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Analysis

Why Good Cash Flow Forecasting is Essential in Uncertain Times

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Biography

Nick Hood is the Senior Business Adviser at the Opus Business Advisory Group (https://www.opusllp.com), the largest independent advisory, restructuring and insolvency firm in the UK.

Nick was a licensed Insolvency Practitioner, working in the business rescue market for 25 years. He is a committed internationalist, having created the largest global network of independent business rescue firms and having also worked overseas in Canada, Milan and Bahrain.

In his earlier career and after qualifying as a Chartered Accountant in 1970, Nick held senior executive positions in major companies in the construction, engineering and media sectors, as well as working for a boutique investment bank.

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Abstract

It's an old business cliché that cash is king, but it's never truer than when a business and its management are battling with the multiple problems which come with economic and commercial uncertainty. In this article, the author looks at the essentials of producing high quality and flexible cash flow forecasting, achieving effective monitoring of cash resources, and reacting constructively to issues as they arise.

Introduction

Maintaining a strong grip on cash flow when the trading environment in which your business operates becomes unpredictable isn't just common sense, it's business basics. Just as vital is getting the information on a timely basis; in fact, it can make the difference between survival and failure. Knowing what safety margin, you have and when and where the cash pinch points are likely to happen gives you the scope to take better decisions and to implement pre-emptive strategies when they are likely to be most effective. Unfortunately, management do not always give cash flow predictions the priority they should have. The excuses are often lame:

- *'The forecasts are never right'* – This accusation can come from both ends of the commercial spectrum. General management get cross because the predictions aren't precise, while financial management are frustrated because they can't make them more accurate.

In reality, these attitudes miss the point, sometimes deliberately and wilfully. Of course, the numbers won't be spot on or even close – there are too many factors outside management's control or knowledge. The clue is in the name: they are only forecasts after all. The skill lies in understanding why the variations have happened and constantly improving the process and therefore the quality of the data it produces.

- *'We're drowning in variance analysis'* – This is what happens when forecasts are prepared in too much detail, or else every little fluctuation gets explored to the nth degree. There is a flip side to this problem, when the analysis is at too high a level and income or expenditure categories are drawn too broadly. Then the explanations are too generic to be meaningful. Getting the level of detail right can be a process of trial and error and it certainly should be the subject of some serious internal consultation, not just at the whim of the most influential voice within management.

- *'What use is a quarterly cash forecast in a day-to-day crisis?'* **–** This is a serious and utterly valid question. Even in calm financial conditions, monthly cash flows should be the norm and possibly more frequently in a business subject to significant cask peak and trough movements within individual months.

  When sailing through choppier waters, weekly and even daily forecasts can become not just useful but a matter of necessity to avoid a nasty and

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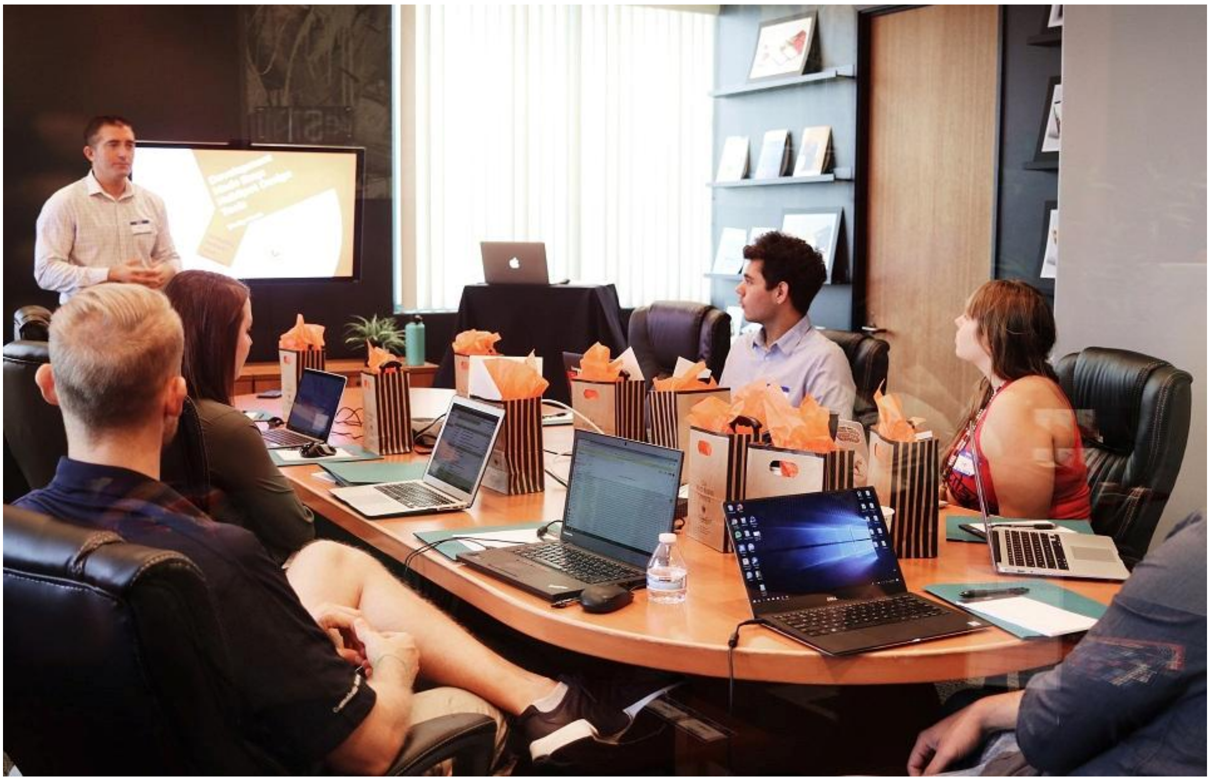
potentially fatal surprise. There is no denying that preparing a forecast down to this level of detail, never mind trying to monitor and react to it will be a huge burden. Nevertheless, it's cash issues that kill most failed businesses. Undershooting a profit target is an embarrassing nuisance, but your landlords changing the locks on your premises because you couldn't pay the rent and didn't know in time to cut a deal with them is usually terminal.

- *'Surely, we don't have to do a full-blown budget package, do we?'* – There are few more totally useless documents than a disembodied cash flow forecast that doesn't start with the borrowings or net cash position in the balance sheet at the end of the month immediately preceding the forecast period and end with the one in the closing balance sheet for the period, as well as agreeing with every interim balance sheet prepared in between.

  Revenue receipts and expenditure payments in the cash flow need to reconcile back to debtor and creditor movements in these balance sheets, which in turn must link to a suitably detailed profit forecast. Capex in the cash flow must also be reflected in the balance sheet fixed asset movements.

  So unfortunately, there are no short cuts. Either the cash flow is part of a fully integrated budget package, or it has no credibility. Regularly flexing the cash flow and budget package is another issue, which is covered next.

- *'An annual budget with a mid-year review will do, won't it?'* – This approach might save resources, but the best financial control systems include the budget (and particularly the cash flow) as a rolling 12-month exercise, to be extended, reviewed and updated for significant changes quarterly at the very least and preferably every month. Otherwise, how can cash flow movements worked out perhaps 15 months earlier and then set in stone possibly be any use in, say, Month 11?



Involving staff in the forecast process pays handsome dividends

Too often, cash flows are put together in executive ivory towers, assembled by those with little hands-on involvement in the day-to-day realities of the business. Cash flow is impacted both in the short and longer term by client retention, debtor days, supply chain management and a host of other factors, into which staff can provide invaluable insights.

Talking to staff helps identify risks and sensitivities which can be fed into the preparation process. Better still it can give staff a sense of 'ownership' of the core assumptions and help motivate them if, and when, you need their help to steer the ship back on course and away from the financial rocks.

Holding quarterly workshops might be a sound strategy to make employees aware of the cash situation and get ideas from them about how the business can generate extra revenue, cut costs and increase cash flow. Additionally, it can have the priceless benefit of giving staff a sense of involvement in cash generation.

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Obviously, there will be sensitivities about exactly what and in how much detail is disclosed to the workforce, especially during a serious crisis, but if handled sensibly this ought not to be a barrier to important staff involvement.

Core assumptions and sensitivity analysis

There are two core elements to a cash flow forecast as part of an overall budget package. The first is the set of assumptions on which the package is calculated, covering everything from revenue growth, bad debt experience, gross margins, overhead levels, financing costs through to capex. This establishes the base line for the package.

Secondly, the numbers should then be stress tested across a range of different scenarios, which helps management and other stakeholders to understand and plan for their potential impact on cash flow, where major risks may lurk and how they might be mitigated.

An absence of this type of financial modelling lays bare the possibility that the management team might not have the imagination to identify how the complexities of commercial life could throw their business into crisis, never mind the ability to do anything to stop it happening.

What about capex?

The cash flow forecast may highlight that extra financing could be needed either to support existing operations, improve efficiency and productivity or to invest in new projects. Entrepreneurs have been known to expand their way out of trouble without sufficient due diligence. Preparing a formal business proposal for any investment or fund raising adds vital internal discipline to cash management. It also provides a

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worthwhile 'explainer' for disappointed executives and staff when their pet project is turned down or deferred.

Cash flow forecasts as a decision-making tool

In tough times, it is even more important to manage a business's cash resources effectively, so cash flows must be at the very centre of strategy setting, decision making and most fundamental of all, how management allocate their scarce time and energy. Wasting that precious time on activities that will never pass cash flow scrutiny is not uncommon, especially during periods of stress. This sort of 'displacement' behaviour is dangerous, so using cash flow disciplines to avoid indulging in it is a real bonus.

Does management have the bandwidth for all this cash flow activity?

Uncertainty ramps up the pressure on senior management to ferocious levels, so that challenging tasks like cash flow forecasting, monitoring and updating can easily disappear down priority lists. There is no shame in bringing in extra resource to make sure that this key task does not slip into arrears. There may be a valuable extra benefit from having a fresh pair of eyes look at the forecasts and challenge the underlying assumptions.