

Cash Management

- A firm which purchases raw materials on credit is required by the credit terms to make payments within 30 days
- The firm allows its credit buyers to pay within 60 days. Its experience has been that it takes on an average 35 days to pay its Accounts Payable and 70 days to collect its accounts receivable.
- Further 85 days elapse between the purchase of raw material and sale of finished goods, i.e. average age of inventory is 85 days.
- Find out the firm's Cash Cycle?
- Also estimate the Cash Turnover.

- Cash Cycle = 85 Days + 70 Days – 35 Days = 120 Days
- Cash Turn Over = Days in a Year / Cash Cycle
= $360/120 = 3$

Thus if the annual cash requirement of the firm is ₹240 Lakhs and Cash Turnover is 3 then the minimum cash requirement will be ₹240 Lakhs / 3 = ₹80 Lakhs

Cash Management Strategies

It includes the following:

- Stretching the Accounts Payable
- Efficient Inventory –Production Management
- Speeding Collection of Accounts Receivable
- Combined Cash Management Strategies

1. Stretching Accounts Payable

- It implies that the firm should pay its accounts payable (Creditors) as late as possible without damaging credit standing.
- In the earlier example if the Accounts payable are stretched from 35 days to 45 days, its cash cycle will be 110 days.
- Earlier $85 + 70 - 35 = 120$ days,
- Now $85 + 70 - 45 = 110$ days

- This will result in the increase in cash turnover from 3 to 3.27 which will lead to decrease in minimum cash requirement from ₹ 80 lakhs to 73.40 lakhs.
- Cash Turnover earlier = $360/120= 3$
- Cash Turnover now = $360/110= 3.27$
- Min. Cash Req. earlier = $240 \text{ lakhs}/3 = ₹ 80 \text{ lakhs}$
- Min. Cash Req. earlier = $240 \text{ lakhs}/3.27 = ₹ 73.4 \text{ lakhs}$
- Reduction in Cash requirement = $80-73.4=6.60 \text{ lakhs}$
- If the rate of borrowing is 10% the savings to the firm is 0.66 lakhs.(10% of 6.60 lakhs)

Efficient Inventory-Production Management

The above mentioned technique can be applied as follows :

- Increasing raw materials turnover by using more efficient inventory control techniques
- Decreasing the production cycle through better production planning, scheduling and control techniques
- Increasing the finished goods turnover

- So if the firm in the above example is able to reduce the average period of inventory from 85 days to 70 days then the effect will be as follows:
- Cash cycle will be $70+70-35= 105$ days
- Cash Turnover will be $360/105=3.43$
- Min. Cash requirement= $240/3.43= 70$ lakhs
- Thus the savings is Rs. 10 lakhs and saving in interest is Rs.1 lakh.

Speeding Collection of Accounts Receivable

- The average collection period of the receivables (Debtors) can be reduced by making changes in
 - **Credit Terms (30/5)**
 - **Credit Standards-** It specifies the criteria for determining to whom credit should be extended.
 - **Collection Policies**

- For example in the above illustration let us see the effect when the accounts receivable period reduces from 70 days to 50 days.
- Cash Cycle = 85 days + 50 days - 35 days = 100 days
- Cash Turnover = $360/100 = 3.6$
- Min. Cash Req. = $240 \text{ lakhs}/3.6 = 66.67 \text{ lakhs}$
- Reduction in Cash Balance = 13.33 Lakhs
- Savings = 1.33 Lakhs

Combined Cash Management Strategies

- If in the above illustration
- Average accounts payable increases by 10 days
- Inventory holding period reduces by 15 days and
- Accounts receivable period decreases by 20 days

Cash Cycle will be as follows

- $= (85 - 15) + (70 - 20) - (35 + 10)$
- $= 70 + 50 - 45$
- $= 75$ days
- Cash Turnover $= 360/75 = 4.8$
- Minimum Cash Requirement $= ₹240 \text{ Lakhs}/4.8$
- $= ₹50 \text{ Lakhs}$
- Thus there will be a reduction of Cash requirement of ₹30 Lakhs and a savings of ₹3 lakhs.

Basic Principles of Cash Management

- Cash Management Planning
- Cash Management Control
 - (i) Accelerating Cash Inflows
 - (ii) Controlling Cash Outflows
- Determining Optimum Cash Balance
- Investing Surplus Cash

Cash Management Planning

Cash Budgets

A budget is a forecast statement in financial terms of management's plans over a future period of time.

A cash budget is the calculation of the money coming in and going out of the business for a specified future period.

Money comes in from sales, for cash or from debtors, through credit sales, loans, sale of fixed assets and any other sources of cash.

Money goes out for cash purchases, payment to creditors for goods on credit, repayment of loans, cash expenses, purchase of fixed assets and any other expenditure the business may have.

A cash budget is cumulative in that the balance from one month is carried forward to the other month.

The cash budget ignores none-cash items, such as depreciation, which is a loss of value of fixed asset which does not cause a loss of cash.

Format of a Cash Budget:

Months	January	February	March	April
Receipts				
Cash sales	X			
Debtors	X			
Loan	X			
Total receipts	Y			
Payments				
Cash purchases	X			
Creditors	X			
Fixed assets	X			
Expenses	X			
Less total payments	Z			
Net receipts/ payments	W			
Add Opening balance	B			
Closing balance	C			

Example 10: Prepare a cash budget for the months of June, July, August 2011 from the following information:

- 1) Opening cash balance in June ₹7,000.
- 2) Cash sales for June ₹20,000; July ₹30,000 and August ₹40,000.
- 3) Wages payable ₹6,000 every month.
- 4) Interest receivable ₹500 in the month of August.
- 5) Purchase of furniture for ₹16,000 in July.
- 6) Cash Purchases for June ₹10,000; July ₹9,000 and August ₹14,000.

Solution:

Cash Budget for the Period June to August 2011

Particulars	June	July	August
Opening Cash Balance	7,000	11,000	10,000
Add: Cash Receipts (estimated)			
Cash sales	20,000	30,000	40,000
Interest	-	-	500
Total Receipts	27,000	41,000	50,500
Less: Cash Payments (estimated)			
Cash Purchases	10,000	9,000	14,000
Payment of Wages	6,000	6,000	6,000
Purchase of Furniture	-	16,000	-
Total Payment	16,000	31,000	20,000
Closing Balance (surplus/deficit) (Total receipts – total payments)	11,000	10,000	30,500

Cash Management Control

- The efficiency of the firm's cash management program can be enhanced by the knowledge and use of various procedures aimed at:
 - Accelerating Cash inflows, and
 - Controlling Cash outflows

- Accelerating Cash inflows:
- Efficient Cash Management is possible only when the collection of cash are accelerated
- Collection Process may be sped up in any of the following manners:
 - The mailing time of payment from customers to the firm may be reduced
 - The time during which payments received by the firm remain uncollected may be minimized

Methods of Accelerating Cash Inflows

1. Prompt Payment by Customers

2. Early Conversion of Payments into Cash

- Transit time (Postal Float)
- Cheque Processing time within the firm (Lethargy)
- Collection time within the Bank Float (Bank Float)

3. Concentration Banking is the procedure where collections are sped up by making the process of collection decentralized. The following are the advantages of decentralized collection

- The mailing time is reduced
- Collection time is reduced since the payments are deposited in local Bank

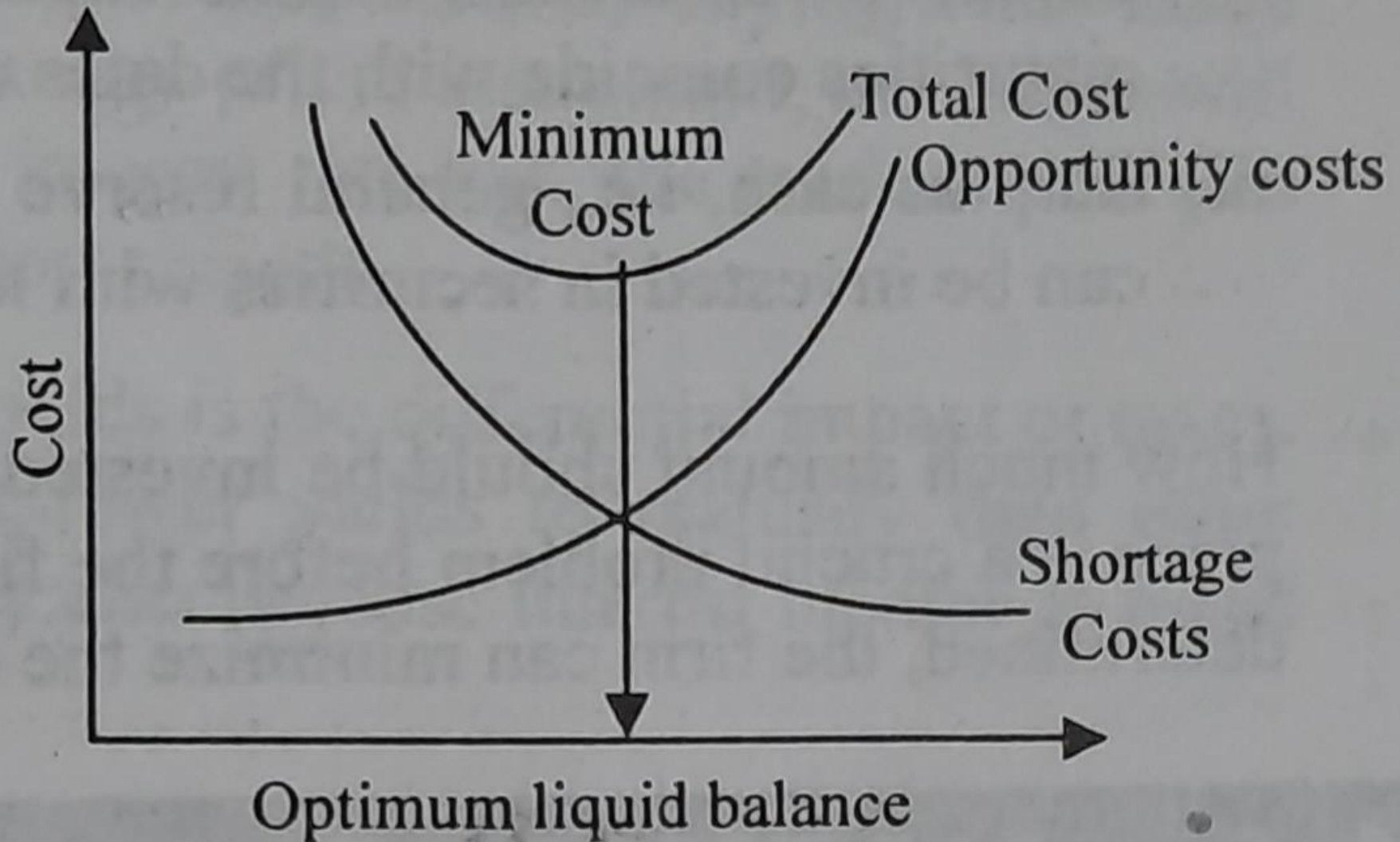
4.Lock Box System

- In Lock Box System the customers will mail their cheques to post office lockbox rented by the Company at appropriate locations.
- The designated branch of the local Bank collects the cheques from the lock box twice or thrice per day as per agreement and put them on clearing directly.

Controlling Cash outflows

- Methods of Slowing Disbursement
- Mailing Payments on Friday
- Centralization of Accounts Payable
- Paying through Draft
- Avoidance of Early Payments
- Centralized Disbursements

Determining Optimum Cash Balance



- With increasing liquid balance 'Opportunity' or 'holding' costs increase ,but the 'shortage' costs go down and vice versa.
- The Combination of opportunity costs and shortage costs gives the total cost of maintaining liquid balance at various levels.
- The point which gives the minimum total cost is the point of optimum liquidity balance which is a trade-off of shortage costs against opportunity costs.

Investing Surplus Cash

- Although maintaining cash balance is good but the excess of cash balance should not be left idle because by doing so the business will lose the opportunity of earning interest.
- Though excess cash should be invested in marketable securities but their selection should be made cautiously otherwise there may be loss instead of the desired gain.

- The Criteria for security selection may be the following:
 1. Marketable
 2. Short maturity
 3. Risk of Default
 4. Liquidity
 5. Yield