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Cash Management in Business

Introduction ::

Cash management is concerned with the management of cash which is an important component of working capital representing a perfectly liquid asset possessed by an organization. The need of optimal cash in every business cannot be overemphasized on the one hand, too little cash at its disposal may seriously damage its smooth operations and on other hand, too much of cash balance may come in the way of maximum profits. Therefore, it is obvious that any balance more than the maximum cash balance is unproductive and it should always be kept to the minimum. Effective management of cash available for day-to-day operations is essential, if cash needs of a business are to be met effectively. Thus, it may be rightly regarded as an appendage of financial function or financial management. Cash management is as old as 'use of money' itself in business.

Modern system of cash management also includes controllership. It is concerned with making use of cash resources in such a way that maximize a firm's profit without endangering its liquidity position or credit standing in the market. Cash management refers to the functions of a financial executive concerning in a business enterprise. Cash management is as old as the use of money in business but its nature and scope has changed considerably with the passage of time. Traditional cash management was relatively simple. It was more concerned with treasure ship, it regarded a holding of a large cash balance as assign of sound financial position and efficient cash management of a business concern.

Meaning of Cash Management:

As Sydney Robbins "A business wants to get hold of it in the shortest possible time, but to keep the least possible quantity on hand."

Cash Management is the management of the cash balances of a concern in such a manner as to maximize the availability of cash not invested in fixed assets or inventories and to avoid the risk of insolvency. According to Keynes there are three motives for holding cash, the transactions motive, the precautionary motive and the speculative motive. The most useful technique of cash management is the cash budget.

Factors of Cash management:

1. Ascertainment of the minimum cash balance and controlling the levels of cash.
2. Controlling of cash inflows.
3. Controlling of cash outflows.
4. Optimum investment of surplus cash.
5. Providing for contingencies.
6. Consideration of cost of shortage of cash.
7. Availability of other sources of funds.
8. Centralized disbursements.
9. Synchronizations of cash flow
10. Cost of cash management.
11. Uncertainty in cash flows.

Baumol's Model for cash management:

Most firms try to minimise the sum of the cost of holding cash and the cost of converting marketable securities to cash. Baumol's cash management model helps in determining a firm's optimum cash balance under certainty. As per the model, cash and inventory management problems are one and the same.

There are certain assumptions that are made in the model. They are as follows:

1. The firm is able to forecast its cash requirements with certainty and receive a specific amount at regular intervals.
2. The firm's cash payments occur uniformly over a period of time i.e. a steady rate of cash outflows.
3. The opportunity cost of holding cash is known and does not change over time. Cash holdings incur an opportunity cost in the form of opportunity foregone.
4. The firm will incur the same transaction cost whenever it converts securities to cash. Each transaction incurs a fixed and variable cost.

For example, let us assume that the firm sells securities and starts with a cash balance of C rupees. When the firm spends cash, its cash balance starts decreasing and reaches zero. The firm again gets back its money by selling marketable securities. As the cash balance decreases gradually, the average cash balance will be: C/2. This can be shown in following figure:

The firm incurs a cost known as holding cost for maintaining the cash balance. It is known as opportunity cost, the return inevitable on the marketable securities. If the opportunity cost is k, then the firm's holding cost for maintaining an average cash balance is as follows:

Holding cost = k (C/2)

Whenever the firm converts its marketable securities to cash, it incurs a cost known as transaction cost. Total number of transactions in a particular year will be total funds required (T), divided by the cash balance (C) i.e. T/C. The assumption here is that the cost per transaction is constant. If the cost per transaction is c, then the total transaction cost will be:

Transaction cost = c (T/C)

The total annual cost of the demand for cash will be:
Total cost = k (C/2) + c (T/C)

Optimum level of cash balance

As the demand for cash, 'C' increases, the holding cost will also increase and the transaction cost will reduce because of a decline in the number of transactions. Hence, it can be said that there is a relationship between the holding cost and the transaction cost.
The optimum cash balance, C is obtained when the total cost is minimum.
Optimum cash balance C
Where, C is the optimum cash balance.
T is the total cash needed during the year.
k is the opportunity cost of holding cash balances.
With the increase in the cost per transaction and total funds required, the optimum cash balance will increase. However, with an increase in the opportunity cost, it will decrease.

Formula of cash management:

The determination of the optimum cash balance, when variations can be predicted, can be done with the help of formula for economicorder quantity of inventory management. The formula for EOQ can be used with slight changes:

C = Optimum cash balance
B = transaction costs
I = Rate of interest on securities
T = Total demand of cash

Illustration:

Suppose, a firm needs Rs.1,20,0000 during a month. The transaction cost per unit is Rs.100 and the rate of interest on marketable securities is 6% (it means monthly 0.5%). On that balance the optimum cash balance can be determined as follows:

C = = Rs.69282

Cash Budget:-

The cash budget is a part of cash management. The cash budget is of use to non-seasonal industries as well. The cash budget focuses on the incidence of cash receipts and cash payments and is the net result of the sales, manufacturing and staff budgets as also the investments and financial outlays envisaged by a company according to its corporate plan for the year. The cash budget points out periods when cash would be plentiful and when borrowing would be required. It helps the company in better management of working capital and enables the bank to take credit decision realistically. This method is useful for determining working capital requirements, as long as the company can separate cash inflows and outflows relating to purely working capital purposes from others.

The cash budget is intended:

1. To see that adequate amounts of cash are available for capital as well as revenue expenditures.
2. To make proper arrangement of acquiring cash, if there is any expected shortage of cash.
3. To see that surplus amount of cash is invested properly to earn maximum return.

For the months from 1st April,2012 to 31st June,2012.

Particulars	April	May	June
Cash Balance **Receipts:** 1. Cash Sales 2. Collection from debtors 3. Receipts from bills receivable 4. Interest and dividend 5. Sale of fixed assets 6. Receipts from loan, debentures etc. 7. Receipts from shares issued 8. Others			
Total Receipts (A)			
Payment: 1. Cash Purchase 2. Payment to creditors 3. Wage and salaries 4. Administrative expenses 5. Selling expenses 6. Purchase of fixed asset 7. Repayment of loan 8. Payment of taxes			
Total Payment (B)			

Closing Cash Balance (A-B)			

Importance of Cash Management :

- Business analysis report that poor management is the main reason for business failure. Poor cash management is probably the most frequent stumbling block for entrepreneurs. Understanding the basic concepts cash flow will help you plan for the unforeseen eventualities that nearly every business fact.
- A firm should hold sufficient cash, neither more, nor less. If the firm holds surplus cash, this excessive cash remains idle, which simply increases the cost without contributing anything towards the profitability of the firm.
- Cash balance should be kept to the minimum level which is required to meet actual cash needs of a business. In a sound cash management programme, profits are maximized through skillful administration of available cash resources.
- Another important objective of cash management of every Indian industries is the determination of an exact mix of cash and marketable securities.
- Computation of various ratios has been suggested to find out the liquidity and solvency position of a Indian company. Generally current and quick ratios are used in order to test a firm's liquidity and solvency position.

Conclusion:

Good cash management is simple. It involves:

- Knowledge when, where and how your cash needs will occur
- Knowing the best sources for meeting additional cash needs
- Being prepared to meet these needs when they occur, by keeping good relationship with bankers and other creditors.

The starting point for good cash management is developing a cash flow projection. Smart business owners know how to develop both short-term cash flow projections to help them manage daily cash and long-term cash flow projections to help them develop the necessary capital strategy to meet their business needs. They also prepare and use historical cash flow statement to understand how they used money in the past.

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