

CHAPTER 7:CASH MANAGEMENT

Financial managers actively attempt to keep cash (non-earning asset) to a minimum

It is critical to have sufficient cash to assuage emergencies

Steps to improve overall profitability of a firm:

- Minimize cash balances
- Have accurate knowledge of when cash moves in and out of the firm

1.1. Reason for holding cash

- Transactions balances
 - Payments towards planned expenses
- Compensative balances for banks
 - Compensate a bank for services provided rather than paying directly for them
- Precautionary needs
 - Emergency purposes

1.2. Cash Flow Cycle

- Ensure that cash inflows and outflows are synchronized for transaction purposes
 - Cash budgets is a tool used to track cash flows and ensuing balances
- Cash flow relies on:
 - Payment pattern of customers
 - Speed at which suppliers and creditors process checks
 - Efficiency of the banking system.

1.3. Float

- Difference between firm's recorded amount and amount credited to the firm by a bank
- Two types of float:
 - Mail float: Arises due to the time it takes to deliver a check.
 - Clearing float: Arises due to the time it takes to clear a check once the payment is made
- Both these floats do not exist anymore due to:
 - Electronic payments
 - Check Clearing for the 21st Century Act
- Check Clearing for the 21st Century Act (Check 21)
 - Allows banks and others to electronically process a check

§ Formula:

Float = Available balance – Ledger balance

- o Available balance (balance show on bank account)
- o Ledger balance (balance of a firm show on its book)

- Ø Checks written by a firm generate disbursement float
- Ø Check received by the firm create collection float

1.4. Improving Collections and Extending Disbursements

Improving collection:

- o Setting up multiple collection centers at different locations
- o Adopt lockbox system for expeditious check clearance at lower costs

Extending disbursement:

- o General trend:
 - § Speedup processing of incoming checks
 - § Slow down payment procedures
 - § Extended disbursement float – allows companies to hold onto their cash balances for as long as possible.
 - §
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3. Marketable securities

When a firm has excess funds, it should be converted from cash into interest-earning securities. In other words, cash not needed for transactions should be held in interest-earning marketable securities.

The choice of security should depend on yield, maturity, investment size, safety, and marketability.

There are many types of securities:

- Treasury bills: Short-term obligations of the government
- Treasury notes: Government obligations with a maturity of 1-10 years
- Federal agency securities: Offerings of government organizations
- Certificate of deposit: Offered by commercial banks, savings, and other financial institutions
- Commercial paper: Represents unsecured promissory notes issued by large business organizations
- Banker's acceptances: Short-term securities that arise from foreign trade

4. Management of accounts receivable

Accounts receivable as an investment should be based on the level of return earned equals or exceeds the potential gain from other investments.

In considering the extension of credit, there are three primary policy variables to consider in conjunction with our profit objective:

- Credit standards
- Terms of trade
- Collection policy

Credit standards, collection policy, and terms of trade are primary variables to consider when extending credit to customer

4.1 Credit standards

Determine the nature of credit risk based on prior records of payment and financial stability, current net worth, and other related factors.

5 Cs of credit:

- Character: Refers to the moral and ethical quality of the individual who is responsible for repaying the loan.
- Capital: The level of financial resources available to the company seeking the loan and involves an analysis of debt to equity and the firm's capital structure
- Capacity: Refers to the availability and sustainability of the firm's cash flow at a level high enough to pay off the loan.
- Conditions: Refers to the sensitivity of the operating income and cash flows to the economy.
- Collateral: Determined by the assets that can be pledged against the loan.

4.2 Term of trade

Stated term of credit extension:

- Has a strong impact on the eventual size of accounts receivable balance
- Creates a need for firms to consider the use of cash discounts

4.3 Collection policy

In assessing collection policy, a number of quantitative measures may be applied to the credit department of the firm.

- Average collection period: An increase in the average collection period may be the result of a predetermined plan to expand credit terms or the consequence of poor credit administration)

$$\text{Formular: Average collection period} = \frac{\text{Accounts receivable}}{\text{Average daily credit sales}}$$

- Ratio of bad debts to credit sales: An increasing ratio may indicate too many weak accounts or an aggressive market expansion policy.

- Aging of accounts receivable: is a periodic report that categorizes a company's [accounts receivable](#) according to the length of time an invoice has been outstanding. It is used as a gauge to determine the financial health of a company's customers. If the accounts receivable aging shows a company's receivables are being collected much slower than normal, this is a warning sign that business may be slowing down or that the company is taking greater [credit risk](#) in its sales practices

5. Inventory management

Inventory has 3 basic categories:

- Raw materials
- Work in progress
- Finished goods

Amount of inventory is affected by sales, production, and economic conditions

Inventory is the least of liquid assets - should provide the highest yield

5.1 Economic ordering quantity (EOQ)

Economic ordering quantity is the most advantageous amount for the firm to order each time.

- Costs are minimized when totally carrying costs and total ordering costs are equal
- Helps determine the optimum average inventory size that minimizes the total cost of ordering and carrying inventory.
- Determine this value by translating it into average inventory size and determining the minimum total cost amount

$$\text{Formula: } EOQ = \sqrt{\frac{2SO}{C}}$$

Where,

S = Total sales in units

O = Ordering cost for each order

C = Carrying cost per unit in dollars

5.2 Safety Stocks and Stock Outs

Stock out occurs when a firm is:

- Out of a specific inventory item
- Unable to sell or deliver the product

Safety stock reduces such risks

- Increases cost of inventory due to a rise in carrying costs
- This cost should be offset by: Eliminating lost profits due to stockouts or increased profits from unexpected orders.

$$\text{Formula: Average inventory} = \frac{\text{EOQ}}{2} + \text{Safety stock}$$

$$\text{Formula: Carrying costs} = \text{Average inventory in units} \times \text{cost per unit} \times \text{Carrying units}$$

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