

Understanding Float ...

Float is defined as "the difference between book cash and bank cash, representing the net effect of checks in the process of clearing."

This is a very broad definition – as you will see, float has different meanings for different industries. The above definition about is probably the most common meaning of "float".

$$\text{Float} = \text{Firm's Available Balance} - \text{Firm's Book Balance}$$

Types of Float

Disbursement Float is generated when a firm writes a check, causing a decrease in the firm's book balance but to change in its available balance.

Collection Float is created when a firm receives a check, causing an increase in the firm's book balance but no change in its available balance.

Items affecting float include mailing time, processing delay and availability delay.

Measuring Float

The size of the float is a function of both the amount of dollars and length of delay involved. A common measure of float is Average Daily Float and is calculated by multiplying the amount of float by the number of days it is outstanding, and then dividing that by the number of days in the period (See Below).

Example :

Consider Company Z that has \$500 of float outstanding for the first 12 days of the month and \$750 outstanding for the last 19 days. The calculation would be as follows :

$$\text{Average Daily Float} = ((\$500 \times 12) + (\$750 \times 19)) / 31$$

$$\text{Average Daily Float} = \$653.23$$

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The Cost of Float

The cost of collection float is simply the opportunity cost of not having that money in cash. At the very least, the firm could earn interest on that cash if it were available for investing.

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Electronic Data Interchange

With the growing popularity and growth of electronic banking, transfers, payments, etc... comes the prospect that float soon will be a thing of the past. If the business world continues to move toward electronic data interchange, there will be no delay time and thus float will be non-existent.

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Mastering the Use of Float – Warren Buffet of Berkshire Hathaway is the Best

Take a look at an industry that lives and dies by the use of float – the insurance industry. Warren Buffet explained float well when he said, "float is money we hold but don't own." In the insurance industry, float arises because premiums are received before losses are paid, an interval that can extend over many years. An insurance business has value if its cost of float over time is less than the cost the company would otherwise incur to obtain funds. If the cost of float is greater than the market rates for money, the business will incur losses.

This is the key to Warren Buffet's success. By investing Berkshire's float in the market in safe, low-rate government bonds, he has been able to make money from float – it has cost Berkshire nothing. In Buffet's words, "Since 1967, when we entered the insurance business, our float has grown at an annual compounded rate of 21.7%. Better yet, it has cost us nothing, and in fact has made us money. Therein lies an accounting irony : Though our float is shown on our balance sheet as a liability, it has had a value to Berkshire greater than an equal amount of net worth would have had."

Closing Thoughts

As you can see, float is something that needs to be managed well so as not to become an incredible cost. At the same time, if managed correctly, it can actually be a source of earnings for a corporation.