

## The Two Essential Tools to guide you through the Recession

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Would you drive a car that didn't have a temperature gauge? Would you drive one without a fuel gauge? That's what it's like running a business without a quality **budget and cash flow projection**. These two essential tools may well make the difference between surviving or not.

The overarching reason is that these tools give you a fast feedback mechanism that allows you to "take the temperature" of the business today and allow you to make appropriate modifications to your strategy or tactics to create the desired outcome.

First we will deal with the budget. A budget is not an exercise that you look at the end of the year to see how good your crystal ball was. It is your best effort to predict the monthly activity of the business in as much detail as is appropriate. Here's how you do that and how you use it:

1. Who should be involved in the process? Obviously senior management and/or the owners as well as the bookkeeper, controller or CFO. One person needs to have overall responsibility for the process. That person should require that budgets be prepared by department heads e.g. sales, marketing, production, purchasing whatever departments drive the business activities. Clearly there needs to be cooperation between departments that interact so that they reach a consensus and then present their budgets to senior management. Senior management's job at this point is to either accept their budgets or not.

For example, sales and marketing may come up with an increase of x% over last year when senior management knows that given recent new product introductions that number would be setting the bar way too low. Alternatively, sales budgets may be appropriate but production doesn't have the capacity or resources to match.

2. After the first draft has been prepared (more on that process later) management should review the result looking at two things: is it plausible in light of history and the present climate and secondly, if we achieved it would we be happy with that outcome? The first test of course might cause a redraft until plausibility is achieved. The second is tougher because if you are not happy with the most predictable outcome then fundamental change is needed.
3. Typically, the unhappiness will come from a lack of reasonable profit. If that's the case then revenues, margins and expenses need to be re-evaluated and strategies put in place immediately such that, if successful, will produce the desired result. It is beyond the scope of this paper to suggest what those modifications may be but here's a hint.....it's not always about increasing sales or cutting costs. It could be about being more efficient in all your processes, raising margins by eliminating lower margin activity, it could be about hiring as well as de-hiring. Each situation is unique.

4. We have now just seen the **first benefit of budgeting** and that is the recognition that things may well need to change.
5. As this is a forward looking tool it should be completed at least one month prior to the start of the new fiscal year. When to start the process will vary in each case but around month 9 or 10 of the current fiscal might be appropriate. It should give you enough time to complete while at the same time you will also have enough of the current year's data as a benchmark.
6. Eventually, the numbers come together, are approved by senior management and that becomes the budget for the upcoming fiscal year. These numbers are entered into the accounting system so that monthly financial statements will be forthcoming comparing actual to budget.
7. As we move through the fiscal year, starting month 1, the actual results will be compared to budget and major variances examined. It's probably too soon for corrective action unless the first month or so happens to be a peak period.
8. A word here about the choice of year end. The smart choice is not always December 31st by any means. A good choice is the period that starts with your best months if you have any seasonality to your business. The reason is that those months often determine whether you have a good year or not. If those months are below budget you still have most of the year left to make the necessary tactical or strategic changes. If those peak months are at or near your year end, there's not much or any time left to impact the year's results. So a company involved in retail may be advised to have a September or October year end.
9. As each month is complete the budget is used to produce a "forecast". **This is a critical part of the entire process** where month 1 budget is replaced with month 1 actual and so on. This gives us the ability to forecast the year with the growing benefit of real numbers replacing budgeted numbers.
10. After month 3 its time to reflect on what the new forecast is predicting the year will look like. Depending on what we see changes may now be needed. For example, if forecast earnings are now too low consideration must be given quickly to appropriate changes. These changes are referred to in paragraph 2 above but with the added proviso that the impact of the changes must be felt in this fiscal year. Here's where senior management earns the big bucks!
11. If the now predicted outcome is dramatically different from the original budget it may be prudent to produce a first revised budget and monitor against that. This is not a step to be taken lightly as it's a bit like waving a white flag. Of note here...if certain employees are to be bonused against budget then they are bonused against the original budget not the recast as that was their commitment against which they should be measured.
12. In the event that we are now approaching latter months and try as we may, the outcome is not looking good either in absolute terms or against the original budget, then at least we have time to prepare the company and its stakeholders for a poor year. Again, what this may mean in detail is beyond the scope of this white paper.

13. **The other essential tool is the cash flow projection.** The critical use of the cash flow projection and forecast is to ensure the company has adequate cash to pay its obligations as they become due.

14. It may well be that even if a budget is acceptable when management looks at the cash flow it may determine that the cash available won't support the budget. For example, at a time of rapid growth there may not be enough cash to support the increase in receivables and inventory. A truism that we use is that "a business cannot grow faster than its cash flow will allow"

15. The cash flow model is based on the budget, produced at the same time and updated monthly to create a forecast. The difference compared to a budget is that the cash flow represents the impact of cash in and cash out and will exclude non cash items such as depreciation but include items such as capital spending, debt repayment or dividends etc.

16. Any negative variances must also be examined in the same way as the budget. Are receivables coming in on time? Is inventory turning as it should? Are we matching long term assets with long term financing? Are we growing too fast for our financing facilities? Will the deteriorating cash flow put us in breach of lending covenants? Is adequate capital available?

17. As with the budget process any forecast shortfalls should be recognized as soon as possible and remedial action taken quickly. Banks hate surprises so they need to be in the loop if a problem is looming. If you need additional capital or investment the sooner you identify that the more likely you are to be successful. Money raised in a panic (if it can be done at all) is very expensive!

18. On the positive side if it becomes clear that you will exceed budget and cash flow it may encourage you to make investments in new resources, acquire a competitor, run that new marketing campaign or reduce debt faster all with the confidence that comes from a well run successful business.

In conclusion, these tools are absolute "musts" not "nice to haves." They must become part of your corporate DNA and may well make the difference between success and failure. Done properly they will not only enhance your profitability they will also raise the value of your business.