Methods for cash flow forecasting

It’s horses for treasury courses. As treasurers establish a cash flow forecasting strategy, it is essential to be aware of what is available to them.

Dan Bland reports

Most of the cash flow analysis the average company does when it comes to forecasting is financial accounting. It is required disclosure for listed companies; it is good for investors, but it is not what helps a CEO run the company.

The problem with cash flow statements is that they are historical. An accounting of the company’s cash in the previous reporting period is necessary, but what’s past is not necessarily prologue.

Unfortunately, viewing a company by its cash flow is not a priority for most companies. Assessing by sales, profit, or revenue is more common, but these have their flaws. Increased sales don’t imply increased real cash profits. With cash flow visibility, an investor can see where the real cash is going.

As The Corporate Treasurer outlines in this feature, what really helps the management strategise, and streamline costs is the type of forecast a treasurer can do: funding forecasts, short-term cash plans, and foreign exchange outlooks.

In a recent survey conducted by Reval, a treasury and risk management software provider, just 4% of treasurers in Asia reported a fully optimised cash flow forecasting process that integrated the business processes.

Accordingly, from a 2011 survey by Treasury Information Services, a consultancy, 75% to 80% of senior executives said they don’t trust their internal cash flow projections. Most people lost faith in them because they are not doing it right.

“Many organisations don’t appreciate the importance of cash flow and therefore don’t put too much effort into forecasting it,” says David Blair, a treasury consultant, who previously worked for Huawei, Nokia and Cargill.

But for those who did report a working programme in the Reval survey, 63% said it improved strategic decisions at the company, and 22% said it even helped them bring down interest expenses.

The kind of benefits described in Reval’s survey don’t just arrive from the standard cash flow statement forecasts. It requires treasurers to set their goals and implement appropriate methods to reach them.

PURPOSE, NOT TIMING
The first thing to determine is the purpose of the plan. Forecasting plans are often thought of purely on the basis of time horizon. For example, if it is a five-day plan then a treasurer will manage individual accounts, with credits and debits planned to the day. If it is a 12-month plan, then they will compile cost and sales projections from all business units.

As mentioned, there are three primary reasons to do cash flow forecasts: to manage medium- and long-term funding; to establish short-term cash plans; and to monitor foreign exchange needs.

In the first case, Blair advises that the objective of a funding forecast should be to project the needs of the company as a whole and of the subsidiaries specifically. As such, the plan will need to be broken down by each functional currency of the legal entities on a month-to-month basis, as well as the functional currency of the company as a whole.

For example, if a Hong Kong-based company has a subsidiary in India planning to fund a new production facility, the process may be more time consuming than expected. Treasurers should project more variance in funding scheduling for projects in countries with less mature financial markets, Blair advises.

While some organisations settle for a simple 12-month forecast at the beginning and end of their fiscal year, Blair argues this is a perilous course. Treasurers should update their plans monthly and roll them forward. No one wants to be caught flat-footed with unexpected borrowing costs when the fixed 12-month plan they made a year ago leaves them with only a month of planned funding.

“In the bad old days, budgets would be approved once a year forward twelve months. By the time you got to the last
month of the budget, you only had a one month plan. In a fast moving world, that’s no way to operate.” Blair says.

CASH PLAN
The objective of a short-term cash forecast is to actively manage the amount of cash parked in individual bank accounts on a day-to-day basis and by currency.

A good reason to do this is to establish if a cash transfer from a cash concentration account into a subsidiary operating account is necessary and sufficient to meet short-term payment obligations.

These balance projections should suck in real time accounts payable and accounts receivable data from enterprise resource systems.

Short-term cash plans are critically detailed and accurate. Long-term funding plans have adjustment cushions where treasury and finance can work together to patch certain gaps. But if a short-term plan fails and factory workers don’t get paid, treasury could be blamed for the resulting riots.

FOREIGN EXCHANGE
Annual funding plans will typically be drawn up in the functional currencies of a company’s subsidiaries. This may not reflect the specific currency expenditures of the company, however.

For example, a factory in China may state its functional currency as renminbi, but if it buys components from Japan in...
yen and accepts payments for its products in US dollars, its functional currency may have little to do with its FX needs.

Treasurers that want to cut down on foreign exchange costs should make a specific plan to determine: hedge to float ratios, hedging projects, and foreign currency reserves.

**THE THREE HORSES IN PLAY**

There are several common methods to execute each of the above plans. Broadly speaking, these three commonly-used systems have shown to be effective: consolidation, extrapolation and modeling.

“When thinking about cash-forecasting, there are two primary factors which intersect – the timeframe and the method,” advises David K. Waltz, a Fortune 500 treasurer and author of the blog Treasury Café.

In terms of efficacy, the consolidation model works if a treasurer has buy-in from the organisation. Extrapolation projections can be applied if a company doesn’t support cash flow. Modeling, on the other hand, works best if industry data is freely available and acts as a good marker for the company’s business model.

**CONSOLIDATION METHOD**

The consolidation method is one where raw data is inputted by all of the company’s business units, and consolidated by the treasury department into a collective forecast plan. Sometimes this is called “bottom up” forecasting. This method is best suited to long-term funding plans and is responsive to the overall business, and can be used to incentivise certain divisions or business functions. On the other hand, it can be inaccurate and swayed by human error.

Treasurers should be mindful sales divisions can be overly optimistic in their sales projections.

But these variances can be targeted and adjusted for, if treasurers have the available data.

“I’m a big fan of countermeasures: financial projects based on historical and or other trend patterns to predict future performance. By applying several countermeasures in a consistent and triangulated way, it can be an effective forecasting tool to counter formal sales forecasts from operational teams,” says Helmut Zodl, Lenovo’s CPO for Asia-Pacific and Latin America, in a recent interview with The Corporate Treasurer.

**MODELING**

Another method is to take an industry metric and project it forward.

“Take a mobile operator,” says Blair. “Subscriber numbers drive the business. Management will have a plan, based on sales investment and past performance, for how many subscribers they’ll have in the next year. They’ll also have a plan for ARPU growth [average revenue per customer]. Treasurers can then multiply those together and create a cash flow plan.”

Contingency plans can be developed based on those results. In Blair’s example, CFOs could look at the model a treasurer developed and make strategic plans that will come into effect if certain subscriber growth rates are achieved or missed.

Every month, Lenovo’s Zodl and his team look at how his model has performed.

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**TOP TIPS: IMPROVING CASH FLOW**

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He then uses mathematical metrics and indicators to gauge what the performance should be. He even tracks where his order load is every day, so he can make better guesses on when payments will come in based on the current position of his shipments.

“I guarantee you that 99% of these mathematical forecasting models and counter measures are actually more accurate than sales forecasts because they are very un-judgmental,” Zodl says.

The model has the disadvantage of being subject to the whims of the market. If a treasurer's shipping company developed funding plans based on historic shipping rates, only to have the rates plunge in following months, all that effort might be for naught.

This makes the model more suitable for long-term funding projections. Less so for short-term cash plans and foreign exchange hedging.

Extrapolation Model
Finally, for the treasurers for whom neither of these methods is an available option, there is the extrapolation method. Put simply, it is a future extension of the cash flow statement generated by accountants.

Extrapolation forecasts use the basic operating income minus payables information companies generate for accounting to project cash flow into the future.

The exercises are useful insofar as seasonal affects, such as Chinese New Year and Christmas, can have consistent measurable impacts on businesses. However, they are unresponsive to real-time developments. You can easily imagine how company data from 2007 would have been useless during the financial crisis.

“It in the unhappy circumstance that a treasurer is not in a cash flow-oriented organisation and can’t get consistent cash flow forecasts from internal participants, they can take past data and project it forward,” says Blair.

This method can work for a short-term cash plan; employee pay days are fairly predictable. But if a historically reliable customer runs late on payments, it can set a whole plan awry.

It can be a lonely road for treasurers in organisations that live and die on sales, but if a treasurer has the right tools for the right plans they can provide useful support for their business.

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**Intelligent analysis** Monitor the numbers after you have set your forecast goal and established a method

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| 1. Setting up a chart for sales and invoicing | Assess total costs of goods produced, itemised how much labour and working hours is required, transportation and freight costs, how many days it takes to process the order |
| 2. Record of transportation | Reduce wastage of shuttling half empty loads |
| 3. Assessment of suppliers | Assess and compare each suppliers’ service standards and pricing |
| 4. Record of fines and penalties paid | Set up a database of fines and reduce occurrence of penalties |
| 5. Record of clean LC | Assess results and effectiveness of cleaning up LCs |
| 6. Record of inventory and warehousing | Monitor and control the time required to switch between warehouses, reduce the time and costs of warehousing whenever possible |
| 7. Record of logistics costs | Compare historical data and address any abnormal issues |
| 8. Record of quality control assessments | Compare historical data and address any abnormal issues |

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