

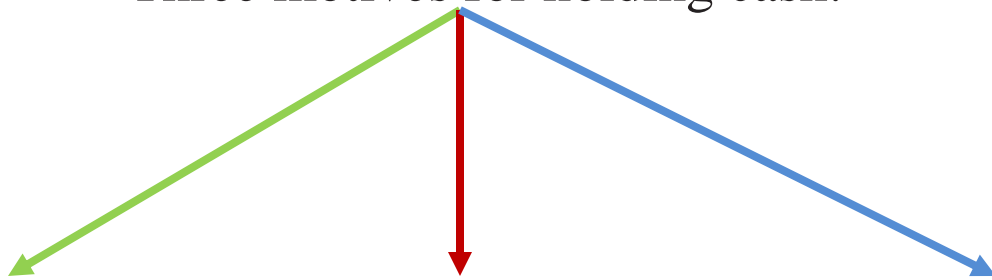
Once the overall level of current assets is determined, other questions remain



1. How much should be carried in cash?
2. How much should be carried in marketable securities?

We will also find out how to improve the efficiency of cash management and how to invest funds in marketable securities.

### Three motives for holding cash:



#### **Transactions motive:**

To meet payments, such as purchases, wages, taxes, and dividends, arising in the ordinary course of business

#### **Speculative motive:**

To take advantage of temporary opportunities, such as a sudden decline in the price of a raw material

#### **Precautionary motive:**

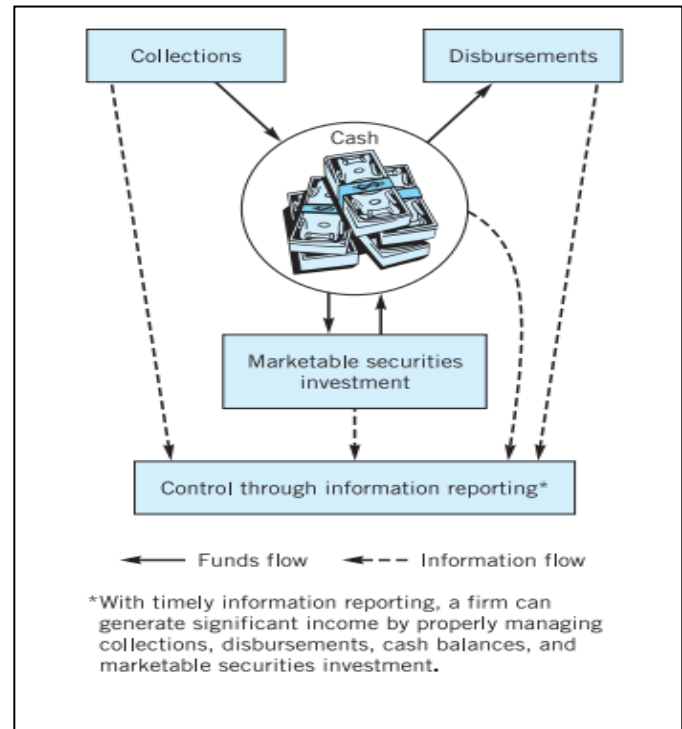
To maintain a safety cushion or buffer to meet unexpected cash needs. The more predictable the inflows and outflows of cash for a firm, the less cash that needs to be held for precautionary needs.

## Note:

It is important to note that all firms do not keep cash for all cash needs and manage it through marketable securities (cash equivalents) and un-borrowed portion of credit arrangements.

### Three most important determinants in the efficiency of cash management:

1. Collection
2. Disbursement,
3. Temporary investment of cash



# Golden Rule

*“Speeding up” cash receipts and “s-l-o-w-i-n-g d-o-w-n” cash payouts.*

## Collections:

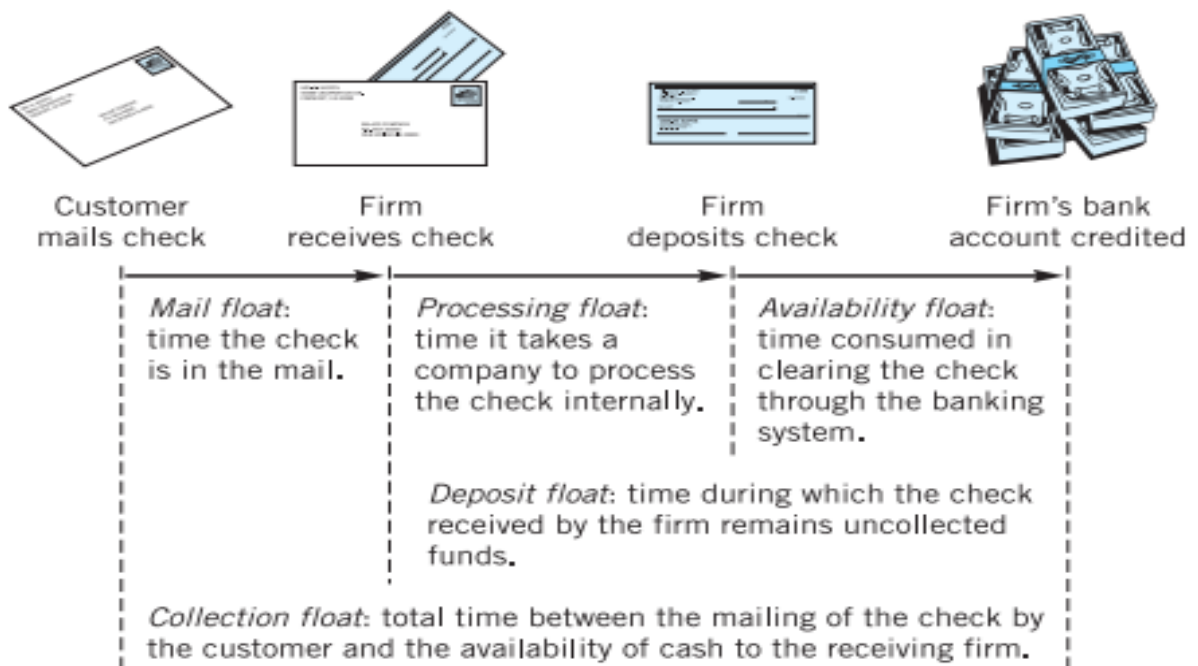
A number of methods are designed to speed up this collection process by doing one or more of the following:

- (1) Expedite preparing and mailing the **invoice**;

**Invoice** Bill prepared by a seller of goods or services and submitted to the purchaser. It lists the items bought, prices and terms of sale.

- (2) Accelerate the mailing of payments from customers to the firm; and

(3) Reduce the time during which payments received by the firm remain uncollected funds.



**Earlier Billing.** An obvious but easily overlooked way to speed up the collection of receivables is to get invoices to customers earlier. Customers have different payment habits. Some pay their bills on the discount date or the final due date (or later), and others pay immediately on receipt of an invoice. In any event, accelerated preparation and mailing of invoices will result in faster payment because of the earlier invoice receipt and resulting earlier discount and due dates. Computerized billing could be used to accomplish this. In addition, some companies find it advantageous to enclose invoices with shipped merchandise, send invoices by fax, or even request advance payment.

Billing can be eliminated entirely through the use of a **preauthorized debit**. A customer signs an agreement with a firm allowing the firm to automatically debit the customer's bank account on a specified date and transfer funds from the customer's bank to the firm's bank. Insurance and mortgage payments are often handled this way, as they both involve recurring payments of a fixed amount.

**Preauthorized debit**  
The transfer of funds from a payor's bank account on a specified date to the payee's bank account; the transfer is initiated by the payee with the payor's advance authorization.

# LOCKBOX SYSTEMS



**Lockbox** A post office box maintained by a firm's bank that is used as a receiving point for customer remittances. *Retail lockbox* systems cater for the receipt and processing of low- to moderate-dollar, high-volume remittances, whereas *wholesale lock-box* systems are designed to handle high-dollar, low-volume remittances.

**Electronic lockbox**  
A collection service provided by a firm's bank that receives electronic payments and accompanying remittance data and communicates this information to the company in a specified format.

# Rule of selecting Lockbox system:

The customary rule for deciding whether or not to use a lockbox system is simply to compare the added cost of the more efficient system with the marginal income that can be generated from the accelerated funds availability. If costs are less than income, the system is profitable; if not, the system is not worth implementing. The degree of profitability depends primarily on the geographic dispersion of customers, the size of the typical remittance, and the earnings rate on the released funds.

## Some other methods to speed up collection procedures

### Accounts receivable conversion (ARC)

A process by which paper checks are converted into Automated Clearing House (ACH) debits at lockboxes or other collection sites. It reduces availability float associated with check clearing.

### Automated Clearing House (ACH)

A nationwide electronic funds transfer system. Payroll direct deposit and direct payment of mortgage bills are examples of typical ACH payments.

### Remote deposit capture (RDC)

Technology that allows a user to scan checks and transmit the scanned digital check images to a bank for posting and clearing.

## ● ● ● Concentration Banking

The firm that uses a lockbox network as well as the one having numerous sales outlets that receive funds over the counter have something in common. Both firms will find themselves with deposit balances at a number of regional banks. Each firm may find it advantageous to move part or all of these deposits to one central location, which is known as a *concentration bank*. This process of **cash concentration** has several effects:

- It *improves control* over inflows and outflows of corporate cash. The idea is to put all of your eggs (or in this case, cash) into one basket and then to watch the basket.
- It *reduces idle balances* – that is, keeps deposit balances at regional banks no higher than necessary to meet transactions needs (or alternatively, minimum **compensating balance** requirements). Any excess funds would be moved to the concentration bank.
- It *allows for more effective investments*. Pooling excess balances provides the larger cash amounts needed for some of the higher yielding, short-term investment opportunities that require a larger minimum purchase. For example, some marketable securities are sold in blocks of \$100,000 or more.