Nobility or Financial Sustainability?

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Abstract

This article attempts to provide an uncomplicated view on two important notions in Finance viz. Profit and Cash Flow. The significance of maintaining ‘reasonable’ profit level and ‘adequate’ cash flows have been explained using common sociological and physiological examples. Further, it is argued that the firms ought to have followed the notion of sustainability, i.e. People, Planet and Profit, all along.

Keywords: Financial Sustainability, Triple Bottom Line, Profit, Cash Flows

Profit and Cash Flow

Finance is not as complicated as it seems when the focus is on just two factors viz. profit and cash flow. Other topics which are typically considered to be complicated have not been included to avoid numerical models and also to ensure that the focus on the bigger picture is retained.

For example, capital budgeting problem is typically treated as a numerical problem. The estimated future cash flows are discounted by a given discount rate / cost of capital to identify a suitable investment alternative. Whereas, nothing could be more complex than identification of the cost of capital and more emphasis should be given to this strategic issue.

Returning the discussion, the term ‘profit’ is defined and interpreted in numerous ways and here the definition is very simple. ‘Profit’ may be described as the quantum of money that is left after all the expenses of an organisation, in a given time period, have been met. If any organisation continuously generates less money than what it spends, it cannot sustain itself in the long run.

Cash Flow and Borrowing

Cash flow could be compared to blood flow in the body. If the body generates sufficient amount of blood an individual remains healthy. On the contrary, it is time to meet the creator if more blood is lost than what is being generated. In a different scenario, if the body fails to generate fresh blood but just manages to circulate the available blood it could be compared to Financial Engineering. Neither the body nor an economy would grow in strength by just recirculating the resources. It would result in structural weakness eventually leading to (sub-prime!) crisis.

If the body cannot generate adequate blood due to illness or any other reason, temporary additional support in the form of an intravenous fluid or blood transfusion (loan) is essential. Though some firms appear to have mastered this technique and thrive on OPM – Other Peoples’ Money it is not a sustainable model. Neither the body nor the business can thrive forever on borrowed resources.

Thinking conservatively, a transfusion or borrowing is acceptable if a human life or corporate life needs to be saved. However, to take a fair view, new born babies and new firms also need external support for survival. In general, sick firms with a good chance of turning around, firms that have made an occasional loss, new firms and firms that seek expansion may consider borrowing as an option.
Level of Borrowing

It is difficult to generalize or quantify a borrowing model. It depends on the ability of a firm to repay and the outlook of the management. Some managements prefer higher debt levels in their capital structure. Most individuals don’t like to take instruction from others on what to eat and how much to eat. The intake is a matter of choice and metabolism. Same deduction can be made about borrowing. It is a matter of choice and ability of a firm to repay the debt.

Sometimes, pampered children want to exist just on chips and chocolates. They keep watching all the television commercials and are prone to temptation. This prompts the parent (finance manager) to provide advice on what is good for health and, at times, to ration the food (debt) consumption.

Product Development and Customer Satisfaction

This also raises another interesting question. Why do some firms keep on advertising about their products? Most of the neighbourhood stores don’t rely on advertisement for their sales. The customers seem to feel the presence of such stores organically over a period of time. They explore the new stores looking for new products or better price and end up as customers if they are able to get a good deal. Such stores seem to focus on providing the best option at an acceptable price and try to reduce unnecessary expenditure.

Likewise, corporate firms could try to focus on the produce and strive to provide a good deal to the customer. Usually, if the product / service is good it will sell itself and doesn’t need a huge marketing budget. It only needs a market presence i.e. it should be made available in the potential markets. Buyers would eventually notice the product / service.

Interest Burden and Fund Allocation

Back from the detour, a business cannot and should not survive entirely on borrowed money / capital. If the borrowing is too frequent or too heavy, the interest component would devour the business just like a parasite devouring the host body.

And, money is comparable to blood for other reasons too. Some organs might need more blood supply than other organs. But, blood cannot be denied to any organ. Denial would result in rotting and decaying. Likewise, blood shouldn’t stagnate as it would lead to sickness.

Money too must flow to all the parts of a firm. If money stagnates at any point, in the form of high inventory or unproductive capital investment, it would hurt like a blood clot. Initially the symptoms would appear and some firms ignore the symptoms. Whereas, many other firms treat the symptom like treating a blood-clot-induced headache with a paracetamol tablet.

While paracetamol might help to alleviate the pain it is certainly not a cure. The clog must be removed to prevent recurring headaches. Similarly, firms must address the root cause of the issue that affects the cash flows. Else, the issue would persist and return later to haunt the firm.

None of the claims of business firms about their values and beliefs would matter if they continuously incur losses. The only rule is that they should generate more money that what is being expended. The focus must be on product development and on maintaining the cash flows. Profit would be consequential.
Sustainability

The notion of ‘profit’ is so naturally interwoven into ‘cash flow’ and it is hard to deal with them separately. Reasonable profit, earned without causing any harm to the people or planet is the only thing that matters.

Are there any definitions to the terms ‘reasonable profit’, 'harm', 'people' and 'planet'? Yes, and they are very simple and straightforward descriptions.

Reasonable Profit - ask the conscience. For individuals without a conscience, think like a customer. Would any individual like to be cheated? That is the answer for quantum of profit.

People - any stakeholder who is directly / indirectly affected by corporate action. Instead of defining them as suppliers, employees and consumers define them as parents, friends and children.

Harm – any corporate action that would hurt the parents, friends and children. No one wants to hurt the parents, friends or children and if anyone wants to do so they must be subject to solitary confinement.

Planet - it is the house where an individual lives. Would anyone fill the house with filth, toxic chemicals and fumes? Anyone intent on doing these is not eligible to live in the society.

This is fancied as sustainability, the triple bottom line. This doesn’t seem like a complex or noble thought. After all, this is what every organisation must have been doing all along.