Perfect planning

IN THE LATEST ARTICLE IN OUR CASH FORECASTING SERIES, SARAH BOYCE DISCUSSES THE AIMS OF LONG-TERM FORECASTS AND HOW TO CREATE THEM

While short-term cash forecasts generally focus on cash management issues, longer-term forecasts (covering periods beyond one year) are designed to address liquidity risk (ie the risk that the organisation has insufficient funds to continue as a going concern).

The key objectives of a long-term cash flow forecast are to:

- Identify trends and overall cash generation, or consumption, arising from the business's current strategic objectives;
- Identify the impact of changes to the business plan or changes in economic conditions on the liquidity position (scenario analysis); and
- Model the impact of transformational events such as acquisitions, divestments or major investment plans.

Once created, a long-term cash flow forecast can be used to:

- Identify any conflicts between spending ambitions and resources (for example, identify whether a major acquisition can be afforded without increasing gearing);
- Develop a financial strategy to include the points below and so provide the basis for planning access to funding and investment markets:
  - Levels of gearing
  - Mix of fixed and floating debt
  - Amount of committed headroom
  - Monitoring/targeting/maintaining a credit rating
  - Dividend policy; and
- Enable the organisation to clearly and consistently communicate its longer-term financing strategy to the wider community.

The forecast will be used by:

Lenders – 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;

Equity investors – to assess future returns on their investment and so make investment decisions;

Rating agencies – to populate their internal models and identify an appropriate rating for the organisation;

Advisers – as backup for a going concern disclosure or as part of the materials that are required for a significant corporate transaction (for example, a listing); and

Private equity – to plan the whole life of their involvement, including an exit strategy and equity pricing.

How a forecast is generated

In many Western economies, a company may estimate cash flows over a five-year period. But a company may forecast up to 15 years or more for infrastructure finance projects or in countries such as Japan where financial markets are traditionally noticeably less 'short-term' in nature.

Almost all companies base longer-term forecasts on projected financial statements, known as the pro forma statement method, rather than on forecasts of cash receipts and payments. The main reasons for this are:

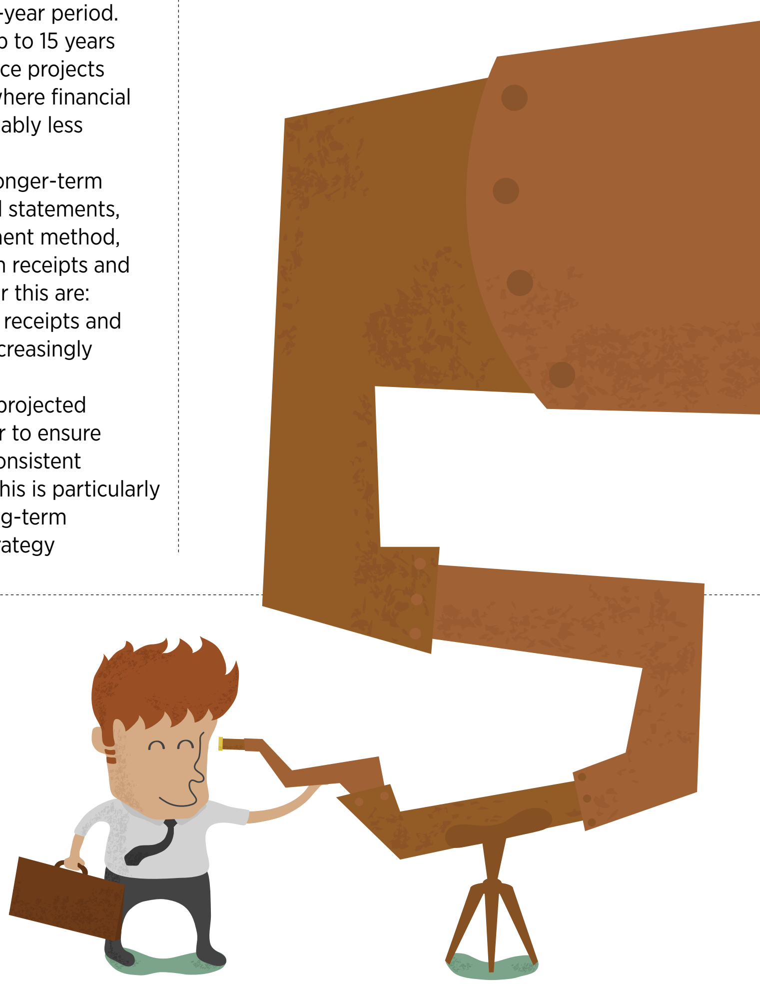
- Beyond about three months, receipts and payments forecasts become increasingly inaccurate; and
- Preparing the forecast from projected accounting data makes it easier to ensure that the cash flow forecast is consistent with the accounting forecast. This is particularly important when identifying long-term targets as part of a financial strategy or for management communicating externally as figures need to be consistent and readily accessible.

There are a variety of ways to generate accounts-based cash flow statements, but one of the most straightforward, and therefore most widely used, is an approach derived from the corporate budgeting and planning system that uses an opening 'actual' balance sheet together with a forecast income statement to generate a forecast closing balance sheet and forecast cash flow statement.

Steps in the process:

1. Source an opening balance sheet based on actual data.

2. A sales forecast is generated and the income statement and balance sheet items that appear to be a constant percentage of sales are identified. Where better-quality or specific



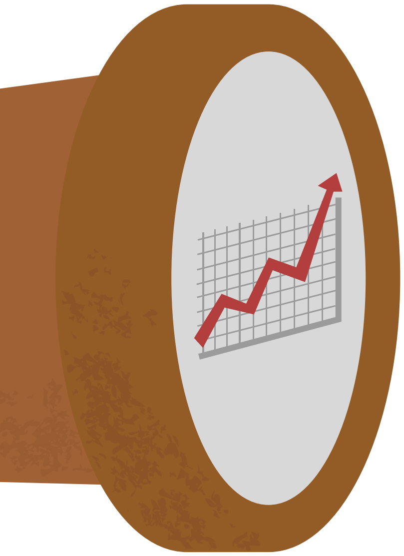
information is available, this is substituted for the ratio.

3. Projected income statement, closing balance sheet and cash flow statement are created.

4. Steps 2 and 3 will be repeated for each period (for example, each year) until the forecast has rolled as far forward as required.

Inevitably, the 'assets' will not equal the 'liabilities and equity' in the forecast closing balance sheet and so 'cash' is used as the balancing figure.

If the assets are less than the liabilities, the company is forecasting a cash surplus. If the total assets are greater than the total liabilities, the company is forecasting a cash deficit that will need to be financed.



Coordination across the organisation to create a realistic forecast is key since the firm may have to live with the consequences of any decision for decades

The forecast should be regularly updated to reflect the latest information while staying aligned to the statements produced by the finance department.

Most organisations will use this process to generate a range of forecasts (as a minimum 'plan' plus a downside case), based on a range of scenarios.

Stress testing, where a company will flex the forecast to see how far from forecast it can move before the plan fails (for example, sales fall by 5% resulting in an inability to service debt), is also frequently adopted.

Financial analysis that can be driven from a cash flow forecast derived from prospective financial statements can include:

- Ratio analysis, including credit ratios such as interest cover and gearing;
- Potential credit ratings (inferred from the ratios and underlying business risk); and
- Headroom available (both committed and uncommitted headroom); that is, the amount of fully available cash plus undrawn borrowing facilities.

Conclusion

Long-term forecasts are created to measure the impact on liquidity, capital structure and credit ratings of both 'business-as-usual' and/or transformational activity and enable the organisation to identify the size, source (debt or equity) and tenor of any associated funding requirement.

It is important that the treasury team has a strong working relationship with the finance team and local management as well as being fully aware of the strategic thinking of the board when developing long-term plans since, by creating and maintaining a robust long-term cash flow forecast, the organisation can opportunistically access the lending markets and save on finance costs over the long term. The ability to source finance at the 'right price' for a project may influence the decision to undertake that project.

Coordination across the organisation to create a realistic forecast is key since the firm may have to live with the consequences of any decision for decades. This means that the finance version of the forecast may need to be adjusted to show a more prudent picture of predicted future cash flows (sales forecasts are invariably highly optimistic) to ensure that any decisions taken are appropriate.

It is important that the cash forecast used by treasury can be reconciled to the forecasts used by the rest of the organisation to ensure that the board is making decisions on one consistent set of numbers. So any adjustment should be shown separately rather than by changing the base figures.

NEXT TIME...

- **In the final article in this series, we will suggest various helpful hints and tips for putting together a cash forecast over any timescale**

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