12 Basic Principles for Better Cash Flow Planning and Forecasting

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Building Value through Strategy, Risk Assessment and Renewal,
by **Bill Hass** and **Shep Pryor**
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Cash flow is the key to understanding business viability and enterprise value. Unfortunately, GAAP accounting is a weak tool when trying to understand cash flow. Lenders and borrowers need to "peel back the onion" and examine the details to really understand the operational sources and uses of cash for most businesses.

Cash pays lenders and vendors, and ultimately the investors. While asset based lending has replaced cash flow lending for many organizations, both lenders and borrowers need to understand future cash flow. Cash flow eventually builds or destroys the borrowing base. For a lender, recovering principal from the ashes of a bankrupt company is certainly the poorest alternative. For borrowers, it is even clearer, since no rational borrower wants the experience of dealing with a bankruptcy court if they can avoid it. So, a dose of knowledge about cash flow planning (Exhibit I) should be prescribed for both parties.

Exhibit I

Basic Types of Cash Flow Plans and Forecasts	
Type	**Description**
Daily	For managing cash disbursements, bank balances, and compliance with the borrowing base.
13-Week	For managing lender expectations and operations especially useful in turnarounds and situations of financial distress. Usually independent of financial accounting system but tied to the borrowing base.
Monthly (1-year)	For Evaluating annual plans and budgets and balancing operations. Usually tied to financial accounting and budgeting system. Used by both healthy and distressed organizations to evaluate cash needs. Usually a pre-condition for a bank loan and used to test loan covenants.
Annually (5-year)	For evaluating longer term viability and enterprise value. Used by both healthy and distressed organizations as part of strategic planning and renewal efforts. Usually evaluated as a condition of bank term loans and to test loan covenants.

This article contains 12 principles (Exhibit II) to help bolster any cash flow planning effort, whether for the next 13 weeks, as typically used in working through a financial crisis, or monthly or annually as part of a healthy company planning process.

Exhibit II

	12 Basic Principles to Consider When Preparing Cash Flow Forecasts & Plans:
1	Understand cash flow contributions of different product lines and/or business units and overall strategies and risk.
2	Involve those who will be accountable.
3	Identify and communicate key performance measures.
4	Adapt the Cash Flow Planning and update processes to the organizational capability.
5	Encourage open debate and fact-finding on the cash flow plan.
6	Quantify the magnitudes and likelihood of risks and opportunities to the base plan.
7	Monitor execution weekly or daily .
8	Update assumptions and renew outlook weekly.
9	Communicate thoroughly.
10	Recognize owner and stakeholder priorities.
11	Focus on significant improvements and strategic initiatives.
12	Measure and monitor for results.

A borrower with disciplined cash flow planning processes is not only safer and healthier, but also a better customer for even the most asset-focused lender.

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PRINCIPLE # 1.
Understand Cash Flow Contributions of Different Product Lines and/or Business Units and Overall Strategies & Risk.

Aggregate numbers are not very useful for decision making. Fortunately, simple one-product-line businesses are generally easy to model and understand. Break the forecast down into activities that are understandable and predictable. This process may also shed light on units or products that are abusive users of cash. Curtailing those activities may boost cash in time of need.

Narrowing the scope of the cash flow planning can help to avoid some of the complications that make the planning process more difficult. Examples that contribute to complexity abound:

- Product line seasonality,
- Customer payment patterns, terms and needs,
- Supplier power and payable status
- Competitive environment, and
- Product life-cycle

Once this more granular approach has become part of the organization's normal planning process, planners will notice that the parts can then be aggregated into totals for the organization, however complex. The object is developing an understanding how cash flow may change in the future and the factors that can be changed to improve it. Professionals often refer to this de-layering process as "peeling back the onion."

PRINCIPLE # 2.
Involve Those Who Will be Accountable.

Accountability is one of the best, but most misapplied tools of business. Delegating authority and holding managers accountable for results has allowed corporations to become global in scope and allowed for the successful management of multibillion dollar enterprises. However, the crucial element in all accountability systems is buy-in by those who are to be held accountable for producing the results.

The 13-week cash flow projection is a great tool for understanding the capabilities of the current management and financial team. On an ongoing basis, this discipline tests the team's ability to forecast how the company's cash will react in the coming weeks. Once such a discipline is in place, it can be even more valuable in ensuring that managers at all levels are participating in building the business value and meeting or exceeding cash flow plans.

People make everything happen! Involving the employees helps them understand the goals of the business and metaphorically prompts them to row in the same direction, so the boat will never capsize.

Even outside consultants and professionals need to tap the knowledge of those responsible for day-to-day operations. Involving operating personnel in the process is critical to developing a realistic cash plan. Cash flow planning should not be just an empty exercise only understood by the accountants or outside advisers. It must become a part of the job of all key employees. Cross-functional teams are often used to improve speed of action and accountability.

PRINCIPLE # 3.
Identify & Communicate Key Performance Measures.

When a business is in distress, a turnaround manager or CRO will usually establish a daily or weekly report that goes far beyond the typical borrowing base report, providing vital signs on the business and identifying the key drivers of weekly cash flow. These are unique to each company but typically include measures such as new shipments, cash balances, receipts and disbursements, new purchase commitments, overtime hours, productivity, changes in inventory, special collection efforts, and special terms granted. This daily or weekly report helps focus management attention on the actions needed to meet the goals outlined in the 13-week cash flow.

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This approach should not be left to a CRO, but should be used in a disciplined way by management, so that a CRO will never have to be part of the company. Clearly, while this tight focus on cash is critical in a crisis, it has value as an everyday tool of management, in even the healthiest company.

Healthy organizations have the time to balance short-term and longer-term needs. This allows them to build a longer term performance management system designed to keep them healthy and build value for the longer term. While ongoing cash flow is critical to maintaining the health of a profitable business, healthy businesses are able to look more toward the longer term fundamental drivers of cash flow and profitability such as relative market share, relative product quality, choice of profitable and growing customer segments, new product investment, and investments in longer term cost reductions.

PRINCIPLE # 4.
Adapt the Cash Flow Planning and Update Processes to the Organizational Capability and Needs.

Veterans of corporate turnarounds frequently state that the companies they joined to turn around did not have basic controls in place to manage the business. Thus, it is not surprising to hear that many distressed companies that have sought downsizing solutions ***do not*** have the capacity to do all the things that need to be done such as

- manage ongoing operations,
- execute critically needed improvements,
- update forecasts and plans and
- manage key negotiations.

For this reason, outside advisors are usually needed to provide the resources to get the additional jobs done. However, they must frequently use existing systems and people in the process. When the need is short-term, daily and weekly cash collections and disbursements become the focus. However when the need is maintaining or renewing longer-term health, the focus will be on identifying changes in the environment, competition, the business model an product line strategies,

The message to healthy companies is to improve their existing financial systems and management capability, for these help avoid distress and will limit what the company can do in times of crisis.

PRINCIPLE # 5.
Encourage Open Debate and Fact-Finding in Preparing the Cash Flow Plan.

Facts are friendly. Knowing that there will not be enough cash to pay back the bank helps everyone in the organization focus on how to solve the problem. Without the information, financial embarrassment comes seemingly out of the blue, and management quickly runs out of options. The first hurdle to climb is that of facing the truth and working it into the planning process.

Once committed to dealing with the true facts, management must learn how to be increasingly more accurate. Experience shows that the first forecast or plan is not always the best, and plans are typically biased in one way or another. Management may be biased toward protecting certain departments or suppliers unfairly or taking more risks than necessary to avoid controversy. An outsider can often be the best referee between insiders and stakeholders because he or she is unbiased and experienced, and can see the situation more objectively.

The ideal situation is to develop an environment that encourages an open fact-based debate on all of the issues by all relevant levels of management. Organizations that kill the messengers of bad news frequently find themselves in distress. Unfortunately, such organizations are difficult to turn around, as the cultural suppression of bad news also tends to suppress creative business solutions.

PRINCIPLE # 6.
Quantify the Magnitudes and Likelihood of Risks and Opportunities embedded in the Base Plan

No plan is without risk or opportunities! Armed with this understanding, managers can use a discussion of risks and opportunities to

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uncover bias in the cash flow plans. Insiders know risks and opportunities associated with detailed operations. However, an outsider can often identify and “ball-park” or quantify risks and opportunities associated with plans and strategies much better than insiders. In some organizations, this may argue for facilitation of the discussion of the plan by outside advisors.

Once the risks and opportunities have been included in the debate, it is helpful to rank them by quantifying the magnitudes and likelihoods of the various risks. For example, the impact of a product recall that is being contemplated could be highly significant, so there might need to be specific contingency plans added to the cash flow planning. On the other hand, the potential impact of a new product launch may be only modest, as the launch is being scaled cautiously upward over several months. This may require only a footnote to the cash forecast.

In either case, quantification helps facilitate communication and possible corrective action. Organizations in financial distress will focus their discussion of risks and opportunities on the weekly cash flow forecast, while healthy organizations will focus their discussions of risks and opportunities on longer-term environmental and competitive threats and opportunities.

PRINCIPLE # 7.
Monitor Execution Weekly or Daily.

People respond to deadlines. Good operators focus on daily, date specific, and weekly metrics, breaking the year into bite-sized chunks. They recognize that plans and deadlines that are not acted on are a waste of time. Short term cash forecasting, such as the 13-Week cash flow, is all about building understanding by tracking changes, errors, and sources of errors in receipts and disbursements, and then formulating appropriate responses. Having the right cash flow metrics and reports is not enough! Managers need to review the reports, improve metrics and *act on them!*

Even in financially distressed situations, managers may drag their feet on needed actions like collecting problem receivables, disposing of excess inventory or executing a head-count reduction. Pressure from outsiders can often be the best motivator for insiders and other stakeholders to take action and work together to meet deadlines and execute on key assumptions in the 13-week cash flow. Because the 13-week cash flow invokes a weekly discipline, it is a most effective tool for dealing with crisis.

In healthy organizations managers have their fingers on the pulse of operations and take corrective action when planned results are not achieved. Disciplined processes are in place to identify and correct problems before they get out of control.

PRINCIPLE # 8.
Update Assumptions and Renew Outlook Weekly.

There is something magic about the weekly management meeting. Managers plan most effectively when they discuss events regularly, and learn to accept that only change is inevitable. A plan is usually out of date the day it is issued and understood. Each cycle of the plan is an opportunity to move the assumptions closer to reality and to aim for more accuracy. In cash crisis situations, short term planning and rolling weekly updates are the norm. No one should be allowed to fall in love with the plan or key assumptions that are not being realized. They should be encouraged to nurture the cash flow planning assumptions and process with a constant goal of making it better.

A strong lesson from the turnaround world is that pressure from outsiders sometimes results in management considering more than one strategy, and using different assumptions. Not surprisingly, this update and renewal process often opens everyone's eyes to better alternatives. Why should any management team ignore this lesson, only to let a successor team successfully turn their business around after they have failed to realize the changes around them?

Even healthy companies must renew themselves. Very few companies remain at the top of their industries for more than 10 to 15 years. Success has a way of breeding overconfidence that can eventually lead to decline and financial distress. Truly successful companies continuously review all

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the assumptions upon which their business models are based. They make changes before they are out of cash.

PRINCIPLE # 9
Communicate Thoroughly

Misunderstandings abound in distressed situations, where they can be least afforded! Face-to-face communication is best, but managers should strive to become adept at communicating in all possible modes in today's internet speed world.

In crisis situations, the short term 13-week cash flow planning process requires a disciplined focus on facts and assumptions that are proven or refuted every day with the cash balance. Top management must convince the entire organization of the required discipline, so that the facts get into the planning process as soon as possible. To reduce the chances of miscommunication, key assumptions and requests should always be put in writing. Misunderstandings are likely to occur, thus direct communication on the issues should be complete and thorough to reduce future problems.

In healthy organizations, the discipline of meeting or exceeding expectations becomes part of the culture and communication is effective.

PRINCIPLE # 10.
Recognize Owner & Stakeholder Priorities.

Every successful plan needs to strike a balance among the needs of all key stakeholders. Finding the right balance may take several trials or the pressure of a crisis. Planners should communicate enough with the various parties at interest to understand the goals and objectives that are held by the different parties. For example, some stakeholders value today's cash and the security it can bring, while others are willing to take moderate liquidity risks to achieve higher levels of cash and value in the future.

Lenders want to get repaid. What can be more clear than that? Stakeholder priorities are sometimes clearly identified in contracts or under the law, but all stakeholder priorities are subject to negotiation. Inevitably, the priorities fall out of balance. Developing an understanding of the needs of all key stakeholders and rebalancing them is an ongoing challenge for all companies. When a company falls into distress, the setting of priorities may be best accomplished by an independent outsider. Sometimes it requires a legal process and a judge – either in or out of bankruptcy.

PRINCIPLE # 11.
Focus on Significant Improvements and Strategic Initiatives.

A 13-week cash flow can take a company in many directions. It may force needed changes to avert a cash crisis. It may be used to buy the time to execute a transaction, or to build a new understanding of an impending crisis. Clearly, the short term planning process focuses management on changes needed for short term survival. How much of this direct focus is needed depends on the situation.

Any financially challenged company can start by asking the question, "What can we hope to accomplish by undertaking this short term 13-week cash flow planning process?" In many cases, the answer is that it will be a step toward greater flexibility and safety in the long run, because it encourages a focus on significant short term improvements and communication of needs. To some organizations, it will mean avoiding the embarrassment of a missed payroll or eventual liquidation.

For the healthy organization, a handful of strategic initiatives that produce cash and build long term value can help motivate the organization to make the changes needed. However, balance is needed, as too many initiatives may lead to a lack of focus on important priorities.

PRINCIPLE # 12.
Measure and Monitor for Results

Short term cash flow forecasting can be a great mutual training ground to improve business discipline and focus, for all levels of management. The accuracy of results of such a process can be easy to measure. At times when cash flow is far ahead of corporate

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needs, the precision of the cash flow may not be the only thing that matters, because of the other benefits that can arise from the discipline and insight of the process.

The 13-week cash flow planning process helps the organization evaluate management capability, understand ownership goals, analyze existing contracts, develop plans for continual corporate renewal, and more.

Preserving or building value should be the goal of most organizations but, in times of crisis, buying time to better monitor and understand the situation is also important. In any distressed case, measuring and monitoring financial results against a 13-week cash flow plan is a key element in communication, and in building trust and understanding.

Healthy companies that focus on generating cash over the long term will build value for all stakeholders. The discipline of the cash flow forecast on each new investment is just as important to them as the 13-week cash flow is to the survival of the financially challenged organization.

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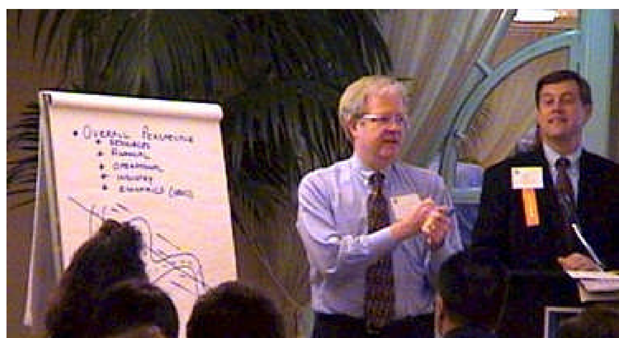

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