Executive summary

In an uncertain economic environment, how do businesses successfully anticipate and respond to fluid cash flow situations? Given the competing demands on their attention, why should business executives be spending more time on cash flow analysis and scenario planning today? Sponsored by Bank of America Merrill Lynch and written by Inc. magazine, the following article presents several expert viewpoints on effectively assessing and planning for future cash flow needs to increase operational stability and create competitive advantages.
A strategic imperative

Effective cash flow analysis is a valuable tool for business owners and managers through all economic conditions, but it’s an even more critical task during periods of economic downturn and unusually competitive market forces. For those who typically take an inconsistent approach, those efforts may be suffering even more today. That’s a shame, says Gregg Landers, managing director of growth management at CBIZ MHM, a Salt Lake City-based firm that provides integrated business services to companies with up to $100 million in annual revenues. By failing to take a disciplined approach to managing cash flow, to formulating cash flow projections, and to tailoring strategic plans based on those projections, businesses miss out on potentially significant benefits. Specifically, properly managing cash flow in the current strained economic environment could spell the difference between weathering this prolonged cycle and going out of business due to being unable to seize market opportunities or stay competitive on price.

In fact, effective cash management can be a significant opportunity creator, positioning you to seize the advantage when your competitors are weak — likely from poor cash management — and capture market share from them. “Liquidity is the number one problem most businesses face today,” notes Michael Hards, a senior vice president and Treasury Solutions Executive at Bank of America Merrill Lynch.

Managing cash flow means utilizing an effective annual budget on a monthly basis in a way that clearly identifies spending targets and revenue targets. It also entails holding managers accountable to spending targets and adjusting those targets down when revenues fall in order to retain feasibility of the original budgeted income targets. “This, of course, requires doing a proper cash flow forecast so there are no unexpected shortfalls of cash or covenant issues with the bank,” Landers emphasizes.

Despite the critical importance of these processes, businesses often fail to embrace them. “Without a strategy, it’s just opportunistic survival, and usually a savvy competitor will come out on top in the end,” says Landers.

Benefits include long-term viability and effective capital deployment

Intelligent and informed cash flow management is especially important in an environment where capital has become increasingly difficult for many business owners to obtain and venture capitalists often demand a majority stake of any company in which they are willing to invest, says Chris Stephenson, partner and cofounder of ARRY VE, a management consulting firm headquartered in Seattle. Two of the most important benefits Stephenson sees businesses deriving from good cash flow scenario planning are increased assurance of long-term viability and more effective deployment of capital.

“We can do a good job of managing cash flow, improve a company’s ability to forecast and maintain liquidity, and that’s a tremendous competitive advantage in today’s marketplace.”
Data gathering and mining

The most effective way for businesses to leverage cash flow planning to improve their performance is to create multiple projections based on different scenarios. This imposes a disciplined approach to identifying the most relevant data, analyzing it, and using it to create plausible and theoretical “if-then” scenarios that can be applied to various aspects of the business. It presents a higher-value and, in the long run, easier alternative to the too common approach of combing randomly through disjointed financial projections, expense reports and pro forma financial documents.

Cash flow scenario planning starts with a basic understanding of cash flow projection, an accounting exercise typically performed in an Excel worksheet or some similar software program. A cash flow projection is a forecast of cash funds a business anticipates receiving and disbursing through the course of a given span of time and the anticipated cash position at specific points. The purpose of this is to determine deficiencies or excesses in cash needed to operate the business during the projection period.

If deficiencies in cash flow are revealed, financial plans must be altered, either to provide more cash — via equity capital loans or price increases, for example — or to reduce expenditures, such as by cutting back on inventory or limiting credit sales. If excess cash is revealed, that might indicate an unnecessarily high level of borrowing or idle money that could be put to work for the business.

Cash flow projection data selection

Preparing a meaningful cash flow projection scenario requires input and analysis of all relevant data. The basics of cash inflow and outflow are standard, as are such variables as sales volume, accounts receivable, bad debt, inventory on hand, accounts payable and depreciation. Other data may also need to be included, depending on business- and/or industry-specific conditions. The key consideration for any business when determining what additional data to include is the degree to which variances in a particular data set are likely to have a material impact on the performance of the overall business or on a specific aspect of the business, factors that can vary widely among businesses.

Forward-looking data are always inaccurate, and it is important that businesses compare projected data to actual numbers and understand what caused the differences between what they were expecting and what occurred, Hards says. Focusing on data with the greatest likelihood of having a meaningful effect on business performance is key.

By knowing where they are going long-term and creating a budget with those strategic objectives in mind, businesses are also advancing themselves towards achieving their strategy.

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Scenario planning in action

Stephenson offers an example by way of illustration. A consulting firm was looking at creating a second location in another city that was generating a consistent amount of work for the firm. Based on preliminary analysis, the principals concluded that renting a local office there would be cheaper than continued travel costs. However, their analysis didn’t capture upfront costs such as collateral, furniture and recruiting in the new city. After preparing a cash flow projection using additional data relevant to their new situation, they were able to create “if-then” scenarios that showed a good portion of their cash would be tied up funding overhead for the new office. If revenue from that office were to suffer a decline, the company’s overall cash flow could quickly turn negative. As a result, they continued traveling to the new city for an additional 18 months. During that period, their profit margins were lower, but they were able to build up a war chest to invest in the new location without putting at risk the cash needed to maintain operations.

Application and analysis of “if-then” scenarios

A useful approach in utilizing cash flow projection “if-then” scenarios is something called BWML, which stands for best-worst-most likely case scenarios, and businesses should always prepare all three. For instance, a worst case scenario might assume no growth in the first two years, best case might assume 10% growth for those years, and most likely case might assume 5%. Spreadsheets should be set up so you can very quickly analyze various “if-then” scenarios and see the impact of each in a broad way. Landers cautions that it’s important to remember that “a forecast is wrong by definition, so don’t get lost in ‘analysis paralysis.’” He counsels targeting and planning the most likely scenario, then looking at the other two and considering what actions you would need to take if they should come to fruition.

Formulating appropriate response plans

An important part of the exercise is formulating response plans for all scenarios, at least on a broad level. Taking it to the next level involves analyzing each “if-then” scenario and ranking it by various criteria, such as its likelihood to occur, the importance of the business functions it would affect, such as sales, profits, payroll and recruiting, and the degree of impact it would likely have if it did occur. A key criterion that should never be overlooked is the potential impact on working capital and liquidity management, Hards stresses. Appropriate action/response plans can then be formulated for each scenario, with the level of detail increasing in tandem with the likelihood of occurrence, the severity of its potential impact, or whatever criteria the business owner deems most significant.

Rule sets for execution of response plans

Once the cash flow projection “if-then” scenarios are created and ranked and accompanying response plans established, when and how should a business expect to put those plans into action? A general approach that can be tailored to work for most companies is to formulate a set of rules for response plan activation with specific events or benchmarks triggering implementation.
“I like the idea of a response plan and would recommend setting triggers, not just to implement them, but to formulate them as well,” Stephenson asserts. He advocates keeping the plans flexible and the planners open-minded. Rather than a strict scenario such as, ‘if’ our cash balance falls to three months of operational expenses, ‘then’ we will cut 10% of our workforce, he would prefer to see an interim step. Instead of having the scenario automatically trigger the response plan, “I’d rather see the management team first try to put together a new forecast and look to cut enough expenses to turn cash flow positive again,” he says. “That approach meets the spirit of a response plan without making commitments to specific actions. The trigger is a very important part of this and requires constant monitoring.”

Conclusion

The bigger a company gets, the more frequently it should conduct cash flow analysis exercises, Hards says. A company doing $50 million a year in sales should analyze cash flow at least weekly. Many banks offer tools and services that make it easier to do this. “These tools not only help with forecasting and maintaining liquidity — a critical consideration for most businesses today — they can also help streamline processes and cut costs,” he says. For example, implementing a corporate or commercial card product for small purchases can remove them from the accounts payable process, where transactions typically cost between $6 and $15 each.

Other significant benefits good cash flow scenario planning can return to business owners and managers are comfort, control and direction, Landers says. “Business owners want to be in control. Knowing you will need cash in six months is very different than being surprised when that time comes. Good cash flow scenario planning lets you assess the risks, and it gives you the information you need to take action to move the company in a direction that mitigates that risk,” he says. “You gain comfort from reducing uncertainty, you put yourself in position to take control, and you obtain the direction you need to take action in a way that achieves the most desired scenarios.”

However, perhaps the most important benefit flowing from good cash management is the opportunity it creates to seize the competitive high ground via improved liquidity forecasting and management. A rising tide lifts all boats, as the saying goes, but when times are tough, weaknesses and vulnerabilities are magnified. Cash management is a big differentiator, one that can enable growth in a competitive marketplace. Your good cash management practices can position you to seize opportunities and capture additional market share when your competitors are weak.