Managing the Cash Problem

In These Inflationary Times, the Problem of Cash Management Shouldn’t be Let to Chance

Many construction executives are concerned with how to ensure a positive balance in their cash accounts.

Their concern is warranted because, even when operations are profitable, negative cash flows can occur. It is not unusual, particularly in a small construction operation, for the cash situation to be left to chance, with little real effort expended in planning or managing cash flow problems.

Even in those organizations that have addressed the problem of providing basic financial data for decision making, the problem of cash management is often not analyzed from the correct perspective.

The system must translate the cash needed to meet unplanned contingencies (such as overruns) or planned expansion of operations (such as new contracts) into projected cash requirements in addition to the cash needs resulting from regular business operations.

The output of the system, a cash flow forecast, should be prepared on a regular basis, preferably monthly. This procedure allows management to determine the impact of anticipated future events on future cash balances. Thus, management is able to arrange credit lines before they are needed or to cut back expansion plans if they cannot be supported by available or borrowed cash.

Further, management often finds that a statement of projected cash needs, which carefully spells out requirements and assumptions used, assists in “selling” a lender on making a loan commitment, since it indicates to the lender that management has the capabilities to plan as well as to manage the business.

Planning System

The planning system needed to provide information on cash requirements is supported by a combination of planning information and historical accounting data, and...
its output must be analyzed on a regular basis. The exhibit presents a graphic representation of the sources and flow of data.

The starting point—the actual cash balance at the time the plan is prepared—is obtained from accounting records. Information on future cash receipts may be available from a variety of sources, depending on the nature of company operations and the internal information available. It will usually be a combination of accounting data and plans, translated into dollars.

Potential sources of future cash receipts are aged accounts receivable data, schedules of planned construction draws, and sales forecasts. All of these sources of information contain an element of uncertainty and should be based upon a thorough analysis of historical trends as well as anticipated events.

Adjustments to these amounts should be made on a continuing basis as assumptions are shown to be incorrect or other variances from plan are perceived. If internal record-keeping systems do not provide accounts receivable information in the form required, some manual effort will be needed to analyze the timing of potential collections for use within the planning system.

Once cash receipts have been forecasted, the planned level of cash disbursements must be estimated to complete the cash forecast.

Cash disbursements which reflect the normal level of business operations may be estimated and calendarized from accounting data, such as payroll reports and accounts payable agings, if regularly prepared.

If accounts payable aging data is not available, it will be necessary to classify invoices by their anticipated month of payment for inclusion in the forecast. Because this may be a large manual task, it is preferable to establish accounts payable agings as part of the normal procedures for processing accounts payable.

In fact, effective cash management dictates the need for thorough procedures in this area, including, at the minimum, a monthly forecast of such payments for analyzing cash needs.

The input of invoices and payroll expenses alone does not provide a complete perspective on cash disbursements within the cash forecast. Two essential considerations are also required, both related to the planning perspective.

These are purchase commitments and special purchases. Purchase commitment requirements are determined by pricing out committed or approved purchase orders for which invoices have not yet been received. Such commitments must be analyzed to determine the expected receipt date of the materials or services and the resulting profile of payments by month.

Special purchases not made in the normal course of operations, such as capital equipment purchases, typically represent significant amounts. Therefore, it is very important that they be included in the cash plan.

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All exceptions to planned costs and their resulting cash disbursements must be reflected in the cash plan. In the job cost area, all variances from original budgets must be identified on a timely basis.

The most efficient method to identify these variances is to perform a regular "cost-to-complete" analysis of all active jobs by determining the current percentage of completion and total incurred costs to date of each job and estimating costs required to complete the job. Estimates of costs to complete the job should be determined by including not only the original budget for the remaining construction stages, but also contingencies which may affect remaining costs, such as material damage or loss.

Such an estimate would be available if a formal job cost analysis is performed on a regular basis with input from field supervision.

If a formal system of job cost analysis is not available, good communication between company management and job site project managers provides some basis for decisions on unplanned job costs to be considered in the forecast. This communication can be accomplished by regular written job progress reports or formal job status meetings.

Another, more subjective consideration related to job costs is the projection of price changes for materials and labor. In times of significant inflation, price increases can significantly change a contractor's cash requirements profile.

An example is the volatile wallboard prices over the last few years. Differences in the original job budget and the calculated estimate at completion resulting from the estimated price changes should be carried directly to the cash forecast statement after determining the month in which they are likely to be reflected in actual cash disbursements.

The projected cash requirements—the output of the system—should be analyzed monthly to provide an effective tool for managing the cash problem. The actual cash forecast statement can also be prepared on an "as needed" basis to provide an analysis of the effect of special events, such as new contracts, on the company's cash position.

In either case, the cash forecast furnishes management with an effective representation of cash needs for internal or external analysis. The exhibit shows a simple example of a cash forecast statement. This example should be expanded to include the detail appropriate for each company. However, the key to successful use of such forecasts is their formal preparation on a monthly basis and participation of appropriate personnel in obtaining information which properly reflects future needs.

**Other Considerations**

Although the forecasting system suggested here will facilitate the management of cash flow, the procedures and perspective it requires will provide other benefits. Even if the contractor does not have formal systems to provide the needed information, the informal analysis and communication that is required to develop the forecast will assist in overall management of the company.

For example, communications from field supervisors on continuing shortages or loss of materials may indicate that stronger controls are needed over the receipt and storage of materials. An analysis of the cash position may indicate that the timing of retainer agreements and the percentage paid for retainers cause a cash squeeze and may encourage the negotiation of different contract terms in the future.

The point is that information accumulated for preparation of a cash forecast has an added benefit: it can help the contractor achieve better overall management of the company by providing a basis for management action to implement improvements in other company operations. These benefits, in addition to effective cash management, will provide a substantial return on the investment in time required to support the system.

(Editor's Note: The author, Robert J. Salvaria, is with Touche Ross' management services department in Los Angeles and is a respected authority on cash management in construction.)