

REVIEW OF FINANCIAL MANAGEMENT IN PRIVATE FIRMS: UNLOCKING THE CASH MANAGEMENT MODEL

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ABSTRACT

Financial management is a complex body of knowledge that is still evolving without any successful template for its practice, especially in private firms. This paper reviews research on actual financial management in private firms to see if cash management models critical to working capital management are incorporated. The approach is to review all the models in extant literature used for cash management, itself a component of working capital. However, search results show that only Pugmire (1952) outlines the activities involved in actual financial management practice for local schools in the United States. He identified the generalizable constituents of the financial management process, including budgeting, accounting, auditing, records and reports, and cost analysis. The choice of cash as the review focus is because it is the essence of financial management in private firms: determining and sourcing capital as cash and utilizing it by allocation process to generate more cash and maximize the firm's value to stakeholders. Therefore, this paper contributes to financial management literature by extending Pugmire's (1952) template for public schools with cash management models in extant literature that can also be adapted for private firms, with potential for further research.

KEYWORDS: financial management, private firms, cash management, model

JEL CLASSIFICATION: M4, M5, M12, M2

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INTRODUCTION

Financial management is a complex body of knowledge that is still evolving without any successful template for its practice, especially in private firms. The purpose is to map extant literature for clarity on definitions, templates used and usable for financial management practices generally and specifically in private firms, and gaps that can guide further research. For clarity, I start with the definition of management because of the management component of financial management. The definition of choice is that of Henry Fayol by Sethy, which states that "to manage is to predict and plan, to organize, to command, to co-ordinate, and to control." The elements of this definition are reflected in the financial management definition by the London School of Business and Finance (2018) as "the strategic planning, organising, directing, and controlling of financial undertakings in an organisation or an institute.... to achieve organizational objectives." These objectives include: "maintaining enough supply of funds for the organization; ensuring shareholders of the organization get good returns on their investment; optimum and efficient utilization of funds; creating real and safe investment opportunities to invest in" (London School of Business and Finance, 2018).

Taraba & Hoke (2021) identified three elements of financial management: financial planning, control, and decision-making. Taraba & Hoke (2021) hold that these activities or processes must be conducted within the financial policies and regulations framework. Taraba & Hoke (2021) define the three activities as follows: "financial planning is the process of determining an organization's capital requirement, structure, and allocation. Financial control is an activity that ensures that assets are utilized efficiently, economically, and effectively; and that there is accountability and transparency within the

organization through reconciliation of actual performance with plans. Financial decision-making deals with the investment and financing decisions regarding the sourcing of capital by way of new shares or bonds and distribution of profits among providers of the capital of the firm". Moreover, Pugmire (1952) defines firms as business organizations created for profit motives, including corporations, limited liability companies (LLCs), or partnerships that provide professional services. The tasks of a finance manager are therefore evident from the preceding definitions: financing decision (maintaining appropriate cash level), investing decision (finding safe investment possibilities to invest in), and dividend decision (guaranteeing good return on investment to providers of capital, as well as optimum and efficient utilization of funds).

Financial management also involves the knowledge of fundamental terminologies, financial statements, and the ability to plan financial flows (Taraba & Hoke, 2021). Essentially it is the management of liabilities and assets side of the balance sheet. It involves the decision to allocate capital between non-current and current assets and putting the current assets to work out more cash for reinvestment and distribution to providers of capital. The capital (equity-debt/ liabilities) flows in initially as cash / current assets and then is allocated to non-current assets, current assets (working capital), and expenses. The current assets and current liabilities as working capital work to create more money as net income to achieve working capital management objectives: profitability, liquidity, and efficiency.

Furthermore, financial management embraces investment decision-making, capital budgeting, working capital management, cash flow management, financing decision, capital structure, cost of capital, risk management, financial analysis, financial planning, and valuation (Pavelkova,2021). Coe (2011) expands coverage to accounting, internal controls, auditing, evaluating financial conditions, budgeting, cash management, banking, purchasing and contracting, borrowing, and risk management. Search engine results from Google Scholar, Web of Science, and Scopus confirm over 10,000 different topics, as corroborated in the appendix below for 15 journal articles representing different approaches used by entities to practice financial management. However, only Pugmire (1952) out of the search results outlines the activities involved in the actual practice of financial management for local schools in the US. Constituents of financial management identified by him which can be generalized, include budgeting, accounting, auditing, records and reports, and cost analysis. For that reason, this paper selects cash management models as its focus.

The cash focus is because every business decision or activity ultimately translates to cash as king (a popular maxim of corporate finance). Therefore, the approach is to review all the models in extant literature used for cash management; itself a component of working capital. The perspective here is that cash is the essence of financial management in organizations, especially private firms: determining and sourcing for capital as cash and utilizing it by allocation process to generate more cash to stakeholders and maximize the firm's value.

The remaining section of this paper will look at a brief literature review under 'methods' based on the selected 15 journal articles. After that, the author examines the prescribed financial management guidelines for private firms from the work of Pugmire (1952); then, cash models in the literature are added under 'results and discussion and conclusion.

2.0 METHODS

Financial management involves a wide spectrum of a company's financial decisions (Agyei-Mensah, 2011) discussed in the literature under different themes and without any clear-cut template, especially for private firms. Typically, themes cut across: theories of borrowing behavior in SMEs (Adair et al., 2014); the relationship between working capital management and profit performance (Akgun & Karatas, 2021); cash conversion cycle (CCC) in supply chains (Banomyong, 2005); ranking of factors

that inform capital structure decisions (Frank & Goyal, 2009); and family cash flow management (Godwin, 1990). Others include development of the theory of ownership structure of the firm based on the theory of agency, the theory of property rights and the theory of finance (Jensen & Meckling, 1976); development of alternative model for planning and controlling cost of projects for small medium size construction firms (Kern & Formoso, 2006); cash holding motives (Keynes, 1937; Wray, 2006); financial management practices in local schools in US (Pugmire, 1952); financing choices between single family offices (SFOs) and private equity firms (PE) (Schickinger et al., 2022); and, gauging shareholders' dissatisfaction with directors from the information content of firm payout policy (Tanyi et al., 2021).

Given that financial management practices decide the fate of private firms (Collis & Jarvis, 2002), a guiding template of what constitutes financial management becomes an imperative. To investigate the existence, if any, of such template, we performed a systematic literature review following the six main steps delineated by (Durach et al., 2017) 1) clarifying the research question, 2) specifying the characteristics of focal studies, 3) gathering the potentially related literature, 4) choosing the studies that clearly fit criteria, 5) integrating the literature, and 6) reporting or describing the findings. Two guiding questions were therefore formulated for the search: 'what are the various research themes used for financial management in private firms? How many studies include cash management and/or cash management models?' Initial search in google scholar generated the following results and their key words: 'financial management in/of private firms' (3 articles); financial management practices in small firms' (1 article), financial management practices of small firms' (7 articles), totalling eleven articles without duplicates and time limit. Next, the same key words were repeated in SCOPUS and Science Direct which generated four extra relevant articles that finally constituted the review sample. The results are given as appendix below.

3.0 RESULTS AND DISCUSSION

An examination of the search results shows that only Pugmire (1952) specifically deals with financial management practices although in local schools in United States. Despite the specific mentioning of financial management practices, gaps exist over cash management and guidelines for financial management in practice particularly for private firms. This paper fills this gap by adding cash management models to the work by Pugmire (1952) from extant literature review and how they contribute to achieving working capital management objectives.

3.1 Financial management process in US local schools by Ross (1952)

Pugmire (1952) identifies five activities to comprise financial management process: budgeting, accounting, auditing, records and reports and cost analysis.

Budgeting

Pugmire (1952) describes financial management as the processes and devices by which local school systems budget, record, audit, and report, and analyze their financial operations. His review on budgeting covered public budgeting definition by Burke (1951), critical principles of budgeting by Lutz (1950) and types of budgets by Akerly (1951). He gives Burke's (1951) definition of public budgeting as a "well-conceived program of governmental action for a given period, with reasonably accurate plans for making financial outlays involved and raising the necessary revenues." Pugmire (1952) further explains that in public sector the budget document is called the 'budget' while budgeting is the process. Pugmire (1952) explains that Lutz (1950) identifies participation as a critical principle for achieving efficiency and benefit to the educational system. Finally, Pugmire (1952) claims that Akerly (1951)

recommends 'performance budgeting' over the traditional public budgeting because of public relation benefit in terms of input-output ratio for moneys allocated for service to the children.

Accounting

Pugmire's (1952) review on accounting component covers the role of accounting system by Barry & Hill (1951), accounting manual by The National Committee on Governmental Accounting (1951) and leadership of the accounting department by Bucknum (1951). He observes from the studies by Barry & Hill (1951), the importance of an efficient and uniform accounting system based on well developed manuals and use of machines. His review of The National Committee on Governmental Accounting (1951) shows that the manuals should state clear purposes, principles, and specific procedures and forms, procedures, and relationships of accounting and budgeting. Finally, his review of Bucknum (1951) finds that the department should be overseen by a central treasurer as recommended.

Auditing

Pugmire (1952) reviews four studies on auditing as a component of financial management. First is that by Morphet & Lindman (1950) identifies auditing exercise as a legal requirement. Next is the separation of roles over audit of internal controls and external audits including their contractual rights and duties per the directives of The National Committee on Governmental Accounting (1951). The directives among others stressed the need for clear distinction between audit of internal control and external audits by agencies and that audit contract should clearly state auditors' responsibilities, procedures, and remuneration. Two other studies reviewed by Pugmire (1952) were that of Pittenger (1951) and Burke (1951). Pittenger (1951) recommends that internal audit should be continuous and performed by the school accountant as a distinct function from external independent audit which should be limited to only audit activities. The main finding from the work of Burke (1951) is that auditors "should not disallow expenditures simply because the law has not yet made it mandatory or permissible."

Records and Reports

Financial records are necessary for preparation of acceptable annual reports. Review of literature by Pugmire (1952) covered records for fixed asset by Harris (1951); insurance by Daum (1951); and financial transactions (Stoy, 1951) necessary for the preparation of financial reports.

Cost Analysis

Pugmire (1952) observes that the importance of cost analysis had not been considered in extant literature as a device of financial management. He points out that it would be useful for determining cost-quality relationships, costs per-pupil, formulation of financial policy and 'in knowing whether the dollars being spent on education in its community are yielding maximum educational values.'

3.2 Cash management models

Cash is a component of working capital and the essence of working capital management. Cash management therefore is the process of planning, controlling, and directing cash and cash equivalents to achieve the objectives of profitability, liquidity, and efficiency. These objectives apply to the three motives for holding cash: transactionary, precautionary and speculative (Keynes, 1936, p.170). Efficient cash management enables the firm to pay maturing obligations as well as minimize holding costs of excess cash balance. The models are approaches proposed for cash management.

Four cash management models are identified in literature as discussed below.

3.2.1 Miller –Orr Model

This model adapts inventory levels approach under inventory management. It sets three cash levels for efficient management of cash. It is designed to determine the time and size of transfers between investment account and cash account. It has the following features:

- The firm operates in an environment of uncertainty because of random cash flows.
- Variance of daily changes in cash balances.
- Aim is to minimize costs (efficiency): transaction costs, opportunity costs of holding cash, borrowing costs and bankruptcy costs.
- Difference between upper level and lower level is called the range or spread and derived from the formula below:
- Spread =

$$3 \left(\frac{\frac{3}{4} \times \text{Transaction cost} \times \text{variance}(\sigma^2) \text{ of cash flow}}{\text{Interest rate (daily)}} \right)^{\frac{1}{3}}$$

Where,

Transaction cost = investing in uncertainty

- Variance (σ^2) = measure of dispersion

Assume for example,

- Minimum cash level is given as \$ 25,000
- Transaction cost = \$ 50 per transaction for every time you earn or invest cash.
- Variance (σ^2) = \$ 250,000 (assume standard deviation is \$5,000)
- Daily interest rate = 0.05%
- Therefore spread =

$$3 \left(\frac{\frac{3}{4} \times \text{Transaction cost} \times \text{variance}(\sigma^2) \text{ of cash flow}}{\text{Interest rate (daily)}} \right)^{1/3}$$

$$3 \left(\frac{\frac{3}{4} \times \$ 50 \times \$ 250,000 \times 10,000}{0.05/100 = 0.0005 = 5/10,000 \times 10,000} \right)^{1/3}$$

= \$ 7,970 = the range over which we allow cash flows to move without us taking any control action.

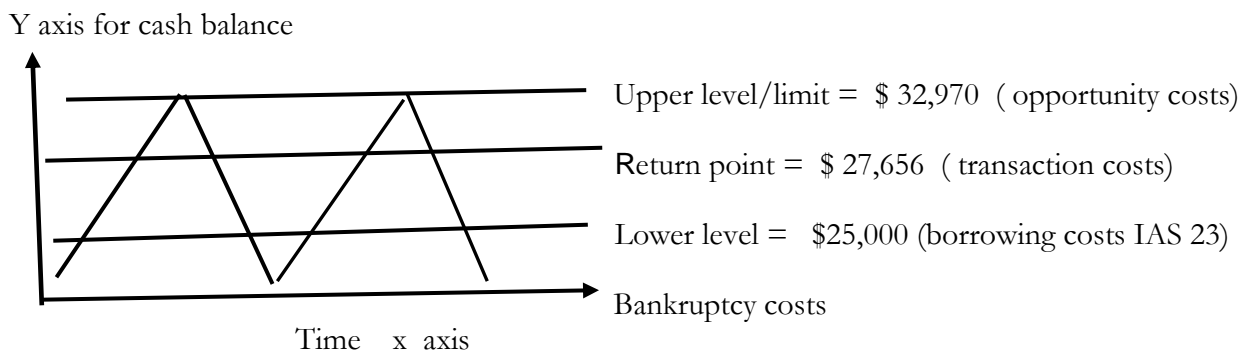
- Maximum level = Minimum level + spread
= \$ 25,000 + \$ 7,970 = \$ 32,970

This represents the maximum level we are willing to hold on cash. Anything above that level is inefficient. Hence, we take the difference between this level and the upper level (total cash in hand) and invest in short term securities.

- Return point = Minimum level + 1/3 of the spread
 = \$ 25,000 + 1/3 of \$ 7,970 = \$ 27,656

These are the key numbers we are expected to calculate.

Figure 1 Miller -Orr Cash levels



(Source: Author, 2022)

3.2.2 Baumol Model

This model was developed in 1952 by Williams J. Baumol who uses Economic Order Quantity (EOQ) concept of inventory management to derive the optimal cash balance that minimizes cash management costs as shown below:

$$\text{EOQ of cash} = \sqrt{2CD/H} \text{ or } \sqrt{2Co/Ch}$$

Table 1 Model comparison

EOQ model for inventory	Baumol model for cash
Q= Order quantity	Amount invested per transactions
Co = Cost of an order	Cost per transaction
Ch = Cost of holding one unit per annum	Opportunity cost of holding cash
D = Annual demand	Net cash generated or used per annum

(Source: Author, 2022)

3.2.3 Ratios /analysis

'A *ratio* indicates how many times one number contains another'¹¹. For example, a ratio of 2: 1 means 2 for every 1. 'Ratio analysis is a quantitative method of gaining insight into a company's liquidity,

operational efficiency, and profitability by studying its financial statements such as the balance sheet and income statement.ⁱⁱⁱ

Ratio analysis can be used to examine efficiency of operations as one of the three objectives of working capital management. It effectively uses liquidity ratios and turnover ratios (activity ratios)-also used for calculating cash conversion cycle.

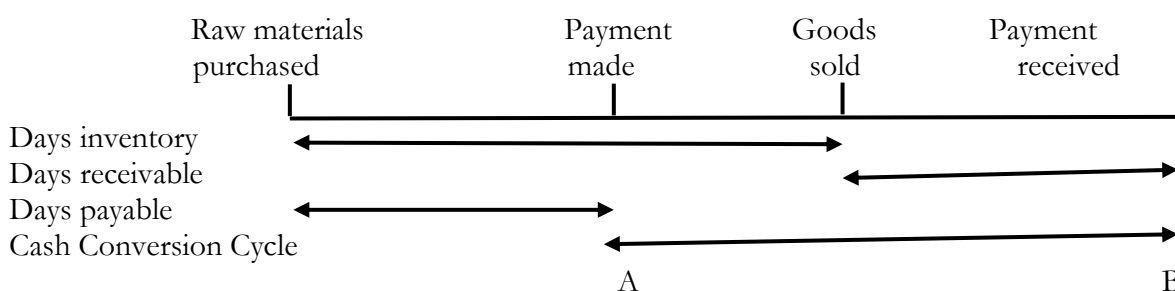
Liquidity ratios

The relationship between current assets and liabilities is used as a measure of liquidity (ease of asset conversion to cash) in the firm. Liquidity ratios has three categories: current ratio (current assets/current liabilities; 2:1 as standard), quick ratio (current assets-inventory/ current liabilities; 1:1 as standard) and cash ratio (cash and cash equivalents/current liabilities; 1:1 as standard but can be lower).

Cash Conversion Cycle

Traditionally designed for manufacturing firms but can still be applied in other organizations. It measures the time in days it takes a firm to pay for raw materials and to generate cash from the sale of its inventory. The shorter the better. It is effectively a measure of liquidity risk according to Wikipedia. The aim therefore is to reduce the likelihood of the business going for overdraft. Working capital is essentially the management of cash conversion cycle as illustrated below:

Figure 2 Cash Conversion Cycle diagram



(Source: Author, 2022)

From the figure above minimizing the time from A – B is the aim because this is what this company must finance in terms of payments to suppliers before receiving cash inflows. This can be linked to the efficiency of operations of the company.

If the company buys too much raw materials inventory and still pays the supplier while the raw material is still settling as inventory in the store capital is being tied up unnecessary. If the company is slow to convert the raw materials to finished goods, that is inefficiency and cost money.

If the goods are sold but cash is not collected quickly then the company is also incurring further costs. Therefore, it is important to minimize the time between cash inflow and cash outflows. Achieving such efficiency is to minimize cash conversion cycle. Managing the individual parts of working capital means managing the 'whole picture' in an optimal way to give the firm a competitive advantage over its competitors in the market square.

- a) Cash conversion cycle in days is calculated using efficiency ratios analysis (Turnover / activity ratios).
- a. Days sales in inventory (Inventory Turnover Period)

$$= (\text{Average Inventory} / \text{Costs of goods sold}) \times 365 \text{ days} = x$$
 - b. Debtors' collection period = Trade receivables ÷ Sales x 365 days = y
 - c. Days in Trade Creditors (Creditors Payment Period)

$$= \text{Trade Payables} \div \text{Costs of goods sold} \times 365 \text{ days} = (z)$$
- Cash collection Cycle in days (CCC) = x + y - z

NB: Cost of goods sold is used as an approximation of purchases- always missing in published financial statements. Turnover ratios is aimed at controlling receivables, and inventory to quickly turn into cash for settlement of payables.

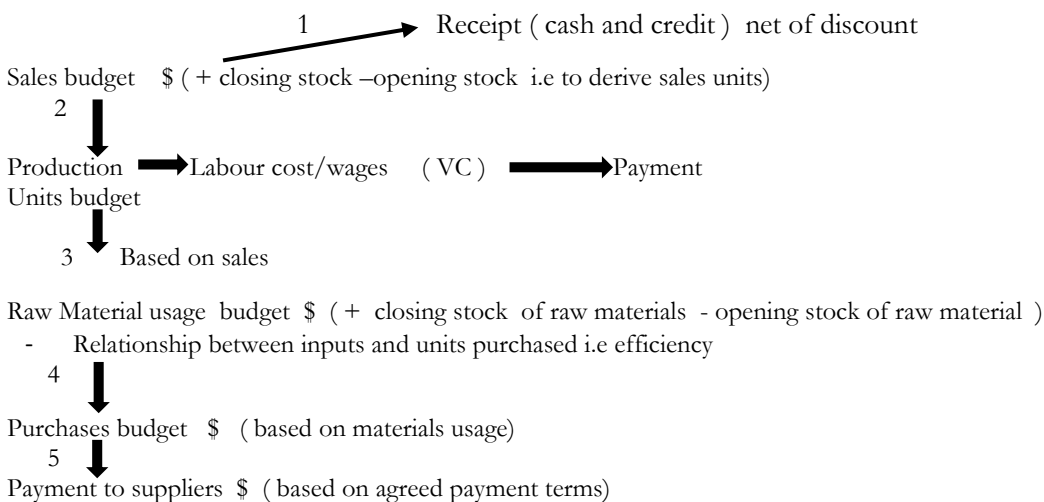
3.3 Cash budget model

The cash budget is a plan of receipts and payments for a future planning period, such as a month, quarter, or year to know the company's cash position at any time. It can be used to achieve the objectives of working capital management as follows:

- a) Efficiency- helps to control and keep the various payments within budget.
- b) Profitability- helps with monthly sales monitoring and planning how and where to invest surplus cash balance, for example, in treasury bills to improve profitability.
- c) Liquidity helps monitor monthly closing balances and decide what to do with surpluses and how to finance deficits.
- d) Survival helps determine monthly cash requirements and monitor cash positions for the firm to discharge maturing obligations, stay solvent, make a profit and continue in business.

As illustrated in the flow chart below, procedures include determining sales levels in units and value, cash receipts from cash sales and debtors, payments, and cash balances.

Figure 3 : Cash budget flowchart



(Source: Author, 2022)

4.0 CONCLUSIONS

Financial management is a complex body of knowledge that is still evolving without any successful template for its practice, especially in private firms. Financial management follows a standard process involving planning, budgeting, and setting objectives. It is thus futuristic and fraught with uncertainty.

The purpose here was to map evidence in the extant literature on whether cash management is covered in the financial management practices of private firms. Results showed that the focus in the literature has been more on the elements of financial planning, financial control, and financial decision-making and less on cash management which is the ultimate in financial management. Nevertheless, efficient cash management can achieve profitability, liquidity, and efficiency as the essence of financial management in private firms.

This paper reviews research on actual financial management in private firms to see if cash management models critical to working capital management are incorporated. The approach is to review all the models in extant literature used for cash management, itself a component of working capital. However, search results show that only Pugmire (1952) outlines the activities involved in actual financial management practice for local schools in the United States. He identified the generalizable constituents of the financial management process, including budgeting, accounting, auditing, records and reports, and cost analysis. The choice of cash as the review focus is because it is the essence of financial management in private firms: determining and sourcing capital as cash and utilizing it by allocation process to generate more cash and maximize the firm's value to stakeholders. This paper contributes to financial management literature by extending Pugmire's (1952) template for public schools with cash management models in extant literature that can also be adapted for private firms, with potential for further research. Therefore, this study has implications for entrepreneurs and future research.

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He is a doctoral scholar with research activities mainly focusing on cost management, financial management, and auditing. He has over two decades of private and public sector industry experience, including ten years in academia.

Appendix. Summary of dimensions of private firms' FM practices in the literature

Year	Authors	Financial management Dimensions	Key point	Findings
2021	Schickinger A. et al	Capital structure comparison	Research on Single Family Offices is still in its infancy	
2020	Akgun and Karatas	Examination of the relationship between working capital management and business performance	The authors examined the aforementioned relationship during the 2008 financial crisis	For code law nations, there is a negative link between gross working capital and business performance. For all EU nations, liquidity metrics evaluated by current ratio have a statistically significant influence on business performance as measured by ROA. The financial crisis of 2008 had a substantial negative influence on ROA.
2018	Karadağ	Cash, receivables and inventory management in small businesses	primary data is used, mainly due to the unavailability of an official database for financial management practices or performance indicators of Turkish SMEs	
2015	Adair & Adaskou	Test of the assumptions of trade-off theory (TOT) and pecking order theory (POT) regarding corporate leverage		The relationship between corporate leverage and the age of SMEs, as well as their size, remains inconclusive with respect to both theories
2014	Brijlal et al	Financial reporting and interpretation skills	Use of external consultants	Majority of the SMME owners were found to lack interpretation skills and an awareness of how to use information from financial statements
2013	Abanis, et al	Financial management themes/dimensions in practice in Uganda small firms	The earlier researches conducted also showed that one of the most significant reasons behind the failure of SMEs is poor cash management and inadequate use of essential business and management practices (Kazooba, 2006).	

2011	Agyei-Mensah, B. K.	Financial management practices in Ghana private firms	Financial management involves a wide spectrum of a company's financial decisions	High utilization of family members impedes sound practices
2006	Kennedy, et al	Differences in attitudes and practices in the financial management of firms		30% of those in business now are not keeping very extensive records
2005	Banomyong	The Cash Conversion Cycle measurement	The Cash Conversion Cycle (C2C) is a powerful performance metric for assessing how well a company is managing capital	Huge variations from company to company within a supply chain
2002	Deakins et al	Process of financial management	Assumption of inadequate financial management practices as contributors to turbulence in the small firm sector	Limited literature on financial management practices in small firms
2002	Collis and Jarvis	Use of financial information in small companies	Financial management is critical to their success and survival	Most widely used and most useful sources of financial information is monthly/quarterly management accounts and cash flow information in various forms
1996	Peel and Wilson	Capital budgeting and working capital practices of small firms	This is a neglected and important area of small business research	A relatively high proportion of small firms in the sample claimed to use quantitative capital budgeting and working capital techniques
1991	Ang, James	Small Business Uniqueness and the Theory of Financial Management	It is fair to say that the theory of modern corporate finance is not developed with small businesses in mind.	there are new and interesting topics in small business financial management research
1991	McMahon et al	Use of accounting information	Trends in financial management practice of small firms	No significant change in financial management practices of small firms over fifteen years. Research needed in accounting systems, financial reports, working capital management, fixed asset management and managerial planning and control.
1990	Godwin		Family Financial Management'	
1976	Jensen and Meckling	This paper integrates elements from the theory of agency, the theory of property rights and the theory of finance to develop a theory of the ownership structure of the firm		
1976	Gregory	Cash flow management	Under stable economic conditions, this is a matter of deciding when to transfer assets and how much	Review and recommendation
1952	Ross	Financial management of Schools in US	Template-summary of key elements	