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CASH MANAGEMENT: A CONCEPTUAL FRAMEWORK

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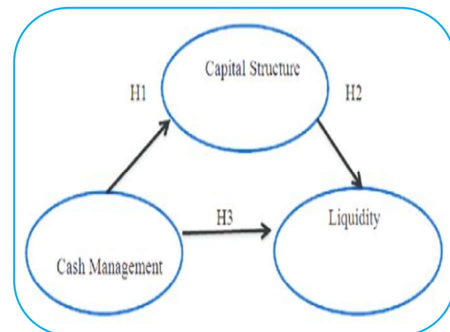
ABSTRACT

Cash assets management is rapidly emerging as a vital area in any business organization. 'Cash assets Management' implies making sure that all the business generated revenues are effectively controlled and utilized in the best possible manner to result in gains for the organization. The management of cash resources holds a central position in the area of short- term financing decisions. Holding of cash carries the opportunity cost of profits which could be made if the cash was either used in the company or invested elsewhere. The company has to balance the advantages of liquidity against profitability. Cash should be held until the marginal value of the liquidity it gives is equal to the value of the interest lost. This paper is a modest attempt to study the conceptual framework of cash Management.



KEY WORDS: *Asset Management, Cash Cycle, Cash Management.*

INTRODUCTION

Cash assets management is concerned with optimizing the amount of cash available to the company, and maximizing the interest on any spare funds not required immediately by the company. The fundamental objective of cash assets management is 'optimization 'of liquidity through an improved flow of funds. All companies in advanced countries are planning to use the services of banks to help them collect payments on monthly bills they issue to consumers and other types of cash management services. Cash assets management has gained importance due to uptrend in interest rate that increased the opportunity cost of holding cash. This encouraged Finance Manager to search for more efficient ways of managing cash. Another reason is the technological developments, particularly computerized electronic funds transfer mechanism changed the way of cash assets management. The basic objectives of cash assets management are:

a) to ensure availability of cash as per payment schedule, and
b) to minimize the amount of idle cash

To achieve the above objectives, proper planning and forecast of cash flows is needed. The expected cash inflows and cash outflows are to be presented in the form of cash budget. This will help in efficient management of cash assets. Most cash assets management activities are performed jointly by the firm and its banks. Effective cash assets management encompasses proper management of cash inflows and outflows which entails:

- improving forecasts of cash flows
- synchronizing cash inflows and outflows

- using floats
- accelerating collections
- getting available funds to where they are needed
- controlling disbursements[1]

Cash is a non-earning asset, therefore, the Finance Manager should take care to minimize the assets in the form of cash. Surplus balance of cash can be suitably be invested in liquid, short- term and long-term investments as per the policy of the company. The cost of holding cash is the loss of interest that if cash is invested profitably elsewhere. The cost of surplus cash is the cost of interest/opportunities foregone. The cost of shortage of cash is measured in the cost of raising finance or ultimately in the cost of bankruptcy or restructuring. The cash shortages can result in sub-optimal investment decisions and sub-optimal financing decisions. Since the basic purpose of any cash management system is to reduce the cost (cost of interest payments, cost of collection, cost of disbursement of funds etc.). Cost involved any cash management system like any other system may broadly be divided into fixed cost and variable costs. Fixed costs of maintaining any system may be like depreciation on hardware used, fixed employee cost etc. The variable cost of a cash management system normally depends on the volume of funds handled by the company.[2]

Adequacy of Cash

Cash Surpluses arise for many reasons and last for varying time periods. The Treasurer will need to consider opportunities for short-term investment in order to put any cash surpluses to work. Some of the reasons for cash surplus are:

a) profitability from operations
b) low capital expenditure
c) absence of profitable avenues of investment
d) sale of a part of business
e) raising of funds from issue of stock and bonds for long-term capital projects, temporary fund is not used
f) conservative dividend distribution policy

The firm may keep surplus funds in liquid form for the following reasons:

- To buy back shares in near future
- To enhance the dividend payment to shareholders
- Waiting for strategic opportunity to arise like acquisition and takeover of weak units
- When the return on reinvestment is lower than the bank deposit rate

The continuous deficit in cash flow will show the signal for forthcoming situation of financial distress. The cash flow problems may arise from the following reasons:

- Continuous operating losses will cause deficit in cash flows. A company which cannot able to cover the depreciation charge but is in the surplus state of cash, is the potential unit for cash starvation.
- When the rate of inflation is higher, the need for cash also increases and it will cause excessive outflow of cash over the inflow.
- Non-recurring expenditure or payments may cause cash flow problems. The situation may arise in times of repayment of long-term debt, purchase of capital goods out of internal accruals, payment of dividends and corporate tax etc.
- When the seasonal or cyclical sales are higher, then such firms may require more funds than in the off-season which will also create cash flow problem.
- Over trading is one of the reasons which cause cash flow problems. A firm which do business more than its working capital can absorb, will create cash flow problems.
- Continuous growth in business of a firm may lead to continuous cash requirements to support its production and working capital shortages.
- Inefficient working capital management like poor collection of debtors, failure to raise invoices in time, excessive holding of inventory, payments without proper sanction, managing without cash

planning and cash budgeting, failure to recognize the requirements of working capital For purchase of capital equipment, failure to get working capital, use of working capital limits or its enhancement in time etc., will lead to cash flow problems.

The cash shortages can result in the making of sub-optimal investment decisions and sub-optimal financing decisions:

Sub Optimal Investment Decisions-These decisions would include the disposal of profitable lines or divisions, inability to undertake profitable investment projects, and failure to maintain an adequate level of working capital etc.

Sub-optimal Financing Decisions - These decisions would include the taking out of very expensive loans and being granted overdraft facilities subject to restrictive covenants which include personal guarantees from directors, restrictions on investment restrictions on additional finance, restrictions on directors' remuneration, restrictions on dividend payments etc.

A company can take the following steps to improve its liquidity position without trying to obtain outside funds:

- Try to increase the speed of stock turnover. If stock is at present turned over 4 times in a year, pushing this to 5 times would boost the flow of funds through the company. The stock turnover could be accelerated either by increasing sales revenue or by reducing the level of stocks being carried.
- To increase sales revenue, it may be necessary to drop the selling price. Usually companies with a high stock turnover or asset turnover are working with lower profit margins than companies with a low turnover.
- The other way of increasing the inventory (stock) turnover is to lower the level of inventories, which releases funds and so increases liquidity.
- The company can delay paying its creditors, and it can accelerate collecting debts. Debt collection can be speeded up by spending more time on the control problem by chasing-up late payers, or by making the rewards for early payment more attractive.
- If the company wishes to go outside the business to improve its liquidity situation there are at least three ways open to it,
  - ✓ Obtain a short period loan from a bank or other financial institutions,
  - ✓ Obtain an overdraft from the bank
  - ✓ Pledge its debtors to a bank or raising of Funds through a factor.
- Some capital expenditure items which are not urgent can be postponed.
- In case of cash problems, some assets purchased in the past, which are of less crucial can be sold.
- Re-schedulement of loans repayments with the acceptance of the banks, financial institutions etc.
- Dividend payments can be reduced or skipped-off in case of severe cash crunch.

Cash Cycle

Richards and Langhlin (1980) suggested that the cash flow cycle could be modelled on the basis of its elements, which they identified as:

a) Inventory Conversion Period - The time taken to convert raw material to finished goods and dispatch them to fulfill customers orders.
b) Receivables Conversion Period - The time taken to convert sales into cash received.
c) Payables Deferral Period - Average time from purchase/usage of raw materials, labor and expenses to payment.

$$\text{Cash Cycle} = (a)+(b)-(c)$$

Effective working capital management would require us to reduce the cash conversion cycle to manageable proportions. By reducing the inventory conversion period and the receivables conversion

period and by extending the payables deferral, this can be achieved. The close observation of the cash cycle from time to time would itself ensure that things are under control.

Cash Management Models

The following methods are useful in management of cash:

Baumol's Model - Baumol (1952) suggested that cash may be managed in the same way as any other inventory and that the inventory model could reasonably reflect the cost - volume relationships as well as the cash flows. In this way, the economic order quantity could be applied to cash management.

It provides a useful conceptual Foundation for the cash management problem. in the model, the carrying cost of holding cash-namely the interest forgone on marketable securities is balanced against the fixed cost of transferring marketable securities to cash, or vice-versa. The Baumol model finds a correct balance by combining holding cost and transaction costs so as to minimize the total cost of holding cash. As in the EOQ model, the Baumol model assumes that the rate of cash usage is constant and known with certainty. The optimal level of C is found to be:

$C=2BT/I$

Where

C = Optimal transaction size

B = Fixed cost per transaction

T = Estimated cash payments during the period

I = Interest on marketable securities p.a.

- The model can be applied only when the payments position can be reasonably assessed.
- Degree of uncertainty is high in predicting the cash flow transactions.
- The model merely suggests only the optimal balance under a set of assumptions. But in actual situation it may not hold good.

Miller-Orr Model - The Miller-Orr Model (1966) specifies the following two control limits

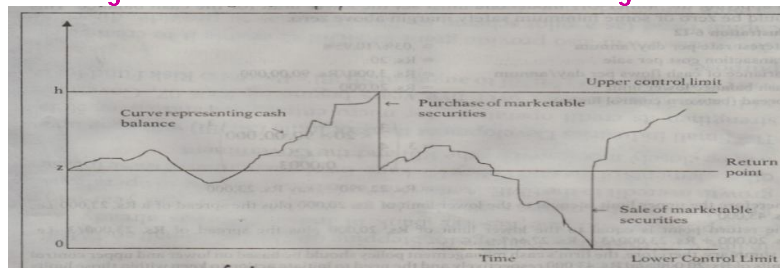
h = Upper control limit

o = Lower control limit

z = The return point for cash balances

This is represented in Figure: 4.1

Figure: 4.1 Miller-Orr Model of Cash Management



The Miller-Orr model, as shown in Figure will work as follows

- When cash balance touched the upper control limit (h securities are bought to the extent of Rs. (h-z).
- Then the new cash balance is z.
- When cash balance touches loner control limit (o), marketable securities to the extent of Rs. (z-o) will be sold.
- Then the new cash balance again return to point z

Assumptions

- The major assumption with this model is that there is no underlying trend in cash balance over time.
- The optimal values of h and z depend not only on the fixed and opportunity costs but also on the degree of likely fluctuations in cash balances.

The Miller-Orr model can be used in times of uncertainty and random cash flows. It is based on the principle that control limits can be set which when reached trigger off a transaction. The control limits are based on the day-to-day variability in cash flows and the fixed costs of buying and selling Government securities.[6]

CONCLUSION

Cash is one of the current assets of a business. It is needed at all times to keep a business going. A business concern should always keep sufficient cash for meeting n obligations. Any shortage of cash will hamper the operations of a concern and any excess of - will be unproductive so cash management is the most important function and significant contribution in the dynamic management of business affairs. Cash management is also important because it is difficult to predict cash flows accurately, particularly the inflows, and there is no perfect coincidence between the inflows and outflows of cash. The cash management aims at the optimum utilization of funds.

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