Chapter 7

Cash Management
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CASH MANAGEMENT

7.0 CASH MANAGEMENT:

Cash in one of the current assets of the business. It is needed at all times to keep the business going. A business concern should always keep sufficient cash for meeting its obligations. Any shortage of cash will hamper the operations of a concern and any excess of it will be unproductive. Cash is the most unproductive of all the assets.

7.0-1 Role of Cash Management:

➢ Forecasting of cash requirements and preparation of cash budgets.
➢ Estimation of working capital requirements and planning the levels of investment in current assets.
➢ Establishment of banking relationships, arrangement of funds for working capital requirements, providing of security for working capital finance.
➢ Monitoring the credit collection.
➢ Monitoring the liquidity and funds position of different divisions of the firm.
➢ Investment of temporary surplus funds in short-term marketable securities and sale of it when the need of cash arises.
➢ Ascertainment of collection and payment floats, efficient playing of the float etc.
➢ Transmission of funds to various division and receipt of funds from various collection centers.
➢ Ensure that sufficient cash is available for meeting day to day financial obligations.
➢ Maintaining sufficient cushion for meeting contingencies and unexpected financial obligations.
➢ Identify surplus funds in certain divisions and transfer them to the division which are facing deficit of cash.

7.1 MOTIVES FOR HOLDING CASH:

1. Transaction Motive

A firm needs cash for making transactions in the day-to-day operations. The cash is needed to make purchases, pay expenses, taxes, dividend, etc,

2. Precautionary Motive

A firm is required to keep cash for meeting various contingencies. Though cash int10ws and cash out1ows are anticipated but there may be variations in these estimates. For example, a debtor who was to pay after 7 days may inform of his inability to pay; on the other hand a supplier who used to give credit for 15 days may not have the stock to supply or he may not be in a position to give credit at present. In these situations cash receipts
will be less than expected and cash payments will be more as purchases may have to be made for cash instead of credit. Such contingencies often arise in a business. A firm should keep some cash for such contingencies or it should be in a position to raise finances at a short period.

3: Speculative Motive

The speculative motive relates to holding of cash for investing in profitable opportunities as and when they arise. Such opportunities do not come in a regular manner. These opportunities cannot be scientifically predicted but only conjectures can be made about their occurrence. For example, the prices of shares and securities may be low at a time with an expectation that these will go up shortly. The prices of raw materials may fall temporarily and a firm may like to make purchases at these prices. Such opportunities can be availed of if a firm has cash, balance with it.

7.2 MANAGING CASH FLOWS:

After estimating the cash flows, efforts should be made to adhere to the estimates of receipts and payments of cash. Cash management will be successful only if cash collections are accelerated and cash disbursements, as far as possible, are delayed. The following methods of cash management will help:

7.2-1 Methods of Accelerating cash Inflows:

1. Prompt Payment by Customers. In order to accelerate cash inflows, the collections from customers should be prompt. This will be possible by prompt billing. The customers should be promptly
informed about the amount payable and the time by which it should be paid. It will be better if self-addressed envelope is sent along with the bill and quick reply is requested. Another method for prompting customers to pay earlier is to allow them a cash discount. The availability of discount is a good saving for the customer and in an anxiety to earn it they make quick payments.

2. **Decentralized Collections.** A big firm operating over wide geographical area can accelerate collections by using the system of decentralized collections. A number of collecting centers are opened in different areas instead of collecting receipts at one place. The idea of opening different collecting centers is to reduce the mailing time from customer's dispatch of cheque and its receipt in the firm and then reducing the time in collecting these cheques. On tile receipt of the cheque it is immediately sent for collection.

3. **Lock Box System.** Lock box system is another technique of reducing mailing, processing and collecting time. Under this system tile firm selects some collecting centers at different places. The places are selected on tile basis of number of consumers and tile remittances to be received from a particular place. The firm hires Post Box in a post office and tile parties are asked to send the cheques on that post box number. A local bank is authorized to operate the post box. The bank will collect the post a number of times in a day and start the collection process of cheques. The amount so collected is credited to the firm's account.
7.2-II Methods of Slowing Cash, Outflows:

A company can keep cash by effectively controlling disbursements. The objective of controlling cash outflows is to slow down the payments as far as possible. Following methods can be used to delay disbursements:

1. **Paying on Last Date** - The disbursements can be delayed on making payments on the last due date only. If the credit is for 10 days then payment should be made on 10th day only. It can help in using the money for short periods and the firm can make use of cash discount also.

2. **Payments through Drafts** - A company, can delay payments by issuing drafts to the suppliers instead of giving cheques. When a cheque is issued then the company will have to keep a balance in its account so, that the cheque is paid whenever it comes. On the other hand a draft is payable only on presentation to the issuer. The receiver will give the draft to its bank for presenting it to the buyer's bank. It takes a number of days before it is actually paid. The companies can economies large resources by using this method. The funds so saved can be invested in highly liquid low risk securities to earn income thereon.

3. **Centralisation of Payments.** The payments should be centralized and payments should be made through 'drafts or cheques. When cheques are issued from the main office then it will take time for the cheques to be cleared through post. The benefit of cheque collecting time is availed.

4. **Inter-bank Transfer** - An efficient use of cash is also possible by inter-bank transfers. If the company has accounts with more than one
bank then amounts can be transferred to the bank where disbursements are to be made. It will help in avoiding excess amount in one bank.

7.3 DETERMINING OPTIMUM CASH BALANCE:

A firm has to maintain a minimum amount of cash for settling the dues in time. The cash is needed to purchase raw materials, pay creditors, day to day expenses, dividend, etc. So cash budget is the most important tool in cash management.

7.3-1 CASH BUDGET:

A cash budget is an estimate of cash receipts and disbursements of cash during a future period of time. 
In the words of Soloman Ezra, a cash budget is “an analysis of flow of cash in a business over a future, short or long period of time. It is a forecast of expected cash intake and outlay.” It is a device to plan and control the use of cash. The cash budget pinpoints the period when there is likely to be excess or shortage of cash. Thus, a firm by preparing a cash budget can plan the use of excess cash and make arrangements for the necessary cash as and when required.

7.4 INVESTMENT OF SURPLUS FUNDS:

1. Treasury bills - The treasury bills are issued by RBI on behalf of the Central Government. Earlier they were issued on the basis of tenders
floated regularly but now are available on tap system, i.e., on rates announced by RBI every week. These bills are issued only in bearer form. Name of the purchaser is not mentioned on the bills, rather they are easily transferable from one investor to another. No interest is paid on the bills but the return is the difference between the purchase price and face (par) value of the bill. Since there is a backing of the Central Government, these are risk free securities. A very active secondary market exists for these bills so it has made them highly liquid. Treasury bills are one of the popular marketable securities even though the yield on them may be low.

2. **Negotiable Certificates of Deposit (CD's)** - The money is deposited in a bank for a fixed period of time and marketable receipt is issued. The receipt may be registered or bearer, the latter facilitates transactions in the secondary market. The denominations and maturity periods are decided as per the needs of the investor. On maturity the amount deposited and interest are paid. The CD's are different from the treasury bills, which are issued on discount. The short-term surplus funds can be used to earn interest in this method.

3. **Inter-Corporate Deposits**: These are short term deposits with other companies which attract a good rate of return. Inter-corporate deposits are of three types:

   (i) **Call Deposits.** It is a deposit which a lender can withdraw on one day's notice. In practice it takes three days to get this money. The rate of interest at present is 14 percent on these deposits.
(ii) **Three Months Deposits.** These deposits are popular and are used by borrowers to tide over short term inadequacy of funds. The interest rate on such deposits is influenced by bank overdraft interest rate and at present the borrowing rate is 22 per cent per annum.

(iii) **Six-month Deposits.** The lenders may not have surplus funds for a very long period. Six-month period is normally the maximum which lenders may prefer. The current interest rate on these deposits is 24 per cent per annum.

4. **Bill Discounting.** A bill arises out of credit sales. The buyer will accept a bill drawn on him by the seller. In order to raise funds the seller may get the bill discounted with his bank. The bank will charge discount and release the balance amount to the drawer. These bills normally do not exceed 90 days. A company may also discount the bills as a bank does thus using its surplus funds. The bill discounting is considered superior to inter-corporate deposits. The company should ensure that the discounted bills are

(a) Trade bills (resulting from a trade transaction) and not accommodation bills (helping each other).

(b) The bills backed by the letter of credit of a bank will be most secure as these are guaranteed by the drawee's bank.

5. **Investment in Marketable Securities.** A firm has to maintain a reasonable balance of cash. This is necessary because there is no perfect balancing of inflows and outflows of cash. Sometimes more
cash is received than required for quick payments. Instead of keeping the surplus cash as idle, the firm tries to invest it in marketable securities. It will bring some income to the business. The cash surpluses will be available during slack seasons and will be required when demand picks up again. The investment of this cash in securities needs a prudent and cautious approach. The selection of securities for investment should be carefully made so that the amount is raised quickly on demand.

6. Money Market Mutual Funds (MMM):- Money market mutual fund means a scheme of a mutual fund which has been set up with the objective of investing exclusively in money market instruments. These instruments include treasury bills, dated Government securities with an expired maturity of up to one year, call and notice money, commercial paper, commercial bills accepted by banks and certificates of deposits.
7.5 ANALYSIS OF CASH MANAGEMENT

Q. What is the main motive of cash holding?

<table>
<thead>
<tr>
<th>Motive</th>
<th>Opinion in (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transaction</td>
<td>88</td>
</tr>
<tr>
<td>Precautionary</td>
<td>8</td>
</tr>
<tr>
<td>Speculation</td>
<td>2</td>
</tr>
<tr>
<td>Any Other</td>
<td>2</td>
</tr>
</tbody>
</table>

When asked about the motives of holding cash, average answers show that 88% of the cash they hold for Transaction motive, 8% for Precautionary and 2% each for Speculation and other purposes.
Q. Where do you prefer to invest surplus cash?

<table>
<thead>
<tr>
<th>Preference</th>
<th>(% of preference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment in certificate of deposit</td>
<td>4</td>
</tr>
<tr>
<td>Investment in short term deposit</td>
<td>52</td>
</tr>
<tr>
<td>Any other</td>
<td>44</td>
</tr>
</tbody>
</table>

Almost half of the respondents (52%) invest their surplus funds in short-term deposits and 4% in certificates of deposits. But many of the respondents also invest in various other options.
Q. What method do you use for acceleration of cash inflows?

<table>
<thead>
<tr>
<th>Methods</th>
<th>Opinion in (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Decentralized</td>
<td>4</td>
</tr>
<tr>
<td>Internet banking</td>
<td>14</td>
</tr>
<tr>
<td>Personalized effort</td>
<td>38</td>
</tr>
<tr>
<td>Offer of cash discount</td>
<td>36</td>
</tr>
<tr>
<td>Any other</td>
<td>8</td>
</tr>
</tbody>
</table>

38% respondents believe in putting personalized efforts for acceleration of cash inflows as compared to 36% respondents who rely more on offering cash discounts. 14% use internet banking, 4% use decentralized banking system and 8% use other methods.
Q. From where do you arrange cash in urgency?

<table>
<thead>
<tr>
<th>Options</th>
<th>Opinion in (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank</td>
<td>84</td>
</tr>
<tr>
<td>Friend</td>
<td>10</td>
</tr>
<tr>
<td>Relatives</td>
<td>6</td>
</tr>
<tr>
<td>Any other</td>
<td>0</td>
</tr>
</tbody>
</table>

84% respondents arrange cash from Banks for urgent use. This again shows dependency of these small companies on Banks for short-term planned or unplanned requirement of funds. 10% depend on Friends and 6% rely on Relatives.
Q. Do you make Cash Budget for managerial decisions?

<table>
<thead>
<tr>
<th>Percentage of Companies</th>
<th>Opinion</th>
</tr>
</thead>
<tbody>
<tr>
<td>98</td>
<td>Yes</td>
</tr>
<tr>
<td>2</td>
<td>No</td>
</tr>
</tbody>
</table>

98% respondents prepare Cash Budget for estimating future cash in-flow and out-flow. This proves the importance of cash for running businesses. Only one respondent (2%) answered 'No' to this question.