Cash Flow Management and Forecasting-
The Ignored Solution to Financial Distress

Cash flow management and forecasting are the key tools for every business to plan strategically a company's future financial liquidity and save it from a financial crunch. In an era of increasing cost of capital, matters pertaining to money management are entrusted to an expert finance professional like a Chartered Accountant. The professional who possesses a deep insight of business and finance coupled with technical skills of finance & accounting, is well suited to carry out this onerous task. All other 4Ms of business management (Man, Material, Machinery and Methods) revolves around money management. However, what may lack at times is the steadfastness and focus that money deserves amidst a plethora of other management and regulatory issues that a finance professional deals with. The article intends to bring back the focus and reinstate Cash, the real king, back to its throne, and even more. Read on to know more…

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Cash is the King; Cash is the Oxygen

It would be a repetition to read 'Cash is King'. Enough has been discussed and written about the paramount importance of Cash and its effective management. However, it is always desirable to give a second look at the age-old fundamentals

of finance management with renewed emphasis, till it becomes our habit to deal with cash with utmost care. Let us understand what makes cash the crowned king and why must business managers *kowtow* at the altar of cash management. And if you are one of the kind whose self-esteem does not allow believing in kingship of cash, consider Cash to be the Oxygen.

To keep going, what oxygen is to a living being, cash is to a business. This explains the renewed emphasis of cash. A cell is the smallest building block in the body and no cell can function without oxygen, the element used to burn food. Similarly, each smallest entity within an organisation is a unitary cell or a group of cells which needs cash to function. Despite being a life-giving component, oxygen cannot be stored and needs to be inhaled, processed within the body, and exhaled out of the body, thus converting food into energy. Likewise, cash must be inhaled (inflow) and then exhaled (outflow) by an entity, using it to convert raw material (food) into energy necessary to create, grow and maintain assets (cells). A cash outflow as a result of economic activity is carbon dioxide that one should not be emotionally attached to. It has to necessarily go out.

For a business organisation, the CFO and treasury manager constitute the heart and lungs that sets up the artillery and pulmonary system to manage the flow of cash within the body. Cash management is in fact a collective responsibility of several organs of an organisation.

Now keeping analogies aside, the following portion of the article discusses the meaning of cash, cash management and forecasting in greater details.

Meaning of Cash

To put simply, cash means money. However, for our discussion, we shall consider cash as an inclusive term comprising of hard cash (coins or notes), cheques, drafts promissory notes, bank balance, cash-in-transit and money orders. Cash is used to pay for the value of purchase or use of goods/services at the time of delivery.

Cash vs. Accrual; Profitability vs. Liquidity- Significance of Cash Concept

Here, the attempt is not to undermine the importance of accrual concept of accounting and the need for profitability, and there is no tussle between cash and accrual concept of accounting at play in this article. Both cash and accrual concept have limitations and give a distorted state of business when used in isolation.

While financial reports based on accrual concept helps in long-term decision making, cash based reports are more useful in short-term context. The profit & loss statement derived from accrual concept indicates the performance of the business, but something more pertinent than the performance is survival of business. And it is cash flows which gives an insight into the liquidity position and act as an early warning system for the depleting health of business.

Despite having encouraging top line, rosy EBITDA (Earnings before interest, taxes, depreciation and amortisation) and comfortable PAT (Profit after tax), a business may still be burning cash and heading towards insolvency. It is therefore necessary to focus on two more parameters apart from Net income from operations *i.e.,* Net Equity and Net Cash from Operations. These three make up the triple bottom line parameters. An analysis of these three concepts may yield startling results of cash flow mismatch, and faulty capital structure. Companies tend to use working capital to finance cap-ex in pursuit of over-ambitious expansion path, thus creating operational cash gaps; and use long-term capital to finance working capital needs as an easy way to manage short term cash needs, thus channelising money away from cash generating assets. Both the situations result in a cash flow mismatch. Poor visibility on cash flow forecast may result in high leveraging of the business, making it difficult to service interest cost, which is the first smoke of cash burning. The fire may be doused with little use of sprinklers of cash flow management and forecasting.

Cash Flow Management- What, Why, When and How?

Meaning- Cash management is a finance activity that involves handling cash inflow and outflow and optimal allocation of cash, so as to reduce carrying cost and maintain liquidity and solvency of the business.

Tools and Concepts of Cash flow Management- It is an inexact science encompassing one or more of the following techniques:

a. **Cash Budgeting-** It is generally prepared annually along with the master budget, and sets the road map for proposed cash flows on the basis of historical transaction and future plan. It is future oriented and may be prepared for one

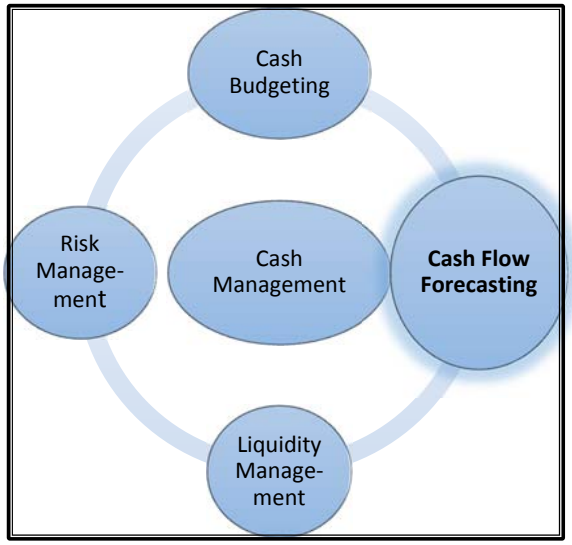
year or more.

b. **Cash Flow forecasting**- It is a tool to give an outlook of financial liquidity over a short term period, comprising of forecasted inflows and outflows. Most cash management activities revolve around short term forecasting. While long term forecasting is used to make capital budgeting decisions.

c. **Liquidity management**- It is a dynamic concept that aims to maintain a balance between liquidity and profitability on a day-to-day basis, by making investment and expense allocation decisions. Tools for liquidity management are timely invoicing, issue of post-dated cheques, availing short term credit through instruments like Letter of credit, Bank guarantee, Buyers credit, short term liquid investment, cash and bank pooling, bill discounting, factoring of receivables, to name a few.

d. **Risk Management**- Risk of loss from exchange rate fluctuation, complex financial instruments, cash pilferage, signatories' fraud, legal covenants, price rise, *etc.* can be perilous if not dealt cautiously. Business can be shielded from measurable and immeasurable risks by establishing strong internal controls, identification of risk areas, use of risk management tools like hedging, insurance, automation of treasury function, in-house legal expertise and other tools of risk management.

Cash management can be both preventive and corrective in approach. Regular cash management exercise is vital for healthy finances, similar to what regular exercise is to human body. Entities which mismanage cash either die a natural death or undergo business restructuring after steady wealth erosion. The symptoms of cash mismanagement go undetected in the early stage of business, especially when entities have deep pockets either in the form of equity or debt. If ignored initially, the cash situation may turn cancerous, requiring medicinal as well as surgical interventions.



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Cash flow forecasting

It is generally a regular exercise which may be done annually, half-yearly, quarterly, monthly, weekly or even daily when the cash situation is in acute distress. It gives both, a bird's-eye and an atomic view of cash surplus or funding gap. Deep analysis of actual vs. forecast variances helps in improving the forecast.

Methods of forecasting:

For short term forecast, generally, the Direct method or Receipts and Disbursements Methods is used.

For long term forecast, generally, the Indirect method or Adjusted Net Income approach is used.

Cash Flow forecast for short-term decision-making is more popular, easy to prepare and easy to understand. While preparing forecasts in excel spreadsheets, cash flow may be plotted under the heads depending upon the cash management needs, namely Operational, Investment, Financing needs, Statutory and Contingency activities. This may further be broken down under Income & Expenditure heads; MIS heads; and/or Balance sheet heads so as to make it comparable with accrual based financial reports. In short, it should be prepared from granular level; flowchart may be used to connect the input data with the cost and revenue drivers and cash flow assumptions. The drivers and assumption must be established after deep diving and be reviewed on an ongoing basis.

Classification of Cash flow activities

a. **Operational Activities:**
   i. ***Revenue***- Separate forecasting for cash and credit collection may be made depending upon past trend, credit terms and sales plan in immediate future. Further, forecast basis may be different for different class of debtors. It is also important to factor seasonal variations.
   ii. ***Purchase***- Consumption of raw materials is normally a variable of revenue and production. With a production plan in place and established inventory level, one can forecast the purchase requirement, and payment shall be forecasted based on terms of payment.
   iii. ***Employee cost***- These are more or less fixed. However, variable factors like performance incentive, salary increment, hiring and retrenchment, loans & advances against salary should also be factored while forecasting. The basis for variable component may be the cost driver like production, hours booked, historical trend, *etc*. This should be in line with the Human Resource budget.
   iv. ***Operating & Administrative Expenses***- A gamut of expenses comes under this head ranging from rent, repairs & maintenance, marketing, travelling, printing & stationery, power & fuel, communication, legal, *etc*. Some of the expenses are fixed in nature and are periodical while others are variable and relatively sporadic. The nature and nomenclature may differ from industry to industry; hence, basis for forecasting may accordingly be applied.

b. **Investment Activities**- These include capital expenditure, interest income, purchase & sale of investment products likes shares, fixed assets, business acquisition, *etc*. The cap-ex budget & capital budgeting decisions would determine the need and timing of investment activities.

c. **Financing activities**- It includes sourcing of Debt & Equity to finance or refinance and its repayment along with interest & dividend, bank charges, *etc*. These flows are pre-determined and do not change frequently.

d. **Statutory Activities**- These include various taxes & penalties levied by the law of the land, License fee, statutory deposits, refunds, *etc*. These are unavoidable cash flows and any default in payment may result in huge penalties. Therefore, cash should be separately earmarked to meet statutory dues.

e. **Contingency activities**- These include what cannot be reliably forecasted and may manifest in any unknown form like litigation, change in market forces, change in law of land, accidental loss, *etc.* A buffer may be created under each head before allocating the surplus. The quantum of buffer may be decided based on available indication for future transaction and past trends of forecasting error.

For short term forecast, generally the Direct method or Receipts and Disbursements Methods is used. For long term forecast, generally the In-direct method or Adjusted Net Income approach is used

Pre-Requisites for efficient cash flow forecasting

For a cash flow forecast to be useful for decision making, it is incumbent to have the following in place:

a. **Management's commitment**- The senior management must underline the urgency and priority of cash flow management, which will set the tone of cash discipline across the organisation.

b. **Robust book keeping**- Accurate & timely accounting and reporting of financial and non-financial data is the single most important pre-requisite for cash flow forecasting and management to meet its objective.

c. **Treasury SOPs of highest standards**- The SOPs and approval matrix must be strictly implemented with zero-tolerance approach. It is a bitter medicine that must be taken to avoid fatal health hazards pertaining to cash transaction.

d. **Participation of all stakeholders**- It shall include integrated finance team, MIS & budgeting team, sales and marketing team and

The success of forecasting stems from the accuracy of forecast *vis-à-vis* actual cash flow, and prioritising the cash allocation, which should be complemented by efficient liquidity and risk management.

all other user departments, the participation of which is required for developing and using cash flow forecasts.

e. **Regular historical Variance analysis-** It will help improve the accuracy of forecast and identify cash burning areas.

f. **Tight monitoring of cash flow-** It goes hand in hand with cash management activities, which can be both preventive and remedial in nature. Internal audit team can cross-check the means and end use of funds.

Cash forecasting/management under distressed situation

While it may appear to be a child's play to put numbers in a forecast model based on established drivers for each cash flow heads, but in reality, forecasting involves a painful deep digging of the assumptions and stress testing of cash flow drivers. It is a solution-oriented exercise rather than compliance-oriented. The graver the cash situation, the stricter is the requirement of forecasting discipline. Even a minor lapse is reprehensible, when there is acute cash crunch. Mere numbers filling does not result in the success of forecasting, it stems from the accuracy of forecast *vis-à-vis* actual cash flow, and prioritising the cash allocation, which should be complemented by efficient liquidity and risk management.

Reasons for Cash Distressed Situation:

a. Faulty and overambitious growth planning
b. Use of operational funds used for cap-ex
c. Cash siphoning
d. Fake revenue booking
e. Enormous spending
f. Mismatch of gestation and loan repayment period
g. Litigations resulting in huge penalty
h. Long period of declining revenue

The techniques, as shown in the adjacent table, may be used to improve cash flows, but it must be kept in mind that distressed situation should never be considered as an irreparable damage; the idea is to find the best possible solution.

Areas	Techniques
Revenue	a. Reconciliation of long drawn debtors b. Invoice financing and cash discount for premature payment c. Immediate release of invoices d. Rigorous follow-up from debtors
Purchases	a. Stretching vendor payments by relaxing pricing terms; delaying reconciliation; issuing Post-dated cheques b. Avoiding cash & advance purchases c. Maintaining best inter-personal relationship- It may sound funny, but at times it is the best way to pacify the upset vendors and seek additional time.
Cash and Bank balance	a. Cash Pooling from various units & non-active bank accounts; central cash flow decision making b. Minimal Cash transactions, and tight control over cash handling, and approval process c. Cash hoarding- based on risk assessment the need for contingency measures d. Inter-unit reconciliation e. Daily preparation of BRS
Related Party	a. Receivables and advance should be realised while corresponding payables could be delayed b. Independent monitoring to avoid cash siphoning
Loans & Borrowings	a. Revision of moratorium period; debt restructuring b. Refinancing of loans
Salaries	a. Salaries must be paid on time so as not to lose employees' confidence b. Bonus and incentive may be postponed
Expenses	a. Cost cutting measures b. Payments approvals based monetary limits, and four-eye concept

Challenging issues in cash management

There are difficult issues which do not have theoretical correct answers, and requires professional judgment and problem-solving skills coupled with sharp, agile and analytical bent of mind to deal with myriad of circumstances. Few of them are given below:

a. Liquidity management is still easy by borrowing from money market but how to address deficit management?
b. In a cash deficit scenario, which of the five cash flow needs are of more priority? Normally statutory dues, salaries and electricity dues are non-negotiable payments, but in a dire cash crunch situation, one may have to prioritise vendor payment and loan repayment over others, say to avoid winding up petition from vendors; NPA status in banking loan; or save higher penalty cost.
c. Few debtors with large sales volume-what if the debtors default?
g. How to manage regular outflow when inflows are seasonal?
h. Fewer vs. many vendor dependency? While less number of vendors are easy to manage when negotiating , the same may develop a monopolist tendency and may dictate the payment terms.
i. Holding of Inventory- Just-in-time vs. Economic order quantity?
j. Borrow or sell? Whether to continue borrowing or to downsize operations and sell assets?

Users of Cash Flow Forecast

Any user of financial statement may also be interested in knowing the current and future liquidity position of the organisation, like:

a. Lenders and Bankers
b. Management team
c. Investors
d. Cost centers managers
e. Employees & Vendors
f. Government Authorities

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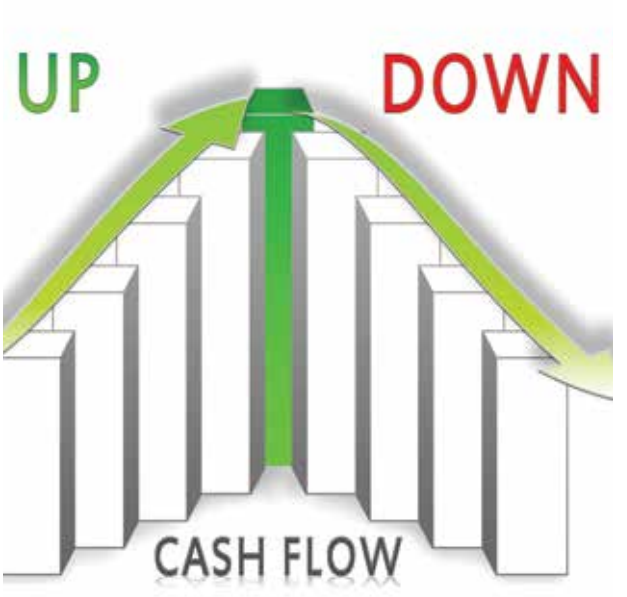

Conclusion

For smaller businesses with little capital back-up, cash mismanagement means immediate doom, and it can never grow. In case of bigger organisations with initial large funding, it is unintentional but a habitual offence of finance controllers to ignore the early signs of cash flow mismatch, or have incongruous understanding of funding gap till capital erosion starts. A good finance controller who vouches for Cash to be king (or oxygen) shall keep cash management as his top priority, and use cash flow management tools as a routine exercise for taking operational and financing decisions. While it may appear traditional to think about managing business from cash flow perspective with so much emphasis, it is actually all the more relevant in today's era of increasing cost of capital. The finance professionals are expected to manage cash as much as any other business issues.

No wonder, in our tradition, small shopkeeper worships the *galla* (cash box); cash is called as goddess *Laxmi* in Hinduism; and *munim* (fund manager or accountant) is the most trusted and respected individual in any business entity. Cash management is such a powerful tool that can indeed infuse life in a de-oxygenated dying entity. ■