

What are the Required Factors to Reach Excellence in Cash Flow Forecasting?

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This article takes a close look at the number of system and business related factors which can positively influence co-operation in the cash flow forecasting process.

As recent surveys have shown, corporate treasurers dedicate a lot of resource and attention to their cash flow forecasting processes. Despite these efforts, many challenges are seen as obstacles in the way to an effective cash flow forecasting process. Challenges such as decentralised treasury structures and the difficulties of managing forecast data quality, are two examples that can seem insurmountable.

The authors of this article are convinced that increased efficiency of the cash flow forecasting process and the reliability of its results can only be reached by improvements in intercompany co-operation.

The Evolution of Cash Flow Forecasting

Let's start with our expectations of the cash flow forecasting process. Going back a few decades we can take the analogy of the risk management (RM) function, which has developed from ex-post analysis to a higher ex-ante orientation. We more or less expect the same to happen in cash flow forecasting as well. It would be reasonable to expect that scenario-based risk analysis would be found at the top of the pyramid. This would be the desired order from a functionality point of view with cash flow forecasting.

This means that in a perfect world we would like to be able to manage the liquidity of a corporation with risk-based simulation capability.

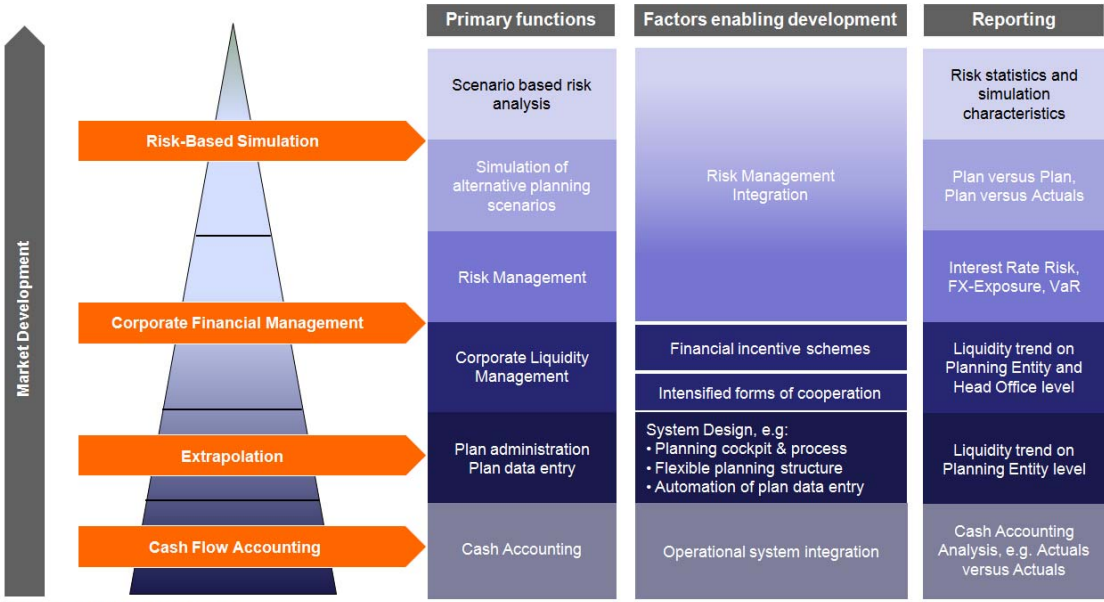


Figure 1: The Evolution of Cash Flow Forecasting

The essential question we must ask ourselves is: what are the factors that can help to reach this higher-level of the pyramid in cash flow forecasting?

Derived from practical experience we have identified four factors of similar importance that will have to be mastered in cash flow forecasting in order to reach excellence:

1. Multidisciplinarity, which represents the integration of related disciplines into the cash flow forecasting function.
2. Flexibility, which represents the flexible but consistent design of the cash flow forecasting system.
3. The intensified forms of co-operation between the head office and the planning entities¹.
4. The use of adequate financial incentive schemes.

Factor 1: Multidisciplinarity

There is no doubt that cash flow forecasting will either further develop its risk management capabilities, or will be further integrated into risk management functionality, in the future. This extended risk management orientation is required to deal with the uncertainty we currently encounter in the mid-to-long-term of the cash flow forecast. The integration of cash flow forecasting with the risk management function therefore becomes a must.

On the other hand we will further develop the precision of our short-term cash flow forecast. The further integration of operational systems and sub-ledgers, such as accounts payable (A/P) and accounts receivable (A/R), as well as already contracted financial transactions provided from the treasury management system (TMS) into the cash flow forecast will become more and more important in the future.

Factor 2: Flexible but Consistent Design of the Cash Flow Forecasting System

The planning process consists of several steps, which from a controlling perspective, would best be integrated into a cockpit.

¹ Planning entities and local units are interchangeably used in this article.

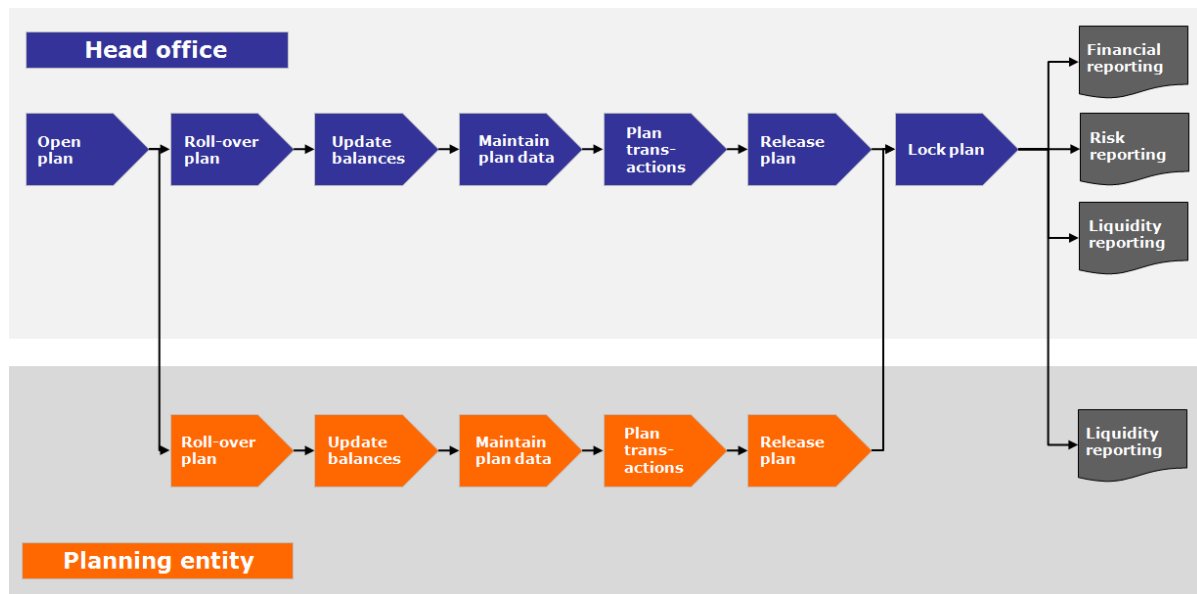


Figure 2: The Planning Process

Flexibility in the design of the planning process

One should make sure that the planning process can be flexibly designed for the various planning purposes of the company. For example, to proactively manage your cash pool you might have to perform a daily cash flow forecast for the short-term cash disposition. Besides this daily process you might also have a forecasting process taking place on a monthly basis, which is required for your longer term planning needs, for your capital expenditure plans and corporate financing activities. The system should therefore be designed to enable you to define different cash flow forecasting processes with different time patterns and planning intervals.

Flexibility in the design of the planning structure

The planning structure is made up of two components: the organisational structure and the planning grid. A cash flow forecasting system has full flexibility when its design allows the combination of the organisational structure with the planning grid of the company, by assuring consistency of the planning data throughout the organisation. This statement seems rather contradictory. It is not, however, when the afore mentioned components are managed within a consistent framework.

The hierarchical structure of the planning entities participating in the cash flow forecasting process should be known to the cash flow forecasting system. This is particularly important when we want to aggregate cash flow forecast information from bottom-up, or when we have to assure overall consistency between the forecasts of the various organisational entities for planned intercompany transactions.

The second component of the planning structure is the definition of the economical dimensions at the required level the liquidity planning is carried out by the organisational entities. The system should allow each organisational entity to process its planning data at the desired level of granularity, but making sure that the planning data can be hierarchically aggregated to serve the purpose of the company overall.

In order to assure overall aggregation of the forecast information and granularity on the individual level for each planning entity, the system should allow a differentiation between planning types - the lowest level at which the planning information is maintained - and various aggregation levels which allow planning types to be grouped.

With such an approach, the system would make it possible, for example, to allow at the highest level for a differentiation of the forecast information between cash inflows and outflows and at subsequent levels between operational, investment, financial cash flows, credit lines and limits and at any further levels between market segments or products and so on.

The planning types which are available for planning purposes for the organisational entities have to be part of the overall planning grid. In this manner, the possibility to aggregate information across all business units can be assured.

This logic is illustrated in figure 3.

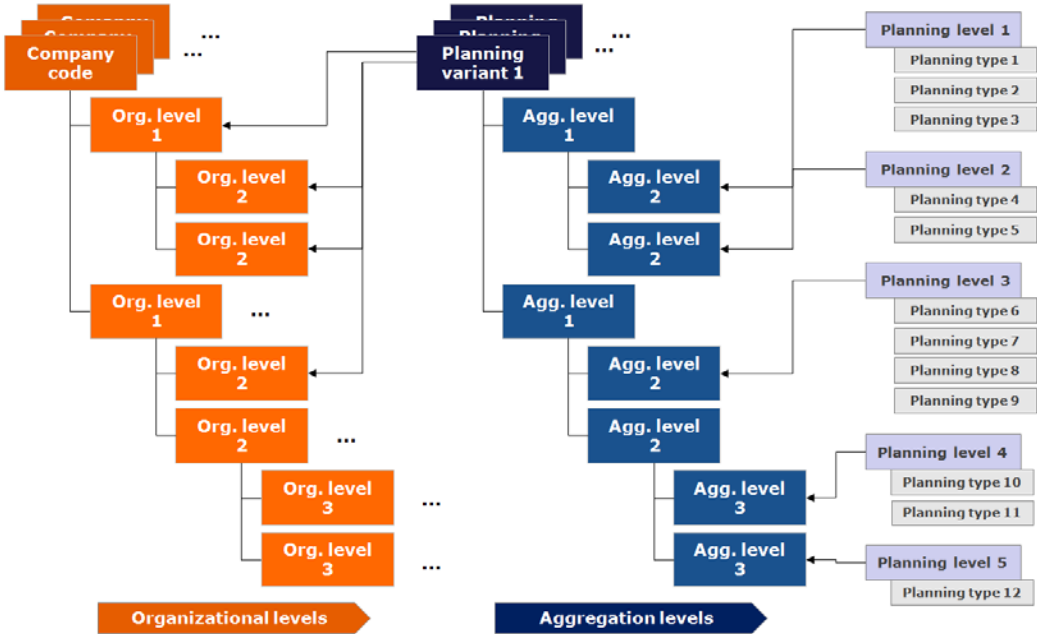


Figure 3: Structure and Assignment of the Planning Grid

The major design issues are:

- The system is fully flexible when it is capable of assigning the elements of a planning grid consistently to the individual planning entities, which are part of a hierarchical organisational structure.
- The planning data in the system is robust, when the data can be aggregated consistently along several aggregation levels of the organisational structure and along several aggregation levels of the planning grid.

Automation of the plan data entry

Various functions could be used to facilitate the data entry procedure. You could think of various automated ways of integrating actual data, as mentioned in the factor 1 section with the integration of operational systems. This can be particularly important, when already contracted financial transactions with their future cash relevant components can be automatically provided from the TMS to the cash flow forecast, making the manual entry of already contracted treasury positions obsolete in the cash flow forecast.

Furthermore you could facilitate the manual data entry process for planned forecast data by directly integrating functions in the solution for copying and distributing planned cash flows with a regular pattern.

Factor 3: Intensified Forms of Co-operation Between the Head Office and the Business Units

No one-directional information flow

It is very important, that the planning process is not seen as a one-directional information flow limited to forecast information being provided by the planning entities to the head office.

In some cases, the planning entities will have difficulties to accept the centralised forecasting process if they have to perform an own liquidity report for their own reporting purposes in parallel. To mitigate the risk of parallelism in cash flow forecasting within the company, it is important to define a common denominator of the cash flow grid, that will serve all the requirements of the corporation, by using the flexibility of planning variants earlier mentioned.

Based on a consistent planning structure, reports can be defined to better serve the requirements of the planning entities and the company overall. Intercompany communication and the quality of the cash flow forecast can be improved by the use of consistent plan, actual comparison reports.

Integrating related financial business processes into the planning layer

Another important element to intensify the collaboration between local business units and the centre is via the integration of related financial business processes into the planning layer.

A step in this direction is for example to ask the planning entities to notify foreign exchange (FX) hedging and financing transactions in the cash flow forecast based on their analysis of the liquidity trend of their business unit. These notifications are then integrated into the cash flow forecast in the form of planned transactions. Planned transactions are preconfigured financial instruments that are integrated into the cash flow forecast. By using such a planned transaction framework the planning entities are encouraged to accurately plan their forecast. The local units so become responsible for their own cash disposition.

For the sake of control and data consistency, contracting rules have to be implemented in the planned transaction framework. The contracting rules make sure, that planned transactions follow the same internal rules and regulations that are valid for real transactions.

Furthermore, automatic mirroring of internal transactions over several levels of the organisational structure will help in keeping planned transactions consistent on a company-wide scale.

Figure 4 illustrates the logic of the planned transaction framework within the cash flow forecasting process.

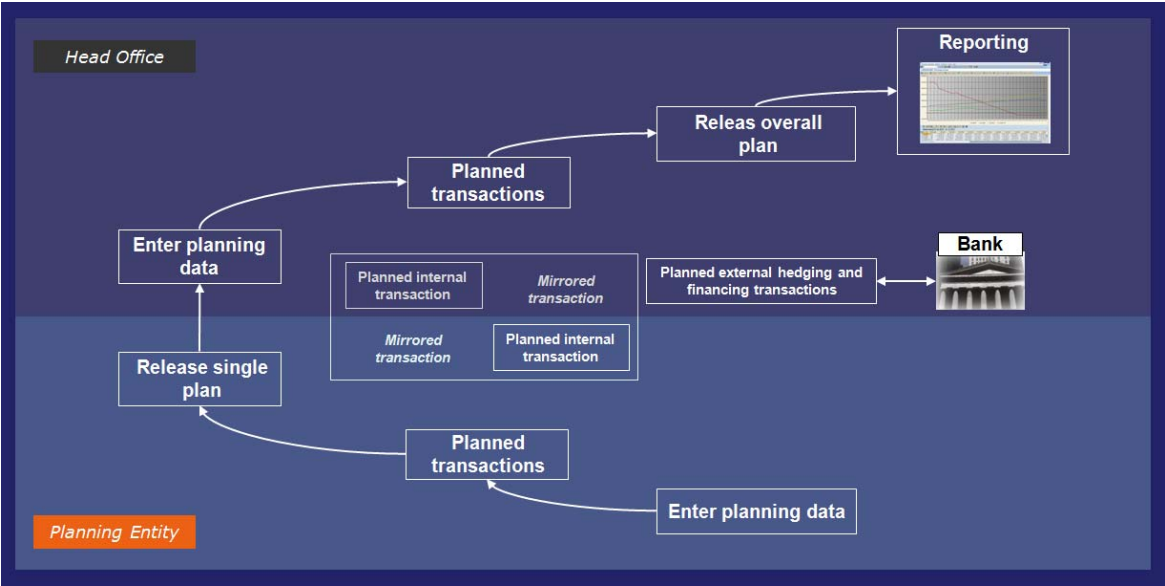


Figure 4: Planned Transaction Framework

Factor 4: Use of Adequate Financial Incentive Schemes

Sharing benefits and costs related to the accuracy of the forecast of FX exposures

The planned transaction framework discussed earlier can be used by the local units to notify their expected FX exposures to the centre. By the use of this notification process, the head office will gain an overview of the FX exposure of the various local units at an early stage and so be able to manage the FX risk of the company more proactively.

Having such a notification process in place one can go a step further and measure the accuracy of the forecast information provided by the local units with the help of actual comparison reports. Once this kind of accuracy analysis can be performed, the outcome could be linked with remuneration schemes to encourage the planning entities to forecast their liquidity trend more carefully.

Crediting interest income on planned transactions

By giving the planning entities the possibility to improve their interest income, they can be motivated to perform more accurate forecasts. In addition to the benefits of having local entities profit from interest income from cash pooling structures, local entities could be credited with interest income that is based on the accuracy of the forecast of their cash disposition for cash holdings outside of common cash-pools. Asset Liability Management (ALM) functionality can be used to allocate the interest income between the local units and the head office more efficiently.

As a positive incentive the local units could earn a higher interest income that compounds through time, when they properly forecast their future cash balances and lend excess cash balances (outside of cash pools) to the head office at more competitive interest rates.

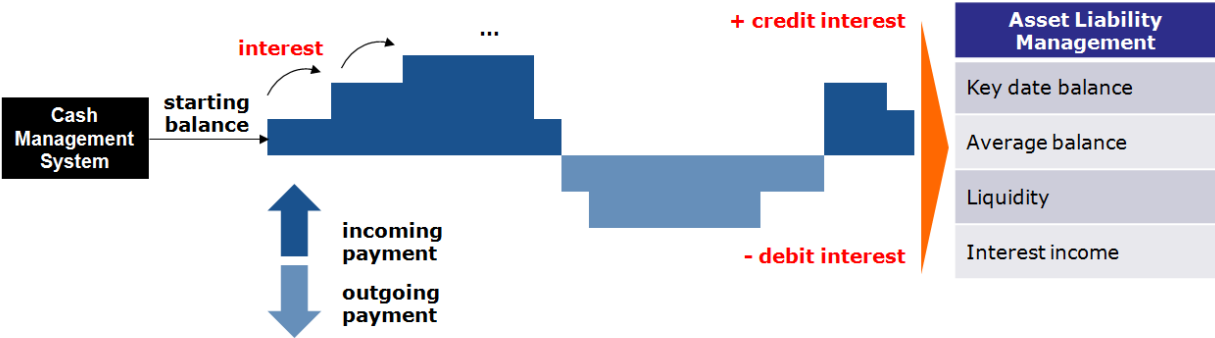


Figure 5: Asset Liability Management Integration

This financial incentive will help to increase the interest of the planning entities to properly forecast their future cash flows.

Conclusion

You might think that technology advancement is the most important factor in making this functionality work, however this is by no means the case. There are cash flow forecasting systems already capable of doing this job. However, it seems that new forms of enterprise-wide collaboration in cash flow forecasting still have some time to go to make them common reality. Perhaps it is a question of dissemination of the concept, maybe it simply needs some courage of the treasury function to go into a new age of new models of company-wide co-operation in order to reach excellence in cash flow forecasting.