Societies and Inflation

Why Do Companies Have Liquidity Problems?

PROFESSOR JOHN SIZER

(Professor of Financial Management and
Head of Department of Management Studies,
University of Technology, Loughborough)

During the last twelve months some dynamic changes have taken place, and continue to take place, in the external environment in which companies operate. The energy policy of the Arab countries, the shift in the distribution of world income between the oil rich developing countries and the developed industrialised countries, a continuing escalation in world commodity prices, rampant domestic wage and price inflation, and the aftermath of the three-day working week in the United Kingdom, have caused companies to recognise that they are operating in an environment that requires faster and more sophisticated adjustments and reactions than in the past. In particular many accountants and managers are having to recognise for the first time that cash flow is in many ways more important than profit shown in the Profit and Loss Account. They must also recognise that the liquidity problems they face are also being faced by their customers and their suppliers.

On the day the Chancellor presented his Budget to the House of Commons, the Confederation of British Industry reported that its latest survey of industrial trends

> "provides strong evidence of the widespread nature of the deterioration in corporate liquidity that has taken place and that is expected to take place".

In his Budget speech the Chancellor said

> "There is however a more immediate and urgent threat to employment in Britain at the moment than inadequate demand.
>
> "The impact of inflation on the company sector risks forcing thousands of firms to restrict their output and lay off workers in the coming winter not through lack of demand, but simply through lack of working capital."

In this article the causes of the liquidity crisis referred to in the Chancellor's speech are identified.

Impact of Inflation on Working Capital Cycle

As the Chancellor indicated in his Budget speech the exceptionally high rate of inflation has had its major impact on the company sector's working capital requirements. In every business there is a circulating asset or working capital cycle of activity. The working capital cycle for a manufacturing company is illustrated in Figure I. It will be noted that profit is shown in the Profit and Loss Account when the customer is invoiced, not when the cash is received. The amount of circulating capital required by a company and its level at any particular time will be governed by the speed with which the cash cycle can be sustained. The faster the cycle the less the investment in working capital must be, and the faster the rate of turnover in the elements of working capital the less the total investment needs to be. The rate of inflation is also a major determinant of the rate of growth of investment at each stage of the working capital cycle. A company facing a high rate of inflation but nil growth in real terms, finds that the inflation increases the investment in the early stages of the working capital cycle before any additional cash was generated from higher selling prices. Many companies planned for growth in real terms in 1974 and this growth also led to a build

up in the investment in the early stages of the working capital cycle before additional cash flow inflow was generated.

This situation was further seriously aggravated by the Price Commission criteria for allowing higher prices. The Chancellor admitted in his Budget speech that the high rate of inflation

> "has made the operation of the price controls far more severe than was originally intended".

It was not possible to increase prices sufficiently to cover the higher costs and leave sufficient cash flow to finance the higher investment in working capital. Nor were the prices allowed by the Price Commission generating adequate profits to allow external finance to be raised. Not only were the Price Commission criteria too hard, but also the need to seek Price Commission approval for higher prices delayed the period between higher costs and investment in working capital occurring and the subsequent increase in selling prices. Two other factors were also affecting the speed with which the cash cycle could be sustained. First, because companies' suppliers were facing similar liquidity problems their service to customers was affected. Raw materials and components were in short supply, which caused production interruptions and bottlenecks. This adversely affected stock control and production planning and, therefore, the level of stocks and work-in-progress. Similarly, companies' customers had liquidity problems and they extended the period of credit taken and also, in some instances, the level of bad debts increased.

The situation many companies faced was very similar to that of a company that is overtrading. Like a company that is overtrading, companies in 1974 have budgeted for and achieved higher profits, but have a deteriorating cash position because the profits generated have not been translated into net cash inflows. The company facing a liquidity crisis in November 1974, like the company overtrading, found that the rise in sales and profits was

accompanied by a disproportionate increase in stocks, work-in-progress and debtors which more than absorbed the cash flow generated by the higher sales.

Other Factors Influencing Company Liquidity

If a company has no access to external funds not only must it finance additional investment in working capital from internally generated funds, but also pay dividends, interest payments, and corporation tax, and hopefully, undertake essential capital investment. These other factors have been added to Figure I to give the permanent and working capital cycle shown in Figure II.

In November 1974 many companies had limited, or nil, access to medium and long term external finance. The Stock Market was in a depressed state because investors had little confidence in the ability of the Government to solve the country's serious economic problems and at the same time in the ability of companies to achieve growth in earnings per share and dividends compatible with the current rate of inflation. Investors were pessimistic about the future profitability of the private sector with the result that price earnings ratios were at extremely low levels and dividend yields extremely high. Lack of shareholder confidence and the high cost of equity finance meant that virtually all companies had no access to this important source of company finance. Furthermore, the high rates of interest and/or the fact that many companies had reached their borrowing limits because of lack of interest cover or asset cover, resulted in companies being unwilling, or unable, to raise long and medium term loans. Industrial and commercial companies relied heavily on bank finance; some £2,300 million during the first half of 1974. By November the generation of internal cash was not sufficient in many companies to provide a satisfactory basis for seeking further funds from the banks. They were therefore concerned that they would be unable to meet their corporation tax payments when they became due in January 1975 - payments that would be substantially higher than in previous years for three principal reasons. First, the inflation had allowed

many companies to generate higher, but nevertheless inadequate, taxable profits. Secondly, the taxable profits are calculated on the first-in first-out (FIFO) basis of stock valuation. This meant that a large portion of the taxable profit achieved was required "to maintain the working capital of the business intact", i.e: the cash flow generated was required to replace stock at higher prices, but was partially to be drawn out of the company in the form of tax payments. Thus, the Chancellor admitted in his Budget speech that inflation

> "has increased the cost of replacement stocks to a degree which under the present tax rules imposes burdens which industry was never meant to carry".

A third reason for the substantial increase in corporation tax was the tax changes introduced by the Chancellor in his April 1974 Budget.

In the aftermath of the three-day week, there were significant signs of the impending liquidity crisis in the corporate sector. In the first quarter of 1974 the financial deficit of industrial and commercial companies rose sharply to by far the highest quarterly figure recorded. Companies borrowed £1,300 million from banks. Despite these signs the Chancellor increased the rate of corporation tax from 50% to 52% and the advance corporation tax (ACT) on dividend payments. He also required additional payment to be made amounting to 50% of ACT due to be paid during the financial year 1974. These measures increased company taxes payable in 1974/75 by some £475 million.

Effect on Capital Expenditure

With lack of cash to finance additional working capital, to pay dividends, interest, and corporation tax, it is not surprising that many companies had to cut back and postpone planned capital expenditure programmes. Furthermore, lack of confidence in the Government's ability to solve the country's serious economic problems without a significant

fall in the level of consumer demand and increase in unemployment made Boards of Directors extremely pessimistic about their future investment intentions. The CBI reported in its Survey of Industrial Trends that, while fifteen months earlier the number of companies expecting to lift capital expenditure reached record levels,

> "the collapse of investment intentions is widespread throughout manufacturing industry."

More seriously, not only was there a lack of finance to allow essential capital expenditure to take place, there were also indications that many companies were having to cut back the level of their output because they could not finance their increased investment in working capital. The number of bankruptcies and company liquidations was also increasing at an unhealthy rate. It was not surprising to read in the Chancellor's Budget speech

> "The same factor (lack of working capital) could force some firms into bankruptcy and it is already compelling many of them to cut back on plans for investment to which they were firmly committed only a few months ago."

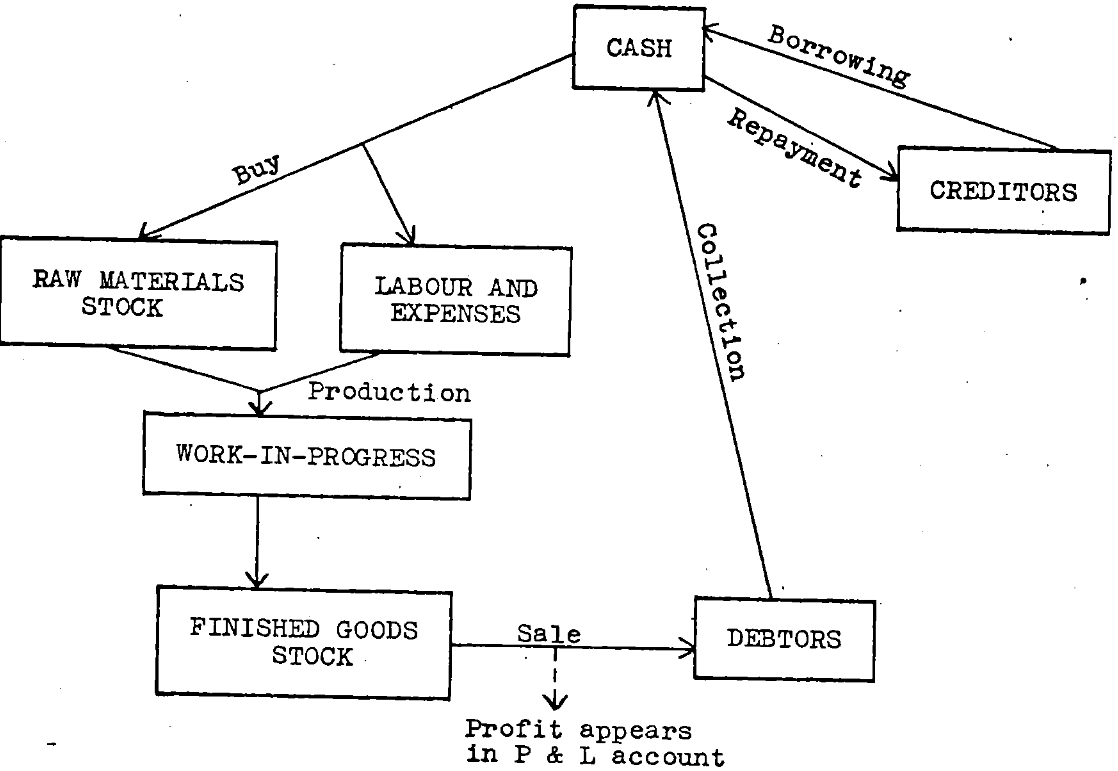

FIGURE I WORKING CAPITAL CYCLE OF MANUFACTURING FIRM

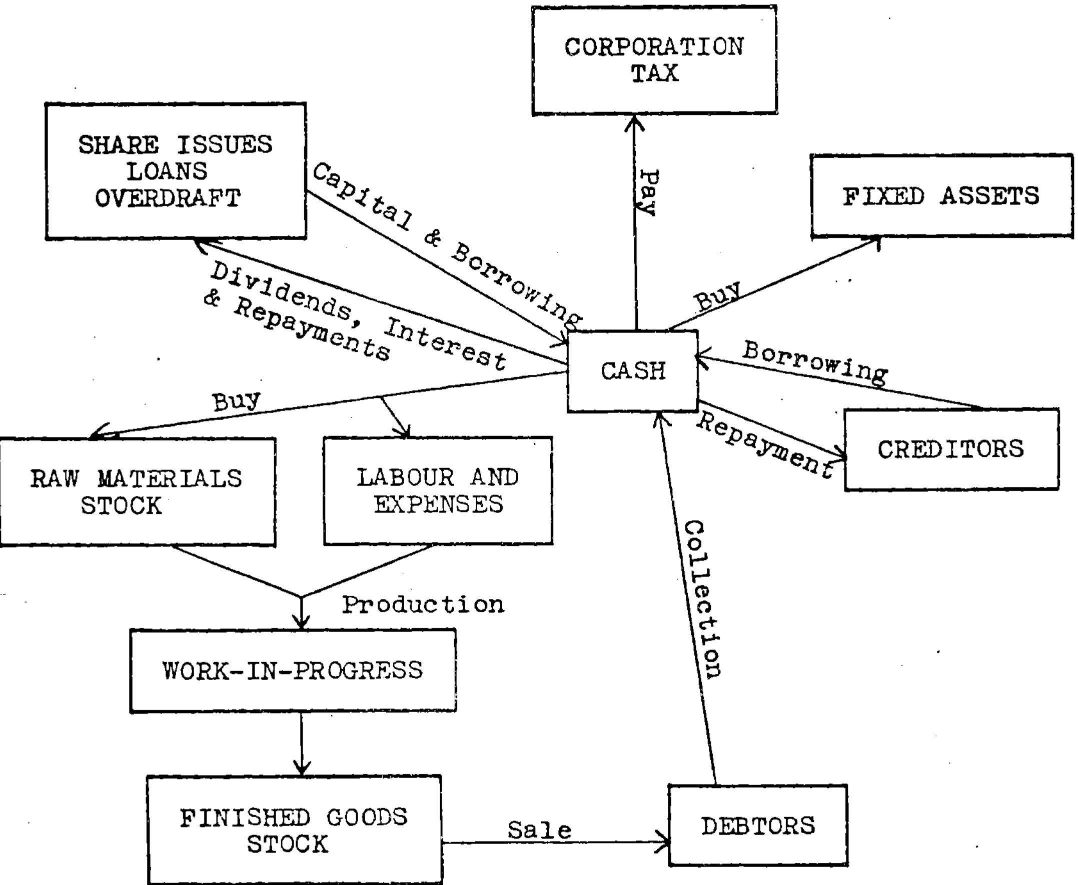

FIGURE II PERMANENT AND WORKING CAPITAL CYCLE OF MANUFACTURING FIRM