

CLEARER SIGHT LINES

Improving an organisation's forecasting programme enhances value by directing cash towards higher-value investments. Bob Stark explains

▶ The number one treasury issue that causes CFOs the most potential concern is unreliable cash visibility and forecasts, according to a 2018 CFO Publishing survey.

Cash forecasting is an art that is difficult to perfect. Every organisation talks about forecasting more effectively, but few allocate sufficient resource. Understanding the importance of an accurate cash forecast is critical. While there are many reasons to forecast, there are a few key areas that should be addressed to help CFOs and treasurers communicate the connection between accurate cash forecasting and bottom-line financial performance.

What is cash forecasting?

A key component of corporate cash management when performed accurately, forecasting enables greater certainty of projected cash balances. Longer-term investing, reduced borrowing costs, more effective hedging programmes and better mobility of global cash – cash positioning is concerned with today and often the next five business days. The purpose is to manage daily liquidity to ensure shortfalls are covered and surpluses are concentrated to earn some yield on excess cash.

Cash forecasting typically extends cash positioning with horizons anywhere from one week to one year. Forecasting leverages multiple data sources to increase confidence in the projected cash balances so that better cash decisions can be

made. The value of forecasting is based upon the value of those better decisions.

Why forecast?

Ineffective cash forecasting costs the company money and impacts shareholder value. A poorly executed cash-forecasting programme drives a number of negative consequences, so it is critical for CFOs and treasurers to understand the link between effective cash forecasting and bottom-line financial performance.

Excuses such as “we’re cash rich” or “interest rates are too low” no longer satisfy hungry investors who demand that cash be deployed or returned to them. Without adequate visibility of forecast cash and where cash needs to be deployed to meet growth targets, CEOs and CFOs risk looking foolish in front of shareholders and analysts.

Accurate cash forecasting allows

companies to better understand their cash troughs and hence their ‘worst-case’ cash scenario. If they have confidence in this figure, they can ensure they only borrow to fund that as opposed to adding more for contingencies or a margin of forecasting error. This is important: debit interest tends to be more costly than credit interest and companies are often judged, both formally (for example, when they have covenants) and informally using gross metrics such as interest cover, return on capital employed or gearing.

The volatility in global currencies shows no signs of abating, meaning that the pressure on CFOs to maintain the value of foreign cash inflows and outflows persists. Companies can experience earnings per share losses from unexpected and unhedged currency impacts or have difficulty in maintaining (let alone increasing) return on cash in a post-Basel III environment.

Forecasting cash will allow segregation of operational and non-operational cash into time buckets as well as



“The amount of idle cash sitting in our subsidiaries has dropped by 50%, and more efficient investments have grown revenue by 53%. Our cash management operations are now streamlined so that unnecessary overdrafts are avoided, payments and financial transactions are funded and all excess cash is invested in the short-term money markets.”

Nadeem Ahmed, financial controller, Zahid Tractor

deliver the needed accuracy to allocate cash to longer-duration investment strategies. This will help preserve previously realised investment returns or help to find an alternative for cash balances that are no longer wanted by your bank.

Certainty in projected cash balances drives the CFO's ability to anticipate and prepare for corporate actions and strategic investments. For example, without confidence in cash forecasts, the CFO and treasurer are not relied upon to contribute to key M&A decisions such as providing guidance on the components of cash, debt and equity to calculate a total acquisition cost.

When cash is held globally, share buybacks or dividend hikes are a challenge. CFOs may find it cheaper to borrow cash domestically than repatriate funds – this analysis requires certainty into projected cash balances. Confidence in the cash forecast is critical to optimise business value; CFOs need an effective cash forecast in order to make commitments on how to reinvest cash to meet organic growth targets. Lack of confidence will lead to unnecessary borrowing or equity financing.

Consolidation of data

Finding the right information and determining the most efficient (ie automated) way to integrate it into a consolidated forecast system is key. “Around 70% of transactions are now processed electronically and we have gained full visibility over our cash and financial transactions. Our processing times are significantly

reduced and we have made noteworthy operational cost savings, which have more than offset the implementation costs,” says Sean De Silva, cash management section head – government of Sharjah.

While automation is important, data quality is also paramount to success. When building the forecast, each line item may be sourced in different ways. The source of the information will determine the best way to build the forecast for each line item. For example, many treasury teams prefer to import accounts payable data directly from the enterprise resource planning system, while for receivables information they may wish to extrapolate historical data and model using a linear regression. For treasury teams to be effective, it is important that all methods be fully automated and secure so that initial set-up, maintenance and daily execution to build the forecast are easy and can be maintained by the user (and not need re-programming).

Collaboration

Making decisions on the best data to build the forecast also requires determining who to collaborate with to smoothly access that key information. In many cases, treasury does not have direct authority over the people who own systems and/or business responsibilities that offer that data. Yet, treasury relies upon this outside information to build a comprehensive forecast, so good internal communication skills are critical to receiving quality information in a timely way. Accounts Payable, financial

planning and analysis, IT and regional controllers all forecast projections for decentralised organisations. Many treasury teams plan, with their CFOs, a top-down collaboration model that builds effective cash forecasting into the team's objectives and compensation. This draws attention to the forecasting objectives and motivates each team to fulfil their roles.

Measurement

The most important – and often overlooked – step is the measurement of forecast accuracy. Implementing a process to measure forecast accuracy at a detailed level to identify the source of variances is critical to improving the quality of the forecast and ultimately reducing forecast variances. Equally important is implementing a feedback loop – to systems and to people – that ensures forecast data is improved based on variances that were identified. The feedback loop is especially important when non-treasury resources are contributing to the forecast to ensure that the right behaviours and cash-forecast numbers are positively reinforced while opportunities for improvement are well communicated. This is especially effective when feedback is aligned to key performance indicators and quarterly objectives of those outside the treasury team.

Key to success

A forecast variance analysis should be detailed with multiple snapshots taken. If only a summary picture is reviewed, then a lot of the variability is hidden within that time frame. Measuring daily, weekly or bi-weekly will help uncover the ups and downs between forecast and actuals that might otherwise go unnoticed.

The business intelligence features of a treasury management system offer the data visualisation and analytics required to provide this level of detail.

Cash forecasting is especially important if you are cash rich with a high percentage of non-operational cash deposits. Multinationals with significant foreign revenues must forecast better, so they can hedge effectively and deliver cash predictably to their stakeholders. The key to forecasting is flexibility so that you have many options to model the different streams of forecast data. The accuracy of your data will determine if importing, regressing, extrapolating or other methods of calculations are needed to build your forecast effectively.

Without measuring forecast accuracy, it is impossible to know if you are good at forecasting. Data visualisation helps focus on important variances – whether by category, time bucket or geography – and isolate what data needs to be improved for future forecasting. Return on investment of cash forecasting is very high.

In summary, the value of forecasting is driven by what your organisation can do with additional cash. The value of cash can be measured by investing longer with higher returns on cash, repaying debt, earning yield from early supplier payments or investing in new organisational projects. Perfecting the cash forecast means freeing up cash from working capital and direct it to these higher-value uses. 📈

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