A Study on Cash Management and Determinants of Cash Holding

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ABSTRACT

In every business cash is the backbone of any organization and it also plays vital role in decision making. Cash is the blood of any organization. A business cannot operate without cash and without cash management. Cash movement is a two-way traffic, cash inflow and cash outflow. Cash management means management of liquidity in order to meet their day-to-day commitment. Cash management fulfills certain motives like transaction, precautionary, speculative and tax motive. In particular firms with strong growth opportunities and riskier cash flows hold high cash. Firms that have the greatest access to capital markets, such as large firms and those with high credit ratings should hold low level of cash. There are certain no of determinants of cash holding like growth opportunities, sale of asset, dividend to shareholders etc.

Keywords: *Cash management, Motive, Determinants, Cash Inflow, Cash Outflow.*

INTRODUCTION

Cash is the life blood of any business. Without blood no human-being can exist, like that without cash no business will sustain. Cash play a vital role in this modern world. cash includes money in hand, petty cash, bank account balance, customer checks, and marketable securities. Managing cash is so important as management of business. Cash is one of the assets of business. Cash management means the management of liquidity to meet day to day activities. Successful cash management involved not only avoiding insolvency but also reducing days in account receivables, selecting appropriate short-term investment portfolio. For organization cash management could be actual holding of cash or cash stored in banks. Successful cash management is essential for small business owners because they typically have less access to affordable credit and have a significant amount of upfront costs they need to manage while waiting for receivables.

Cash management deals with managing of

* Cash inflows and outflows
* Cash flows within the firm
* Cash balances held by firm at a point of time

The efficient management of cash in business is necessary to put the cash to work immediately and application of cash that generates income. So good cash management includes

Cash Planning

It is a technique to plan and control the use of cash. A cash flow statement shows the flow of cash or cash equivalent. It also includes cash inflows from various sources anticipated and cash outflow will determine possible use of cash.

Cash Forecasts and Budgeting

Cash budget is most important device for the control of receipts and payments of cash. It is an analysis of flow of cash in a business over a future. The short-term forecasts can be made with the help of cash flow projection. The long-term forecast indicates company's future financial needs for working capital, capital projects.

There are two methods for calculating cash forecasts such as

* Receipts and disbursement method
* Adjusted net income method

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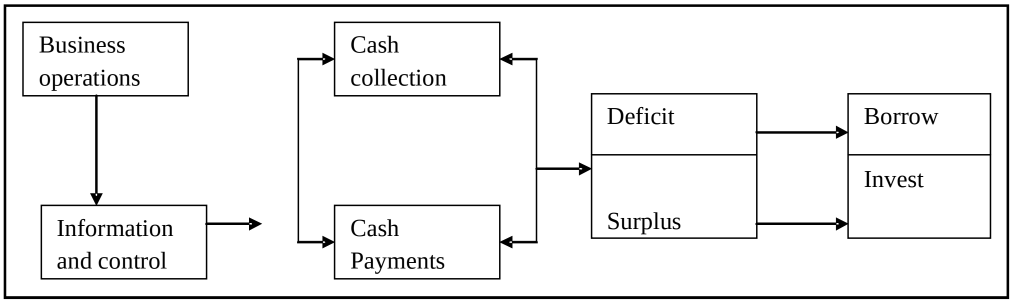
Cash Management Cycle



Cash Management Cycle by Prof. Anuj Verma

REVIEW OF LITERATURE

Cash Management originally means the management of liquidity in order to meet their day to day commitment (Collins & Jarvis, 2000). Small businesses have a poor cash management attention (Denver, 2005) .Efficient and effective liquidity management is very important for the survival, especially for smaller businesses (Sardakis et al, 2007). Cash management is a very broad subject and there are a lot of factors to consider when trying becoming more efficient. Which factors to consider depends on the company and type of industry (Ekanem. 2010).

OBJECTIVES

* To find out motive for cash management.
* To identify the determinants of cash holding.
* To find out the important relationship between cash management and profitability of corporate firms.

RESEARCH METHODOLOGY

The research article is purely based on secondary data which has been collected from various research journals, articles, various company sites and research is descriptive in nature.

MOTIVE OF CASH MANAGEMENT

Transaction Motive

Transaction motive refers to the need to hold cash to satisfy normal disbursement collection activities associated with a firm's ongoing operation. Transaction means the act of giving and taking of cash or kinds in the ordinary course of business. A firm frequently involves in purchase and sales of goods or services. A firm should make payment in terms of cash for the purchase of goods, payment of salary, wages, rent, interest, tax, insurance, and dividend and so on. A firm also receives cash in terms of sales revenue, interest on loan, return on investments made outside the firm and so on. If these receipts and payments were perfectly synchronized, a firm would not have to hold cash for transaction motive. But in real, cash inflows and outflows cannot be matched exactly. Sometimes receipts of cash exceed the disbursement whereas at other time disbursement exceeds the receipt. Because of this reason, if disbursement exceeds the receipt, a firm should hold certain level of cash to meet current payment of cash in excess of its receipt during the period.

Precautionary Motive

Precautionary motive refers to hold cash as a safety margin to act as a financial reserve. A firm should hold some cash for the payment of unpredictable or unanticipated events. A firm may have to face emergencies such as strikes and lock-up from employees, increase in cost of raw materials, funds and labour, fall in market demand and so on. These emergencies also bound a firm to hold certain level of cash. But how much cash is held against these emergencies depends on the degree of predictability associated with future cash flows. If there is high degree of predictability, less cash balance is sufficient. Some firms may have strong borrowing capacity at a very short notice, so that they can borrow at the time when emergencies occur. Such a firm may hold very minimum amount of cash for this motive.

Speculative Motive

The speculative motive refers to the need to hold cash in order to be able to take advantage of bargain purchases that might arise, attractive interest rates and favorable exchange rate fluctuations. Some firms hold cash in excess than transaction and precautionary needs to involve in speculation. Speculative needs for holding cash require that a firm possibly may have some profitable opportunities to exploit, which are out of the normal course of business. These opportunities arise in conditions, when price of raw material is expected to fall, when interest rate on borrowed funds are expected to decline and purchase of inventory occurs at reduced price on immediate cash payment.

Tax Motive

A highly tax firms are bound to keep sufficient cash balances. Firms have to pay tax every year; if they fail then firms will pay some additional charges. Firms that face high repatriation tax cost should hold large amounts of cash than firms with low repatriation tax costs.

DETERMINANTS OF CASH HOLDINGS

Growth Opportunities

Firm's strong growth opportunity is to guarantee their financing. The firms face two situations, outside funds and inside funds. For outside funds firms have to issue shares to public, lend from banks. But for inside funds retain earning is necessary which leads to growth.

Firms with strong growth opportunities have greater financial distress costs. So firms have to hold large accounts of cash to avoid high financial distress cost.

Sale of Asset

Firms can raise funds by selling their assets. Firms with specific assets can raise funds at very high cost by selling these assets. So there is a direct relation between firm's cash level and asset.

Dividend to Shareholders

Companies which pay dividends can raise funds easily from market. Cash holdings can also increase with dividend payments. Firms which pay dividends may have to reduce or cut their dividends when having a cash shortage. Therefore, holding large amount of cash enables firms to avoid these situations. So there is a direct relationship between dividend payment and cash holdings.

Cash Flow Volatility

Companies which faces cash volatile and cash shortage leads them to forgo some profitable investment objects. So firms have to hold sufficient cash to meet these circumstances.

Substitute of Liquid Asset

Liquid asset means which can be converted easily into cash with in short period of time. So firms have to keep substitute of liquid asset to meet contingencies.

Investment

There is a positive relationship between cash holding and investment. So cash holding enable firms to avoid outsiders funds and investment in profitable projects.

Leverage

Debt can be used to finance firm's investment opportunities and seen as cash substitute. Therefore, there is a negative relationship between cash holdings and leverage. Highly leveraged firms have easier access to capital market and no need to hold more cash. Debt increases the chances of financial distress and bankruptcy. To reduce these chances firms have to hold more cash.

Debt Restructure

The debt structure also influences the firm's cash holdings. Firms which have short-term debt in their capital structure are expected to hold more cash. These firms can avoid financial distress by holding large amounts of cash.

Measurement of Profitability

Profitability is measures to show how the firm is effective. Profit is a difference between revenues and expenses over a period of time. Profit can be measures in various ways and gross profit is between sales and of sales sold.

Corporate firms can easily determine measure the profitability level by through using profitability ratios. This can be measured after preparing financial statements. Net profit is obtained after subtracting operating expenses like interest, taxes and electricity from the gross profit, hence net profit margin ratio is measured by dividing profit after tax by sales and it can be illustrated as below.

$$\text{Net profit} = \frac{\text{Profit after tax}}{\text{Sales}}$$

The profitability ratios shows firm's ability to earn a return which can be easily measured and the return is normally a margin either by sales, capital invested. It shows a return on every unit of sale after taking into account both cost of sale and expenses and the higher the ration in relation to the industry average ratio the higher the profitability of firm and vice versa.

According to some, Profitability is a return expected by the management in relation to what it invested. According to them, profitability can be measured by using.

$$\text{Gross Net profit} = \frac{\text{Gross profit margin}}{\text{Total Sales}}$$

It shows increase in gross margin in relation to the industry average indicates reduction in cost of industry sales which increases the profitability of the firm.

Return on Investment

ROI means relationship between net profits after interest & tax and the proprietor' funds.

$$\text{Return on Investment} = \frac{\text{Net Profit (after interest \& tax)}}{\text{Capital Employed}}$$

ROI shows the overall efficiency of a firm.

Gross Profit Margin

Gross profit is the difference between the revenues of the firm which is the amount realized from the sale of a product/service by an organization with the costs that was incurred to produce that revenue in other wards it's the earnings before subtracting depreciation, interest and taxes. The formula for calculating gross profit margin is

$$\text{Gross profit Margin} = \frac{\text{Gross profit}}{\text{Net Sales}}$$

A high gross profit margin ration indicates high sales, good management and profitability which higher selling prices, low-costs of goods sold, whereas a low gross profit margin ratio indicates low profitable firm. But he stated that in order to come up with that analysis, the ratio obtained should be compared to the industry average ratio.

Return on Total Assets (ROTA)

Return on assets indicates the profitability on the assets of the firm after all expenses and taxes. Generally, a higher ratio means better managerial profit and efficient utilization of the assets of the firm and lower ratio is the indicator of inefficient use of assets. ROA is calculated as under:

$$ROA = \frac{\text{Net Asset after Tax}}{\text{Total asset}}$$

Return on Equity (ROE)

Return on equity indicates the profitability to shareholders of the firm after all expenses and taxes. It indicates the relationship between profits of a company and its equity capital. ROE is calculated as under:

$$ROE = \frac{\text{Net Profit after Tax - Preference Dividend}}{\text{Equity Share Capital (Paid-up)}}$$

RELATIONSHIP BETWEEN CASH MANAGEMENT AND PROFITABILITY OF FIRMS

In case of a deficit the firm should aim at increasing the cash inflows to the firm that is by motivation customers to settle their debts in time, reducing the period it takes for payment from its clients which increased the availability of cash and these surplus cash finally invested for profit maximization in firms. Cash management is very important to the firms this is because a firm needs cash to invent in inventory receivable and fixed assets and to make payments to operating expenses in order to maintain growth in sales and earnings. The firm may make adequate profits, but may suffer from shortage of cash because its growing needs may be consuming cash very first so that management should look to ways of increasing cash inflows to the firm and minimizing cash outflows like delaying of operating expenses like rent then the surplus cash may be managed into an investment portfolio thus increasing the profitability of firms. Similarly, cash management involves the increasing of cash inflows and reducing of cash inflows this helps the firms to maximize the profitability levels. Particularly when the cash inflows exceed the cash outflows the difference being the profit, of firms. So firm should aim at increasing cash inflows through increasing sales, persuading clients to pay their debts earlier, encouraging clients to buy using cash by proving them cash discounts.

CONCLUSION

Cash is the lifeblood of each and every business. If a firm maintains its cash level at optimum way then it should succeed in long-term. If a firm fails to maintain optimum cash level then it has lose its business. Cash management have certain motives; such as transaction, precautionary, speculative and tax motive. It indicates firms with strong growth opportunities, firms with riskier investment and small firms hold more cash than other firms. Firms that have greater access to the capital market and large firms hold less cash. When cash flow is too low and when outside funds are expensive, firms should hold liquid asset.

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