Fabulous forecasting

WITH CASH TAKING CENTRE STAGE AGAIN AND EXTERNAL RESOURCES SCARCE, EFFICIENT USE OF INTERNAL RESERVES HAS BECOME MORE IMPORTANT THAN EVER, SAYS SARAH BOYCE

This article is the first of a series on cash forecasting and it explores the benefits to an organisation of producing cash forecasts.

Cash forecasting (identifying short-, medium- and long-term liquidity requirements) is a key element in managing liquidity risk and a valuable aid to the organisation as a whole. But the benefits (or otherwise) of cash forecasting have long been debated by organisations of all sizes. In the 'good old days' when there was plenty of liquidity for all, the view frequently adopted was that the resources required to deliver an accurate forecast in a timely manner could not be justified (the cost or benefit analysis just didn't stack up). Arguably, this has never been the case, but particularly in the post-Lehman environment, cash has reverted to centre stage and efficient use of internal resources has become much more important given scarce external resources.

Forecasting: the pros and cons

A reliable cash forecasting system is seen by many companies as essential to manage liquidity risk effectively. Knowledge of funding required, given a range of scenarios, is important when planning any timescale. By predicting shortfalls and surpluses, the cash manager can optimise the use of cash and facilities to improve investment returns, negotiate better borrowing terms and conditions, and minimise external borrowing.

For cash management purposes, there are usually three timescales for forecasting, each serving a different purpose:

- Short-term, today up to 30 days (or longer); the forecast is by day and by week;
- Medium-term, one month (or the end of the short-term forecast) to one year, where the forecast is prepared by month; and
- Long-term, over one year, where the forecast is for one or more years (frequently up to five years in Western Europe, but it may be up to 15 years in countries such as Japan, where financial markets are traditionally less short-term in nature, or for infrastructure finance projects) and prepared by year, half yearly or quarterly, depending on the organisation.

Cash forecasts can be generated by two principle forecasting methods over the different time periods – the long-term, strategic forecast, commonly generated from the management accounting statements in an organisation; and the short- to medium-term forecast based on a receipts and disbursements methodology.

Long-term forecasts

The objectives of a long-term forecast are to identify structural cash shortages and surpluses (including requirements for committed facilities) by identifying the potential impact of strategic initiatives or business changes on the company's:

- Long-term liquidity;
- Capital structure;
- Balance sheet; and, ultimately,
- Credit ratings and ratios.

For companies planning a corporate transformation, such as a merger or acquisition, or even 'just' significant capital expenditure, long-term forecasting is essential to identify the size and tenor of any funding requirement.

Potential investors, such as banks or bond holders, may also require long-term forecasts to ensure that sufficient cash is generated to enable the company to make loan and interest payments on long-term debt without jeopardising other activities of the business.

Short-term forecasts

Short-term forecasts are used to manage day-to-day cash requirements by identifying the amount and timing of expected cash receipts and payments.

The objectives of short-term forecasts are to:

- Ensure there is sufficient liquidity to meet all short-term obligations and to avoid expensive, unanticipated overdrafts or other emergency funding;
- Put short-term surpluses to optimal use by ensuring that there are no idle balances sitting in non-interest or low-interest-bearing accounts; and, ultimately, to
- Optimise liquidity across the company – the 'right amount in the right place at the right time'.

Generating a short-term forecast, which tells treasury that funds are required in advance, gives the cash manager time to:

- Look for surpluses from other parts of the group that can be used, via inter-company loans, to fund the shortages;
- Look for the cheapest source of funds in the market;
- Enter the market when terms and conditions are most favourable; and
- Ensure adequate facilities are available when required.

Having to produce liquidity at short notice means that cost of funds may well be higher and can be difficult in certain market conditions.

Intra-group funding, practised by most large groups, is more effective if it is based on forecast positions, rather than as a reaction to short-term situations, and the use of forecasts minimises the amount of unnecessary transfers. This is particularly important where cross-currency and/or cross-border liquidity management are concerned.

Moving money cross-border can be expensive and (in the context of daily cash management) time-consuming due to the accounting and regulatory requirements that must be complied with.

Short- or medium-term cash forecasts can also be used in FX risk management, since, by producing both local currency and foreign currency cash forecasts, a cash manager can identify the size and timings of currency flows to:

- Identify any natural hedges (foreign currency assets that are offset by same currency liabilities in other parts of the group);
- Match any currency needs against currency surpluses elsewhere in the company; and
- Determine any remaining exposure and decide whether to hedge them in the FX market.

Establishing a short-term cash forecasting system can also help the business to understand working capital drivers. For example, receipts and disbursements forecasting can identify mismatches between credit periods granted to customers and the amount of credit used and credit taken from suppliers against credit terms offered, and terms or commercial behaviour can be modified as necessary.

Challenges

There are several challenges associated with generating a cash forecast. And treasurers often cite forecasting as the most difficult element of cash management for the following reasons:

- Internal communication and culture;
- Systems challenges;
- Quality of data; and
- Resource challenges – lack of expertise on how to develop a forecast.

For a cash forecasting system to work successfully, it is important that operating units understand the importance of forecasts and buy in to the process. This requires clear communication and, frequently, an education process to ensure that the preparers of forecasts know that their forecasts are being used and that they are not merely a control imposed from the centre. The operating companies need to understand how important accurate forecasts are in helping to ensure that the business has sufficient funding to be able to continue functioning; regular feedback from treasury can also help here.

Of those companies that do prepare cash forecasts, few use sophisticated computer software. Various studies have found that more than half of the companies surveyed use spreadsheets as their primary forecasting tool. Even larger companies are not heavy users of technology, such as treasury workstations, for forecasting. But the use of spreadsheets should not be dismissed out of hand as their simplicity and widespread use makes them a simple solution for finance teams to provide information.

Like all forecasting, cash flow forecasting is only useful if the data is accurate and it is regularly updated and refined. All information supplied needs to be concise, on time and in an agreed format. Poor-quality data – in particular, inaccurate sales figures or misreported intercompany items – can be a major hurdle as they can skew the entire process. It is an ongoing challenge to obtain realistic, rather than aspirational, numbers from sales and marketing teams, and is one of the major areas of tension between treasury and central finance teams.

> Moving money cross-border can be expensive and time-consuming

Conclusion

Cash forecasting can be an invaluable tool for cash managers, but it will only be useful if it is tailored to meet the needs of the business by being:

- Relevant for the purpose for which it will be used by being produced using an appropriate time horizon;
- Prepared using reliable base data with buy-in from operating companies; and
- Checked against actual numbers and refined by feeding back to contributors over time to improve accuracy.

This will ensure that the time and money cost of preparing each forecast is justified.

WHAT WILL BE COVERED IN THE REST OF THE SERIES?

- **Future articles will discuss alternate methodologies in producing forecasts over differing time horizons and suggest an approach that may be adopted when implementing a cash forecast process.**

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