Defining the Difference #106

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"This article was written during the fallout of the Great Recession and published in the Corporate Board in 2010. The current crisis presents an immediate focus on cash management in the face of severely declining revenues for nearly all companies." H. Stephen Grace, Jr., Ph.D.

Cash Flow Monitoring As A Governance Tool

by H. Stephen Grace, Jr. and John E. Haupert

Revenues, market share, P/E ratios-all may look solid under board review, but the company can still collapse tomorrow without adequate cash. Given the present economy, wise boards should worry first about cash flow as an immediate measure of corporate health. The tools for analyzing cash flow can also give the board important clues about where the company is headed in the future.

Board oversight and control responsibilities are complex and continue to grow. Directors are expected to be the financial, operational, and ethical guardians of the company, and can no longer leave it to management or shareholders to take responsibility for performance. The economic downturn intensified the pressure on boards, with more attention directed to liquidity, operational risk, and market risk.

It is increasingly clear that boards must focus more on operational and capital cash flows. Troubled companies understand the importance of their cash flows; for some, unfortunately when it is too late. Too often, companies deemed to be healthy have not focused on cash flows that are an important indicator of a company's chance of survival. Understanding how to interpret cash flows and continuous oversight of them by boards is essential. Cash flows are the lifeblood of a business.

Cash flows can be measured in an effective, timely manner. Cash data can be much more understandable and give a clearer financial picture than an income statement.

The need for this oversight tool provides an excellent opportunity for boards and chief financial officers to interact in focusing on cash flows to monitor their company's performance and financial health. Fortunately, these flows can be measured in an effective, timely manner, and there are many options for doing so that are easy to implement.

CFOs can clearly explain why this data is so useful and can make the required data available to the appropriate directors, drawing on internal and external auditors, and others. Following are some thoughts and ideas about the importance of cash flows as a tool to monitor company performance.

Large, sophisticated businesses recognize the importance of tracking cash flows. One of the authors served as the CFO of a diversified holding company that was the managing general partner of two sizeable general partnerships. In one, the other two general partners were Northwestern Mutual and Equitable Assurance Company. In the second, the partners were Metropolitan Life and American General.

Each partnership met quarterly. An important component of these meetings was the CFO's review and discussion of financial and operational results. Every one of these discussions focused on partnership cash flows, basically the receipts and disbursements from the normal course of operations, investment income, capital expenditures and other significant cash items.

All the partners agreed that this was more useful than reviewing the income statement because it avoided esoteric accounting entries and footnotes that were confusing and distracting. The cash data was much more understandable and gave a clearer picture of financial performance that was supported by money in the bank or other liquid assets.

These meetings were an exercise in highly effective governance. The general partner representatives were informed, involved, and their institution had "skin in the game." They understood the business and recognized that tracking the cash flows was the most effective way to stay on top of the business.

Directors of any company, in any line of business, would do well to adopt these techniques to improve their financial oversight.

Cash flows can be budgeted, and measured effectively and efficiently with basic cash management systems that are well understood. Furthermore, a comparison of actual cash flows to budgeted cash flows is straightforward. The various receipts and disbursements can be compared to budget, and variances identified. Discussions on the causes of the variances can uncover problems or opportunities. There should be no need for approximations or adjustments. The cash flows either did or did not occur within the particular time period.

Operational and capital cash flows are not easily subject to manipulation. They are a safeguard against efforts to manipulate income, such as reclassifying operational expenses as capital expenditures, as occurred at some companies. Should capital expenditures exceed budget, this variance would be identified, and an analysis of the variance would identify the actual causes.

Onetime charges, if not budgeted, can produce a serious negative variance in operational cash flows. Comparisons of annual or quarterly net income amounts may exclude these onetime events; but cash flow analyses make this impossible. Such outflows impact cash balances for the period and, if unbudgeted, create a negative variance that must be analyzed and understood.

The board should look to the CFO to play a major role in structuring the team responsible for budgeting, measuring and explaining cash flow anomalies.

Who should be given the authority for budgeting the operational cash flows, tracking the actual cash flows, developing the variance reports, and providing explanations of the variances that occur? There are many options. However, an effective approach involves having the company's operating units working with a financial unit such as treasury, financial analysis, accounting or some combination of these financial units.

The board can look to the CFO to play a major role in structuring the team responsible for budgeting, measuring and explaining cash flow anomalies. Both internal audit and the external auditor can provide input to the team, and assist in insuring accuracy.

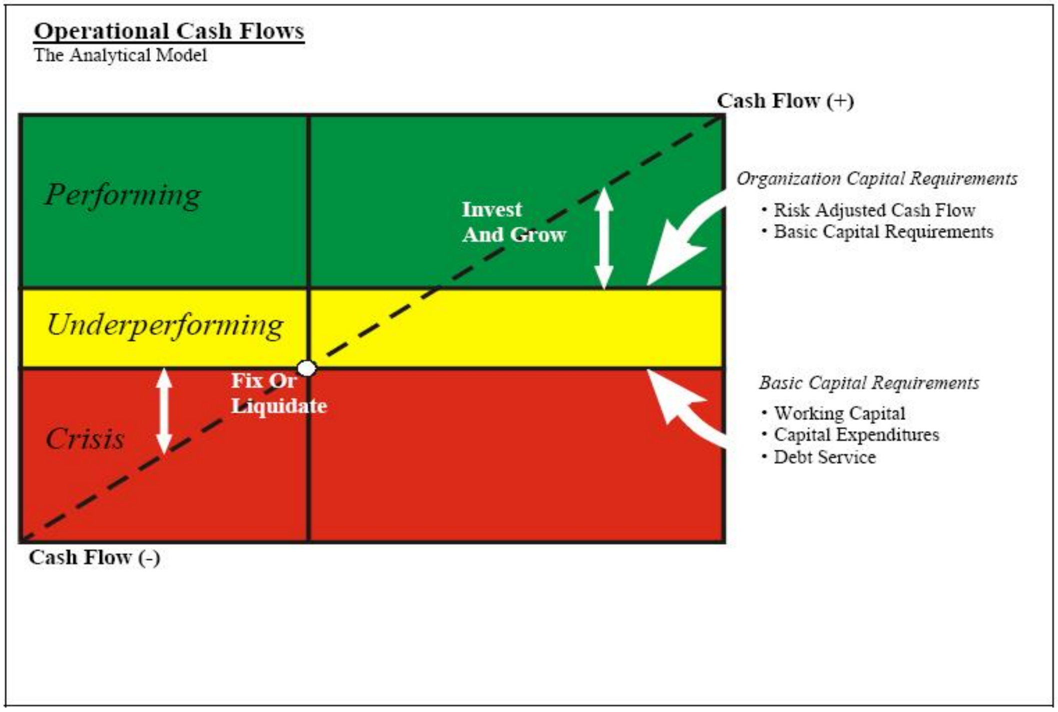
CFOs can devise different methods to present cash flow data, and interpret it for their board. The analytical framework shown on page 13 will aid in understanding and monitoring operational and capital cash flows. To analyze performance, a model is developed and monitored for each business unit that generates cash flows. This model identifies basic requirements such as working capital, capital expenditures and debt service and determines if cash flows will be adequate. If operational cash flows do not provide enough for adequate working capital, do not fund budgeted capital expenditures, and do not cover the required debt service, the business operation is in the "crisis" zone. The options for the business operation are to "fix" or to "liquidate."

The model also determines a Risk Adjusted Return on Equity. When added to the Basic Capital Requirements, this establishes the Market Capital Requirements. As can be seen in the cash flows model, if the operational cash flows exceed the Basic Capital Requirements but fall short of Market Capital Requirements, the business operation is "under performing." While not in "crisis" mode, steps need to be taken to improve performance.

If the operational cash flows exceed the Market Capital Requirements, the operation is in the "Performing" zone. This shows an opportunity to invest and grow, pay down debt, or to make cash distributions to equity holders.

This relatively simple presentation of cash flow data can give the board a solid understanding of whether their firm generates a positive cash flow, and if it is adequate to meet present and future needs. This ability to monitor whether a firm is generating a sufficient cash flow will improve a board's oversight and control system, in good times or bad. A board that understands the components of basic capital and market capital requirements, and how they are affected by cash flows, has considerable insight into the risks confronting the firm, and can effectively address its oversight responsibilities.

The cash control activity comprises two parts. The first involves managing the firm's receipts and disbursements. The second involves monitoring the company-wide cash position.



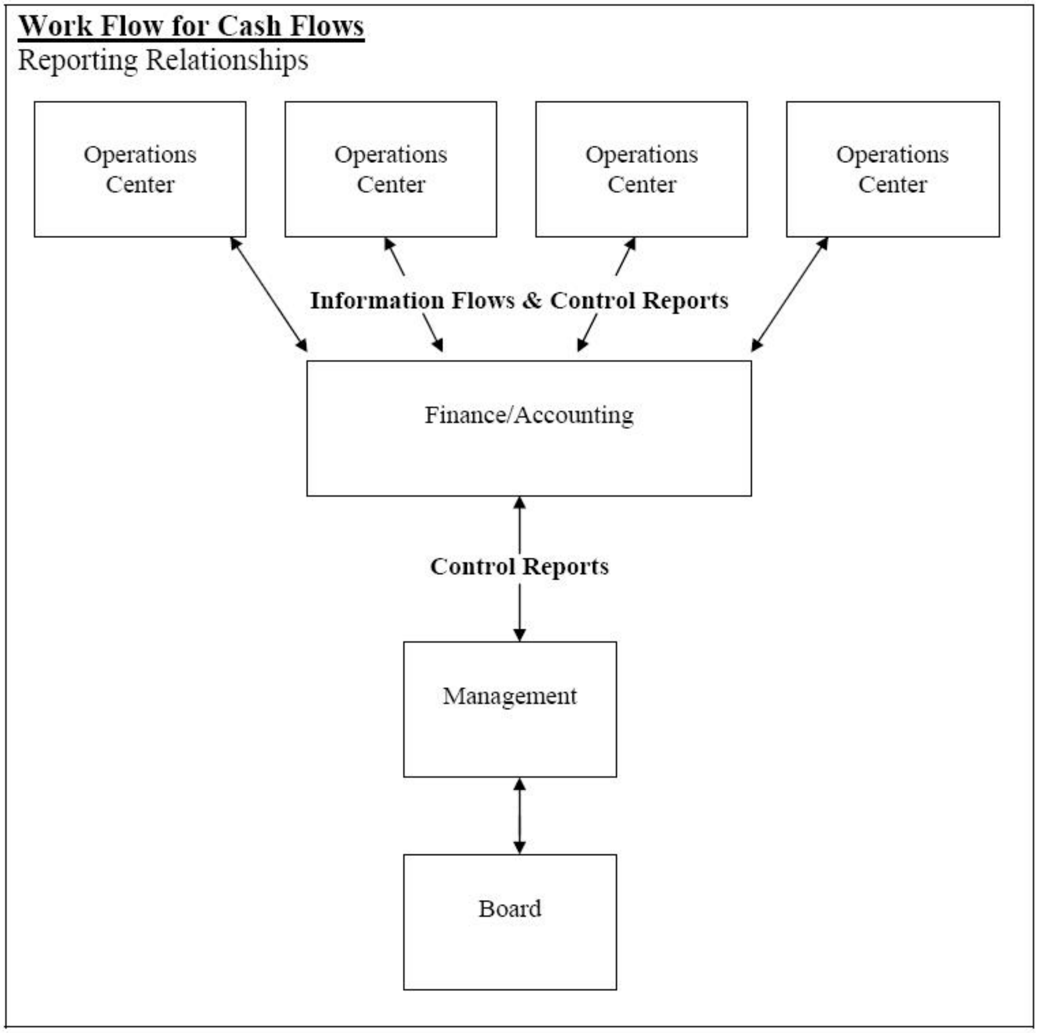
Cash receipts and cash disbursements. Controlling a firm's cash inflows and outflows involves monitoring information and control reports between the firm's operations centers and its cash management center; then, the flow of control reports from the cash management center to senior financial management. To effectively monitor cash inflows and outflows, the firm focuses on: the varying liquidity requirements and forecasting difficulties facing the different operations centers; development and implementation of effective reporting guidelines; and the manner and frequency with which periodic variance reports are developed and transmitted.

Different sectors of a firm often have different liquidity needs, and will face unique problems in developing their forecasts.

Any attempt at developing an effective cash control system must start with the varying liquidity requirements and forecasting difficulties of the firm. Different sectors of a firm often have different liquidity needs, and face unique problems in developing their forecasts.

Good cash forecasts are built on the correct recognition of the amounts of inflows and outflows expected to take place, and when these are expected to occur. The various areas within the firm may be able to forecast the timing for these cash flows, but experience difficulty in estimating the amounts involved.

Electricity and gas utilities are examples of firms with this type of problem. As winter and summer approach, forecasters must predict the weather conditions in order to determine the projected revenues and expenses in the forecasting period. The timing of the revenues does not pose much of a problem for these firms, since most bill a certain percentage of their customers on each day during the month.



With flows for previous forecasting periods available, it is not difficult to accurately estimate the percentage of revenues expected at a point in time. The problem is estimating the total amount of revenues for the period. Similarly, the timing of major outflows is predictable, but the problem is forecasting the amounts (like revenues) which will be affected by actual weather conditions.

Senior financial management must have consolidated cash forecasts early enough to permit them to react to the problems forecasted. This leads to the requirement that the cash management center obtain the data from the areas within the firm responsible for forecasting early enough to permit the consolidation of the data. The different areas may require varying lead times, particularly those subject to volatile revenues based on uncontrollable factors such as weather.

Timing of the forecasts depends on when the various areas are able to prepare their estimates and on the time required to consolidate them and prepare the other cash related data. Once the reporting times are set, they must be observed. This is particularly critical in the early stages of implementing a cash control system.

Each area of activity within the firm is constantly confronted with operating pressures, which make it difficult to complete their forecasts on time. However, those responsible for this activity need to know that their forecasts are being used, and are important to the well-being of the entire company. Also, the cash management center needs to respond immediately when the forecasts are not received on time.

Those areas that are late should be contacted as soon as the deadline has been missed, and followed up in writing. A further method for enforcing the guidelines is to maintain a checklist of the times at which the forecasts are received, and forward the checklist to senior financial management.

Company-wide cash flow reporting structures must be realistic, and recognize the constraints each of the areas face.

Similar consideration must be given to shaping the guidelines for reporting the actual cash inflows and outflows. These also must be realistic and recognize the constraints each of the areas face.

An important point in the reporting of the inflows and outflows is the tie between cash management and cash control. The same information required for the cash management center to monitor and manage the zero balance accounts can also be used for cash control purposes.

Company-wide cash position. Controlling the company-wide cash position requires the monitoring of all headquarter, division, and subsidiary bank accounts.

Monitoring the headquarter-controlled cash position should be fairly straightforward since the cash management center is in constant communication with the headquarter's accounting staff. Guidelines for maintaining the cashbook on each bank account, handling the support data, and reconciling the accounts are established in accordance with the requisites for internal control.

A means of monitoring non-headquarters-controlled accounts on a current basis must be developed. A weekly report indicating beginning and ending balances and total inflows and outflows along with monthly bank reconciliations permits timely monitoring of these accounts.

The importance of a firm's cash flows has focused increased attention on the need for cash control systems. An effective cash control system enables the monthly, weekly, or daily monitoring of operation centers' cash flows. This, in turn, creates an awareness of any unwarranted cash flow variances on a timely basis.

One story that is often heard in financial circles describes the damage to a major firm whose board reviewed quarterly financial results with its sole focus on the income statement. The company's board was told that operating income for the quarter was $490 million, and was projected to increase to $525 million in the following quarter.

According to this data, everything looked rosy and no further questions were raised. However, the *cash flow* for the following quarter was projected to be a *negative* $475 million, a $1 billion difference. The firm filed for bankruptcy a few months later. Whether apocryphal or not, the point of the story is clear. Ignoring cash flows can be dangerous for corporate health and bad for directors who should know better.

Cash is not only "king" today, but has always been "king." Understanding and monitoring cash flows is an important aid to boards in addressing their continually expanding responsibilities to oversee and direct their firms.

Monitoring cash flows is an important tool in effective risk management, and serves as a powerful check and balance on other forms of financial and operational reporting. CFOs should coordinate the necessary financial and operational resources and take the lead in making use of this important monitoring tool and, in doing so, create effective presentations to keep board members on top of the truest measure of a company's finances-adequate cash flow.

If you would like to know more...

If you would like to know more about this case, or about the kinds of business-based analysis of claims and damages that can be obtained from H.S. Grace & Company, Inc., you are invited to contact members of our group, Al Fenichel, Charles Fischer, Steve Grace, and H. Stephen Grace, Jr., Ph.D. at (713) 572-6800.

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