Cash management, treated as an art form rather than a discipline by some of its practitioners, has really come into its own only in the past decade. Of course, many major corporations have had highly sophisticated cash management operations for a long time, but they are exceptions in that these companies represent a tiny fraction of the business organizations for whom professional cash management might have been beneficial, and profitable, over a long period of time.

Up until 1967 or thereabouts, historical trends in the cost of money worked against the need for maximizing the potential profit to be earned from intelligent and disciplined cash management. In the 20 years immediately after World War II, interest rates for large borrowers rarely rose above 6 percent. Given the overhead costs then required to maximize cash flow and to manage short-term investments, potential profit from these activities was slim. Only major companies with the leverage of substantial cash flows found the effort really worthwhile.

The upsurge of interest rates since the late 1960’s changed the ground rules. With borrowing rates ranging upward from 8 percent, and mortgage money in the 10 percent range, the cost of money has been an important factor in business in the past decade. In fact, it has been significant enough to have been the principal cause of bankruptcy for countless contractors during the frequently recurring money crunches.

Many economists are now convinced that the United States, given the many factors at work in the world business community, will never again experience an extended period of cheap money. If that is the case, the techniques of professional cash management that are now more or less limited to the large corporations will have to be learned and applied by smaller companies.

For some, it could be a matter of survival. For many, the competitive balance is at stake, for the higher the cost of money, the greater the impact on the cost of delivering goods and services.

Too often the need for a cash management program is not realized until the situation becomes critical. The following scenario is a very familiar one. It typifies those businesses guided by reactions to crisis rather than by planning and control.

The “Jones Company” is a medium-sized contractor. It has been operating successfully for 25 years. In the past ten years, its growth has been dynamic. In that period, volume increased over 100 percent. However, the bottom line results have not kept pace with the growth in volume.
“... the techniques of professional cash management that are now more or less limited to the large corporations will have to be learned and applied by smaller companies.”

The founder of the business was a successful entrepreneur who ran the organization until his death in the early 1970s. He managed largely on instinct, or on the seat of his pants, as he put it. The founder had an abiding suspicion of financial analysis. Fortunately, his instincts were good and his understanding of the business so thorough that the business prospered in spite of the lack of financial data and formalized planning and control.

Lacked Expertise

His successors in management did not have his intuitive sense about contracting. They lacked the information systems they needed to make decisions. The results they achieved were not comparable to earlier years, but acceptable to the heirs who now controlled the company. Management was under no external pressure to correct its lagging profit picture. They tended to blame the shrinking margins on inflation, low bid prices, and on factors relating to the company’s growth, particularly on costs involved in material price increases.

In order to get a penetration in Area “X” and to reduce costs, “Jones Company” decided to construct a satellite office. The fact that the company would have to borrow money at the then 7 percent prime rate to cover its additional working capital requirements caused by the move was not found onerous. Management felt that once the new warehouse was in operation, overall costs would drop and the profit picture would improve.

After the new facility was completed, the “Jones Company” found that the costs increased more than anticipated. Operating costs did not drop, as expected, and interest rates rose dramatically. To make matters worse, the banks demanded interest rates in excess of prime and refused to increase the line of credit. The company was caught in a classic cash and profit squeeze. Management reacted to the crisis by calling in consultants to analyze its operations and make recommenda-
tions to improve the branch’s cash flow. The consultants’ analysis turned up a number of weaknesses, the most glaring of which was the lack of adequate information on which to base management decisions. Warehousing was largely a matter of guesswork. Some items were overstocked while many fast-moving items were constantly out of stock. Expensive charge orders at marginal profit were not uncommon. Inventory was also found to be unbalanced as between the two warehouses (short in one while over in the other).

The analysis also revealed that some customers were only marginally profitable, if at all. Certain accounts were getting extended terms for progress payment.

The company was paying its suppliers within 30 days of receipt of the invoice, which often arrived days before the merchandise. That practice was maintained in the past out of a sense of pride rather than necessity. Management believed it was getting better service from its suppliers than its competitors and locked itself into the practice. Customers, on the other hand, were taking up to 90 days or more to pay their bills. Therefore, as volume increased because of the new branch, the cash crunch became more severe.

Many of the weaknesses found in the “Jones Company” would take time to correct. The development of information systems adequate for management purposes usually requires a long lead time to develop and implement. This is especially true of inventory control systems, which are usually complex and require large expenditures of time, effort and money to design, implement, and perfect. The “Jones Company” management was resourceful enough to use whatever information was available to change its procedures as required.

Happy Ending

Our story has a happy ending in that the “Jones Company” was able to negotiate with its suppliers for extended terms without affecting prices and the level of service. It raised its bid prices on those jobs which were marginally profitable. It hired a new branch manager, who reduced the size of the past-due account category without antagonizing customers. The company was able to resolve its cash flow problems. The information systems it developed and management’s ability to plan and control made the company more profitable than ever. The interest it earned on the excess funds generated by its continuing aggressive cash management program contributed to its profitability.

The saga of the “Jones Company” demonstrates how a resourceful management can help itself out of a crisis situation by a careful analysis of the problem and the will to institute corrective measures. However, the institution of a cash management or any other profit-improvement program need not await the advent of a crisis. Certainly, cash management can be beneficial to a company that is not experiencing cash flow problems. Such a program can make funds available for investment at very attractive rates. What is even more attractive about this result is that it increases profits without requiring any increase in production facilities, investment, or measurable risk.

Some of the more sophisticated cash management programs make full use of the bank account float to maximize the funds available for investment. This is sometimes referred to as “playing the float.” It involves taking advantage of the normal time required for checks to be received by creditors and processed for collection. The undrawn funds remaining in the bank account during this period are available for investment in highly li-
Liquid securities, such as treasury bills, commercial paper or certificates of deposit. It requires close coordination and cooperation with the company's bankers to make sure that funds are always available to cover possible overdrafts. Needless to say, if compensating balances are required under bank loan agreements, the float may not be available for investment.

The zero balance bank account approach to cash management is often difficult for smaller or medium-sized companies to accept. The use of liquid short-term investments as a substitute for cash seems on the surface to fly in the face of conservative wisdom. Very often a company grows because of rigid adherence to the tenets of facial conservatism. Such attitudes, which work well for a business in its formative years, often survive their usefulness when the company has grown relatively large. The reverence for large "cold" cash balance idles resources that could be used to maximize profitability.

The ideal circumstances for cash management are where there is a steady, regular inflow of money and a similarly steady disbursement of funds. In the real world this rarely occurs. This requires the development of detailed plans and controls to monitor the flow of goods, services and cash. One of the steps in this planning process is the development of cash budgets which take into account the timing difference between a transaction and the related cash flow. In this manner, budgeting of cash inflows and outflows provides management with the probable cash position, provided operations proceed as planned. The budget forecasts cash excesses or shortages, and thus provides the opportunity to invest idle cash, or the need to delay disbursements, or to borrow funds.

**Must Be Accurate...**

In budgeting cash receipts, the principal problem is the development of an accurate method for predicting the collection of accounts receivable. This requires the accumulation of statistics on which to base collection forecasts. It also requires reliable records to compare actual performance with budgeted amounts.

The budgeting of cash disbursements is based upon the planned flow of physical goods. The timing of payments for raw materials, labor, expenses, capital expenditures, etc., provides the basis for projecting cash requirements. Here again, an historical base is required to forecast the timing difference between acquisition and payment for goods and services.

The planning process and the preparation of budgets are totally integrated steps. Planned cash inflow is based upon sales forecasts. The sales predictions, in turn, serve as the base for planning inventory levels. Inventory, in turn, is the basis for budgeting purchases of raw materials, for labor, and for other direct and variable expenses.

The preparation of the cash budget is an essential step in the cash management program. Equally important is the requirement for timely and accurate records which reflect actual
cash inflow and outflow. These must be compared with budgeted amounts to assess the validity of the planned cash position. Variations from the plan may signify the availability of additional cash for investment. On the other hand, a negative variation may require that management take immediate action to cut back on projected expenses, defer capital expenditures, increase its collection efforts, etc. The important thing is that management should not be the victim of unforeseen circumstances. By planning and budgeting it is able to take measures to avert a cash crunch. This is the advantage of management by planning and control, as opposed to management by reaction to crisis or “dead reckoning.”

The existence of plans, budgets and accurate timely records permits managers to chart a more profitable course. This includes the ability to maximize the funds available for investment. Through good planning, budgeting and control, managers can take a more aggressive posture in their money management strategy and increase the profitability of their companies.