Short Term Cash Forecasting: Best Practices and Pitfalls to Avoid

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A cash forecast is only as good as its source data.

This seemingly simple statement underlines a reality that pervades the treasurer’s office in multinational and domestic corporations: reliable cash forecasting, even in the short term, has proved to be extremely difficult to achieve in practice. Securing accurate cash forecasting always scores highly in surveys of corporate treasurers’ priorities, but very few working treasurers claim to attain the high levels of cash visibility and usage that will be achieved when a truly effective short term forecasting solution is in place.

This unsatisfactory situation originates from several sources:

- The inability to monitor and manage the complete cash management process
- The use of flawed forecasting models
- The use of outdated technology that lacks the necessary levels of control and visibility
- The lack of understanding as to where to source the data required for an accurate cash forecast

This research focuses on short term cash forecasting, which for practical purposes in most corporations projects the future cash position over a two to three month term. We will consider:

- The Benefits of Effective Cash Forecasting
- The Challenges of Achieving an Accurate Cash Forecast
- Outdated Forecasting Models
- How Traditional Solutions Fail the Challenge
- How to Achieve Cash Forecasting Nirvana

“The corporate treasurer must not minimise the importance of cash forecasting. A company’s financial health strongly depends on the treasurer’s ability to foresee cash needs as tied to the company’s current monetary availabilities and projected inflows and outflows.”

Enrico Camerinelli, Aite Group

The Benefits of Accurate Cash Forecasting

Truly effective cash forecasting enables treasurers to achieve a range of best practice results that are simply not possible in sub-optimal forecasting environments, based on flawed models and inadequate technology and service provision. A complete short term forecasting solution can enable treasurers to achieve a range of valuable benefits that will increase the quality of treasury operations.

Some of these benefits include:

Liability Management

As liquidity is made fully visible, treasurers may use surpluses to pay down expensive external debt. A fully integrated liquidity management program increases visibility to cash balances and cash flow trends throughout the organisation, enabling corporate treasury to mobilise and consolidate intercompany cash positions. Through higher consolidation of cash at the corporate or regional level, treasury can utilise these funds to pay down external debt, thus reducing interest expense. As a result, Treasury is able to borrow at more favourable terms, thereby lower interest expense and enabling credit status enhancement.

Liquidity Management

Surplus internal liquidity may also be put to work productively by providing low cost finance for investment in commercial development and other strategic initiatives. There are a number of ways in which the cash resources of the organisation revealed by best practice forecasting can be put to use to provide superior results. These include low cost internal funding, consolidation into a notional pool, or physical sweeping in a zero-balancing arrangement.

An accurate forecast enables treasury to consolidate and invest surplus cash with the required maturity profile to meet forecasted future needs. It also enables the amounts needed to service known future cash outflows to be retained. Treasuries benefit through the combination of maximised interest income and minimised interest expense, as determined by the evolution of the net cash position.
The Challenges of Achieving an Accurate Cash Forecast

In practice, generating a reliable enterprise-wide short term cash forecast has proved to be an elusive issue for treasurers globally. The benefits of doing so are well known, but there are multiple obstacles and challenges to doing so successfully. The issues include using up to date and precise information, managing change effectively, working with errors and omissions and managing the workload effectively according to the demands of the corporate organisation.

Up-To-Date Information Is Essential

The first and most profound challenge is that of ensuring that the forecast is being generated using accurate and up-to-date financial information, so that it reflects the true capital position of the organisation.

Effective FX Exposure Management

Forecasting can additionally identify upcoming foreign exchange exposures, so that treasury can plan and execute effective hedging operations to mitigate the risk. A cash flow hedge program typically involves a separate forecast process mandated to the global business units. However, integrating applicable currency exposures such as intercompany sales into the cash flow forecast process, can both improve treasury efficiencies and reduce duplicative efforts from the global subsidiaries.

Savings on Bank Overdraft Costs

In an environment where most or all liquidity needs are accurately forecasted, the need to use overdraft facilities is sharply reduced or eliminated, achieving significant reductions in bank fees and interest charges.

Eliminating the Need for “Idle Cash”

A reliable forecast has the ability to mobilise ‘trapped’ or ‘hidden’ cash. This is comprised of current and projected cash surpluses that are being held around the corporate infrastructure for a variety of reasons such as the future cash utilisation needs of the individual corporate entities in question or legal / tax planning reasons. The interest management of the entire organisation benefits from this enhanced efficiency, which is directly attributable to enhanced cash forecasting.
The Challenge of Change

In reality, events that impact the cash forecast are happening continually within corporations’ financial ecosystems. Business activity is occurring, in new purchases, sales and expenses. New invoices are being issued and received. Receivables arrive in bank accounts. Direct debits are actioned. Payments are transferred out of bank accounts, and continue their progress to the beneficiary’s bank account – usually out of the sight of the originating treasury or payment management system. Treasury is executing debt, investment and hedging transactions. An accurate forecast must be updated promptly with all significant data. If the model in use embeds any significant approximation or estimate, the forecast process falls short – perhaps significantly short – of best practice cash management.

An Uncertain Workload

Forecasting can – and often does – provide a heavy and unpredictable workload for treasury departments, which are generally lean operations. Forecasting may require extensive research and manual effort. The most effective cash management can only be performed based on accurate forecast information, so that cash movements, investments and borrowings can be accurately performed. The forecasting solution must meet the challenge of managing the necessary data, on time and with complete precision, so that the subsequent cash management operations can be properly executed.

Accommodating the Corporate Organisation

A final forecasting challenge is meeting the specific policy demands and organisation structure of the parent institution. The corporate organisation must be accurately reflected in the forecast structure. This approach ensures intercompany cash positions are accurately forecasted and future intercompany cash flow decisions are compliant with both corporate tax and legal requirements. The solution in a specific corporate treasury depends on the centralisation level, the nature of the business in terms of commercial function and geographic distribution, and other analytical dimensions that may be required by finance policy.

Managing Errors and Omissions

It is essential that errors and omissions within bank account statements and payment processes are detected promptly and are effectively resolved – and this presents a complex and demanding set of operational challenges for the team managing the exercise, especially if the necessary levels of visibility and process control are lacking.

Precision Is Essential

The most effective cash management requires the highest level of accuracy with source information, to achieve optimal cash movements, investments and borrowings. Without this precision, treasury needs to spend precious time validating their data, and performing the research required to quantify any necessary adjustments. Timely and consistent variance analysis is an important component of an effective cash flow forecast process. Validating actual cash flows settled at the bank versus projected cash flows, is a critical step in improving the accuracy of future cash flow forecasts.

“Automating the cash forecast can be challenging on several fronts. When using available payables and receivables data for cash forecasting purposes, certain adjustments have to be made, which are typically manual: for example - due dates on invoices don’t necessarily align with actual cash flow dates. If certain customers, for example, pay on a certain date of the week/month, adjustments have to be made to capture the actual value date of the cash receipts.”

Frederik Westerling, Deloitte & Touche LLP
Outdated Forecasting Models

Treasury cannot achieve best practice cash management results if it is working with the outdated and flawed forecasting techniques that are still in use in many regions.

An organisation's short term cash forecast construction model may be flawed if it attempts to integrate imprecise budgetary and financial planning techniques with actual treasury cash flow information. A budgetary, or indirect cash flow forecast methodology, will often yield inaccurate short term forecast results, thereby reducing the treasurers' ability to effectively manage short term liquidity.

This difficulty originates from a lack of clarity about the difference between a budget type of forecast (indirect method) and a treasurer's short term cash forecast (direct method). Budget based forecasts combine hard information derived from bank balances, cash flows and accounts payable and receivable with less precise FP&A (financial planning and analysis) data originating from budgeting and long term planning exercises. Such forecasting solutions are constructed for strategic planning purposes, and do not contain the timing details required for treasurers to effectively manage short-term liquidity.

Some treasuries use statistical treatments to try to make sense of the FP&A data they are receiving by analysing it against history. Adopting a statistical approach effectively means that the essential need to predict the short term liquidity outlook is not being effectively met by the methods in use, and so statistics are used as a type of Band-Aid to try to find a closer approximation to actual reality. This is important from a strategic perspective, but may be less than ideal for immediate short term cash management purposes.

Such hybrid forecasting inevitably leads to unsatisfactory results, as the construction process is not rigorous or fully controlled. Hence, many treasurers report low levels of satisfaction with the projections they are receiving through inconsistent methodology, when it is precision that they need to achieve best practice cash management results.

FP&A and budgetary forecasting are valuable tools for strategic finance analysis and planning, for medium term (beyond three months) and perhaps long term purposes. Treasurers can play a strategic advisory role however, by comparing their comprehensive short-term forecast against the FP&A and budgetary plan. Treasury's ability to compare the current quarter cash flow projections versus the original FP&A and budgetary plan can serve as an invaluable perspective to the CFO and executive management.

“For the short term, payables and receivables data that is available should reflect closely what the actual collections and disbursements will be, but for the medium or longer term, the completeness of this data diminishes, and manual adjustments should be incorporated to create a more complete forecast.”

Frederik Westerling, Deloitte & Touche LLP
How Traditional Solutions Fail the Forecasting Challenge

Virtually all treasury management technology includes a forecasting module. However, these solutions frequently fall short of treasurers’ core cash forecasting demands, and so users time and again resort to spreadsheets to cobble together some kind of forecast. Consequently, finance management is often not receiving accurate reporting on the enterprise’s true cash position and prognosis. This most unsatisfactory situation results from a flawed theoretical approach based on old technology and spreadsheets, incomplete functionality and service, and ultimately the lack of control by treasury.

A Flawed Theoretical Approach

The issues that arise from trying to combine treasury forecasting with financial planning and budgetary exercises are analysed above in ‘Outdated Forecasting Models’. Fundamentally, this approach tries to forge a compromise between two essentially incompatible disciplines with respect to short term forecasting. The strategic concerns of budgeting and financial planning are distinct from the operational urgencies of managing short term cash in treasury. Treasurers complain consistently about the poor quality and timeliness of cash forecast data submitted by finance subsidiaries. A key reason for this is a lack of appreciation for treasury’s needs in the commercial business. There is no apparent value to the originators in the exercise, as they do not generally understand treasury’s operations – and they do not (directly) suffer the consequences of inaccurate and late forecasting.

Treasurers absolutely need to be in control of the forecasting process. Short term cash forecasting – and the resultant cash management decisions and operations – are their professional responsibility, and therefore treasurers require direct responsibility over all elements of forecast construction. The starting point needs to be a forecasting model that consistently delivers a timely and accurate short term forecast. This is simply not available from many traditional solutions, and hence the general dissatisfaction with forecasting in many sections of the contemporary treasury industry.

Spreadsheet Failings

The many forecasting solutions that depend on spreadsheets are relying on technology that is not fit for the purpose of supporting a core function of finance and treasury. There are many documented spreadsheet failures that support this assertion, such as the recent discovery of a copy and paste error in a spreadsheet analysis in an academic paper that resulted in incorrect assumptions being made about the optimum indebtedness levels for several G20 countries’ economies. Spreadsheet solutions tend to be loosely developed and poorly documented, and their users are very vulnerable to failures that often prove to be very difficult – and even impossible – to recover.

The Consequences of Incomplete Functionality and Service

Traditional treasury technology solutions lack the necessary functionality to penetrate the banking system, so that up to date balance and transaction statements will often not be available, and the true status of payment execution and the current position at the bank are not in practice visible. This means that users of such technology do not have the means to monitor and understand many of the critical bank-corporate processes that are essential components of forecasting, and also of general cash and treasury management. They are, in effect, flying blind in the performance of a time critical financial management business function, in an environment of elevated financial and operational risk.
The TMS must be in real time contact with all relevant elements of the organisation’s financial ecosystem. The necessary connectivity includes a communications hub, bureau services and the external banking universe.

Technology can now empower treasurers to overcome historical barriers and achieve full short term forecast visibility.

Conclusion

Effective cash forecasting can have a huge impact on a company’s ability to manage its debts and investments, and make smarter more informed decisions about its cash. Overdrafts and other external borrowings can be minimised or eliminated altogether. With the ability to deliver accurate short term forecasts, organisations can manage their short term cash in a more effective manner.

Developing a best practice short term cash forecast requires a complete and robust picture of all the elements of the current cash position, based on up-to-date balance and transaction reports, and real time visibility of all the payments and collections in process, and open treasury transactions, combined with all payables and receivables held in the organisation’s ERP and accounting systems.

With these elements in place, a treasury team’s ability to deliver a reliable cash forecast is amplified immensely. Cash management decisions will be taken in full confidence of the accuracy and completeness of the short term forecast. The benefits that accurate cash forecasting can have on the organisation are widespread, and can lead to significant improvements in cash return, decreases in the cost of business, and further enhance the Treasury function as a strategic partner supporting critical capital allocation decisions.
About Kyriba

Kyriba is the global leader in Proactive Treasury Management. Our software-as-a-service (SaaS) treasury and risk solutions enable finance teams to optimise their cash, manage their risk, and work their capital. Our award-winning cash, treasury, payment, risk management and supply chain finance solutions are used by more than 800 organisations worldwide, including Amway, Electronic Arts (EA), PulteGroup, Inc., and Qualcomm, to unlock new business value, drive corporate growth and ensure compliance. For more information on how to be more proactive in your treasury management and drive business value, contact treasury@kyriba.com or visit http://www.kyriba.com.