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Sitting on Idle Cash Costs the Company and Shareholders

Cash is often referred to as a "non-earning asset". Cash and cash equivalents swept into liquid investment accounts earns very little return. Cash is needed to fund current operations, provide compensating balances for the banks to maintain favorable credit ratings, to take advantage of vendor and supplier discounts, to fund capital projects and for speculative or emergency needs such as an acquisition of another firm. The amount of cash a company holds should be based on its annual cash budget, which should define the amount required to meet these needs.

Excess cash that is not put to use to grow market share or fund other growth initiatives, or to reduce debt or pay shareholders, has a cost to the firm and shareholders in the form of lost opportunity cost. Holding excess cash reduces overall return on assets (ROA).

Shareholders prefer to see the cash earning more than it can in bank accounts or short-term instruments. That preference often translates into pressure for the firm to buy back shares, pay dividends, or increase existing payouts if management can't identify promising prospects for acquisitions or new capital investments. Payouts to shareholders allow them to diversify their investments and provide opportunities for them to realize higher returns. Debt holders, on the other hand, would rather see companies maintain plenty of cash to cover their interest and principle burdens.

Choosing between debt reduction and share repurchase as a use for excess cash wouldn't be a cut-and-dried matter of arithmetic even if companies didn't have to worry about bankers' conditions or credit ratings. That's because it's far more difficult to accurately estimate the cost of equity than that of debt. The appropriate risk premium to be added to the price of equity has long been subject to debate, whereas the premium for debt is widely accepted to be the spread between its current interest rate and that on comparably termed Treasuries.

As for spending cash on acquisitions, there's plenty of risk that a deal will produce less than what a company has earned in the past. Yet management seems increasingly confident that they can effectively deploy excess cash in new investments. The value of M&A activities worldwide increased 37 percent during the first six months of 2004, with more companies using cash rather than stock to fund the deals.

Decisions as to how best to deploy excess cash should be based on the firm's capital budgeting process. Through capital budgeting, management examines the viability of investments and projects based on the expected future cash flows and compute the net present value (NPV) and internal rate of returns (IRR) for its capital options.

A cash management scorecard can be used to calculate the returns that companies would generate by paying down capital employed (debt and equity including retained earnings) with the excess amount of cash on their balance sheets. To calculate the opportunity cost of excess cash, first figure out how much of a company's cash exceeds its industry benchmark, using the lowest quartile in a given industry as a % of sales. Then subtract the excess from the amount of capital a company employs. The company's return on capital employed is then compared with what the return would be after excess cash is used to reduce the amount of capital employed.

Industry benchmark information can be obtained from published sources such as ***RMA Annual Statements Studies***.

If you need assistance determining how your firm stacks up with its cash position, and also with your capital budgeting process, please contact Harvest CFO Consulting by telephone 724-934-4752, or e-mail dhillier@harvestcfo.com. Also, please visit our website at www.harvestcfo.com.

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