Unit 11 Cash Management

QN1 What is cash? What are the objectives or motives of holding cash?

Cash is an idle and non-earning asset. Therefore, the firm should keep sufficient cash, neither more, nor less. More cash balances reduce the rate of return on equity and hence minimize the value of stock. The term cash includes coins, currency, cheque held by the firm and balances in its bank accounts.

Motives of Holding Cash

1. **Transactional motive:** The principle motive for holding cash is to conduct day to day operations. A cash balance associated with routine payments and collections like purchase of raw material, payment of wages, salaries, interest, dividends, taxes etc.
2. **Compensating balance:** A cash balance that a firm must maintain with a bank to compensate the bank for services rendered or for granting a loan. Firm often maintains bank balances in excess of transactions needs as a means of compensation for the various services.
3. **Precautionary motive:** A cash balance held in reserve for random, unforeseen fluctuation in cash inflows and outflows. For examples – flood, strike, inefficiency in collection of debtors, cancellation of order of important customers, sharp increases in cost of raw materials.
4. **Speculative motive:** A cash balance that is held to enable the firm to purchase that might arise. For examples- purchasing raw material at a reduced price on payment of immediate cash, falls in price of share and securities, purchasing at favorable price.

QN2 What do you understand by float? Is it better to have positive or negative float?

Float is the difference between the balance shown on a firm's cheque book and the balance on bank's record. A firm's net float is a function of it ability to speed up collection of cheque received and to slow down collections on checks written.

Net Float= Disbursement float - Collection float

Collection float: The delay between the time when a payer or customer deducts payment from its cash account and the time when payee actually receives the funds in a spendable form.

Disbursement float: The laps between the time when a firm deducts a payment from its checking account ledger (disburse it) and the time when funds are actually withdrawn from its accounts.

Components of float

Both collection float and disbursement float have the same three basic components:

1. *Main float*: The delay between the time when a payer mail a cheque for payment and the time when the payee receives it.

2. *Processing float*: The delay between the receipt of chque by the payee and its deposit in the firm's account.
3. *Clearing float*: The delay between the deposit of a cheque by the payee and the actual availably of funds.

Positive net float is better. Positive net float shows the funds released by the positive amounts and that amounts can be invested in the business and the value of the firm will increases.

QN3 Write short notes on following cash management techniques.

Concentration Banking: A collection procedure in which payments are made to regionally dispersed collection centers, then deposited in local banks for quick clearing. Funds are finally transferred in one place called concentration bank. Those funds are centrally managed by cash manager for disbursement, short term investment or borrowing, cash budget etc. Concentration banking is used to reduce collection float by shortening the mail and clearing float components. Mail float is reduced because regionally dispersed collection centers bring the collection point closer to the point from which the cheque is sent. Clearing float should also be reduced, since the payee's regional bank is likely to be in the same city as the bank on which the cheque is drawn; it may even be the same bank.

Lockbox system: Lockbox system is the technique of accelerating the flow of funds. With concentration banking, a collection center receives cheques, processes them, and deposits them in a bank. The purpose of lock box system is to eliminate the time between the receipt of cheques by the firm and their deposit in the bank. A lock box is a post office box under the control of bank. According to this system, the firm rents a post office box in each important center. The customers around center are advised to remit the cheque directly to the post office box arranged for that area. The bank collects the cheque for several times a day and deposits into firms account. Those funds are transferred by wire to firm headquarters.

Wire transfer and Depository Transfer Cheque: Increasing cash availability involves moving funds among banks. There are mainly two methods:

Firms can also use *wire transfers* to reduce collection float. Wire transfers are telegraphic communications that remove funds from the payer; bank and deposit them into the payee's bank, thereby reducing collection float. Wire transfers can eliminate mail and clearing float and may reduce processing float as well.

A *depository transfer cheque* is an unsigned cheque drawn on one of the firm's bank accounts and deposited into its account at a concentration or major disbursement bank, there by speeding up the transfer of funds. Once the DTC has cleared the bank on which it is drawn, the actual transfer of funds is completed.

QN4 What are the Functions of cash management?

There are various functions of cash management. They are:

To cash planning: Cash flows should be planned to project cash surplus or deficit for the period. Cash budget is prepared for this purpose.

To design and managing cash flows: The cash management shall be designed as inflows of cash should be accelerated and the outflows of cash should be decelerated.

To maintain cash and marketable securities in amounts close to optimum level:

To place the cash and marketable securities in the proper institutions and in the proper forms:

QN5 How a firm can control in disbursement of fund?

Effective control of disbursements can also result in more availability of cash. The objectives in disbursement are to slow them down as much as possible the combination of fast collections and slow disbursements will result in maximum availability of funds.

Payables Centralization: Centralization of payables, which permits the financial manager to evaluate the payments coming due for the entire firm and to schedule cash transfers to meet these needs on a company-wide basis.

Zero balance account: Typically, a firm established several zero balance accounts in their concentration bank and then funds are transferred from or to ZBAs from a master account. As cheques are presented to a ZBA for payment, funds are automatically transferred from master account.

Controlled disbursement accounts: Controlled disbursement account are similar to zero balance accounts, except that controlled disbursement accounts can be set up at any bank. Typically, these accounts are established at remote locations. These accounts are not funded until the day’s cheques have been presented against the account.