causes of cash flow constraints
4. To appreciate indicators and consequences of liquidity problems
5. To acquire skills to improve cash flow.

**1.1 Importance of cash flow to a business**

Cash to a business can be compared to what blood is to a person. Just like blood in a living organism, cash circulates and gives life to a business. When its flow is lacking the business gets into trouble and when it dries up the business surely dies. Unlike the living things though, a business’s cash flows into and out of the business. Cash is required to obtain materials, tools, equipment and all the services that go into performing a contract. Cash flows into the business when the business receives money from its customers.

There is a time lag between spending cash on the project and receiving payment from the client (the cash cycle). If the business deals with governments this period can be long and unpredictable. When dealing with the private sector there is even the risk of non-payment. The longer the contract period the more the cash required to run the business.

It can be disastrous for a business to run out of cash as it risks work stoppage and desperate measures.

**1.2 Relating profit and cash**

Profit determination is subjected to accounting conventions and is not tangible until converted to cash. The impact of trading losses is not also felt until the out turn of cash! True profits are made when revenues are paid for and losses incurred at the point of paying out cash. Businesses are accustomed to talk of profits. They fail to realize that profits are book figures calculated according to accounting rules and are not hard cash. Profitable businesses can actually become cash strapped!

There is a timing difference between recognition of revenue and when it turns into cash e.g. invoicing a client and getting paid takes time. Most commonly a business pays out cash to procure materials and to pay wages and other costs before receiving cash payment. True profit will be made when the client pays to the business a sum larger than the cash that went out in order to do the works. The larger that sum, and the shorter the period of getting it back the better for the business.

There are timing differences too between recognition of expenses in the income statement and when cash is paid out e.g. purchase of an excavator is done and paid for at a point in time but charged to the income statement as depreciation over a period of five years. The impact on cash flow of acquiring an asset is therefore shown much later in the income statement from when it actually occurred. When a business buys goods or services on credit, the cost occurs at the time of purchase but cash is depleted when the suppliers are paid. For a cash purchase the impact is immediate.

Prudent financial management requires to increase the rate of inflow of cash and to minimize the rate of outflow of cash. It is also requires that the business invests only into ventures that that will returns it with larger margins as quickly as possible. When these rules are followed, the practice will build up a healthy cash reservoir, the equivalent of a cash dam.

**1.3 Funds flow statement**

A funds flow statement removes the timing differences between generating revenues, incurring costs and the movement of cash and brings out cash changes over a period of time. It answers the common question of “where did the profits go?”

The funds flow statement for a period explains the changes that have taken place between one date and another. It explains how profits or losses as well as other financial decisions made during that period affected the cash position of the business.

A business must make prudent decisions that will maintain its liquidity in the short term and increase its cash over the long term.

**1.4 Actions that improves cash flow**

In general, a business will increase its cash reserves if it manages its working capital better. This means reducing cash held in inventories and receivables on one hand and obtaining supplies on credit on the other. It will be cautious to purchasing fixed assets such as land and equipment for cash. Where such assets are necessary, the investment should be matched with long term financing. Fresh cash capital injected in the business by way of shares or long term borrowing could provide such financing. Financing of fixed assets could also be funded through leasing or hire purchase arrangements. Where heavy investment is already made in fixed assets, the business could improve its liquidity if it disposes off some of those fixed assets or use the sale and lease them back arrangements.

**1.5 Actions that reduce cash**

Cash reduces when the business pays out dividends or the business owners take out the cash for personal use. This includes getting paid salaries that are beyond the capability of the business as well as getting personal expenses paid for by the business. Payment of long term or short term debt also depletes cash as well as purchasing of fixed assets that are not matched with appropriate long term financing. The payment of taxes should be planned for as it also depletes cash. Lending out money or extending business credit also depletes cash from the business. Delayed incoming payments, having inadequate trading credit and increasing stock levels unnecessarily should be avoided as such practices will deplete cash resources from the business.

Another major cause of cash shortage in a business is overtrading. In simple terms it means taking on contracts beyond the financial capacity of the entity. Profitable and aggressive businesses get into the trap of doing too much too soon; stretch their cash resources with the hope of making it big and then end up in trouble when cash is held up in unpaid invoices, too much inventories and work in progress.

Other causes of cash constraints include having inadequate trading credit, high interest rates, high operating costs, and low trading margins.

**1.6 Indicators of liquidity problems:**

A business that is experiencing cash shortage is at risk of becoming insolvent and subsequently bankrupt. It is not abnormal for any business to have a temporary cash shortage; however when cash is chronically short, the business is heading for trouble. The following are some indications that a business is experiencing liquidity challenges: delay or failure to meet suppliers payments due; failure to settle essential obligations; poor liquidity ratios, i.e. the quick ratio and the current ratio and over investment in capital assets; defaulting on loans; stock outs of key materials and bouncing cheques.

**1.7 Consequences of liquidity problems**

Delay in execution of work; expensive procurements; low morale amongst staff; withholding of services and supplies; unethical practices; loss of business; failure to take advantage of special offers on lucrative terms; litigation, recalling of loan facilities; insolvency and bankruptcy.

**1.8 Techniques to improve liquidity**

Avoid non profitable assignments; negotiate for suppliers credit; obtain advance payments; avoid or restrict allowing credit (do credit vetting); factor the cost of delayed payment into the price; offer early payment discounts, provide for interest charges on delayed payments when contracting; have standby facilities e.g. overdraft, maintain a health minimum cash reserve; avoid clients with poor paying reputation.

Below is an example that demonstrates financing decisions captured in a funds flow statement and how they affect the liquidity of the business.

**1.9 Example of a funds flow statement:**

|  |  |  |
| --- | --- | --- |
| Income Statement | | |
| Year | 1 | 2 |
| Sales | 100 | 150 |
| Costs | 80 | 120 |
| Profit after tax | 20 | 30 |
|  |  |  |
|  |  |  |
| Balance Sheet | | |
| Fixed assets | 10 | 20 |
|  |  |  |
| Accounts Receivable | 50 | 75 |
| Inventories | 10 | 20 |
| Bank | 5 |  |
| Total current assets | 65 | 95 |
| Accounts Payable | 2 | 4 |
| Overdraft |  | 8 |
| Net current assets | 63 | 83 |
|  |  |  |
| Net assets | 73 | 103 |
|  |  |  |
| Capital | 30 | 30 |
| Cumulative profits | 43 | 73 |
|  | 73 | 103 |
|  |  |  |
| Funds Flow Statement | | |
| Profit |  | 30 |
| Increase in accounts receivable | | -25 |
| Increase in inventories |  | -10 |
| Increase in accounts payable |  | 2 |
| Investment in fixed assets |  | -10 |
| Outflow of cash |  | -13 |
|  |  |  |
| Bank balance at start of year |  | 5 |
| Bank overdraft at end of year | | 8 |
| Change in cash position |  | -13 |

**Discussion topics:**

* What is the importance of liquidity to a road contractor?
* Can a profitable business have liquidity problems? Indicate possible causes of liquidity constraints to such a business.
* Can a non profitable business have good liquidity? Identify how such a business would maintain liquidity.
* Advise Munaku on how he could improve the liquidity of his business (refer to the balance sheet and the funds flow statement appendix iii and iv).
* Identify symptoms of cash shortage and the consequences to a road construction business.