

Knowledge Center

The Benefits (and Secrets) of Successful Cash Forecasting

By Richard Ketchen, CGA

If there's one thing that treasurers hate, it's surprises, especially when it comes to cash.

At a time of economic uncertainty and tightening financial markets, you might think that large corporations would be relying on cash forecasting to better manage scarce working capital resources. If that's what you're thinking, you're in for a surprise.

In spite of the obvious benefits of cash forecasting, most treasury consultants say that forecasting just isn't getting done. And of those forecasts that are prepared, many are badly flawed, laced with inaccurate information.

However, for the companies and their treasurers who can find a way to gather reliable information and apply the right methodology, cash forecasting pays off, both strategically and financially.

Economy demands better forecasts

Cash forecasts have traditionally been seen as a means to ensure that surplus cash is fully invested. However, bank sweep accounts and low interest rates combined with an inverted yield curve have removed much of the incentive to closely manage short-term funds.

Today, a slowing economy, sagging stock market and tighter credit have shifted the motivation to more strategic purposes as capital becomes scarce and the competition for it more intense.

Treasury and cash management consultant Claudia Volk of CJVolk Associates, Inc., says everyone from bankers to venture capitalists to investors to bankruptcy courts is paying more attention to cash forecasts. "Maybe 10 years ago cash flows were more of an internal management tool; they're now becoming more critical from an external point of view."

However, for some companies, cash forecasting remains a crucial internal management tool.

"Many companies on the lower end of the investment scale are finding it difficult to find financing,"

observes Bruce Lynn, managing director, treasury, The Financial Executives Consulting Group. "Which means that if they can't find it externally, they're going to have to look for it internally."

Forecast preparation faces numerous obstacles

Treasurers face a multitude of problems when it comes to forecasting, even before dealing with the consequences of an inherently inaccurate process. A lack of access to information and no perceived need to manage cash resources are seen as the biggest reasons by treasury consultants.

"It's very difficult to obtain cash forecasts from subsidiary operations," says Susan Griffiths, president, Global Cash Management Ltd. "Subsidiaries have a multitude of financial reporting duties. The last thing they want is some[one] from corporate treasury saying 'oh, by the by, could you give me a cash forecast'."

That "typical" response is often the result of a lack of authority that treasury has over operating divisions. The relationship can be further complicated by a poor understanding of the forecasting process and the information that's required.

"You've got to educate people and make them aware of what you need and why you need it," says Volk. "That's critical to being able to do any sort of successful forecasting."

For many companies, it's also a question of priorities. Cash is not something that the operating units are usually measured on, another reason why accurate information can be difficult to obtain.

"Most operating units are not rewarded or even penalized for being net users or suppliers of cash. If they're making profits, they're left alone by higher management," says Lynn.

Yet subsidiaries can make profits in different ways that have a direct impact on cash flow, which can create problems in other areas of the company. As Lynn points out, "They can take risks by extending payment terms, by stocking warehouse inventory to unreasonable levels and by selling in exotic currencies."

The right incentives pay off

The key to first finding cash, and then better managing it, comes from the greater visibility that an accurate forecast will provide. Griffiths says that the right incentives can make all the difference to getting more accurate information.

"You sometimes have to change incentives, not just rewards based on sales," she suggests. "You need some other financial incentives that will motivate people to work on these things like cash forecasting."

One company that has taken an incentive-based approach to ensure that cash management gets the attention it deserves is The Gallup Organization.

"We look at it as a team process," says Ken Mar, treasurer, The Gallup Organization. "Not only from collections, but from gross margins, to people managing their projects the correct way, and getting to what our goal is for gross margins. We take it all the way down the line."

That team process has made more people committed to and accountable for cash management.

"We require our salespeople to have all contacts written so payment is received within a 45-to-60-day

period," Mar explains. "If Gallup doesn't receive that money from our billings, then they do not receive the incentive or commission on that cash."

While that may sound like cruel and unusual punishment, Mar says the policy makes sense for everyone involved.

"Salespeople love incentives," he says. "From top to bottom, everybody is competing; it makes it kind of fun."

For Gallup, a little fun had a big payoff. More reliable cash forecasting together with tight control on disbursements have enabled the company to better manage their cost of capital and eliminate debt.

"We had short-term debt tied up at 8% to 9%, so it wasn't worth our time to invest our money and still have the short-term debt out there," says Mar. "A year and a half ago we'd taken out all our short-term debt; the only thing we have left is our long-term debt."

Benefits not always so black and white

Sometimes though, the benefits of forecasting are less tangible according to Lynn. He gives the example of a Fortune 100 company with \$1-\$2 billion in cash and marketable securities, and debt with a higher cost than its short-term investment return. However, even though their cash forecast showed a significant surplus, they weren't prepared to eliminate the debt to save money.

"The client said no, because if they decided to build the next version of their product, they didn't have time to arrange bank financing. If they lost six months, they lost the market," explains Lynn.

Because the company wanted to react quickly, they were ensuring that if they were to forecast poorly, they still had the cash for their next product cycle.

"I think that's sometimes lost in the forecasting process," says Lynn. "You forecast for whatever time frame you wish. The question is, what do I do with this forecast? If I know that three months from now I'm not going to have any cash, hopefully that three months will be enough time to raise the cash. If not, you're staring death in the face."

The bottom line is accuracy

The key to realizing the full benefit of cash forecasting is accuracy. If they're accurate, and that's the big if, then companies know more about the future and can react sooner, faster and better.

"That gives you a competitive advantage," says Lynn. "With that advantage you improve your risk-return profile."

Not only should your risk-return profile improve, you'll increase the prospects of hitting another forecasting target, says Mar. "One of your goals should be no big surprises."

Keep it simple, say the experts

Cash forecasting is generally considered to be more of an art than a science. So is it time to

hang up your lab coat and reach for a painter's palette?

Susan Griffiths, president, Global Cash Management Ltd., says that for many treasurers, forecasts are seen as being too difficult or simply too unreliable. "People come up with grandiose plans for preparing a cash forecast," says Griffiths. She suggests starting on a smaller scale with a simpler approach. "Sit down with the people at the operations level and say, 'this is what we're going to need. What is the best way to get this information that is not going to put a real burden on you?'"

Bruce Lynn, managing director, treasury, The Financial Executives Consulting Group, says that the intimate knowledge of operations is one of the critical factors in accurate forecasting. "The key to forecasting is the ability to take the collective wisdom of the financial and operating units and to tie that together so that you can look at forecasting on an enterprise-wide basis," says Lynn.

Griffiths says treasury often tries to push information requests to business operations. "It doesn't get done at all because people ignore it, or it's done very badly so they get the wrong information...and then they give up."

So, if you're successful with Griffiths' recommended bottom-up approach, how do you make the best use of the information? Simplicity again seems to be the answer, according to James Sagner, principal, Sagner/Marks, a treasury consulting organization.

One effective technique is called distribution. "Distribution is simply taking historical day of the week and day of the month activity and putting them together in a very simple manner to come up with weighted factors to get forecasts for each day of the next period," says Sagner. "It's naïve, but it works pretty well."

Sagner says the technique has been used successfully with a number of clients, but that it requires statistical information and "you have to go through the exercise of doing the analysis."

"I don't think it's going to get any more sophisticated than this because statisticians have tried for the last 20 years and you really can't do much better," comments Sagner.

--Richard Ketchen

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