IMPROVE CASH FLOW WITH BETTER FORECASTING

The rewards of accurate cash flow forecasting may have never been greater than they are today. But many companies may find that effective, short-term predictive ability remains elusive. We offer tips and tactics for improving accuracy.

It’s never been more important to predict, manage and optimize your cash flow.

At the same time, the behavior of customers and vendors – even those you have worked with over the long term – can be hard to predict. Given the pace of change, relying on historic trends may also be inadequate.

DRAWBACKS OF CONVENTIONAL SYSTEMS

Traditional reporting systems typically focus on accounting-based, or book, cash balances and don’t recognize actual cash on hand that is available for use.

Those systems and databases don’t typically retain adequate historic data and non-bank solutions have not yet advanced to support more effective forecasting. Further – more than 10 years of corporate restructuring have reduced the availability of treasury resources.

STEPS TOWARD IMPROVEMENT

Even in the face of these challenges, it’s possible to significantly improve the precision of your forecasts without incurring prohibitive costs.

First steps:

• Take inventory of your resources.

• Re-examine your forecasting tools and their level of precision. What data do you have available?

• Define your requirements in terms of how frequently the forecast should be updated and the length of the forecast horizon.

• Make a candid assessment of your current process. How accurate, effective and timely has your recent forecasting been?

CHARACTERISTICS OF AN EFFECTIVE FORECASTING SYSTEM

As you begin to advance this effort, you may find you will need to strike a balance between the cost of improving effectiveness and the business penalties incurred by lack of precision.

Forecasts can be more effective when they are focused on underlying in-flows and outlays rather than aggregate net cash flow. At a minimum, you might segregate and evaluate primary cash flow components including lockbox receipts, supplier payments, payroll and so forth.

Decentralized organizations may want to consider extending their analysis to the separate flows for each operating unit.

FOCUSING YOUR FORECASTS

Once primary components are established, consider how to focus your forecasts.

• Is historical trend analysis alone sufficient?
• Should you consider fundamental analysis of key events/dependencies? This requires combining a focus on data with discrete business analysis. Examples include known payroll cycles, check run frequencies and loan payment commitments.

• You might look at day of week and day of month dependencies. Day of week collection patterns of a typical lockbox operation may show large concentrations of Monday deposits. You may also want to consider day of the month patterns, noting deposit concentrations surrounding the dates that follow statement-based billings.

When you have basic issues in hand, look toward continuous improvement.

• Consider the merits of a fundamental view of primary customer/vendor terms and behaviors.

• Focus on your major trading partners and assess behaviors that stray from long-standing practices and trading terms.

Once you have improved your understanding of primary cash flow components, residual balances can then be addressed through more simplistic historical trend analysis.

TACTICS FOR CONTINUOUS IMPROVEMENT

When you have basic issues in hand, look toward continuous improvement. Consider:

• Including a regular variance analyses in your cash flow forecasting procedure to determine how accurate the model was.

• Evaluating the impact of any unusual or unexpected events that occurred during the time period.

• Analyzing variances between the forecast and actual outcomes to determine if modifications are needed in your process.

• Determining how structural changes may impact historical trends. These can include changes in customer behaviors, postal system initiatives, and payment system evolution. If you recognize structural changes or trends, consider a heavier weighting to more recent data observations.

Other things to consider are: Reviewing the level of coordination with operating units and functions. Incorporate expected impacts from new events. Are any new product launches with extended terms on the horizon? Any recent shift in minimum order sizes? Other initiatives to shorten collection cycle times? Is Accounts Payable thinking about extending average payment terms?

Evaluate the potential of operational changes to encourage more timely planning, for example, restricting last minute wire transfer or manual check requests and/or requiring senior management approval for any exceptions to these rules.

The most effective models often don’t focus on a single expected state. Consider expanding your model’s flexibility to include the impact of a variety of assumptions and scenarios. Focus and plan for worst case.

Precise cash flow forecasting is not easy, but studies have shown that companies that succeed in this task can optimize their cash flow and significantly improve decision making and best practice behaviors.

For more information, contact your relationship manager or visit pnc.com/treasury