



Effects Of Micro Finance Banks Liquidity On The Working Capital Of Small And Medium Scale Enterprises

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ABSTRACT

The paper x-rayed the effects of Micro Finance banks liquidity on the working capital of small and medium scale enterprises. Pertinent literature were reviewed in the area of: concept of liquidity, concept of working capital, synopsis of small and medium scale enterprises, how microfinance banks finances SMEs, effects of microfinance banks adequate liquidity on the working capital of SME's, and effects of CBN liquidity ratio for microfinance banks on the working capital of SME's. The literature reviewed disclosed that Small and Medium Scale Enterprises constitute a vital engine in economic growth and development of any nation; and that there is no universally accepted definition of Small and Medium Scale Enterprises. Also, the reviewed literature revealed that reasons for establishing the micro finance banks among others is to provide financial services that are needed by the economically active poor; micro, small and medium enterprises, to conduct or expand their businesses. However, if micro finance banks are not financially liquid, they will not be able to discharge their functions appropriately, which will in turn affect the working capital of SME's. it was however recommended that Micro finance banks should ensure they maintain equilibrium in their liquidity, since adequate liquidity serves as vehicle for profitable operations especially to sustain confidence of depositors in meeting short run obligations.

Keywords: Micro Finance Banks, Liquidity, Working Capital & SMEs

INTRODUCTION

Liquidity as a concept is receiving serious attention all over the world especially with the current financial situations and the state of the world economy. Some of the striking corporate goals include the need to maximize profit, maintain high level of liquidity in order to guarantee safety, attain the highest level of owner's net worth coupled with the attainment of other corporate objectives. The importance of liquidity management as it affects corporate profitability in today's business cannot be over emphasized. The crucial part in managing working capital is required maintenance of its liquidity in day-to-day operations to ensure its smooth running and meets its obligation (Ibe, 2013; Eljelly, 2004).

The ultimate objective of any firm including Small and Medium Scale Enterprises (SME's) is to maximize profit. But, preserving liquidity of the firm is an important objective too. The problem is that increasing profits at the cost of liquidity can bring serious problems to the firm. Therefore, there must be a trade-off between these two objectives of the firms. One objective should not be at the cost of the other because both have their importance. If profit is not cared about, the firm cannot survive for a longer period. On the other hand, if liquidity is not cared about, the firm may face the problem of insolvency or bankruptcy. For these reasons working capital management should be given proper consideration, as these will ultimately affect the profitability of the firm (Ghosh and Maji, 2003).

Microfinance banks were introduced specifically to serve the poor segment of the Nigerian society. Micro finance banks are companies licensed under the CBN Act No. 24 of 1991 (as amended). Reasons for establishing the micro finance banks among others is to provide financial services that are needed by the economically active poor; micro, small and medium enterprises, to conduct or expand their businesses. Specifically, Edafiaje (2011)

noted that Microfinance banks were specially made to address financial needs of the poor and provide a basis for economic growth starting from the grassroots; which is within the purview of SMEs. However, Microfinance banks are unable to meet up their obligations because they are not financially liquid to do so. Akintola (2010) stated that several small scale business operators alleged that they had made several attempts to get loans from microfinance banks due to stringent conditions such as the low income level of depositors, customers' bad attitude, liquidity squeeze of microfinance banks etc. This inability for microfinance banks to meet up the financial needs of SME's has an adverse effect on the working capital of these SME's.

In an ideal situation, working capital would not be necessary because there would be no uncertainty, no transaction costs, and no scheduling costs of production or constraints of technology. The unit costs of producing goods will not change with the amount produced. Businesses will 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 an ideal situation there would be little need to hold any form of inventory other than a limited amount of goods in process during production. But such an ideal business assumes that demand is exactly known in advance, that suppliers keep to their due dates, production can be smoothed and orders executed directly without costs and delays. There would be no need of holding cash for working capital other than for the initial costs, because it could be possible to make the payment from every receipt of sales. There would also be no need for receivables and payables if customers pay cash immediately and the firm would also make its payment promptly. However, problems of working capital exist because these ideal assumptions are never realistic and therefore working capital levels make a significant part of a firm's investment in assets and these assets have to be financed implying that investments may have benefits as well as costs.

In line with the premise above, Kaur (2010) stated that the management of working capital is one of the most important and challenging aspects of the overall financial management. Merely more effective and efficient management of working capital can ensure the survival of a Small and Medium Scale Enterprise. In the same vein, Fess (2011) noted that the measure of working capital has long been accepted as a useful tool for financial analysis. Yet a critical review of the structure of this concept, as it is currently applied, raises some very serious questions concerning its validity as a measure of current positions among Small and Medium Enterprises. Hence, it became imperative to study the effects of micro finance banks' liquidity on the working capital of small and medium scale enterprises.

Statement of the Problem

Banking system liquidity is vital to the sustainability of the financial system. Indeed a quick look into the global financial market crises between 2007 and 2009 stresses this point. Tensions appeared in global markets and even in Nigeria, as liquidity in money markets declined significantly, following credit rationing in the interbank markets. The tightening of liquidity in the market and increasing default risk, culminated in the intervention of central banks in the financial system. In Nigeria, the Central Bank, injected over N620 billion or approximately \$4.1 billion, representing 2.5 per cent of Nigeria's entire 2010 GDP into the banking system to improve the banks' liquidity and keep them from failing. Between 2008 and 2009, Nigerian banks wrote off loans equivalent to 66% of their total capital. A majority of these write offs occurred in the eight banks, which received intervention from the CBN. The write offs occurred because most of the assets created were relatively illiquid and had diminished in value (Udukwe, 2013).

The financial crisis has clearly shown how liquidity issues can spread and be transmitted throughout an entire financial system. The dire consequences of insufficient liquidity, make liquidity risk management a key element in a bank's overall risk management structure. The inability of a bank to meet its obligations upon request may result in a bank run. To reduce the risk of a bank run, banks are statutorily required to maintain a certain proportion of their assets as liquid assets. A bank can employ various strategies to keep liquidity levels above statutory requirements, however, these deposits come with a cost. A bank that attracts significant liquid funds at lower costs has the potential for generating stronger profits and efficiently delivering its financial intermediation functions to the benefit of the economy vis-à-vis SME's. Against the background of the foregoing, microfinance banks' liquidity has an overbearing effect on SME's working capital. This is because, if microfinance banks are not financially liquid to discharge their functions to SME's, the working capital of these SME's will be affected. Hence, this study x-rayed the effects of micro finance banks' liquidity on the working capital of small and medium scale enterprises.

Conceptual Review

The conceptual review is discussed in subheadings as thus:

Concept of Liquidity

Liquidity is a financial term that means the amount of capital that is available for investment. Today, most of this capital is credit, not cash. Bank Liquidity simply means the ability of the bank to maintain sufficient funds to pay for its maturing obligations. It is the bank's ability to immediately meet cash, cheques, other withdrawals obligations and legitimate new loan demand while abiding by existing reserve requirements. Nwaezeaku (2008) defined liquidity as the degree of convertibility to cash or the ease with which any asset can be converted to cash (sold at a fair market price).

Liquidity management therefore involves the strategic supply or withdrawal from the market or circulation the amount of liquidity consistent with a desired level of short-term reserve money without distorting the profit making ability and operations of the bank. It relies on the daily assessment of the liquidity conditions in the banking system, so as to determine its liquidity needs and thus the volume of liquidity to allot or withdraw from the market. The liquidity needs of the banking system are usually defined by the sum of reserve requirements imposed on banks by a monetary authority (CBN 2012).

Liquidity can be referred to as a measure of the ability and ease with which assets can be converted to cash on short notice, or by having access to credit, in response to meeting cash and collateral obligations at a reasonable cost. It can also refer to the ability of banks to meet their liabilities, unwind or settle their positions as they fall due (Basel Committee of Banking supervision). Liquidity is also defined as the availability of funds, or guarantee that funds will be available quickly to cover all cash outflow commitments in a timely manner. From these definitions, it is clear that easily convertible assets are kept in anticipation of customer demand. An asset is liquid, if it is readily converted to cash without materially impacting on the price of the asset. The ease of moving or transferring the asset is also an important factor for an asset to be liquid. If an asset cannot easily be moved or transferred and the full market value of an asset cannot be easily realized at short notice, such an asset is said to be illiquid. Examples of illiquid assets include unsecured loans to bank customers or real estate, while liquid assets include cash, government treasury bills and debt instruments or central bank reserves (Udukwe, 2013).

According to business dictionary, liquidity is a measure of the extent to which a person or organization has cash to meet immediate and short-term obligations or assets that can be quickly converted to do this. Liquidity can also be a measure of the ability and ease with which assets can be converted to cash. Liquid assets are those that can be converted to cash quickly if needed to meet financial obligations; examples of liquid assets generally include cash, central bank reserves and government debt. To remain viable, a financial institution must have enough liquid assets to meet its short term obligations, such as withdrawals by depositors.

Liquidity can further be termed as a bank's capacity to fund increase in assets and meet both expected and unexpected cash and collateral obligations at a reasonable cost and without incurring unacceptable losses. Also, liquidity is a financial term that means the amount of capital that is available for investment. Today, most of this capital is credit, not cash. Bank Liquidity simply means the ability of the bank to maintain sufficient funds to pay for its maturing obligations. It is the bank's ability to immediately meet cash, cheques, other withdrawals obligations and legitimate new loan demand while abiding by existing reserve requirements. (Olawejunmi and Adeyemi, 2015).

On a broad perspective, Udukwe (2013) noted that liquidity can be classified into three categories; namely central bank liquidity, market liquidity and funding liquidity. On the one hand, central bank liquidity constitutes deposits of financial institutions held at the central bank. These deposits are required by the central bank and are often known as reserve balances. Reserves are held by banks to meet the prudential guidelines or statutory requirements. On the other hand, market liquidity involves buying and selling of assets without unduly affecting the assets price. In other words, an asset's market liquidity is the ease at which an asset can be sold quickly without incurring unacceptable losses. Lastly, funding liquidity describes the ability to raise cash or its equivalent, quickly either through collateralized loans, asset sales or by borrowing. A bank, is therefore, liquid if it is able to meet funding needs as at when the demand arises and if at all times outflow of funds from the bank are less than or equal to inflows into the bank. Short of this, there will be a liquidity mix match, which can lead to a crises or a run on the bank.

Concept of Working capital

According to Bhattacharya (2009), the concept of working capital was perhaps first evolved by Karl Marx, though in a somewhat different form, and the term he used was “variable capital”. Working capital as current assets minus current liabilities and their view was elaborated by Park and Gladson (2003). This definition is also known as “net working capital”. Current assets are sometimes called as “gross working capital”. The current assets can be divided to four primary components: (1) cash and cash equivalents; (2) marketable securities; (3) accounts receivable; and (4) inventory and the three major items of current liabilities are: (1) accounts payable; (2) expenses payable, including accrued wages and taxes; and (3) notes payable (Chen, Wang, & Lin, 2009). Narrower definition for working capital is inventory + accounts receivable – accounts payable. This definition emphasizes operating efficiency of a firm. Articles with all kind of definitions to working capital are accepted in this study to the group of articles from which analyses are made. Making decisions that affect to working capital is called working capital management (Planware, 2011).

Working Capital is defined as a company’s total investment in current assets or assets that a company expects to be converted into cash within a year or less (Keown; Martin; Petty; & Scott, 2005). It is employed to structure and grow a business, and to finance daily operations. Working Capital Management is then concerned with the difference in the firm’s current assets and current liabilities, and the decisions related to net working capital allocation (ibid).

Lyytinen (2009) noted that Working Capital may be defined according to the following concepts:

1. **Gross Working Capital:** It refers to the firm’s investment in total current or circulating assets.
2. **Net Working Capital:** The term “Net Working Capital” has been defined in two different ways:
 - i. It is the excess of current assets over current liabilities. This is, as a matter of fact, the most commonly accepted definition. Some people define it as only the difference between current assets and current liabilities. The former seems to be a better definition as compared to the latter.
 - ii. It is that portion of a firm’s current assets which is financed by long-term funds.
3. **Permanent Working Capital:** This refers to that minimum amount of investment in all current assets which is required at all times to carry out minimum level of business activities. In other words, it represents the current assets required on a continuing basis over the entire year. The following are the characteristics of this type of working capital:
 - i. Amount of permanent working capital remains in the business in one form or another. This is particularly important from the point of view of financing. The suppliers of such working capital should not expect its return during the life-time of the firm.
 - ii. It also grows with the size of the business. In other words, greater the size of the business, greater is the amount of such working capital and *vice versa*

Permanent working capital is permanently needed for the business and therefore it should be financed out of long-term funds.

4. **Temporary Working Capital:** The amount of such working capital keeps on fluctuating from time to time on the basis of business activities. In other words, it represents additional current assets required at different times during the operating year. For example, extra inventory has to be maintained to support sales during peak sales period. Similarly, receivable also increase and must be financed during period of high sales. On the other hand investment in inventories, receivables, *etc.*, will decrease in periods of depression. Suppliers of temporary working capital can expect its return during off season when it is not required by the firm. Hence, temporary working capital is generally financed from short-term sources of finance such as bank credit.

5. **Negative Working Capital:** This situation occurs when the current liabilities exceed the current assets. It is an indication of crisis to the firm.

Synopsis of Small and Medium Scale Enterprises

The question has always been “how small is a small-scale business”? There appears to be no consensus on the definition of small and medium scale enterprises. Only operational definitions are available; the definition varies a great deal across countries, individuals, institutions and organizations and this arises as a result of different levels of economic advancement.

Okojie (2005) defined small and medium scale enterprises as businesses that can be established by individuals as a sole-proprietor, partnership- consisting of few persons or company, which cannot take more than fifty persons.

According to him, The European Commission (EC) initiated a set of definition of the small and medium enterprises excluding agriculture, forestry and fishing as:

- Micro enterprises: from 1-9 employees.
- Small enterprises: from 10-99 employees
- Medium enterprises: from 100-249 employees.

The Central Bank of Nigeria Monetary Policy circular No. 22 of 1996 has defined a small or medium scale business enterprises as any manufacturing or service enterprise whose business turnover does not exceeds N500, 000(including land and working capital) and or the annual turn-over did not exceed N5 million.

In the 1990 budget, Federal government of Nigeria (CBN) also defined small/medium scale enterprises, for the purpose of commercial bank loans as those enterprises with annual turnover not exceeding N500, 000 and for Merchant Bank loans, those enterprises with capital investments not exceeding N2m excluding cost of land or maximum and of N5M.

The Small and Medium Industries and Equity Investment Schemes (SMIEIS) defined Small and Medium Enterprises (SMEs) as any enterprises with a maximum asset base of N200 million excluding land and working capital and with the number of staff employed not less than 10 or more than 300. Small and medium enterprises have been defined along a broad continuum of size and type. In terms of size measures used to classify SMEs include employment, assets and revenue. According to Akabueze (2002), business activities that meet these criteria will be considered as eligible Small and Medium Scale Enterprises and this can partake in small and medium industries and equity investment scheme (SMIEIS).

How Microfinance Banks Finances SMEs

According to Ogbunaka (2003), microfinance banks undertake credit assessment in similar ways that commercial bankers do but with more emphasis on activities than collateral of recent, when having a loan in commercial banks it must be based on the (5Cs) of lending which guide bankers on credit creation and management among other analytical tools.

These 5Cs of lending are known in banking as the principles of good lending because it help in reducing credit risk to bankers and it is important that prospective bank borrowers understand it so that they would approach banks with applications that get successful The 5Cs are character, condition, capacity, capital and collateral in commercial banks. Funds (loans) from microfinance banks play several roles for small scale business as follows:

- Constitute a relatively cheap source of funds to small scale businesses
- Represent a financial guaranty for loans that is easily accessible to small scale Businesses
- Microfinance banks helps to reinforce responsibility of operators of small scale businesses
- Microfinance banks helps to reinforce the repayment discipline of borrowers i.e. small scale businesses.
- Contributes undeniably to reinforcing the viability of the small scale businesses and it long term self sufficient
- Allow the microfinance banks to serve small scale businesses who do not have the collateral facilities to borrow money.

Effects of Microfinance Banks Adequate Liquidity on the Working Capital of SME's

According to Nwankwo (1991), adequate liquidity enables a bank to meet three risks. First is the funding risk – the ability to replace net outflows either through withdrawals of retail deposits or nonrenewal of wholesale funds. Secondly, adequate liquidity is needed to enable the bank to compensate for the non-receipt of inflow of funds if the borrower or borrowers fail to meet their commitments. The third risk arises from calls to honour maturity obligations or from request for funds from important customers. Adequate enables the bank to find new funds to honour the maturity obligations such as a sudden upsurge in borrowing under atomic or agreed lines of credit or to be able to undertake new lending when desirable.

Adequate liquidity is also needed to avoid forced sale of asset at unfavourable market conditions and at heavy loss. Adequate liquidity serves as vehicle for profitable operations especially to sustain confidence of depositors in meeting short run obligations. Finally, adequate liquidity guides against involuntary or non-voluntary borrowing from the regulatory authorities where there is a serious liquidity crisis, the bank is placed at the mercy of the Central Bank, and hence the control of its destiny may be handed over. Having adequate or sufficient liquidity to meet all commitments at all times at normal market rates of interest is indispensable for both large and

small banks (Nwankwo, 1991). Liquidity is the life blood of a banking setup. If microfinance banks are financially liquid to discharge their functions to SME's, the working capital of these SME's will be positively affected i.e. SME's will have a positive working capital.

Effects of CBN Liquidity Ratio for Microfinance Banks on the Working Capital of SME's

The total volume of banking system liquidity is greatly influenced by the monetary operations and monetary targets of the central bank. The process of monetary policy implementation require the use of policy instruments that serve to stabilize interest rates at a level that is in tandem with the monetary targets set by the Central Bank. Stability in monetary aggregates means that the Central bank achieves equilibrium between demand for and supply of liquidity in the banking system.

The central bank injects liquidity through its open market operations (the purchase of domestic securities), reverse repo operations or by extending credit facility. Banking system liquidity is impacted by balance sheet structure and hence cash flows obligations of banks. Customers withdrawal of deposits are often random and unpredictable, as a result, the liquidity reserves of individual banks vary and are not constant, often resulting in surplus or deficit liquidity in the banking system. Liquidity is surplus in the banking system, when inflow of funds into the system is only as a result of the monetary operations of the central bank and not in response to a voluntary demand for liquidity by banks. On the other hand, the banking system is faced with tight liquidity conditions or a deficit, when the voluntary demand for liquidity by the banking system needed for complying with the statutory reserve requirement, or honour current liabilities exceeds the volume of monetary operations of the Central bank. Central Banks require deposit money banks (DMBs) to keep a minimum liquidity ratio that ensures that the banks are able to meet current liabilities and settle outstanding obligations as they fall due. Liquidity ratio is measured as a ratio of liquid assets to current liabilities. Liquid assets include cash, short term investment securities and government bonds while current liabilities on the other hand include, customer's deposits, borrowings etc.

Udukwe (2013) deposed that the minimum liquidity ratio as specified by the Central Bank of Nigeria is 30%. However, a higher liquidity ratio increases the safety margin of banks. Besides the liquidity ratio, there are other legal reserve requirements that the Central Bank of Nigeria use in regulating the liquidity in the banking system. The Central Bank also requires that banks hold a certain percentage of their deposits as reserve with the Central Bank. The fraction held is called the Cash Reserve Ratio. Therefore, micro finance banks that are unable to meet up CBN Liquidity Ratio will be unable to advance loans to SME's, which in turn will affect their working capital.

SUMMARY AND CONCLUSION

The study investigated the effects of micro finance banks liquidity on the working capital of small and medium scale enterprises in Delta State. Banking system liquidity is vital to the sustainability of the financial system. The dire consequences of insufficient liquidity, make liquidity risk management a key element in a bank's overall risk management structure. The study showed that micro finance banks among others are established to provide financial services that are needed by the economically active poor; micro, small and medium enterprises, to conduct or expand their businesses.

RECOMMENDATIONS

The following recommendations were made in this study:

1. Liquidity is the life blood of a banking setup. Therefore, Micro finance banks should ensure they maintain equilibrium in their liquidity, since adequate liquidity serves as vehicle for profitable operations especially to sustain confidence of depositors in meeting short run obligations.
2. Small and Medium Scale Enterprises should update themselves through various trainings and workshops on relevant working capital management practices like: cash management practices, accounts receivables management practices, inventory management practices, accounts payable management practices, and investment management practices. The understanding and application of these working capital management practices, will in turn lead to the profitability, liquidity, reduction of financial cost, and ease of releasing more capital for the strategic objectives of SMEs.
3. Central Banks require banks to keep a minimum liquidity ratio that ensures that the banks are able to meet current liabilities and settle outstanding obligations as they fall due. Liquidity ratio is measured as a ratio of liquid assets to current liabilities. Liquid assets include cash, short term investment securities and

government bonds while current liabilities on the other hand include, customer's deposits, borrowings. So, Micro finance banks should comply with CBN on liquidity ratio for them to be viable.

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