LESSON –13

CASH MANAGEMENT

13.0 Objective :

After studying this lesson, you should be able to:

i) understand the functions and objectives of cash management
ii) explain the need for holding cash
iii) know the different facets of cash management.,
iv) determine the optimum cash balances
iv) develop the cash management strategies

Structure :

13.1 Introduction:

Cash is the most important asset for the operations of the business firms. It is the basic input needed to keep the business running on a continuous basis and also the ultimate out for the business operations. The business firm should always maintain sufficient cash reserves, because the excessive cash will remain idle, shortage will disrupt the firm operations. Normally, every business firm holds 1 to 3 percent of its assets in the form of cash to enable itself to discharge its routine obligations such as payment of salaries, bills, day-to-day expenses, repayment of loans, dividends, interest, etc. The meeting capacity of business transactions depends more on the amount of cash it holds either in bank or on hand. To enable its liquidity and paying capacity, a sound cash management is necessary.

13.2 Functions of Cash management:

The following are the functions of cash officer of any business concern irrespective of its size, nature, volume of business, age, etc. The same can also be referred as management of receipts and payments, which includes:

i) Forecasting cash needs;
ii) Expediting cash collections;
iii) Disbursing cash to meet firm's obligations and
iv) Gainful investment of surplus cash;

Diagram 13.1. Receipts and payments

13.3 Different levels of cash:

In any business firm, the cash balance may be either shortage or excessive and it is difficult to maintain exactly the required amount. Cash receipts and payments of a firm very rarely coincide, thus coincidence of cash receipts and payments is a big challenge. Either a firm faces cash shortage or cash surplus if not cash officer controls its cash flows. Normally, in these days of heavy competition, due to the uncertainties of cash sales and cash collections disbursements tend to be more than the cash receipts. The function of cash management is to match these two either by borrowing during times of cash shortage or investing cash in times of surplus so as to ensure that the firm is free from cash problems. Thus, cash manager invests the excess cash in securities and see that it will be made available in times of scarcity.

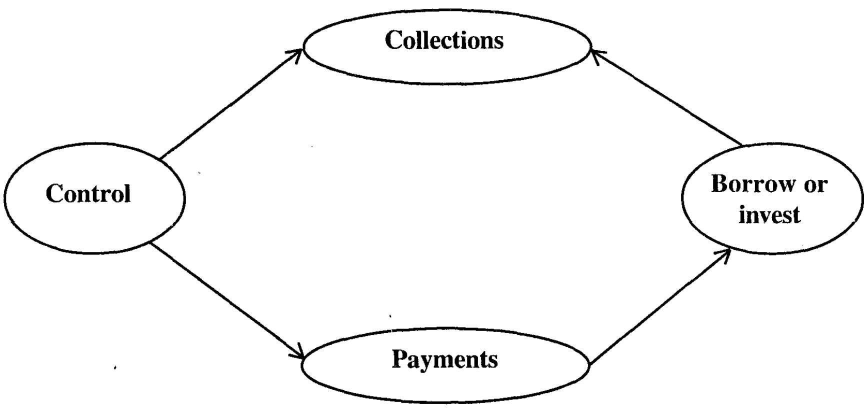

Diagram 13.2 Cash cycle

13.4 Objectives of Cash management:

The twin objectives of working capital management such as profitability and liquidity are also implied to cash management. The cash manager has to arrange right amount of cash at right time for a right purpose to pay for. It does not mean that he can hold heavy amount at the cost of interest. In simple, the idle cash causes interest loss and the firm incur opportunity cost, which indirectly affects the profitability. Therefore, the cash manager has to hold optimum level of cash and not a rupee extra or short beyond the optimum level of cash.

13.5 Importance of Cash management:

Cash is unique resource and not comparable with any other component of current asset. If excess cash is held, it will not generate profits since cash is sterile. It will not be productive directly as in the case of other assets. Inventory bought excess will be useful even after sometime, without loss of value and many a time value of inventories tend to increase due to inflation. Hence idle cash will not generate profit but causes loss of interest. Further, cash shortage causes irreparable loss to the management, since firms loose not only profitable business opportunities but also goodwill when they fail to clear the bills timely due to cash shortage.

13.6 Motives for Holding cash:

Keynes, the famous economist said that the businessmen hold cash for 3 motives, which are as follows:

i) Transaction motive;
ii) Speculative motive; and
iii) Precautionary motive

13.6.1 Transactions motive:

Cash manager is expected to arrange right amount of cash at right time to pay for a right purpose. Infact, the cash receipts will never synchronize with cash obligations to pay for. Hence to meet the expenses timely, a firm has to hold optimum amount of cash and keep the firm comfortable in its cash transactions. Larger the business transactions more the amount of cash balance to be maintained and vice - verse.

13.6.2 Precautionary motive:

Firms at times need cash without prior notice. They need cash under emergency conditions such as break down of machines, fire, theft t, accidents etc failing which they have to pay heavy penalties. In such cases cash rich companies can withstand rather than nil less cash companies. Thus, causalities, accidents, theft, machinery break - down, etc., in organizations generally demand cash immediately. To meet the said eventualities, the firms have to maintain cash balances. This cash balance is called precautionary cash balance. Hence they have to raise funds in very short notice or some times spontaneously also. At that time only cash rich companies credit worthy will be able to survive under hectic conditions cited above.

13.6.3 Speculative motive:

Of course, not all firms do business with speculative motives. Occasionally, every business firm comes across speculative conditions such as sudden and heavy fluctuations in prices of raw materials and rates of interest leading to raise in market for goods. Hence, there is sudden rise in demand for goods, which warrants availability of cash in very short notice. Thus the speculative conditions give chance to raise profitable opportunities. Firms, having ability to generate cash in short notice will take advantage of these speculative conditions of business opportunities.

13.7 Controlling of cash flows:

The task of cash manager is to match the inflows and outflows of cash. For this, the manager starts with cash budget, where total cash receipts and payments of an enterprise are forecasted. In this broad exercise of cash management, synchronization of cash flows is the real task. The cash flows will never synchronize and it always the disbursements tend to be higher than receipts. Then the cash manager wisely accelerates the inflows and delays disbursements by all means without affecting liquidity and profitability the twin objectives of any business enterprise.

In practice collection of cash from debtors is time taking. The present system is so poor that cash manager can not expedite collections unless he plans and takes necessary steps to reduce the gap between the date - the customers pones bills by cheque and the date of funds made available for firm's use i.e., reaching time and processing time. The cheque in transit takes minimum 2/3 days to receive and again the check has to be collected through bank, which takes minimum of ten days. Under the present state of postal and banking system the minimum days that comes around 15 days. Hence, in order to reduce the time period the cash manager has to speed up mailing, cheque processing and collection times.

13.7.1 Decentralized collections:

To save mailing and processing time, can firms have decentralized collection practices? For this the firms lave to open several bank accounts and use them as collecting centers operated throughout the country. These centers collect the money and deposit in banks on the same day, which can be credit to central office account by using electronic media.

13.7.2 Lock box system:

Under the lock box system, lock boxes are arranged in banks, which are collection centers. The customers are supposed to drop cheques into these boxes and the bank picks-up these cheques and deposits them into the firm's bank account and send the information daily to the firm. With this process, the firm can save lot of transaction time and also save the cost for their processing. Finally, it results to reduce the transit amount of cash and therefore with less cash balances one is able to maintain the business.

13.7.3 Cash discounts:

The customers are informed at the time of invoicing that they will be paid cash discounts on invoice for 2 per unit if they pay before the maturity date of the bill. This way receipts can be expedited, which is more benefited in the event of growing opportunities of the business of at the time of shortage of funds in the business?

13.8 Collection responsibility:

The sales personnel are made responsible to collect the bills, so that they do not recommend the credit for doubtful parties. This would also minimize the delay in receipts if the parties are sound and sales personnel pursue the bills pending.

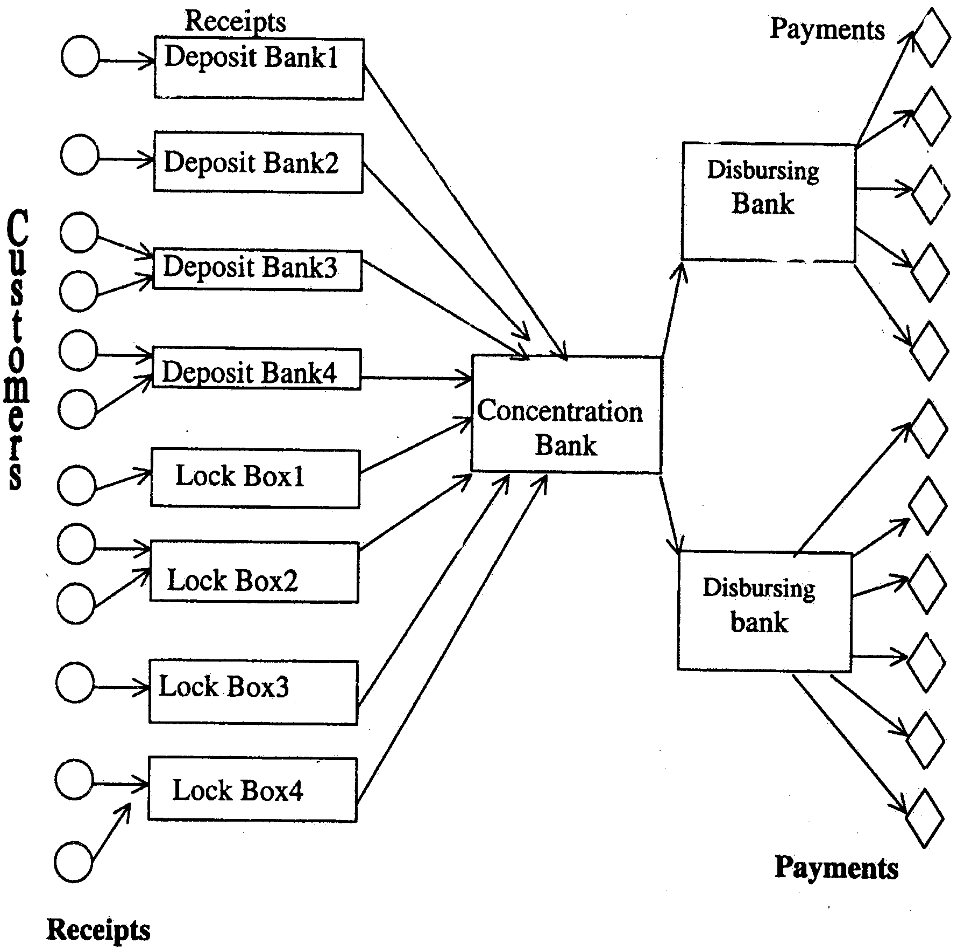

Exhibit 13.1. Cash Management System

13.9 Factors affecting cash:

The amount of cash requirement of a business firm depends upon the following factors, which are discussed as under:

i) Credit position

Firms having goodwill in the market do not require cash balance much. They get services and goods on credit as they re-pay the bills timely out of the in sale proceeds and have such firms need not maintain thereby cash balances.

ii) Debtors position:

The ability to pay bills depends upon the company's sales policy i.e., whether on credit or cash, credit for how long. Longer the credit period more the cash balances it should prepare to make its purchases. Further, a firm extending liberal credit will have its debtors position high and consequent of it more bad debts also. And firms with tight credit policy will maintain low debtors position and less bed debts hence and the firm is able to do the business with less cash balances.

iii) Nature of market:

It has great influence on cash requirement, in certain markets one has to buy on cash, since credit facility is not available. In some of the unorganized sectors and small businesses where bank loans are not extended, the firms have to arrange their own cash.

iv) Inventory levels:

Higher the inventory levels a firm follows, more the 'cash' required. Lower the inventory level less is the cash balance to be needed. Thus, inventory level certainly influences the cash requirements of the business.

v) Technology

The firms, which are, followed manual methods need more cash by week ends to pay for wages. Whereas, the firms whose business activities are more technology based required less amount of cash for the above said purposes

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vi) Efficiently in using cash:

Cash balance depends upon the efficiency is using cash. Professional managements maintain, optimum cash balance and discharge cash obligations.

13.10 Management attitude towards cash Management:

Management attitude too will influence the cash requirements of business. Conservative managements do hold huge cash balance and, clear the bills without reminders, whereas aggressive management | which maintain small cash balances in order to gain more and clears the bills after several remainders.

i) Cash budget practices:

Firms with cash planning and budgeting can avoid sudden and unsaid obligations and run firms smoothly without cash out problems.

ii) Protection against loss:

Companies have to take necessary measures to prevent theft or burglary by going for insurance. These protection measures will keep the firm comfortable, of course firms incur extra expenditure towards insurance premium.

iii) Short costs or cash out problems:

Firms if they do not maintain cash balance, have to face cash out problems thereby incur extra expenses or lose profitable opportunities. These costs are called short out costs and the firms, who are unable to get cash, will be ready to incur such costs. So, management has to trade-off between short-term losses and benefits of adequate cash balances.

iv) Speculation factor and uncertainties:

Firms in speculation business should have excess cash than others. Hence, one should take into account whether the business is involved in such business and should hold more cash in order to continue without sales and timely market for its production.

v) Cooperation from bankers:

Firms, which pay their loans timely will be in good terms with banks. Such firms can go 'easy' in times of cash shortage, since bankers will extend cooperation and provide extra credit in times of need and when market conditions are bright.

13.11 Benefits of adequate cash maintenance:

The following are the benefits to a business firm who maintains adequate cash:

i) Cash discount

Firms can enjoy cash discounts and get goods / services at considerable prices if they made down payments. This will increase profits and credibility. Occasionally, creditors may also extend cash discounts for people who pay in - advance or with - in stipulated period.

ii) Large scale buying

If firms buy raw materials in large quantities they can get at low prices, which will increase the overall profitability of the firms? The firms with cash balance are able to order bulk purchases to get them at lower prices.

iii) Meet contingencies boldly

Firm with adequate cash balance can absorb comfortably the unexpected changes in the market. Technological and demand of the product.

iv) Liquidity

Firms, regular in payments of bills and taxes will be respected by the suppliers and cooperate by way of supplying required quantity of goods at lower prices. The suppliers can also ensure supply of goods in times of scarcity.

v) Profitability

Firms, which bargain at the turn of purchasing inputs and services, will get production at low cost. This will enhance profit margin of the firms, which in turn will enhance its profitability.

vi) Business opportunities

Profitable opportunities can be had only if the firms maintain adequate cash. Otherwise, they loose new and bright business chances. New business opportunities will come to firms with abundant cash. Firms often face cash - out problems do not ensure growth and cannot under - take new ventures.

vii) Easily overcome contingencies

Firms some times involve in accidents such as fire, theft, break down, change of technology, need for modernization etc. The cash - rich companies can over - come such eventualities easily.

viii) Better Bargain

Firm with adequate cash can bargain and obtain inputs at reasonably low price and reduce cost of production.

13.12 Cash budget:

Cash budget is the summary statement of the firms expected cash inflows and out flows over a projected time period. It is a fool to forecast the cash inflows and outflows a for specific period. Cash forecasting is the focal aspect of cash budget. The expected cash receipts and payments are portrayed to arrive cash balance or cash shortage. The cash budgets can be prepared for weekly, monthly, quarterly and yearly. It is a short-term cash forecasting method. To work various policies of working capital 'cash budget' will help particularly for making the following polices.

i) Purchase,
ii) Credit
iii) Cash, and
iv) Inventory.

i) Components of cash Budget:

Sales
Collection of Sunday debtors
Receipts of interest and dividend
Expenses and advances
Wages and Salaries
Purchase and sale of assets
Loans / credit Deposits

While preparing cash budget information relating to the above is necessarily collected. Cash manager has to keep the following plans ready while preparing the cash budget.

- Production plans,
- Purchase plans,
- Financial plans, etc.

ii) Methods of preparing cash budget:

There are various methods of cash budget preparation, of which the Receipts and payment method is one of the methods for preparation of the cash budget. It summarizes the receipts and payments for a specific period.

Exhibit: 13.2 Pro- forma for Cash Budget on a Hypothetical firm

:

a) **Opening cash balance**	Jannuary	February	March	April
b) **Receipts**				
Cash Sales				
Collection of Debtors...				
Rent				
Dividends				
Receipts from sale of machinery				
Interest on securities				
Total receipts				

c) **Payments**				
Cash purchases				
Creditors paid				
Wages / Salaries				
expenses				
Dividends				
Taxes				
Purchase of assets				
Rent				
Total payments				
d) Net cash flow (b-c)				
e) Closing balance (a+d)				
f) Minimum cash balance				
g) Surplus / short (a-b)				

iii) Variance in cash budget method:
i scenario may be normal, optimistic and pessimistic. Taking these situations into consideration the budgets are prepared. These variable cash budgets suggest levels of cash balances depending upon future trends**.**

13.13 Optimum level of cash

Cash balance cannot be too high or low. The lower cash balance than the required level creates problems. The higher level of cash balance will ensure liquidity, but the firm has to sacrifice profits, as excess cash will not yield returns. Higher the holding of cash more the carrying costs, lower the level of cash, more the transaction costs. Thus, cash manager of a firm has to trade off between higher levels of cash balance and reach out optimum level of cash. The following diagram 13.3 shows graphically the optimum level of cash.

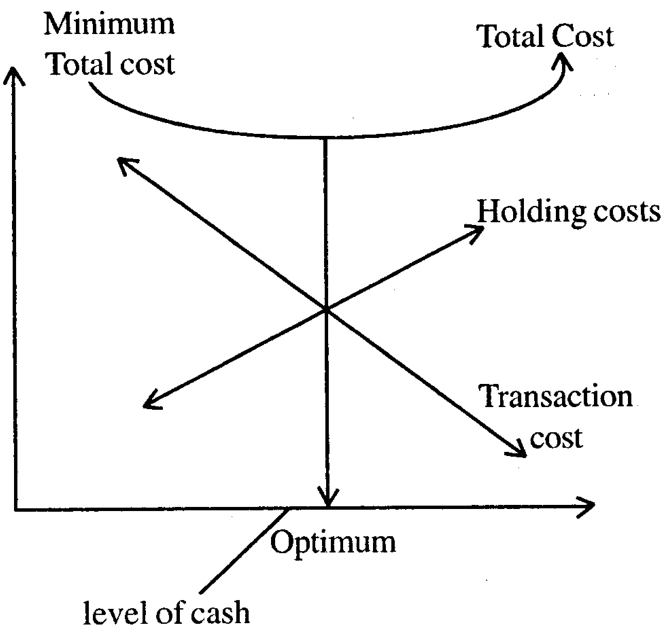

Diagram 13.3 Optimum level cash

The intersection of the two cost curves gives the minimum cost point. Any point either below or above the intersection point results in higher costs.

13.14 Cash Planning:

Cash Planning refers to looking into future cash needs of a firm and it is a practice, which should be carried out periodically. Firms practicing cash planning will not have cash problems. Thus, cash planning is as good as insuring a firm from shocks of cash shortage caused by market uncertainties. Hence, the cash planning is a tool to control the use of cash optimally. Cash budget is the most significant device for planning and controlling cash receipts and payments.

13.15 Cash Management strategies

It is necessary for a firm to have an optimum cash balance. For this purpose, it is necessary to know the cash cycle and cash turnout rate.

(i) Cash Cycle: Cash cycle refers to the process by which cash is used to purchase material and convert material into finished goods and sales and ultimately result in collection of receivables. Cash cycle can be calculated as (average number of days taken to collect from accounts receivables + average age of inventories - average number of days for payments of accounts payable.)

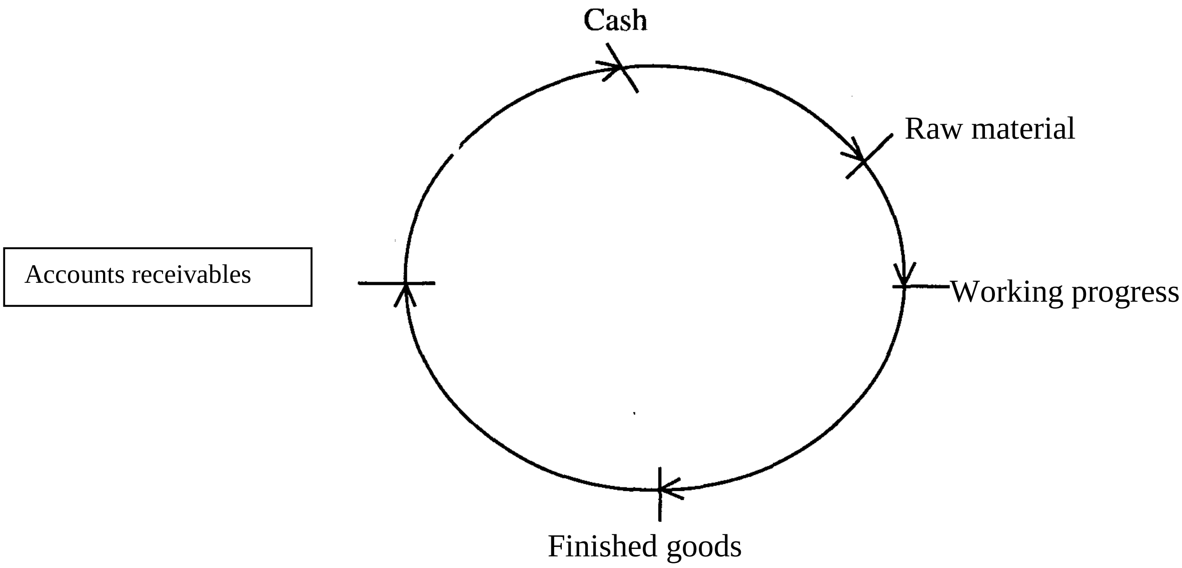

Diagram 13.4 Cash cycle

(ii) Cash Turnover:

Cash turnover means number of times firm's cash is used during each year. It can be calculated as:

$$\text{Cash Turnover} = \frac{\text{No. of days in a year}}{\text{No. of days in a cash cycle}}$$

$$\text{Minimum Operating Cash balance} = \frac{\text{Firm's total annual outlays}}{\text{Cash Turnover rate}}$$

In order to reduce the minimum operating cash balance, the following strategies may be followed:

a) Stretching accounts payables

The management of a firm can delay paying the bills without loosing its credibility. By stretching the accounts payable, cash cycle gets reduced and cash turnover rate gets increased. Thus, the minimum cash requirement is reduced and results in savings.

b) Efficient production

With the usage of efficient production techniques and effective scheduling, the inventories can be transformed speedily into finished goods. Besides, the management can also use better inventory techniques, so that the taken time to hold inventories will be reduced.

c) Efficient Collection

Using all possible techniques, the firms can collect cash from accounts receivable as quickly as possible without losing future sales, so that cash cycle will be better.

Illustration:13.1
From the following information what would be the saving on cost? Assume 10% is earnings of the investment, what would be the effect of stretching accounts payable on the minimum operating cash requirement?

Cash Turnover =10 times
Annual cash outflow = Rs 3,00,000
Accounts payable can be stretches by 30 days.

$$\text{Cash Turnover} = \frac{\text{No. of days in a year}}{\text{No. of days in cash cycle}} = \frac{360}{10} = 36 \text{ days (present)}$$

Cash cycle, when accounts payable can be stretched by 30 days would be:

$$= \frac{360}{6} = 60 \text{ days}$$

$$\text{The minimum operating balance } = \frac{3,00,000}{10} = \text{Rs } 30,000$$

$$\text{The proposed operating cash balance} = \frac{3,00,000}{60} = \text{Rs.}5000$$

The reduction in cash balance = Rs. 30,000 - Rs.5000 = Rs. 25,000

Saving by investment of cash released (25000 x 10%) Rs. 2,500/-

13.16 Summary:

Cash is the most liquid asset and is considered as the lifeblood of a business firm. Cash is held to meet the needs of day-to-day transactions and to meet future uncertainties. But, it is an idle resource which has an opportunity cost. Hence, it should be properly planned, controlled and managed. A firm should neither have an excess cash balance nor a shortage and it should be an optimum level of cash balance. The cash budget is probably the most important tool in cash management. It is a device to help a firm to plan and control the use of cash. The cash management strategies are helpful to minimize the operating cash balance requirements.

13.17 Key words:

Cash budget: A forecast of a firm's expected cash inflows and cash outflows.
Cash discount: it is offered by sellers to induce early payment by the purchasers.
Cash management: it is concerned with holding sufficient cash to demand and investing cash balance to maximize return.
Cash Turnover: the number of cash cycles completed in one year.
Cash Planning: it is technique to plan and control the use of cash.
Lock-box System: it eliminates the time between the time cheques are received by the firm and the time they are deposited in the bank for collection

13.18 Self Assessment Questions

1. Explain different principal motives of holding cash.

2. What are the benefits of cash management?

3. Explain Lock - Box system.

4. What do you mean by concentration banking?

5. Explain utility of cash budget.

6. What are sources and uses of cash?

7. Explain the methods of cash budgeting.

8. Explain the techniques used in accelerating cash collections.

9. Distinguish between a deposit float and payment float.

10. How does appropriate cash balance be determined?

11. Prepare a monthly cash budget for six months beginning from April 2003 on the basis of the formation.
    i) Estimated monthly sales are:

	Rs.
January	22,000
February	3,40,000
March	3,20,000
April	2,00,000
May	1,80,000
June	11,00,000
July	12,20,000
August	10,00,000
September	70,000
October	2,20,000

ii) Wages and salaries are estimated as:

April	20,000
May	20,000
June	32,000
July	35,000
August	33,000
September	33,000

iii) Cash sales are 40% of sales and the credit sales are collected in two months.

iv) Purchases amount 60% of sales and are made and paid for in the month preceding the sales.

v) The firm has to pay Rs. 100,000 as interest on debentures during June.

vi) The firm had committed to purchase fixed assets during August for Rs. 500,000. The firm has Rs. 1,38,000 cash balance as on 1.4.2003.

13.19. Further Readings:

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