

Importance of cash management in small to medium sized businesses



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CASH MANAGEMENT The degree of importance cash management to small and medium enterprises (SME) can be summarized in the old adage, “Cash is King.” Contrary to popular belief, it is unsatisfactory cash management, and not bad management techniques that causes business enterprises to fail. Cash refers to money readily available for use in the bank or in the business (as opposed to potential sources of money like inventory, debtor dues, property and profit). 1 Cash management is defined as the procedure involving keeping cash flow under surveillance, closely studying its movement trends and adjusting it to suit the business. 2

Cash management is important to SME as it regulates cash flow and prevents prolonged cash shortages that result from too much difference between cash inflows and cash outflows. 3 Cash inflows come from customers, lenders and investors, while cash outflows include payments made to suppliers, creditors and as employee salaries. Negative cash flow occurs when cash outflow is more than cash inflow (due to several reasons such as weak debtor collections, outdated inventory, etc.); in such a situation, the SME is forced to borrow money from lenders, otherwise it will be in bad trouble – the main source of which is non-payment of dues to creditors, suppliers and employees. SME do their best to avoid this scenario and instead strive to attain a positive cash flow, which takes place when the cash inflow is more than the cash outflow. The overall aim of the SME is to generate profit. But the amount of profit earned is meaningless if the SME does not experience a positive cash flow, simply because it is possible to spend cash, not

1: The Importance of Cash Management: FindLaw

2: WARD, S. 2007. Cash Flow Management: About, Inc.

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3: Ibid.

profit. A positive cash flow is therefore seen as a sign of good cash management and a sign that the enterprise is financially sound. 4

Cash management techniques of SME and consumers are similar in several ways, while they also differ in many ways. SME cannot therefore practice all techniques as consumers and vice versa. There are 5 cash techniques of consumers that SME can practice, as these are sound methods conducive towards generating a positive cash flow as well as profit for the enterprise. Firstly, it is important and practical to prepare a cash flow projection for a certain period (usually 6 months), forecasting the income and expenditure over that period. 5 Secondly, it is a good practice to set aside a certain amount as emergency fund to be used in case of unexpected developments. 6 Thirdly, leasing of equipment presents a better alternative as compared to purchase, as the former does not result in cash blockage that is caused by the latter. 7 Fourthly, the overall aim is to create profit (savings in case of consumers) in the long run. 8 Lastly, bills should be paid on or within their due time; however, it is not advisable to pay too early. 9

There are several typical improvements in cash management that can help SME. The first way is to restrict inventory to include just the right quantity without excess (it can happen in response to suppliers' lure of discounted prices); excess or obsolete inventory must be disposed of at or under cost. 10 The second way is to draw up a cash flow analysis periodically in order to prevent cash flow problems; there are several computer software accounting programs with built-in reporting characteristics that can be used for

4: The Importance of Cash Management: FindLaw

5: What Every Business Owner Needs to Know about Cash Flow: Oklahoma
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6: Cash Reserves: First Tennessee Bank National Association.

7: What Every Business Owner Needs to Know about Cash Flow: Oklahoma

Society of CPAs

8: Cash Reserves: First Tennessee Bank National Association.

9: What Every Business Owner Needs to Know about Cash Flow: Oklahoma

Society of CPAs

10: Ibid.

this purpose. 11 The third way is to choose the lease, rather than purchase option to

acquire equipment in the interest of not tying down large amounts of cash.

12 The fourth way is to keep customers' credit facilities under constant surveillance, and make adjustments as and when deemed necessary. 13The

fifth way is to entrust an employee to send out customer bills as soon as the goods or services are handed over to him or her. In case of credit

transactions, the employee should ensure that prompt, regular bills are

dispatched so as to reach customers just before the due time. 14 The sixth

way is to create a deposit policy where work in progress is involved, making it mandatory for customers to pay a part of the total invoice amount before

the work is begun. 15 The seventh way is to encourage prompt payment

from customers by a carrot-and-stick policy: provide a discount for early

payment, and a penalty fee for payments made after the due date. 16 The

last way is to pay vendor bills on time, but not too early before that (except in case early payment discount is offered). 17

Several operational benefits are foreseen if the suggested improvements in

cash management are implemented by SME. First of all, they will experience <https://assignbuster.com/importance-of-cash-management-in-small-to-medium-sized-businesses/>

positive cash flows, enabling them to pay vendors, creditors and investors on time, all of which enhances the SME financial status. Lenders, especially banks, respond positively to requests for finance if they see a good financial status report. Employees are paid on time, which makes them psychologically secure, which in turn enables them to put forward their best efforts in serving the company. The company profit is enhanced

11: WARD, S. 2007. Cash Flow Management: About, Inc.

12: What Every Business Owner Needs to Know about Cash Flow: Oklahoma Society of CPAs

13: WARD, S. 2007. 5 Steps to Shorten Your Cash Flow Conversion Period: About, Inc.

14: What Every Business Owner Needs to Know about Cash Flow: Oklahoma Society of CPAs

15: WARD, S. 2007. 5 Steps to Shorten Your Cash Flow Conversion Period: About, Inc.

16: What Every Business Owner Needs to Know about Cash Flow: Oklahoma Society of CPAs

17: Ibid.

because lease expenses are permitted to be shown as SME business expenses, rather than as liabilities. SME owners are benefited because their businesses are healthy, operating well and generating profit – which is the main aim of SME as well as every other type of business.

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