International Journal of Business and Management Invention
ISSN (Online): 2319 – 8028, ISSN (Print): 2319 – 801X
www.ijbmi.org Volume 2 Issue 5 ‖ May. 2013‖ PP.01-05

The Due Process of Cash Flow Statements Management for Business Managers and Investors

[1]Faboyede, Olusola Samuel, [2] Ben-Caleb, Egbide, [3] Fakile, Adeniran Samuel

[1,2,3]Department of Accounting, School of Business, College of Development Studies, Covenant University, Canaanland, Ota, Ogun State, Nigeria.

ABSTRACT: *In today's world of global economic and financial crisis, it is a fact that one of the priorities for today's economic climate is the effective and efficient management of cash flows. Business analysts have identified poor cash flow management as the main reason for business failure for entrepreneurs, managers, and investors. Companies sometimes engage in unusual or aggressive accounting practices in order to flatter their reported figures, especially earnings. In the wake of recent high-profile scandals, the landscape is beginning to change. As a result, some investors now shun reported earnings and focus more attention on other metrics such as cash flow statements to evaluate the operational health of a business. Analyzing the operating cycle and forecasting cash needs will minimize the amount that must be financed without running short of cash. This paper gives an incisive and in-depth understanding of cash flow statement management, its planning, elements, and significance. It offers strategies on best practices for managing liquidity crisis in a slow down economy. It finds that management of cash flow statements is a basic practice needed in a healthy business and that business leaders/managers must develop this skill to manage finances and avoid trouble. This basic skill must however be applied according to certain financial controls to ensure integrity in the bookkeeping process. The paper concludes that smart cash flow decisions are paramount to survive the current unstable economic dispensation. Hence, it recommends that businesses and investors need the cash flow management expertise to battle the current economic meltdown environment which is characterized by tightening finances, rising inflation, general depression, and increased supply chain risk.*

Keywords: Cash flow Statements, Liquidity, Management, Quality of Earnings, Strategy.

I. INTRODUCTION

One of the priorities for today's economic climate is the management of cash flows. These are undoubtedly, tough and difficult times. Executives and investors are challenged more than ever to strike the right balance between reducing costs and making the targeted investments that will ensure future success. The continued uncertainty in economic forecasts makes this balancing act even more challenging. With persistent global panic, unemployment has been on the rise, shortage of liquidity and acute scarcity of credit have remained visible in the financial institutions, even as stock market developments have been marked by high fluctuations and corporations have continued to post financial losses. No one can predict how long the current global economic/financial recession will last. However, it is certain that every economic crisis comes with opportunity. Some companies and investors will go from good to great, while others will just fade away, making room for more innovative competitors. To be among the winners, executives cum investors need to answer key questions relating to cash flow statements management. (Bouhdary, 2008; Nwachukwu, 2009))

Business analysts have identified poor management as the main reason for business failure. Poor cash management is probably the most frequent stumbling block for entrepreneurs. Having an understanding of the basic concepts of cash flow helps in planning for the unforeseen eventualities that nearly every business faces. (United States Small Business Administration, n.d.). There are different groups of people who read the financial statements, each looking for different types of information. For investors, earnings might be the most important area, but the statement of cash flow is extremely important to management, lenders, and tax authorities as well as investors. (Investopedia, n.d.)

The management of cash flow statements is a basic practice needed in a healthy business. Business leaders and managers must develop this skill because expecting others in the organization to manage finances is clearly asking for trouble. This basic skill ought to be done according to certain financial controls to ensure integrity in the bookkeeping process. (McNamara, 1999). For a new or small business outfit, the biggest challenge is likely to be cash flow management. Probably, the most important financial statement for a new business is the cash flow statement. The overall purpose of managing cash is to make sure that there is enough cash to pay current bills. Businesses can manage cash flow by examining a cash flow statement and cash flow projection. The cash flow statement basically includes total cash received minus total cash spent. Cash management looks primarily at actual cash transactions.

1.1 STATEMENT OF PROBLEM

Financial Statements (The Income Statement and Balance Sheet) are prepared using the accrual basis of accounting, which does not give the "reality" of financial conditions. The accrual basis is generally preferred for financial statements because it more accurately matches revenue sources to the expenses incurred generating those specific sources. It is therefore necessary to convert the accrual basis in order to analyse the actual level of cash flowing into and out of the business. (Entrepreneur, 2006).

Companies sometimes engage in unusual or aggressive accounting practices in order to flatter their reported figures, especially earnings. In the wake of recent high-profile scandals, the landscape is beginning to change. The majority of investors are now keenly aware of the concept of quality of earnings. The knowledge is now fairly common in investment community that corporate management can in various ways manipulate earnings as reflected on the income statement. As a result, some investors have decided to shun reported earnings and focus more attention on other metrics to evaluate the operational health of a business. The cash flow measurements are part of these metrics. As analysts have lost faith in earnings-based metrics in the wake of Enron, WorldCom, and others, many have gravitated toward the cash flow statement (Siegel, 2006).

1.2 SIGNIFICANCE OF STUDY

Business executives and investors who will run with the best should strongly consider the best practices of cash flow management in order to strike a balance that allows both cost reductions and smart business decisions. As credit lines tighten and spending slows, companies should manage their cash-to-cash cycle and shore up shareholder confidence. Leading companies pay particular attention to balance-sheet health because liquidity management has become an integral part of an organization's core processes. The ability to reduce leverage and increase cash flow through working capital practices enables organizations to support long-term cash needs, the benefits of which can be tremendous (Bouhdary, 2008)

Investor's increased focus on the cash flow statement is beneficial. The analysis of the cash flow statement is integral to understanding a company's financial performance and position because it often provides a check to the quality of the earnings shown in the income statement.

Cash flow management is about achieving maximum effectiveness of cash receipts and payments. The aim is to strike a balance between generating satisfactory returns or yield from deposit accounts or short term investments and ensuring cash is available when needed to pay the day-to-day running expenses of the organization as well as the fairly predictable "lump sum" amounts like computer equipment replacement expense.

Managing cash balances is the most important part of working capital management. An organization that runs out of cash resources will have to stop operating immediately. Problems like inability to pay monthly salaries and dishonoured cheques from banks will arise. Also, the trustees or directors could further mean personal liability or even imprisonment (National Council for Voluntary Organizations, 2006).

Profit growth does not necessarily mean more cash on hand. Profit is the amount of money we expect to make over a given period of time while cash is what is available on hand to keep the business running. Over time, a company's profits are of little value if they are not accompanied by positive net cash flow because the company can only spend cash and not profit (United States Small Business Administration, n.d.). Even profitable companies can fail to adequately manage their cash flow, which is the reason the cash flow statement is important. The investors are able to see if a company is having trouble with cash (Falex, n.d.).
Finally, it should be noted that the management of cash flow statements is a management tool, which enables the formalization of the planning process for next year and provision of a basis for developing other projected financial management tools such as the income statement and balance sheet; provision of an estimate of borrowing requirements, repayment capacity, and scheduling; and monitoring of actual cash flow and potential problems identification (Dalsted and Gutierrez, n.d.).

1.3 STATEMENT OF OBJECTIVES

This paper seeks to throw some light on the fundamentals of cash flow statement management, planning, components, and importance. It gives an exposition on the dynamics of liquidity management in a recession economy as well as guidelines on how to practice good/effective cash flow management. It establishes that the importance of cash flow statements planning/management cannot be overemphasized particularly in an era of tightening finance, rising inflation, and depressed productivity economy.

II. UNDERSTANDING CASH FLOW

Cash flow refers to the flow of cash into and out of a business over a period of time. A major business owner management task is to watch the cash inflows and outflows. The outflow of cash is measured by the cheques that are written every month to pay salaries, suppliers, and creditors while the inflows are the cash received from customers, lenders, and investors.

Where the cash received into the business is more than cash payments or outflows, the company is said to have a positive cash flow. This is very good, though the concern here is what to do with the excess cash. Like good human health, a positive cash flow is most appreciated or recognized if it is lacking. On the other hand, a negative cash flow exists where outgoing cash exceeds in-coming cash to the business. A negative cash flow can be caused by reasons such as too much or obsolete inventory or poor collections on accounts receivable (Online Women Business Center, n.d.).

Cash flow management is the solution to the problem of lag between the time suppliers and employees are paid and the time collections are received from customers. In its simplest sense, cash flow management means delaying outlays of cash as long as possible while encouraging anyone who owes the business money to pay it as rapidly as possible (Entrepreneur, 2003). The operating cycle is the system through which cash flows from the purchase of inventory through collection of accounts receivable. This measures the flow of assets into cash. The operating cycle is the amount of time that must be financed. Analyzing the operating cycle and forecasting cash needs will minimize the amount that must be financed without running short of cash.

It is best to have enough cash on hand each month to pay cash obligations of the following month. A monthly cash flow projection helps to identify and eliminate deficiencies or surpluses in cash and to compare actual figures to past months. When cash flow deficiencies are found, business financial plans must be altered to provide more cash. When excess cash is revealed, it might indicate excessive borrowing or idle money that could be invested. The objective is to develop a plan that will provide a well-balanced cash flow (Financial Guide, n.d.).

It is important to forecast likely cash requirements when planning the short or long-term funding requirements of a business because the generation of profit does not necessarily guarantee business development, or even survival. More business fail for lack of cash flow than for want of profit. Companies that take steps to manage cash flow will be better placed for competition, capitalizing on available opportunities and weathering downturns (Barrickman, n.d.).

Cash flow planning involves forecasting and tabulating all significant cash inflows relating to sales, new loans, interest received etc and then analyzing in detail the timing of expected payments relating to suppliers, wages, other expenses, capital expenditure, loan repayments, dividends, tax, interest payments, etc. The difference between inflows and outflows give the net cash flow. Any likely short-term bank funding requirements can be ascertained when the net cash flow is added to or subtracted from opening bank balances.

A cash flow statement typically has three components, which include internal and external sources namely:

- Operating Cash Flow, usually referred to as working capital, is the cash flow generated from internal operations. It is cash generated from sales of the product or service of a business. It is the real lifeblood of the business, which is under the control of the business.
- Investing Cash Flow comes from non-operating activities like investments in plant and equipment or other fixed assets, nonrecurring gains or losses, or other sources and uses of cash outside of normal operations.
- Financing Cash Flow refers to cash to and fro external sources such as lenders, investors and shareholders. Examples of financing activities are obtainment of new loan, repayment of a loan, issuance of stock and payment of dividend (Online Women Business Center, n.d.)

2.1 THE PRACTICE OF GOOD/EFFECTIVE CASH MANAGEMENT

Good cash management means knowing when, where, and how cash needs will occur, what the best sources for meeting additional cash needs are, and being prepared to meet these needs when they occur, by keeping good relationships with bankers and other creditors. Developing a cash flow projection is the starting point for avoiding a cash crisis. In doing this, the following points should be noted:

- The central purpose of the exercise should be decided (internal planning and control, loan negotiation, etc)
- Identifying the target audience (directors, bank managers, etc)
- Setting time intervals and horizon (e.g. monthly for 12 months).
- Setting out required level of detail
- Checking that all necessary key assumptions and data have been adequately researched.
- Compiling opening balances for all items that will involve cash flows within forecasting period.
- Thinking through the likely impact of critical assumptions on cash flow projections.

When preparing cash flow projections, dangers such as overstating sales forecasts, underestimating costs and delays likely to be encountered, ignoring historic trends or debtors' performances, making unduly-optimistic assumptions about availability of bank loans, credit, grants, equity, etc, and seeking spurious accuracy whilst failing to recognize matters of strategic importance, should be avoided (Plan Ware White Paper, n.d.).

To ensure the existence of good/effective cash management in place, the following tips are of paramount significance:

- ✓ Increasing sales (especially those involving cash payments)
- ✓ Reducing direct and indirect costs and overhead expenses
- ✓ Deferring discretionary projects which cannot achieve acceptable cash paybacks (e.g. within a year)
- ✓ Increasing prices, especially to slow payers
- ✓ Reviewing the payment performances of customers (involve the sales team)
- ✓ Becoming more selective when granting credit
- ✓ Seeking deposits or multiple stage payments
- ✓ Reducing amount of time of credit given to customers
- ✓ Billing as soon as work has been done or order fulfilled
- ✓ Improving systems for billing and collection
- ✓ Using the 80/20 rule to control inventories, receivables, and payables
- ✓ Improving systems for paying suppliers
- ✓ Generating regular reports on receivable ratios and aging
- ✓ Establishing and adhering to sound credit practices- train staff
- ✓ Using more pro-active collection techniques
- ✓ Adding late payment charges or fees where possible
- ✓ Increasing the credit taken from suppliers
- ✓ Negotiating extended credit from suppliers
- ✓ Making prompt payments only when worthwhile discounts apply
- ✓ Reducing stock levels and improving control over work-in-progress
- ✓ Selling off or returning obsolete/excess stock
- ✓ Making use of factoring or discount facilities to accelerate receipts from sales
- ✓ Deferring or re-staging all capital expenditure
- ✓ Using alternative financing methods, such as leasing, to gain access to the use (but not ownership) of productive assets
- ✓ Re-negotiating bank facilities to reduce charges
- ✓ Seeking to extend debt repayment methods
- ✓ Netting off surplus assets or making them productive
- ✓ Entering into sale and lease-back arrangements for productive assets
- ✓ Deferring dividend payments
- ✓ Raising additional equity
- ✓ Converting debt into equity
- ✓ Making medium and short-term cash flow forecasts and updating them regularly (Plan Ware White Paper, n.d.).

As the global financial crisis rages on, executives are being asked what their bailout strategy is. And for an increasing number, the answer is spend management. Leading companies and investors alike have come to view spend management as a key stimulus package for holding down costs and improving performance. These are critical imperatives in today's down economy. To this extent therefore, the insights and best practices for controlling costs, reducing risk and improving performance mentioned above are very invaluable in the down economy (Business Wire, 2008).

III. CONCLUSION

These are times whereby organizations and investors walk the tight rope engendered by the on-going global financial crisis. Smart cash flow decisions are necessary for unstable times so as to secure the future. This paper has dwelt extensively on the issues of cash flow statement, its definition, components, planning, management, importance and improvement. Among other things, it has given useful insights on reading and creating an effective cash flow statement, analyzing beyond numbers to show how management decisions affect a company's cash flow, using cash flow figures to analyze financial performance. Further, the value of a cash flow statement in providing insight into operating, financing, and investing activities as well as the importance of using financial information to implement positive cash flow strategies have been revealed.

Cash shortages can prevent a business from meeting its financial obligation, and make it difficult to plan for the future/company expansion. Just like a family has to understand cash issues for survival, a business also must understand information about its usable cash in order to sustain its life. Therefore, businesses and investors need the cash flow management expertise to battle the current economic meltdown environment which is characterized by tightening finances, rising inflation and increased supply chain risk.

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