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Cash Management

by Sophia

WHAT'S COVERED

In this lesson, you will learn about the tools of efficient cash management. Specifically, this lesson will cover:

1. Managing Float

In financial and economic terms, the term **float** refers to duplicate money, or money counted twice, that exists in the banking system in the time gap between when a deposit registers in the account of the recipient, or payee, and when that same amount is deducted from the payer's account. In a greater context, float can refer to the amount of currency available to trade.

EXAMPLE Countries can influence the value of their currency by decreasing or increasing the amount of float available to trade.

The timeframe in which float is most noticeable is the period of delay between when a check is issued by the payer and the moment when the assets to cover that check are removed from the payer's account. As soon as the payee – the one receiving the check – deposits the check in their account, the bank immediately credits that account in the amount of the check, under the assumption that the payer's bank will eventually issue the cash to cover the check.

HINT

Until the payer's bank issues the cash to cover the check, that same amount of currency exists in both accounts – the payee and the payer.

When the payee's bank alerts the payer's bank of the pending check, the duplicate funds are deducted from the payer's account. At this point, the check is considered to have cleared the bank. Notice that in this process of check clearing, both bank float and customer float occur.

Bank float refers to the timeframe of the clearing process, from the moment funds are deposited in the bank to when they are actually credited. Customer float refers to the time gap between when funds are deposited to the moment they are released for use by the depositor. The difference between these two types of float is known as negative float. Negative float is used by the bank as the overnight investable funds.

Float can cause marginal changes in the money supply. Before electronic check clearing, bad weather or communication problems often caused float to significantly increase, as the clearing of checks was delayed. Another aspect of float time is its use to defraud, commonly known as **check kiting**.

When managing cash disbursements, a company should endeavor to increase the amount of time present in the disbursement cycle. In other words, it is appropriate to delay making payments until they come due in order to have use of available cash for as long as possible. Some methods for accomplishing this include mailing checks far away from those waiting to receive payment, disbursing checks from a remote bank, or purchasing with credit cards.

Methods such as these present a company with three types of float to take advantage of:

- Mail Float: Time spent in the mail.
- Clearance Float: Time spent trying to clear the bank.
- Processing Float: Time required to process cash flow transactions.

TERMS TO KNOW

Float
Duplicate money that exists in the banking system in the time gap between when a deposit registers in the account of the recipient and when that same amount is deducted from the payer's account.

Check Kiting
A form of check fraud, involving taking advantage of the float to make use of non-existent funds in a checking or other bank account.

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2. Managing Collections

The cash receipts cycle requires a diligent collection process. A company must balance this need for quick cash collections with the needs and desires of its customers. Customers who are important to a firm's business should be treated carefully as opposed to customers who mean little or nothing to its future. Therefore, collection efforts must be customer-specific in order to be effective.

Specific collection techniques include:

- Letters
- Telephone calls
- Faxes
- Emails
- Legal action

IN CONTEXT

Below is an example of a message from a collection letter:

> *Our records indicate that a balance of $ 4,650.30 is over 90 days past due. We have sent monthly statements and reminders several times, but we have yet to receive payment or any explanation as to why payment should not be made. Please review this matter immediately. I will call you in the next five days to arrange payment.*

The overall collection process should be proactive and preventive. Wherever possible, a company should try to collect payment immediately as products or services are delivered – that is, receive payment in cash. This eliminates the need for invoicing and follow up collection techniques. A firm should always require deposits from customers that have a history of making late payments. It should use credit applications to weed out bad customers and include a clause in the credit application that states all collection costs are reimbursed by the customer on delinquent accounts.

Commercial banks offer a service to companies, known as **lockbox banking**. This service facilitates the collection and processing of account receivables. Typically, a lockbox is a special post office box that the bank can access. The service works as follows:

1. A company establishes a lockbox service with their bank, for the purpose of receiving customer's payments.
2. Those customers then send their payments to the post office box, instead of to the company.
3. The bank then collects the funds from the lockbox, processes them, and deposits them into the company's account.

Since the bank is the entity collecting and processing the funds, those funds can be immediately deposited into the company's account, without taking the extra step of being processed by the company's accounting system, thereby accelerating the process of cash collection. An additional benefit of the lockbox service is the ability of companies to have these special mailboxes in various locations around the country, allowing customers to send payments to the nearest lockbox.

TERM TO KNOW

Lockbox Banking

A service offered to organizations by commercial banks that simplifies collection and processing of account receivables by having those organizations' customers' payments mailed directly to a location accessible by the bank.

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3. Managing Disbursements

Cash payments are vitally important to manage in order to maintain a successful business. How a company manages various disbursements and current assets can have a significant impact on its cash flows. There are several problem areas to watch out for, such as payroll, purchasing, inventories, and insurance.

Disbursement Considerations	Description
Payroll	Payroll is a hefty cash outflow and requires special attention. One obvious trend in payroll management is to implement a flexible workforce, since the flow of work fluctuates. Outsourcing and temporary workers are often part of a flexible workforce. However, a company must retain a full-time workforce for core activities. A firm can also increase payroll float times by simply distributing payroll checks after the point when banks will clear checks.
	Flexible purchasing practices can help a company maintain and generate cash flow. A company may consider renting certain items as opposed to purchasing. A manager may

Purchasing	ask, do we really need this item, and how often will we use it? If practical, a firm can order items out of season when prices are low. Finally, a firm may consider using credit cards to make purchases since this will allow more time for making payments.
Inventory	Inventories have several hidden costs that can drain cash flow. These costs include storage, insurance, spoilage, handling, taxes, and financing. A company should get rid of inventory that is not moving. Obsolete inventory should be removed immediately. A firm may also find new ways of disposing of inventory. For example, it is better to sell inventory at cost than not at all. The overall objective is to maintain inventory levels at a profitable level.
Insurance	A company should make sure it does not over-insure the business. A firm should purchase insurance in group packages to obtain the lowest premiums. It should start by covering the largest risks first. It should then structure as high a deductible as is affordable. A company should avoid duplication and excessive insurance and shift certain costs, such as health insurance, to the employee through higher payroll deductions. Insurance should be used to cover risks that are material but occur infrequently.

SUMMARY

In this lesson, you learned that float is the gap of time between when money enters a payee's account and leaves a payer's account. By **managing float**, a company makes use of cash on hand for as long as possible. The methods a company can use include mail float, clearance float, and processing float. A company can also manage its cash flow by **managing collections** to make them as quick as possible, and by **managing disbursements** to control costs related to payroll, purchasing, inventory, and insurance.

Best of luck in your learning!

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