Cash Flow Forecasting

So what's the big issue?

Speak to treasurers around the world and if they could have one wish it would be to have consistently accurate cash flow forecasts. In very small businesses cash flow forecasting is straightforward since there is a small number of unpredictable transactions and the business owner is very close to each transaction. As businesses grow larger the picture will change. There will be relatively predictable elements such as loan repayments, insurances, leases, wages and salaries and so on. But the two biggest headaches are usually accounts receivable and accounts payable.

In all businesses there are customers who will pay early, on time and late. This means that it is difficult to rely on the invoice due dates as the predicted date of payment. For many businesses the payment date and the due date matches exactly less than 10% of the time. You would think that accounts payable would be easier since you are in control of the timing of payment. Again this is not the case since the invoice may not have been processed, may be disputed or stuck in authorisation or may not have been sent in the first place. So even though you are in control of the timing of cleared invoices you are ready to pay, you have only limited control over internal and external parties that contribute to the total result.

All this means that treasury departments are forced into keeping buffers of cash to deal with the uncertainties. Most often these cash buffers earn little or nothing for the company versus other short term investments or paying down overdrafts. So there is a real cost to this uncertainty even though it is invisible to most people in the company.

What have companies tried to do in the past?

The logical answer to all this is to have a short term forecast in place that would tell us exactly how much cash is due to come and out on a daily basis. In the past, this could be a very difficult process for companies with huge numbers of customer and supplier transactions. So the quick answer would be to take a top down approach. For example if you know the value of customer orders at a point in time, you know the standard lead times for delivery and you know the customer payment terms, then you should be able to predict the exact date that the payment should arrive. But this will almost certainly be inaccurate since delivery will not always be on time, there may be some dispute with the order or invoice and the customer may not pay on time. But a valid argument would be that no forecast will be completely accurate and that as long as the forecast error is consistent then the inaccuracy is manageable. While all this is true, the real problem with this intuitive logic is that is does not recognise the variability in payment behaviours that exist in every company.
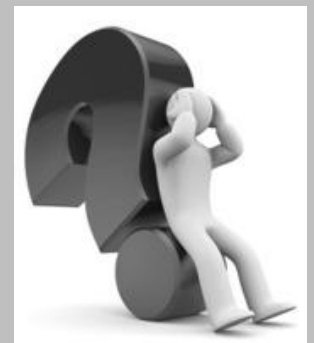
How has technology advanced the situation?

With the advent of powerful ERP systems and the increasing ability of software to extract and crunch huge amounts of raw data has changed the picture considerably in recent years. There are numerous solutions out there that plug into your ERP suck out the right data and are able to construct very detailed analyses of customer and supplier payment profiles. These solutions have effectively solved one part of the puzzle – how do I process huge amounts of transactional data into meaningful information for the user? But all these solutions assume that the due date and the payment date will be the same. Therefore they merely produce a much more detailed model but still assume that if the forecast error is consistent then it should be manageable.
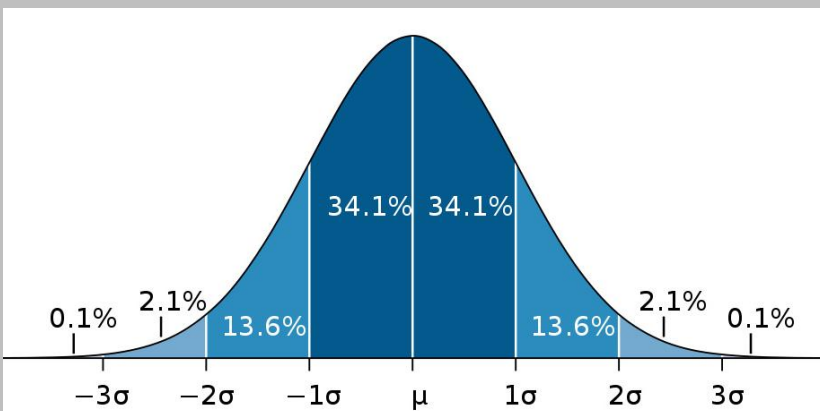
What is the remaining gap?

The remaining gap is about how we understand the variability in the forecast error. From one day to the next the answer will be different due different customer and supplier combinations. None of the models that we have seen even try to measure this problem. Therefore it is impossible for these otherwise sophisticated models to allow the user to iron out the issues that cause variability, ultimately making it harder to improve the forecast error over time.

What is Informita's solution?

At Informita we have been looking at this problem for a number of years, hoping that one of the software players would recognise the issue and provide a viable solution. To date this has not happened. As a consequence we have built our own models to extract data from our clients' ERP systems, model that data to understand both the forecast error and the variability of results caused by erratic payment behaviours. Once these issue are uncovered, we can look into the detail by customer and by supplier to see what is driving the problem. Major problems can be having terms that are so short that a process is not capable of paying on time, invoices not sent the correct location or invoices not sent at all. These problems can be uncovered by drilling into the data on a regular basis. That will then allow the forecast error to improve consistently over time by solving the process issues that drive the inaccuracy. We have seen processes that drive forecasting accuracy to less than 5% using these methods.

Model Results

We ran the model for two very different companies to display the type of data that can be quickly displayed. In Company A's case, we see a fairly regular profile of a payables forecast accuracy. In this case we see a forecast error because the model's forecast versus actual payments was either under or over forecast in different weeks. The average forecast error was 2% over the period, but the variability in the forecast accuracy results would have been misleading since we can see that there is no consistency by week. This is not an unusual profile for most companies and clearly suggests that by ironing out the peaks and troughs that the model is displaying that we can reduce the variability and improve the level of forecast accuracy. In the case of Company A key issues that caused variability were the fact that many suppliers invoices only arrived just before due date and that many discounts were being lost on short payment term invoices that were not being paid within the discount term. If you ran the model and you had a profile like Company B the alarm bells should be ringing very loudly. In this case we see a similar level of variability in the results, but the average forecast error was 66% and supplier payments were always above the forecast. In this case Company B was growing extremely quickly. As revenues grew, the need to purchase products and services to support was growing at a similar rate. Since customer terms were much longer than supplier terms, the result of this growth was a severe working capital shortage. The main way of dealing with this shortage was to deliberately delay payments to suppliers. In many cases the variability was caused by suppliers demanding payment at short notice before any further product would be shipped. In each of these cases, we were able to

segment the supplier base, to help pinpoint the exact supplier where the problems were evidencing themselves and then look at the process issues that were driving that specific issue. Very often Treasury departments do not have access to transactional level data while Procurement and Payables can find it difficult to understand the treasury implications of erratic payment performance. We were able to display an objective and direct linkage between treasury forecast issues and purchase to pay performance.
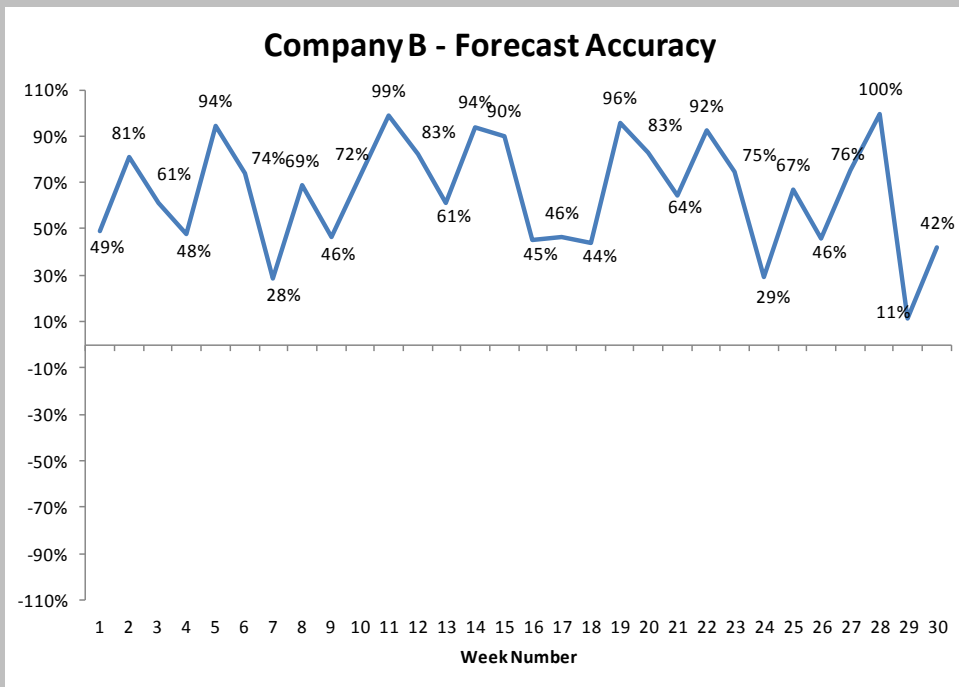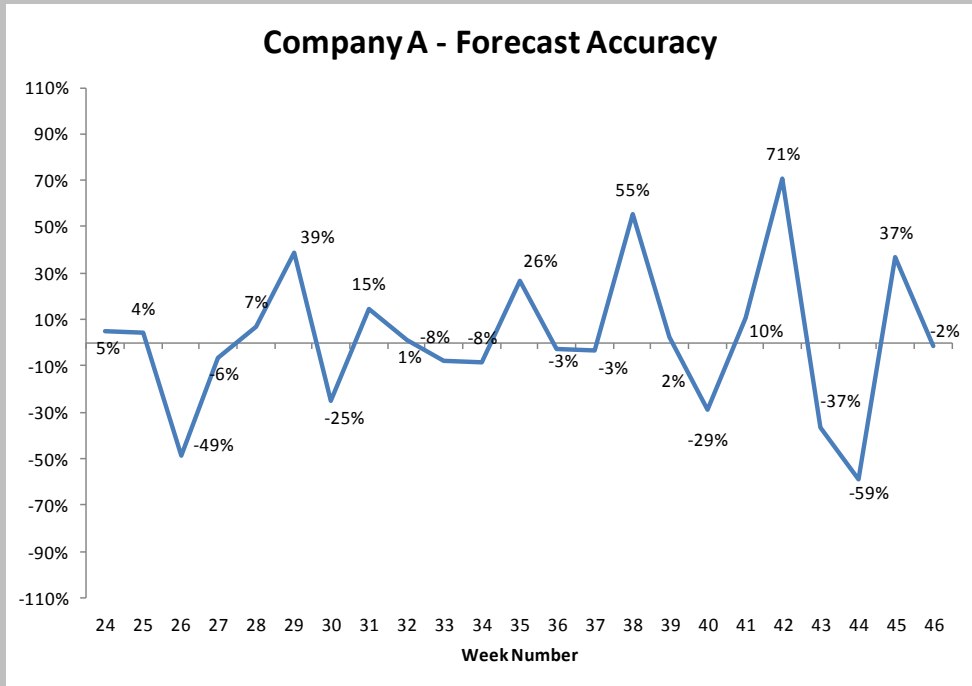
Conclusion

We believe that this is the last link in the chain of solving the problem of short term cash flow forecasting in a large volume transactional environment. The surprise is that the technology to perform this kind of analysis has been out there for several years. At some point the software providers will catch up but it is also necessary for many companies to fully realise the extent of the problem and its inherent cost to business operations. The real Holy Grail of cash flow forecasting would to marry up the longer term cash flow forecast with the profit and loss budgeting process, but the short term step must be completed first. In the meantime, we look forward to working with our clients to improve cash flow forecasting accuracy.

About Informita

Informita was formed to act as an advisor to companies in the areas of working capital and procurement, focusing on Analytics, Implementation and Advisory. Informita is there to support your working capital and procurement programmes from cradle to grave in a cost efficient and effective manner. Our people have a mixture of deep industry and consulting experience across many sectors and geographies. This gives us the ability to bring insights across many industries and cultures.

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