

Short-Term Financial Planning for Small and Medium Sized Enterprises

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Abstract:

Short-term financial planning is one activity that concerns everyone in business. In this work paper we will try to illustrate such planning demands, among other things, sales projections from marketing, cost numbers from accounting, and inventory requirements from operations.

Keywords: SME, short-term finance, investments, assets, costs, long-term finance

The policy that a small and medium sized enterprise (SME) adopts for short-term finance will be composed of at least two elements:

- the size of the SME's investment in current assets: this is usually measured relative to the SME's level of total operating revenues. A flexible or accommodative short-term financial policy would maintain a high ratio of current assets to sales. A restrictive short-term financial policy would entail a low ratio of current assets to sales.
- the financing of current assets: this is measured as the proportion of short-term debt to long-term debt. A restrictive short-term financial policy means a high proportion of short-term debt and more long-term debt.

The Size of the SME's Investment in Current Assets

Flexible short-term financial policies include:

- keeping large balances of cash and marketable securities;
- making large investments in inventory;
- granting liberal credit terms, which results in a high level of accounts receivable.

Restrictive short-term financial policies are:

- keeping low cash balances and no investment in marketable securities;
- making small investment in inventory;
- allowing no credit sales and accounts receivable.

Determining the optimal investment level in short-term assets requires an identification of the different costs of alternative short-term financing policies. The objective is to trade off the cost of restrictive policies against those of the flexible ones to arrive at the best compromise.

Current asset holdings are highest with a flexible short-term financial policy and lowest with a restrictive policy. Thus, flexible short-term financial policies are costly in that they require higher cash outflows to finance cash and marketable securities, inventory and accounts receivable. Future cash inflows are highest with a flexible policy. Sales are stimulated by the use of a credit policy that provides liberal financing to customers. A large amount of inventory on hand provides a quick delivery service to customers and increases in sales. In addition, the firm can probably charge higher prices for the quick delivery service and the liberal credit terms of flexible policies. A flexible policy also may result in fewer production stoppages because of inventory shortages.

Managing current assets can be thought of as involving a trade-off between costs that rise with the level of investment and costs that fall with the level of investment. Costs that rise with the level of investment in current assets are called *carring costs*. Costs that fall with increases in the level of investment in current assets are called shortage costs.

Carring costs are generally of two types. First, because the rate of return on current assets is low compared with that of other assets, there is an opportunity cost. Second, there is the cost of maintaining the economic value of the item(ex. the cost of warehousing inventory belongs here).

Shortage costs are incurred when the investment in current assets is low. If a firm runs out of cash, it will be forced to sell marketable securities. If a SME runs out of cash and cannot readily sell marketable securities, it may need to borrow or default on an

obligation. If a SME has no inventory or if it cannot extend credit to its customers, it will lose customers. The two kinds of shortage costs are:

1. trading or order costs: order costs are the costs of placing an order for more cash (brokerage costs) or more inventory (production setup costs).
2. costs related to safety reserves: these are costs of lost sales, lost customer goodwill, and disruption of production schedules.

Figure 1 illustrates the basic nature of carrying costs. The total costs of investing in current assets are determined by adding the carrying costs and the shortage costs.

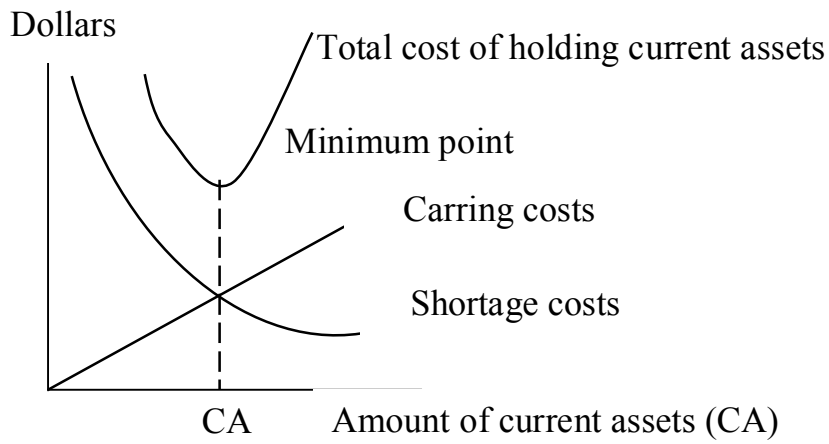
The minimum point on the total cost curve (CA) reflects the optimal balance of current assets. The curve is generally quite flat at the optimal, and it is difficult, if not impossible, to find the precise optimal balance of shortage and carrying costs. Usually we are content with a choice near the optimum.

If carrying costs are low or shortage costs are high the optimal policy calls for substantial current assets. In other words, the optimal policy is a flexible one. This is illustrated in the second graph of figure 1.

If carrying costs are high or shortage costs are low, the optimal policy is a restrictive one. That is the optimal policy calls for modest current assets. This is illustrated in the bottom graph of the figure 1.

Opler, Pinkowitz, Stulz and Williamson examine the determinants of holdings of cash and marketable securities by publicly traded SME's. They find evidence that SME's behave according to the static trade-off model described earlier. Their study focuses only on liquid assets so that carrying costs are the opportunity costs of holding liquid assets and shortage costs are the risks of not having cash when investment opportunities are good.

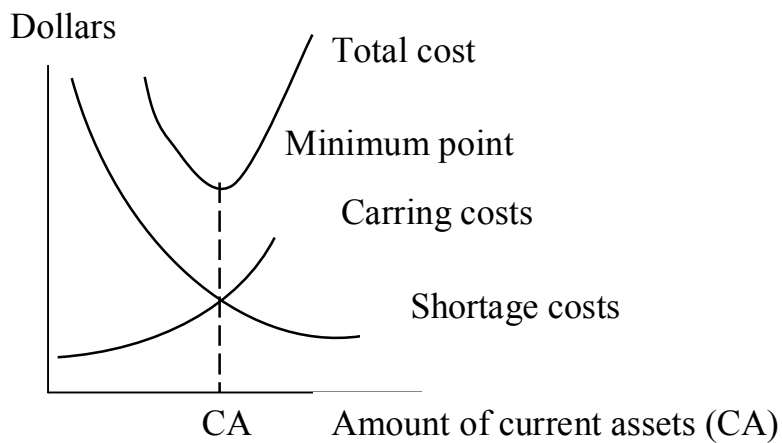
Carrying costs increase with the level of investment in current assets. They include both opportunity costs and the costs of maintaining the asset's economic value. Shortage costs decrease with increases in the level of investment in current assets. They include trading costs and the costs of running out of the current assets.



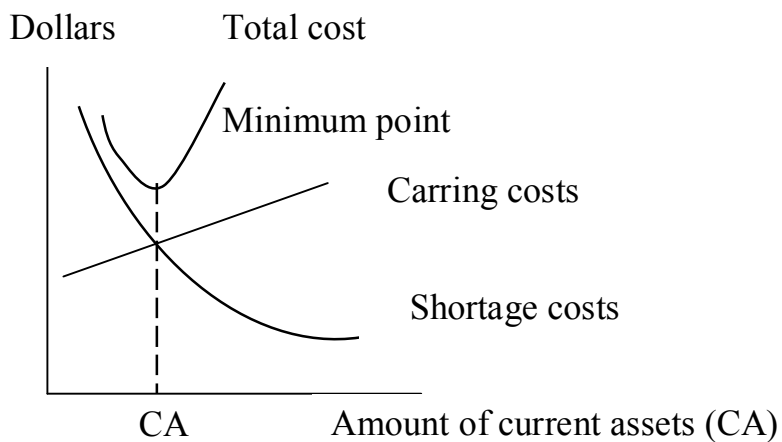
The optimal amount of current assets. This point minimized costs

Figure 1 – Carring Costs and Shortage Costs

Flexible policy



Restrictive policy



Alternative Financing Policies for Current Assets

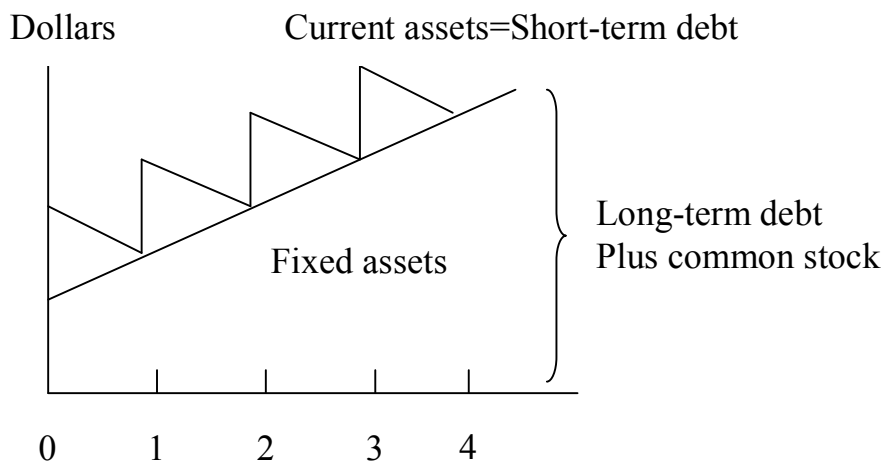
In an ideal economy short-term assets can always be financed with short-term debt and long-term assets can be financed with long-term debt and equity. In this economy, net working capital is always zero.

Imagine the simple case of a grain elevator operator. Grain elevator operators buy crops after harvest, store them and sell them during the year. They have high inventories of grain after the harvest and end with low inventories just before the next harvest.

Bank loans with maturities of less than one year are used to finance the purchase of grain. These loans are paid with the proceeds from the sale of grain.

The situation is shown in Figure 2. Long-term assets are assumed to grow over time, whereas current assets end at zero just before the next harvest. These assets are financed by short-term debt and long-term assets are financed with long-term debt and equity. Net working capital (current assets minus current liabilities) is always zero.

Current assets cannot be expected to drop to zero in the real world because a long-term rising level of sales will result in some permanent investment in current assets. A growing SME can be thought of as having a permanent requirement for both current assets and long-term assets. This total asset requirement will exhibit balances over time reflecting (1) a secular growth trend (2) a seasonal variation around the trend and (3) unpredictable day-to-day and month-to-month fluctuations.



In an ideal world net working capital is always zero because short-term assets are financed by short-term debt.

Conclusions:

The flexible financing strategy implies surplus cash and little short-term borrowing. This strategy reduces the probability that a SME will experience financial distress. SME's may not need to worry as much about meeting recurring short-term obligation. However, investments in cash and marketable securities are zero net present value investments at best.

Most SME finance inventories with short-term bank loans and fixed assets with long-term financing. SME's trend to avoid financing long-lived assets with short-term borrowing. This type of maturity mismatching world necessitate frequent financing and is inherently risky because short-term interest rates are more volatile than longer rates.

Short-term interest rates are normally lower than long-term interest rates. This implies that, on average, it is more costly to rely on long-term borrowing than on short-term borrowing.

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