



Skill Development Technique in Financial Management

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ABSTRACT

We need to develop skill in business with the help of financial management that will help to increase business opportunities. Cash flow management and forecasting are the key tools for every business to plan strategically a company's future financial liquidity and save it from financial crunch. In the present era of increasing cost of capital matters relating to money management are most important and various financial problems can be solved with technical skills of finance and accounting. Four Ms of business management i.e. Man, Material, Machinery and Methods are revolves around money management. However, what may lack at times is the focus that money deserves amidst a plethora of other management and other regulatory issues. This paper intends to understand various skills and techniques essential to understand cash flow management and forecasting in financial management.

KEYWORDS:

Forecasting, Liquidity Management, Cash Budgeting, Risk Management

INTRODUCTION:

Cash management is a finance activity that involves handling cash inflow, outflow and optimal allocation of cash so as to reduce carrying cost and maintain liquidity and solvency of the business. We need to develop skill in managing the cash in business in a very efficient manner that is possible with the Cash flow management and forecasting. It may be possible that despite of having encouraging EBITDA (Earnings before interest, taxes, depreciation and amortisation) and comfortable PAT (Profit after tax) a business may still be burning cash and heading towards insolvency. It is therefore necessary to focus on two more parameters apart from Net income from operations i.e. Net Equity and Net cash from operations. An analysis of these three concepts may yield startling results of cash flow mismatch and faulty capital structure. Companies tend to use working capital to finance expansion projects thus creating operational cash gaps and use long-term capital to finance working capital needs as an easy way to manage short term cash needs, thus diverting money away from cash generating assets. Both the situations result in a cash flow mismatch. Poor visibility on cash flow forecast may result in high leveraging of the business, making it difficult to service interest cost. This type of risk can be avoided with the help of cash flow management and forecasting as a part of skill development in financial management.

OBJECTIVES OF THE STUDY:

- 1) To understand the importance of cash flow management
- 2) To know cash flow forecasting with methods of forecasting
- 3) To study classification of cash flow activities
- 4) To assess various pre-requisites for efficient cash flow forecasting
- 5) To discuss challenging issues in cash management

1) Importance of cash flow management :

Cash management is a finance activity that involves handling cash inflow and outflow and optimal allocation of cash, so as to reduce carrying cost and maintain liquidity and solvency of the business.

Tools and concepts of cash flow management: It is a technique which covers one or more of the following:

- A) **Cash Budgeting:** It is generally prepared annually along with the master budget and sets the road map for proposed cash flows on the basis of historical transaction and future plan. It is future oriented and may be prepared for one year or more.
- B) **Cash flow forecasting:** It is a tool to give an outlook of financial liquidity over a short term period, comprising of forecasted inflows and outflows. Most cash management activities revolve around short term forecasting. While long term forecasting is used to make capital budgeting decisions.
- C) **Liquidity management:** This aims to maintain a balance between liquidity and profitability on a day-to-day basis, by making investment and expense allocation decisions. Tools for liquidity management are timely invoicing, issue of post-dated cheques, availing short term credit through instruments like Letter of credit, Bank guarantee, short term liquid investments, bill discounting, factoring of receivables etc.
- D) **Risk management:** Risk of loss from exchange rate fluctuation, complex financial instruments, cash pilferage, signatories' fraud, price rise etc. can be dangerous if not dealt cautiously. Business can be shielded from measurable and immeasurable risks by establishing strong internal controls, identification of risk areas, use of risk management tools like hedging, insurance and other tools of risk management.

Cash management can be both preventive and corrective in approach. Regular cash management exercise is vital for healthy finances. Entities which mismanage cash either die a natural death or undergo business restructuring due to steady wealth erosion.

2) Cash flow forecasting and methods of forecasting:

It is generally a regular exercise which may be done annually, half-yearly, quarterly, monthly, weekly or even daily when the cash situation is in acute distress. It gives a clear view of cash surplus or funding gap. Deep analysis of actual vs forecast variances helps in improving the forecast.

Methods of forecasting:

For short term forecast, generally the direct method or Receipts and Disbursement Method is used.

For long term forecast, generally the indirect method or Adjusted Net Income approach is used.

Cash flow forecast for short-term decision making is more popular, easy to prepare and understand.

3) Classification of cash flow activities:

a) Operational Activities:

- 1) **Revenue:** - Separate forecasting for cash and credit collection may be made depending upon past trend, credit terms and sales plan in immediate future. Forecast basis may be different for different class of debtors.
- 2) **Purchase:** - Consumption of raw materials is normally a variable of revenue and production. With a production plan in place and established inventory level, one can forecast the purchase requirement and payment shall be forecasted based on terms of payment.
- 3) **Employee cost:** - These are more or less are fixed. However variable factors like performance incentive, salary increment, hiring and retrenchment, loans and advances against salary should also be considered while forecasting.
- 4) **Operating and Administrative expenses:-** Expenses coming under this head are rent, repairs & maintenance, marketing, travelling, printing & stationary ,power and fuel , communication ,legal etc. some of the expenses are fixed in nature and are periodical while others are variable.

b) Investment Activities: These include capital expenditure, interest income, purchase and sale of investment products likes shares, fixed assets, business acquisition, etc. The capital expenditure budget and capital budgeting decisions would determine the need and timing of investment activities.

c) Financing activities: It includes sourcing of Debt and Equity to finance or refinance and its repayment along with interest and dividend, bank charges etc. These flows are pre-determined and do not change frequently.

d) Statutory Activities: These include various taxes and penalties levied by the law of the land, License fee, statutory deposits, refunds, etc. These are unavoidable cash flows and any default in payment may result in huge penalties. Therefore, cash should be separately earmarked to meet statutory dues.

e) Contingency activities: These includes what cannot be reliably forecasted and may manifest in any unknown form like litigation, change in market forces, changes in law of land, accidental loss etc. A buffer may be created under each head before allocating the surplus. The quantum of buffer may be decided based on available indication for future transaction and past trends of forecasting error.

4) Pre –Requisites for efficient cash flow forecasting:

For a cash flow forecast to be useful for decision making, it is incumbent to have the following in place:

- a. Management's commitment:** - The senior management must underline the urgency and priority of cash flow management, which will set the tone of cash discipline across the organisation.
- b. Robust book keeping:** - Accurate and timely accounting and reporting of financial and non-financial data is the single most important pre-requisite for cash flow forecasting and management to meet its objective.
- c. Participation of all stakeholders** – It shall include integrated finance team, MIS and budgeting team, sales and marketing team and all other user departments, the participation of which is required for developing and using cash flow forecasts.

- d. **Regular historical variance analysis:** - it will help to improve the accuracy of forecast and identify cash burning areas.
- e. **Tight monitoring of cash flow** – It goes hand in hand with cash management activities, which can be both preventive and remedial in nature. Internal audit team can cross – check the means and end use of funds.

5) Challenging issues in cash management:

There are difficult issues which do not have theoretical correct answers, and requires professional judgement and problem –solving skills coupled with sharp, agile and analytical bent of mind to deal with myriad of circumstances. Few of them are given below –

- a. Liquidity management is still easy by borrowing from money market but how to address deficit management?
- b. In a cash deficit scenario, which of the five cash flow needs are more priority? Normally statutory dues, salaries and electricity dues are non-negotiable payments, but in a dire cash crunch situation, one may have to prioritise vendor payment and loan repayment over others, say to avoid winding up petition from vendors; NPA status in banking loan; or save higher penalty cost.
- c. Few debtors with large sales volume-what if the debtors default?
- d. How to manage regular outflow when inflows are seasonal?
- e. Fewer vs. much vendor dependency? While less number of vendors are easy to manage when negotiating, the same may develop a monopolist tendency and may dictate the payment terms.
- f. Holding of inventory – just – in – time vs. Economic order quantity?
- g. Borrow or sell? Whether to continue borrowing or to downsize operations and sell assets?

Users of cash flow Forecast

Any user of financial statement may also be interested in knowing the current and futures liquidity position of the organisation like:

- a. Lenders and Bankers
- b. Management team
- c. Investors
- d. Cost centres managers
- e. Employee and vendors
- f. Government Authorities

A cash flow projection is used for assets valuation, financial budgeting, capital structures decisions; investment decisions, cost management and other operational, tactical and strategic decision, apart from day to day liquidity management.

Conclusion:

For smaller business with little capital back-up, cash mismanagement means immediate doom, and it can never grow. In case of bigger organisations with initial large funding, it is unintentional but a habitual offence of finance controllers to ignore the early signs of cash flow mismatch, or have incongruous understanding of funding gap till capital erosion start. A good finance controller shall keep cash management tools as a routine exercise for taking operational and financial decisions. While it may appear traditional to think of about managing business from cash flow perspective with so much emphasis, it is actually all the more relevant in today's era of increasing cost of capital. The finance professionals are expected to manage cash as much as any other business issues. Cash management is such a powerful tool that can indeed infuse life in a de-oxygenated dying entity.

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