



Cash management: A conceptual framework

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Abstract

For business operations, cash is the most valuable resource. It is both the fundamental input necessary for the firm to operate continuously and the end result of its operations. Because excessive cash will remain idle and a lack will cause operational disruptions, the company should always have enough cash on hand. In order to meet its regular obligations, such as paying wages, bills, daily expenditures, debt repayments, dividends, interest, and so on, every business usually keeps between one and three percent of its assets in the form of cash. The amount of cash available for commercial transactions, whether in the bank or in hand, has a greater impact on the meeting's capacity. A solid cash management is essential to facilitate its liquidity and capacity to pay.

Keywords: Cash management, inventory management, liquidity, working capital management

Introduction

The word cash is used for cash management purposes to refer to not just coins, currency notes, checks, bank drafts, and demand deposits with banks but also near cash assets like time deposits with banks and marketable securities since they are easily converted into cash. The most liquid asset is cash. Receivables and inventories can be converted into cash, which is the common denominator to which all other current assets can be reduced. Every business needs cash to survive because it is necessary for purchasing the supplies, machinery, and other assets used in the production of goods and services. In addition to being close to cash, marketable securities also serve as a reserve pool of liquidity that can be used to get cash quickly when it's needed. The primary goal of cash management, a key component of working capital management, is to maximize the flow of cash inside a company. It entails managing, predicting, and regulating cash inflows and outflows in order to guarantee that a company has adequate cash on hand for its day-to-day operations and future requirements. Effective cash management helps keep liquidity, lowers financial risks, and promotes long-term expansion.

Importance of Cash Management

- **Ensuring Liquidity:** Ensuring the business has sufficient cash on hand to meet its obligations.
- **Optimizing Working Capital:** Managing cash flow efficiently can improve working capital management and overall business performance.
- **Improving Profitability:** Efficient cash management can help businesses reduce borrowing costs, invest surplus cash effectively, and ultimately improve profitability.

Functions of Cash Management

▪ Inventory Management

Inventory management guarantees to remove the barrier of any trapped sales, resulting in a greater amount of stock on hand. Effective financial management allows businesses to attempt to liquidate current inventories, which will guarantee cash inflows, as higher inventory stocks imply lower levels of liquidity.

▪ Receivables Management

In most cases, a firm will record a sales entry after a credit sale, but the payment is frequently in the pending status. The purpose of cash management is to pay all accounts receivable bills in a timely manner in order to avoid any liquidity crisis.

▪ Payables Management

When a firm makes a purchase on credit, its payables represent its obligation. Businesses sometimes borrow money from banks or lending institutions and are required to pay it back within a certain period. Therefore, good fund management ensures that the payback is made on schedule, preventing any fines or compensatory interest.

▪ Short-Term Investment

The core of cash management is centered on variables such as preventing financial hardship and bankruptcy. Additionally, this may be used to boost the value of money by investing in government securities and other short-term assets.

Cash Management Models

To effectively manage cash, one needs to have a solid foundation and a realistic approach to figuring out how much cash the company needs to cover its day-to-day costs. In order to accomplish this, a few models were created to assess the amount of money across various variables. The two most important models are discussed in detail below:



Let us now elaborate on each of these models

The Baumol's EOQ Model

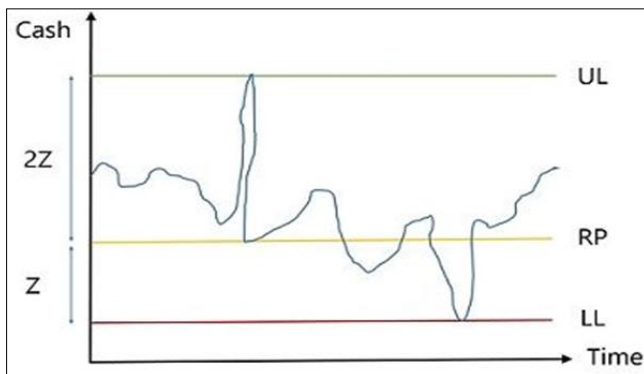
The Miller-Orr' Model

Baumol's model only predicts the cash withdrawal, but cash is the most unpredictable aspect of the company, according to Merton H. Miller and Daniel Orr.

The institution could occasionally have more money than it needs, which would discourage withdrawals and perhaps necessitate investments. As a result, rather than calculating the withdrawal amount, the corporation should decide on the return point or the amount of money to be kept.

This model prioritizes withdrawing the money only when the available funds are less than the return point of money, while investing the surplus amount over this threshold.

Given below is the graphical representation of this model:



Where, 'Z' is the spread of cash;

'UL' is the upper limit or maximum level

'LL' is the lower limit or the minimum level

'RP' is the Return Point of cash

The aforementioned chart shows a lower limit, which is the bare minimum of money a company needs to operate. The return point, or average cash requirement, is obtained by combining this lower bound with the spread of cash (Z).

But to maximize the return on investment, the corporation shouldn't put the money until it hits the highest threshold. Adding the lower limit to three times the spread (Z) yields this upper bound. In most cases, the flow of money may be seen across both the upper and lower limits.

To determine the return point of cash and the spread between the minimum and maximum levels, let us now examine the Miller-Orr model's formula:

$$Z = \sqrt[3]{\frac{3TV}{4i}}$$

Where,

'Return Point' is the point at which money is to be invested or withdrawn;

'Minimum Level' is the minimum cash required for business sustainability;

'Z' is the spread across the minimum level and the maximum level;

'T' is the transaction cost per transfer;

'V' is the variance of daily cash flow per annum;

'i' is the daily interest rate

Motives for Holding Cash

Majorly there are three motives for which the firm holds cash.

1. Transaction Motive: The transaction motive is the amount of money a corporation needs to cover its day-to-day operational needs. The company needs cash in the form of salaries, wages, interest, dividends, purchases, and more in order to make its payments during the normal course of business. In addition, it earns money from its sales, investments, and debtors. The company's cash inflows and outflows frequently do not align, so the cash is held up to pay its regular bills.

2. Precautionary Motive: The precautionary motive describes a company's propensity to keep cash on hand in case of unforeseen events or contingencies that may arise during the course of its operations.

A corporation may have to deal with contingencies like rising raw material costs, labor strikes, lockouts, and shifts in demand, etc., as the future is unpredictable. As a result, the companies retain the cash in order to maintain continuous operations in the face of these uncertainties.

3. Speculative Motive: The businesses maintain cash in order to profit from any future bargain purchases that may occur. For instance, the company will keep its money and wait for the raw material prices to drop if it thinks they will in the future. As a result, a company keeps cash on hand in order to take advantage of potential opportunities that may fall outside the scope of its regular operations. These prospects might include a low interest rate on the borrowed money, an anticipated drop in raw material prices, or a positive shift in government policies.

Thus, the cash is the most significant and liquid asset that the firm holds. It is significant as it is used to pay off the firm's obligations and helps in the expansion of business operations.

Factors Affecting Cash Management

Many things affect a company's cash management, both internally and externally. Profit margins, dividend and tax regulations, reserves and surplus, depreciation policies, growth plans, and operating efficiency are all examples of internal variables. Interest rate changes, investment options, government regulations, and regulatory agency regulations are all examples of outside forces. Factors such as the certainty of cash inflows and outflows, the availability of inventory, and the availability of borrowing alternatives also have a big impact.

Internal Factors

- **Profitability:** Greater cash inflows usually result from higher profits.
- **Taxation and Dividend Policies:** A company's cash flow can be greatly affected by its tax obligations and dividend payouts.
- **Reserves and Surplus:** A healthy surplus and reserves can act as a buffer against unforeseen financial demands.
- **Depreciation Policy:** The timing of cash flows is impacted by depreciation costs, which lower earnings but do not entail an actual outflow of cash.
- **Expansion Programs:** Capital expenditures are necessary for investing in growth initiatives, such as new facilities or products, which can affect cash flow.
- **Operational Efficiency:** Efficient operations may shorten cash conversion cycles, resulting in more timely inflows and perhaps lower cash needs.

External Factors

▪ Changes in Interest Rates

Variations in interest rates can have an impact on the cost of borrowing and the returns on investments, which can impact choices about how to manage cash.

▪ Investment Options

Where a company decides to invest its extra money might be impacted by the availability and appeal of investment prospects.

▪ Government Economic Regulations

Tax changes and economic stimulus packages are examples of government actions that have an impact on corporate revenues, costs, and investment choices, all of which have an impact on cash flow.

▪ Guidelines and Regulations

The way a business manages its cash can be impacted by regulatory reforms, such as those affecting accounting or banking.

Other Important Factors

▪ Predictable Cash Flow in and Out

Effective cash management depends on being able to forecast and comprehend the timing and magnitude of cash inflows and outflows.

▪ Inventory Levels

In order to prevent too much money from being tied up in excess inventory, it is imperative to manage it efficiently.

▪ Credit Regulations

The conditions of credit that are extended to customers and obtained from suppliers have a big impact on cash flow.

▪ Borrowings in the Short Term

Having access to short-term funding might be helpful in handling short-term cash constraints.

▪ Payments to customers and providers

Cash flow is directly influenced by the timing and terms of payments made to clients and suppliers.

▪ Capital Spending

Decisions about investing in long-term assets might have a big impact on cash flow.

Conceptual Framework

A firm's financial well-being and long-term viability depend on its ability to manage its cash effectively. It guarantees that the company is able to fulfill its responsibilities, keep its cash flow, and make wise choices regarding investments and expansion. By enabling a firm to prevent cash shortages, lower borrowing costs, and increase profits, a strong cash management plan is beneficial.

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