

# Out with the old...

HOW DO YOU GO ABOUT REVISING A TREASURY DEPARTMENT'S SHORT-TERM CASHFLOW FORECASTING WHEN THE COMPANY HAS UNDERGONE DRAMATIC CHANGE? VOLEX'S FORMER GROUP TREASURY MANAGER, **DAVID REID**, DESCRIBED HIS APPROACH AT THE ACT NORTH WEST REGIONAL CONFERENCE, THE WORKING CAPITAL CYCLE, HELD IN MANCHESTER IN OCTOBER.



## Executive summary

Volex operated in 25 locations in 21 countries in South America, North America, Europe and the Far East. Seven of those countries had foreign exchange restrictions. With 21 currencies in regular use, 28 bank relationships and 100 bank accounts, it was a mammoth task to impose the change and discipline on the group's liquidity management. The key tasks were to minimise overseas cash holdings, repatriate cash generated to the UK, manage FX exposures and identify cash surpluses or shortfalls and adjust borrowing levels accordingly.

cashflow forecasting process that would better suit how this re-energised company would operate in future.

Volex Group was split up into three divisions – Power Products, Interconnect and Harnesses. Power Products manufactures powercords to suit all power outlet types with applications from vacuum cleaners and washing machines to printers and laptops. The Interconnect business constructs connectors and cables for what's known as one-tenth voltage systems, typically what you find in GPS and cellphones. And Harnesses supplies multi-cable and connector solutions for aerospace and automotive applications.

Volex had reduced its manufacturing footprint substantially in the years following 2000. It does still manufacture in the UK, at Leigh in Warrington, but manufacturing is largely carried out at low cost locations in China and Eastern Europe, with smaller operations and sales offices throughout Asia.

Foreign exchange and government restrictions over cash movements existed for Volex in places like China and India. Local legislation also required the company to maintain local bank accounts for tax and utility supplier agreements. Hence we had to have a large number of non-core relationships.

The company traded primarily in US dollars, euros, sterling and renminbi, with currencies from the Thai baht to the Vietnamese dong for local operations.

Treasury at Volex was tasked with making cash work harder for the group. Apart from small overdraft facilities borrowing was centralised in the UK. Credit interest earned abroad was immaterial, so as operating cashflow was generated, the aim was to speed it back to the UK to reduce the interest bill and maintain central headroom.

**W**ith the economy fast sinking into recession, companies more than ever need to manage their working capital cycles and seek out potential savings.

Driving the balance sheet for efficiency was the focus of the ACT's North West Regional half day conference in October, which took place in Manchester. Among the speakers was David Reid, formerly group treasury manager at Volex and more recently ensconced at fibre optic cable group B3 Cable Solutions.

He outlined the process at Volex, a company that experienced upheaval in the years following the end of the dotcom bubble. Here he tells the story.

**A NEW BEGINNING** A new board of turnaround specialists had returned the company to profitability and positive cashflow and were looking to complete the exercise by refinancing on improved commercial terms and taking the company away from the restrictions imposed by the "Stressed lending" team of the existing banking syndicate. Cashflow forecasting at that time reflected the lender's requirement for reassurance about middle to longer-term liquidity and, as such, shorter-term optimisation of cash for interest and foreign exchange purposes had been of secondary importance.

Shortly after joining Volex I started working on a new



Foreign exchange exposures were offset internally, where possible, with the net balance traded externally.

Volex borrowed via a number of revolver drawings with a broad maturity profile. Fluctuations in working capital were handled inside a UK multicurrency cashpool which had an underlying overdraft facility attached.

**MANAGING THE LIQUIDITY** The company was financed primarily by Lloyds TSB with a revolving credit facility, which was designated in US dollars as this was the primary functional currency.

A Bank of Scotland facility was arranged as a top-up inside permitted indebtedness clauses that we negotiated when the company was refinanced in December 2006. This was an invoice discounting facility.

A Wachovia facility was arranged in June 2008 to enable surplus cash to be swept back to the UK to reduce central borrowing costs. The US prefers to pay by cheque, which meant that funds had to be left in the US to cover the outstanding balance. Putting an overdraft facility in meant we were able to sweep the funds back to the UK and maintain a far cheaper cash balance in the US, to cover outstanding uncleared cheques.

When I joined Volex I found the cashflow forecasting process had not been designed with short-term cash management in mind. We were obliged to provide our banking syndicate at that time with a breakdown of where the pots of liquidity were and breakdown levels going forward.

The forecast was submitted three weeks out of four and went out 13 weeks and the group FD used it as a tool to assess where in the world his cash was tied up. This led to heated phone calls to regional finance directors, who always insisted the high fund balances they reported were purely on a bank statement basis and actually committed funds.

As a treasury tool, it didn't meet the business need to identify short-term available balances for the UK from overseas, predict short term investable surpluses or short-term mid-month borrowing requirements resulting from a mismatch between debtor receipts and creditor payments.

A dispensation was also given to the business units at period ends so their finance managers didn't have to submit their cashflow forecasts, as production of the management accounts was deemed to be of higher priority – which is fine when you're sitting on decent levels of liquidity but is not recommended when liquidity is tight.

The outflow and inflow analysis of the cashflow forecast was drawn on lines to calculate operating cashflow – which largely meant one line in for trade payables and one line for trade receivables. They were not broken down into their constituent parts.

This meant that no distinction was made for analysing material cashflows in the business that affected day-to-day liquidity. For example the accounts payable aged debt might indicate that £1m of cash was due in from a customer in that period, but if you spoke to your credit manager, he would say that – for any number of reasons – the money wasn't going to arrive.

## THE CASHFLOW FORECASTING PROCESS HAD NOT BEEN DESIGNED WITH SHORT-TERM CASH MANAGEMENT IN MIND. WE HAD TO GIVE OUR BANKING SYNDICATE A BREAKDOWN OF WHERE THE POTS OF LIQUIDITY WERE AND BREAKDOWN LEVELS GOING FORWARD

**INSTIGATING CHANGE** This wasn't going to provide the level of detail required to predict daily cash balances, and was unacceptable when operating limits in respect of the facilities were based on the daily calculations of our bankers.

After identifying how forecasting could help business decision making, we agreed to move to forecasting on a cleared funds basis; to focus our subsidiary management and subsidiary finance teams on how we pay and receive cash so we could better manage the liquid cash balance.

We also reduced the length of the cashflow forecast from 13 weeks to eight, which was a far more accurate reflection of the order book. We moved away from using the accounting stretch forecast for sales and purchases and moved to a process where we knew when the top ten customers paid and suppliers were paid – this flushed out the major liquidity issues.

The idea was to focus on the big cash movements in and out of the company based on the 80/20 rule looking at the day such transactions were due to happen. The UK has a multicurrency cash pool and access to the London money market. The four participant UK companies moved to forecasting daily cleared fund balances so we could take advantage of overnight or longer deposit rates for any surpluses.

The group's overseas surplus funds were un-utilised against debt, which is obviously at its most inefficient over a weekend. We set a maximum level of funds that could be held by subsidiary companies outside the UK and measured it every Friday to encourage anything over an agreed limit to be returned to the UK to reduce the overdraft level.

**GATHERING DATA** We also made greater use of the internet to check subsidiary cash balances periodically, to try to solicit any amounts we found which they had not disclosed. These improvements resulted from a 12 month project where we worked to understand how cash flowed in, out and around the group. I sent out a treasury audit file to each location before making a site visit. This file requested information about collection and payment practices, settlement terms, credit management style, and bank system security processes.

It also asked them to identify which customers and



## cash management

### CASE STUDY

suppliers were responsible for their material cashflows. I asked them to identify the top ten in each category so I could construct standard templates in Excel that could easily be consolidated.

I then built up a basic receipts and payments schedule for each currency and used data from the returns to the treasury audit file questionnaires to pre-populate the cashflow templates with the top ten customers and suppliers identified.

During onsite visits, I introduced the model and discussed the reasons for its implementation. This relationship-building side to the process was absolutely critical. So often the head office of group companies sends out requests for huge amounts of data without necessarily sharing the reasons why it is needed. I sold this process as a tool for managing liquidity locally as well as helping the group manage global plans. Its simple nature was generally well received.

Once all the submission templates and on-site audits were complete, I built a consolidation model in Excel which had a link into the Reuters market system. Our facility limits were denominated in a foreign currency, so we needed to translate currency movements at rates my lending bank was using. This also provided rates for interest accruals and accruals for non-utilisation fees as well.

There were four categories of cashflow (trade receivables, trade payables, payments on indirect costs and inter-company trading movements) and under the actual variation of each category it required the top ten cashflows to be identified by materiality.

Identifying your top ten customers and suppliers in cash terms gives you a start in pinpointing who is responsible for your material flows. This is essential information, so you can develop your submission template and focus your accounts team on the dates on which these flows impact the business.

The top ten fixed payments represent items such as rent, wages, financial insurance – these kinds of debits going through your bank account usually reoccur on exactly the same date. If you can plug these numbers into your cashflow forecast and roll them forward as far as you are looking, then you're only forecasting the remainder of the cashflows, which are your key suppliers and your customers.

These of course are the hardest elements to forecast but at least you are not getting lost in the detail.

I gathered the cashflow template submissions, which detail the top ten customers and suppliers, and customised each cashflow forecast for each location. I also completed the actuals by going back through a month's worth of transactions, using the bank statements. This did take some time but it proved a useful part of the implementation

**THE TOP TEN CUSTOMERS FOR HIGH-END INFORMATION GIVE YOU A START IN IDENTIFYING WHO IS RESPONSIBLE FOR YOUR MATERIAL FLOWS. THIS IS ESSENTIAL INFORMATION**

process, as the finance managers had working examples of how the information was to be presented and how closing balances in the cashflow forecast tied back to bank statement balances.

So once I'd been around the group and submitted this cashflow forecast to each entity and got the process in place, I then asked them to submit their cashflow forecast every Tuesday and took it into a consolidation model. So the cashflow forecasts were collated weekly and on an actual plus eight weeks forward view. Long and short-term net currency positions are identified, which are traded internally first and the remainder then traded externally. The group's aggregate cash positions are assessed, so for liquidity monitoring we can see where we have to fund any shortages and where funds might be available to enable this. And once the absolute level of available cash – or lack of it – is established, we adjust our revolving drawings to maintain our overall levels inside the limits we've negotiated.

Issues of liquidity and currency holdings can be identified on a group basis. So once we know the forward view we can look at the maturity profile of the revolver drawdown, look at the overdraft facility we have available and adjust the revolving drawdowns to make sure we stay inside the overdraft limit. Finally we trade out the net currency positions.

**AGREED TARGETS** The senior finance team have agreed targets for operating cashflow. Once treasury has derived a cash position through their forecast the two models are compared. Quite honestly, the two processes never give the same answer but they are supportive, enabling the treasury and accounting teams to raise questions so the assumptions can be tested in both models, thus providing a sense check.

Once we've worked out the net foreign exchange positions, we hedge these externally using the Reuters system to benchmark the prices we are offered and we usually take prices from two banks to get a competitive process. To help group funding we examine the intercompany loan routes we use in conjunction with intercompany trade dependences to find the most tax efficient method of funding.

With each weekly submission, the subsidiary operations are required to identify where their actual cashflows are materially different from the previous week's forecast. In treasury, identifying margin for error across the group is useful when planning borrowing requirements. It also helps the subsidiary finance managers identify problem payers and ensures they are on top of the supplier payment process within the organisation.

If outward payments have been forecast incorrectly then the cause may be control issues, or that payment control has been handed to the supplier by way of direct debits, in which case communication needs to improve. You may find patterns emerge that indicate customers always pay late at quarter ends or during local festivals or holidays. This information can be useful to refine debtor receipt information.

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Additional reporting by Graham Buck, a reporter on The Treasurer.