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The Tool of the Turnaround: The Importance of Cash-Flow Forecasting

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Cash flow is the heartbeat of every business, but when a company is either near or in the midst of a distressed situation, cash flow can be a heart in need of a pacemaker. Much like an irregular heartbeat, cash flow can be inconsistent with high payables one week and large collections or a high payroll the next. No company can weather these economic mood swings over an extended period of time unless it learns to manage its resources, especially its liquidity. This is best accomplished through accurate forecasting of future demands on cash flow and greater control of accounts receivable and payable. Nothing less than the company's solvency and viability are at stake, which requires a robust cash flow forecasting analysis.

The purpose of cash-flow forecasting is to help company and lenders analyze problems and determine whether they have the internal resources to fix them. The goal is to use cash management to identify peak needs from a timing perspective. A cash forecasting tool is, in effect, a dashboard that displays those critical metrics for short- and long-term decision-making that goes beyond liquidity. In addition to solvency, the ability to pay creditors and service debts as they become due and, of course, generate profitability is essential.

It is important for all of these issues to be addressed to the satisfaction of all constituents (lenders, vendors, customers and the workforce) if the company is to conduct a successful turnaround. Accordingly, the best form of cash flow management has an intangible quality: as a basis for building trust and a better relationship with stakeholders.

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Importance of Cash Flow Tool

In a turnaround, understanding the real-time status of cash flow is critical as is the ability to forecast liquidity, particularly in the short term of 13 weeks. Executives need to take the temperature of the company's financial health while providing potential remedies, in particular those areas where management and most likely outside professionals can enhance value. The forecasting tool offers a thorough assessment of the health and viability of the business while assisting management in quantifying the

- an analysis of the borrowing base;
- identification of expense reductions or liquidity enhancements to fix the problem internally; and
- identification of the need to seek cash externally.

Cash-flow analysis changes the focus from accounting activity to cash accumulation and generation. When accounting focuses on earnings before interest, taxes, depreciation and amortization (EBIDTA) along with accruals designed to even out monthly results, the company's actual cash profitability is sometimes obscured. Instead, cash flow analysis strips out all non-cash calculations and returns the company's focus to the core drivers of profits.

Another benefit of cash-flow analysis is its short-term feedback, so necessary in times of financial distress or

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costs and results of a turnaround over a period of time.

Effective forecasting should be designed to provide vital information about profitability in both the short- and long-term. Its emphasis is in providing a graphic picture of viability and solvency—information that is so crucial to every company in a distressed state. Among its capabilities is separating critical from non-critical expenses by delving into the minutiae with data to delineate expenses that can be deferred to improve current and short-term liquidity. Such information can be especially helpful when examined in light the most important findings revealed by the cash flow analysis:

- the depth of the cash hole the company is in;

crisis. Instead of waiting to take action until monthly financials are completed, which also means a delay in determining and implementing fixes, management can promptly respond to real-time analysis and indicators of the need for corrective action.

This is facilitated by using an analysis that compares weekly actual cash flow results to the forecast for key receipt and expense-line items. The analysis should identify favorable and unfavorable variances and briefly explain the key causes of these variances. Tracking the data on a weekly and cumulative basis allows managers to (1) respond quickly and adjust cash-disbursement decisions to any fluctuations in receipts or other evolving needs of the business, (2) revise forecasts if they discover significant discrepancies as compared to

actual results and (3) identify any timing variances that can impact short-term liquidity. This summary serves as a vital communication tool internally and with key external partners.

The company and its lenders can now use the cash flow forecasting tool as a means to enhance the probability of success given its capability of tracking the progress and results of each of the steps necessary to achieve successful turnaround. This is an effective way to create a cooperative environment among all constituents, a situation that is often the exception rather than the norm with distressed companies and their creditors.

It is the tool's intangible byproduct of relationship management that may offer the greatest value besides its evaluation of cash flow, ability to forecast and its tracking of steps and results. Such issues as the state of capital structure, overleveraging and those previously unrealized opportunities for conserving cash can be resolved, which helps improve communications while earning credibility.

The Forecasting Tool and Lender Relationships

Any reasonable expectation of creditor acceptance of a turnaround plan needs to include cash flow forecasting with its ability to isolate key problems plaguing the business, determine the most efficient ways of correcting them and uncover previously unrecognized sources of cash availability, which helps highlight the company's efforts to fix issues internally. A good forecasting analysis can be used to effectively say "here is what we have done to right the ship, and now we need your help." Some of these are viewed as subjective areas. Subjective or not, the data will still assist business executives and their company's lenders on matters of viability, status with stakeholders and areas where working capital can be improved. Lenders will also want to know about the status of covenants, especially if the business appears headed toward default.

The last thing that a distressed company needs is the inability to answer any and all questions raised by lenders while proceeding with the turnaround proposal. Lenders want nothing less than an accurate, succinct and digestible report about what is actually going on with the business and what they can expect in the next few months. For that reason, cash flow forecasting is the most communicative way to keep everyone on the same page. When lenders can analyze and confirm

data accuracy, the potential success of a turnaround plan is reinforced and more likely to gain external acceptance.

Importance of Executive Buy-In

Executives and managers of distressed companies are no doubt aware that financial change management is integral to developing an effective turnaround strategy, but that does not mean they are willing to accept something other than the *status quo*. Such reticence is most likely to occur when "outsiders" such as turnaround specialists, financial advisors, restructuring counsel and bankruptcy attorneys enter into the picture. Perhaps this can be attributed to the initial response whenever change is viewed as threatening and outside of one's comfort zone regardless of the situation. It is one of the most common obstacles faced by outside financial consultants and one that needs to be overcome: without executive buy-in, a turnaround plan is doomed and, unfortunately, the same fate probably awaits the company.

How does one begin to bridge this reluctance given the stress that always accompanies restructuring? Once again, the cash flow forecasting tool can play a pivotal role through the clarity of its data and conclusions. The ability to accurately project information of vital importance to executives can facilitate discussion and make what may be a bitter pill much easier to swallow, especially when the tool is viewed as a benefit to the company's future well-being. It is particularly helpful when all parties are looking for a quick turnaround of results. Everyone is on the same page because the forecasting tool gives visibility to the "facts."

Forecasting's Impact on Vendors and Customers

One of the most powerful functions of cash flow forecasting is its role in determining whether business with vendors and customers is producing optimum results for the company's bottom line. Start with vendors, especially the terms and their accounts payable, both of which can have daily impact on a firm's liquidity. The fact is that for any business, especially one in distress, some vendor terms are not conducive to improving the liquidity situation. If anything, they may be hurting it, especially if vendor payments are accelerating due to changing terms, a common accounts-payable problem. There are still vendors who insist on cash-on-delivery, a challenging

situation for a liquidity-sensitive company that is either in or rapidly approaching a distressed state. It is at this point that a company has to decide whether a continuing relationship with such vendors is antithetical to a successful turnaround. In certain cases, there is little or no reason to maintain the vendor in the supply chain under these conditions.

Cash forecasting fits into this equation by determining through analysis which vendors really are essential to keep the company on the road to profitability. The data can help identify any vendor whose terms are impractical and focus instead on business relationships with those whose agreements are more suitable for accounts payable and the daily cash flow. There is less likelihood of unsuitable or unnecessarily early payment terms falling through the cracks.

The application is similar in its analysis of customers, specifically with core customers and whether they are the source of cash the company would like them to be. It is a way to separate, break down and measure the customer base. The data may show that the company, despite its financially starved condition, may just be better off without certain customers due to decidedly unprofitable pricing and terms. It can also help identify which customer orders and lines are cash-critical to the continuing operation of the business.

Some companies, despite their liquidity issues, fail to aggressively collect cash from customers because they fear a backlash will negatively impact customer relations. Cash flow projections show that such fears can only hamper the successful turnaround. Companies need active and healthy account receivables if they expect to return to profitability.

Cash-flow forecasting can analyze if a customer base is deteriorating and—equally important—the reasons why. No turnaround can be successful without such information vital to the interests of every affected party. All of this data has to be handled sensibly and managed properly. Just as the relationship manager is vital in dealing with lenders and creditors, the same approach applies to vendors and customers. It's much easier to negotiate terms when the data is irrefutable.

Working Capital and Company Distress

There are a number of issues that can compromise a company's cash flow and its efforts to turn the corner on profit-

ability. Working capital ranks among the biggest. Mistakes resulting from failure to manage working capital properly continue to occur in the business world despite the plethora of case studies revealing warning signs that could and should have been detected and corrected had financial forecasting been put into place. These include the following:

- *Proper inventory management.* Every inventory manager understands that levels have to be managed and kept in line; however, as the forecasting program has shown repeatedly, the opposite is often the case. Frequently, inventory turn rates for either raw materials or finished goods fall well below what is necessary to assure adequate cash flow, a major detriment to acceptable liquidity. Inventory is supposed to generate cash, not drain it. A good cash flow model identifies and focuses on issues like obsolete, slow-moving inventory. Using the forecasting tool to identify slow-moving stock keeping units, a company can develop a program to sell inventory attractive discounts through targeted channels, resulting in the generation of additional cash.

- *Managing accounts receivable properly.* While this point is emphasized in every business school, problems persist. It is incumbent on companies to collect on a timely basis and to keep a check on the credit levels of their customers. Red flags should fly if customer payments become too extended, especially when the business is already cash-starved. In a troubled situation, a missed payment may mean a late check or a lost customer.

- *Accounts payable timing.* A solid financial forecasting program can easily detect whether vendors are being paid on a much faster basis than accounts receivable is collecting. Such oversight can push a company closer to a distressed state. The goal is to initiate a working-capital cycle in which vendors are paid in a time period considered normal for the particular business or industry. Consider cash-flow analysis for developing more favorable shipping terms. Accounts payable cannot go out faster than accounts receivable come in.

Cash flow forecasting is designed to examine all of these issues and provide a path to turnaround beginning with detecting cash depletion, projecting when it might occur and averting it. Among its multiple varied functions are identifying collateral shortfalls early and pinpointing other sources of cash gener-

ation such as unencumbered assets that can be collateralized should there be an economic shortfall. Again, communication with lenders and creditors is essential and necessary should there need to be a request for additional liquidity or an over-advance on existing lines of credit.

The Zone of Insolvency

Management discussion and analysis are better served when the data and conclusions of cash flow forecasting can corroborate their views on the state of the company and its potential for turnaround. It certainly represents a powerful tool on behalf of lenders and creditors to assess whether the numbers are realistic given the current and future operational condition of the company, all of which come under the scrutiny of a forecasting analysis. The profit-and-loss statement is evaluated against the real-time status of cash flow to present a clearer picture to all concerned constituents.

There is the possibility that the program will verify that the company is in the zone of insolvency, which requires even greater management of fiduciary responsibility for creditors, lenders and investors. Here again, cash flow forecasting, be it on a daily, monthly or 13-week basis, is vital to attaining a realistic picture of the business at present and whether it can restructure its way to viability. Companies that are on the verge or already have fallen “into the zone” should consider engaging legal counsel to assist them in meeting their fiduciary obligations. Such action can help the company’s status with creditors and lenders.

What should not be overlooked is that cash-flow analysis can restore the immediacy and focus on cash generation that is so vital to the turnaround process. A forecasting tool provides the impetus for corrective action and real-time feedback once the action is implemented. Time delays that used to exist between completion of statistics and responses are eliminated.

Yet as dynamic as the forecasting tool is, its calculations are not made in a vacuum or as a stand-alone. Its findings should be considered in conjunction with other tools such as liquidation analysis, valuation estimates and perhaps other subjective measures as executives assess if their turnaround strategies for their company are viable.

However, if a turnaround is realistic based on these forecasts, management needs to adopt a best-practices approach

of ongoing and open communication with its constituents, preferably on a weekly basis. This is the best way to stay focused on the key issues that must be addressed. It will also help ease the path for restructuring, turnaround, viability and, most important, future profitability. ■

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