Made-to-measure short-term forecasting

Richard Hodgkinson, an independent consultant, takes a closer look at some of the techniques that can be used in short-term cashflow forecasting.

Short-term cashflow forecasting in the context of the theme 'short-term liquidity management' is the art of forecasting cleared funds balances for the near future from approximately this week to three months.

I am not talking about the sort of medium-/long-term forecasts that tell us we must arrange additional borrowing facilities. Such forecasts take into account the strategic direction of the businesses and are patiently built up from 12-month or longer forecasts of cashflow, which have the rigour of also addressing the balance-sheet consequences: a major exercise usually undertaken annually and updated two or three times a year. I am also excluding the overnight forecasting exercise as this is a separate issue.

The purpose of the short-term forecast is to help optimise and smooth the interest charge in the profit and loss account by being able to borrow or deposit funds at a range of maturities. A borrower will be able to reduce interest cost by borrowing in the money market against an overdraft, and also reduce interest rate risk by selecting a range of maturities for those money market borrowings. The interest saving arises from the differential between short money market rates and prime rate, which is usually higher, and the fact that most corporates are charged a lower margin on money-market borrowings than on overdrafts by the banks. For companies with surplus funds it is vital that they temper their desire to earn the maximum interest on term deposits with the need to have sufficient liquid cash to meet expected and unexpected downturns in cashflow.

To succeed, frequent accurate forecasts by amount and time period are essential. But, how do we prepare these forecasts when the annual budget exercise and its various updates are too long-winded and inflexible?

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In answering this question I have been able to draw on my experience as a treasurer and consultant, with a number of different companies. I have also enlisted the aid of the Association's Central London regional group, whose recent discussion on the subject yielded up a number of pearls of wisdom.

The main messages that come across are that since every company is different, there is no right way, and accuracy is difficult to achieve. First of all, I will cover some of the techniques used and then identify some of the problems and how they can be overcome.


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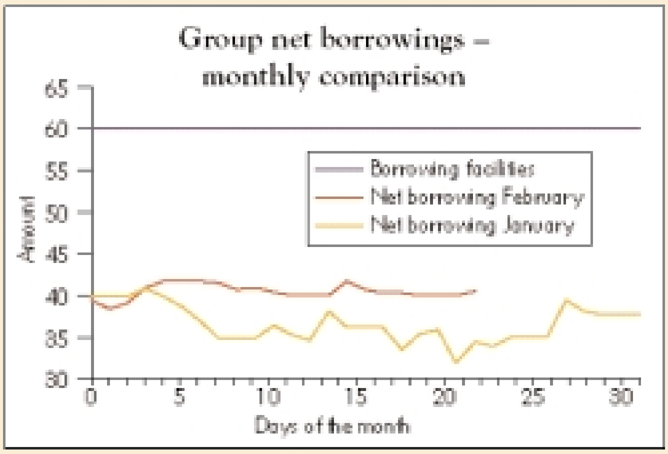
Forecasting techniques

The most common technique is the rolling receipts and payments forecast, which is prepared by each subsidiary and then consolidated by the treasury department. Often prepared weekly, these forecasts go out as long as 13 weeks ahead and show weekly anticipated movements. One company that was represented in our discussion group shows the last three weeks' actual figures for comparison and provides a commentary on the past week's variances. Some companies only go out two weeks ahead and try to forecast daily movements, while others do not require the breakdown of receipts and payments, an overall movement figure being deemed sufficient. Their format though will be dictated by what is considered most appropriate for the business and the state of its cashflows and balances.

As an aid to improving forecasting, and used alongside the cashflow forecast, some companies chart historic cleared balances on a daily basis to provide an indication of expected movements in the immediate future. The example shown in *Figure 1* was in its early stages of development and so does not plot the equivalent balances for the same period in the previous year. As well as being a forecasting tool, this chart formed part of the daily cash report circulated to the group finance director and other senior management. This technique works best when there are regular patterns of receipts or payments and, where businesses are seasonal, can be of great use in forecasting balances many months out.

The following are a number of problems I and others have come across, and ways of improving forecasting. Sadly, there is not always a satisfactory solution, but I hope readers will not be too despondent knowing they are in good company!

FIGURE 1



Motivation

There are many groups of companies, especially those giving a large degree of autonomy to subsidiaries, in which all of cash management, let alone forecasting, is given insufficient priority. The forecasting therefore suffers from inaccuracy and delays. For companies where cash is king (Hanson was a good example of this), the importance placed on these activities resulted in good performance. The ingredients for success seem to be the good old stick and carrot:

- it must be given priority backed from the chief executive down though the organisation, at both head office and subsidiary levels. Venture capital companies are very rigorous when monitoring the companies in which they have invested and I am sure could teach most corporates some tricks. By imposing onerous penalties for not meeting targets they instill a need for active compliance;
- to motivate staff to comply they must know that their jobs depend it. Bonus schemes that are based on cash generation and performance measurement will concentrate the minds of operating managers and accounting staff alike; and
- it helps a lot if staff believe in what they are doing. The treasurer can play an important part in selling the need for better forecasting and cash management to both general management and to the staff carrying out the work. Quantifying the benefits will certainly assist in achieving this.

Reconciling forecasts

The purists in organisations who are producing three-month short-term forecasts, will insist on making sure they agree with the latest updated budget cashflow forecast. This latter exercise is often based on the accounts rather than cleared balances; relying on it as the basis of a short-term forecast can be a trap for the unwary. In my experience, reconciling the two in practice leads to the exercise being done mechanically and so is not worth the time and effort expended.

Error analysis

By keeping records of forecast as well as actual figures, and by analysing the variances, the reasons for forecasting errors can be identified. An approach for reducing the margin for error for each type of variance can be developed, improving forecasting over time.

Process review

Some of the processes leading to inaccuracies in forecasts can, on review, be altered to allow more accurate forecasting. Making payments electronically is an example of how certainty can be improved. The length of time it takes for the presentation of cheques drawn can be forecast after much analysis, but until one investigates, one doesn't know if a finance manager is keeping back cheques in a drawer and dribbling them out to the suppliers who call loudest and longest.

No easy answer

Summing up, there are no easy answers. Each business is unique and will require a tailor-made approach. When deciding what resources to devote to the exercise it is worth trying to quantify the benefits. The benefits of better forecasting may not be as great as better cash management, but they do need to be assessed in each case. ■

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