Chapter 5

Cash Flow Management

Chapter Objectives

Students must be able to:

- Explain Why Cash Flow Management is Important.
- Explain What are Key Principles to Cash Flow Management.
- Understand the Dangers of Debt and How to Keep It Under Control.
- Explain How to Get Out of Debt.
- Explain the Decision Making Process as Regards Buying and Renting.
- Explain the Pitfalls of Borrowing to Invest.
- Understand the Use of Leverage.
- Explain the Budgeting Process.
- Explain the Need to Keep Proper Records.

Chapter 5

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Introduction

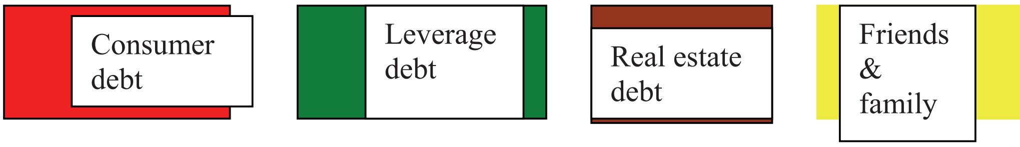
One of the most important components of financial planning is personal financial management which has cash flow management as its most crucial activity. Managing the money you have and will acquire during your working life is critical to achieving your financial objectives. Cash flow management affects both the rich and the poor. Living within your means or optimizing your cash flow will result in a trouble free life. Omitted life will show its harsh realities. Even people earning good incomes can benefit from efficient cash flow management.

However, cash flow management is vital for those with smaller incomes so that the efficient use of cash allocation will bring at least some of their goals into reality. As was stated in chapter one the pressure on people to spend beyond their means is very high. Keeping up with the Joneses or Johans if you will in Malaysia, and buying into wants instead of needs will put pressure on their limited income. With many rich people displaying their wealth, the not so fortunate are caught up in a snare trying to keep up with them. This desire has also encroached into their children where schoolmate pressure for the same things has put a heavy burden on the parent’s budget. The “kiasu’ effect on children has practically destroyed the children’s youthful exuberance for fun and games. Mothers are busy shuttling their kids to tuition, music and more tuition. No wonder sport is dying in the nation. It is also a sorry state to see playing fields turned into building grounds. The cash free life of sports and outdoors activity has been replaced by the more expensive computer games, play stations and spectacles.

How do people afford these additional expenditures? Credit of course. People leverage on their income and borrow using credit cards. The credit card allows them to borrow twenty times their income as the minimum required payment is only 5%. To add to their woes they indulge in more than one credit card. The problem is that the expenditure splurge is on consumer items. They do not provide an investment yield but a consumption yield. At the end of all the spending there is no asset to show for it. Therefore the abuse of credit should be halted and credit use must be for the right reasons and used beneficially. There is a need for a credit card in today’s internet world but the correct application of credit cards is essential to stay on track of achieving all your goals.

Credit and Debt

Debt has many colors according to some financial planners. Red is identified as consumer credit which is a consumption debt. Green debt is the good one used to leverage investments that will add value or grow your net worth. Then you have the brown debt that is mortgage debt or real estate debt. Yellow debt is friends and family debt which can hardly be collected. Perhaps you can have a grey debt when you stand guarantor for some loans.



Credit has a function. It will be impossible to purchase a residence or a motor vehicle without incurring debt. Due provisions must be made to make these payments from your existing cash inflow. These are the most common assets purchased to have an ordinary life. But the decision factor has a high degree of variability here. You can buy a high end car or a medium to low end vehicle. You can buy a medium cost house or apartment or a bungalow. Your level of income will decide your purchase. However it must be comfortable. Otherwise you will be always balancing your cash flow to meet these fixed commitments.

Credit Cards – A Financial Tool or Debt Trap

Credit cards are considered a financial tool. They allow payments through internet on-line services. They provide for cash-less transactions which are considered safer. Overseas travels are safer and more convenient because payments can be made using the credit cards. There is no need for currency exchange and you avoid carrying cash which can be lost or stolen easily. Of course you stand the risk of losing your credit cards. But the recovery or cancellation can be quite immediate unlike the loss of cash. Today of course the ATM world has made the need to carry foreign exchange unnecessary. You can withdraw in foreign currency using your ATM cards.

Some even use credit cards for the recording function of purchases and expenses. The credit card companies provide details of money spend which can be convenient but it is all at a cost. It is common for the Inland Revenue Officers investigating a case to examine the credit card statements to evaluate the individual’s spending habit and ability to make payments to gauge a person’s real income.

Credit cards are very useful to make immediate payments when your cash flow is irregular or when your check is in the mail. Emergency use of credit is perhaps the best reason for owning a credit card but this should not turn into a dependency. The setting up of an emergency fund is preferred to using a credit card for emergency use. There are various justifications for having a large line of credit available to take advantage of business opportunities. Timing is of the essence, they say. A credit line is therefore very beneficial at times. However, the problem is paying back. Even credit card companies have been asked to demonstrate to cardholders how long it takes to pay back credit if the minimum payment scheme is followed. We do not have relevant statistics but how many households have the required three to six months emergency fund. The popularity of credit cards tells the real story of human behavior. Finance companies cite credit card business as an important business segment accounting for one of the largest growth sectors.

It would be difficult to control overspending with credit cards. Impulse purchases and buying based on wants and desires rather than needs will dominate buying behavior. Credit card companies offer credit for a good reason. The interest charged is very high amounting to 18% per annum. Using the rule of 72 the banks and finance companies are doubling their money every 4 years. On the other hand by offering less than 4% to deposit holders, the savers are doubling their money every 18 years. RM 5,000 becomes RM 10,000 in eighteen years. Of course there are risks associated with lending on credit card or no collateral basis. However, one can try to be late and see the whole recovery machinery reigning down on you. The banks have established debt recovery administration systems that can be quite intimidating. Credit card abuse is therefore happening at the consumer level and at the financial intermediary level. We need to keep all things under control.

An interesting definition of control is the ability to start something, continue its use and the ability to stop its use. If you want to borrow using a credit card you should have the ability to borrow, make payments and stop the credit by completing the repayment. It would be better to keep the balance zero at the end of each month. This way you can utilize the interest free period offered by credit card companies.

This definition of control can be applied in many other circumstances. If you started a habit of gambling, and are continuing it the problem gets bad when you are unable to stop the gambling habit. A brief adventure into something non-optimal like drinking is only bad if you cannot stop the habit. People start with the idea that a couple of glasses won't hurt but end up drinking everyday. They have no control because they are unable to stop. The ability to start, change and stop and completing cycles are important habit patterns.

Slaying the Credit Card Debt

Local author and financial planner Rajen Devadasan had written a book' "From debt slavery to money mastery" that focused on ways to get out of debt. Firstly you have to understand your predicament. Write down all your debts in detail, who, the amount, due date and penalties for late payment. Then he recommends slaying the highest costing debt first. As an alternative you can target the lowest debt to get the good feeling of gaining control over your debts. You have started addressing your debt situation. If it is credit card debt the best approach is to pay down as large an amount as possible and stay with that fixed amount for the remainder of the term. This way the debt will be liquidated very quickly. The revolving loans of shorter duration are the more expensive loans. Credit card debt is 18% per annum while mortgage loan is less than half that amount. Auto loans are different cattle of fish and will be addressed later in this chapter. Sometimes it is good to consolidate all the loans into one long term loan. A second mortgage loan can be used to settle the expensive credit cards as long term borrowing is more beneficial to the borrower. Handling debt requires tightening your belt very seriously and becoming consumer debt free has its benefit from the point of view of personal self-esteem and morale. It is an important requisite for retirement. Being debt free before retirement is on everyone's mind.

The author of the book "The Richest man in Babylon" had written a classic from many angles. His take on handling debt is worthy of emulation by all lenders. He said you should negotiate your debt with all concerned. You must continue to save your ten percent for retirement and you need 70% for survival to keep your family fed, clothed and sheltered. The remaining 20% you use to pay everybody on a consistent, fair and proportionate basis. This book was written in 1926. The moral of the story is not to kill the goose that lays the egg. Only if the borrower keeps on surviving can he meet his obligation. I wonder how much of this wisdom is applied today.

Who is Given Credit?

Financial intermediaries or lenders do a credit evaluation before offering credit. The principal areas of observation are as follows:

1. Character or past history

How punctual a payer are you? Have there been instances of non-payment? Honesty and reliability is evaluated.

2. Capital position.

Obviously net worth counts for your borrowing ability. A lot of assets reflect your solvent situation. Banks are notorious for offering you an umbrella when it is sunny and bright but calling back the umbrella when it is raining. In the first place it is interesting that someone should borrow when they have enough assets in their ownership. That is another issue. But the more assets you possess the more the banks are willing to lend you. Someone in need of capital but with no capital to show will have a hard time borrowing. Facts of life.

3. Capacity to pay

Your income position is vital. Lenders are keen to see free income to meet new financial commitments. They would like to be assured of stable income or continuity of employment or business.

4. Collateral

Collateral or property pledged as lien will assure the lender of asset backing in case the borrower has difficulty paying the loan. Good security ensures not only the loan but may even offer lower cost of borrowing.

5. General economic conditions

The state of the economy will reflect the lending environment. An economy doing well will have everyone very positive and banks and borrowers thrive. A liquidity or banking crisis will have everyone running for cover. Right now in early 2008 the USA is experiencing the effects of sub prime lending crisis. This has caused the banks to tighten the grip on lending. Sometimes the reaction is too severe so much so that even borrowers with good standing are denied loans. The supply of money is an important factor that affects liquidity and economists monitor this to determine the inflationary impact of the supply of money.

Right now (April 2008) the lending climate is still healthy. The base lending rate is 6.75% and Bank Negara's overnight policy rate has been maintained at 3.5% over the last two years. Every major bank and finance company is promoting easy credit. However, whether the big business loans are common is difficult to say. We do not have a special index to monitor the issuing of various types of loans. In this climate people may wonder if borrowing is a good idea. Insurance companies are offering fixed term loans for long periods of time.

Islamic finance is also gathering momentum. They employ a fixed profit sharing rate over long periods of time. It makes sense to lock in at low levels of interest rate for long periods of time. Further inflation is a friend of long term borrowing. When you make equal payments over the long term you are using depreciated ringgit to make your loan repayment. This is provided your borrowing is based on fixed interest rate. Most banks also use adjustable interest rates.

Types of Credit

Revolving credit

There are a variety of credits offered by banking institutions. We have explored credit card loans. They and overdrafts come under the category of revolving credit. You have a line of credit available which you can pay up and re-borrow. They may require a certain minimum payment over a specified term but they allow the credit to revolve.

Installment credit

Installment credits are fixed term loans which require you to liquidate the loan on an installment basis. We call this amortization - paying up the principal and the interest over a stated number of periods or installments. Housing mortgages are the most common type of installment loans. The houses act as collateral or as a lien to the lenders, who can sell the collateral if the borrower defaults on the loan.

Mortgages will either have a fixed rate of interest or a variable or adjustable rate of interest. Depending on the capital liquidity situation adjustable rates will vary with economic circumstances. Banks will quickly raise interest rates if the money market tightens. But because of competition rates are kept low or at market levels. Furthermore Bank Negara is there supervising the situation. Banks can collude to keep rates artificially high. The presence of Bank Negara as a lender of last resort keeps interest rates at the right level. But Bank Negara can only influence the short term rates. Market forces will dictate the long run equilibrium interest rate.

Car Loans

In Malaysia car loans are offered by finance companies on a simple interest basis. This means the interest rate is charged on the original principal loan amount over the number of years. If you take a RM 100,000 car loan at 5% interest rate over 5 years, the loan interest is 5% of RM 100,000 i.e. RM 5,000 * 5 = 25,000. The total interest 25,000 is added to the loan amount of 100,000 and the 125,000 total is paid over 60 installments of RM 2,083. The 5% simple interest rate when expressed as an annualized percentage rate becomes 9.5%. It is taking a long time for Malaysians to demand for mortgage type car loans. The banks have perhaps lobbied Bank Negara for the continuation of this basis due to the higher risks involved. But we must be aware that the low percentage interest rate offered on car loans does not tell the whole story. Some countries have made it a law to state the annualized percentage rate to borrowers when they apply for such loans.

Another difficulty is early repayment. Finance companies employ the Rule of 78 by which most of the interest is charged up front and so the rebate on early payment is much lower than it otherwise would be. This makes it not profitable to settle car loans at the later stage, two or three years before full settlement. It is at precisely these times that borrowers are tempted to settle. They either are anxious to buy a newer car or have some extra cash to settle this liability. Financial planners would have to advise otherwise.

Long Term or Short Term Loans

A common question asked is should one go for longer term loans or for shorter durations. The answer depends on your financial circumstances. Shorter the term the lower the overall interest cost. The longer the term the higher the interest cost, but the monthly payment will be slightly lower. However, on balance, the lower payment does not justify the extra interest cost. Banks charge interest on the borrowed amount on a daily basis and extending the loan does little to bring the monthly payment down. Therefore if the borrower can afford it he must keep the term as short as possible. It is expedient to keep the term to less than 20 years.

Overdraft types of loans or balloon or bullet repayment loans are common for businessman. There is greater risk with these types of loans and it is not recommended for the common man. It is quite logical to think that the longer one postpones the repayment the better the financial arrangement. You have a longer opportunity to use the money and you pay back in depreciated ringgit. But you will need a lump sum when the payment is due. Only business owners and investors can turn up lump sum money when required. Employees are better off amortizing their loan. They should pay down the principal as they go along.

To Buy or Lease Properties

This is a typical decision making area. Should one rent or buy? As usual the answer depends on the financial circumstance of the person. The financial environment and the individual’s personality all have a factor to play. Income is the main determinant of these questions. To rent will of course be cheaper, but you will not be the owner of the asset. It is hard to accept that after all those rent payments you will not own the asset. In retirement you will need a residence and it will be sad if you are still renting your premises.

Buying properties has been made very convenient. Your down payment is usually less than 20% and in most situations it is about 10%. The collateral of the house allays the fears of the banks and therefore you are most likely to get a loan. The rent you would otherwise pay a landlord is now being applied to the mortgage payment. At the end of the twenty odd years you become the owner of the asset. Where the rent is close to the mortgage payment it is best the individual buys the asset. If the rent is but one-third of the mortgage then perhaps there is reason for a low income earner to rent the premises.

Most often premises are rented because of the location. The person may have an ideal retirement location in a different place from his current working environment. Sometimes the place needed for a growing family is larger than is normally required. So a person may wait until his retirement to buy his own place. However with inflation at its current level and with no sign of abating it is best for the individual to put some money on any property so that he can have an asset hedging against inflation. Even if his ideal property is inflating his current asset can provide some cushion. Postponing purchase will not be good unless the inflation and interest rate are in your favor.

The biggest reason to buy will be the investment potential of the property. If the property is rented out the rent can be used to meet mortgage payments. In the end with just the down payment the owner is able to own 100% of the asset after twenty years. The person who paid the bank is not him but the tenant. The best location will earn the best rental. Therefore the choice of location is important. With population exploding exponentially the demand for houses will always move in tandem.

The rental income will be shielded from tax because of the expenses allowed against the income. The interest expense and repairs are allowed as deductions against the income. It is also realized that properties have a low correlation with other investment assets and therefore provide a good avenue for diversification.

Therefore buying your own property has a stronger basis than renting. However, the caveat it all depends on the individual circumstances applies.

To Buy or Rent a Car

Renting a car may make more sense than renting a house if the cost justifies it. Today car rental agencies have the very short term renter in mind. Therefore just like credit card debt the car rental is very expensive. However, if there is available a situation of long term car rentals than perhaps there can be a case for renting a car. Cars are depreciating assets. That is why finance companies use simple interest and cost the whole period interest to the repayment.

The realistic situation is that easy finance is available for everyone to avail themselves of car loans. Once committed it is perhaps better to complete the term of the finance. There is very little benefit to settle the loan as your rebate follows the Rule of 78 which is not beneficial to the borrower.

Should You Borrow to Invest?

Individuals are sometimes faced with the question of whether they should borrow to invest. The simple answer to that question will be, it all depends. In most situations the cost of borrowing is known but the return on investments is uncertain. If a person is confident that the investment will offer a higher rate of return than the cost of the borrowing than perhaps borrowing to invest is justified. However, given the cost of transactions and the very little margin between cost and return it seldom makes sense to borrow and invest in standard types of investments like mutual funds. Leverage for property investment makes sense for the reasons explained earlier. However, for unit trust and bond investments the margins are too little to bother too much.

A detail cost benefit analysis for Amanah Saham Bumiputra reveals that the advantage is slight. The government linked agency can offer higher returns than the cost of borrowing but the margin is still too slim. Unless the spread between borrowing cost and return is at least 3% there is very little advantage.

How Much Debt Should Be Acceptable?

This is critical for financial planners to solve. Leverage can be good or bad. It is said that a rich man is usually comfortable with borrowing and enhances his wealth by borrowing. Being rich also allows him greater freedom to borrow as his income can support his borrowing. Leverage when it turns right magnifies your rate of return. On an equity basis borrowing magnifies your return. However there is a financial risk because the interest expense must be paid first. But the total return of the investment belongs to the owner and not the lender. Therefore a person may only have 20% equity on an investment like property but 100% of the return on the investment goes to him. The lender only receives the fixed interest payment. Capital gains go to the equity owner. Therefore it is good to develop a healthy attitude to leverage. Most rich men do. However, consumer debt is a hallmark to remain a slave to society. Life must be balanced between current satisfaction versus future and greater consumption. Delayed gratification allows your money to work for you. Capital is king. Savings is the most common way to accumulate investment capital.

In the final analysis the poor must improve their income position. Risk propensity or risk tolerance does not have the income bias. Rich and poor can be risk averse or risk tolerant. There is no clear evidence of risk preference between income groups. Therefore income generation is the critical factor for financial independence. You must have sufficient income to allocate to savings and investments. You can only leverage and use borrowing to good effect if you have sufficient income to support the borrowings. But given your income and risk tolerance good financial decisions can make the difference between reaching your goals and living an unfulfilled life.

Budgeting

The budget is a planning tool that projects anticipated cash inflows and outflows into the future. It takes into account historical cash flows adjusted for planning inputs. Budgeting has good intentions. You would like to control your expenses and therefore you would like to budget your expenses. If you are disciplined enough you will not spend more than the budgeted amount. You put a lid on how much you will spend on each specific item of expenditure. Of course budgets will work within the income or cash inflows expected for the relevant period. The government will allow for a deficit budget to stimulate the economy. When an individual budgets for a deficit he is planning to stimulate his consumption desire. The success of budgeting depends on the discipline and the level of desire to trim expenses and save for longer term objectives like education funding and retirement funding.

Budgeting allows for monitoring cash shortages and timing differences. But in financial planning its best use is to generate savings that can be better utilized into savings and investments.

Budgeting starts with established goals. Once a goal has been set the allocation must be made. The budget must allocate the scarce resources to the various objectives. This process will also make the person determine his priorities. The goals must differentiate between short, medium and long term goals. The budget will first address the short and medium term goals. However it is important to distinguish between urgent and important. Very often what is urgent may not be important. Steven Covey called it the quadrant 2 activity, not urgent but important. Planning is predominantly in this area as financial planning is not an urgent activity but vastly important.

An important pre-requisite for budgeting is recording of expenses and income. This in itself is a useful exercise. Only after tracking your expenses can you rein it in. It then follows that you re-allocate your cash inflow between current consumption and future goals. The construction of the cash flow statement is paramount for this exercise.

<u>Budget Implementation</u>

It is difficult to implement something new. Steven Covey and many other human development authors have suggested that to form a good habit you have to practice for at least 21 to 30 days. Once you have a budget you have to scrutinize it and follow it for at least 30 days. Perhaps when we are talking about a lifetime of saving we should at least follow it for three months.

Envelope system

To provide better discipline a visual and practical step would be put into different envelopes the budgeted amount of expenditure for each item of expenditure. So during the month you will know when the budgeted amount is up. From then on it is a judgment call if you want to spend more. If only life is that simple.

<u>Where Does Our Money Go?</u>

It will be illuminating to find where our money goes. It is also good to monitor the rate of inflation for each item and if your consumption items follows that of the Statistics department's basket of goods. This would establish your personal inflation rate. The Consumer Price Index is sometimes artificially low. You have to draw your own rate.

Monitoring is vital to achieve your objectives unless you generate so much income that it does not matter. Budgeting must be flexible. But a little leniency can throw the whole scheme out of gear. It takes discipline to budget and follow it.

Conclusion

Cash flow management cannot be overemphasized. Achieving goals cannot be undertaken without constructing a true and accurate cash flow statement. Budgeting will allow the proper allocation of cash flow according to priorities. Savings and investments to meet objectives must come from additional income or saved expenditures. It is often the expenses that can be saved to put into savings and investments. There are of course tax strategies that can help achieve better after tax cash flows. But the biggest target in modern times is getting rid of consumer debt and channel the interest and principal paid into worthwhile goals and objectives.

Self Assessment

1. The following words describe the term ‘credit’ except:

   A. leverage

   B. borrowing

   C. collateral

   D. gearing

2. The following are criteria used by lenders except:

   A. income capacity

   B. net worth

   C. collateral

   D. necessity

3. Which of the following statement(s) is/are true?

   I Credit card debt is an example of an installment type credit

   II The most common type of long term installment credit is the housing mortgage

   A. I only

   B. II only

   C. Neither

   D. Both

4. Which of the following ratios indicate a weak debt position?

   A. A debt service ratio of 0.5

   B. A debt to asset ratio of 0.5

   C. A debt service ratio of 0.3

   D. A debt to asset ratio of 0.3

5. A realistic goal setting in the budgeting process would involve the following steps except:

   A. quantifying each goal
   B. establishing the optimum amount based on want
   C. establishing the time frame
   D. allocating the required amount based on the budget

6. The following items are likely to be part of a budget, except:

   A. total assets
   B. regular savings and investments
   C. insurance premiums
   D. increase in expected income

7. All the following represent the Rule of 72 applications except:

   A. RM 5,000 becomes RM 10,000 in 7.2 years if interest rate is 10%.
   B. RM 4,000 reduces to a purchasing power of RM 2,000 in 18 years if inflation is 4%.
   C. RM 6,000 becomes RM 12,000 in 10 years if investment rate is 7.2%.
   D. RM 8,000 is reduced to a purchasing power of RM 4,000 in 10 years if inflation is 10%.

8. The following statements regarding Amortization are correct except:

   A. Amortization is the process of paying off a mortgage by making periodic payments
   B. Each amortized payment includes a principal and interest portion.
   C. The interest portion is highest at the beginning
   D. The monthly payment of a 10 year mortgage is reduced by half if the term of the loan is extended to twenty years.

9. The following are reasons why someone would choose to rent instead of buying, except:

   A. It is easier to move to and from a rented premise

   B. Renting has fewer headaches

   C. The difference between rent and mortgage payments can be invested more advantageously

   D. There are more tax advantages to renting than owning a property.

10. The following are ways to get out of debt faster except:

    A. Pay down more than the minimum required

    B. Settle the credit over a longer period and use the difference in a savings account

    C. Pay a fixed amount instead of a fixed percentage

    D. Settle the credit that has the highest interest rate first.

Answers: 1- C, 2- D, 3- B, 4- A, 5- B, 6- A, 7- D, 8- D, 9- D, 10- B