

Managing Cash with Effective Liquidity Planning

Treasurers are tasked with providing enough capital for operations and expenses while minimizing borrowing expenses, maximizing investment returns, and reducing financial risks. Effective liquidity management is essential to mitigate financial risks such as unexpected cash flow fluctuations or liquidity issues while efficiently managing cash and debt balances. Liquidity planning is an extension of the cash forecasting process, leveraging inputs and assumptions from across the finance organization. Having the ability to create multiple versions over varying time periods allows for scenario evaluation and stress testing. As actuals are received, variance analysis can be used to assess forecast accuracy and spotlight opportunities for revision.



COMPONENTS

The components of liquidity typically include:

- 1. Cash Flow Forecasting:** Predicting future cash inflows and outflows over a specified period on a weekly, monthly, or quarterly basis helps identify potential shortfalls or surpluses in cash reserves to inform investment and funding decisions. Treasury and FP&A may have the same forecast over the mid to long term. However, FP&A's forecast is commonly based on assumptions applied to GL data, monthly or quarterly. Treasury's shorter-term forecast, often daily then weekly for 13 weeks, generally uses inputs from actual cash flow activity and applies assumptions to FP&A data to adjust for cash settlement timing.
- 2. Working Capital Management:** Managing the company's current assets and liabilities ensures that there is enough liquidity to cover day-to-day operations. This includes monitoring inventory levels, accounts receivable, and accounts payable. In addition, it may be necessary to earmark cash for specific payments such as taxes.
- 3. Contingency Planning:** Developing strategies to address unexpected disruptions to cash flow, such as economic downturns, supply chain disruptions, or unforeseen expenses, may involve maintaining access to emergency lines of credit or establishing cash reserves.
- 4. Debt Management:** Monitoring debt repayment schedules, determining whether long or short-term debt is required, and negotiating favorable terms with creditors is beneficial. Given the current interest rate environment, this can be extrapolated to decrease borrowing costs by using excess cash to pay down debt.

5. **Investment Policies:** Establishing guidelines for investing excess cash reserves to generate returns while maintaining liquidity should be considered. Investments should be chosen based on liquidity, risk profile, and potential returns.
6. **Stress Testing:** Conducting scenario analysis to assess the impact of different events on liquidity helps identify opportunities and risks and develop appropriate strategies.
7. **Communication and Reporting:** Maintaining open communication channels with key stakeholders, including investors, lenders, and internal departments, to keep them informed about the company's liquidity position requires regular reporting on liquidity metrics and performance.
8. **Foreign Exchange:** Ensuring you are tracking restricted and trapped cash, planning for cash repatriation, M&A, and building a plan for managing FX exposures.
9. **Variance Analysis:** Measuring actual cash flow versus forecast at the appropriate level of detail provides visibility into forecast accuracy and precision, as well as the nature of a forecast variance, whether they are the result of timing or operational differences. Variance analysis also includes measuring cash flow versus forecast to assess the impact of changes in assumptions.
10. **Regulatory Compliance:** Ensuring relevant regulations and standards governing liquidity management, such as Basel III requirements for banks or internal liquidity stress testing guidelines to keep in compliance.

CHALLENGES

Liquidity planning comes with its own set of challenges, which can vary depending on the nature of the business, its industry, and the economic environment. Some common challenges include:

- **Forecasting Accuracy:** Predicting future cash flows accurately can be challenging, especially in volatile or uncertain market conditions. Unexpected events, such as changes in customer demand, supplier disruptions, and regulatory or interest rate changes, can impact cash flow projections. Other challenges include managing timing assumptions, whether incorporating the latest large transactional decisions from business partners or applying daily/weekly timing assumptions to monthly inputs.
- **Complexity of Financial Structures:** Businesses with complex financial structures, such as multinational corporations with multiple subsidiaries or those with various debt instruments, face additional challenges in managing liquidity across different entities and financial instruments.
- **Seasonality and Cyclical Trends:** Businesses that experience seasonal fluctuations or cyclical trends in their cash flows may find it difficult to accurately forecast liquidity needs throughout the year. They must account for variations in revenue, expenses, and working capital requirements.
- **Access to Credit:** While lines of credit and other forms of financing can provide liquidity during cash shortages, securing credit may be challenging for businesses with limited creditworthiness or during economic downturns when lenders tighten their lending criteria.
- **Cost of Liquidity:** Maintaining excess liquidity as a buffer against cash shortages incurs opportunity costs, as idle cash earns minimal returns compared to investing it in higher-yielding assets. Balancing liquidity needs with the desire to maximize returns presents a challenge for businesses.

- **Regulatory Compliance:** Compliance with regulatory requirements, such as liquidity risk management regulations imposed by financial regulators, can be complex and resource-intensive. Businesses must invest in systems and processes to ensure compliance with relevant regulations.
- **Market Conditions and External Factors:** External factors, such as changes in interest rates, currency fluctuations, geopolitical events, and macroeconomic trends, can impact liquidity planning. Businesses must monitor these factors and adjust their strategies accordingly.
- **Behavioral Factors:** Human behavior, such as overconfidence or risk aversion, can influence liquidity planning decisions. Managers may be hesitant to draw on credit lines during periods of uncertainty or may underestimate liquidity needs during expansionary phases.
- **Technology and Data Management:** Leveraging technology for cash flow forecasting and liquidity management requires robust systems and data analytics capabilities. Businesses must invest in technology infrastructure and data management processes to support effective liquidity planning.

Addressing these challenges requires a combination of financial expertise, strategic planning, risk management, and technological capabilities. Businesses must continuously monitor and adapt their liquidity planning strategies to navigate changing market conditions and regulatory requirements effectively.

BEST PRACTICES

Implementing best practices in liquidity planning can help businesses effectively manage their short-term cash needs and maintain financial stability. When implementing best practices, it is important to consider:

- your organization's requirements
- where is the data coming from, and is it reliable
- who the audience is, and what the data will be used for

Here are some key best practices:

- **Regular Cash Flow Forecasting:** Develop a robust process for forecasting cash flows, incorporating historical data, sales projections, expense estimates, and other relevant factors. Update forecasts regularly to reflect changing market conditions and business circumstances. Forecast at the appropriate level of detail, and ensure actuals and forecasts use the same set of cash flow categorizations. Within the organization, align on clear ownership of forecast inputs; maintain close working relationships with teams providing inputs to your forecast to help ensure you incorporate the latest assumptions.
- **Scenario Analysis:** Conduct scenario analysis to assess the potential impact of various economic, operational, and financial scenarios on liquidity. Consider both optimistic and pessimistic scenarios to identify vulnerabilities and develop contingency plans.

- **Working Capital Optimization:** Optimize working capital management by monitoring and managing accounts receivable, accounts payable, and inventory levels. Implement strategies to accelerate cash inflows and delay cash outflows without adversely affecting business operations.
- **Maintain Adequate Reserves:** Maintain sufficient cash reserves to cover short-term cash needs, such as operating expenses, debt repayments, and unexpected expenses. Set aside reserves based on cash flow forecasts, liquidity requirements, and risk tolerance levels.
- **Diversification of Funding Sources:** Diversify funding sources to reduce reliance on any single source of liquidity. Maintain access to multiple financing options, including bank lines of credit, commercial paper programs, cash reserves, and short-term investments.
- **Stress Testing and Sensitivity Analysis:** Conduct stress testing and sensitivity analysis to assess the resilience of liquidity planning strategies under adverse conditions. Identify potential liquidity gaps and develop strategies to address them proactively.
- **Communication and Transparency:** Maintain open communication channels with key stakeholders, including investors, lenders, and internal management, regarding liquidity planning objectives, strategies, and performance. Provide regular updates on liquidity metrics and risk factors.
- **Regulatory Compliance:** Stay informed about regulatory requirements governing liquidity risk management, such as Basel III regulations for banks or industry-specific guidelines. Ensure compliance with relevant regulations and incorporate regulatory requirements into liquidity planning processes.
- **Technology Integration:** Leverage technology solutions, such as cash flow forecasting software, treasury management systems, and data analytics tools, to streamline liquidity planning processes and enhance decision-making capabilities. Invest in technology infrastructure and data security measures to support effective liquidity management.
- **Continuous Monitoring and Review:** Establish a framework for monitoring liquidity metrics, tracking performance against targets, and reviewing liquidity planning strategies regularly. Adjust strategies and tactics based on changing market conditions, business priorities, and risk factors.
- **Variance Analysis:** Define a materiality threshold and identify the driver of the variance by category and business unit or entity (based on the level of forecast detail). Once the variance driver is identified: (i) determine how they impact the forecast going forward; is the driver to an errant input, or is a change in methodology warranted (ii) understand how the actuals impact the month, quarter and year-end forecast, and (iii) influence decisions on raising capital, investing cash, and updating the forecast to meet targets.

Aligning cash forecasting and liquidity planning creates a streamlined process that updates your financial positions with real-time data. Having a clear list of goals to achieve during the project and KPIs to track after the process is live will indicate how the project team implemented the tool and how the business utilizes it, ultimately ensuring you can measure the success of the initiative.