CASH MANAGEMENT

Meaning and Nature of Cash, Motives for holding cash, Objectives of cash Management, Dimensions of cash management - Cash Planning, Managing the cash flows, Determining optimum level of cash & Investing surplus cash.

MEANING OF CASH

Cash is the most liquid asset, is of vital importance to the daily operations of business firms. It is crucial for the solvency of the firm & thus, it is referred to as the life-blood of the business firm.

Cash is the important CA & basic input needed to keep the business running on a continuous basis & it is also the ultimate output expected to be realised by selling the service or product manufactured by the company.

Cash is the money which a firm can disburse immediately without any restriction. It includes coins, currency notes & cheques held by the firm & balances in its bank account. Sometimes marketable securities or bank time-deposits are also considered as cash. The basic feature of this type of near cash assets is that they can be easily converted into cash.

MOTIVES FOR HOLDING CASH

The Transaction Motive :

It requires a firm to hold cash to conduct its business in normal course. The firm needs cash primarily to make payments for purchases, wages & salaries, other operating expenses, taxes, dividends, etc. For transaction purpose a firm may invest its cash in marketable securities, i.e., it will purchase those securities whose maturity equals with anticipated payments in future. The transaction motive refers to holding cash to meet anticipated payments whose timings is not properly matched with cash receipts.

The Precautionary Motive :

It is the need to hold cash to meet contingencies in future. It provides a buffer to meet some unexpected emergency. The precautionary amount of cash depends upon the predictability of cash flows, i.e., if the CFs can be predicted with accuracy, less cash will be maintained for an emergency. The precautionary balance may be kept in cash & marketable security.

The Speculative Motive :

It relates to the holding of cash for investing in profit-making opportunities as & when they arise, i.e., when the security price change. The firm will hold cash when it is expected that interest rates will rise & security prices will fall. Securities can be purchased when the interest rate is expected to fall; the firm will benefited by the subsequent fall in interest rates & increase in security prices.

OBJECTIVES OF CASH MANAGEMENT

Why do we need to manage cash flow in the organization? What is the use of cash management in the business?

Following purposes of cash management will resolve the above queries:

- **Fulfill Working Capital Requirement: The organization needs to maintain ample liquid cash to meet its routine expenses which is possible only through effective cash management.**
- **Planning Capital Expenditure: It helps in planning the capital expenditure and determining the ratio of debt and equity to acquire finance for this purpose.**
- **Handling Unorganized Costs: There are times when the company encounters unexpected circumstances like the breakdown of machinery. These are unforeseen expenses to cope up with; cash surplus is a lifesaver in such conditions.**
- **Initiates Investment: The other aim of cash management is to invest the idle funds in the right opportunity and the correct proportion.**
- **Better Utilization of Funds: It ensures the optimum utilization of the available funds by creating a proper balance between the cash in hand and investment.**
- **Avoiding Insolvency: If the business does not plan for efficient cash management, the situation of insolvency may arise. It is either due to lack of liquid cash or not making a profit out of the money available.**

DIMENSIONS OF CASH MANAGEMENT _(FACETS OF CASH MANAGEMENT)

The management of cash is important because it is difficult to predict cash flows accurately, particularly the inflows & there is no perfect co-incidence between inflows & outflows of cash.

In order to resolve the uncertainty about cash flows prediction & lack of synchronisation between cash receipts & payments, the firm should develop appropriate strategies of cash management.

The firm should evolve strategies regarding the four facets of cash management :

- **Cash Management: Cash inflows & outflows should be planned to project cash surplus or deficit for a specific period. Cash budget is prepared for this purpose.**

- **Managing the Cash flows: the cash flows should be managed properly, it means that the inflows should be accelerated while cash outflows should be decelerated.**

- **Optimum cash level : the firm should decide about the appropriate level of cash balance. It deals with determining the optimum level of cash balances, i.e., avoiding the cost of excess cash & dangers of cash deficiency.**

- **Investing Surplus cash : The surplus cash balance should be properly invested to earn profit by investing them in bank deposits, marketable securities, etc.**

CASH PLANNING

- **CFs are indispensable parts of business operations of all firms.**
- **CP is a technique to plan and control the uses of cash.**
- **It protects the financial condition of the firm by developing a projected cash statement from a forecast of expected cash inflows & outflows for a given period.**

- **The forecasts may be based on the present operations or the anticipated future operations.**
- **CP may be done on daily, weekly or monthly basis.**

- **A Cash budget is the most significant device to plan for and control cash receipts and payments.**

- **It is a summary statement of the firm's expected cash inflows & outflows for a projected time period.**

- **It gives information on the timings & magnitude of expected cash balances & CFs over the projected period which helps the financial manger for financing them & ultimately to exercise control over the cash & liquidity of the firm.**

Managing the Cash Flow

After preparing the cash budget, the finance manager should ensure that there does not exist any deviation between projected cash flows & actual cash flows. The efficiency of the firm's cash management programme can be enhanced by the knowledge & use of various procedures aimed at:

a. **Accelerating cash inflows, &**
b. **Controlling cash outflows.**

Thus, the twin objectives in managing CFs should be to accelerate cash collection to as much as possible & to decelerate or delay cash disbursement.

With reference to the control of inflows & outflows, float is an important technique to reduce the length of the cash cycle. When a firm receives or makes payments in the form of cheque, there is usually a time gap between the time the cheque is written & when it is cleared, this time gap is known as float.

The float for the paying firm refers to the time that elapses between the point when it issues a cheque & the time at which the funds underlying the cheque are actually debited in the bank account.

For the payee firm, float refers to the time between the receipt of the cheque & the availability of the funds in its account. So, float denotes the funds that have been dispatched by a payer but not in a form that payee can spend.

To get an idea of float mechanism & its utility in the management of CFs, one must know the related banking procedure. When a cheque is issued by the paying firm, the bank balance of the firm is not immediately reduced, rather the bank reduces the balance only when the cheque is presented to it either personally or through the clearing system.

Similarly, when the firm receives a cheque from the customer & deposits the cheque in the firm's account, rather the bank credits the cheque amount only when it is cleared by the paying bank.

The cash balance shown by a firm on its books is called the book or ledger balance whereas the balance shown in its bank account is called the available or colleted

balance. The difference between the available balance & the ledger balance is referred to as the float.

TYPES OF FLOATS

DISBURSEMENT FLOAT:

The amount of cheque issued but not presented for payment is known as the disbursement float. For eg., suppose that ABC Co. has a book balance as well as available balance of Rs. 4 lacs with its bank. SBI, as on March 31. on April 1, it pays Rs. 1 lac by cheque to one of its suppliers & hence reduces its book balance by Rs. 1 lac.

SBI, however, will not debit ABC Co. account till the cheque has been presented for payment on say, April 6. until that happens the firm's available balance is greater than its book balance by Rs. 1 lac.

Hence, between April 1 & April 6, ABC Co. has a disbursement float of Rs. 1 lac.
DF = Firm's available bank balance Minus Firm's book balance
= Rs. 4 lac – Rs. 3 lac = Rs. 1 lac

COLLECTION FLOAT:

The amount of cheque deposited in the bank, but not yet cleared is known as the collection float. For e.g., suppose that XYZ Co has book balance as well as available balance of Rs. 5 lac as on April 30. On May 1, XYZ Co receives a cheque for Rs. 1.5 lac from a customer which it deposits in the bank. It increases its book balance by Rs. 1.5 lacs. However this amount is not available to XYZ Co. until its bank presents the cheque to the customer's bank on, say May 5. So, between May 1 & May 5 XYZ Co has a collection float of (-) Rs. 1.5 lac.

Collection Float = Firm's available bank balance Minus Firm's book balance
= Rs. 5 lac – Rs. 6.5 lac
= (-) Rs. 1.5 lac

NET FLOAT:

The net float at a point of time is simply the overall difference between the firm's available bank balance & the balance shown by the ledger account of the firm. If the NF is '+', i.e., PF is more than RF (Collection Float), then the available balance exceeds the book balance & vice-versa. If the firm has '+' NF, it can issue more cheque even if the net bank balance shown by the books of account may not be sufficient. A firm with a positive NF can use it to its advantage & maintain a smaller cash balance that it would have in the absence of float.

The course of action adopted by a firm to manage the PF & the RF (Receipt Float) is known as playing the float, which has emerged as an important technique of cash management in most of the firms.

ACCELERATING CASH COLECTIONS / SPEEDING UP COLLECTIONS

A company can conserve cash & reduce its requirements for cash balances if it can speed-up its cash collection. Cash collections can be accelerated by reducing the lag or gap between the time a customer pays bill & the time the cheque is collected & funds become available for the firm's use.

When a company receives payments through cheque that arrive by mail, all the 3 components of collection time are relevant. The financial manager should take steps for speedy recovery from debtors & for this purpose proper internal control system should be installed in the firm.

Once the credit sales have been effected, there should be a built-in mechanism for timely recovery from the debtors. Periodic statements should be prepared to show the outstanding bills. Incentives offered to the customers for early / prompt payments should be well communicated to them.

Once the cheques / drafts are received from customers, no delay should be there in depositing these receipts with the banks. The time lag in collections of receivables can be considerably reduced by managing the time taken by postal intermediaries & banks.

Within these time gap, the delay is generally due to the mailing time, i.e., the time taken by cheque in transit & the processing time, i.e., the time taken by the firm in processing cheques for internal accounting purposes. The amount of cheques sent by customer yet not collected is known as 'Deposit Float.'

To speed up collection, companies may use concentration banking & lock boxes which are essential systems for expeditious decentralised collection.

1. **Concentration Banking.**
2. **Lock Boxes / Lock Box System.**

A) <u>Concentration Banking</u> :

A firm may open collection centres (banks) in different parts of the country to save the postal delays. This is known as CB. Under this system, the collection centres are opened as near to the debtors as possible, hence reducing thee time in dispatch, collection, etc. the firm may instruct the customers to mail their payments to a regional collection centre / bank rahter than to the central office. The cheques received by the regional collection centre are deposited for collection into a local bank account. Surplus funds from various local bank accounts are transferred regularly (mostly daily) to a concentration account at one of the company's principal banks.

Within the vast network of branches set-up by banks, regional / local collection centres can be easily established. To ensure that the system of collection works according to plan, it is helpful to periodically audit the actual transfers by the collecting banks & see whether they are in conformity with the instructions given.

The collection centre (concentration banking) results in saving of time, & hence results in better cash management. However, the selection of collection centres must be based on the volume of billing / business in a particular geographical area. It may be noted that the concentration banking also involve a cost in terms of minimum cash balance required with a bank or in form of normal minimum cost of maintaining a current account.

<u>B) Lock Box / Lock Box System :</u>

In case of concentration banking cheques are received by a collection centre & are deposited in the bank after processing. Lock box system helps the firm to eliminate the time between the receipt of cheque & their deposits in bank. Here, the firm establishes a

number of collection centres, considering customers location & volume of remittances & accordingly hires a post-office box. Customers are advised to mail their payments to special post-office boxes called lock-boxes, which are attended by local collecting banks, instead of sending them to corporate headquarters.

The local bank collects the cheque from the lock box once or more a day, deposits the cheque directly into the local bank account of the firm, & furnishes details to the firm.

Thus, the LB System:
1. **Cuts down the mailing time, because cheques are received at a nearby post-office instead of at H/Q.**
2. **Reduces the processing time because the company does not have to open the envelopes & deposit the cheque for collection, &**
3. **Shortens the availability delay because the cheques are typically drawn on local banks.**

In India, the LBS is not popular. However, commercial banks usually provide service to their large clients of:
1. **Collecting the cheques from the office of the clients, &**
2. **Sending the high value cheques to the clearing system on the same day. Both these services help in reducing the float of the large clients.**

However,, these benefits are not free. Usually, the bank charges a fee for each cheque processed through the system. The benefits derived from the acceleration of receipts must exceed the incremental costs of the LBS, or the firm would be better without it.

When is it worthwhile to have a LBS?

The answer depends on the costs & benefits of maintaining the LBS.

CONTROLLING DISBURSEMENTS

The effective controlling of disbursements can also help the firm in conserving cash & reducing the financial requirements. Disbursements arise due to trade credit. There is no advantage in paying sooner, then agreed. Thus, by delaying payments the firm makes maximum use of trade credit, which is an interest-free source of funds.

The technique generally used by the firm here is known as "playing the float", to maximise the availability of funds. When the firm's actual bank balance is greater then the balance shown in the firm's book, the difference is called "payment float".

OPTIMUM CASH BALANCE

One of the primary responsibility of the financial manager is to maintain a sound liquidity position of the firm so that dues may be settled in time. The firm needs cash not only to purchase RM & pay wages but also for payments of dividends, interest, taxes, etc. thus, the test of liquidity means the availability of cash to meet the firm's obligations when they become due.

The financial manager should determine the appropriate amount of cash balance. Thus, it is related to a trade-off between risk & return. If the firm maintains a small balance, its liquidity position weakens & it suffers from inadequacy of cash to make payments,

but a higher profitability can be attained by investing surplus funds in profitable opportunities. On the other hand, if the firm maintains a high level of cash balance, it will have a sound liquidity position, for that it has to forgo the opportunities to earn interest.

INVESTMENT IN MARKETABLE SECURITIES
(INVESTING SURPLUS CASH IN MARKETABLE SECURITIES)

Excess cash should be normally invested in marketable securities which can be conveniently & promptly converted into cash. Cash in excess of the requirement of operating cash balance may be held for two reasons:

- **The WC requirement of firm fluctuates because of elements of seasonality & business cycles.**
- **Excess cash may be held as a buffer to meet unpredictable financial needs. A firm holds extra cash because CFs cannot be predicted with certainty.**

Instead of holding cash for these 2 reasons the firm may meet its precautionary requirement as & when they arise by making short-term borrowings. The extra cash held by the company should be invested in marketable securities which are considered as near cash items.

The financial manager should examine 3 basic features of security while choosing among alternative securities, viz., *safety, Maturity, and marketability*.

a) **Safety: A firm usually requires a high return on its investment but the higher return yielding securities are relatively more risky. The firm would invest in safe securities.**
b) **Maturity: It refers to the time period over which interest & principal are to be made. The price of long-term security fluctuates more widely with the changes in interest rate than the price of short-term security. Thus, for safety reasons excess cash should be invested in short-term securities.**
c) **Marketability: it refers to convenience & the speed with which a security can be converted into cash. The 2 important aspects of marketability are 'price' & 'time'. If the security can be sold quickly without loss of price, it is termed as highly liquid or marketable security.**

CASH CONTROL REPORTS

Cash reports providing a comparison of actual development with forecast figures, are helpful in controlling & revising cash forecast on a continual basis. Several types of cash reports may be prepared, viz., the daily cash report, the daily treasury report, the monthly cash report.