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*Full Length Research Paper*

# The effectiveness of cash management policies: a case study of Hunyani flexible products

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**The study sought to evaluate the effectiveness of cash management policies at Hunyani Flexible Products (HFP) using data from 2000-2010. Other objectives of the study were to identify the key processes and models in cash management; examine the impact of poor cash management on the overall company performance and come up with strategies that can lead to an effective cash management system. The descriptive survey method was used to solicit information from the respondents and a case study approach was used. The research study was confined to respondents at Hunyani. Flexible Products where a sample of forty (30) respondents was drawn. Data was obtained through interviews, administering questionnaires and by observations. From the research findings, it was established that there is a high deficiency of an effective cash management policy although some attributes of an effective management system were present. The study found that there is a positive relationship between the level of cash flow and the profitability of the company. The research concluded that, cash management is a culture that forms part of the strategy of companies and depends more on managers themselves than the characteristics of companies.**

**Keywords:** Cash management, effectiveness, cash budget, cash flow.

## INTRODUCTION

Over the past years, Zimbabwean economy had been unstable due to a number of reasons including political instability. This instability worsened between 2007 and 2008 resulting in cash flow problems for most business organizations hence cash management challenges to corporate financial managers. The economic environment was characterized by hyperinflation with prices rising each and every second affecting the time value of money. However, the advent of the year 2009 marked an improvement with the introduction of multi-currency system as inflation was to some extent wiped out.

In business, all motives for holding cash which include transaction, precautionary and speculative seemed to be of little importance. It was very difficult for companies to hold cash to satisfy the transactionary motive. Hirt (2002) states that, the transactionary motive is the need to hold cash to satisfy the normal disbursement and collection activities associated with the firm's ongoing operation. Many companies were having negative cash flows which resulted in difficulties in funding business commitments such as paying suppliers, meeting payroll demands and paying taxes. Holding inadequate amount of cash or cash equivalent interrupted the normal flow of most business activities. There was also failure by most business organisations to satisfy the precautionary motive. Holding cash for precautionary motive, assumes management, needs cash for emergency purposes when the cash flows are less than what is projected (Tobin, 2006). It was difficult for firms to cover for any unexpected needs for cash by acting as a preventive balance. Moreover, due to inaccurate safety margins by many firms, they experienced financial difficulties with organizations failing take advantage of unexpected investment opportunities. It was also difficult for organisations to satisfy the speculative motive. According to Wright (2002) specula-

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tive motive is holding cash to take advantage of additional opportunities such as a bargain purchase. Although, the year 2009 showed marked improvement due to the stability of the economy, the researchers noted that, some organisations were still in financial difficulties thus unable to take advantage of investment opportunities.

Effective cash management is the fundamental starting point to ensure that the company's finances are in strong position but this subject is often given insufficient attention. Due to non synchronicity of cash inflows and outflows, the outflows may be more than the inflows and the inflows may be more than the outflows at a particular point in time. This needs regulation because, left to itself, cash flow is apt to follow a monotonic pattern and showers of cash may be scanty hence, there is a dire need to control it through cash management. Application of cash management policies has been difficult such that some policies have been rendered in applicable in organisations in Zimbabwe. The researchers is of the view that this is emanating from a lack of synchronization between cash inflows such as receipts from bills receivable and cash sales, and outflows such as payments on accounts and bills payable. This is resulting in business organisations holding inadequate amount of cash or cash equivalent hence, interrupting the normal flow of the business activities. This has prompted the present researchers to carry out a study to evaluate the effectiveness of cash management policies using a case study of Hunyani Flexible Products.

Hunyani Flexible Products specialises in flexographic packaging. It is a high quality, low cost packaging provider to most of Zimbabwe's industry. The company products includes, folding cartons, corrugated cartons, sheet board and fluting, paper, sacks bags, labels, flexible packaging, books and diaries, pamphlets, brochures and posters. It caters its products to food, industrial, cosmetic and toiletry, soap and detergent, pharmaceutical, construction, and printing and publishing sectors.

## Research questions

The study seeks to answer the following questions:

1) What are the key processes and models of cash management at Hunyani Flexible Products?

2) How effective are the cash management policies at Hunyani Flexible Products?

3) What are the effects of poor cash management on overall company performance?

## LITERATURE REVIEW

According to Remenyi (2001), the purpose of literature review is to establish the area of study, establish a theoretical framework for the subject area of study and to identify studies, models and cases supporting the research topic. The researchers looked deeper into what other scholars have produced pertaining to cash management employed by companies in the manufacturing industries.

### Cash management

Davidson (1992) defined cash management as a term which refers to the collection concentration and disbursement of cash. It encompasses a company's level of liquidity, management of cash balance and short term strategies. Pindado (2004) also defines cash management as part of working capital that makes up the optimal level needed by a company. Bort (2004) noted that, cash management is of importance for both new and growing businesses. Companies may suffer from cash flow problems because of lack of margin of safety in case of anticipated expenses such that they experience problems in finding the funds for innovation or expansion. Weak cash flow makes it difficult to hire and retain good employees (Beranek, 2000).

Ross (2000) says that, it is only natural that major business expenses are incurred in the production of goods or the provision of services. In most cases, a business incurs such expenses before the corresponding payment is received from customers. In addition, employee salaries and other expenses drain considerable funds from most business. These make effective cash management an essential part of the business financial planning. According to Bort (2004) cash is the lifeblood of the business. The key to successful cash management lies in tabulating realistic projections, monitoring collections and disbursements, establishing effective billing and collection measures, and adhering to budgetary parameters because cash flow can be a problem to the business organization.

### Cash collections

According to Ross (2000), cash collection is a function of accounts receivable, it is the recovery of cash from a business or individual with which the company is issued an invoice. Gitman (2008) and Vanhorne (2001), offer theoretical positions drawn from their observations and consulting experience on the fact that a firm can improve its cash management efficiency by collecting accounts receivable as soon as possible. The most obvious way of bringing forward cash inflows, would be to press debtors for earlier payment although this policy will result in goodwill and problems with customers (Palom, 2001).

There will be very little scope for speeding up payments when the credit period currently allowed to debtors is no more than the norm for the industry. Myers (2004) defend

the idea put forward by Palom (2001) and indicating that it might be possible to encourage debtors to pay more quickly by offering discounts for earlier payment. In order to improve cash management efficiency and enable more availability of cash the company can use this as an alternative solution. The objective of managing accounts receivable is to collect accounts receivable as quickly as possible without losing sales from high pressure collection techniques (Gitman, 2008).

### Cash collection techniques

According to Gitman (2008), there are four cash collection techniques namely letters, telephone calls, personal visits and legal action. Letters are written communication of expressions, opinions and communication recorder for later reference (Palom, 2001). After a certain number of days, the firm sends a polite letter reminding the customer of the overdue accounts. If the account is not paid within a certain period after this letter has been sent a second more demanding letter is sent. A telephone call is a connection established over a telephone network between two parties (Chastain, 2008). If letters prove unsuccessful, a telephone call may be made to the customer to request immediate payment. If a customer has a reasonable excuse, arrangements may be made to extend the payment period. Personal Visits involves sending the credit controller to confront the customer and this can be very effective. Payment can be made on spot. Legal action is a judicial proceeding brought by one party against the other for a wrong doing (Davidson, 1992). Legal action is the more stringent step, an alternative to the use of a collection agency

### Cash Disbursement

According to Gitman (2008), cash disbursement is a function of accounts payable; it includes all outlays of cash by the firm during a given financial period. The objective of cash disbursement is to control payments and minimize the firm's cost associated with making payment. Vanhorne (2001), defends the idea put forward by Ross (2000), which says that the objective of cash disbursement is to delay payment as long as it is legally and practically possible. In pursuing this objective the firm should not compromise its relationships with suppliers as this may withdraw trade credit.

According to McLaney (2006), negotiating a reduction in cash outflows may be done in order to postpone or reduce payments. This will be done by taking longer credit from suppliers. However, if the credit period allowed is already generous, creditors might be very reluctant to extent credit even further and any such extension of credit would have to be negotiated carefully. There would be a serious risk of having further supplies refused. The rationale for such a move is to have complete control of the cash and to provide greater investment opportunities with larger sums of money available as surplus, (Bort, 2004). Given the context of a company, cash disbursements are controlled through a policy of delaying payments to suppliers. However, failure to meet financial obligations by the company on time, owing to cash shortages mean loss of further supplies from injured suppliers. This is extremely damaging since some products would be vital to continuing business operations.

### Preparations and Implementations of cash budget

Gitman (2008) states that, a cash budget is a statement of the firm's planned inflows and outflows of cash. It is used by the firm to estimate its short term requirement with particular attention being paid to planning for surplus cash or for cash shortages. Kirkman (2006) arrived at the same idea by highlighting that as a component of implementing an effective cash management program, a cash flow statement called a cash budget may be prepared. Chastain (2008) asserts that budgets are the financial road map companies' use, when planning business expenses and tracking the cash flow throughout the business year.

Vanhorne (2001) says that, a common cash management tool found in companies is a cash budget. Most companies prepare budgets on the departmental level and roll these individual budgets into one master budget. Creating several smaller budgets, can help managers determine which operations use more cash and struggle to stay on the projected budget amounts. This discovery gives managers an idea of when improvements needed to correct the company's cash flow problems. Therefore, cash budgeting is another aid to an effective cash management. Sastry (1995) asserts that, in order for a cash budget to be implemented effectively there has to be a budget committee comprising the high level executive officers of the organization and officers representing the minor segments. Gitman (2008) agrees with Lucey (1993) that a budget manual should also be introduced in the preparation of a cash budget. Platt (2003) is of the idea that implementation of the cash budget is a vehicle to good cash management.

Pindado (2004) argued that, cash budgets, whether prepared on an annual, monthly, weekly or daily basis, can only be estimates of cash flows. Even the best estimates will not be exactly correct, so the deviations of the cash budgets are inevitable. This uncertainty about actual cash flows, ought to be considered when the cash budget is being prepared. It is desirable to prepare additional cash budgets based on different assumptions such as sales levels, costs, collection periods and bad debts. A cash budget model could be constructed, using microcomputer and a spreadsheet package, and the

sensitivity of cash flow forecasts to changes in estimates of sales, costs and could be analyzed by planning for different eventualities management should be able to prepare contingency measures in advance and also appreciate the key factors in the cash budget. Knowledge of the probability distribution of possible outcomes for the cash position, will allow a more accurate estimate to be made of the minimum. Palom (2001), advocate the use of a probability distribution of possible outcomes for the cash position to allow a more accurate estimate of the cash budgets hence making it possible to turn around the cash management problem.

## Ways of Improving cash management

### Postponing capital expenditure

According to Moffet (2004), postponing capital expenditure is one method that can ease cash shortage hence, suggests efficient cash management. Kirkman (2006) states that, some capital expenditures are more important and urgent than others hence, it might be imprudent to postpone expenditure on fixed assets which are needed for the development and growth of business. On the other hand, some expenses are routine and might be postponable without serious consequences. When a lot of cash is used to pay for fixed assets, the company may come up against a cash crunch that prevents it from paying suppliers, buying materials and even paying salaries. It's a good idea, to maintain a level of working capital that allows making through those crunch times and continuing to operate the business.

### Concentration Banking

According to Gitman (2008) concentration banking is a means of accelerating the flows of funds of a firm by establishing collection centres. The purpose of establishing collection centers is to shorten the time from the sale on credit until the payment becomes usable funds for the firm (Buckley, 2004).The average collection period has two parts the first part is the time from sales until the customer mails the payment. The second is the time from when payment is mailed until the firm has collected funds in the bank. The collection and cheque clearing process may be expedited through a number of strategies. In order to enjoy the benefits of expeditious cheque, a lock box system may be used to replace the network of regional collection offices. Under this plan, customers are requested to forward their cheques to a post office box and the local bank picks up the cheques. The bank can then process the local cheques through the local clearing house for rapid collection and perhaps have the funds available for use in 24 hours or less (Beranek, 2000). Whether the corporate uses a collection system or less expensive lock box system, excess cash balances at the local banks are remitted to the corporate headquarters bank through a daily wire transfer or an automated clearing house that makes the funds immediately available for corporate use.

### Cash operating cycle

Williams (2001) defined cash operating cycle as the period from payment of raw materials to receipt of money from debtors. The period represents the time that the cash is tied up in its operations. A lengthy cash operating cycle may be costly to the company and hence need to be shortened in order to have an effective cash management (Buckley, 2004). The basic strategy is to reduce the cash operating cycle as much as possible without adversely affecting the operations of the business.

Companies can actively consider ways of shortening the cash operating cycle to make the company more generative (Moffet, 2004). Gitman (2008), states that, a cost benefit analysis can be performed to determine whether it is worthwhile to employ more resources, additional staff or a new plant, for instance to speed up the production process and there by shortening the operating cycle. Delivery time to customers should be checked to ensure that there are no delays which could be easily avoided. The company can also consider giving customers discounts for prompt payments or reducing the period of credit given to all customers if this is unlikely to have detrimental effect. McLaney (2006) argued that, for such schemes to be worthwhile, both the costs and benefits should be estimated in advance. For instance before offering a prompt payment discount, the cost of the early payment discount should be calculated less than the additional interest received on the cash from the earlier customer payments.

Palom (2001) points out that, the 'cash cycle' can be shortened by taking longer to pay suppliers. However, great care is required here as this may give the company a poor name in the market and suppliers may be unwilling to cooperate when the company needs urgent raw materials for a rushed contract. In the long term if suppliers become aware that a company is a persistent late payer, they may add an additional charge to the price they quote, to cover additional funding costs.

## Cash Management Models

There are two main cash management models that is the Baumol –Allouis –Tobin (BAT) model (Tobin, 2006). The aim of this model is to calculate the optimal amount of securities to be liquidated whenever the concern requires cash. The level of securities will maximize interest

received on marketable securities while minimizing the cost of selling marketable securities. However, according to Whalen (2004) the model has its weakness in that it does not apply in real life since the use and receipt of cash cannot be depicted through instantaneous replenishment and gradual use of cash.

Another cash management model suggested by Miller *et al* (2001) is the Miller Orr Model, which is a stochastic model that aims at determining the amount of marketable securities to be sold or purchased whenever there is need for cash. A stochastic model is a model based on real life assumption that cash use is random. The model indicates that the firm sells marketable securities when a lower limit of cash is reached. Marketable securities are purchased when the upper limit of cash is reached as it becomes necessary to reduce cash. When there is no attempt to manage cash balances clearly the cash balance is likely to ‘meander’ upwards or downwards (Tobin, 2006). The Miller–Orr Model imposes limits to this meandering. If the cash balances reach an upper limit the firm buys sufficient securities to return the cash balance to a normal level (called the return point). Whalen (2004) states that the cash balances reaches a lower limit, the firm sells securities to bring the balance back to the return point.

## RESEARCH METHODOLOGY

In this study, a case study approach was applied to carryout in depth analysis of cash management policies using a case study of Hunyani Flexible Products focusing on the period 2000 to 2010. Saunders (2005) defines a case study as the development of intensive knowledge about a single case or small number of related cases. The case study is appropriate for research because of the accessibility to the organization which will provide the researchers with the understanding of the organization needed to make an in depth analysis of the findings used to propose recommendations for further research. The researchers targeted the whole population involved in the handling of cash at Hunyani Flexible Products. A sample of thirty out of fifty employees was chosen using judgmental sampling by the researchers which included ten managers, ten accounts clerks, and ten employees who include non management staff.

## DATA PRESENTATION AND DISCUSSION

### Level of awareness of Cash management models

The study sought to identify the key processes and models of cash management used at Hunyani Flexible Products. From the findings 10% of the respondents expressed that they were aware of cash management models used at Hunyani Flexible Products, citing the Baumol model and the Miller Orr Model and 50% of the respondents showed that they are not aware of the cash management models. The research findings indicated that the majority of respondents were not aware of the key processes and cash management models used at Hunyani Flexible Products which denotes that no cash management models were being applied at Hunyani Flexible Products.

### Effectiveness of cash management policies

Research results showed that 30% of the respondents indicated that the cash management policies at Hunyani Flexible Products were effective, while 10% showed that there were indifferent and 60% of respondents were of the view that the cash management policies were ineffective. Their views and opinions suggested that suppliers demanded earlier payment, customers delayed making payments, and stakeholders sought an improved cash generation and credit reduction. This view is supported by Stowe (2004) and Palom (2001), who say that suppliers demand earlier payments and failure to meet financial obligations by the company on time, owing to cash shortages mean loss of further supplies from injured suppliers. This is extremely damaging since some products would be vital to continuing business operations.

### Effectiveness of Cash disbursement Policy

From the findings 40% of respondents indicated that the control of cash disbursement at Hunyani Flexible Products was effective. Their views were that payments to suppliers were delayed as long as practically possible in order to make cash available which is consistent with Gitman (2008) who postulate that that the objective of cash disbursement is to delay payments to suppliers as long as it is practically possible. They eluded that in order to have a total control over cash, payments to suppliers were made once per week. 60% of the respondents indicated that the control of cash disbursement was ineffective at Hunyani Flexible Products. They indicated that delaying payment to supplier’s especially key suppliers of raw materials and utilities resulted in a risk of compromising relationships with suppliers hence chasing them away and finding it difficult to purchase raw materials on credit. This is supported by McLaney (2006), who states that stretching accounts payable may be financially attractive to the company but it raises an important unethical issue. It may cause the firm to violate the agreement it entered into with the supplier. Myers (2004) states that, clearly a supplier would not look kindly on a customer who regularly and purposely postpones paying for purchases.

## Effectiveness of Cash collection

The study also sought to find the effectiveness of cash collection at Hunyani Flexible Products as an avenue to effective cash management. From the study 30% of the respondents pointed that the cash collection policy was effective and the results seem to suggest that, cash inflows were brought forward as quickly as possible through pressing debtors for earlier payment. However, 70% of respondents indicated that, the policy was ineffective. They alluded that some debtors were in the 120 days ageing period therefore lengthening the average collection period. This is in agreement with Vanhorne (2001) who says that slow payments may be costly to the company and lengthen the average collection period. Inefficiency of some of the collection techniques were also highlighted as part of the causes. Popular collection techniques cited included letters, telephone calls and personal visits. This is supported by Gitman (2008), says that, the most popular techniques used in bringing forward cash flows are letters, telephone calls, personal visits and legal action. Respondents alluded that as part of their collection techniques they made telephone calls to the debtors and if they fail to respond on time the credit controller would make personal visits.

## Effectiveness of cash budgets

From the findings 20% of respondents indicated that, cash budgets were effective whilst 10% indicated that they were satisfactory. The respondents concur that at Hunyani Flexible Products, cash budgets are prepared on a monthly basis and on a departmental level and these departmental budgets are consolidated into one master budget. This is in agreement with Brealey (2005) who says that budgets should be prepared on a departmental level and these budgets should be rolled into one master budget. Respondents commented that these budgets are prepared basing on sales, costs, debtors ageing and creditors ageing as suggested by Moffet (2004). 60% of respondents expressed that cash budgets were ineffective as they sighted some deviations from the cash budgets. They indicated that, although budgets are prepared and implemented, they are just estimates and may not be exactly correct as evidenced by deviations of the cash budgets. This is in line with Vanhorne (2001) who said that cash budgets whether prepared on an annual, weekly or monthly basis are just estimates of cash flows.

## Cash operating cycle

From the findings 60% of the total respondents shows that, the cash operating cycle ranges from 120 days and above. Research results shows that Hunyani Flexible Products appears to have a lengthy operating cycle which is becoming costly for the company. The major problem they highlighted resulting in lengthy cash operating cycle was a longer lead time in the importation of raw materials from South Africa, slow production due to machinery breakdowns lengthening the work in progress conversion time and late cash inflows from debtors which lengthens the debtors' conversion period. This is supported by Stowe (2004) who says that, a lengthy cash operating cycle suggest inefficient cash management and a slow production process may lengthen the cash cycle.

## Impact of the cash management on the overall company performance

The researchers also intended to examine the impact of cash management on the overall company performance. In order to determine the efficiency of the cash management policy, the researchers carried out a cross sectional review of the company end of year cash flow statement and end of year accounts to assess the relationship between profitability and cash flow. As can be seen by diagram, it shows that as the level of cash flow increase from 10-40 also profitability increases by the same amount. When the company had a positive cash flow it was more profitable than when it had a negative cash flow. Research results showed that there is a positive relationship between the efficiency of cash management policies and practices and the overall business performance. This is in agreement with Bort (2004) who states that when the company has a positive cash flow it is more profitable than when it has a negative cash flow. The results are also consistent with a study carried out by Platt (2003) in Europe which sought to evaluate the impact of cash management on the overall company performance. Research results showed that there appears to be a positive relationship between the efficiency of cash management practices and the overall business performance. The results are also in agreement with a study carried out by Kamath (2009) in Asia. The study found that companies with very accurate cash flows forecasts appears to be more profitable that those with poor forecasting.

## RECOMMENDATIONS

In light of the above findings, the researchers proposed the following recommendations

- Hunyani Flexible Products management should embrace a 'total cash management' philosophy that is putting cash management at the heart of both business
- Strategy development and the operational decision making.

- Administrators should calculate the cash amount best suited for the level of activity, plan timing of relevant payments and collections and draw up a policy of investments in assets with high liquidity that can be converted in to cash allow transaction costs to serve as support for their funds maintained by the company.
- Cash collections should be closely monitored with the aim of accelerating cash inflows to speed up the collecting of accounts receivables.
- Cash disbursements should be also closely monitored with the aim of negotiating a reduction in cash outflows so as to reduce payments.
- Financial projections should be accurate inorder to project and forecast the amount of cash earned through business operations. Accurate forecasting should be based on a range of scenarios and risks so that the organization would be having an understanding of the key drivers of the cash position.
- Instilling a cash conscious culture is integral to maintaining a steady focus on cash. The company should employ a cash focus at the top communicating it throughout the organisation.
- The company should actively consider ways of shortening the cash operating cycle to make the company more generative. A cost benefit analysis should be performed to determine whether it is worthwhile to employ more resources, additional staff or new plant to speed up the production process and shorten the cash operating cycle.
- Clear policies for cash management including the investments of surplus funds needs to be established.

## CONCLUSIONS

Conclusively, the responses were indicative of higher deficiency of an effective cash management although some attributes of an effective management system are present at Hunyani Flexible Products. The research established that most suppliers demanded earlier payment and failure to meet the financial obligations by the company on time owing to cash shortages resulted in further supplies refused from the injured creditors. This extremely damaged the operations of the company especially when the raw material would be vital for the operations of the business. The study also revealed that customers delayed payments such that more cash would be tied up in debtors. The major cause which may be attributed to this is weak collection and credit policies. The study concludes that, the key to successful cash management lies in tabulating realistic projections, monitoring collections and disbursements, establishing effective billing and collection measures, and adhering to budgetary parameters because cash flow can be a problem to the business organization.

The study also concludes that, cash management is a culture that forms part of strategy of companies and it depends more on managers themselves than on the characteristics of the companies.

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