

Consultancy advice for JOT Toy Company

Suggested answers

Communication document on JOT's forecast cash flow problems

Differences between profit and cash:

1. Profit is an accounting term which takes account of sales made and revenue expenditure incurred using the accruals concept.
2. Profit does not include any working capital requirements or reflect the timing of sales receipts or the timing of manufacturing of products.
3. Profit does not include capital expenditure.
4. Profit includes non-cash items such as depreciation.

JOT's forecast cash flow problems:

5. Due to the seasonality of JOT's sales, it incurs large cash outflows to build up its inventory levels, which has no effect on profit during the year but a large impact on cash flows.
6. By the end of the current year, JOT's overdraft is forecast to be €2,230,000, which is €730,000 million OVER the agreed overdraft limit of €1,500,000, so an additional source of financing needs to be URGENTLY put in place. (Forecast overdraft of €2,230,000 is based on €1,450,000 plus sales of €6,590,000 less costs of €10,270,000 in the remainder of the year).

Ways in which JOT could improve its cash flow:

7. JOT could ask for a part payment of the customer's order when the order is placed, in order to obtain a discount, although most large customers may not like this and JOT could lose sales. It could also be viewed by JOT's customers as a sign that JOT is in financial difficulties and also it is not the norm for companies placing orders to pay for goods (even part payment) before the products are delivered.
8. Factoring would be immediately helpful and is used extensively by many businesses and would allow JOT to receive cash almost immediately after goods are invoiced to its customers, rather than waiting on average around 2 months (60 days) as it presently does.

Recommendation:

9. It is recommended that JOT should use a debt factor as this would generate cash immediately after despatch of goods and this would help finance the company's growing working capital requirement and prevent the company from breaching the agreed overdraft limit.

Justification for the recommendation:

10. Cash is the life blood of an organisation, especially a small unlisted company such as JOT, which could be forced into liquidation if it does not find a way to manage its cash flow and to NOT exceed the banks agreed overdraft limit.