The Most Liquid Assets

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Our previous installment explained why most professionals consider the Balance Sheet to be the most important of the financial statements. The other statements, such as the Income Statement, the Statement of Cash Flows, and other management reports are geared towards showing the results of the company's activity over a specified period of time. The Balance Sheet shows the cumulative results of the company and what benefit has accrued to the owners and creditors of the company as of specific points in time.

Cash

Items on the Balance Sheet are listed in order of liquidity. The first item listed is always Cash.

While Cash is unfortunately often one of the smaller numbers on the balance sheet, the Cash figure is often considered one of the most important. Cash, after all, is what both owners and creditors are most interested in. One of the main goals of almost every non-government owned entity is, or should be, to generate cash.

In order to be considered as "Cash", an asset must be readily available for the payment of current obligations. Usually this means funds on deposit at a reliable bank. In some cases highly liquid stocks or bonds that can be turned into cash within a day are counted as Cash. These cash equivalents must be readily convertible into money and must have an insignificant risk of change in value.

The qualifications that an asset must be a standard medium of exchange and a store of value to be considered "cash" are slightly less straight forward. Can the Thai Baht be considered "Cash"? Yes, if you are doing your accounting in Thailand. In many other countries, a holding of Bahts would probably be considered a Temporary Investment. On the other hand, if you buy much of your materials from Thailand, and transact in the local currency, Bahts may be classified as cash on your balance sheet.

So, is a large cash balance on a company balance sheet a good thing or a bad thing? Like most other questions in life, the answer is a resounding "it depends". In the go-go growth years a large cash balance was considered a sign of management ineptitude - if they couldn't find anything to do with their money other than leave it in an interest bearing account, they weren't worth investing in. Everyone knew that every asset out there grew in value faster than cash did. Rates of return were expected to be much higher than the "paltry" 5% or so that banks were paying on deposits.

In 1999, managers who held onto too much cash were usually fired, because they obviously lacked the guts or the insight to deploy that cash more profitably. Then came the dot-com crash and the telecommunications crash. In the early 2000's smaller telecom companies had virtually no value other than their cash holdings. Any other metric you looked at, even the common ones such as revenue, profitability, number of customers, etc. had no predictive value in explaining their stock price. The single best variable for valuing a telecom company back then suddenly became its cash holdings, and the second best variable was how much confidence the market had that management wouldn't just willy nilly blow through that cash. Other businesses at that time, however, still were pariahs if they held too much cash. Real estate companies in the early 2000's, for example, were supposed to be buying and leveraging as much as they could, and a portfolio manager with unemployed cash was considered deficient.

In today's business environment cash only earns small fractions of a percent return, and yet every company treasurer is doing his or her best to hoard it. Distressed assets are flooding the market at good enough prices that there is an excellent probability of them generating a return exponentially higher than the return on cash sitting in a bank. Today, though, cash is king. Today may be the day to go out and scoop up tremendous bargains and convert those little green pieces of paper, or electrons in your broker's computer, into actual tangible productive assets. That cash sitting on your balance sheet could have tremendous value or be a sub-par asset, depending on your expectations. Whether rightly or wrongly, though, it is cash today that is on top of every owner's and creditor's mind.

Accounts Receivable

Accounts Receivable and Inventory are the two most deceptively simple items on most company balance sheets. An invoice is an invoice and a widget is a widget. What could be more simple than that? Just add them up, slap the number on the financial statement, and move on, right? Not so fast.

Accounts receivable are an obligation of the company's customers to pay the company for goods or services it has provided. Accounts receivable and inventory are both current assets, but accounts receivable are considered to be the more liquid of the two. Asset-based lenders will usually loan 80% - 85% of the face amount of accounts receivable, but only 20% - 60% of the stated value of the inventory.

A very interesting issue in accounting, to the extent that accounting can be considered interesting, is when does a receivable become a receivable? Is it at the time the customer places a purchase order? When the company produces a portion of what it is selling to the customer? When the company designates the specific items to be shipped? When the goods being shipped get close enough to the shipping area? When the goods are shipped to the customer? Or when the goods are received by the customer? The answer is "any of the above", depending on the company's policies.

Obviously the creation of a receivable is not that arbitrary, but it is much more dependent on facts and circumstances than on any bold line etched in stone. Remember the cardinal rule of accounting, that for every debit there is an equal and offsetting credit (and vice-versa). Accountants have significant discretion as to when to recognize (record) revenue. Revenue is a credit who's corresponding debit is most frequently Accounts Receivable. It follows that if the accountants have discretion as to when to book the credit, they also have an equal and corresponding discretion of when to book the debit - i.e. when to declare that a receivable exists.

Revenue Recognition is a separate topic that will have its own chapter. For now, the important thing to understand is that a receivable exists on the books when an accountant says it exists. In companies with asset-based loans there is often tremendous pressure to make receivables exist as quickly as possible, because every $100 of receivables represents another $85 available to borrow.

Receivables are also an area that is subject to considerable instance of fraud. Tangible assets such as inventory or buildings are much easier to verify than receivables, which are mostly accounting entries that are backed up by pieces of forgeable or sometimes confusing paper (contracts, shipping documents, purchase orders, etc.). The difficult nature of verifying receivables is shown in one of the most common methods used by auditors to verify the validity of a company's accounts receivable - the auditor waits long enough and sees if they were paid. Immediately verifying a receivable is a much more arduous process, and no matter how much documentation you look at you never really know with certainty until payment is received.

Assuming the receivables are valid, another main concern is their valuation. Not every valid accounts receivable will be paid. Customers dispute their bills, go insolvent, renegotiate, etc. Typically companies with the strongest market power can pick and choose their customers and only deal with stellar credit risks. Other companies sometimes make a niche out of selling to the poorer credit risks, - the higher margins they make are a form of risk premium they charge their customers for their higher expected default rates.

Sometimes, customer risk profiles and credit worthiness change with economic or political conditions. Distributors of flooring products, for example, sell mostly to smaller retail outlets. These stores generally performed very well and paid all their bills during the housing boom, but suddenly became very dicey after the crash in housing when their customers either stopped paying them or disappeared altogether. The bad debt experience of flooring distributors changed markedly when the economy did.

Historical payment patterns and the health of the industries being sold to are not the only factors used in valuing accounts receivable. Customer concentration is another. In general, selling to larger, more established companies is considered safer than selling to small companies or start-ups. The large steel mill that sells to the six largest auto manufacturers should be a much safer receivable than the little metal-bending shop down at the end of a dirt road. When that steel mill becomes 90% of your accounts receivable, though, your risk profile becomes skewed much more than most analysts would like to see, and the value of your receivables may be considered to be less than what is stated on the balance sheet.

Receivables are not like wines or some cheeses. They do not get better with age. Receivables are issued with terms, including the date by which they must be paid. The further a receivable goes beyond its stated terms, the less likely it is to be paid in full. Asset-based lenders usually specify the age of receivables that they will lend against. Dishonest borrowers will sometimes credit and rebill their receivables, recycling old accounting entries into young accounting entries and keeping them eligible to be borrowed against.

Accounting rules require that companies that sell on credit establish an allowance for bad debts, recognizing that not every receivable will be paid in full. Just as with revenue recognition and the creation of the receivable in the first place, there are no hard and fast rules to determine what the allowance for bad debts should be. It is a judgment call. Both receivables and their allowances, therefore, are areas that management can use to smooth earnings if management is so inclined. In fat times, reserves for bad debt often grow beyond what is really needed. In lean times, reserves are used to cushion the blows.

An interesting phenomena that paralleled the rise of asset-based lending was the increased focus on the creation of accounts receivable. What was previously an arcane accounting function suddenly rose to the forefront of management's thought processes. Instead of representing deferred gratification, accounts receivable became instant cash - $85 in new borrowing for every $100 in new accounting entries created. In cash-starved companies, this manifests itself in many ways:

- Faster revenue recognition, which makes the income statement less conservative.
- More bad debts, as the pressure shifts incentives from creating quality receivables to creating receivables in quantity. Management needing the instant cash that receivables are worth will lower their credit standards just to be able to book the entries.
- Lower gross margins, as some companies buy product and immediately resell it close to cost, because the receivable can be borrowed against immediately but the payment for the product doesn't need to be satisfied for 30 - 90 days.
- Unwieldy return policies that justify credit -rebills at the expense of more customer or operationally friendly processes.
- Inappropriate diversifications into higher credit risks or inefficient product lines just to avoid limitations on customer concentrations that lenders often impose.
- Pushing sales out the door before they are ready or before the customer wants them, increasing operational costs and customer dissatisfaction.

Obviously these are short-term, desperate measures. They buy some time, but not much. Managements that employ these techniques usually believe that salvation is just around the corner, and if they can only hold on until then good money will come in and replace the bad and all will be well. Once every so often they are right.