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On the financial management concept of "cash is the king"

Tongfeng Chen*, Wang Chang, Hu Fagang
Suzhou University School of economics and management city of Suzhou Anhui Province (CHINA)

ABSTRACT

At present, many Chinese enterprises lack well understanding on cash flow. They still attach great importance on profits while ignoring cash flow. However, a number of enterprises went bankrupt during this financial crisis. The direct trigger for bankrupt was enterprise' funds tension, which made cash flow couldn't turnover smoothly. Therefore, cash flow is extremely important for enterprise. This paper analyzes the status of cash flow in enterprise's financial management, and compares it with enterprise's accounting profits. It is pointed out that cash flow is more importance than profits in economic activities. It determines enterprise's value. It is proved again that, the financial management concept of "cash is he king" is a magic weapon which enables enterprises to successfully get through the financial crisis.

KEYWORDS

Cash is the king;
Cash flow;
Accounting profits;
Enterprise value.

CASH FLOW CRISIS

Modern enterprise is the combination of different interest groups, which is set up for profits. If enterprise earns no profits for a long time, it will be valueless to exist. Therefore, the main object of modern enterprise is pursing profits. Nevertheless, some enterprises with abundant "profits" doom to go bankrupt. The financial crisis exploded last year made lots of enterprises in China go bankrupt. The direct trigger of which was capital chain fracture, instead of accounting profit insufficient.

Some enterprises have experienced cash flow crisis since April, 2008. Taking CNPC (China National Petroleum Corporation) as an example, the net cash flow of CNPC was -44.91 billion in 2008, which was 76.89 billion less than the same period of the year before. Interest-bearing debt of CNPC was 125.59 billion in 2008. By the end of 2008, the total amount of liabilities had reached 347.05 billion, increased by 21.5% compared with the number at the beginning of the year, 285.58 billion. At the end of the same year, among the real estate companies listed in Shanghai and Shenzhen, there were 70 companies presented net outflows of cash, constituting 60.87% of the sample analyzed. Among the companies listed in Hong Kong, 18 companies had the same experiences, constituting 64.29% of the sample analyzed. It can be deduced that the overall situation of the listed real estate companies is: cash flow is quite in shortage. Although the real estate market has rebound with financial environment and financial conditions improved this years, the development trend of real estate market is still unclear; enterprises are still facing capital collecting pressures. Another example came from the airlines bankruptcy case in China—East Star Airlines bankruptcy case, which attracted much attention. East Star Airlines got into trouble of capital turnover from the beginning; the situation got worse because of the shock of financial crisis. Insufficient cash flow highlighted the problem of capital chain tension. Cash flow insufficient in this financial crisis has alerted people of the importance of cash flow, and left the biggest heritage to business world—reacquainting the concept of "cash is the king".

Therefore, it is far insufficient to measure enterprise's value with accounting profits. Enterprise's financial management idea should be transformed. "Cash is the king" is a constant truth. Moreover, the financial management idea of "cash is the king" has deeply rooted into people's hearts since the subprime crisis erupted. This kind of idea is the law of survival and magic weapon for enterprises to successfully get through financial crisis; it is also the core concept of enterprise financial management. It has been proved that cash flow determines enterprise's value, instead of accounting profits.

CASH FLOW—BLOOD FOR ENTERPRISES' ECONOMIC ACTIVITIES

The most concern of SASAC (State-owned Assets Supervision and Administration Commission) on state-owned enterprises is capital chain fracture. Therefore, SASAC has proposed the financial management concept of "cash is the king" since 2009. A clear requirement was put forward October, 2011 which was "In 2010, every state-owned enterprise should adhere to the financial management concept of 'cash is the king' during the implement of budget management. Enterprises should take cash flow management as the core and detail fund budget arrangement to efficiently locate enterprise's financial resource" This requirement further confirms the status of cash flow in enterprise financial management—it is the necessary blood for enterprise's economic activities.

In theory, enterprise's cash flow refers to the inflows and outflows of cash and cash equivalents during some certain periods, namely the income and spending of cash and cash equivalents. Enterprise's cash flow includes three specific concepts: cash inflow, cash outflow and net cash flow. In general, if the difference between cash inflow and cash outflow is negative, the enterprise is indicated that it cannot make ends meet, while a positive difference means good cash flow of the enterprise.

A CFO of Kodak company has ever said, "If there is no cash, an enterprise makes bankruptcy. It is cash that an enterprise should be based on. Bold investment could be made thanks to cash. In addition, cash is the criterion to measure an enterprise's power. Some enterprises could manipulate profits by some means, but no one can manipulate cash because cash is the cash." How important cash is. It can be said that cash is the king. Any enterprise cannot do anything without cash flow, for cash flow accompanies every economic activity of enterprise. For enterprises, sustained, stable and healthy cash flow is the important guarantee for their development, and it is the premise and key point for enterprise's survival. It is only when enterprise has sufficient cash, can it purchase production materials and labor, organize production activities, and create values for itself. On the other hand, bad management on enterprise's cash flow can lead to cash shortage and lack of ability to pay, which results in cash crisis and brings fatal blow or even bankruptcy. Just like examples coming from CNPC, listed real estate companies and East Star Airlines mentioned above. Of course, there are still lots of bankrupt domestic enterprises due to capital chain fracture. Hence, it is only when enterprise has sustained, stable and healthy cash flow, can it achieve long-term survival and development in the market.

There were still some enterprises realize the importance of cash flow before the financial storm struck, such as Vanke Group. Vanke first cut big price on a nationwide scale to guarantee sufficient cash. By the end of the first quarter, Vanke had held cash of 26.92 billion, increased by 34.8% compared with the end of last year. Only holding the cash in hands is the most secure. In the opinion of Li Jiacheng, a company can go bankrupt even it make profits; while it is not easy to go bankrupt if the cash flow is positive. To face the global financial crisis, Li Jiacheng, followed the "cash is the king" concept of financial management, which reduced the risks from crisis. Therefore, the wax and wane of an enterprise is tightly linked with its cash flow, and the cash flow, is of more importance than profit or loss.

CASH FLOW: THE MAJOR CRITERIA FOR EVALUATION OF ENTERPRISE MANAGEMENT

Generally speaking, there is a certain importance of enterprise accounting profit. In enterprise financial management, entire enterprise can improve the operating performance, optimize various ways and measures to enhance economic efficiency through the analysis of enterprise profits. And the profits of enterprise represent new wealth creation. The more profits, the more wealth the company increases, the closer to business goals. Therefore, enterprises engaged in the production and management is to make profits. However, the success doesn't depend on its generous profits. It is not necessary to make a successful career with generous profits, but will definitely succeed with 'cash flow'. Modern enterprises need not only profits but also 'cash flow'. people generally believe that 'cash flow' is more important if there is only one choice. The famous enterprise, Haier Group, gives high praise on cash flows. In its administrative rules, the 13th stipulation states: Cash flow is more important than profits. The management considers cash flow as an important criterion for the evaluation of business, showing that modern enterprises pay much more attention to cash. To make 'cash flow' as a significant criterion is mainly reflected in the following aspects.

The quality of enterprise's earnings can be truly reflected by 'Cash flow'

The concept of enterprise's accounting profits differs from that of cash flow. Accounting profit is formed through standardized accounting system by accountants in accordance with accrual accounting. It is just a book result. Although it's straightforward to make accounting profit as an indicator of measurement of enterprise's value, in some ways, it will lose its real meaning. For instance, the realized profits in most cases will include many items, such as account receivables and account payables. If those items can't be recovered for a long time, there is a certain degree of risk. Bad debt losses may occur. So that it is difficult to convert them into cash. It will not only affect normal production and business activities, but also distort the quality of enterprise's earnings, to some extent even endanger the life of those enterprises.

'Cash flows' is in accordance with the cash basis of accounting. It only confirms the actual receipt and payment of cash, but does not recognize the changes of rights and obligations, which can truly reflect the strength of enterprises. Corporate accountants will be easily influenced by others through wash sales, expanding the scopes of credit sales and other bad behaviors in order to manipulate profits and gain income. However, this kind of behavior can't lead to the increase in cash. Therefore, using 'cash flow' to reflect the company's revenue can avoid this kind of illegal behaviors. So using 'cash flow' makes up the defects that profits can't reflect the real profitability and more truly reports the quality of enterprise's earnings.

Cash flow is more indispensable than profits

An entrepreneur once said: 'Business is not necessarily bankrupt and liquidated if it is insolvent, but will certainly be on the way of death if there is no cash flow.' Therefore, without the support from cash, profits are just like fish out of water, it will dry up and die sooner or later. Cash is the necessary resources for an enterprise, which will fall into the dilemma of bankruptcy and liquidation if there is no cash flow.

Accounting profit is such a kind of wealth increased and accumulated through business production and activities. It is also a reflection from the process of production and operation activities. It is an accounting index, but without real sense of payment. Cash is the prerequisite for normal production and operation activities. Enterprises can only operating with cash, and can only achieve continuous running with cash profit. If cash flow breaks during the process of business activities, it will be like that human's hematopoietic function becomes disordered, even if profit-making enterprises can't survive. Their financial condition will eventually deteriorate, the consequences could be imaginable. So it is fictitious profits without cash flow.

Cash flow can show enterprise's solvency more forcefully

Profit can't reflect enterprise's solvency fundamentally. The operational cash flow based on cash basis isn't affected not only from the choices of corporate accounting policies and accounting estimates, but also from the impact of current asset cashability. Hence, it can directly reflect the practical ability to create cash from operating activities, and more accurately reflect the enterprise's ability to repay short-term debt relative to current ratio and quick ratio.

Cash flow can determine the value of enterprises more precisely

Investors, establishing business, aim at creating as much wealth as more, which firstly manifest as the value of enterprise. Cash is the monetary form of capital in enterprises. Its essence is appreciation. In the daily economic activities, monetary funds translate into non-monetary funds, then, back to monetary funds. This cycle process constitutes the funds movement and is in order to achieve added value of business. The goal of enterprise's cash flow is to create business value, which reflects the quality of enterprise's earnings, determines the viability of enterprises and supports those enterprises' market value. Therefore, enterprises should follow the superior financial management concept, 'cash is the king' to create more cash flow, and to create greater value to achieve the goal of maximizing enterprise value.

Enterprises seek to maximize its market value. Thus it can help operators to avoid pursuit of short-term benefits at the expense of long-term interests, to refrain from both irrational use of corporate resources and pursuit profit using short-term behavior. Therefore, enterprise's financial management goal is not to maximize profits, but to maximize enterprise value, making enterprises both profitable and more wealthy.

KEEPING "CASH" CIRCULATED

Currently, the financial crisis continues and the economic difficulties are still very large. In order to achieve its goal of sustainable development, every enterprise must make adequate preparations. They can't blindly concern profits. they should reject incorrect cognition of 'vital profits, light cash flow', pay more attention to the important role of cash flow in enterprise's financial management, increase overall understanding of cash flow and maintain adequate cash flow, which is conducive to the health of production and operation activities.

Cash flow is a vital lifeline to maintain enterprise existent and growing. It runs through all economic activities of enterprises, and is a cyclic process. For enterprises, 'cash flow' is essential, just like oxygen to humans. Usually, 'cash flow' is generated by business activities, investing activities and financing activities. Therefore, in order to maintain cash circulated, operators can generally take the following measures:

(1) Strengthen the management of operating cash flow. Cash flow generated from operating activities mainly records the status of cash flow in purchase and sale of goods, services, and other activities, reflecting company's own feature of 'hemopoiesis'. Only there are 'hemopoiesis', enterprises can continue to survive and operate, and on this basis to invest and expand business. However, if the enterprise's 'hemopoiesis' is weak, and relies solely on financing, it is difficult to maintain normal operation, and just let investment activities alone. Enterprises will go toward extinction step by step. Therefore, strengthening the management of operating cash flow is a good premise and foundation of excellent cash flow management of investment and financing.

There are mainly two aspects to strengthen the management of operating cash flow: (1) Improve capital efficiency. In order to avoid wasting and idling cash, operators should use a variety of cash management tools to improve the rate of return of cash flow. And implement funds central management, put the using principle of funds, which is 'time is money, speed is life', into effect. (2) Establish and improve the internal management of cash flow. That is to accelerate the flow rate of cash and to ensure the smooth flow of cash. Operators should make great efforts to management of cash payments and accounts payables, delay time of payment to the greatest extent by using credit period, making funds on hand be fully utilized; then do well in inventory management, accelerate inventory turnover, and reduce the occupancy of stock funds as much as possible; What's more, strictly determine the administrative measures of accounts receivables, timely collect them, establish credit approval system to make risk of bad debts controlled at an acceptable level, reasonably withdrawing bad debt reserve of accounts receivables, accelerate rate of capital turnover, and shorten turnover time of accounts receivables.

(2) Strengthen the management of investing cash flow. Cash flow from investing activities is a kind of 'exchange of blood transfusion'. Company's investing cash tends to flow in two directions, one is fixed assets, intangible assets and other long-term assets, and the other is equity and debt investments. En-

terprises should choose investment projects that are small investments, can produce the desired result quickly, and gain bigger economic returns. Then adjust the structure of the source of funds, making a reasonable proportion between debt funds and equity funds. Accordingly, investment funds will withdraw from circulation as quickly as possible, and provide long-term stable cash flow for enterprises.

(3) Strengthen the management of financing cash flow. Financing has the function of 'transfusion'. When the amount of business investment exceeds net cash inflow generated from operating activities, company must deal with it as such a way of financing. Enterprises borrow funds mainly through the absorption of investment from investors or the rational use of commercial credit and bank credit. It is commendable to increase the enterprise's disposable cash flow, but should minimize the cost of financing, and control the scale of funding according to enterprises' abilities.

In short, the concept of financial management, 'cash is the king', should make the survival at first. Ensure that cash flow required by all economic activities is adequate. Development is the second. This requires companies not only to recognize the importance of cash flow, but also to do a good job of risk management of cash flow, capital turnover and so on, to ensure unobstructed business capital chain, enabling businesses to better operate and develop, finally arriving at an invincible position.

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