



WHAT IDLE CASH?

A couple of weeks ago I was paging through a series of annual audit reports on a Washington agribusiness firm. These reports indicated that the firm was financially healthy, doing well competitively, and responding favorably to the vigorous direction of its manager. However, one seemingly small item in the audit reports caused some concern. The audits seemed to show excessively large cash balances over the years. At the first possible opportunity I asked the manager, "Is there a particular reason for the large amount of what seems to be idle cash in each year's statement of current assets?" The manager was rather surprised by the question, replying, "What idle cash? There are times during our busy season when we barely have enough cash to meet our day-to-day requirements."

Strange as it may seem, we were both correct in our observations. A closer look at monthly cash flows revealed a relatively low cash carryover during the three months of peak business activity. However, during the other nine months, cash balances in the form of demand deposits (checking accounts) often exceeded \$30,000. This idle cash balance represented an unused resource, i.e., it was being held as a contingency against the forthcoming peak season and remained inactive until that time. These funds were failing to earn a return during nine months of every year. The costs associated with other unused assets were readily recognized by the manager. In fact, during the off-season this particular firm leased some of its loading equipment to other local concerns in an

attempt to increase their returns from these assets.

Unfortunately, the manager failed to associate any real cost with the holding of idle cash balances. Agribusiness firms which experience great seasonal variations in business volume are particularly susceptible to this failure. A look at a firm's month-to-month cash balance is often indicative of the "feast or famine" nature of its operations. It is not unusual to find agribusiness firms conducting 90% of their annual dollar volume of business during a three month period. Some firms cease operations completely for as long as six months or more every year. What your idle funds are doing during these periods of business inactivity is quite important.

Are your idle funds earning a return, or do they remain unproductive during the off-season? Are you aware of the costs of idle cash or have you failed to realize that cash, like other assets, must be FULLY used if it is to make its maximum contribution to profits?

Can You Afford Idle Cash?

Twenty years ago, the typical agribusiness manager had less reason to study the nation's money market for the purpose of making short-term investments. His job was to make sure the firm maintained adequate cash reserves to meet daily requirements, plus a contingency fund. A sizeable cash balance at the end of the busy season was looked upon as a "safety measure" or a "necessary carryover" for next year's activity. The manager was not expected to employ imagination and foresight in the use of these

idle funds. More often than not, post-depression conservatism prevailed and idle cash balances, far in excess of immediate needs, were maintained over extended periods of time.

Times have changed. Most agribusiness firms can no longer afford the luxury and cost of idle cash. Of course, a manager must still retain enough cash for operating needs and emergency purposes, but during periods of low business activity, he should be encouraged to invest idle cash and keep these funds working for the business through the entire year. In order to perform this latter function proficiently, the modern-day agribusiness manager must be familiar with this nation's money and security markets, their attributes and characteristics.

Even a small firm with a few thousand dollars available for just a few days can often earn a profit. Naturally, it is likely to be a small profit. However, if this procedure is repeated often enough during the year, the small profits become more meaningful and often represent a large portion of the firm's total profits.

I am not suggesting that agribusiness managers immediately drop their normal managerial efforts and become money market speculators with their firm's finances. On the contrary, I am proposing that money market investments be considered ONLY when excess cash appears or is anticipated, and when the manager is knowledgeable enough about the money and securities markets to make such investments wisely. Then I am suggesting entrance into the money markets at a risk factor which will complement your normal type of agricultural activity. That is, if your firm is in a high-risk agricultural industry, you may use (and need) the security of relatively safe investments in the money market during your off-season. On the other hand, if your agricultural business has proven

relatively stable, and your board of directors approve, more risky investments of excess cash may be warranted to enhance profits. In the final analysis, if your firm does carry an excessive idle cash balance over several months, the only thing you cannot afford to do is allow those funds to remain idle. The costs, in the form of sacrificed income, of holding idle cash balances are tremendous when considered over long or multiple time periods.

A Relatively Simple Procedure

Generally speaking, idle cash balances appear in two different forms: (a) compensating balance, or (b) seasonal carryover. The first form can only rarely be found in the agribusiness industry, while the latter is quite prevalent and appears under numerous titles, e.g., cash, unallocated reserves, and accumulating funds designed to cover a major impending expenditure.

Compensating Balance:

When a business opens a line of credit with a bank, or borrows money from it, security of some kind must be provided. Security can be provided by a claim to the ownership (a mortgage) of a physical asset. Another form of security, less common to agriculture, is called a compensating balance, i.e., the bank requires the business to maintain a compensating cash balance in its checking account of from 10 to 20% of the total amount of the loan. With a mortgage, the business can utilize the mortgaged asset even while the bank carries claim to its ownership. In the second case, the compensating balance has no usefulness to the business, i.e., the funds must remain on deposit and, therefore, idle.

To avoid the cost of this unused capital, the firm may ask the bank to remove the compensating balance requirement in favor of a guarantee that the checking account will return them an annual profit. The idle funds

are then invested in the money market, perhaps under a bank lien, with monthly gain or loss reports then being prepared. A loss during one or two months is not too startling so long as off-setting gains appear prior to the end of each year.

Seasonal Carryover:

Seasonal carryover represents the liquid cash balance on demand deposit at the end of the season of heavy business activity. There are two procedures a manager may take to increase the proportion of this seasonal carryover which is available for investment.

The first procedure is a speed-up in the transfer of cash receipts from his business to the bank. Each day the payment remains "in process" is a day of inactive cash utilization. If your agribusiness firm has several sub-stations or regional offices, each using a local bank, you may wish to convert to the use of bank wires which would enable you to quickly transfer the funds to a central account.

The second procedure relates to the use of lock boxes, i.e., U.S. Post Office boxes enabling your customers to send their remittances direct to your bank rather than to your business. Banks pick up the remittances, process them the same day, and send your firm a list of payments. By following this procedure, your money reaches your bank account perhaps two days earlier.

How do you determine what proportion of your off-season cash balance should be made available for short-term investments? Your board of directors should establish a minimum account balance which they feel must be maintained at all times to cover emergencies and daily operating requirements. This minimal balance need not be a constant figure throughout the year, but should be related to normal seasonal requirements. Anything in excess of this

minimal amount should be made available for short-time investments. Within the guidelines of the policies and procedures formulated by the directors, the manager should have sole authority to decide when and how deeply to enter the money and securities markets. This degree of autonomy is vital to timely decision-making, i.e., this will enable the manager to take advantage of a favorable market without losing time.

Investment Alternatives

There are several alternative investment opportunities available to firms with idle cash balances. In some cases these investments are made for as long as one year, while others are designed to act over periods as short as three days. These investment alternatives include:

U.S. Government Obligations:

A major government obligation is the U. S. Treasury Bill. This Treasury bill does not bear a stipulated rate of interest. However, they are sold regularly at a discount from their face value and may mature over one year or less. The discount rate, of course, varies with the current short-term commercial rate of interest.

Other government investments include interest bearing bonds, certificates, and notes. Each is available for purchase in the open market, with their rate of return also varying with day-to-day conditions in the money market. Often particular agencies of the government, rather than the government itself, issue interest bearing obligations. Such agencies include the Federal Land Bank, the Federal National Mortgage Association and various redevelopment agencies located throughout the country. Generally speaking, the interest rate on these obligations exceed those attached to U. S. Treasury obligations.

Certificates of Deposit:

Certificates of deposit are marketable claims to funds that have been deposited with a bank for specified periods of time earning a stipulated rate of interest. Such certificates appear in two forms: (a) non-negotiable, and (b) negotiable. Both bear a rate of interest, and both are issued by commercial banks.

Non-negotiable certificates are those issued in the name of the person or company making the deposit and cannot be redeemed until the due-date.

Negotiable certificates are made payable to the bearer and are usually handled (sold) only by large banks and brokerage houses. They carry an interest rate which cannot exceed a maximum established by the Federal Reserve System. However, they are commonly bought and sold in the so-called secondary markets at the prevailing rates of interest.

Banker's Acceptances:

Drafts drawn in connection with instructions from a bank (often a foreign bank) to make a payment to the holder at a future date are referred to as banker's acceptances. Since the bank which is guaranteeing this payment has not yet received its money, it sells acceptances; the buyer provides the money in return for a stipulated rate of interest.

Tax Anticipation Bills:

A firm buying tax anticipation bills is really paying its taxes prior to the date they are due. For doing so, the U. S. Treasury pays interest to the firm on the amount paid. For example, your business may buy a bill yielding 6% interest and having a due-date of April 22. However, let's assume that your estimated taxes are due on April 15. As a result of your purchase, your firm obtains an extra week's interest by buying the tax anticipation bill. Again, large brokerage houses make up the

secondary market in this investment alternative.

Commercial Paper:

It was not long ago that commercial banks frowned on commercial paper. Now commercial paper is accepted as a method of borrowing short-term funds and investing idle cash. In fact, it's now a major factor in this nation's money market.

Commercial paper, of course, is merely a written promise by the seller to pay the buyer a certain sum of money on a certain date plus a certain interest charge. Commercial paper can be purchased direct from an issuing business: hundreds of which are super-sound investment risks. Commercial paper may also be purchased from a broker who has made the direct purchase and resells to you for a profit.

If you buy direct, the seller may stipulate a due-date as short as three days and agree, upon maturation, to deposit the borrowed money in any bank you choose. If you buy through a broker, however, a maturity of 15 days or more can be expected and you are expected to hold the paper until that date.

Once you become more experienced in money market maneuvering, you may prefer to deal with a commercial paper broker by means of a repurchase agreement; often referred to as a repo agreement. In a repo agreement, you agree to buy a piece of commercial paper, and the seller agrees to re-buy it on a certain date. Such agreements may mature over as little as three days. As a result, many large businesses use this alternative to invest idle cash for a weekend only. The repo agreement, of course, enables you to shift your reliance on the issuing company over to the brokerage house.

What About the Risks?

There is actually very little internal risk involved in short-term investing of idle cash in any of the ways listed above. By this I mean there is very little chance that an issuing firm or agency will fail to meet its written obligation which you have purchased. The real risk, therefore, is more directly associated with your understanding of the nation's money market and how it works. Investing idle cash, as suggested above, for short periods of time is not for beginners. It requires intelligence, perseverance, and imagination on the part of the manager. If you are unable to spend much of your off-season time observing the money market movements, perhaps you had better look elsewhere for your investments, do without, or ask your bank to suggest alternatives. On the other hand, if you have both idle time and idle cash during the slack season, along with a talent for making profitable business transactions, the money market provides an excellent opportunity whereby idle cash balances can prove both useful and profitable.

Disadvantages

There are, of course, some disadvantages associated with the investment opportunities mentioned earlier. For example, if your firm should suddenly develop a need for the idle cash which you have invested, you may be totally unable to get it, at least not without

paying a penalty. Commercial paper cannot be redeemed prior to its due-date and although government obligations, certificates of deposits, and banker's acceptances are sold on the open market, they sell at the prevailing interest rate. This rate may have increased since the time the investment was first made. Substantial losses can thereby be accumulated by the unsuspecting novice investor.

Summary

Many agribusiness firms do an excellent job of utilizing all their physical assets to the maximum. These same firms, however, may fail in the utilization of their more liquid assets such as large idle cash balances which appear in the accounts during the slack season. Cash, like all productive resources, should be fully employed if the firm is to earn a maximum profit. In short, idle cash shouldn't be idle. It should be kept busy throughout the year contributing towards the firm's total profit. The nation's money and securities markets provide several opportunities for the employment of such funds. Before entering these markets, however, agribusiness managers must have a thorough knowledge of the various investment alternatives and be prepared to spend much time studying money market conditions, movements, and characteristics. Talking with your banker or financial counselor is always a good place to begin.

Agribusiness Management Manual

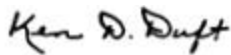
An agribusiness management manual titled, "Statistical Decision Theory: An Aid to Agribusiness Management" printed by the Department of Agricultural Economics and Cooperative Extension Service, Washington State University, is also available online in a pdf format. You may download it for free if you wish.

Addendum

Following the distribution of the above issue of “Agribusiness Management”, I received a letter from Mr. Riley E. DeLap, Vice President, Agribusiness Services, First National Bank of Oregon, calling my attention to two items. In regard to my statement that in establishing a line of credit “...security of some kind must be provided,” Mr. DeLap noted that in some cases this security may be of an intangible nature. Second, Mr. DeLap noted the requirement of maintaining a specified compensating balance ordinarily applies only to large or national credit accounts who are entitled to minimum interest rates, or to borrowers that require a fairly constant flow of credit such as a finance company.

In regard to both items, I acknowledge Mr. DeLap’s statements and accept their addition to my original text. I welcome comments such as the above relative to any issue of this newsletter.

Sincerely,



Ken D. Duft
Extension Marketing Economist