WOMEN'S ENTERPRISE CENTRE

Why Am I Always So Short of Cash Even Though I'm Selling More Than Before?

Frequently Asked Question:

Why am I always so short of cash, even though I'm selling more than ever before?

The quick answer is that you are so short of cash BECAUSE things are going so well with your business. While this may sound impossible, rapid growth often causes cash strain on your business.

A growing business can be called a "cash sponge". The demands of increasing sales, support services, inventory, labor costs, etc. can rapidly soak up all those extra dollars a business manager expects to see flowing in when the sales numbers are rising. Not only does the business have to invest more resources in inventory and labor, but receivables typically grow along with sales. So, while you are getting busier and busier, you have more and more tied up in receivables.

For example, if you are able to turn your inventory over five times in a year, you would need an inventory level of approximately $20,000 to support sales of $100,000. If sales grow to $125,000 then inventory levels would probably need to rise to $25,000. The demands on the business infrastructure and staff may require overtime from the present staff or the hiring of more employees. In addition to the increased wages, other costs (unemployment taxes, workers' compensation, employer's portion of social security payments, supplies, freight, etc.) also rise. While these costs are all expected, if you sell on terms other than COD, your receivables will also increase from perhaps $12,500 to roughly $15,600 assuming a constant average receivable period of 45 days. The net result is that your sales are up, but you are "lending" about $3,000 more to your customers while investing something in excess of $5,000 more in your business. This $8,000 to $9,000 may represent all or more than the extra profit from your increased sales. Faster rates of growth and/or lower rates of inventory turnover produce even larger effects meaning that the cash demands of growth exceed the cash supplies from that growth. These increasing net cash demands are continuous for as long as the business is growing. If sales become steady, then the extra profits begin to emerge as extra cash since the costs and receivables levels also stop growing.

So, how does a business finance growth? There are only two basic sources of financing -- externally generated funds and internally generated funds. External sources are the ones we all think of when it's time to raise money and include more investment from the present ownership, bringing others in as investors, borrowings in the form of loans, or by increasing your obligations to vendors (accounts payable).

The only true long-term internal source of funds is profits. The business manager must be constantly vigilant in maintaining profit margins by watching both pricing and purchasing. However, most businesses are not able to make as high a percentage profit as would be needed to provide all the funds necessary for rapid growth. So, growth must occur at a controlled rate or the management must find more external capital. If profits are not constantly generated, the implications for business longevity are pretty clear. We have seen several mature businesses who complained of "being undercapitalized and if they could just get a loan" or come up with an investor, they "would be all right". After digging a bit deeper, we often find that a more than adequate amount of capital has been invested but the company has not been generating profits for such a long time that they are, in effect, consuming their capital in supporting the present operations. As an excuse for business difficulty or failure, "under capitalization" ranks right up there with "poor management" as being one of those catchall terms, which is often used when, one is unsure what's wrong.

As the investment in machinery, equipment, and inventory rise, so, too must the amount of permanent capital generated by or invested in the business rise. Even with seasonal or cyclical fluctuations, a growing business generally has growing demands for permanent capital. There is an old rule of business finance that advocates matching the length of financing of an asset to the useful life of that asset. It is very dangerous to attempt to finance long term capital needs with short-term capital sources. The manager who uses a short-term loan or, worse yet, line of credit, to finance permanent increases in inventory or the purchase of equipment, is virtually guaranteeing a future cash crisis. Short term sources of financing should be used only for the purchase of short terms assets like that portion of inventory that is truly seasonal and will, therefore, be sold during the term of the financing.