CHAPTER 1:
INTRODUCTION

In a “perfect” world, there would be no necessity for liquidity. In such a world, there would be no uncertainty, no transaction costs, information search costs, scheduling costs, or production and technology constraints. The unit cost of producing goods would not vary with the amount produced. Firms would borrow and lend at the same interest rate. Capital, labour, and product markets would reflect all available information and would be perfectly competitive. In such a world, a firm does not have any advantage to invest in short run.

But the world in which the firm is to function is not perfect, it is characterized by uncertainty, transaction cost, information cost, variability of cost associated with producing goods for sale. Firms are also facing limitation to use production capacity and technology. These real world characteristics introduce problems to the firm to deal with.

In a dynamic economy, active or latent threats to and opportunities for the business originate with some kind of change: change in consumer behaviour, technology, competitor action, or change within the business itself. Usually, where change is anticipated, the threat can be avoided and the opportunity can be seized. Since it is important to ensure that all change is anticipated change (Marques, Maria Manuela Farelo Athayde, 1988). Cash and liquidity management has become more important than ever before. Companies are realizing that it is difficult to maintain adequate cash flow and profit margins in a global economic crisis.

The credit crisis has driven an exceptional reduction in the availability of external liquidity sources, which results that most corporate giving their liquidity management strategy high priority (Webb Andy, 2010). Now corporate financial management has given priority to maximize corporate value while reducing the

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1 http://theses.gla.ac.uk/2065 University of Glasgow
2 http://www.corporatetreasurynews/cash/Multinational Corporate treasurers: Liquidity decision-making at-the sharp end
firm's financial risks. Reasons behind it are economic recession, corporate restructuring activities, and to finance more modern facilities.

Liquidity risk management is of paramount importance because a liquidity shortfall at a single institution can have system-wide repercussions (According to Basel Committee on Banking Supervision, 2008). Financial market developments in the past decade have increased the complexity of liquidity risk and its management.

Liquidity is the ability to meet expected and unexpected demands for cash through ongoing cash flow or the sale of an asset at fair market value. Liquidity risk is the risk that at some time an entity will not have enough cash or liquid assets to meet its cash obligations. The most striking example of loss due to this risk is a run-on-the-bank event that causes an institution to fail. This type of event hit banks during the Depression when too many customers demanded to have their money paid immediately in cash and that demand exceeded cash reserves (According to Report of the Life Liquidity Work Group of the American Academy of Actuaries to the NAIC’s Life Liquidity Working Group Boston, MA - December 2, 2000).

The existence of an adequate liquidity and its careful management can make substantial difference between the success and failure of an enterprise.

Proper utilisation of fixed capital and working capital with proper use of production capacity promotes the rate of growth, cut down the cost of production and makes the productive system efficient. Fixed capital investment generates production capacity and working capital helps in the utilisation of that capacity as maximum as possible. The emphasis so far has been given on the growth and efficiency of fixed capital. The management of liquidity has often been neglected, resulting in sub-optimal utilisation of working capital.

The company fails to meet its obligations results in bad credit rating and leads to closure of the company. A major precondition for the very survival is an avoidance of serious resource constraints. This requires holding of large

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Principles for sound liquidity risk management and supervision, September 2008, Bank of International settlements
investments in current assets which include cash and near cash items such as receivables, short-term securities etc.

The concept of liquidity in case of companies has two dimensions viz; quantitative and qualitative. The quantitative aspect includes the quantum, structure and utilization of liquid assets. The qualitative aspect emphasizes upon the ability of a firm to meet all present and potential demand on cash in a manner that minimize cost and maximize the value of the business.

Corporate liquidity covers the quantum of current/liquid assets, their structure, the circular flow of these assets and technical solvency in the sense of measuring the extent of current assets as cover over short-term obligations.

1.1 Operating Cycle/ Cash Cycle

Technically, liquidity depends upon the production or cash cycling. The operating cycle can be said the heart of the liquidity. The operating cycle consists of three phases:

a)  **Cash Gets Converted into Inventory**

This would include purchase of raw materials, conversion of raw materials into work-in-progress, finished goods and terminate in the transformation of goods into stock at the end of the manufacturing process. In the case of trading organizations, this phase would be shorter as there would be no manufacturing activity and cash will be converted into stock directly. This transformation of raw material into finished goods will totally be absent in case of service organization.

2. Conversion of Inventory into Receivable

In the second phase, the inventory is converted into receivables as credit sales are made to customers. Firms, which do not sell on credit, will obliviously do not consist of second phase of the operating cycle.

3. Conversion of Receivable into Cash

This phase represent the stage when receivables are collected and complete the cycle of operation. Thus, the firm has involved from cash to inventory, to receivables and to cash again. Thus the process of gaining liquidity is of vital importance (Barad Mahesh M., 2010).

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4 [http://etheses.saurashtrauniversity.edu/id/eprint177](http://etheses.saurashtrauniversity.edu/id/eprint177)
Fig 1 Operating Cycle

Thus, the operating cycle is a continuous process. If it is possible to complete the sequences instantaneously, there would be no need of liquid fund. But since it is not possible; the firm is forced to maintain current assets.

It is often observed that whenever a financial analysis of companies is done, more emphasis is given on the profitability of the business rather than on its liquidity. Of course, this is quite obvious, as the most important financial objective of any business is to earn profit. But another significant variable is liquidity which means the ability of a company to honour short term financial obligations. Liquidity management therefore involves the amount of investments in liquid assets.

Uncertainty being the only certain thing in a business, management of a business is ultimately reduced to the management of uncertainty which, when translated in real terms, means minimization of the impact of uncertainty. This is possible only when a business is ready to take on a different scenario than the one predicted. Surprise is a word which, in business, implies lack of preparedness. As like the changes in weather are very natural, so is the change in the situation of a company. The environment in which companies operates is ever changing. So there is the need to dynamically manage the liquidity of the firm also.

1.2 Meaning of liquidity

Liquidity is the ability of a company to meet the short term obligations. Liquidity also refers to a firm’s ability to generate positive cash flows to meet short-term financial obligations. Short term, generally, signifies obligations which mature within one accounting year. Short term also reflects the operating cycle: buying, manufacturing, selling, and collecting. It is the result of the time lag between the
expenditure for the purchase of raw materials and the collection for the sales of finished products.

Liquidity is having enough money in the form of cash, or near-cash assets, to meet your financial obligations. In business, cash is king, particularly during the time when money supply is short or when the markets are turbulent. Without cash, company cannot pay its bills nor carry out growth plans, and it may find it difficult to get credit or take advantage of business opportunities (Dr. W. Villagio). A company that cannot pay its creditors on time and continue not to honor its obligations to the suppliers of credit, services, and goods can be declared a sick company or bankrupt company.

According to H. Bhattacharya, “a firm can maintain liquidity if it holds assets that could be shifted or sold quickly with minimum transaction cost and loss in value.”

According to Solomon E. and Springle J., “Whenever one speaks of a firm’s liquidity, he tries to measure firm’s ability to meet expected or unexpected cash requirements, expand its assets, reduce its liabilities or cover any operating losses.”

It must be remembered that different items of current assets have different degree of liquidity. Cash is the most liquid asset. For other types of current assets, liquidity concept has two dimensions, i.e. Time and Risk. The speed with which current assets other than cash can be converted into cash is known as time dimension of liquidity consideration. More quickly and rapidly current assets are converted into cash, more liquid those current assets shall be. Probably due to this factor, liquid assets are also called quick assets. At the same time, liquidity has also risk dimension, this is kind of loss in value by conversion of current assets into cash.

If all the current obligations are met without any delay as and when these become due, it represent the financial strength of the organization, market believes in it and this will sustain the credit standing of the organization. But failure to meet such obligations on continuous basis would adversely affect the credit standing and market reputation. Keeping liquidity is usually costly, but helps avoiding negative effects of unexpected cash-flow shocks.

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a) Approaches of defining liquidity

Basically, there are two approaches of defining liquidity which are as follows:

i) Shiftability theory of liquidity management

One of the generally held beliefs is that cash is the most liquid of all assets and hence, liquidity should be understood and calculated in terms of the cashability of all other assets. From this belief, shiftable theory of liquidity management was first developed for financial institutions. According to this theory, an institution can maintain liquidity if it holds assets that could be shifted or sold for cash quickly with minimum transaction costs and loss in value.

(ii) Liquidity newly defined

A finance manager may have a very high liquidity in his hands in the form of cash or cash equivalents, but there may be a dearth of raw materials in the market, as a result of which production will stop, distribution channel will dry up and consequently, cash inflow to pay for the maturing liabilities shall also stop throwing the company to the brink of liquidation. If the purpose of liquidity is to keep the operations of the business going, then the inventory which was hitherto considered to be the most illiquid of all current assets would turn out to be the first component of the liquidity of a business.

Corporate liquidity has so far been defined as a pyramid of current assets in descending order of realizability with cash holding the top position and inventory the last. However, the pyramid is now upside down with inventory at the top” (Bhattacharya, 2006).
According to the above two approaches the first one says that cash is the most important element of liquidity and inventory is the least but the other approach explains the reverse of the first one i.e., inventory has more importance and cash the least.

b) Maintaining Right Degree of Liquidity

The liquidity is a vital factor in business operations. For the very survival of business, the firm should have requisite degree of liquidity. It is found that excess-liquidity and deficient-liquidity both have negative implications for a company.

Excess-liquidity is that situation where company has more assets which can be converted into cash in short span of time. Liquidity involves costs. Cash being the most important component of liquid assets is unproductive. Spread between the borrowing and deposit rates and also between the short and long term rates are not adequately capitalized. Excessive investment in current assets should be avoided because it impairs the firm’s profitability, as idle investment earns nothing.

Deficient-liquidity is the situation in which the company does not have enough liquid assets to pay off its short term financial commitments resulting in an acute loss of creditability of the firm.

Both these situations are alarming, so here should be a proper balance in between these two extreme situations for efficient operation of business through skillfull liquidity management. It should be realized that the working capital needs of the firm may be fluctuating with changing business activity. This may cause excess or shortage of working capital frequently. The management should be prompt to initiate an action and correct imbalances.

(i) Adverse consequences of inadequate working capital

- Due to non-availability of funds, it may become difficult for the company to undertake profitable projects; thus growth may be little.
- Due to inadequate working capital fixed assets may not be efficiently utilized and this may lower down the rate of return on investments.
- Due to lack of working capital, the company may not be in a position to honour its short-term commitments. As a result, it may lose its reputation and is likely to face tight credit terms.
The firm cannot pay day-to-day expenses of its operations and its credit inefficiencies, increases cost and reduces the profits of the business.

(ii) Dangers of excessive working capital

- Excessive working capital means unnecessary accumulation of inventories. This may increase the chances of inventory mishandling.
- Excessive working capital may serve as an incentive for adopting defective credit policy and also for relief of collection from receivables. This may result in increased bad debt losses which may adversely affect the profit.
- Excessive working capital means idle funds, which earn no profits for the business, cannot earn proper rate of return on its investment.
- In case of redundant working capital there is always a chance of financing long terms assets from short terms funds, which is very harmful in long run for any organization.

c) Factors affecting liquidity

Liquidity to one business may be different from liquidity for another business. There are no set rules or formulae to determine the amount of liquid capital needed by an enterprise. Large number of factors influences the liquid capital needs of a concern. All of them have their own importance. Therefore, an analysis of the relevant factors should be made in order to determine the total requirements in liquid capital. These factors are:

(i) Nature of the Business:
The liquidity / working capital requirements of a firm basically depend upon the nature of the business. For instance, Public utility undertakings require small amount of working capital, while, trading and financial firms require relatively large amounts of working capital and manufacturing undertakings require sizable amount of working capital.

(ii) Scale of Operations:
The larger the scale of operations of a business unit, greater is the amount of working capital required. A large scaled production industry needs large amount of liquid capital in comparison to productive institute of small size. Public utilities have very little need for current assets because of cash dealing. They have to invest abundantly
in fixed assets. On the other hand, trading and financial firms have less investment in fixed assets but they required large amount to be invested in liquid capital.

(iii) Production Policy:
If the policy is to keep steady flow of production by accumulating inventories, then it requires high amount of liquidity.

(iv) Length of Production Cycle:
In a manufacturing business, the amount of liquidity increases in direct proportion to length of manufacturing process. Need for liquid capital requirement of enterprises be assessed in the light of the level of production proposed to be carried out and the Speed of production cycle.

(v) Seasonal Variations:
In certain industries raw material is not available throughout the year. Generally, during the peak season, a firm requires larger liquidity than in the slack season. Some industries like sugar industry, woollen industry and cola industries in India required a large amount of liquidity in the productive season.

(vi) Working Capital Cycle:
If the operating cycle is lengthy, then the requirement of liquid capital is large and vice versa.

(vii) Volume of Sales:
This is the most important factor to determine the size and components of liquid capital. The volume of sales and size of liquid capital are directly related to each other, with the increase in the volume of the sales, there is an increase in the required investment in liquid capital in the form of inventory and receivables. Another view regarding this, more the sales volume of the concern, less will be the need of liquid capital because the concern may easily provide for meeting the day-to-day payment out of higher sales proceeds.

(viii) Credit Policy:
Credit terms granted by the concern to its customers as well as credit terms granted by its suppliers will also affect the liquid capital requirements. If the concern has allowed very liberal credit terms to its customers and/or has adopted a slack collection procedure, more funds will be tied in book debts and liquid capital needs will also be high. Where suppliers have granted liberal credit terms to concerns, there will be less
need for liquid capital. Not only this, the ratio of cash and credit sales or purchases will also affect the level of liquid capital.

(ix) **Business Cycles:**
During the boom period, larger amount of liquid capital is required due to increase in sales, rise in prices, optimistic expansion of business, etc., and vice versa. Under a business boom, extra investment in fixed assets may be made by some concerns to increase their production capacity. This act of the concerns will need further addition to the liquid capital.

(x) **Earning Capacity and Dividend Policy:**
Company with good earning capacity requires less liquid capital. In case of high dividend paying firms more liquid capital is required, as dividends are always paid in cash to the shareholders resulting in cash outflows. Ploughed back of profit is an important source of liquid capital provided that profit is earned in cash. Therefore, in the concerns in which profit-earning capacity is due to good production and marketable securities management and monopoly, they need a lesser amount of liquid capital.

(xi) **Proportion of Raw Material in Cost:**
The concern having large proportion of raw materials in its production need higher liquidity, because, the concerns have to pay higher amount of purchases of raw materials.

(xii) **Credit Availability:**
If a company have liberal credit facilities from the bank, it may run business with a small liquid capital.

(xiii) **Growth Rate of Business:**
The growth in existing business and the tendency of expansion directly affected the amount of liquid capital. As a general rule, growing firms need a continuously increasing amount of fund both for fixed and liquid capital.

(xiv) **Economic conditions:**
When the economy is in recession the enterprise may prefer to hold larger amount of cash balance in order to invest when the economy improves. Again, in recession the enterprise may have to face difficulties in collecting the debts. In a period of rising prices holding of cash will lead to loss of purchasing power. As such, the enterprise should maintain lower cash balances during the period of inflation.
Other Resources:
Beside the above factor various other points are responsible for the amount of liquid capital:
- Role of industrial development
- Means of transport and communication
- Political stability
- Debt maturity
- Cash inflow
- Price level change

1.3 Liquidity Management
Liquidity is considered to be life-giving force to an economic entity. It needs sufficient finance to carry out purchase of raw materials; payment of day-today operational expenses including salaries and wages, repairs and maintenance expenses etc. and management of funds to meet these expenses are collectively known as Liquidity Management (Dr. Mukhopadhyay D.)\(^7\).

One of the most important areas in the day-to-day management of the firms deals with the management of liquidity. Which is defined as all the short-term assets used in daily operations? This consists primarily of cash, marketable securities, accounts receivable and inventory. The balances in these accounts can be highly volatile as they respond very quickly to changes in the firm’s operating environment. A highly liquid firm has sufficient cash to pay its bills at all times and vice versa. Since the environment in which a company operates is uncertain and to reduce the influence of this uncertainty regarding requirement of cash and to ensure proper liquidity there is need to have protective liquidity which is to keep certain cash reserve in addition to the cash requirement.

Liquidity management implies conversion of assets into cash during the normal course of business and to have regular uninterrupted flow of cash to meet outside current liabilities as and when due and payable and also ensure availability of money for day-to-day business operations (Barad Mahesh M., 2010). Liquidity

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\(^7\) Fm48.pdf Working capital management in heavy engineering firms — A case study
management therefore involves the amount of investments in liquid assets to meet the short term obligation.

The efficient management of liquidity is an integrated part of overall finance management and has a bearing on the objective of the consolidation of short-terms solvency position. To achieve this, it is necessary to generate sufficient liquid fund. The extent to which liquidity can be gained will naturally depend upon the magnitude of the sales, the efficiency of collection department for the collection of debts and the period of operating cycle etc.

The crucial part in managing and maintaining liquidity in day-to-day operation is to ensure its smooth running and meets its obligation (Elijelly, 2004).8

The key issues in liquidity management are as to how much must be invested in each component of liquidity management and how to manage these components effectively and efficiently. Each current asset has unique characteristics and its investment level may vary from time to time. Thus both the investment decision and the management of liquidity become complicated. The financial manager has to monitor these assets continuously to maintain their optimal levels (Barad Mahesh M., 2010).

There are different levels of liquidity management. These are:

- **Day-to-day cash management** - this type of liquidity management involves controlling day-to-day cash flow variability by balancing cash positions and lines of credit.

- **Ongoing/intermediate term cash flow management** - this type of liquidity management involves ongoing cash needs over the next six to twenty-four months. It involves analysis of cash inflows and outflows. If the analysis indicates a high risk of future cash needs exceeding future available cash, this type of management would include a plan to restore liquidity. Ongoing liquidity management tools can include restructuring or fine-tuning the portfolio (e.g., renegotiating the terms of large liabilities or assets), selling more or fewer of selected products, diversifying where possible, and

changing the investment strategy if needed (e.g., increasing high quality public securities and reducing commercial mortgage acquisitions).

- **Stress liquidity risk management** – this type of liquidity management involves the ability of the company to meet the demands of many policy holders for cash over a short period. Although such an event may never occur, it is essential that the cash demand be met if it does.

Good liquidity management requires a strategic management plan, possible action plans, and ongoing analysis and monitoring at all three levels. The three levels of liquidity management should be designed to provide required cash at the appropriate time, while, at the same time, allowing for investment policies that maximize returns on investments (Report of the Life Liquidity Work Group of the American Academy of Actuaries to the NAIC’s Life Liquidity Working Group Boston, MA - December 2, 2000).

(I) **Liquidity Management policy**

**Financing Current Assets:**

Current assets of enterprises may be financed either by short-term sources or long-term sources or by combination of both. The main sources constituting long-term financing are shares, debentures, and debts from banks and financial institutions. "The long term source of finance provides support for a small part of current assets requirements which are called the working capital margin. Working capital margin is used here to express the difference between current assets and current liabilities. There are three approaches of financing current assets that are popularly used:

(i) **Matching Approach**

Under this approach a match is established between the expected lives of current asset to be financed with the source of fund. For this reason, a firm would select long-term financing to finance permanent current assets or finance temporary or variable current assets through short-term sources. Thus, a ten-year loan may be raised for financing machinery bearing expected life of ten years. Similarly, one-month stock can be financed by means of one-month bank loan. This is also termed as hedging approach.

(ii) **Conservative Approach**

Conservative approach takes an edge over and above matching approach, as it is practically not possible to plan an exact match in all cases. A firm is said to
be conservative when it depends more on long-term financial sources for meeting its financial needs. Under this financing policy, the fixed assets, permanent current assets and even a part of temporary current assets is provided with long-term sources of finance and reduces risk. Another advantage of this approach is that in the absence of temporary current assets, a firm can invest surplus funds into marketable securities and store liquidity (Barad Mahesh M., 2010).

(iii) Aggressive Approach

As against conservative approach, a firm is said to be following aggressive financing policy when it depends relatively more on short-term sources. Under this approach the firm finance not only its temporary current assets but also a part of permanent current assets with short-term sources of finance.

In nutshell, it may be concluded that for financing of current assets, a firm should decide upon two important constraints; firstly, the type of financing policy to be selected (whether short-term or long-term) and secondly, the relative proportion of modes of financing. This decision is totally based on trade-off between risk and return. As short-term financing is less costly but risky, long-term financing is less risky but costly (Barad Mahesh M., 2010).

1.4 Concepts of working capital

Theoretically speaking, there are two concepts of working capital viz. (Working capital management & control principles & practice, Mathur, B. Satish 2001)

1. Gross working capital (comprising total current assets) and
2. Net working capital (i.e., current assets less current liabilities)

The main items are explained as under:

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a) **Constitutes of Current Assets**

(i) **Cash in Hand:**
The amount of money in the form of cash that a company has after it has paid all its costs. It is written at the top of the assets side of a balance sheet to show the amount of money held by a company in the form of notes and coins.

(ii) **Cash at Bank:**
Cash at bank is the amount of cash deposited in the bank by the concern for the purpose of exploiting this resource in the times of need and emergency. In practice, it is assumed that a big volume of bank deposit indicates a sound liquid position of the business. But from the financial management's point of view, this assumption is considered unwise because such balance is devoid of generating any earning so proves expensive if retained.

(iii) **Bills Receivables:**
Receivables are assets created on account of sale of goods and rendering of services on credit in the ordinary course of business. Receivables represent short-term debts, which enterprises owned. They mainly include book accounts, notes and bills, accrued receivables, prepayment on purchases, advances to employees or subsidiaries etc. As a matter of fact, receivables carry a considerable degree of risk attached to them like in case of default.

(iv) ** Marketable Security:**
Marketable securities refer to the amount of cash in excess invested by the enterprise in assets, which can be easily converted into cash within an accounting period. Such investment is temporary in nature and is regarded as near money. Marketable securities mainly consist of government securities, government treasury bills, bonds, shares, debentures etc.

(v) **Inventory:**
Inventory consists of raw material, work-in-progress and finished goods in which the funds of the company are tied up. Generally the liquidity of the company is tied up in the inventory because it takes time to convert inventory into sales.

(vi) **Other Currents Assets:**
The balance sheet of a company comprises of many other 'terms on assets side. Which too constitute a part of liquid capital. To name a few, they are loans and advances, interest accrued, and payment of tax, prepaid expenses, deposits with financial
institutions etc., and can be convertible into cash within one business cycle, which is usually one year.

b) Constitutes of Current Liabilities

(i) Bank Overdraft:
An overdraft occurs when money is withdrawn from a bank account and the available balance goes below zero. In this situation, the account is said to be "overdrawn". If there is a prior agreement with the account provider for an overdraft, and the amount overdrawn is within the authorized overdraft limit, then interest is normally charged at the agreed rate. If the negative balance exceeds the agreed terms, then additional fees may be charged and higher interest rates may apply (Wikipedia).

(iii) Account Payable:
This liability is also called trade creditors. Trade creditors are the parties to the business transactions that oblige a company with credit facilities regarding purchase of raw materials, stores, and goods for resale on credit terms etc. Accounts payable are debts that must be paid off within a given period of time in order to avoid default (Investopedia).

(iii) Provisions:
Tax and dividends due for payment within a period of a year are included under this head.

(iv) Other Current Liabilities:
Other current liabilities like unclaimed dividends, outstanding expenses and salaries, unexpired discounts, interest accrued but not due on loans etc. are a few of the items that too fall under the head current liabilities in construction of liquid capital structure and these are to be repaid within one accounting year.

1.5 Misunderstanding of profit for cash

An incorrect understanding of profit and cash can cause severe liquidity problem simply because all the profit may not contain cash and, it is by cash alone that one pays the bills.

Cash does not enter into the profit and loss account of an enterprise, hence cash is neither profit nor loss, but without cash, profit (loss) remains meaningless for an
enterprise. Profit is liability, and like any other liability it is nominal in nature; cash is the real thing which an enterprise manager manages very hard in day-to-day payment of obligations.

Enterprise managers often complain that in spite of their companies making good profit they continue to remain in hand-to-mouth condition in discharging their day-to-day obligation (Bhattacharya Hrishikes, 2005).

This problem of misunderstanding is more prominent in case of fast growing companies, their profit prompts that everything is going on well and in right direction. Which results in not paying attention towards liquidity and the companies indulge in doing all expenses related with the growth of the companies which makes even the growing companies becoming sick.

Cash is the life-line of an organization. A sustained growth of an enterprise depends upon the cashability of the profit, not the profit per se as reflected in the income statement. A cash shortage in the short run may not allow a company to see out the long-term at all!

1.6 Profitability vs. Liquidity

Liquidity management has a direct bearing on the profit earning capacity of the company. It is already established fact that there is inverse direct correlation between the liquidity and profitability. Conventionally, it has been seen that if a company desires to take a greater risk for bigger profits and losses, it reduces the size of its working capital in relation to its sales and vice versa. Hence, a company should strike a balance between liquidity and profitability.

A financial manager has to ensure on one hand that the firm has adequate cash to pay for its bills, has sufficient cash to make unexpected large purchases and cash reserve to meet emergencies, while on the other hand, he has to ensure that the funds of the firm are used so as to yield the highest return.

This poses a dilemma of maintaining liquidity or profitability

The large holding of current assets, especially cash, strengthens the firm’s liquidity position (and reduces risk), but also reduces the overall profitability. Thus, a risk-
return trade off is involved in holding current assets (Working capital management, Rangarajan Krish, Mishra Anil. 2005). Levels of fixed as well as current assets depend upon expected sales, but it is only current assets which can be adjusted with sales fluctuations in the short run. Thus, the firm has a greater degree of flexibility in managing current assets.

- **Liquidity vs. Profitability Trade-off**

**The Liquidity Versus Profitability Principle:** There is a trade-off between liquidity and profitability; gaining more of one ordinarily means giving up some of the other.

As in the above picture "Liquidity" as being on one end of a straight line and "Profitability" on the other end. If one steps forward on the line and move toward one, then automatically move away from the other. In other words, there is the trade-off between liquidity and profitability.

To determine the appropriate level of current assets, management must consider the tradeoff between profitability & risk. For each level of output, the firm can have different levels of current assets. It is observed that greater the output, greater the need for investment in current assets to support that output which results in blockage of funds in liquidity while hampering liquidity (Working capital management, Jain Kumar Narender, 2004).

Similarly, there is a direct relationship between higher risk and higher return. A company taking higher risk could endanger its liquidity position. However, if a company has a higher return it will increase its profitability.

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Analysis of the two extreme situations

- **A lot of cash but is not profitable:** It may take a while, but if it remains unprofitable, it will eventually go bankrupt. Its available cash will be used to finance the losses, but when the cash runs out, the assets of the company will have to shrink because there will be insufficient funds to replace them as they wear out. The company will become smaller and smaller and will eventually fail.

- **Very, very profitable but is not very liquid (i.e., does not have much cash)?** For example, if a company expands so rapidly that it is constantly building new buildings and buying new equipment, it may be possible that payments to the contractors and vendors be late due to the lack of cash. In other words, the company is spending money much faster than it is making it. So, one can see that it's dangerous to be on either extreme of the line: (1) highly liquid but not very profitable, and (2) highly profitable but not very liquid. There's a broad middle ground between the two extremes where the company wants to reside.

Thus, a financial manager has to ensure on one hand that the firm has adequate cash to pay for its bills, has sufficient cash to make unexpected large purchases and cash reserve to meet emergencies, while on the other hand, he has to ensure that the funds of the firm are used so as to yield the highest return.

**1.7 Strategies for managing of liquidity**

In this framework, the liquidity of the firm for any future period of time is determined by the relationship between the amount of cash available to the firm and the amount of cash needed to pay the firm's future obligations. Since being a going concern it is assumed that a firm is solvent, the amount of cash available to the firm will always have to equal or exceed the firm's required cash payments on a daily basis.

Corporate managers take several actions one after the other, to stem the process. Some of these actions may arrest the process without much loss of future credibility of the business; some may arrest it temporarily and some actions may just hasten up the process. Some of these actions or strategies are defined as under:
(i) **Debt Maturities:**
One starting point in the analysis of liquidity is to always keep an eye on the company's debt maturity schedule, so that the arrangement of cash can be adequately done.

(ii) **Extracting cash from working capital:**
In the time of need cash can be arranged from monitoring receivables through factoring or securitization, liquidating unneeded inventories, or stretching out payments to suppliers. Each of these responses has certain potential drawbacks. If no factoring or securitization facilities are already in place, these may take several months to establish. If aggressive discounting is necessary to sell inventory quickly, this could have severe implications for the company's future pricing power. Whereas, in stretching payment terms to suppliers, the company risks spreads as making suppliers unwilling to ship goods.

(iii) **Reducing capital expenditures:**
Companies generally have some margin to reduce capital expenditures temporarily from planned levels. It is necessary to consider which of the planned expenditures are mandatory for the company to sustain normal operations.

(iv) **Selling assets:**
In severe adversity, the company may choose to sell entire operations or lines of business to raise cash.

(v) **Drawing down surplus cash and equivalents and liquidating marketable securities:**
These are the most reliable backup sources of liquidity for any company as cash could be easily arranged from converting marketable securities into cash as this can be done in a very short span of time and without much loss in value. Similarly, excess cash can anytime be used to repay the maturing obligations. There is need to carefully ascertain the amount of such assets on hand and the potential for fluctuations in the amounts.

(vi) **Bank credit facilities:**
Bank credit is generally a company's most reliable source for debt capital. When a company loses access to the commercial paper and public debt markets, banks are often the lenders of last resort to help in making payment of obligations.
(vii) **Cash Discount:**

The discount policy which is to pay less if one pays within the time period specified by the company, can result in quickening of cash flows on a continuous basis and at the same time in lowering down the incidence of bad-debts.

(viii) **Credit Policy:**

In order to maintain liquidity the enterprise may allow credit only to few selected customers who has good financial position and on the other hand sales also should not be adversely affected.

1.8 **Behavioral aspects of Liquidity management**

It seems appropriate to consider briefly how liquidity management should be carried out in the company. Many firms have an intuitive feel for what they might do in a financial crisis, even though it is not formally planned and written down. Statements such as this reveal that, despite its importance, liquidity management is often denied in practice the benefits of formal analysis. It is contended here, however, that if liquidity management is to be of any value to the firm, it should be the object of thorough and systematic discussion by the entire top management team as it effect the capacity of the firm to act properly in response to unexpected change in its external and internal environment as liquidity management impacts production, marketing, technological, administrative, strategic and other areas of management.

As a concern is not run by an individual it is collective effort of many individuals working together for a common goal. Similarly the managers of different areas like production manager, marketing manager, administrative manager etc. can have conflicting viewpoints and may ask for funds for their areas but liquidity management for corporate success should be seen as a group responsibility involving the participation at top level of the several areas of management. The finance officer's control over the resources of the business will depend on his bargaining power, both internally and externally. Overall, the finance officer's bargaining power will determine the form in which financial mobility will reside. If that power is weak, the business will most likely end up relying exclusively on those resources which are most predictable, most completely under the finance officer's control leaving the
liquidity for unforeseen events or contingency aside (Marques, Maria Manuela Farelo Athayde, 1988).

1.9 Requirement to study Corporate Liquidity Management

The importance of the liquidity in the field of finance is similar to the need of food for a human. As a human can’t survive for a long time without food despite of having luxurious things etc., as food is the basic necessity for survival. Similarly, it is known that the primary objective of a business organization is to earn more and more profit and to maximize shareholder’s wealth. One cannot even think of attaining this objective without giving due consideration to liquidity management. As a firm needs cash to purchase stocks, give wages to employees, for preparation and packing of goods etc, without it the firm will not be able to generate sales and without sales profit can’t be imagined. This means that liquidity has certain relationship with profitability also.

Corporate Liquidity Management is being studied to find out how company manages to survive in the drastically changing business environment and to find out how the company manages its short term operational requirements to ensure the smooth running of the business transactions.

The efficient and effective management of working capital enables a firm to maximize profitability and also to maintain adequate liquidity in the business. The manner of the management of working capital determines to a large extent the success or failure of an enterprise. Many a time, in the event of failure of business enterprise, inadequate working capital is given out its main reason. But in the evaluation it may be the mismanagement of working capital. Working capital is as important as blood in the human body. Insufficient working capital creates trouble in smooth functioning of day to day business operations which also affect profitability. (Management of working capital, Talekar Dagduji Shankar, 2005)\textsuperscript{11}