

# Towards understanding

UNDERSTANDING CASH MANAGEMENT CONCEPTS IS FUNDAMENTAL FOR TREASURERS AND THEIR STAFF. ARE YOU COMFORTABLE WITH THOSE ALL-IMPORTANT TERMS?

## Executive summary

If treasurers are going to make their organisation's cash management processes as efficient as possible, then they need a strong grasp of how cash management actually works. Concepts such as availability, finality, value and float need to be a key of the day to day vocabulary.


- **Value** The moment when funds cease to be useable to the originating party and instead become useable funds to the beneficiary in the sense that they can reduce overdraft balances, earn interest or be withdrawn.
- **Value-dating** The practice of dating a customer transaction at some date other than the date at which the bank itself lost or gained value. It is used by banks in some countries as a method of compensation. It can be applied to all methods of payment both forward and backward in time.
- **Forward value-dating** The time between a bank being notified of a transaction in favour of a customer and the customer receiving future value for the item.
- **Back value-dating** The time between a bank being notified of a transaction to the customer's account and the item being valued on a date prior to the date of the transaction.

An example of forward value-dating is when a bank collects value for cheques which clear in five days, but does not give value to the customer until day six.

An example of back value-dating is when a bank processes an outgoing payment request on one day but values the debit to the customer's account to a prior value date. Banks also back value transactions to correct errors or upon negotiation with customers.

Although there is evidence that the practice of value-dating as a method of bank compensation is falling out of favour it is still widely used in Europe and can also be found in other parts of the world. Value-dating is not to be confused with "availability" which is the date at which the customer may use the funds. Availability may or may not include value days as additional compensation for the transaction.

As an example of the difference between "value" and "availability", when interest is earned on a current account, a bank may agree to accrue interest from the day of deposit, i.e. the deposit has been given value immediately. Availability, however, i.e. the date at which the funds may be withdrawn, may not be given until the clearing cycle has been completed and the funds are final.



To understand cash management treasurers have to be familiar with some fundamental concepts.

**Availability** Availability is the time at which a company will have access to funds that have been deposited at the bank. Because of the collection process this may take a few days, or, in the case of international collections, several weeks. Availability, however, does not imply finality. Although funds have been made available, the bank may still withdraw them at a future date should the deposited item fail to settle.

**Finality** Finality is the time after which a payment is considered to become irrevocable and cannot be returned without the permission of the beneficiary account holder. It is important to establish when finality of payment occurs so as to limit the:

- Risk of non-payment, i.e. the risk that an item is recalled by the originator or the originating bank (e.g. a stopped cheque).
- Unnecessary loss of value in both the collection and the payment cycle.

It should be noted that finality varies by instrument and from country to country. Finality may be immediate, weeks or months, and in certain circumstances (usually for consumer direct debits) may be infinite.

**Value** The following are definitions related to the concept of value.

## cash management

### CASE STUDY

**Security of principal** While there may be people within the company assigned to take risks and improve returns, that is not the role of the cash manager. An overriding consideration for the cash manager in performing the role is at all times to safeguard security of principal.

**The opportunity cost of funds** Opportunity cost is the cost of an alternative use of funds that is foregone.

Cash in a bank account earns little or no interest. To the extent that alternatives are available such as paying down debt or investing at a higher rate of return, there is an opportunity cost to the company i.e. the cost of the opportunity lost or not taken. The cash manager uses the concept of opportunity cost when quantifying the cost of inefficient cash management practices or in weighing up benefits and potential savings of new products and services.

**Time value of money** The time value of money is the concept that money received today is more valuable than money received in a day or two's time on the premise that if received today, it can be invested and so is worth more tomorrow. Cash managers use this concept in a number of different ways:

- *Assessing the opportunity cost of float on collections.* Cash-flows that are delayed in the collection process cost the company money either through lost investment revenue or borrowing costs to cover liquidity requirements.
- *Assessing the opportunity cost of float on payments.* What is the impact of paying electronically and conceivably losing disbursement float? What is the benefit to using slower methods of disbursement?
- *Assessing the value of trade discounts.* Is taking a trade discount and paying earlier going to be more beneficial than delaying the payment until the due date?
- *Assessing the value of a new product or service* Will the cost of a new service to accelerate collections, or control payments, produce benefits in excess of the costs of the service?
- *Assessing investment alternatives* When faced with a number of different investment opportunities, with yields computed on a different basis, determining which one represents the best option.
- *Assessing the value of capital projects* When making investment decisions, calculating if the future projected

#### Box 1: Chain of events

Consider a normal transaction between two companies involving company A ordering goods from company B. The chain of events from the supplier's standpoint is as follows:

- |                     |   |
|---------------------|---|
| ■ Order received.   | ■ Payment received.                     |
| ■ Goods dispatched. | ■ Payment banked.                       |
| ■ Invoice issued.   | ■ Funds available.                      |
| ■ Credit period.    | ■ Funds moved to concentration account. |
| ■ Payment due.      | ■ Advice of funds availability.         |
| ■ Payment made.     |   |

#### Box 2: Stages of float

Stage in process	Name of float*	Responsibility
1. Order received to goods dispatched	Production float	Supplier
2. Goods dispatched to Invoice issued	System (invoicing) float	Supplier
3. Credit period to payment due	Credit period	Supplier
4. Payment due to payment made	Customer float	Buyer
5. Payment made to payment received	Postal (mail) float	Buyer/postal service
6. Payment received to payment banked	System (processing) float	Supplier
7. Payment banked to funds available	Bank (availability) float	Banks
8. Funds available to funds concentrated	Concentration float	Banks
9. Funds concentrated to advice of availability	Information float	Banks

\* The name of float most frequently used in the US is given in parentheses

return from the project exceeds the present day value of the initial cash outflow.

**Float** There are many definitions of float. The one most commonly used is the one for bank float which is defined as: "The time lost between a payer (or payor) making a payment and a beneficiary receiving value."

Traditionally bank float was the only area of float that the treasurer considered. So much emphasis has been placed on reducing bank float, particularly in the US, over recent years that it is now measured in hours rather than days.

As treasurers' responsibilities widen to encompass the management of working capital, it becomes increasingly obvious that bank float is the tip of the iceberg and that many other aspects and different kinds of float need to be considered (See Box 1).

An analysis of this flow in more detail (see Box 2) enables the float and cashflow aspects to be identified. In the following example, the assumption is that payment is made by cheque. Even if using more efficient methods of payment many of the float issues that are discussed above still apply.

Float is, therefore "inefficiency" in the business cycle. If you are the buyer, float accrues to your advantage. If you are the supplier float is a cost to your business. Float has both benefits and costs, but generally the cost to one party is to the benefit of the other party or the bank! The cost/benefit of float can be quantified using the following formula:

$$\text{Cost/benefit of Float} = \text{Amount due} \times \text{Cost of funds}$$

Cost of funds refers to either the marginal cost of borrowing the funds for the period of float, or the lost opportunity cost of funds.