Cash Flow Forecasting in the Age of Covid-19

The pandemic has wreaked havoc on the global and U.S. economies, pressuring businesses across almost all industries to take severe measures to weather the storm to ensure their ultimate survival. An enterprise's liquidity is the essential lifeblood to survival. A process to forecast, monitor and respond to the changes in its cash flow will enhance the likelihood of survival.

A cash flow forecast is essential in charting a path for recovery. The ultimate goal of this process is to develop a set of projections that demonstrate the enterprise's cash flow under various potential scenarios, which require different assumptions and associated risks. Some assumptions will be correct, while others will be proven incorrect over time. These projections should be a minimum of 90 days (the so called 13-week cash flow projection) to a longer-term view of one to two years in length, if the planning horizon allows for such. Optimism should be replaced by realism during the planning phase, and the enterprise will likely have to adapt to new realities over time.

The goal is to preserve the enterprise. Enterprises waiting to perform this analysis will limit their available options.

Reasonable options of forecasting scenarios are as follows:

1) **Best Scenario** – The business returns to normal (Pre Covid-19) operating levels within one to two months.

2) **Likely Scenario** – The business experiences difficulties in resuming operations (issues with retaining key employees, supply chain interruptions, working capital shortages, etc.).

3) **Bad Scenario** – The business has been significantly impacted by the pandemic (former customers are no longer operating, the former workforce is either hesitant or unwilling to return to work, the supplier base is not fully functioning, etc.). Restarting the business will involve addressing many challenging items.

4) **Critical Scenario** – The business has experienced several critical issues (those which cannot be dealt with solely by working within the enterprise and require external measures to overcome).

The cash flow forecast is a real-time model that breaks down the cash inflows and outflows of an enterprise into discrete components and provides an accurate depiction of a business's financial health, or lack thereof. The forecast also provides insight into the levers the business has available for it remain in operation. The goal of this analysis is no longer focused on the impact of the enterprise's Profit/Loss, but more importantly on its liquidity. From a Profit/Loss standpoint, sales are considered essential, however from a cash inflow/outflow perspective, if the receivable is not converted into cash, the effort to generate that sale merely results in cash out the door.

The cash flow projection is comprised of **three** major elements:

1) **Starting Cash Balance** – In order to determine the cash balance available to the business at the beginning of the cash flow forecast, the beginning cash balance is calculated on a "book basis" and requires a bank-to-book cash reconciliation. Utilizing the balance from a bank statement is not an option because it ignores the impact from checks that have been written but not yet cleared, as well as deposits of funds by the business that are not yet recognized in the bank's reported balance. Preparing this analysis will enhance the accuracy of the forecast's finding.

2) **Cash Receipts** – The analysis should segregate the cash remittances by source. That is to say, remittances from existing receivables and future sales and their eventual collection should be segregated on different lines of the analysis. Collection of future receivables should be based on assumptions that have been evaluated for reasonableness; past performance by customers is not assured in a Post-Covid environment. The company's customers will also likely be capital constrained. The company should conduct a thorough review of its sales terms, which should then be communicated with customers prior to shipment. The intent of this is to enhance compliance. A clear understanding should be achieved as to sales/payment terms before transacting any new business with customers. Emphasis on payment terms is essential to help to ensure that anticipated cash receipts will be as planned.

   The process will require the enterprise to contact all significant customers to assess their individual status, which will likely fall into one of the following categories: (1) currently operating, (2) plan to re-start operations by a certain date, (3) no current date planned for re-start, or (4) no intent to reopen. The enterprise will need to make decisions at to granting credit to customers based on the above status and other internal information about the customer.

3) **Cash Disbursements** – The analysis should segregate the cash disbursements into categories such as:

   a) Payroll and associated benefit costs

   b) General operating costs

   c) Product costs

   d) Contractual obligations (leases, maintenance contracts, etc.)

   e) Debt service obligations (both interest on debt and principal repayments)

   Review present obligations to vendors, particularly those suppliers providing products and services to the enterprise's eventual products which are recurring in nature and less dependent on production volume. (This excludes utilities, taxes and employee benefits.) Evaluate which vendors are the sole source for the enterprise's needs, making them more

critical to an ongoing working relationship. Those vendors determined to not be sole sourced provide an opportunity to diversify or expand the vendor base and reduce the enterprise's dependence on any one supplier/vendor. This could serve the enterprise to drive down the cost structure for its products/services.

In developing the analysis, the enterprise should contact each of the vendors to assess its current operating status. Vendors will have (1) not yet reopened, (2) reopened but are under limited production schedules, (3) fully operating and able to meet customer orders, or (4) in the extreme case, have permanently ceased operations. This is an essential step to identify supply chain interruptions as early as possible.

Other Considerations:

1) In a re-start mode, the enterprise most likely will be capital constrained to return operations to a prior "normal capacity". As such, the preservation of cash is a priority to successfully return to normal operations. While the enterprise's vendors most likely will be under similar pressures, the opportunity to record sales may be of greater concern and encourage the vendor to entertain more favorable payment terms. One objective would be to have the vendor freeze the current balance owed until later, at which time a repayment plan for the older obligation can be negotiated. This will allow the enterprise's operations to restart without the need to use existing liquid assets (cash) to eliminate an antecedent obligation.
2) Does the enterprise lease facilities/storage space/equipment that are no longer needed? This may represent an opportunity to extricate the enterprise from a contract and associated ongoing obligation. If the counter party has an opportunity to redeploy the asset, it will be more motivated to negotiate a settlement that terminates this obligation.
3) Evaluate each major product line for its gross margin contributions. Product lines that are not providing a reasonable contribution should be suspended or eliminated.
4) Product development initiatives should be reviewed for criticality. If the estimated time, introduction or needed investment is not in line with the intended gross margin impact, suspension or elimination of the project may be in order.

Addressing a Cash Flow Shortfall:

1) Consideration should be given to drawing down on existing credit facilities, while the credit institution may still allow it.

2) Small Business Administration ("SBA") Economic Injury Disaster Loan.

3) Request support from either a critical customer or critical supplier to the enterprise. Support can be in the form of (1) special pricing, (2) alternative payment arrangements (e.g., consignment), direct lending to the enterprise, or other alternatives.

4) Capital infusions from family or friends, including ownership in the going-forward enterprise.

Additional Benefits from Cash Flow Forecasting:

This process allows for the enterprise to address the criticality of vendors. This will include an evaluation of existing vendors and their related costs, which may highlight areas of unnecessary expenditures that were more difficult to observe under the former operating process. After several periods of comparison of actual results to the forecasted plan, observations of vendors and their contribution to the enterprise's success will become more apparent.

Once the forecast has been prepared, it will be critical for the enterprise to test or continue to validate the assumptions used in its development. By evaluating the differences between actual and forecasted results, an understanding of those differences will enhance the understanding of the business. With the benefits learned from these comparisons, forecasts can be further refined for the business while processes are enhanced, placing the enterprise in a better position to survive and succeed in the new environment.

What's Next:

Once the enterprise has successfully settled into a plan it needs to concentrate on the Three C's: Cash, Communicate and Controls.

The Cash Component has been detailed above. For the overall plan to be effective, it must be effectively communicated to all stakeholders (employees, financing sources, third party contract holders, etc.). Without a full understanding of the plan by all constituents, there is less likelihood there will be buy-in to the plan and its end-results may thus be marginalized. Finally, Controls must be instituted. Controls are comprised of key metrics that are measured on a regular basis to ensure that the plan is achieving the desired results. Key Performance Indicators (KPIs) can be developed to serve as a monitoring regime and an early warning system to management. They should be designed to highlight performance that is not in line with the plan or corporate objectives. If the enterprise does not currently utilize KPIs, it should quickly establish some parameters for performance to which actual results will be evaluated.

BG Consulting Group is available to help you with your cash flow forecasting needs, as well as planning and implementation of KPIs and related considerations. Contact us at 216-956-0378 to schedule a consultation.