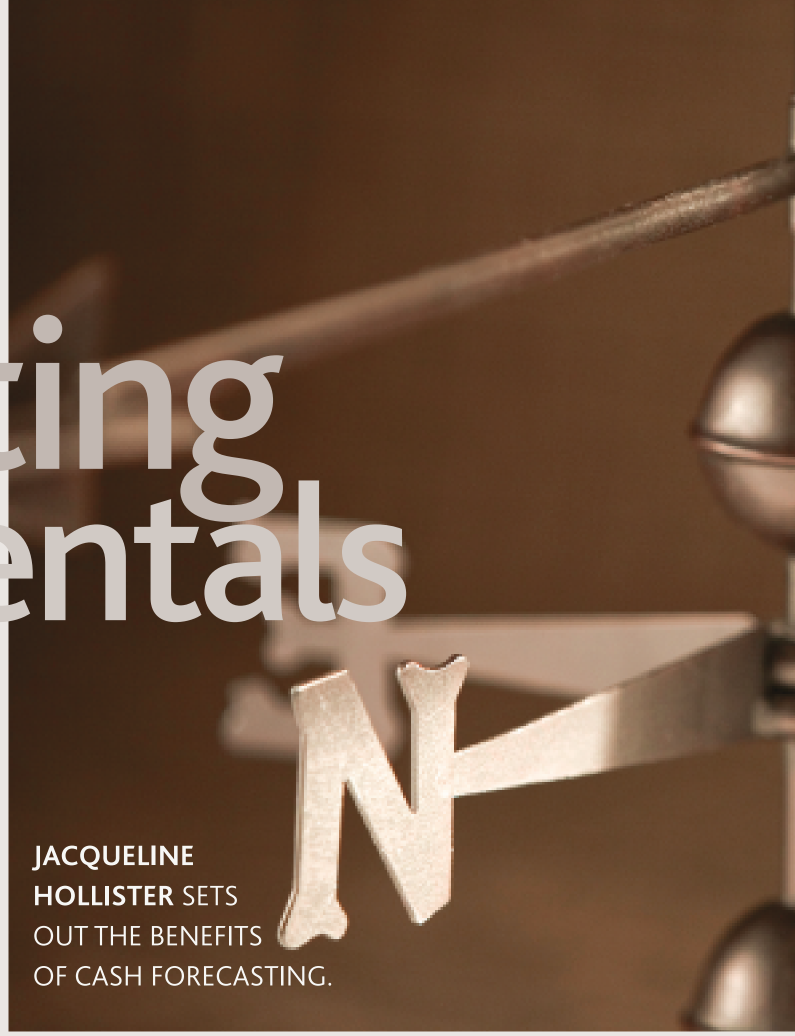
Forecasting fundamentals



JACQUELINE HOLLISTER SETS OUT THE BENEFITS OF CASH FORECASTING.

Executive summary

- Cash is once again king. Finance professionals at all levels of experience need to understand and communicate the straightforward principles and benefits of cash forecasting and management across all strata of management within their organisations.

Cash forecasting has taken centre stage in the current downturn, with organisations of all sizes and types needing to know how cash is flowing through their businesses. There can be no apologies for ensuring that finance professionals at all levels of experience are able to understand and communicate the straightforward principles and benefits of cash forecasting and management. Indeed, treasury professionals have a unique opportunity to engage with all aspects of their organisations' activities, whether cashflows are inwards or outwards.

However, treasurers need to be selective when designing a structure that best suits their business and to take care not to complicate their processes. Following the principles listed here will not guarantee success but it should allow treasurers to isolate the key aspects of cash management for their organisations.

Well prepared and properly used, cash forecasting can be a valuable aid to the cash manager. In companies that make good use of cash forecasting it can be a valuable tool in minimising the cost of funds, maximising interest earnings, and managing liquidity. There is also the need to manage foreign exchange (FX) risk exposure.

MINIMISING THE COST OF FUNDS Having advanced knowledge that funds are needed gives the cash manager time to ensure that adequate facilities are available and to look for surpluses from other parts of the group that can be channelled through intercompany loans. It also buys valuable time to address funding shortages and to look for the most cost-effective source of funds in the market. When liquidity has to be provided at short notice – even immediately if a deficit occurs – there may not be enough time to identify the best and cheapest source available.

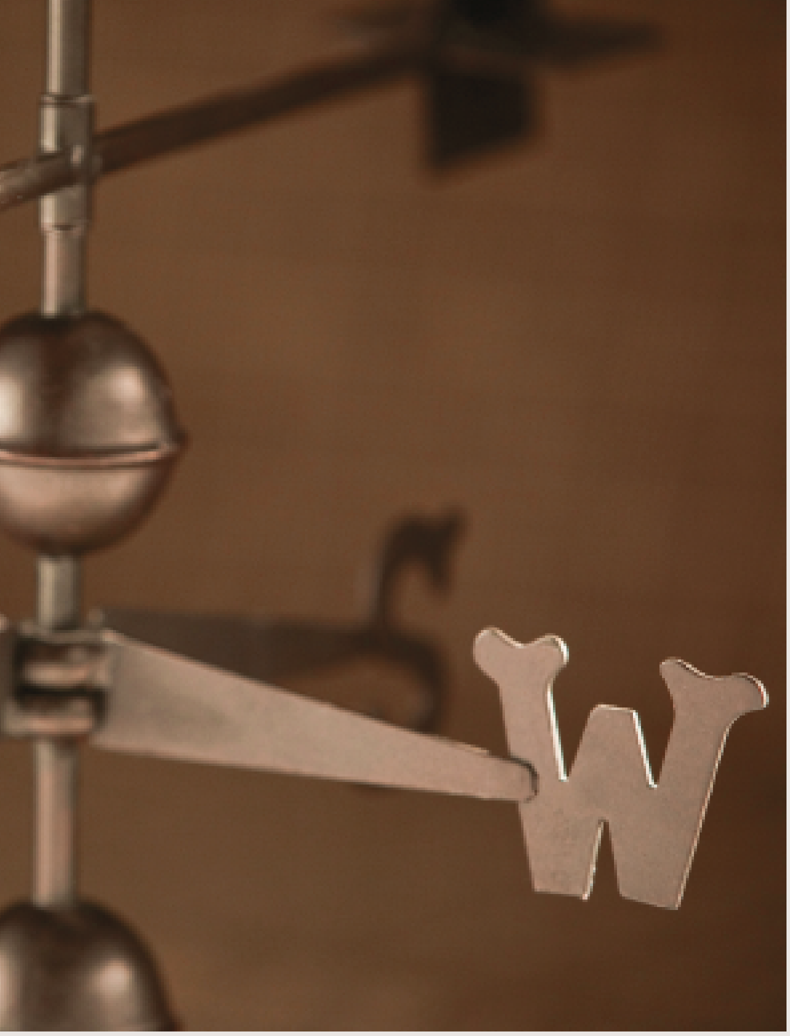
MAXIMISING INTEREST EARNINGS In exactly the same way, knowing that a surplus will occur in advance enables the cash manager to look for the most effective opportunities to maximise return. Examples include identifying other parts of the company that could benefit from a potential source of cheaper funds rather than borrowing externally at a higher rate. Accurate forecasting will enable surpluses that are not immediately required to be invested elsewhere, such as in a fixed-term deposit or money market fund.

LIQUIDITY MANAGEMENT It is the cash manager's job to provide the company with sufficient liquidity for the operating units to function. Minimising the cost of funds and maximising interest earnings are two basic components of liquidity management. When assessing potential surpluses and deficits of cash it is necessary not only to assess amounts and currencies, but also the periods for which the surpluses or shortages will arise.

Intragroup funding, practised by most large companies, is always carried out more effectively when based on planned and expected positions rather than a reaction to a short-term or emergency situation. This is particularly important where cross-currency and/or cross-border liquidity management is concerned. Moving money across borders can be expensive. As well as bank charges, there may be hidden costs such as loss of value while the funds are in transit, the imposition of lifting charges or beneficiary deductions in some countries. Timescales due to early cut-off times may also make covering deficits difficult. Some companies fund subsidiaries for very short periods using swaps based on equally short-term cash forecasts that may be for periods as short as one or two days.

FOREIGN EXCHANGE RISK MANAGEMENT Some companies require their business units to provide both local and foreign currency cash forecasts. This enables treasury to identify the size and timings of currency flows and match them against opposite flows within the company or hedge them in the currency markets.

Identification of currency flows will also enable the company to identify where currency accounts may be necessary (or no longer required). Like all forecasting, currency cashflow forecasting is only useful for risk management purposes if it is regularly updated and refined. Potential flows and estimates become more certain as they



move from the medium term to the short term, for example, and can be predicted with some accuracy.

CASH FORECASTING TIME HORIZONS Short-term forecasting This involves periods forward to 30 days with the objective of predicting forthcoming cash receipts and payments with a reasonable degree of accuracy. The aim is to identify short-term funding requirements as well as surpluses that can be invested. Short-term forecasting is a key tool to ensure that there are no idle balances sitting in non-interest or low-interest-bearing accounts.

Medium-term forecasting This involves estimating net cash positions for periods from one month to one year. It tends to establish typical averages rather than detailed daily positions, and provides the treasurer with an indication of likely funding requirements or investment opportunities over the period.

Long-term forecasting This involves periods in excess of one year and usually includes longer-term sales, purchases and product strategies of the company. Such forecasts may also be used to support the purchase of capital equipment, which may be amortised over a period of several years to enable management to gauge payback periods and potential profit contributions.

HOW RELIABLE CAN FORECASTING REALLY BE? However well produced a forecast, its accuracy declines the further it goes out into the future. The practical use of forecasts in treasury is similarly reduced the longer the time horizon. A five-year loan or investment, for example, will consist of a series of cashflows starting with an inflow/outflow of principal at the start of the period, possibly a repayment schedule, interest payments/receipts during the life of the transaction, and an outflow/inflow of principal at the end of the period. Cash forecasting must be appropriate to a company's business. The form and application of cash forecasting will differ according to the type of business, the size of the cashflows, the different time horizons used, and the type and quality of the information on which it is based.

Longer-term forecasts need to be subjected to sensitivity analysis to reflect the impact of change from year to year. The sensitivity used will vary depending on the type of scenario being modelled but typically includes currency fluctuations, interest rate movements, economic influences and marketplace changes.

Accurate information will be more difficult to obtain in decentralised groups and its collection may need to be delegated to remote business units. If business units are responsible for supplying information it needs to be concise, on time and in an agreed format.

SO HOW USEFUL IS CASH FORECASTING? Cash forecasting should ensure that the company has no nasty surprises as far as liquidity is concerned. It should enable the cash manager to identify potential cash shortages and take remedial action, such as agreeing the delay in making payments, reducing customer credit periods and seeking to speed up cash collections, as well as establishing new credit lines. Forecasting can be an extremely useful cash management tool but only if the forecasts are:

- well prepared using reliable base data;
- produced using time horizons appropriate to the company;
- updated at regular intervals to reflect the impact of change; and
- checked against actual flows and refined over time to improve accuracy.

Companies should devise a system relevant to their own pattern of cashflows, focusing on those flows that have a significant effect on the company's net positions. Technology can assist the corporate cash manager but, unfortunately, many companies make such poor use of cash forecasting that the whole process fails and the potential benefits are never realised.

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Box 1: Case study

BRC Consulting Services reviewed the treasury and cash management function at central treasury and subsidiary level on behalf of a global corporate operating in the UK, Europe, North America and South Africa to evaluate how it compared with best international market practice.

The company operated a predominantly decentralised cash management model and the overseas subsidiaries operated largely autonomously with responsibility for local payments and collections and hedging local currency exposures. Group treasury, however, had been partially centralised and had already implemented a new European banking arrangement and established a euro zone cash pool.

Accurate and timely forecasting was a significant feature of group treasury's ability to manage its global liquidity exposure on a centralised basis but high reliance on Excel spreadsheets, which are by their nature subject to corruption and failure, and an inability to implement a standard forecasting model throughout the subsidiaries, resulted in largely incomplete and inaccurate cash forecasts.

To deliver a more sophisticated approach to cash management, and to remove the time-consuming and inefficient manual processes associated with the use of spreadsheets, BRC Consulting Services helped the company evaluate and select an alternative technology solution.