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Gaining Efficiency from the Silent Balance Sheet

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Companies have traditionally focused on profit and loss, leaving their balance sheets exposed or out of sight. This article argues that by more closely linking profitability with liquidity, treasurers can improve their overall cash management as well as gain an advantage over their competitors.

It is widely understood in business that profitability is key. Wall Street looks for growth in a company's earnings and rewards those companies that achieve these goals with higher stock prices. In turn, these accolades usually result in higher compensation for those in charge.

Even at the lower levels within a company, organisations reward performance primarily based on profit and loss (P&L) metrics (i.e. sales, EBIDTA, market share, etc.) not liquidity metrics (e.g. free cash flow, DSO, debt/equity ratios, etc). As a result, organisations may be sacrificing the future by maximising 'accounting performance' not economic performance. Look at what happened companies, such as Enron and MCI and, more recently, some of the largest financial institutions in the world. All those profits 'suddenly' disappeared, leaving each respective company to beg the markets to strengthen their balance sheet by seeking liquidity. For some it was too late. For others, time will tell whether it is too late.

The Challenge in 2008

The challenge in 2008 will be to 'go beyond EBITDA' and build stronger relationships between profitability and liquidity. For non-financial organisations, stronger bank relationships (i.e. a source of liquidity), better/more frequent metrics and changes in compensation could be solutions.

Each of these solutions place a premium on treasury's ability to play well with others (e.g. tax and operating areas) through more planning and less processing. For example, treasury needs to reduce or eliminate the operational work that threatens to turn treasury into a back office, accounting/reconciling organisation. Treasury should be spending more time looking at opening cash balances and future demands by operating areas to learn if future liquidity available can meet demand. This goal has been pointed out before by several surveys, which have concluded that cash forecasting is the most important issue facing corporate treasury today.

Yet, changing treasury into a planning function is easier said than done. Today's corporations, especially the larger multinationals, use many banks, require the need for many currencies and, generally, have many moving parts (i.e. lines of business and organisational units).

Possible Solutions

To keep their eye on the prize (i.e. sufficient liquidity to fund future needs) companies will be challenged to:

- Select the proper mix of banks based on its organisation/operating structure - accomplishing this task may require changing bank relations, organisational structure or both.
- Establish flexible workflows that can respond promptly - too many times workflows are based on accounting processes that are only 'right' once a month.
- Establishing liquidity metrics at the 'correct' management level for:
  - Operating cash flows associated with sales and purchasing and changes in accounts receivable (A/R) or accounts payable (A/P).
  - Financial cash flows where management is responsible for debt or investment, capital expenditures, capital or tax structures. Typically management for these flows is one or more levels up from the operating level.
- Using the right technology - ERP systems often fail to contain the 'rates and dates' needed to monitor debt, investment or FX decisions.
  - Unlike profits that are often only reported monthly or quarterly, with liquidity the cash needs to be moved each day.
  - The fact that there is no cash to be moved is an event that is best known before an accounting period is over.
- More frequent and timely communication among all players including treasury, controllers, tax and the operating areas, any financial unit that is responsible for significant cash receipts or disbursements, regardless of the currency.
  - Corporate policies are a good method of exposing all of a company's organisations to a common set of goals, however, out of date policies can often leave a company without the controls it needs when it comes to market-based risks.
  - Risk does not respect organisational boundaries. Good corporate policies should be tightly integrated so each organisational component knows what is expected from all parties.

Next Steps

Even the largest companies need a plan that focuses on a just a few steps at a time as the resources devoted to managing liquidity (i.e. treasury) are limited.

Step 1 - Review current organisation and banking structures:

- Many companies grow by acquiring other companies (and their banks).
- If the current structure is unwieldy, requiring many funds transfer, transactions, reconciliations, etc, chances are that too many resources are devoted to processing rather than planning.
- Difficulty in arriving at a current global cash balance each day is evidence of inefficient workflows and wasted resources and (maybe) insufficient liquidity.

Step 2 - Understand your credit agreements, including agreements associated with intercompany loans:

- With banks looking for excuses to reject amendments or waivers (i.e. in 2008 they will be building their balance sheets by lending only to the strongest companies).
- Failure to understand your covenants could leave a company with little negotiating room in discussions with its banks.
- Restricted ability to borrow leaves a company with fewer choices when it comes to liquidity.
- When intercompany loans are involved it is useful to understand their continued relevance from an FX and tax perspective. Excessive intercompany borrowing or incorrectly constructed loans can be inefficient and costly.

Step 3 - Enhance your cash forecasting capability:

- While the steps above can ensure a sufficient understanding of liquidity available, there needs to be an understanding of cash amounts as well as timing.
- The operating areas (source of the major cash flows within a company) must be a part of any enhancement efforts.
- Since most ERP systems are accrual-based accounting systems, treasury may need to acquire cash-based systems that can combine cash, debt, investments with future demand on a global basis.
- Such a system should be widely available within the company with each operating user tasked to forecast their cash needs.

Step 4 - Establish liquidity based metrics, possibly linked to operating unit compensation:

- EBITDA which is a P&L measure associated with most operations but it excludes several important issues associated with liquidity which often only shows up on the balance sheet.
- To properly link liquidity with profitability a company may wish to go beyond EBITDA and include in an operating unit's P&L performance:
  - Net interest expense - units which are net suppliers of funds should get an earnings credit while those that are net users of funds should receive a charge. This action is analogous to the unit going to a bank to borrow or invest funds. Cash is not free.
  - FX gains or losses - while some of these actions can appear in a P&L some can also show up on a balance sheet. By making an operation 'FX neutral' treasury can encourage communication of FX risks between the operating area and treasury itself. What operating area would wish to be exposed to losses if someone in the company can insure them against such losses?
- In addition, there should be a need for some balance sheet metrics at the operating level:
  - Day's cash on hand (DCOH) - every operating unit needs a certain amount of cash on hand. Similar to a DSO (day's sales outstanding) the DCOH can relate cash on hand to current and future disbursements. Cash above a DCOH should be invested.
  - Free cash flow - this is a classic measure that looks at cash levels after CAPEX needs. A positive number implies cash available to reduce debt. A negative number could foretell a liquidity issue.
  - Return on net assets (RONA) - earnings that require large amounts of assets have an opportunity cost or even a real cost (i.e. interest expense) that a central treasury usually pays for. An operating unit that has a high RONA can be said to be efficient as they are probably net generators of liquidity.

Conclusion

2008 will be a year of liquidity as both corporations and financial institutions seek liquidity to grow and prosper. Traditionally, companies have focused mainly on the P&L leaving their balance sheets exposed or out of sight. By more closely linking profitability (EBITDA) with liquidity, organisations can gain more maneuvering room, possibly giving them an advantage over their competitors.

Of course, understanding the problem then taking decisive action can be difficult. Organisations would be wise to review their current profitability/liquidity linkages and, by taking the steps above, avoid any painful surprises that can come from their sometimes too silent balance sheets.