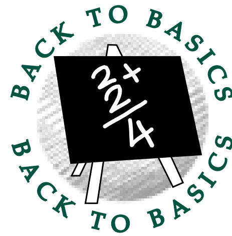

Cash forecasting (*part I*)

Rod Staples of PricewaterhouseCoopers looks at cash forecasting – a vital part of the treasurer's job – and offers a possible implementation framework.

How often have you heard the phrase 'cash is king'? From a treasurer's perspective, managing cash (or lack of it) is a vital part of the job, and cash management is a frequent topic in *The Treasurer*. However, the prerequisite for cash management is cash forecasting, and this article sets out to explore the basics, and outline a possible approach for implementing a coherent framework.

Why forecast cash?

Businesses of any size can probably identify several reasons for actively monitoring and managing their cash (or debt). These may cover both short-term operational issues and medium- to long-term strategic planning, and may involve different objectives. Common examples are shown in *Table 1*.

Forecasts can be based on various methods and horizons, but typically share a primary focus on measurement against absolute constraints, (eg, borrowing/covenant limits), with a secondary aim of improving efficiency (eg, working capital management).

TABLE 1

Common cash forecast uses

Treasury activities:
- liquidity management
- cash pooling and netting
- investment/funding strategy
- interest rate risk management.

Financial planning:
- working capital targets
- project appraisal
- acquisitions and growth
- identifying/managing cash cycles
- P&L interest calculation
- capital structure.

Lender/investor relations:
- covenant compliance
- borrowing limits
- debt repayment schedules
- interest cover ratios
- dividend policy
- asset/liquidity ratios.

The importance of forecasting cash will vary with the potential penalties for getting it wrong. Operational factors that increase the need for timely and accurate cash forecasts include high gearing, high growth, low margin, strong seasonality/volatility of cash flows, and long cash cycle lead-times. Clearly the difficulty of forecasting will depend on the complexity of the cash cycles and the predictability of future activity, but it is often the companies with hard-to-predict cash flows that most need to monitor it closely!

Growing importance

However, a reactive approach may no longer be appropriate. Most corporates would accept that cash flow is a useful performance indicator and provides a healthcheck on the future viability of the business. Many also subscribe to the idea of shareholder value creation, which relies on assessing business strategy through the resulting changes in the discounted value of future cash flows. Thus, a robust cash forecasting process should be seen as a proactive means of showing the cash generation potential of the business, and prove the present value added by management action.

This is becoming more important. The trends in welfare privatisation, lower interest rates in the West, and the removal of currency risk in the euro-zone, are all causing investors to focus on equity returns. This will increase the already significant influence exercised by analysts, and, as a result, market value could become dependent on the availability of reliable forecasts of cash generation. It is even conceivable that a cash forecast might become a reporting requirement.

To support these objectives, traditional cash forecasting has fallen into three generic types:

- short-term (0-3 months) prepared mainly for short-term liquidity management. This is well understood by treasuries, with established forecasting and monitoring routines, often on a bank balance basis;
- operational (3-18 months) produced for longer-term planning, working capital targets, and monitoring borrowing requirements, and usually linked to a budget process. Often preparation is the responsibility of operating businesses, and the underlying processes may not always be well understood by treasury; and
- strategic (1-3 years+) chiefly used for long-term goals and capital structure models. Prepared infrequently and seen as targets not forecasts.

While some organisations use all three in their cash forecasting framework, not all are relevant to every business. But except for small companies, or those without a regular cycle of internal reporting, an organisation is unlikely to rely solely on short-term forecasts.

Appropriate forecast frameworks

Any process to determine a cash forecast framework should include a review of relevant business factors. *Table 2* shows critical business characteristics that increase the need for forecasts, and their potential impact horizon.

Before determining the type(s) of cash forecasting to be adopted, some important decisions have to be made:

TABLE 2

Critical business factors

Factors increasing the need for cash forecasts	Short-term	Long-term
Large number of bank accounts without central pooling	✔	
Numerous FX transactions without account pooling	✔	
Limited headroom/facilities	✔	✔
Intra-month cash peaks/troughs	✔	✔
Activity includes infrequent large-ticket items	✔	✔
Restrictive covenants		✔
Experiencing rapid growth/decline		✔
High gearing		✔
Low margin		✔
Long cash cycle lead-times		✔
Strong seasonal cash cycles		✔
Volatile/unpredictable business activity levels		✔

- what is the main purpose of producing the forecasts? Does it address existing business-critical factors? Subsequent decisions should reflect this analysis, to ensure the level and focus of effort invested in the process is appropriate to the required output and underlying objectives;
- what type of cash is to be forecast? This is important for performance measurement, but can create reconciliation issues if other internal reporting uses different definitions;
- will other related items (ie, trade finance and FX usage, especially if drawn under the same banking facilities) need to be forecast as part of the same process?;
- what currency is to be used, and what conversion rates will be used for consolidation? What unit scale is to be adopted?;
- what are the appropriate horizon and time periods for reporting? This will depend on the volatility of short- and long-term cash cycles, and the business planning horizon;
- what is the intended frequency of reporting? Is this appropriate to the degree of volatility in the business cash cycles?;
- what reporting format is to be used? Common types include 'receipts and payments' and 'net assets', but for effective variance analysis it will be necessary to report actuals in the same format. With more than one reporting entity, formats may need to cater for different business types;
- what sensitivity analysis or 'what-if' scenarios will be run?;
- what variances will be reported (eg, against budget or latest forecast, on cumulative to date or to a future position)? An analysis of the variance components (eg, timing versus permanent) will also be necessary for effective management response; and
- what degree of accuracy/detail is required or expected? Materiality levels should be defined.

All these factors will depend on the specific business; there is no 'one size fits all' solution.

Practical considerations

When considering the above, it is useful to review existing business information, to determine how it might support the process. Another factor is the potential for automation, especially where frequent reporting is required. It is also important to consider the impacts cash forecasting might have on underlying business practices. These might be intended, but there may be unplanned consequences, especially if performance measures can be manipulated.

Other practical issues, especially where several reporting departments/entities are involved, include:

- deciding 'ownership' for production and validity of forecasts, and for explanation of variances;
- procedures to ensure timely, accurate collection of relevant data, and ensuring it is reviewed for consistency with other business information;
- process to determine central assumptions, and to monitor compliance; and
- performance measurement, if applicable (eg, size of variances).

Above all, expectations must be practical. There is no point producing a monthly forecast balance sheet if comparable actuals are produced quarterly.

Reconciling forecast outputs

Frequently, more than one forecast type is produced within the same organisation, eg, short-term liquidity forecasts versus a longer-term working capital budget. In these cases, the outputs should be broadly reconciled, with the differences understood and eliminated where appropriate. Discrepancies between forecasts prepared by different areas, or using different methods, are commonly due to:

- definition of cash;
- FX conversion rates;
- point of measurement;
- value and timing of significant non-trading items (eg, additions/disposals, tax and dividend payments);
- assumptions used for trading cycle (historical patterns);
- economic assumptions (eg, interest rates, market growth); and
- mismatches of intercompany items.

Creating a 'cash flow culture'

There is a danger that cash forecasting may become a theoretical exercise. Management may need to engender a 'cash flow culture' to improve the quality of forecast results, through:

- re-appraisal of the current forecasting framework, to ensure clear objectives and valid supporting processes;
- align performance measurements and incentives to forecast expected outcomes, not targets;
- continual review of assumptions; and
- focus on understanding variances to add value.

For many companies, their existing processes are the result of historical practice rather than an objective review of cash drivers and business requirements.

By re-examining the cash forecasting framework, opportunities may be identified for improved efficiency, better reporting and a more coherent approach across different forecast types and horizons. And in the context of the growing importance of being able to demonstrate cash generation potential to the market, now might be a good time! ■

Rod Staples is a consultant in the European Corporate Treasury Consulting Team at PricewaterhouseCoopers.