Cash and Short-term Financing

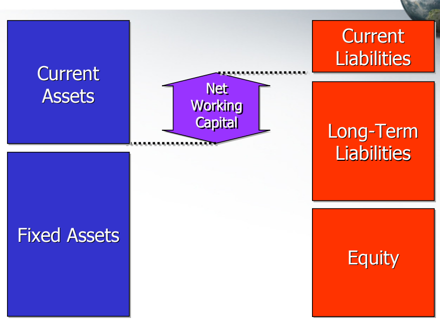
Topics

- Cash and Net Working Capital
- Short-term Financial Policy
- Cash Budgeting

Cash and Net Working Capital

- Current Assets: Cash and other assets that are expected to be converted to cash with the year.
  - Cash and Marketable securities
  - Accounts receivable
  - Inventory
- Current Liabilities: Obligations that are expected to require cash payment within the year.
  - Accounts payable
  - Accrued wages
  - Taxes
- Net Working Capital = CA – CL

Balance Sheet Model of the Firm



Cash Management

- Definition of Cash

Balance Sheet:

Asset = Liabilities + Equity

CA + Fixed Assets = CL + LT Debt + Equity

where, NWC = CA – CL = Cash + Other CA – CL

Cash + Other CA – CL = LT Debt + Equity – Fixed Assets

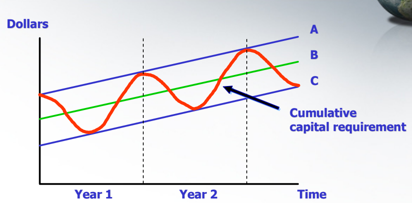
Cash = LT Debt + Equity – Fixed Assets – Other CA + CL

Cash = LT Debt + Equity – Fixed Assets – NWC (w/o cash)

Short-term Financial Policy

- Two elements
  - Size of the firm's investment in current assets
  - Financing of current assets

Firm's Cumulative Capital Requirement



Lines A, B, and C show alternative amounts of long-term finance.

Strategy A: A permanent cash surplus
Strategy B: Short-term lender for part of year and borrower for remainder
Strategy C: A permanent short-term borrower

Short-term Financial Policy

- Flexible ST financial policies
  1. Keeping large balances of cash and marketable securities
  2. Making large investment in inventory
  3. Granting liberal credit terms, which result in a high level of accounts receivable
- Restrictive ST financial policies
  1. Keeping low cash balances
  2. No investment in marketable securities
  3. Making small investments in inventory
  4. Allowing no credit sales and no account receivable

Cash Budgeting

- Cash Budget is a primary tool of short-run financial planning.
- It is the way of identifying the cash flow gap on the cash flow time line.
- It records estimates of cash receipts and disbursements.

Short-term Financial Planning

- Unsecured loans
  - Line of credit
    - Non-committed: Compensating balances
    - Committed
- Secured loans
    - Account receivable financing: Assignment, Factoring
    - Inventory loan: Blanket inventory lien, Trust receipt, Field-warehouse financing
- Other sources
    - Commercial paper, Banker's acceptances

Short-term Financial Planning

- Considerations in determining the most appropriate amount of ST borrowing are:
  - Cash reserves: Flexible financing strategy can reduce financial distress possibility, but it may reduce the ROE.
  - Maturity hedging: Financing LT assets with ST borrowing is inherently risky as ST interest rate is more volatile.
  - Term structure: On average, LT borrowing is more costly than ST borrowing.

Cash Balances

- The optimal amount of short term securities sold to raise cash will be higher when annual cash outflows are higher and when the cost per sale of securities is higher. Conversely, the initial cash balance falls when the interest is higher.

$$\text{Initial cash balance} = \sqrt{\frac{2 \text{ x annual cash outflows x cost per sale of securities}}{\text{interest rate}}}$$

Cash Balances

- Money Market - market for short term financial assets.
  - commercial paper
  - certificates of deposit
  - repurchase agreements