Financial Management

Unit 5

Cash Management

Cash Management refers to the process of collecting, handling, controlling, and investing of a firm's available funds to ensure adequate utilization of the company's resources. It is essential to maintain a satisfactory amount of cash to run a business activity smoothly. It is concerned with the managing of:

a) Cash inflows and outflows of the firm;
b) Cash flows arising within the firm; and
c) Cash balances held by the firm at a given point of time by financing deficit or investing of the surplus cash.

Motives of Holding Cash

Three basic considerations in determining the liquidity or the amount of cash as outlined by Lord Keynes (a British Economist) are:

a) Transaction need: Cash helps in meeting the day-to-day expenses and other debt payments of the companies. Normally, the collection of cash (from sale of goods and services, sale of assets, and additional financing) is not perfectly synchronised with the disbursement of cash (for purchase of goods and services, purchase of capital assets, and meeting other liabilities). Hence, some buffer cash balance is required at most of the times.

b) Speculative needs: Firms would like to tap profit making opportunities arising from fluctuations in commodity prices, security prices, interest rates, and foreign exchange rates. A cash-rich firm is better prepared to exploit such bargains. However, for most firms their reserve borrowing capacity and marketable securities would suffice to meet their speculative needs.

c) Precautionary needs: There may be some uncertainty about the magnitude and timing of cash inflows from the sale of goods or services, the sale of assets, and issuance of securities. Likewise, there may be uncertainty about cash outflows on account of purchases and other obligations. To protect itself against such unexpected events, a firm may require some cash balance.

Objectives of Cash Management

The objectives of cash management are:

a) To ensure steady and adequate supply of funds for the business operations.
b) To ensure that cash designated for investments lands in safe ventures.
c) To facilitate optimum utilization of organisational funds.
d) To make timely payment of cash in the normal course of business.
e) To minimize the amount blocked up as cash balance. The business should have optimal amount of cash balance.

Functions of Cash Management

a) Estimation of Required Capital: Finance Managers work to ensure the right calculation of the required capital depending on the costs they plan to incur, the expected profits and the future policies and programs of the firm.

b) **Allocation of Funds:** It is the job of the cash manager to decide how funds are to be allocated, to whom they are to be allocated and for what purposes.
c) **Control over Business Funds:** Cash management has full control over cash available in the organisation. It plans on how funds are utilized on organisational projects.
d) **Handling Unexpected Costs:** Cash management handles costs that may arise as a result of unexpected situations, for instance-breakdown of machinery.
e) **Initiates Investments:** Cash management ensures that extra funds in the business are invested in the best market opportunities.

Cash Forecasting and Budget

Cash budgeting or short-term cash forecasting is the principal tool of cash management.

Cash Budget is one of the most significant devices that helps businesses to plan for and control cash receipts and payments. It represents the cash requirements of business during the budget period. On the basis of cash budget, the firm can decide whether to invest surplus cash in marketable securities and earn profits; or in case of any shortages, manage it by availing overdraft or credit arrangements with banks.

Cash budgets, routinely prepared by business firms, are helpful in:

- estimating cash requirements,
- planning short-term financing,
- scheduling payments in connection with capital expenditure projects,
- planning purchases of materials,
- developing credit policies, and
- checking the accuracy of long-term forecasts.

The importance of cash budgets can be summarized as follows:

a) **Usage of Cash:** Management can plan out the usage of cash in accordance with the changes of receipt and payment.
b) **Provision of Excess Funds:** It helps in pinpointing the periods of excess cash than required. In this regard management can decide to invest the surplus funds for short term or long-term period, according to the requirements in the business and earn profits.
c) **A Pay-out Policy:** This budgetary system may help the management for future pay-out policy in the form of dividend. At the times of favourable cash budget (liquid) position, the management may decide upon increasing the rate of dividend or retaining the cash balance for future use.
d) **Provision for acquiring Funds:** It gives the top-level management ideas for acquiring funds for particular time duration and the various sources that can be explored.
e) **Profitable Use of Cash:** Businessperson can take decision for the best use of liquidity to make more profitable transaction. It enables firm which has sufficient cash to take advantage like cash discounts on its accounts payable

Methods of Preparing Cash Budget

A cash budget can be prepared in the following ways:

a) **Receipts and Payments Method:** This method is the most popular and is universally used for preparation of the cash budget. This method considers all the expected receipts and payments

for the budget period. All the cash inflow and outflow of all functional budgets including capital expenditure budgets are considered. Accruals and adjustments in accounts will not affect the cash flow budget. Anticipated cash inflow is added to the opening balance of cash and all cash payments are deducted from this to arrive at the closing balance of cash.

b) **Adjusted Net Income Method (Adjusted Profit and Loss Method):** In this method the annual cash flows are calculated by adjusting the sales revenue and cost figures for delays in receipts and payments (change in debtors and creditors) and eliminating non-cash items such as depreciation.

c) **Balance Sheet Method:** In this method, the budgeted balance sheet is predicted by expressing each type of asset (except cash & bank) and short-term liabilities as percentage of the expected sales. The profit is also calculated as a percentage of sales, so that the increase in owner's equity can be forecasted. Known adjustments, may be made to long-term liabilities and the balance sheet will then show if additional finance is needed (if budgeted assets exceed budgeted liabilities) or if there will be a positive cash balance (if budgeted liabilities exceed budgeted assets).

Payables Cash Management

Payables represent amount of cash that a firm owes to its vendors and creditors for the supply of raw materials. It represents a part of the short-term liabilities of the firm. It relates to planning cash outflows carefully to facilitate longer credit periods from firm's creditors. The firm can then retain an adequate amount of money for carrying out the day-to-day business operations. The cash, if well managed, may be invested in profitable business opportunities to generate more income for the business. This in turn enhances business growth.

Receivables Cash Management

Receivables refer to debts owed to the business by its regular customers in lieu of sales in the course of business. A business must properly manage its receivables to facilitate adequate cash flow in the business. Businesses should ensure that they receive payments for their sales on time to avoid shortage of cash which may interfere with the normal business activities. Shorter credit periods should be allowed to customers to avoid bad debts which may put business's financial position at risk.

Benefits of Good Cash Management

a) **Facilitates Business Expansion:** Having swift cash flow management reduces reliance on external business resources such as commercial bank loans thus allowing rapid business expansion.

b) **Building Business Image:** Good cash flow management helps business to settle its debts on time which in turn enhances trust between the firm, its suppliers and creditors.

c) **Minimizes Business Stress:** Having good cash flow management facilitates smooth running of business operations. The management does not have to worry about how business obligations will be met.

d) **Ensures Optimal Cash Flow:** A good cash management policy enables managers to have a better understanding of cash inflows and outflows as and when need arises.

Inventory Management

Inventory Management is a significant part of working capital management for every organisation as it determines stability of supply chain as well as the financial health of an organisation. All firms strive to maintain adequate level of inventory that can meet its day-to-day requirements and try to avoid excess inventory that could lead to spoilage or other losses. Effective inventory management would ultimately result in maximisation of owner's wealth, which is in line with overall objective of financial management.

Types of Inventories

a) **'Raw Materials' Inventory:** It comprises of the materials and items used by a company to produce goods for sale. They are the basic materials that a manufacturing firm purchases from its suppliers. They are then used by the firm to transform into final goods by adopting a set of manufacturing processes.
b) **'Work-in-Progress' Inventory:** 'Work-in-progress' also called as semi- finished goods, are the raw materials that are in the process of transformation into the final products.
c) **'Finished Goods' Inventory:** 'Finished goods' are the ultimate products obtained after the application of the conversion processes on the raw materials and the semi-finished goods. They are the final goods to be sold and their sale contributes fully to the revenue from the core operations of the organisation.

Costs involved in Inventory Management

a) **Ordering Costs:** Ordering costs are incurred when a company orders inventory from suppliers. It comprises of transportation costs, receiving costs, cost of finding suppliers and expending orders, clerical costs of preparing purchase orders, costs of electronic data interchange.
b) **Carrying Cost/ Inventory Holding Costs:** These are costs incurred in storing inventory before they are sold to potential customers. Carrying costs includes inventory risk costs, opportunity cost, inventory financing costs etc.
c) **Cost of Stock-outs/ Shortage Costs:** these are incurred when a company falls short of stock of inventory for any reason. They include:
    a. Costs of emergency shipments.
    b. Loss of customers loyalty and goodwill.
    c. Disrupted production.

Inventory Management Techniques

ABC Inventory Management

This technique involves classifying items into categories in the order of their relevance in the production process. In inventory management, it implies that more valuable items of inventory should be prioritized over less valuable items. 'A' denotes the most valuable raw materials, 'B' being moderate and 'C' being the least valuable products in the inventory. This enables a company to give more attention to the most valuable products. For instance:

- A items: '20% items' accounts for '70% annual consumption value' of items.
- B items: '30% items' accounts for '25% annual consumption value' of items.
- C items: '50% items' accounts for '5% annual consumption value' of items.

The EOQ Model

The economic order quantity (EOQ) is a method that helps a company to estimate the optimum size of an inventory order that will decrease the total inventory costs. It helps in minimizing the holding and ordering costs of inventory overtime. It gives an indication whether or not the current order quantity is reasonable.

Assumptions of the EOQ Model

- Ordering cost and the carrying cost of the inventory are the two costs associated with the inventory.
- Consumption rate of inventory is uniform throughout the year.
- The ordering and carrying costs are known with certainty and are constant over the year.
- The purchasing cost per unit does not change with the amount of inventory ordered i.e. there are no trade/quantity discounts.
- The time gap between order placement and its supply is nil i.e. there is no lead time.

According to this model, the formula for economic order quantity is as follows:

$$\mathrm{EOQ} = \sqrt{\frac{2\mathrm{AO}}{\mathrm{C}}}$$

According to this model:

- EOQ stands for Economic Quantity per order
- A stands for total annual requirement for the item
- O stands for ordering cost per order of that item
- C stands for carrying cost per order of that item

Reorder Point

The inventory level at which the new order has to be placed to replenish the stock is knows as reorder point level. It depends upon:

- Length of the time between the order placement and receiving the supply
- The rate of usage of an item

Reorder point(level) = Lead time in days × Average Daily usage of inventory

Just-In-Time Inventory Management

Just-in-time (JIT) is a management strategy that aligns raw-material orders from suppliers directly with production schedules in order to be able to meet consumer demands with minimum delays. It was first developed and applied in the Toyota manufacturing plants. In this method, labour, material and goods (to be used in manufacturing) are re-filled or scheduled to arrive exactly when needed in the manufacturing process. Thus, this inventory strategy allows companies to increase efficiency (by reducing inventory costs and increasing inventory turnover) and decrease wastage by receiving goods only when they need them for the production process.

Receivables Management

Receivables management describes the policies, techniques and procedures set by an organisation to facilitate the control of credit that it offers to its regular customers in the course of the business. It includes evaluating credit- worthiness of customers, establishing terms of credit and sales policies and planning for a suitable collection process of the receivables. Receivables are considered as the current assets of a company and are also shown in the company's balance sheet. Therefore, they should be translated into cash in a short span of time to enable smooth running of business. A company that has poor efficiency in the management of receivables increases liquidity risk of the firm.

Credit Policy

The term Credit Policy refers to the amount and terms of credit allowed by a firm to its customers. Credit policy is a set of parameters and principles that regulate trade credit offered to customers. It determines the amount of credit on sales of goods and services offered to regular customers in the course of business operations. Credit policies should be favourable to facilitate large volume of sales. However, the management should not adopt very lenient credit policies as this may cause bad debts to the company. Businesses should extend credit facilities after establishing the creditworthiness of the customers. For effective management of receivables, a balanced credit policy is a must.

Credit Policy Objectives

- **a) Outlines Policies and Procedures:** Effective credit policy communicates customers with various options in case they are not able to pay in full.
- **b) Provides Guidelines:** Trade Policy helps outline the guidelines for legally collecting the money from slow or non-paying customers.
- **c) Implements a Plan:** An appropriate credit policy plan helps business in determining reasonable credit limits to be offered to the customers.
- **d) Outlines Steps:** In order to eliminate bad debt, credit policy helps in outlining procedure and steps to collect dues from late paying customers.

Credit Policy Variables

A firm's Credit Policy consists of the following important Variables:

- **a)** Credit Standards
- **b)** Credit Period
- **c)** Cash Discount
- **d)** Collection Effort.

Factors Affecting the Size of Receivables

1. **Credit Policy:** It refers to the amount and terms of credit allowed by a firm to its customers. An organisation which has a very strict credit collection policy will have lower level of receivables. On the other hand, an organisation that has a liberal credit policy will have higher level of receivables.
2. **Level of Sales:** The volume of sales that a company wants to achieve affects the size of its receivables. If a company wishes to increase its volume of sales, it has to offer more credit to company's regular clients. This increases the receivables' size.
3. **Terms of Trade Credit:** Size of receivables also depends on the trade credit terms offered to the firm by its suppliers and vendors. If the terms are strict, the business may not offer much

credit to its customers. This will in turn reduce the size of receivables in a company. On the other hand, if the terms of the credit are favourable, the firm may relax its credit collection policy to its customers thus increasing account receivables.

Benefits of Receivables Management

- **Profit Generation:** Effective management of receivables leads to increase in profits. It is a consequence of larger volume of sales which results from favourable credit terms offered to regular customers.
- **Attraction and Retention of New Customers:** A company that offers credit and manages its receivables efficiently stands a higher chance of attracting new customers and retaining its regular customers than ones with less efficiency in the management of receivables.
- **Improves Investments:** Receivables management enables a business to invest in more profitable opportunities which further encourages sales.
- **Increases Production:** Effective management of receivables increases the rate of production as more 'working capital' is available for operations and less 'working capital' is tied up in accounts receivables.
- **Effective Financial Planning and Control:** A sound management of receivables enables the management to achieve effective financial planning and control.
- **Deal effectively with Competition:** Regulating the amount of credit offered to customers enables a business to survive in a highly competitive environment.
- **Minimize Bad Debts:** Management of receivables helps a company to minimize bad debts associated with inadequate or lack of receivables management.