# Putting cashflow first again

As the credit crunch has turned into recession, so board members naturally want assurance about expected cashflows. In the short term, the board needs to know that enough cash exists to meet corporate obligations as they fall due; early warnings and prompt action can mitigate potential civil and criminal penalties if the company is subsequently judged to be trading insolvently. And in the longer run, the board needs to know that there is sufficiently robust information to identify, and enough breathing space to manage, possible issues around refinancing needs and covenant breaches, as well as to satisfy the going concern questions of the auditors.

In such circumstances, it is a brave treasurer who has not reviewed and revamped the organisation liquidity forecasting processes. But the current environment offers an even greater opportunity (and challenge) for the treasury team to demonstrate their skills in putting cash back at the heart of medium and long-term financial budgeting and forecasting within the business. This is an area usually dominated by accounting rather than cash-based data.

## Executive summary

- The treasurer's liquidity forecast disciplines and understanding of business cash cycles can help meet the corporate hunger for a more cash-based view of the world. But cash-based and performance-related targets must be managed within the same incentivisation framework, and an appropriate balance maintained, to avoid potentially distorting behaviour at the expense of the business.

**A MORE CASH-BASED VIEW** Recognition of the importance of cash is hardly new. "Cash is king", "cash is the lifeblood" and similar aphorisms are regularly quoted even in more benign times. And, of course, the market has now refocused on cash generation as a core performance indicator. This was recently demonstrated by a FTSE 100 company that revealed lower than expected profits but still saw its share price rise because it also announced it had taken effective measures to improve its cash position.

However, in putting cash generation back in pole position the challenge for most organisations lies in creating more visibility of the underlying operational cashflows, and establishing a transparent framework of cash-related targets, based on the specific business levers driving working capital.

There is an element of irony here. Accountants have been carefully trained to present business performance via an accruals-based profit and loss (P&L) account, rather than in a cash-based payments and receipts way. They do so to prevent presenting a potentially distorted view of the business over the short term. So it should perhaps not be too surprising that now there is greater demand for cash-based information they may be slower to adapt.

The liquidity forecast disciplines and understanding of business cash cycles that frequently sit within treasury can provide a more cash-based perspective. They can also assist in the development of appropriate forecast framework structures and assumptions for the mid to long-term.

But at the same time, any longer-term operational, cash-based projections (those with a time horizon longer than three months) need to be completely consistent/reconcilable to accounting-based forecasts such as P&L, balance sheet and FRS 1 funds flow, to ensure joined-up management decision-making.

**PERFORMANCE-BASED METRICS STILL MATTER** Businesses also have to be careful not to throw the baby out with the bath water. While the balance needs to shift back towards a cash-based view of the world, profitability remains important as a measure of the long-term health of a business. Just as profits can be chased at the expense of cash in the good times, so it is important to avoid the equal temptation of enhancing short-term cash generation at the expense of future performance (which can be achieved by, for example, reducing investment). This is one of the key reasons why the accruals basis of P&L accounting was developed in the first place.

The second challenge therefore is to create and manage both cash-based and performance-related targets within the same incentivisation framework, and maintain an appropriate balance, to avoid potentially distorting behaviour at the expense of the business.

**ROBUST METHODOLOGY AND LOGICAL FRAMEWORK**
Embedding such a cash-based reporting culture into the business is likely to mean re-engineering the basic forecasting cycle to include

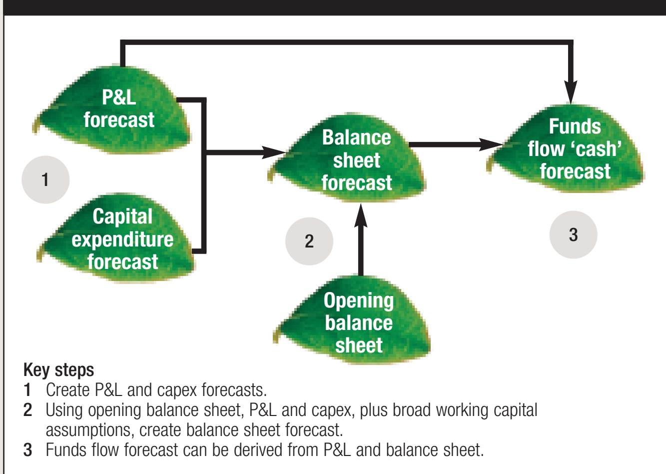
THE RISE IN IMPORTANCE OF CASH GENERATION AS A CORE PERFORMANCE INDICATOR OFFERS TREASURERS A GOLDEN OPPORTUNITY TO DEMONSTRATE THE VALUE OF CASH-BASED DATA. **ROD STAPLES** CONSIDERS THE PROSPECT… AND SETS OUT THE CHALLENGE.

processes specifically designed to produce operational cashflow data.

Typical accounting-based forecast projections (see Figure 1) do not facilitate the extraction of cashflows. They can be used to produce funds flow forecasts that comply with the FRS 1 cashflow reporting standard, but such forecasts do not provide real visibility of the underlying operating cash cycles.

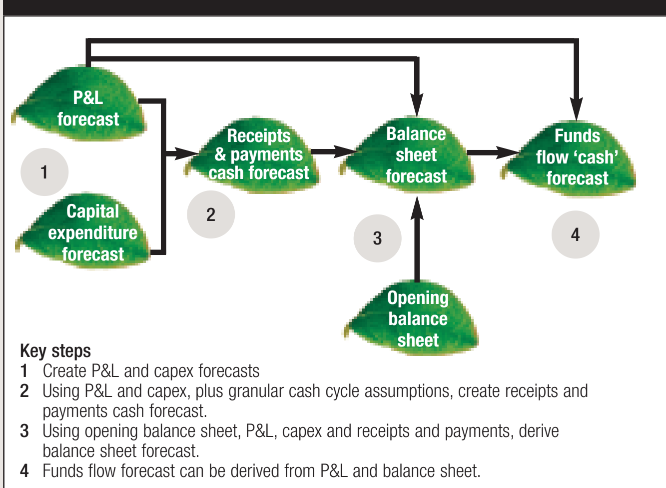
An alternative approach is to use the P&L forecast to develop a more granular receipts and payments cashflow, using working capital lever assumptions (for example, days sales outstanding by sales type). In this way, a balance sheet forecast can be derived, using basic accounting principles applied to the cashflow and P&L outputs. This in turn enables a funds flow forecast to be produced, proving the cash forecast in a more accountant-friendly format (see Figure 2).

**Figure 1:** Typical accounting-based forecast process




Key steps
1 Create P&L and capex forecasts.
2 Using opening balance sheet, P&L and capex, plus broad working capital assumptions, create balance sheet forecast.
3 Funds flow forecast can be derived from P&L and balance sheet.

**Figure 2:** Cash-based forecast process




Key steps
1 Create P&L and capex forecasts
2 Using P&L and capex, plus granular cash cycle assumptions, create receipts and payments cash forecast.
3 Using opening balance sheet, P&L, capex and receipts and payments, derive balance sheet forecast.
4 Funds flow forecast can be derived from P&L and balance sheet.

**BENEFITS OF A CASH-BASED APPROACH** This approach has a number of benefits that play to the strengths of the treasury function.

First, conducting an exercise to identify the key cashflow cycles and working capital levers can significantly increase understanding of the sources of cash generation within the business, and improve communication between the centre and operating units. At the same time it highlights potential cash-saving opportunities.

Second, a receipts and payments cash forecast shows real cashflows, which are inherently easier to explain to non-accountants (probably the majority of the board). They can also be more readily compared to treasury short-term liquidity forecasts, which are typically prepared on the same basis, to ensure a degree of consistency between the short and longer-term outlook. And integrating the cash forecast within the normal planning cycle means that forecast outputs are internally consistent. This supports more informed management decision-making, and increasing market confidence in a company's ability to deliver cash generation initiatives.

Third, the use of a forecast methodology based on applying working capital levers to P&L enables more sophisticated variance analysis and scenario modelling. The cashflow impacts of changing the levers are more visible. Cash variances resulting from changes to P&L (permanent differences) can be separated from timing differences arising from changes to working capital assumptions, and cash sensitivities can be modelled across both dimensions.

Finally, this in turn allows both performance (P&L-based) and cash (working capital-based) measures to be effectively incorporated within the same incentivisation framework, helping to drive positive cash generation behaviour across the organisation, but not at the expense of profitability. More granular targets can be set, and managers can be monitored and recognised, in relation to the working capital elements of cashflow contribution. Separating out the permanent cashflow differences means that managers no longer risk being penalised or rewarded twice for performance (once in the P&L, and again in resulting cashflow).

With all these prospective benefits available by adopting a robust cash-based approach, now would seem an ideal time to present a new vision to the board. It's a vision that puts cash back at the heart of the financial budgeting, forecasting and reporting process, and it's an opportune moment for the treasurer to be seen leading the charge.

Rod Staples is senior consultant, treasury solutions, at PricewaterhouseCoopers.
**roderick.h.c.staples@uk.pwc.com**
www.pwc.co.uk

*This article first appeared in the Autumn issue of The Treasurer's Cash Management supplement.*