The Elusive Cash Balance Case

Student Name

Name of Institution

The Elusive Cash Balance Case

**Question 1**

Hunt Distributing Inc. has a working capital management problem. The main issue is its inability to collect accounts receivable in full and in a timely manner while a significant proportion of operating expenses are paid in the period they are incurred. The owner’s decision to extend lengthy credit periods to customers whose payment ability was not verified has contributed to this problem. The majority of the company’s revenues were collected two and three months after the sale occurred while 3% of revenues were not collected at all. The delay in cash collection results in cash shortages especially in high sales months that follow period of relatively low sales. For example, the projected sales in April are relatively higher than the projected sales in January and February. April has a significant cash shortage since a significant proportion of the cash collected in April relates to sales made between January and March. At the same time, the salaries, utilities, and other expenses incurred in and paid during April are based on the higher sales revenue recorded in April. As a result, the cash disbursed in April is not sufficient to cover April’s expenses.

**Question 2**

To begin with, the company’s cash position has decreased drastically since 2013 despite the increase in revenues and net income. The company’s 2015 revenues and net income were 53% and 55% higher than the 2013 values but the ending cash position is 64% lower. Additionally, Hunt’s ending cash position in 2015 was equivalent to 20% of its net income, down from 86% in 2013, which calls into question the quality of the company’s earnings.

Of even greater concern is the substantial increase in short-term debt. The company is relying on short-term borrowings to finance operations. This comes at the expense of reduced profitability as the company incurs considerable interest expenses from short-term financing. Furthermore, the company’s inventory management has worsened with more cash tied up in inventories. In 2014 and 2015, inventories were equivalent to 16% and 13% of total sales, which is higher than the 8% from 2013.

**Question 3**

Patrick should prepare a monthly cash budget. The monthly cash budget is more beneficial than the quarterly budget since cash collections and cash disbursements vary widely from month to month. This means that in a given quarter, the cash collections could exceed the cash disbursements giving false confidence in the cash sufficiency when a given month could have significant cash shortages. A monthly cash budget will provide a more accurate picture of financing needs in the upcoming year and allow management to develop a sound financial plan.

**Question 4**

An assumption made in projecting cash collections is that all sales occur at the end of the month. This assumption is appropriately conservative and will reduce the likelihood of actual cash needs exceeding the projected cash needs. In the calculation of the interest payment, it was noted that in all three years, the company paid $16,000 more in interest than would be expected after accounting the 10% interest on the bank loan. Given the long-term debt of $200,000, the implied rate on the long-term debt is 8%. Salaries, utilities, and other expenses were assumed to vary with sales while depreciation was held constant. The 2015 tax rate of 35% was assumed to be applicable in 2016.



**Question 5**

The months that are most vulnerable to cash deficits are the high sales months that occur after periods of relatively low sales – December, April, and November. Only February and March had surplus funds.

**Question 6**



In the creation of the financial plan, it was assumed that the company would invest any cash surpluses above the maximum allowable balance of $85,731 regardless of whether there were outstanding loans of not. The company would sell its investments before borrowing to meet the minimum balance of $71,443 and an ending balance between the minimum required balance ($71,443) and the maximum allowable balance (85,731) would be held as a cash surplus as was the case in October 2016. Without any changes to its working capital management, Hunt is expected short-term loan balance from the beginning of 2016 is expected to have increased by $514,519 by the end of 2016.

**Question 7**

Since the company is not in a position to delay salaries, utilities, and other expenses it must quicken the collections of accounts receivable to ensure sufficient cash on hand to meet these obligations. The company could extend cash discounts to incentivize early payments. To reduce the cost to the company, the discounts could be extended only in the months expected to have the highest cash deficits. Hunt Distributing should also enact a credit check policy to ensure that customers who make purchases on account are able to pay for these purchases. The current bad debt rate is unacceptably high when considering the company’s low gross profit rate of 20%. Decreasing the bad debt percentage from 3% to 1% will reduce the cumulative borrowing over the 12-month period by 26% while eliminating bad debt would reduce the cumulative borrowing by 40%.

**Question 8**

The company’s absolute liquidity as measured by the quick ratio has decreased since 2013. In 2011, the company’s most liquid current assets were sufficient to cover its current liabilities 1.11 times over. Liquidity has, however, decreased considerably as the most liquid assets could only cover 79% of current liabilities in 2014 and 75% in 2015. The quick ratio might overestimate the company’s liquidity when considering that a substantial proportion of accounts receivable are not paid for 90 days and the company does not make an allowance for bad debts. Hunt’s management is right to be concerned about suppliers’ continued confidence in the company’s ability to meet its current obligations.

Quick ratio, 2013 = (160,000 + 450,000)/550,000 = 1.11

Quick ratio, 2014 = (48,800 + 600,000)/820,000 = 0.79

Quick ratio, 2015 = (57,154 +700,000)/1,004,553 = 0.75