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**EFFECTIVE CASH
MANAGEMENT—OR, ARE
YOU YOUR BANKER'S
BEST FRIEND?**

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*Presented before the Texas
Manufacturing Association,
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In the past year, because of decreased availability of funds and high interest rates, the effective management of cash has become increasingly more important to, and in some cases critical for, the success of businesses. The need for cash planning is not restricted to large business entities, because ultimately all businesses operate on cash. The purpose of this paper is to discuss the role of the cash budget or forecast in cash management and to present a few suggestions that may improve cash flow.

CASH FORECASTING

When administered wisely, the cash budget or forecast compels management planning and assists the manager in operating and improving the profitability of his business by:

Highlighting operating problems

Maximizing the amount of income from short-term investments

Anticipating short-term borrowing requirements

Recognizing long-term capital needs

In short, cash forecasting is essential to improved cash management.

After one accepts the desirability of cash forecasting, its techniques and the feasibility for the particular business must be considered. Many managers are of the opinion that profit planning and cash forecasting are possible only for large companies with elaborate accounting or management information systems. Cash forecasting is possible regardless of the sophistication of the accounting system. It may be more difficult in some industries and businesses, but generally the only factor limiting the feasibility of forecasting is lack of interest or motivation on the part of management.

The annual cash forecast is an extension of a company's yearly profit plan or budget (see Exhibits 1 and 2) and is formulated by converting estimated revenues and costs on an accrual basis to estimated cash collections and

disbursements. Significant items to be considered in such a conversion are:

Collections of accounts and notes payable

Payment terms of trade payables

Timing of actual payments for estimated federal income taxes and other accrued liabilities

Payments on notes payable and long-term debt

Expenditures for capital improvements

The accuracy of the forecast depends on the quality of the input data. Since the forecast will become the basis for cash management, it is essential that the utmost care and judgment be exercised in its preparation.

EXHIBIT 1

Sample Manufacturing Co.—Cash Forecast (in Thousands),

	<i>Jan.</i>	<i>Feb.</i>	<i>Mar.</i>
Estimated cash receipts:			
Total collections on notes and accounts receivable	\$ 129	\$ 162	\$ 122
Sale of assets		20	
Other		2	
Total	<u>\$ 129</u>	<u>\$ 184</u>	<u>\$ 122</u>
Estimated cash disbursements:			
Operating expenses	\$ 62	\$ 66	\$ 70
Income taxes			
Capital expenditures			
Administrative payroll	20	20	20
Advertising	1	2	1
Insurance	8	1	
Repayment of debt		5	
Interest expense		1	
Dividends			
Other		5	
Total	<u>\$ 91</u>	<u>\$ 100</u>	<u>\$ 91</u>
Estimated cash excess (deficit)	<u>\$ 38</u>	<u>\$ 84</u>	<u>\$ 31</u>

While a company can learn a great deal about itself in the formulation of the forecast, the ultimate benefit lies in assisting the decision maker in the management of cash. The summary cash forecast for Sample Manufacturing Co. (Exhibit 2) shows, by month, the estimated amount of cash available for investment and the estimated amount of required borrowings. Utilizing this information the money manager can:

Devise an investment strategy for estimated investable cash

Plan the type, amount and timing of:

- Short-term working-capital loans
- Long-term financing for capital improvements
- Additional equity capital

Year Ended December 31, 197X

<i>Quarter</i>				
<i>First</i>	<i>Second</i>	<i>Third</i>	<i>Fourth</i>	<i>Year</i>
\$413	\$ 335	\$200	\$220	\$1,168
20	5			25
<u>2</u>				<u>2</u>
<u>\$435</u>	<u>\$ 340</u>	<u>\$200</u>	<u>\$220</u>	<u>\$1,195</u>
\$198	\$ 154	\$ 79	\$164	\$ 595
	20	10	10	40
	200	100		300
60	60	60	60	240
4	3	10	8	25
9	3	11	1	24
5				5
1				1
			10	10
<u>5</u>				<u>5</u>
<u>\$282</u>	<u>\$ 440</u>	<u>\$270</u>	<u>\$253</u>	<u>\$1,245</u>
<u>\$153</u>	<u>\$(100)</u>	<u>\$(70)</u>	<u>\$(33)</u>	<u>\$ (50)</u>

EXHIBIT 2

Sample Manufacturing Co.—Summary Cash Forecast (in Thousands), Year Ended December 31, 197X

	Beginning Balance	Estimated Receipts	Estimated Disbursements Operating	Capital	End of Month				Total Cash	
					Estimated Balance	Desired Balance	Invested	Amount To Be Borrowed	Final Balance	Invested
Jan.	\$30	\$129	\$91		\$68	\$20	\$48	\$20	\$48	
Feb.	20	184	100		104	20	84	20	132	
Mar.	20	122	91		51	20	31	20	163	
Apr.	20	120	85	\$50	5	20	(15)	20	148	
May	20	115	81	100	(46)	20	(66)	20	82	
June	20	105	74	50	1	20	(19)	20	63	
July	20	90	77	100	(67)	20	(63)	\$24	-0-	\$24
Aug.	20	60	51		29	20	(9)	20	15	15
Sept.	20	50	42		28	20	(8)	20	7	7
Oct.	20	40	56		4	20	16	20	23	23
Nov.	20	80	112		(12)	20	32	20	65	65
Dec.	20	100	85		35	20	(15)	20	50	50

The amount of funds available for investment can obviously be maximized by maintaining a minimum cash balance. Factors that should be considered in determining a desired cash balance include minimum operating-cash requirements, compensating balances on loan agreements and the retention of good bank relations. Management should always consider its overall needs, including anticipated borrowings. For example, consider the implications of Exhibit 2. It appears that the company will require short-term financing in the second half of the year. Therefore, it must maintain an adequate cash balance to compensate the bank for services already provided and to facilitate future loan negotiations.

TEMPORARY INVESTMENTS

The Biblical parable describing the fate of the man who buried his talent in the ground may be the first record of the failure of a short-term money manager. The primary objectives of short-term investment are twofold: safety of principal (the creditworthiness of the investment and its marketability) and yield. The poor soul in the parable achieved one but ignored the other. In determining policy for the investment of cash both objectives must be accommodated.

The intended use of the funds is very important in the development of investment policy. If the invested funds are to be used as a return of cash into inventory and receivables as seasonal business develops or as a cushion against a sudden, unexpected drain of cash, a highly marketable, minimum-principal risk investment will probably be considered. If the funds are intended for a specific payment at some time in the future—for capital improvements or tax payments, for instance—a security maturing on or near the date of payment may be purchased with less concern for marketability. Finally, if these are general excess funds over and above seasonal or specific purposes, they may be invested in securities with longer maturities or less marketability, provided that the increase in yield is adequate to compensate for the risk. Depending on the intended use of the funds, the money manager might utilize one or more of the following types of investments:

Treasury bills

U.S. Treasury notes and bonds

Certificates of deposit (negotiable or nonnegotiable)

Savings-and-loan passbook savings accounts

Commercial paper

State and municipal securities

Exhibit 3 illustrates a possible investment plan for Sample Manufacturing Co. The company's summary cash forecast (Exhibit 2) indicates that surplus cash generated in the first part of the year will be needed to help finance capital improvements later in the year. Therefore, the selection of investments has been restricted to those that are highly marketable and have minimum principal risk. An S&L savings account has been used for the temporary investment of cash for periods of time or in amounts not suitable for other forms of investment. This assumes that the association pays interest

EXHIBIT 3

Sample Manufacturing Co.—Investment Forecast (in Thousands),

		<i>S&L</i>			
		<i>Passbook</i>			<i>Total</i>
		<i>Savings</i>	<i>Certificates</i>	<i>Treasury</i>	<i>Funds</i>
		<i>Account</i>	<i>of Deposit</i>	<i>Bills</i>	<i>Invested</i>
Jan.	Purchase 90-day Treasury bills—estimated yield 7.75%			\$ 25	\$ 25
	Deposit in savings account	\$ 23			23
		\$ 23		\$ 25	\$ 48
Feb.	Purchase 60-day certificate of deposit—estimated yield 9%		\$ 100		100
	Withdrawal from savings account	(16)			(16)
		\$ 7	\$ 100	\$ 25	\$ 132
Mar.	Purchase 90-day Treasury bills			20	20
	Deposit in savings account	11			11
		\$ 18	\$ 100	\$ 45	\$ 163
Apr.	Withdrawal from savings account	(15)			(15)
		\$ 3	\$ 100	\$ 45	\$ 148

from date of deposit to date of withdrawal as is the custom in many sections of the country. The savings account gives the money manager maximum flexibility in the event that actual results differ from the original forecast. Where such accounts are not available locally, the funds shown as being held in savings could be invested in short-term certificates of deposit or Treasury bills. The additional investment in certificates of deposit would obviously please the company's banker.

The company's forecast indicates that more than one hundred thousand

Year Ended December 31, 197X

	<i>S&L Passbook Savings Account</i>	<i>Certificates of Deposit</i>	<i>Treasury Bills</i>	<i>Total Funds Invested</i>
May	Maturity of certificate of deposit	(100)		(100)
	Maturity of Treasury bills		(25)	(25)
	Purchase 60-day Treasury bills— estimated yield 7.75%		35	35
	Deposit in savings account	<u>24</u>		<u>24</u>
	\$ 27	<u>-0-</u>	<u>\$ 55</u>	<u>\$ 82</u>
June	Withdrawal from savings account	<u>(19)</u>		<u>(19)</u>
	\$ 8		<u>\$ 55</u>	<u>\$ 63</u>
July	Maturity of Treasury bills		(55)	(55)
	Withdrawal from savings account	<u>(8)</u>		<u>(8)</u>
	Balance, July 31, 197X	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>

dollars in excess funds will be available for about sixty days beginning in February. A certificate of deposit has been purchased with these funds because:

- Interest rates on certificates of deposit of \$100,000 or more are generally negotiable and currently exceed the yields on similar-maturity Treasury bills.
- Additional deposit at the company's bank may help in loan negotiations.

Treasury bills have been used for investment in securities that will mature during periods when cash will be needed for capital improvements. If actual results vary from the cash forecast, the increase or decrease in investable cash could be accommodated by either increasing or decreasing the amount of Treasury bills purchased.

SHORT-TERM BORROWING

In the preparation of its cash forecast, Sample Manufacturing Co. learned that it will need to borrow funds in the second half of the year. In studying the forecast it was noted that the company appears to generate its best cash flow in the first and second quarters, primarily because of seasonal sales trends. Monthly cash receipts and disbursements for the current and prior year were reviewed, and the same trends were noted. Accordingly, the company determined that a revolving line of credit from its bank would best satisfy its credit needs. By determining its loan requirements in advance, the company has increased its chances of securing financing and favorable terms because it can:

- Quantify credit needs in total and by month for the bank
- Alter planned monthly cash balances to provide for adequate compensating balances
- Secure a loan commitment from the bank months before the funds are needed, thereby timing negotiations to avoid a "tight" money market

The preparation of the cash forecast and the planning of short-term investments and borrowings have enabled Sample Manufacturing Co. to establish an overall cash-management plan for the coming year. Exhibit 4 indicates that the proposed plan, if reasonably accurate, will enable the company to pay estimated financing costs with funds provided from the

investment of idle cash. Even if bank interest rates are higher and investment yields lower than anticipated in the coming year, the company's cash-management plan has reduced the vulnerability of its earnings to rising interest costs.

Cash management does not end with the formulation of a plan of action. Actual monthly results of operations should be compared with the cash forecast and significant variations investigated. Variances from the plan may:

Change the type, amount and timing of short-term investments

Alter requirements for borrowed funds

Indicate unforeseen operational problems, e.g.:

Decrease in turnover of accounts receivable

Inventory control or accumulation problems

Provide a means for evaluating forecasting procedures and indicate how improvements may be made

Cash projections may be revised monthly or quarterly to maintain a current forecast for future periods varying from a month to a year. Such revisions may be formal or informal and can be made by inserting the actual results of the period just completed and adjusting the future periods without revising the entire forecast with new estimates. Whenever significant changes occur that affect cash, informal revisions may be made to update and improve the accuracy of the forecast.

EXHIBIT 4

Sample Manufacturing Co.—Analysis of Estimated Investment Income and Interest Expense, Year Ended December 31, 197X

Investment income:	
Certificate of deposit	\$1,500
Treasury bills	1,324
Savings account	<u>376</u>
Total	<u>\$3,200</u>
Estimated interest expense (assuming average interest rate of 11½%)	<u>\$1,763</u>
Estimated excess of investment income over interest expense	<u>\$1,437</u>

IMPROVING CASH FLOW FROM OPERATIONS

Besides planning for the investment of idle cash and the financing of company operations, the cash manager should be continually searching for ways to reduce the time required for the collection of cash, to maximize the time during which cash is retained by the corporation and to maintain optimum levels of noncash assets. These objectives can be achieved in part by:

- Reducing collection time for receivables by using a lock-box system or area-concentration banking.
- Avoiding delays in invoicing customers by:
 - Providing an adequate system for handling seasonal peak loads.
 - Centralizing control of invoicing.
 - Minimizing invoicing errors (customers often will not remit before receipt of a corrected invoice).
- Employing a sound payables system that centralizes the payment of large bills as much as possible. Such a system would facilitate control over timing of disbursements and reduce the funds required in divisional or branch accounts.
- Taking discounts when offered and remitting as late as possible.
- Using drafts instead of checks for trade payables.
- Controlling inventories by:
 - Establishing optimum order quantities
 - Centralizing warehousing
 - Coordinating production schedules with sales forecasts
- Establishing policies for fixed-asset acquisition and depreciation that realize the maximum benefits under applicable income-tax regulations.

Are you your banker's best friend? You probably are if you allow surplus cash to remain idle in demand accounts. Conversely, if you are unable to inform your banker accurately as to the amount and timing of your credit needs so that he can plan for the funding of loan requests, and if the cash balances maintained are inadequate to compensate the bank for the services it provides, you probably are not his friend at all. The money manager should recognize his banker's need to earn a reasonable profit and to receive accurate information about the company's plans and requirements. If he does so he may learn that, especially in times of tight money, his banker is in actuality his best friend. ●