Cash Flow Forecasting

Specification requirements -
Complete and interpret simple cash flow forecasts.
The benefits and limitations of using cash flow forecasts.

It is often said, that in business "Cash is King", this is because cash is the most important asset a business can have. Without cash employees cannot be paid, suppliers cannot be paid, and therefore the business will grind to a halt. Cash is the oil in the machine of business, and a Cash Flow Statement tells us how much cash is or will be available within the business or how much cash will be needed to keep the business running. So as a first step remember that:

"A cash flow statement tells us how much cash is or will be available in a business or how much cash will be needed to keep the business running".

Types of Cash Flow Statement.
There are two types of Cash Flow Statement, these are:
Actual Cash Flow Statements, these show an historic view, showing the actual flows of cash into and out of a business that have occurred over a previous trading period, e.g. 6 months, or 1 year.
A **Forecast Cash Flow Statement** showing the expected flows of cash into and out of a business over a trading period in the immediate future, e.g. next 6 months or year.

Whichever type you will examine they will be made up of three parts, these are:
Revenue, Expenses, Balances
Why prepare and examine Cash Flow Statements?
When we prepare and examine cash flow statements we do it for one of two reasons:
Firstly because a business should always compare it's actual cash flow with its predicted cash flow. This comparison will demonstrate if things have worked out as expected, or not. If they have not worked out as expected, then the reasons for this difference should be examined. This will help a business plan for the future more effectively, and may help prevent a shortage of cash. We can only do this comparison if we have both sets of figures, actual and predicted.
Secondly we can look at a forecast cash flow statement on its own, (a forecast cash flow is also known as a predicted cash flow). The forecast cash flow is used to tell us if the business is likely to have enough money coming into the firm to pay all of its expenses. If the forecast cash flow tells us that it does not have enough money coming in, then the business must arrange to obtain the required amount of money. Perhaps the most popular method of funding a shortage of cash is to borrow from a bank (external) and this borrowing can take the form of loan or an overdraft, but there are other methods of funding, each of which have an important part to play. We will examine these methods of funding later in this section.

A cash flow statement or forecast does not show the profitability of a company, only a Profit and Loss Account shows how much profit a business is making.

To obtain a picture of what a cash flow statement is made up of we will examine the cash flow statement of GoodWood Trading. GoodWood is a sole trader who is just setting up in business; the business will manufacture wooden garden furniture. The items made will be sold through gardening exhibitions, and to local garden centers on a credit basis. The predicted cash flow statement for the first six months of trading is shown on the next page.

	Jan	Feb	March	April	May	June
Revenue	**£**	**£**	**£**	**£**	**£**	**£**
Cash sales	600	1200	1750	2300	2600	3000
Debtor Payments	0	600	850	1300	1490	1430
Total Revenue	600	1800	2600	3600	4090	4430
Expenses						
Raw Materials	970	1200	1350	1380	1670	1500
Wages	800	800	800	900	900	900
Loan Repayments	220	220	220	220	220	220
Rates	40	40	40	40	40	40
Electricity	60	60	60	100	100	100
Travelling	80	80	150	150	150	150
Sundries	130	80	80	80	80	80
Exhibition Charges	150	150	250	250	300	300
Total Expenses	2450	2630	2950	3120	3460	3290
Net Cash Flow	-1850	-830	-350	480	630	1140
Opening Balance	750	-1100	-1930	-2280	-1800	-1170
+/- Net Cash Flow	-1850	-830	-350	480	630	1440
Closing Balance	-1100	-1930	-2280	-1800	-1170	270

Revenue.
Revenue is the income received by a business for goods sold or services provided. It is the cash flowing into a business. For GoodWood we see that it is sub divided into Cash Sales, and Debtors Payments.

	Jan	Feb	March
Revenue	**£**	**£**	**£**
Cash sales	600	1200	1750
Debtor Payments	0	600	850
Total Revenue	600	1800	2600

Cash sales occur when sales are made and payment is immediate. This payment can be by cash, cheque, or credit card. In all of these cases the money is immediately available for use by the business

Debtors Payments. Many businesses sell goods on credit; payment for the goods may not be due for 30 days or more. When goods are sold on credit a Debtor is created. We only enter the revenue from these sales. when payment is made.

Total Revenue. This is the total revenue; all the payments received by a business within the time period. This is the total of money flowing into the business. All of this cash is available for use by the business.

Expenses	**Jan.**	**Feb.**
Raw Materials	970	1200
Wages	800	800
Loan Repayment	220	220
Rates	40	40
Electricity	60	60
Travelling	80	80
Sundries	130	80
Exhibition Charges	150	150
Total Expenses	2450	2630

Calculating Expenses.

Under expenses or expenditure you will find all of the money spent by a business within a time period. This is the money flowing out of the business. There are many different types of expenditure, some of the more common are shown here.
In a cash flow the expenses of a business broken down into its parts. We can see exactly where the money is going. In January GoodWood will spend £40 on rates, £60 on electricity and so on. All of these are examples of money flowing out of a business.
Total Expenses. This is the total of expenditure for the time period. For GoodWood the total expenditure for January is predicted to be £2300. This means that the total of cash flowing out of the business is expected to be £2450.

Revenue	**Jan £**	**Feb £**
Cash sales	600	1200
Debtor Payments	0	600
Total Revenue	600	1800
Expenses		
Raw Materials	970	1200
Wages	800	800
Loan Repayments	220	220
Rates	40	40
Electricity	60	60
Travelling	80	80
Sundries	130	80
Exhibition Charges	150	150
Total Expenses	2450	2630
Net Cash Flow	-1850	-830

Calculating Net Cash Flow

Total Revenue is the total of cash flowing into the business.

Total Expenses. This is the total spending by the company. I.e. the total flow of cash out of the GoodWood Trading. Note. If goods are bought on credit, then they only appear on the cash flow statement when the payment is made.

Net Cash Flow. This calculated by taking total expenses away from total revenue. If revenue is greater than expenses then this figure is positive (+), if expenses are greater than revenue, then the net cash flow is a negative (-).

	Jan	**Feb**	**March**
Net Cash Flow	-1850	-830	-100
Opening Balance	750	-1100	-1930
+/- Net Cash Flow	-1850	-830	-350
Closing Balance	-1100	-1930	-2280

Calculating Balances.

Net Cash Flow. Once calculated this can then be used to obtain the Closing Balance for the period. To find the Closing Balance, if the NCF is a negative we deduct the Net Cash Flow from the opening balance, or we add NCF to opening balance if it is a positive figure. **The opening balance** is the amount of cash available at the beginning of the period. **Closing Balance.** We see that for January we have a closing balance of -£1100, i.e. a predicted cash shortage of £1100. This was found by taking the Net cash Flow -£1850 from the Opening Balance £750. The Closing Balance for one month or period, becomes the Opening Balance for the next month or period. In this case we see that the Closing Balance for January, -£1100, becomes the Opening Balance for February, -£1100.

Revision Questions

All questions refer to the Cash Flow Forecast of GoodWood.

1. In the introduction we stated that a Cash Flow Statement is made up of three parts, these are:

a).

b).

c).

2.

(a) In which month are Debtor Payments the highest?

(b) In which month is Total Expenditure the lowest?

(c) In which month is the difference between Revenue and Expenditure the largest?

(d) In which months is Revenue greater than Expenses?

(e) How much is the difference between Total Revenue and Total Expenditure over the period January to June inclusive?

(f) What is the Total Expenditure for the period January to June inclusive?

(g) What is the Opening Balance for March?

(h) What will be the Opening Balance for July?

(i) What is the Total Revenue for the period January to June inclusive?

(j) In which month are Cash Sales the highest?

(k) What is the Closing Balance for the month of April?

(l) Which is the largest item of Expenditure in May?

(m) If Good Wood received a bill for £1500 on the 1st of July, would the business have enough in the Bank to pay it?

3. Define the following terms.

Revenue

Cash Sales.

Debtors Payments.

Total Revenue

Expenditure.

Total Expenditure

Net Cash Flow

Opening Balance

+ / - Net Cash Flow.

Closing Balance.

Why Forecast and Actual (Historic) Cash Flows can differ.

Forecast cash flow statements are a prediction of the likely flows of cash into and out of a business. They will be based on:

- **Past experience,** (when the business has a previous trading history)
- **Current and likely future economic and financial trends.**
- **The knowledge and understanding of the managers/owners.**
- **The future plans of the business.**

As with all forecasts, the further we look into the future, the less certainty we have. Because of this, and because businesses operate in a world with changing fashions, changing economic climate, and changing competition, a business's actual cash flow statement can in some cases be very different from it's cash flow forecast.

Typical Reasons for Variations between Actual and Forecast—why predicted cash flows can be wrong.

- **Sales are not at the expected level.**

This could be for several reasons;

- Increased /decreased competition.
- Economic growth /decline.
- Changing spending patterns of consumers / changing fashions
- Government influences, e.g. increased or decreased taxation.
- **Raw materials costs increase or decrease.**
- **Interest rates change, affecting demand, and the costs of those businesses with loans.**
- **Debtors pay later than expected.**
- **Increased labour costs.**
- **Inflation**

All businesses should monitor cash flow and examine any differences between actual and forecast figures. This will allow action to be taken before a real business crisis arises. As experience is gained of managing and monitoring cash flow, business owners and managers will be able to improve the accuracy of their forecasts.

But what happens when a business needs cash, or liquidity? Up to now we have just referred to cash, but the fact is we are talking about the liquidity of business.

Liquidity is a measure of the availability of working capital.

If managers of a business say they have a liquidity or working capital problem, this means that they will have a problem meeting all their immediate or near future expenditure demands. That is they do not have enough cash in hand, or do not expect enough cash to be flowing into the business and cannot convert enough assets into cash in the short term to be able to pay all their bills, wages, debts etc. That 'and' is important, firms do not always (in fact rarely) need to keep enough immediate cash on hand to meet likely future expenditure, what they must do though is keep enough 'liquid assets' available, so that cash flow can be effectively managed.

Benefits of Preparing a Cash Flow Forecast.

- An accurate cash flow forecast will allow a firm to get a clear idea of how the business is doing - and how it is likely to perform in the future
- It allows managers to be able to specify times when the business may need additional funding, such as when cash outflow exceeds inflow
- Inconsistencies in performance can be identified, predicted and remedied
- Changes in inflows and outflows resulting from major new investments can be accurately assessed

Limitations of Using a Cash Flow Forecast

- Drawing up of Cash Flow forecasts takes management time that might be more productively used else ware in the business.
- Cash Flow forecasts need to be accurate to have value—is it just a guess?
- The longer the time scale the less accurate the forecast is likely to be
- Inflation can impact on the accuracy of figures
- Cash flow forecast needs to be monitored to have ongoing usefulness.