A Contractor Risks Embarrassment When He Exhausts His Cash Reserves So Cash Flow Planning is Vital to Continued Profitability

Determining Your Cash Needs

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Cash represents an essential investment in every business. Indeed, a construction business risks financial embarrassment anytime it exhausts its cash reserves. That embarrassment may develop from the failure to pay its bills on time. Or it may arise when the business bounces some checks because anticipated cash receipts don’t materialize.

At the same time, a business shouldn’t carry excess cash in its bank account. After all, excess cash sitting idle in a checking account doesn’t generate any income for a business. Instead, a business should invest any extra cash in income-producing assets—e.g., additional inventory, new equipment, or perhaps merely a certificate of deposit. In any event, cash management centers on a trade-off. A business should carry enough cash to avoid financial embarrassment, but no excess.

Obviously, the operating cash balance that achieves that objective varies among businesses. But the process that provides a reasonable estimate of the proper operating cash balance for a business is the same in any circumstance. That process views a firm’s operating cash in a manner analogous to its inventory.

Thus, a firm’s average daily expenditure requirements set the minimum level of cash a business should have in its bank account. Ideally, a business should begin each day with a cash balance that equals that day’s anticipated expenditures. Presumably, the business also should expect receipts each day sufficient to meet the following day’s expenditure requirements. Any business in that circumstance would have no excess cash.

Unfortunately, no business controls its cash flow in a manner that approaches that ideal. Consequently, a prudent business owner adds some cash safety stock to his minimum required operating balance.

From one perspective, that safety stock enables a business to meet unforeseen expenditure requirements. From another perspective, cash safety stock helps absorb the shock from a shortfall in a firm’s anticipated cash receipts. From either perspective, carrying a reasonable inventory of cash in excess of that required for anticipated daily expenditures makes good business sense.

A contractor also may justify
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another addition to his cash inventory. That justification develops when his firm frequently encounters profitable opportunities that require cash. For example, a business may have intermittent opportunities for low-cost purchases that require immediate cash payment. Or a supplier in a cash bind might offer a business a discount in exchange for accelerated payment for a purchase. Or, cash may be necessary to purchase a product necessary to meet a good customer’s immediate needs. In any event, when such opportunities are a common occurrence, a business can justify a cash balance that initially appears excessive.

Of course, our primary concern centers on the proper cash balance a business needs for normal operations. That is the balance necessary to meet its normal, anticipated expenditure requirements plus a reasonable cash safety stock. Identifying that balance begins with the calculation of a firm’s average daily cash expenditures over the most recent three (or, perhaps six) months.

For example, assume a business paid out $150,000 in cash during each of the last three months. Using a standard thirty month in the calculation, the firm’s average daily cash outflow becomes:

\[
\text{Average Daily } = \frac{\text{Monthly Cash}}{\text{Expenditures}} = \frac{150,000}{30} = 5000
\]

Thus, to meet its average daily expenditure requirements, the firm should begin each day with at least a $5000 cash operating balance. Of course, that total represents a minimum requirement. As noted above, a business should carry some cash safety stock to decrease the risk of not meeting its obligations on time due to an unforeseen gap in its cash flow.

Below we review the factors that influence the size of the cash safety stock a business needs to avoid financial embarrassment. However, we will note here that the proper cash balance for a business—including its cash safety stock—typically represents a multiple of its average daily requirements.

Thus, proceeding from the above example, assume that cash sufficient to meet five days’ average expenditure requirements provides adequate safety stock for the business. Thus, we find the firm’s minimum required cash safety stock as follows:

\[
\text{Average Daily } \times \text{Days’ Safety } = \text{Total Cash Expenditure Stock Safety Stock}
\]

\[
150,000 \times 5 = 750,000
\]

Thus, the firm in this instance needs $25,000 in cash safety stock to absorb unforeseen demands on its expenditure requirements, or delays in anticipated collections. Adding that amount to the firm’s normal daily $5000 cash expenditures makes its proper cash operating balance total $30,000. Presumably, that cash balance will meet the firm’s normal requirements, while providing a reasonable cash margin for errors.

Unfortunately, the arithmetic process that identifies a firm’s proper cash operating balance implies a misleading impression of management precision. Indeed, determining the adequate safety stock for a business calls for management judgement that inevitably involves uncertainty. In fact, the cash safety stock necessary to avoid financial embarrassment, while avoiding excess cash balances, depends upon several variable factors.

First, recognize that in any circumstance the average daily expend-
iture calculation disguises fluctuations in a firm’s cash requirements at different times during any month. The more volatile a firm’s day-to-day cash requirements, the less reliable the average daily expenditure total becomes as a basis for determining its proper cash balance. In many circumstances, fifty, sixty, or seventy percent of a firm’s total monthly expenditures occur during a five or ten day period during a month.

That doesn’t alter the management technique for determining a firm’s cash operating balance. However, it suggests that a business should alter the size of its operating balance to accommodate those peak periods. Thus, a business may need to carry a larger balance during peak expenditure periods, while reducing the size of that balance when expenditures and collections are more predictable, or occur on a smaller scale.

For example, assume that the bulk of the cash outflows for the above business occur from the ninth through the thirteenth of each month. During that period, average daily cash expenditures reach $10,000 per day. Presuming the same number of days’ safety stock, the business should enter that five-day period with a $60,000 cash balance—i.e., the $10,000 average daily requirement for the period plus five days safety stock.

Of course, the need for the larger balance diminishes as the business moves towards the end of the peak period. Realistically, that $60,000 total represents the appropriate balance for the ninth day of the month. Then, the need for that balance drops towards the $30,000 level as the business moves towards the thirteenth.

The predictability of a firm’s cash receipts also influence the size of its necessary cash safety stock. More reliable customer payment habits enable a business to operate with a smaller cash cushion. Erratic customer payment habits raise the need for a larger cash safety stock.

At the same time, a business that can defer payments to accommodate its available cash can reduce the size of its safety stock. That potential exists when a business can defer payments to its suppliers without sacrificing cash discounts or impairing future credit consideration. No business should abuse a supplier’s patience. But accommodating suppliers can reduce the size of a firm’s necessary cash safety stock.

Finally, we should note that a business with access to borrowed funds also has less need for a large cash safety stock. A business in that circumstance can fill a temporary gap in its cash flow with a loan. That eliminates any problem that might develop from unanticipated expenditure requirements or expected customer receipts that fail to appear.

In any event, it should be apparent that the process that determines the proper operating cash balance for a business requires an adept mixture of management science with management art. A significant potential for error exists in any circumstance. Hopefully, that error will leave a business with a bit too much cash, rather than not quite enough. Indeed, the former error is less painful than the latter.

At the same time, the lack of precision doesn’t eliminate the potential benefits you can gain from an effort to control the size of your operating cash balances. To anticipate those benefits, imagine the profits that can develop from employing the excess cash that now sits idly in your checking account. It takes only a little imagination to justify the effort to determine your proper cash needs.