Management of cash

Cash is the lifeblood of a business firm; it is needed to acquire supplies, resources, equipment, and other assets used in generating the products and services provided by the firm. It is also needed to pay wages and salaries to workers and managers, taxes to governments, interest and principal to creditors, and dividends to shareholders. More fundamentally, cash is the medium of exchange, which allows management to carry on the various activities of the business firm from day to day. As long as the firm has the cash to meet these obligations, financial failure is improbable. Without cash, or at least access to it, bankruptcy becomes a grim possibility. Such is the emerging view of modern corporate cash management. On the other hand, marketable securities come in many forms and will be discussed later, but their main characteristic is that they represent "near cash" in that they may be readily sold. Hence marketable securities serve as a back up pool of liquidity that provides cash quickly when needed. Marketable security also provides a short-term investment outlet for excess cash and is also useful for meeting planned outflows of funds.

Objectives:

- Cash management encompasses how a company manages its operations or business activities, financial investments, and financing activities.
- A company has to generate adequate cash flow from its business in order to survive, meaning it is able to cover its expenses, repay investors and expand the business.
- In addition to generating cash from its activities, a business also needs to manage its cash situation so that it holds the right amount of cash to meet its immediate and long-term needs.
- Surplus cash to be invested to temporary investment.

Motives/ Purpose of holding cash :

a) The Transaction motive
b) The Precautionary motive
c) The Speculative motive

Factors Determining the Optimum Cash Balance

Synchronization of cash flows

Short costs

Excess cash balance

Procurement and management

Uncertainty

1. Synchronization of cash flows: The need for maintaining cash balances arises from the non synchronization of the inflows and outflows of cash: if the receipts and payment of cash perfectly coincide with each other, there would be no need for cash balances. The first consideration in determining the cash balances is hence the extent of synchronization of cash receipts and disbursements. For this purpose, the inflows and outflows have to be forecast over a period of time depending upon the planning horizon which is typically a one year period with each of 12 months being a sub-period. The technique adopted is a cash period. A properly prepared budget will pinpoint the month/periods when the firm will have an excess or a shortage of cash.

2. Short Costs: The other most important factor in determining the optimum cash is the shortfall in cash needs. The cash forecast as presented in the cash budget would reveal cash shortage periods. Despite this, there may be some additional shortfall. Every shortage of cash whether expected or unexpected involves a cost depending upon the severity, duration and frequency of the shortfall and how the shortage is covered. Expenses incurred as a result of shortfall are called short costs.

3. Excess cash balance: If a firm is having large funds lying as idle, it shows that the firm has missed opportunities to invest those funds and has thereby lost interest which it would otherwise have earned. This loss of interest is primarily the excess cost.

4. Procurement and management: Procurement and management costs are associated with establishing and operating cash management staff and activities. They are usually fixed and are mainly accounted for by salary, storage, handling of securities, etc.

5. Uncertainty: Finally, the impact of uncertainty on cash management strategy is also relevant as cash flows cannot be predicted with complete accuracy. The first requirement is a precautionary cushion to cope with irregularities in cash flows, unexpected delays in collection and disbursements, defaults and unexpected cash needs.

A firm has to maintain a minimum of cash for settling the dues in time. The cash is needed to purchase raw materials, Creditor's day to day expenses, dividend, etc. The test of liquidity of the firm is that it is to meet various obligations in time.

There are basically two approaches to determine an optimal cash balance namely,

1. Preparing cash budget 2. Minimizing cost models.

Cash Budget 3 methods

1. Receipts and payment
2. Adjusted pl method
3. Balance sheet method

Receipts and payment

Illustration 6

From the following information supplied by Bright Ltd., prepare a cash budget for the period from 1st September 2004 to 31st December 2004 :

Months	*Credit Purchases* Rs.	*Credit Sales* Rs.	*Wages* Rs.	*Selling Expenses* Rs.	*Over-heads* Rs.
July	85,000	1,60,000	32,000	8,000	10,000
August	92,000	1,85,000	37,000	9,500	11,500
September	1,00,000	2,10,000	42,000	10,500	13,000
October	1,20,000	2,45,000	49,000	12,500	14,500
November	90,000	1,78,000	35,500	8,900	10,500
December	98,000	1,82,000	36,000	9,000	11,000

Additional Information :

(a) Expected cash balance on 1st September—Rs. 10,500.

(b) Period of credit allowed to debtors—2 months.

(c) Period of credit allowed by creditors—1 month.

(d) Lag in payment for wages, selling expenses and overhead—1 month.

(e) Selling commission @ 2% on sales is payable one month after sales.
(f) Expenditure on machinery worth Rs. 50,000 is payable in October.
(g) Expected cash sales per month Rs. 15,000. No commission is payable on cash sales.

[C.U. B.Com. (Hons.)]

Solution :

Cash Budget

Period For 4 Months ending December 2004

	September Rs.	October Rs.	November Rs.	December Rs.
Receipts				
Balance b/d	10,500	31,800	12,100	36,200
Cash Sales	15,000	15,000	15,000	15,000
Receipts from Debtors	1,60,000	1,85,000	2,10,000	2,45,000
	1,85,500	2,31,800	2,37,100	2,96,200
Payments				
Paid to Creditors	92,000	1,00,000	1,20,000	90,000
Wages	37,000	42,000	49,000	35,500
Selling Expenses	9,500	10,500	12,500	8,900
Overheads	11,500	13,000	14,500	10,500
Selling Commission[1] (2% of previous month)	3,700	4,200	4,900	3,560
Machinery	—	50,000	—	—
Balance c/d	31,800	12,100	36,200	1,47,740
	1,85,500	2,31,800	2,37,100	2,96,200

Note : [1]Selling commission has been calculated on credit sales only.

Illustration 8

From the following particulars prepare monthly cash budget of the Unclear October, November and December of 1996 :

Months	Purchases	Sales	Wages	Expenses
	Rs.	Rs.	Rs.	Rs.
July '96	40,000	60,000	8,000	10,000
August '96	60,000	80,000	10,500	12,000
September '96	50,000	70,000	17,500	12,500
October '96	70,000	90,000	17,100	11,600
November '96	80,000	1,00,000	12,000	11,800
December '96	60,000	1,20,000	12,000	12,300

It is expected that 50% of sales will be in cash and 25% of the purchases can be made on credit.

Debtors are allowed 2 months' credit but will receive 5% cash discount if they will pay-off their dues within the month next to the month of sale. 80% of the debtors normally clear their dues at the end of that period to avail the cash discount. Rest 20% of the debtors pay on the due date.

$\frac{4}{5}$th of the credit purchase is paid after 1 month of that purchase and next to that month the balance $\frac{1}{5}$th is paid.

Wages are paid within 5th of the following month.

Expenses includes selling and distribution expenses which are 10% of the sales.

Any deficiency in cash at the end of a month will be met by taking short-term loan for two months from bank.

At the end of September 1996 the Unclear Ltd. had Rs. 40,000 cash in hand.

[C.U. B.Com. (Hons.)]

Solution :

In the books of Unclear Ltd.
Cash Budget
Period for 3 months ending 31st December 1996

Details	October	November	December
	Rs.	Rs.	Rs.
Balance b/d	40,000	25,000	10,800
Receipts :			
Cash Sales	45,000	50,000	60,000
Receipts from Debtors	34,600	41,200	47,000
	1,19,600	1,16,200	1,17,800
Payments :			
Cash Purchases	52,500	60,000	45,000
Payment to Creditors	13,000	16,500	19,500
Wages	17,500	17,100	12,000
Selling & Distribution Expenses	9,000	10,000	12,000
Other Expenses	2,600	1,800	300
Balance c/d	25,000	10,800	29,000
	1,19,600	1,16,200	1,17,800

Workings :

1. Cash Sales & Receipts from Debtors

	July Rs.	August Rs.	September Rs.	October Rs.	November Rs.	December Rs.
Total Sales	60,000	80,000	70,000	90,000	1,00,000	1,20,000
Less : Cash Sales @ 50%	30,000	40,000	35,000	45,000	50,000	60,000
Credit Sales	30,000	40,000	35,000	45,000	50,000	60,000
80% Collection						
Less : 5% discount after one month		22,800	30,400	26,600	34,200	38,000
20% collection after two months		—	6,000	8,000	7,000	9,000
Receipts from Debtors				34,600	41,200	47,000

2. Cash Purchases and Cash Payment to Creditors

	July Rs.	August Rs.	September Rs.	October Rs.	November Rs.	December Rs.
Total Purchase	40,000	60,000	50,000	70,000	80,000	60,000
Less : Cash Purchase @ 75%	30,000	45,000	37,500	52,500	60,000	45,000
Credit Purchase	10,000	15,000	12,500	17,500	20,000	15,000
$\frac{4}{5}$th payment after one month		8,000	12,000	10,000	14,000	16,000
$\frac{1}{5}$th payment after two months			2,000	3,000	2,500	3,500
				13,000	16,500	19,500

3. Selling and Distribution Expenses

	Oct. Rs.	Nov. Rs.	Dec. Rs.
Sales for Oct. = Rs. 90,000 × 10%	9,000		
Sales for Nov. = Rs. 1,00,000 × 10%		10,000	
Sales for Dec. = Rs. 1,20,000 × 10%			12,000

4. Other Expenses

	Oct. Rs.	Nov. Rs.	Dec. Rs.
Rs. 11,600 – 9,000 =	2,600		
Rs. 11,800 – 10,000 =		1,800	
Rs. 12,300 – 12,000 =			300

Notes :
1. It has been assumed that the entire expenses are paid in the current month in the absence of information.
2. Since there is no deficiency in cash in any month during the budget period, question of taking short-term bank loan, which is given in the question, does not arise.