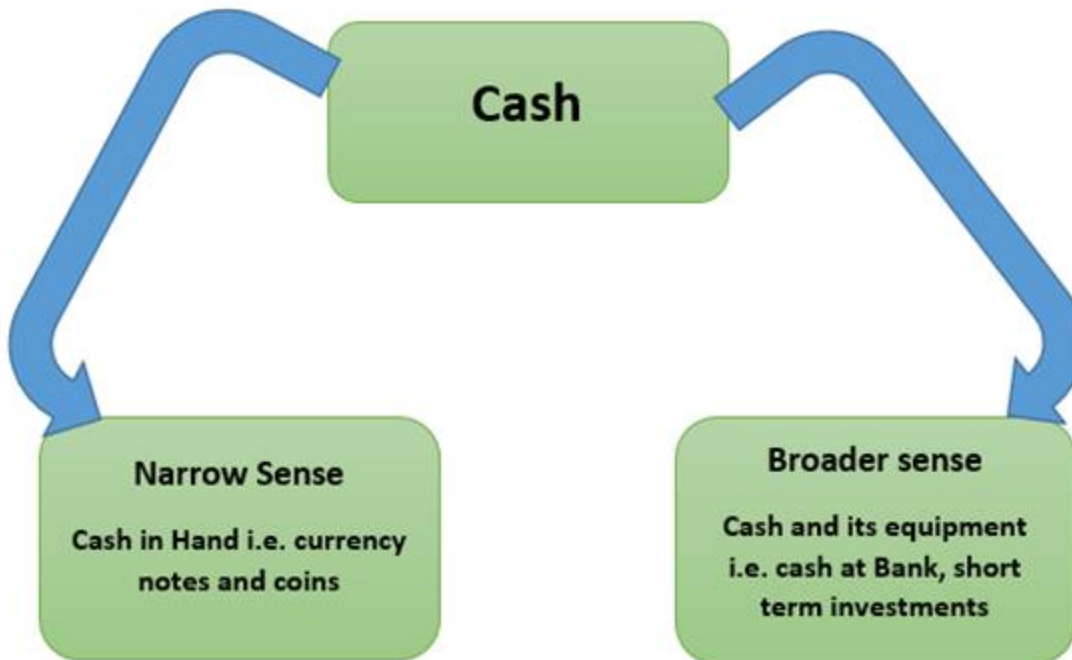
UNIT 75 – UPSC - Management of Cash, Receivables, Inventory and Current Liabilities

In managing financial growth of company, Cash, receivables and inventory jointly form working capital of a firm. It is imperative for experts to keep good balance of these factors.

Management of Cash

Cash is considered as vital asset and its proper management support company development and financial strength. An effective cash management program designed by companies can help to realise this growth and strength. Cash is vital element of any company needed to acquire supply resources, equipment and other assets used in generating the products and services. Marketable securities also come under near cash, serve as back pool of liquidity which provides quick cash

when needed.



Cash management is the stewardship or proper use of an entity's cash resources. It assists to keep an organization functioning by making the best use of cash or liquid resources of the organization. Cash management is associated with management of cash in such a way as to realise the generally accepted objectives of the firm, maximum productivity with maximum liquidity. It is the management's capability to identify cash problems before they ascend, to solve them when they arise and having made solution available to delegate someone carry them out.

The notion of cash management is not new and it has attained a greater significance in the modern world of business due to change that took place in business operations and ever increasing difficulties and the cost of borrowing" (Howard, 1953). It is the most liquid current assets, cash is the common denominator to which all current assets can be reduced because the other current assets i.e. receivables and inventory get eventually converted into cash (Khan, 1983). This emphasises the importance of cash management. The term cash management denotes to the management of cash resource in such a way that generally accepted business objectives could be accomplished. In this perspective, the objectives of a firm can be combined as bringing about consistency between maximum possible effectiveness and liquidity of a firm. Cash management may be defined as the ability of a management to identify the problems related with cash which may come across in future course of action, finding appropriate solution to curb such problems if they arise, and lastly delegating these solutions to the competent authority for carrying them out. Cash management maintains sufficient quantity of cash in such a way that the quantity denotes the lowest adequate cash figure to meet business obligations. Cash management involves managing cash flows (into and out of the firm), within the firm and the cash balances held by a concern at a point of time.

In financial literature, Cash management denotes to wide area of finance involving the collection, handling, and usage of cash. It involves assessing market liquidity, cash flow, and investments. The notion of cash management is not novel and it has gained more significance in contemporary

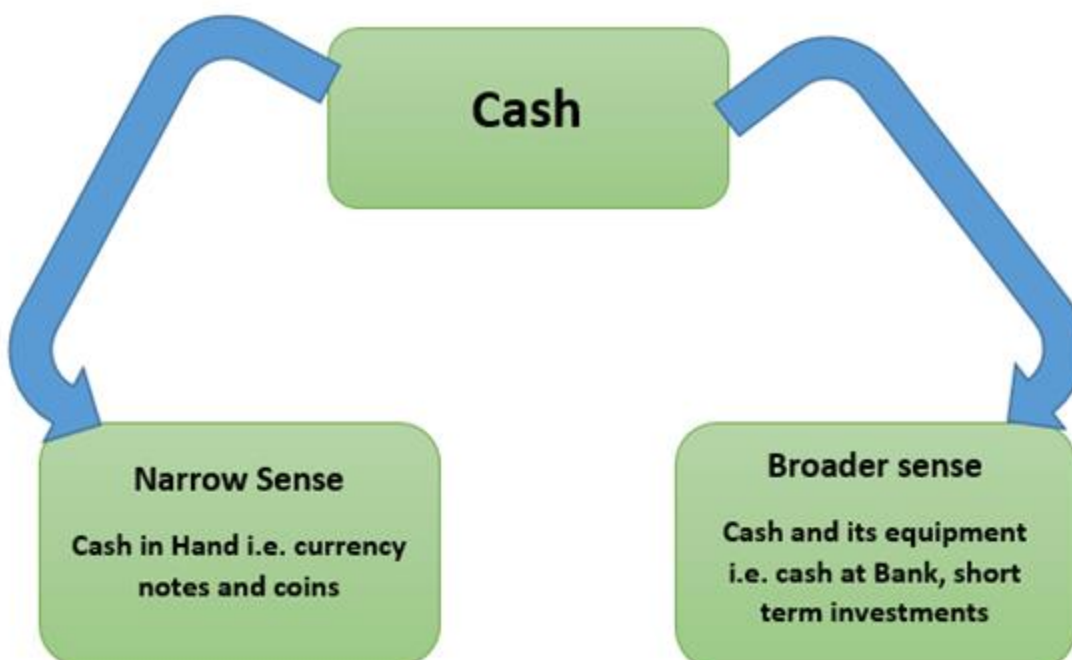
business world due to change that took place in the conduct of business and ever increasing difficulties and the cost of borrowing.

Objective of Cash Management

1. To make Payment According to Payment Schedule: Firm needs cash to meet its routine expenses including wages, salary, taxes etc.
2. To minimise Cash Balance: The second objective of cash management is to reduce cash balance. Excessive amount of cash balance helps in quicker payments, but excessive cash may remain unused & reduces profitability of business. Contrarily, when cash available with firm is less, firm is unable to pay its liabilities in time. Therefore optimum level of cash should be maintained (Excel Books India, 2008).

An effective management is considered to be important for the following reasons:

1. Cash management guarantees that the firm has sufficient cash during peak times for purchase and for other purposes.
2. Cash management supports to meet obligatory cash out flows when they fall due.
3. Cash management helps in planning capital expenditure projects.
4. Cash management helps to organize for outside financing at favourable terms and conditions, if necessary.
5. Cash management helps to allow the firm to take advantage of discount, special purchases and business opportunities.
6. Cash management helps to invest surplus cash for short or long-term periods to keep the idle funds fully employed.



General Principles of Cash Management

Harry Gross has recommended certain general principles of cash management.

1. Determinable Variations of Cash Needs: A reasonable amount of funds, in the form of cash is required to be kept aside to overcome the period expected as the period of cash shortage. This period may either be short and temporary or last for a longer duration of time. Normal and regular payment of cash leads to small cutbacks in the cash balance at periodic intervals. Making this payment to different workers on different days of a week can balance these reductions. Another practice for balancing the level of cash is to schedule cash disbursements to creditors during the period when accounts receivables collected amounts to a large sum but without putting the helpfulness at stake.
2. Contingency Cash Requirement: There may arise certain cases, which fall beyond the forecast of the management. These establish unexpected calamities, which are too difficult to be provided in the normal course of the business. Such contingencies always demand for special cash requirements that was not assessed and provided for in the cash budget. Denials of wholesale product, huge amount of bad debts, strikes, and lockouts are some of these contingencies. Only a prior experience and investigation of other similar companies prove supportive as a customary practice. A useful procedure is to shield the business from such calamities like bad-debt losses, fire by way of insurance coverage.
3. Availability of External Cash: This factor also has immense significance in the cash management which refer to the availability of funds from outside sources. There resources help in providing credit facility to the firm, which materialized the firm's objectives of holding minimum cash balance. As such if a firm succeeds in obtaining sufficient funds from external sources such as banks or private financers, shareholders, government agencies, the need to maintain cash reserves lessens.
4. Maximizing Cash Receipts: Nearly, all financial managers have objective to make the best possible use of cash receipts. Cash receipts if tackled carefully results in minimizing cash requirements of a concern. For this purpose, the comparative cost of granting cash discount to customer and the policy of charging interest expense for borrowing must be appraised continually to determine the ineffectiveness of either of the alternative or both of them during that particular period for maximizing cash receipts. Some techniques proved helpful in this context are mentioned below:

    i. Concentration Banking: In this system, a company launches banking centres for collection of cash in different areas. Thus, the company instructs its customers of neighbouring areas to send their payments to those centres. The collection amount is then deposited with the local bank by these centres as early as possible. Whereby, the collected funds are transferred to the company's central bank accounts operated by the head office.
    ii. Local Box System: Under this system, a company rents out the local post offices boxes of different cities and the customers are asked to forward their remittances to it. These remittances are picked by the approved lock bank from these boxes to be transferred to the company's central bank operated by the head office.

iii. Reviewing Credit Procedures: This type of technique assists to determine the impact of slow payers and bad debtors on cash. The accounts of slow paying customers should be revised to determine the volume of cash tied up. Besides this, evaluation of credit policy must also be conducted for introducing essential modifications. As a matter of fact, too strict a credit policy involves rejections of sales. Thus, restricting the cash inflow. On the other hand, too lenient, a credit policy would increase the number of slow payments and bad debts again reducing the cash inflows.

iv. Minimizing Credit Period: Shortening the terms allowed to the customers would definitely quicken the cash inflow side-by-side reviewing the discount offered would prevent the customers from using the credit for financing their own operations gainfully.

v. Others: There is a need to introduce various procedures for managing large to very large remittances or foreign remittances such as, persona pick up of large sum of cash using airmail, special delivery and similar techniques to accelerate such collections.

5. Minimizing Cash Disbursements: The intention to minimize cash payments is the ultimate benefit derived from maximizing cash receipts. Cash disbursement can be brought under control by stopping deceitful practices, serving time draft to creditors of large sum, making staggered payments to creditors and for payrolls.
6. Maximizing Cash Utilization: It is emphasized by financial experts that suitable and optimum utilization leads to maximizing cash receipts and minimizing cash payments. At times, a concern finds itself with funds in excess of its requirement, which lay idle without bringing any return to it. At the same time, the concern finds it imprudent to dispose it, as the concern shall soon need it. In such conditions, company must invest these funds in some interest bearing securities. Gitman suggested some fundamental procedures, which helps in managing cash if employed by the cash management. These include:

    1. Pay accounts payables as late as possible without damaging the firm's credit rating, but take advantage of the favourable cash discount, if any.
    2. Turnover, the inventories as quickly as possible, avoiding stock outs that might result in shutting down the productions line or loss of sales.
    3. Collect accounts receivables as early as possible without losing future loss sales because of high-pressure collections techniques. Cash discounts, if they are economically justifiable, may be used to accomplish this objective (Gitman, 1979.).

Function of Cash Management

It is well acknowledged in financial reports and various studies that cash management is concerned with minimizing fruitless cash balances, investing temporarily excess cash usefully and to make the best possible arrangements for meeting planned and unexpected demands on the firm's cash (Hunt, 1966). Cash Management must have objective to reduce the required level of cash but minimize the risk of being unable to discharge claims against the company as they arise. There are five cash management functions:

1. Cash Planning: Experts emphases the wise planning of funds that can lead to huge success. For any management decision, planning is the primary requirement. According to theorists, "Planning is basically an intellectual process, a mental pre-disposition to do things in an orderly way, to think before acting and to act in the light of facts rather than of a guess." Cash planning is a practise, which comprises of planning for and controlling of cash. It is a management process of predicting the future need of cash, its available resources and various uses for a specified period. Cash planning deals at length with formulation of necessary cash policies and procedures in order to perform business process constantly. A good cash planning aims at providing cash, not only for regular but also for irregular and abnormal requirements.
2. Managing Cash Flows: Second function of cash management is to properly manage cash flows. It means to manage efficiently the flow of cash coming inside the business i.e. cash inflow and cash moving out of the business i.e. cash outflow. These two can be effectively managed when a firm succeeds in increasing the rate of cash inflow together with minimizing the cash outflow. As observed accelerating collections, avoiding excessive inventories, improving control over payments contribute to better management of cash. Whereby, a business can protect cash and thereof would require lesser cash balance for its operations.
3. Controlling the Cash Flows: It has been observed that prediction is not an exact knowledge because it is based on certain conventions. Therefore, cash planning will unavoidably be at variance with the results actually obtained. Due to this, control becomes an unavoidable function of cash management. Moreover, cash controlling becomes indispensable as it increases the availability of usable cash from within the enterprise. It is understandable that greater the speed of cash flow cycle, greater would be the number of times a firm can convert its goods and services into cash and so lesser will be the cash requirement to finance the desired volume of business during that period. Additionally, every business is in possession of some concealed cash, which if traced out significantly decreases the cash requirement of the enterprise.
4. Optimizing the Cash Level: It is important that a financial manager must focus to maintain sound liquidity position i.e. cash level. All his efforts relating to planning, managing and controlling cash should be diverted towards maintaining an optimum level of cash. The prime need of maintaining optimum level of cash is to meet all requirements and to settle the obligations well in time. Optimization of cash level may be related to establishing equilibrium between risk and the related profit expected to be earned by the company.
5. Investing Idle Cash: Idle cash or surplus cash is described as the extra cash inflows over cash outflows, which do not have any specific operations or any other purpose to solve currently. Usually, a firm is required to hold cash for meeting working needs facing contingencies and to maintain as well as develop friendliness of bankers.
   In banking area, cash management is a marketing term for some services related to cash flow offered mainly to huge business customers. It may be used to describe all bank accounts (such as checking accounts) provided to businesses of a certain size, but it is more often used to describe specific services such as cash concentration, zero balance accounting, and automated clearing house facilities. Sometimes, private banking customers are given cash management services.

Financial instruments involved in cash management include money market funds, treasury bills, and certificates of deposit.

Benefits of Cash Management System

In the period of technology progression, the Cash Management System provides following Benefits to its customers:

1. Funds availability as per need on day zero, day one, day two, day three etc. i.e. Corporate can plan their cash flows.
2. Bank interest saved as instruments are collected faster.
3. Affordable and competitive rates.
4. Single point enquiry for all queries.
5. Pooling of funds at desired locations.

To summarize, Cash Management denotes to the concentration, collection and disbursement of cash. The major role for managers is to maintain the flow of cash. Cash Management include a series of activities aimed at competently handling the inflow and outflow of cash. This mainly involves diverting cash from where it is to where it is needed. It is established that cash management is the optimization of cash flows, balances and short-term investments.

Management of Receivable

Accounts receivable typically comprise more than 25 percent of a firm's assets. The term receivables is described as debt owed to the firm by the customers resulting from the sale of goods or services in the ordinary course of business. There are the funds blocked due to credit sales. Receivables management denotes to the decision a business makes regarding to the overall credit, collection policies and the evaluation of individual credit applicants. Receivables Management is also known as trade credit management. Robert N. Anthony, explained it as "Accounts receivables are amounts owed to the business enterprise, usually by its customers. Sometimes it is broken down into trade accounts receivables; the former refers to amounts owed by customers, and the latter refers to amounts owed by employees and others".

Receivables are forms of investment in any enterprise manufacturing and selling goods on credit basis, large sums of funds are tied up in trade debtors. When company sells its products, services on credit, and it does not receive cash for it immediately, but would be collected in near future, it is termed as receivables. However, no receivables are created when a firm conducts cash sales as payments are received immediately. A firm conducts credit sales to shield its sales from the rivals and to entice the potential clienteles to buy its products at favourable terms. Generally, the credit sales are made on open account which means that no formal reactions of debt obligations are received from the buyers. This enables business transactions and reduces the paperwork essential in connection with credit sales.

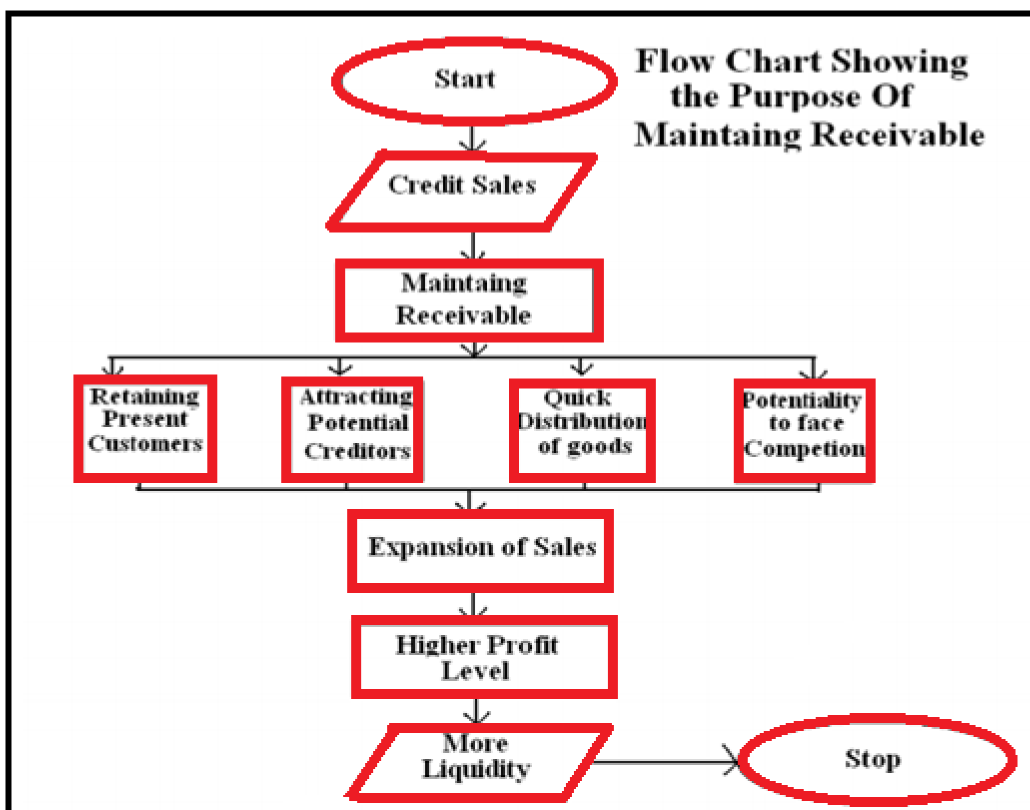
Accounts Receivables Management denotes to make decisions relating to the investment in the current assets as vital part of operating process, the objective being maximization of return on investment in receivables. It can be established that accounts receivables management involves

maintenance of receivables of optimal level, the degree of credit sales to be made, and the debtors' collection.

Receivables are useful for clients as it increases their resources. It is preferred particularly by those customers, who find it expensive and burdensome to borrow from other resources. Thus, not only the present customers but also the Potential creditors are attracted to buy the firm's product at terms and conditions favourable to them.

Receivables has vial function in quickening distributions. As a middleman would act fast enough in mobilizing his quota of goods from the productions place for distribution without any disturbance of immediate cash payment. As, he can pay the full amount after affecting his sales. Likewise, the customers would panic for purchasing their needful even if they are not in a position to pay cash immediately. It is for these receivables are regarded as a connection for the movement of goods from production to distributions among the ultimate consumer.

Maintenance of receivable



Objectives of receivables management: The objective of Receivables Management is to promote sales and profits until that point is reached where the return on investment in further funding receivables is less than the cost of funds raised to finance that additional credit i.e. cost of capita. Management of Accounts Receivables is quite expensive. The following are the main costs related with accounts receivables management:

Cost of Management of Accounts Receivables

Advantages of accounts receivable management:

Accounts Receivables Management has numerous benefits. These include:

1. Increased Sales: Offering goods or services on credit enhances sales, by holding old customers and attraction potential customers.
2. Increased Market Share: When the firm is able to maintain old customers and attract new customers automatically market share will be bigger to the extent new sales.
3. Increase in profits: Increase sales, leads to increase in profits, because it need to produce more products with a given fixed cost and sales of products with a given sales network in both cost per unit comes down and the profit will be better.

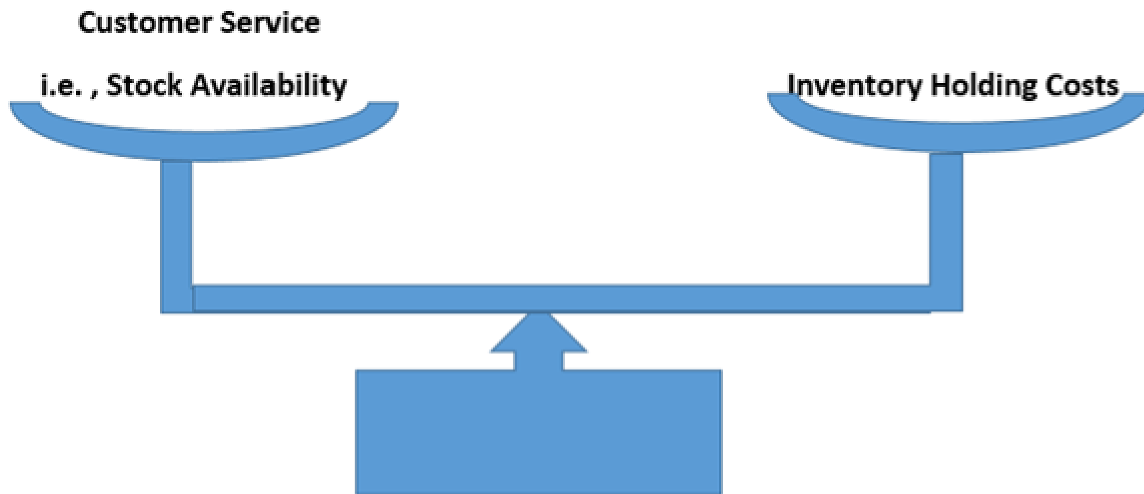
Management of Inventory

Inventory management is basically related to task of controlling the assets that are produced to be sold in the normal course of the firm's procedures. In supply chain management, major variable is to effectively manage inventory. The significance of inventory management to the company depends on the extent of its inventory investment.

The objectives of inventory management are of twofold:

1. The operational objective is to uphold enough inventory, to meet demand for product by efficiently organizing the firm's production and sales operations.
2. Financial interpretation is to minimize unproductive inventory and reduce inventory, carrying costs.

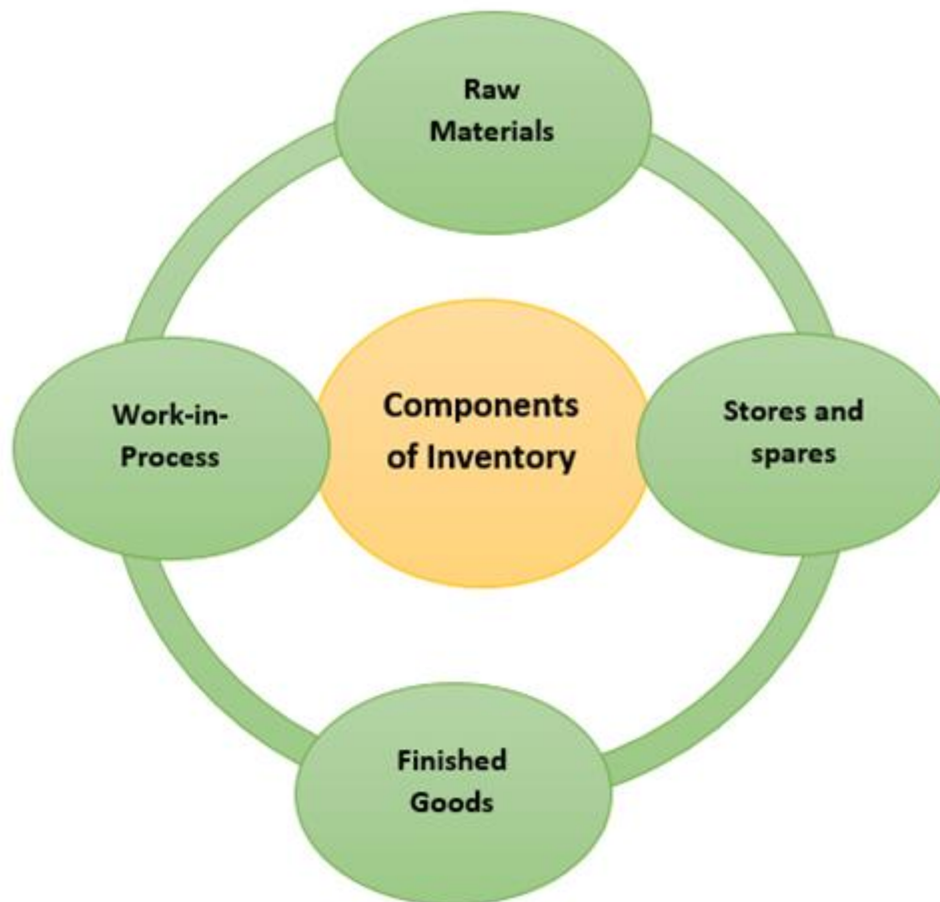
Effective inventory management is to make good balance between stock availability and the cost of holding inventory.



Components of inventory management: Inventories exist in different forms in a manufacturing company. These include:

1. Raw materials: Raw materials are those inputs that are transformed into completed goods throughout manufacturing process. Those form a major input for manufacturing a product. In other words, they are very much needed for uninterrupted production.
2. Work-in-process: Work-in-process is a stage of stocks between raw materials and finished goods. Work-in-process inventories are semi-finished products. They signify products that need to undergo some other process to become finished goods.
3. Finished products: Finished products are those products which are totally manufactured and company can immediately sell to customers. The stock of finished goods provides a buffer between production and market.
4. Stores and spares: It comprises of office and plant cleaning materials like soap, brooms, oil, fuel, light, bulbs and are purchased and stored for the purpose of maintenance of machinery.

Component of inventory



Inventory control encompasses managing the inventory that is previously in the warehouse, stockroom or store. This is to know the type of products are "out there", how many each item and where it is kept. It means having accurate, complete and timely inventory transactions record and avoiding differences between accounting and real inventory levels. Two tools commonly used to ensure inventory accuracy and control are ABC analysis and cycle counting.

The process of Inventory management consists of determining, how to order products and how much to order as well as identifying the most effective source of supply for each item in each stocking location. Inventory management contains all activities of planning, forecasting and replenishment. The main purpose of inventory management is minimize differences between customers demand and availability of items. These differences have caused by three factors that include customers demand fluctuations, supplier's delivery time fluctuations and inventory control accuracy.

Types of Inventory

The aim of carrying inventories is to separate the operations of the firm. It means to make each function of the business independent of each other function so that delays or closures in one area do not affect the production and sale of the final product. Because production cessations result in increased costs, and because delays in delivery can lose customers, the management and control of inventory are important duties of the financial manager. There are many types of inventory. The

common categories of inventory include raw materials inventory, work-in-process inventory, and finished-goods inventory.

Raw-Materials Inventory: Raw materials inventory include basic materials purchased from other firms to be used in the firm's production operations. These goods may include steel, lumber, petroleum, or manufactured items such as wire, ball bearings, or tires that the firm does not produce itself. Regardless of the specific form of the raw-materials inventory, all manufacturing firms maintain a raw-materials inventory. The intention is to separate the production function from the purchasing function that is, to make these two functions independent of each other so delays in the delivery of raw materials do not cause production delays. If there is a delay, the firm can satisfy its need for raw materials by liquidating its inventory.

Work-in-Process Inventory: Work-in-process inventory comprises of partly finished goods requiring additional work before they become finished goods. The more difficult and lengthy the production process, the larger the investment in work-in-process inventory. The main aim of work-in-process inventory is to disengage the various operations in the production process so that machine failures and work stoppages in one operation will not affect other operations.

Finished-Goods Inventory: Finished-goods inventory includes goods on which production has been completed but that are not yet sold. The purpose of a finished-goods inventory is to separate the production and sales functions so that it is not required to produce the goods before a sale can occur and sales can be made directly out of inventory.

Motives of inventory management: Managing inventories involve lack of funds and inventory holding costs. Maintenance of inventories is luxurious. Still there is motive to retain inventories. There are three general motives:

1. The transaction motive: Firm may hold the inventories in order to facilitate the smooth and continuous production and sales operations. It may not be possible for the company to obtain raw material whenever necessary. There may be a time lag between the demand for the material and its supply. Therefore, it is needed to hold the raw material inventory. Similarly, it may not be possible to produce the goods instantly after they are demanded by the customers. Hence, it is needed to hold the finished goods inventory. The need to hold work-in-progress may arise due to production cycle.
2. The precautionary motive: Firms also prefer to hold them to protect against the risk of unpredictable changes in demand and supply forces. For example, the supply of raw material may get delayed due to the factors like strike, transport disruption, short supply, lengthy processes involved in import of the raw materials.
3. The speculative motive: Firms may like to buy and stock the inventory in the quantity which is more than needed for production and sales purposes. It is done to get the advantages in terms of quantity discounts connected with bulk purchasing or expected price rise.

Merits of Inventory Management

There are several advantages of managing inventory in proper way.

1. Inventory management guarantees adequate supply of materials and stores to minimize stock outs and shortages and avoid costly interruption in operations.
2. It keeps down investment in inventories, inventory carrying costs, and obsolescence losses to the minimum.
3. It eases purchasing economies throughout the measurement of requirements on the basis of recorded experience.
4. It removes duplication in ordering stock by centralizing the source from which purchase requisition emanate.
5. It allows better utilization of available stock by enabling inter-department transfers within a firm.
6. It offers a check against the loss of materials through carelessness or pilferage.
7. Perpetual inventory values provide a stable and reliable basis for preparing financial statements a better utilization.

Demerits of Holding Inventory

Besides several benefits, there are some drawbacks of holding inventory.

1. Price decline: It is a major disadvantage of inventory holding. Price decline is the result of more supply and less demand. It can be said that it may be due to introduction of competitive product. Generally, prices are not controllable in the short term by the individual firm. Controlling inventory is the only way that a firm can counter act with these risks. On the demand side, a decrease in the general market demand when supply remains the same may also cause price to increase. This is also long-lasting management problem, because reduction in demand may be due to change in customer buying habits, tastes and incomes.
2. Product deterioration: It is also serious demerits of inventory holding. Holding of finished completed goods for a long period or shortage under inappropriate conditions of light, heat, humidity and pressures lead to product worsening.
3. Product obsolescence: If items are hold for long time, it may become outdated. Product may become outmoded due to improved products, changes in customer choices, particularly in high style merchandise, changes in requirements. Then this is a major risk and it may affect in terms of huge revenue loss. It is costly for the firms whose resources are limited and tied up in slow moving inventories.

In final words, the notion of inventory management has been one of the many analytical characteristics of management. It involves optimization of resources available for holding stock of various materials. If there is shortage of inventory, it leads to stock-outs, causing stoppage of production and a very high inventory will result in increased cost due to cost of carrying inventory.

Managing Current Liabilities

A current liability is an obligation that is payable within one year. The collection of liabilities comprising current liabilities is closely watched, a business must have enough liquidity to guarantee that they can be paid off when due. In accounting area, current liabilities are often

understood as all liabilities of the business that are to be settled in cash within the financial year or the operating cycle of a given firm, whichever period is longer.

In exceptional cases where the operating cycle of a business is longer than one year, a current liability is described as being payable within the term of the operating cycle. The operating cycle is the time period required for a business to acquire inventory, sell it, and convert the sale into cash. In most cases, the one-year rule will apply.

Since current liabilities are normally paid by liquidating current assets, the presence of a large amount of current liabilities calls attention to the size and prospective liquidity of the offsetting amount of current assets listed on a company's balance sheet. Current liabilities may also be settled through their replacement with other liabilities, such as with short-term debt.

The combined amount of current liabilities is major component of several measures of the short-term liquidity of a business. That include:

- Current ratio. This is current assets divided by current liabilities.
- Quick ratio. This is current assets minus inventory, divided by current liabilities.
- Cash ratio. This is cash and cash equivalents, divided by current liabilities.

Common examples of Current Liabilities

Accounts payable: These are the trade payables due to suppliers, usually as evidenced by supplier invoices.
Sales taxes payable: This is the obligation of a business to remit sales taxes to the government that it charged to customers on behalf of the government.
Payroll taxes payable: This is taxes withheld from employee pay, or matching taxes, or additional taxes related to employee compensation.
Income taxes payable: This is income taxes owed to the government but not yet paid.
Interest payable: This is interest owed to lenders but not yet paid.
Bank account overdrafts: These are short-term advances made by the bank to offset any account overdrafts caused by issuing checks in excess of available funding.
Accrued expenses: These are expenses not yet payable to a third party, but already incurred, such as wages payable.
Customer deposits: These are payments made by customers in advance of the completion of their orders for goods or services.
Dividends declared: These are dividends declared by the board of directors, but not yet paid to shareholders.
Short-term loans: This is loans that are due on demand or within the next 12 months.
Current maturities of long-term debt: This is that portion of long-term debt that is due within the next 12 months.
To summarise, financial experts defined current liabilities as "obligations whose liquidation is reasonably expected to require the use of existing resources properly categorized as current assets or the certain of current liabilities."