Chapter-6 : Working Capital Management -1 Cash Management

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[1] Introduction of Working Capital :

Capital needed by business enterprise can be divided into two categories - one is fixed capital and another is working capital. Capital investment in fixed assets and working capital is needed to keep the fixed assets working and thereby to maintain the continuity of the cyclical flow of production and sales. Therefore, working capital is the life blood of business.

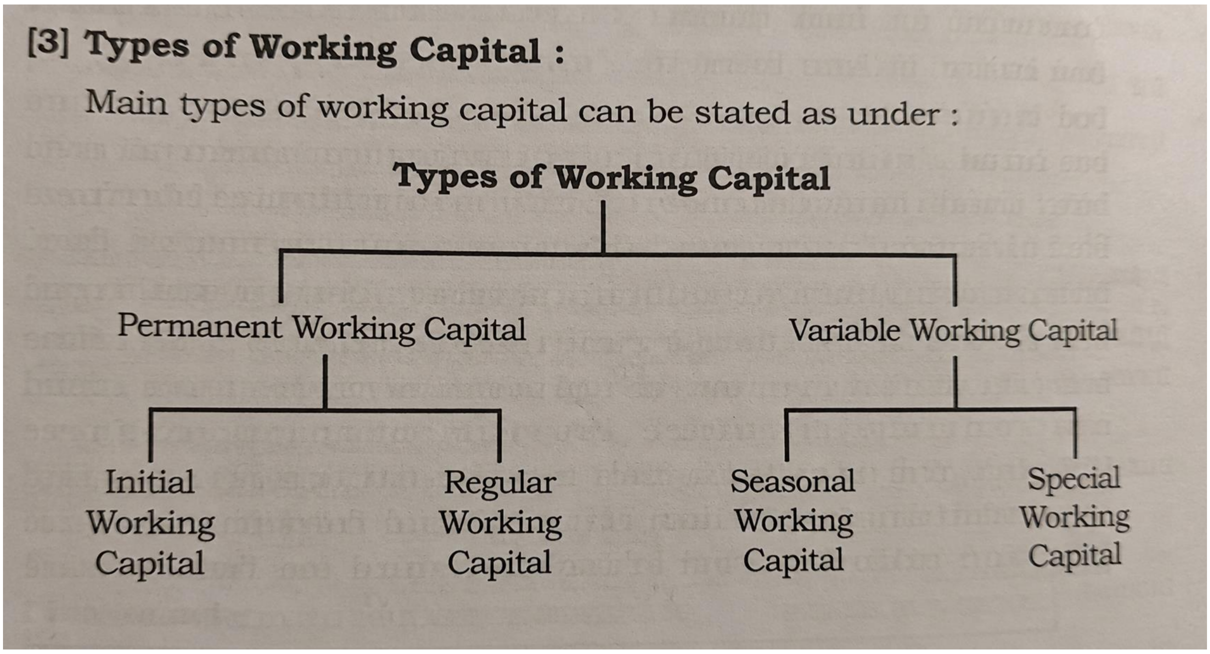
Insufficient working capital can disrupt the cyclical flow of production and sales while excessive working capital can reduce profitability by increasing the cost. Therefore, what is an optimum level of working capital and maintaining the optimum level management of working capital is highly essential. Financial manager's major time is spent after solving working capital problems.

[2] Concepts of Working Capital :

There are two concepts of working capital - one is total working capital concept and the other is net working capital concept.

Total working capital means total investment in current assets like cash, stock, receivables and short-term investments. This concept is important from the view point of financial manager for planning the optimum level of total working capital.

Net working capital means total current assets minus total current liabilities. Total current assets means sum total of cash, inventory, receivables and short-term liquid investments. Total current liabilities include creditors, bills payable, short-term bank loans, bank overdraft, outstanding expenses etc. The concept of net working capital is important from the view point of bank and creditors who are interested in knowing the credit worthiness of the company.


[3] Types of Working Capital :

Main types of working capital can be stated as under :

(1) Permanent Working Capital :

Basically working capital is classified into two categories: permanent working capital and variable working capital.

Permanent working capital means capital required to maintain the minimum level of cash, debtors and inventory for running the business smoothly is known as permanent working capital. It is needed for a longer period of time and there is no scope for its reduction. It remains invested in current assets almost on permanent basis. Its main characteristics are as under :

(a) It is of permanent nature, however, its form goes on changing – from cash to stock to debtors and from debtors to cash.
(b) It never gets detached from the business activities. Therefore it should be raised from long term sources.
(c) With the growth of business requirement of permanent working capital also increases.

Permanent working capital can also be divided into two types :
(a) Initial working capital and **(b) Regular working capital.**

(a) Initial working capital :
Initial working capital means working capital required during the initial period of new business. During this period may extend up to three to five years. So long as the company may not stand on its own footing and financially become self-reliant by building up a good amount of reserve fund, it may require a larger amount of working capital because of the following reasons :

1. Coming newly in the market its product is not popular. Massive advertising campaign is needed to make the product popular. For meeting advertising expenditures more working capital is needed.
2. Customers do not know the credit worthiness of the new company. Therefore, they are less inclined to sell on credit to the company. Company has to make almost cash purchasing which requires more working capital.
3. Banks are also less inclined to give credit to the company.
4. In order to attract more customers it has to give liberal credit to the customers. As a result investment in debtors will increase.

Because of the above reasons initial working capital will be more than the regular working capital. Redeemable debentures and preference shares are the most suitable sources and means of raising initial working capital. When the need is over it can be returned to the investors and the company is freed from the future liability of payment of interest and dividend.
(b) Regular working capital :
Regular working capital is the regular working capital needed for maintaining the minimum level of cash, inventory and debtors till the end of the business. It is needed to meet minimum cash requirements, for maintaining minimum stock level of raw material and finished goods for the continuity of production, minimum investment in debtors and for continuity of sales and for the operating cycle on.
As the regular working capital is needed on permanent basis equity shares are best suited for it.

(2) Variable or temporary working capital :
Working capital, over and above the regular working capital, needed to meet the seasonal requirements or needed to meet the requirements of special circumstances is called variable working capital. It is needed for a short period of time to meet the temporary needs.
It is also classified into two types :
(a) Seasonal working capital and
(b) Special working capital.
(a) Seasonal working capital :
There are certain business which are seasonal. Demand for their products varies from season to season. Working capital required to meet the seasonal needs over and above the regular working capital is known as seasonal working capital.

e.g. Business of woollen wears, rain coats, umbrellas, rain shoes etc. are seasonal business. During the off season manufacturers have to pile up the stock of finished goods for sale during the peak season. For piling up the stock during a certain period of the year more than regular working capital is needed which is known as seasonal working capital.
When the season starts sales also begins and the need of working capital declines. In this way seasonal working capital is needed temporarily and therefore, it is also termed as temporary working capital.
Commercial banks are the most convenient sources of seasonal working capital.

(b) Special working capital :

Every business has to face certain unforeseen contingencies also. Such contingencies include famine, flood, earthquakes, explosion in the factory etc. Which do not happen very frequently. But when they happen, they create a special need for working capital.
Working capital required to meet the needs of special circumstances is known as a special working capital. A provision should be made to meet any type of unexpected contingency. Generally for this purpose contingency fund is created.

[4] Meaning of Working Capital Management :

Working capital management means planning and controlling of the optimum levels of total working capital and its component parts with an objective of making sufficient provision for liquidity and increasing the profitability by reducing the cost.

Working capital management is concerned with planning the optimum level of total working capital and its component parts. Cash, inventory and debtors or receivables are the components of total working capital. Optimum level is the level which is financially the most advantageous. Planning of optimum level is not enough. It requires controlling to see that planned optimum levels are maintained in practice. Its objectives are to make provision of liquidity for meeting obligations on maturity and increase the profitability by reducing different types of costs associated with cash, receivables and inventory and also by reducing the cost of illiquidity.
From the above discussion we can say that working capital management is concerned with the following four matters :

1. Level of total working capital :

Level of working capital is important from the view point of liquidity and cost. Therefore, it is essential to plan optimum level of total working capital.

2. Structural health :

Planning of optimum level of total working capital is not enough. For structural health its component parts like cash, receivables and inventory should also be maintained at optimum level.

3. Cyclical flow :

Working capital is also known as circulating capital. It circulates from cash to raw materials to finished goods to sales to receivables and to cash again. Any disruption in this cyclical flow increases the cost. Management has to see that its cyclical flow is maintained.

4. Liquidity :

Liquidity is associated with working capital that is current assets. Liquidity less than or more than required proves to be costly. Therefore, management has to see that just sufficient liquidity is maintained.
The above four matters should be at the centre of management of total working capital and management of its component parts.

[5] The Components of Working Capital :
The main three components of working capital are as under :
(1) Cash
(2) Receivables
(3) Inventory or Stock
For efficient management of working capital each component needs to be managed effectively. Here after our discussion will be confined to different aspects of management of cash, receivables and inventory.

[6] Management of Cash :
[6.1] Introduction to Cash Management :
Total working capital consists of cash, receivables and stock. Cash is one of the important component parts of working capital.
Cash is the most liquid asset of the company. Company's paying capacity depends upon cash position. Lack of cash may lead to liquidation of the company and that cost may extend up to liquidation of the company. On the other hand plethora of cash also becomes costly because cash does not earn sufficient returns. Therefore, management of cash is needed to avoid the situations of excessive cash and inadequate liquidity.

[6.2] Meaning of Cash Management :
Cash management means determining the optimum level of cash and to see that it is maintained at that level with an objective of reducing cost and increasing profitability.
Cash management is concerned with planning the optimum level of cash balance and regulating to see that it is maintained. Its main objective is to decrease cost and increase liquidity and profitability because there is a trade off between liquidity and profitability associated to each other.

[6.3] Objectives of Cash Management :
The main motives of cash management are as under :
1. Transaction motive :
Business unit has to carry on a large number of transactions. Cash is needed for the payment of such transactions. Moreover cash is needed for the payment of wages, electricity bills, telephone bills, stationery charges, maintenance expenses etc. Cash is also needed for the payment of dividend and interest. If cash income tallied with expenditure, cash management is not of much importance. But a balance of income and payment is rarely found. Therefore, management of cash becomes very important.
2. Precautionary Motive :

Sometimes contingency need for cash also arise. Explosion in the factory, break down of machines, fire, earth quake, floods etc. also create the need for cash. Such events are very uncertain, however, as a precautionary measure to meet such eventuality sufficient provision of liquidity is needed.

3. Speculative Motive :

Speculative motive means motive to make profitable purchase at favourable price. When the prices of raw materials are likely to rise in the near future, company tends to make speculative purchasing at current prices but that requires cash.

4. Maintenance of minimum bank balance :

Each bank desires that every customer should maintain a minimum balance prescribed by the bank. Cash is needed for maintaining that minimum cash balance.

[6.4] Factors Affecting Cash Requirements :

Cash is needed for the aforesaid motives. But how much cash should be maintained is determined by the following factors :

1. Credit worthiness of the company :

Credit worthiness of the firm affects cash requirements in two ways. If the company enjoys good prestige and good amount of credit worthiness, it is not necessary for it to maintain a big amount of liquidity for accidental expenses or precautionary motive because it can raise required cash from any source. Secondly, credit worthiness commands liberal credit terms from suppliers. Liberal credit terms from creditors also reduce cash requirements. Contrary to this, poor credit worthiness requires a very large amount of cash balance to save the business from insolvency.

2. Time period of converting debtors into cash :

Speedy collection from debtors reduces the cash requirements and vice-a-versa.

3. Inventory :

Quantity of inventory also affects cash requirements. A large stock of goods requires a higher level of cash for the payment of insurance premium and transportation charges.

4. Nature of business :

There are certain businesses which require smaller amount of cash. e.g. electricity company, S.T. bus service, railways etc. because they daily receive cash. But the business units facing greater degree of uncertainty need more cash.

5. Sales volume :

Cash requirements are influenced by the sales volume also. The greater the sales volume the greater is the need for cash and the smaller the volume of sales, the smaller is the need for cash.

6. Economic situations :

Emerging economic situations like boom, recession, depression etc. also affect cash requirements.

7. Attitude of directors :

If the directors are of daring power, aggressive and prepared to take the risk they can carry on the business with smaller amount of cash. Contrary to them, directors of conservative nature need more cash because they are safety seekers. For safety they would like to maintain a substantial amount of cash.

[6.5] The Different Aspects of Cash Management

For efficient cash management, management has to take the following decisions :

(A) Planning of Cash Flows

(B) Reports for Cash Flows

(C) Regulation of Cash Flows

(D) Determining Optimum Cash Level

(E) Investment of Surplus Cash

[A] Planning of Cash Flows :

The process of cash management begins with planning of cash flows. In the company there are two types of cash flows. Incoming or inward cash flow and outgoing or outward cash flow. For effective control over cash flows planning of cash flow is very essential.

Planning of cash flows is basically concerned with forecasting of cash receipts and payments. Again there are two methods of forecasting cash flows :

1. Short term forecasting
2. Long term forecasting

(1) Short Term Forecasting or Cash Budget Method :

Short term forecasting is concerned with forecasting of cash receipts and payments during a short period of one month, six months or one year. It is also known as cash budget method.

For planning of cash receipts or cash inflows it is necessary to identify the sources of cash receipts and the month of each receipt.

The main sources of cash receipts are cash sales, collection from debtors, bills receivables, interest on investment in bonds, dividend from other companies, rent, sale of fixed assets etc.

On the basis of past experience cash sales in each month is estimated. Collection from debtors can be forecast on the basis of credit period granted. Interest, dividend etc. are generally received in a specific month. In this way cash receipts is planned.

For forecasting of cash payments first of all different outlets of cash outflow are identified. Such outlets include cash purchases, creditors, bills payables, interest on bonds, dividend, maintenance expenses, salary and wages, rent etc.

Cash purchasing in each month of the specific time period is forecast on the basis of past experience. Payment to creditors depends upon credit period granted by them, payment of bills payable is to be made in the month in which they mature, salary is paid in the next month or at the end of a particular month.

Financial manager knows as to in which month interest and dividends are paid. In this way forecasting of cash payments results into planning of cash outflows.

On the basis of forecasting of cash flow of each month we can know whether there will be surplus or deficit of cash. If the month ends with surplus cash we can think of its investment so that additional income can be generated. If there is going to be a deficit of cash, provision for raising needed cash can be made in advance.

On the basis of short term cash flow forecasting we can prepare the cash budget as per the following format.

Cash Budget

Details	**Jan.**	**Feb.**	**March**
[A] Cash Receipts			
1. Cash sales			
2. Collection from debtors			
3. Bills Receivables			
4. Interest			
5. Dividend			
6. Sale of fixed assets			
7. Others			
Total Income			
[B] Cash Payments			
1. Salary & wages			
2. Creditors			
3. Cash purchase			
4. Ad. cost			
5. Interest			
6. Dividend			
7. Loan instalment			
8. Purchase of assets			
9. B.P. (Bills Payable)			
10. Others			
Total			
Total Cash Balance / Deficit (A – B)			
Opening Balance / Deficit			
Balance at the end of month			

Utilities or Advantages of Cash Budget

1. Effective use of cash :

Proper planning of cash inflows and outflows enables the most fruitful use of cash. It also enables planning of expenses and payments as per cash position.

2. Investment of surplus cash :

Forecast of cash flows indicates the months of surplus cash and the months of cash deficit. Surplus cash will remain with the company. On this basis we can take proper investment alternatives.

3. Dividend policy :

Whether to pay dividend or not and if yes, in what form? Decisions depend upon cash position. It is possible that despite making huge amount of profit, the company may not have enough cash to pay dividend. However directors may decide to pay dividend in the form of bonus shares. In such a situation cash flow statement provides the basis for dividend decisions.

4. Payment of debt :

It is useful for making regular payments to creditors and earn cash discount.

5. Useful for controlling :

Cash flows of different months provide standards for controlling.

6. Useful for co-ordination :

It helps in bringing about co-ordination between different departmental expenses.

7. Timely payment of debt :

Cash budget helps to know the cash position. If enough cash surplus is available, debt can be paid in time.

8. Helps to know when the deficit of cash will arise :

From the cash budget we can understand in which months cash deficit is likely to arise. On the basis of this knowledge we can plan in advance for raising funds for meeting the cash deficit.

9. Decisions of capital expenditures :

Cash budget is useful for deciding when to make capital expenditures.

(2) Long Term Forecasting of Cash Flows :

Cash budget indicates the short-term planning of cash flow. It may be for a period of one year or less than one year. But for knowing long-term cash position and if cash deficit is likely to arise, for meeting the deficit and also for the investment of surplus cash, long-term planning of cash flows is equally important.

And for long-term planning, forecasting of cash flows becomes indispensable. It may be for a period longer than one year, say five years, seven years or even ten years.

Cash receipts and payments method can be used for long term forecasting of cash flows, however, in practice **Adjusted Net Income Method** is very widely used.

This method is almost similar to cash flow statement which represents the cash requirements during a specific future period of time. It indicates how much cash could be raised from the internal source and is there any need to use external sources and how much.

If there is going to be a surplus of cash, we can know how much surplus may be there and how long it may last. On this basis proper investment decisions for surplus cash can be made.

Generally the following format is used for long term forecasting of cash flows as per **Adjusted Net Income Method** :

Long Term Forecasting of Cash Flows

Details	2005	2006	2007	2008
[A] Sources				
1. Net profit after Tax				
2. Non cash expenditures (Dep. etc.)				
3. Increase in debt				
4. Issue of shares				
5. Sundry cash receipts				

Total Cash Receipts				
[B] Uses of Cash				
1. Capital expenditures				
2. Increase in current assets				
3. Payment of debt				
4. Payment of dividend				
5. Sundry cash payments				
Total Cash Payments				
Balance / Deficit (A – B)				
Cash balance in the beginning				
Closing cash balance				

Procedure :

The following procedure is adopted for forecasting long term cash flows as per **Adjusted Net Income Method** :

1. First of all specific future period and its years should be specified.

2. Projected profit and loss accounts and balance sheet of each year of the specific period should be prepared.

3. From the profit and loss A/c we get the net profit after tax.

4. Net profit is not the net cash income because it is found out after debiting certain non-cash expenditures like depreciation, preliminary expenses written off etc. For finding out real income such expenditures should be added to the net profit. Moreover, increase in debt and issue of equity shares also indicate cash receipts but are not recorded in P & L A/c. Therefore, such amounts should be added to the net profit of each year for finding out total cash receipts of each year.

5. After determining total cash inflow, total cash outflow is also determined. For forecasting total cash outflow, total cash expenditures not recorded in the P & L A/c are considered. It includes:

- Capital expenditures
- Increase in current assets
- Repayment of debt
- Dividend paid
- Other miscellaneous cash expenditures

Total of all these is known as cash outflow.

6. By deducting total cash outflow from total cash inflow, we get net cash balance or cash deficit. By adding the balance or deficit in the beginning of the year, we get cash balance or deficit at the end of the year which is carried forward to the next year.

In this way long term cash flows can be forecast by making certain adjustments in the net profit.

Importance of Long-Term Forecasting

Long-term forecast of cash flows indicates in which years there will be surplus cash and in which years there will be deficit. In case of surplus, proper investment decisions can be made and provision in advance can be made to cope up with deficit. Considering the surplus of cash, proper planning of capital expenditures can also be made.

(B) Reports For Controlling

Forecast of cash flows provides standards for controlling. For preventing the deviations from the projected cash inflow and outflow, information regarding the real situation is needed.

For getting the needed information for controlling the cash flows, generally the following reports are used:

(a) Daily Reports of Cash Position

Such reports indicate:

Cash balance in the beginning

Daily cash inflow and outflow

Cash balance or deficit at the end of the day.

(b) Daily Treasury Reports :

It presents the overall picture of changes in cash position, marketable securities, creditors and debtors.

(c) Daily Report of Cash Position :

It indicates cash receipts and payments during the month.

Reality is compared with the projections. Deviations, if any, are found out and if needed corrective or remedial action is taken. In this way management using cash reports is the second aspect of cash management.

(C) Regulation of Cash Flows

In order to conform the reality with the projections of cash flows, regulation of cash receipts and payments is a must. Regulation of cash is concerned with expediting cash receipts and regulating cash payments. Delay in payment without adversely affecting the prestige of the business.

(a) Remedies for Expediting Cash Inflow

In the absence of proper care there is every possibility of delay in cash receipts and if it so happens cash budget loses its importance. Therefore, for expediting cash receipts the following steps should be taken.

1. Deposit the cheques in the bank account for collection without delay :

Generally, debtors send the cheques for their payments by post. Because of variation of details, cheques are not deposited in the bank. Lethargic attitude of clerical staff causes delay in cash receipts. Therefore, cheques received should be processed immediately and should be deposited in the bank for collection without delay.

2. Decentralisation of collection :

For a company enjoying nationwide office for their payments, debtors have to send the cheques to the head office for payment. Delay in this regard is likely to be caused by two reasons: **(a)** Delay in post and **(b)** Delay made by bank in collection of cheques coming from distant places. Such a delay in case of cheques of bigger amount proves to be very costly. In order to avoid

such delay, decentralised collection policy should be adopted. The company should open collection centres in the names of agents or the company itself and debtors should be instructed to send the cheques to the nearby collection centre.
For example, Tata, Airtel etc. have decentralised their collections. Hutch also has decentralised its collection. Such decentralisation of collection prevents the above two types of delays.

3. Use of Means of Transfer :

Use of electronic transfer, at days banking, etc. for the collection of funds from customers should be advised. It avoids postal delay and clerical delay. It is also useful to avoid payment float.

4. Lock Box System :

For avoiding delay in collection places, the key of the box should be handed over to the nearest bank. Customers are advised to send their cheques to the lock box. The company gives the address of the nearest bank to customers. Cheques deposited in the lock box are collected by the company. The company has to pay service charges to the bank and rent of the box.

5. Other Methods :

1. Bank accounts in more than one bank require larger minimum balances. Therefore, accounts should be opened in one or two banks only and not in many banks.
2. Excessive bank balance should be avoided so that excessive bank balance is not maintained.
3. The company having branches at different places should maintain balance in branch accounts within a certain level.

(b) Tactics for Delaying Payments

Following tactics should be used for making tolerable delay in payments :

1. Delay in External Payments :

The company has to make payment of huge amounts to its creditors. By making payments to creditors full use of the available time limit for cash payments can be made. Payments should be made at the last date of the credit period. If this policy is adopted creditors get the amount within time limit, prestige is maintained and in some cases overdraft and its cost could be avoided.

2. Use of Bill of Exchange :

Use of bills payable avoids the need to maintain large cash balance because the amount is to be paid on maturity of the bills payable.

3. Delay in Salary Payments :

Salary payment affects the morale of the workers and their productivity. But making payment on the first week of the next month instead of paying on the last day of the month is considered to be postponement of wages without any adverse effect on the productivity of workers. This policy also sometimes avoids overdraft during intervening period.

4. Use of Float :

There is difference between bank balance in company books of accounts and bank accounts. This difference is known as float. The float arises because the company may have issued the cheque to someone but it has not come to the bank for collection. Meanwhile, such a float can be used for making payments instead of taking overdraft.

[D] Determining Optimum Cash Balance :

Cash is not the costless asset. It has the cost in the form of opportunity cost and it increases with increase in cash balance. Therefore, it is advisable to plan the optimum level of cash balance taking into account different factors like credit worthiness of the company, sales volume, credit terms offered and received etc.

Optimum cash balance is the balance which is economically the most advantageous balance. Once the optimum level is planned efforts should be made to maintain it. Sometimes even the smaller amount of cash also becomes costly and its cost may extend upto liquidation of the company.

[E] Investment of Surplus Cash : Options and Strategies

Surplus of cash as exhibited by the cash budget should be invested somewhere so that it can fetch some income. Surplus cash should be invested in the securities possessing the following characteristics :

1. Profitability :

Investment should be profitable in the sense it should yield reasonable rate of return.

2. Liquidity :

Investment should be such that it can be converted into cash at any time. In other words investments should be marketable.

3. Safety :

Investment of cash is considered to be the second line of cash. Therefore, safety of investment should be given top priority.

The different investment options and strategies possessing the above characteristics can be stated as under :

1. Bank fixed deposits.
2. Open ended schemes of UTI.
3. Treasury Bills.
4. Certificates of deposits.
5. Commercial papers.
6. Inter company loans.
7. Discounting of bills of exchange etc.

(1) Bank Fixed Deposits :

Surplus cash can be invested in the fixed deposits of banks for a period ranging from 30 days to five years depending upon the time horizon of surplus cash. Rate of interest depends upon the duration of the deposit. Banks allow premature encashment or loan against fixed deposit receipts. To that extent it possesses the quality of liquidity and safety in case of nationalised banks.

(2) Open Ended Schemes of UTI :

Certain schemes of UTI like Unit Scheme 64, Master Share, Master Plus, Master Gain, Master Value Fund etc. are open ended. One can enter and exit at any time. UTI is always ready to repurchase the units at NAV based prices. Dividend on units is tax free. There is possibility of capital gains also. Moreover, UTI is a public sector undertaking. Therefore, investments in open ended schemes of UTI possess the characteristics of liquidity, profitability and safety.

(3) Treasury Bills :

Treasury bills indicate government debt to the holder. Three types of treasury bills are available, 91 days, 182 days and 364 days. Selection can be made considering how long surplus cash is available. Discount and Finance House of India Ltd provides secondary market for 182 days and 364 days treasury bills. Therefore investment in treasury bills is safe, profitable and liquid.

(4) Certificates of Deposits :

Surplus cash can be invested in certificates of deposits issued by nationalised banks for a period ranging from three months to one year. After 45 days it can be freely transferred simply by endorsement. It also possesses the characteristics of liquidity, profitability and safety.

(5) Commercial Papers :

Financially sound companies are also permitted by RBI to issue commercial papers for a period ranging from 15 days to 1 year. Discount and Finance House of India Ltd provides secondary market for commercial papers also. Rate of interest depends upon the maturity period. Investment in CP is also safe, liquid and profitable.

(6) Inter Company Loans :

Surplus cash can be given to the other company of the same group or of other group by way of inter company loan.

(7) Discounting of Bills of Exchange :

Surplus cash can be profitably used by discounting bills of exchange accepted by the parties of reputation.

(8) Equity Shares :

Surplus cash can be used for investment in shares of financially sound companies. On investment in equity shares one can get tax free dividend, capital gains and in case of need can raise cash by selling on the stock exchange. However it is subject to market risk.

Exercise

1. What is cash management? What are the objectives of cash management?
2. What are the motives of maintaining a cash balance? What are the factors affecting the level of cash?
3. How would you forecast the short term and long-term cash flows?
4. Explain the utilities of cash flow statement or cash budget.
5. How would you expedite the cash inflows and regulate cash outflows?
6. How is the surplus of cash determined? What would you do with surplus cash?
7. Write short notes on:
    (1) Concepts of Working Capital
    (2) Liquidity versus Profitability
    (3) Tactics for Delaying Payment

(4) Factors Affecting Cash Requirements
(5) Motives for Holding Cash
(6) Investment Strategy of Surplus Cash