Cash flow management

All businesses can experience cash flow problems if they expand too quickly, overinvest in fixed assets and stocks, borrow heavily or give too much credit

Escada was once a leading fashion clothing company. It started as a small partnership in Munich in 1978, became a publicly traded company in 1986, and by 1990 it had grown into one of the world’s best-known fashion brands, popular with many international film stars and celebrities.

However, in recent years the company struggled with internal management disputes, design flops and a shrinking market for luxury fashion items. The company had a string of retail outlets all over the world and a number of these had proved unpopular.

It had also invested heavily in developing new summer and winter collections that proved to be unpopular. Stocks of the clothes built up as sales fell sharply and the company plunged into a loss. Unable to sell off its stocks of unwanted clothing cash flows into the business were not sufficient to cover running costs and, importantly, were not enough to pay for the design, development and launch of a new clothing collection for the next year.

With no way to launch a new collection that may have helped boost sales and with losses mounting, investors lost confidence in the company and its share prices plummeted on the stock market. Creditors were unwilling to lend more to the company and so it became insolvent and was declared bankrupt.

Although Escada was once a very profitable business, it quickly ran out of cash because it had expanded too quickly, had tied too much cash up in stocks of clothing that proved unpopular with consumers and was unable to persuade creditors to lend it more money to help pay its bills.

Businesses, even highly profitable ones, can run short of cash because of the following problems:

- **Holding too many stocks of materials and finished goods**: Buying stocks of materials and components will use up cash. Stocks also need to be stored and this may increase storage costs. If fashion or technology changes or if there is fall demand for the product then a firm will be unable to sell off its stocks easily to raise cash.

- **Expanding too quickly**: Increasing production creates a need for more cash to pay for extra materials, parts, power and possibly overtime payments for workers. However, it may be some time before the business is ready to sell the extra output to raise additional cash.

- **Investing too much money in fixed assets**: Buying new machinery, vehicles and other fixed assets uses up valuable cash reserves. A business may also have trouble selling off its fixed assets if it needs to raise cash quickly. It may be better spread the cost of new machinery by leasing them or buying them on hire purchase.

- **Borrowing too much**: This means loan and interest payments each month will be high. If interest rates rise, repayments will increase. These repayments are likely to be a severe drain on cash flow and profit.