Cash Forecast: The Tool No CEO Should Be Without

By Steve Hancox, *Management Strategies,* Spring 2013

Your accounting firm helps you prepare and understand your financial reports. These reports are extremely valuable to owners, lenders, and in some cases key customers and suppliers. Nevertheless, there is an additional set of data that collectively is even more valuable to your managers – your internal management reports. These are the reports they use on a daily basis to run the business.

People only manage that which they measure. How well these measurements capture the essence of each manager's area of responsibility greatly influence the effectiveness of that manager. A company's management reports are beyond the scope of its accounting firm's year-end work; which means they may never be reviewed. That is unfortunate. The only way to guarantee that everyone is pulling in the same direction is by ensuring that the team is measuring and rewarding all of the right activities. This is how companies greatly improve their results.

While we would never recommend having just one management report, there is one that should be in every company's use. A comprehensive Cash Forecast is a critical management tool. This tool combines the company's Sales Forecast and its Capital Forecast. In addition, it requires a clear understanding of how the various disciplines, processes, and forecasts interrelate.

Building the report requires a thorough understanding of your company's cash cycle. This is the first benefit for many companies. Long before proceeds from a sale are collected, a company needs to invest cash in inventory, payroll, and accounts receivable. In addition to the direct expenditures related to each sale, the firm has on-going expenses.

The benefits of forecasting cash are substantial. It is obviously vital for a company that has little "headroom" (the sum of cash plus borrowing capacity available on the line of credit). However, it is equally valuable to companies that are well capitalized and have ample cash reserves. The cash forecast presents a consolidated snapshot of every significant source and use of funds while providing key early indicators of the strategic alignment of all expenditures. Once introduced to this report, CEO's find the weekly cash forecast report to be indispensible.

As an internal management report, the cash forecast is completely customizable. The basic template includes certain features. Having worked closely with these reports for more than thirty years, we have found that a single page report encompassing thirteen weeks, plus a separate listing of the assumptions, works very well. While there is some flexibility as to the presentation of the income and expense components, it is important that there be adequate detail, or you could miss observing key changes that are taking place.

Reconciling actual versus estimate drives the value of the cash forecast and should start with the CFO or Controller. Once prepared, the CEO should want to be intimately involved. There are two types of reconciling items: those that are purely incidental timing, such as receiving a check one day versus another (think of these as "noise"), and those that may be serving as an early indicator of a problem (consider these "substance"). A good reconciliation process will allow the CEO and CFO to agree on the classification of each item (noise versus substance) and then identify action steps to address each of the substantial variations.

These items of substance serve as early indicators of a potentially significant lapse within the organization. For instance, if inventory is growing or shrinking faster than the model would predict, you need to identify the root cause. If you determine it is simply an aberration, such as an errant forecast, then it is just "noise." However, you might learn that a purchasing manager is acting on something other than the approved sales forecast, or that a major customer is changing their buying habits, etc. Likewise, the trends of Receivables and Payables are significant. It is this early awareness of challenges your business is facing that cash forecasting makes possible.

Cash is not the only aspect of the company that is important; safety, quality, and compliance are also vital. No single management report (Including the Income Statement) covers everything that is important to an organization. However, it would be very difficult to find any report that monitors more of what is important to the management of a company than the cash forecast. Profit is a great tool – but you cannot spend it nor put it on a deposit slip. Cash is king. Every company needs to be on top of cash.

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