

# 7

## Managing cash and stocks

- Cash
- Bank accounts
- Credit settlement
- Stock management



## Introduction

This chapter considers the two main physical items that have potential for control problems – cash and stocks. They are part of what’s known as the ‘cycle of working capital’. We’ve seen in earlier chapters some of the ways in which these can be managed effectively but we will now concentrate on specific areas for control. First we will look at cash being both received and paid. Second, we will consider the flow of stock and the various stages at which problems can occur.

By the end of this chapter you will, therefore, be able to:

- Describe the cycle of working capital
- Identify the various stages at which cash moves in and out of the business
- Identify the various stages through which stock moves around the business
- Discuss methods of control appropriate to the operation
- Calculate ratios relevant to cash and stock control.

## Cash

Cash is the ‘lifeblood’ of the business – without it you can’t pay the bills or your staff and hence businesses can fail if they don’t have enough of it. Here we will show you where the cash comes from and goes to, and how you can improve the cash flow of your business. You should note that cash is NOT the same as profits – businesses can be profitable but fail due to inadequate cash flow. We looked at forecasting this in Chapter 6.

## Working capital

Cash is part of working capital, which we know from Chapter 2 is the money to run the business. As a reminder it’s worked out by taking:

Current assets (CA = cash, stock, debtors, prepayments)  
 – Current liabilities (CL = accruals, overdrafts, creditors).

Generally speaking, if there are more CA than CL, the business is ‘liquid’ which means able to pay its debts. There are two ratios used to express this – the Current Ratio and Liquidity Ratio (also called the Acid Test).

$$\text{Current ratio} = \frac{\text{Current assets } \pounds}{\text{Current liabilities } \pounds}$$

This is expressed as an  $x:1$  – the CA being the  $x$  and the CL being the 1. So, if you have £200 of CA and £100 of CL then the ratio (of £200:£100) is expressed as 2:1.

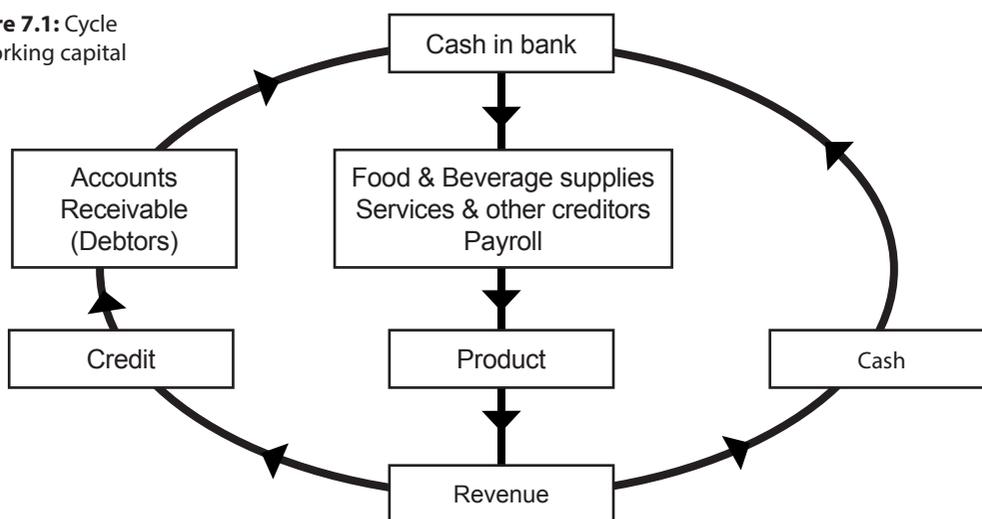
*But* – stocks take a long time to convert into cash (they have to be converted to products, sold and the cash collected) so they aren't as 'liquid' as the other CA. It's best if they are extracted before you make the comparison – if the CA without the stock is more than the CL then you're okay.

$$\text{Liquidity ratio (Acid test)} = \frac{\text{Current assets } \pounds - \text{Stock } \pounds}{\text{Current liabilities } \pounds}$$

The 'acid test' is whether the liquidity ratio is better than 1.1:1 (as in £110:£100). If it is, then you have enough surplus of CA (without the stock) over CL to comfortably pay your bills. Even if the liquidity ratio is less than 1:1 then (although technically insolvent) it's not a disaster – you can usually borrow money assuming that it is only a short-term problem and not a long-term shortage of money.

We need to understand how money moves around the business so that we can see where it comes from and goes to. This is the 'cycle of working capital' (see Figure 7.1).

**Figure 7.1:** Cycle of working capital



1. First, cash is in the bank (or in floats)
2. Then it gets paid out to food and beverage and other suppliers, government agencies, utility companies (all 'accounts payable' or 'creditors'), staff (as payroll) and so on – this takes time.
3. The purchase of these produces a product or service, which is sold to generate revenue
4. The revenue is paid for by either cash, credit cards or credit account (debtors)

5. Cash sales go directly back to the bank
6. Credit cards are transacted electronically, and cash is credited to the bank account a few days later
7. Credit sales (debtors or 'accounts receivable') have to be collected (which takes time as well) until eventually they are paid which also becomes cash in the bank.

Now let's look at the different elements (excluding accruals and prepayments which we covered in Chapter 2). As with other aspects of control there are two potential problems – fraud or theft (deliberate – with cash being potentially very attractive) and errors (not deliberate and more to do with inefficiency).

## Physical Cash

This comes into the operation in several different ways:

### Cash from customers

- Sterling cash
- Foreign exchange
- Credit cards (Visa, etc.)
- Debit cards
- Cheques
- Vouchers (these aren't physical cash but do have a value).

### Cash from debtors

- Cheques
- Bank transfers (including credit cards)

This can also include advance deposit payments for future bookings.

### Cash from interest, commission and rentals

- Bank and building society interest
- Commission on foreign exchange
- Direct transfers for payment of rentals (e.g. for concessions, showcases, leased car park).

### Moving money

Cash should be stored in three places – the till, the safe or the bank – but of course it's not that simple, which is where the problems are likely to appear. Money has to be moved from place to place.