Cash flow forecasting notes & activities

The difference between cash and profit

Profit is calculated by subtracting expenditure from revenue. It might appear that a profitable firm will be cash rich, but this is not necessarily true. Profitable firms may be short of cash for the following reasons:

- The firm has built up its stock levels, and so its wealth lies in assets rather than cash. These stocks may not be saleable in the short term.
- The firm's sales are on credit — in this case, its wealth will be in debtors, rather than cash. The firm may have agreed with its debtors that they need not pay for a given time period (this may damage cash flow, but it will help marketing).
- Profit may have been used to pay dividends to shareholders or repay long-term loans.
- The company may have purchased fixed assets. This will involve a large outflow of cash, but in the accounts the 'cost' of these fixed assets is spread over a number of years. Thus in the year in which the fixed assets are purchased, the recorded 'costs' will be much lower than the actual loss of cash, leading to a potential crisis. (In practice, major purchases of fixed assets are often supported by loans that are repaid in future years.)

Liquidity v. profitability

In the long term, a business must make profit in order to survive. However, even profitable businesses may face difficulties if they do not plan their cash flow carefully. For example, a firm purchasing assets may expect to make profit from these assets in the future, but cash payments for the assets could lead to them being unable to pay suppliers or workers. This could lead to **liquidation**, with the firm being forced to close and sell its assets in order to make these cash payments.

Liquidity is the ability to convert an asset into any form without loss or delay. The most liquid asset that a business can possess is cash. The working capital of a business (current assets minus current liabilities) provides an indication of the firm's scope to pay its short-term debts, as it includes the most liquid assets. All firms, however profitable, must manage their cash and their working capital (which includes those items that can be converted into cash most easily) to guarantee their survival. Thus **in the short term, a business must manage its cash flow in order to remain liquid**.

The need for liquidity must be balanced against the requirement to make profit. Cash supports survival, but it does not create profit in the way that fixed assets such as machinery might. Thus excessive cash holdings can be as undesirable as a shortage of cash. Firms will plan their cash holdings by compiling a **cash-flow forecast**. This is a projection that shows how the firm believes its cash holdings will change over the next x months.

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Steve Godden had just commenced production. After expenditure on equipment, Steve was left with an opening balance of £30,000 from his start-up capital.

Steve's first action on 1 January had been to purchase the lease on a property for £25,000, with the annual rental of £12,000 per annum being paid in two equal instalments in January and July.

Monthly costs were calculated as £5,000 wages and £8,500 for raw materials. Administration was forecast at £2,800 per month. Utilities were estimated to cost £2,000 per quarter, payable in March, June, September and December.

Cash sales were expected to be £15,000 per month, except for sales of £3,000 in January, £10,000 in February and £12,000 in March.

Credit sales would be £5,000 per month, but payment to the firm would take place exactly one month after the sales were recorded.

Cash-flow forecast for Steve Godden, January to June 200X

	January	February	March	April	May	June
Opening balance	30,000					
Cash sales				15,000	15,000	15,000
Credit sales	0	5,000	5,000			
Monthly inflows						
Raw materials, wages and administration	16,300	16,300	16,300	16,300	16,300	16,300
Utilities	0	0	2,000	0	0	2,000
Purchase of lease	25,000	0	0	0	0	0
Rent		0	0	0	0	0
Monthly outflows						
Net monthly balance						
Closing balance						

Questions:

a) Complete the blank spaces in the above cash flow forecast

b) Based on your answer to question (a), indicate whether Steve's cash flow is likely to improve or worsen from July to December

c) Explain two ways in which Steve might improve his cash flow

d) Steve has approached your bank with a request for an overdraft. Based on your calculations, would you provide him with an overdraft? (back up your answer)

The ToneZone

Lizzie James and Tony Holmes had set up 'The ToneZone' as a partnership in 2007. They had both been employed at the town's football club – Tony as a player and Lizzie as a sports science consultant. When Tony's career was ended by a major injury, they decided to set up a fitness consultancy business. For the first four years they had operated from premises which they rented on an annual basis and they had built up a very loyal clientele. At the start of 2011 they moved into their brand new purpose-built fitness centre, having convinced their bank to lend them a substantial amount of money repayable over the next five years. This was a dream come true and the centre was fitted with state-of-the-art rented equipment. They had recruited a receptionist and three newly qualified part-time assistant instructors, enabling Tony and Lizzie to maintain the contracts they had with local authority schools in the town. However, the money from this was very likely to be cut at the end of the financial year.

At the start of 2012, Lizzie was becoming very concerned about the business as it seemed that they had been far too optimistic about the attraction of their new fitness centre, especially as a new 'Esporta' fitness centre had just opened on the outskirts of the town. In addition, some of their longer term clients were not happy about the service and advice they were getting from the new part-time staff. A few customers felt that they were quite rude on occasions and that they were not fully competent when giving instructions on how to use the equipment. In fact, some customers were threatening not to renew their annual membership in April. Lizzie drew up a cash flow forecast for the next six months (**Table 1**) and met with Tony to discuss the situation. They needed to act quickly, if Lizzie's forecast was correct, as the bank manager was very unlikely to extend their overdraft limit.

One area of the business that particularly concerned her was the numerous complaints that had been received about their new staff. When she approached them about this, they pointed out that they had received no guidance or training from either her or Tony on how they wanted them to run the centre when they were not there. They felt very unhappy that they had been thrown in at the deep end, especially as they often found themselves as the only instructor on duty. Lizzie began to realise the **laissez faire** style that they had adopted towards the staff had been a big mistake.

(go to next page for the cash flow forecast and questions)

Table 1: Cash flow forecast for The ToneZone January - June 2012

Overdraft Limit: £4 000

	£000s	£000s	£000s	£000s	£000s	£000s
	January	**February**	**March**	**April**	**May**	**June**
Entrance Fees	4 500	4 000	3 800	4 000	4 200	4 200
Membership Fees				60 000		
Schools Contracts	3 000	3 000	3 000			
Total Sales Receipts	7 500	7 000	6 800	64 000	4 200	4 200
Loan Repayments	1 500	1 500	1 500	1 500	1 500	1 500
Wages	2 200	2 200	2 200	2 200	2 200	2 200
Heating and Lighting	50	50	50	50	50	50
VAT			5500			
Telephone	30	30	30	30	30	30
Insurance			1 200			
Equipment Rental	700	700	700	750	750	750
Contract Cleaners	600	600	600	600	600	600
Advertising	200	200	500	500	200	200
Business Rates	900	900	900	900	900	900
Drawings	3 000	3 000	3 000	3 000	3 000	3 000
Total Payments	9 180	9 180	16 180	9 350	9 230	9 230
Net Cash Flow	(i)	(2 180)	(9 380)	54 650	(5 030)	(5 030)
Opening Balance	7 000	5 320	3 140	(6 240)	48 410	43 380
Closing Balance	5 320	3 140	(ii)	48 410	43 380	38 350

(a) Using the cash flow forecast calculate the:

(i) net cash flow for January; [1]

(ii) closing balance for March. [1]

(b) Explain the advantages to a business, such as The ToneZone, of drawing up a cash flow forecast. [6]

(c) Suggest ways in which Lizzie and Tony might improve their worrying cash flow situation **and** consider any consequences your suggestions might have. [8]