Quadrant II - Notes

Course Code: COG140

Module Name: Factors Determining Cash Needs

Cash Management

Cash management is one of the key areas of working capital management. Cash is the most liquid current assets. Cash is the common denominator to which all current assets can be reduced because the other major liquid assets, i.e. receivable and inventory get eventually converted into cash. This underlines the importance of cash management.

The term "Cash" with reference to management of cash is used in two ways. In a narrow sense cash refers to coins, currency, cheques, drafts and deposits in banks. The broader view of cash includes near cash assets such as marketable securities and time deposits in banks. The reason why these near cash assets are included in cash is that they can readily be converted into cash. Usually, excess cash is invested in marketable securities as it contributes to profitability.

Cash is one of the most important components of current assets. Every firm should have adequate cash, neither more nor less. Inadequate cash will lead to production interruptions, while excessive cash remains idle and will impair profitability.

Factors Determining Cash Needs

Maintenance of optimum level of cash is the main problem of cash management. The level of cash holding differs from industry to industry, organisation to organisation. The factors determining the cash needs of the industry are explained as follows:

1. **Matching of cash flows** – The first and very important factor determining the level of cash requirement is matching cash inflows with cash outflows. If the receipts and

payments are perfectly coinciding or balance each other, there would be no need for cash balances. The need for cash management therefore, arises due to the non-synchronisation of cash receipts and disbursements. For this purpose, the cash inflows and outflows have to be forecast over a period of time say 12 months with the help of cash budget. The cash budget will pin point the months when the firm will have an excess or shortage of cash.

2. **Short costs** – Short costs are defined as the expenses incurred as a result of shortfall of cash such as unexpected or expected shortage of cash balances to meet the requirements. The short costs include, transaction costs associated with raising cash to overcome the shortage, borrowing costs associated with borrowing to cover the shortage i.e. interest on loan, loss of trade-discount, penalty rates by banks to meet a shortfall in compensating, cash balances and costs associated with deterioration of the firm's credit rating etc. which is reflected in higher bank charges on loans, decline in sales and profits.
3. **Cost of cash on excess balances** – One of the important factors determining the cash needs is the cost of maintaining cash balances i.e. excess or idle cash balances. The cost of maintaining excess cash balance is called excess cash balance cost. If large funds are idle, the implication is that the firm has missed opportunities to invest and thereby lost interest. This is known as excess cost. Hence the cash management is necessary to maintain an optimum balance of cash.
4. **Uncertainty in business** – Uncertainty plays a key role in cash management, because cash flows cannot be predicted with complete accuracy. The first requirement of cash management is a precautionary cushion to cope with irregularities in cash flows, unexpected delays in collections and disbursements, defaults and expected cash needs. The uncertainty can be overcome through accurate forecasting of tax payments, dividends, capital expenditure etc. and ability of the firm to borrow funds through over draft facility.
5. **Cost of procurement and management of cash** – The costs associated with establishing and operating cash management staff and activities determining the cash needs of a business firm. These costs are generally fixed and are accounted for by salary, storage and handling of securities etc. The above factors are considered to determine the cash needs of a business firm.