

VAJIRAM IAS TEST SERIES

(Don't write anything in this part)

(Question No.)

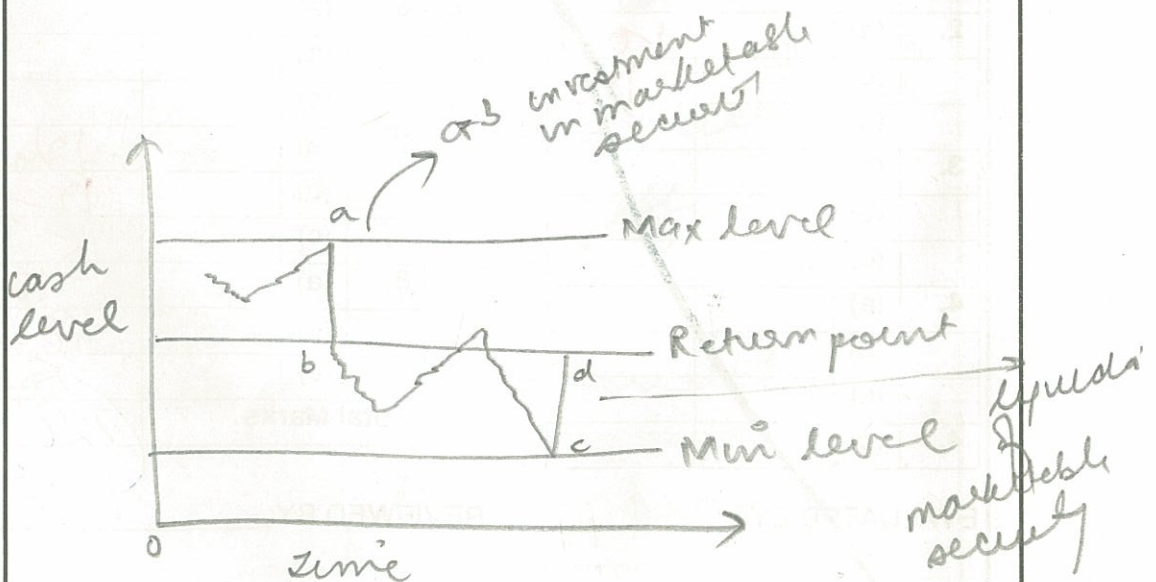
Ques 1.
(a)

Miller Orr Model

Is a cash management model in working capital management.

Assumptions

1. Cash use in firm is STOCHASTIC / RANDOM
2. Therefore application of control required to manage cash
3. no transaction cost for conversion into marketable security of cash
4. No lead time in cash conversion



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Explanation of model

In the given diagram,

3 limits set by firm - maximum, return point and minimum level.

As soon as cash level reaches the maximum level → conversion of cash into marketable securities of amount a-b is done.

This leads to cash returning at return point.

if the cash level reaches the minimum level → marketable securities of amount c-d sold and cash level reaches to return point.

Significance of model - suitable when cash flow is randomised as compared to Baumol model of cash mgmt.

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Return point
calculated =

$$RL = \left(\frac{3b\sigma^2}{4I} \right)^{1/3} + \text{Lower limit}$$

where b = transaction cost

σ = standard deviation
showing variability of
cash flow

I = interest rate

(b)