Chapter 13 Using cash flow forecasting

By the end of this chapter you should be able to complete and amend a **cash flow forecast** and understand the significance of cash flow forecasting to businesses.

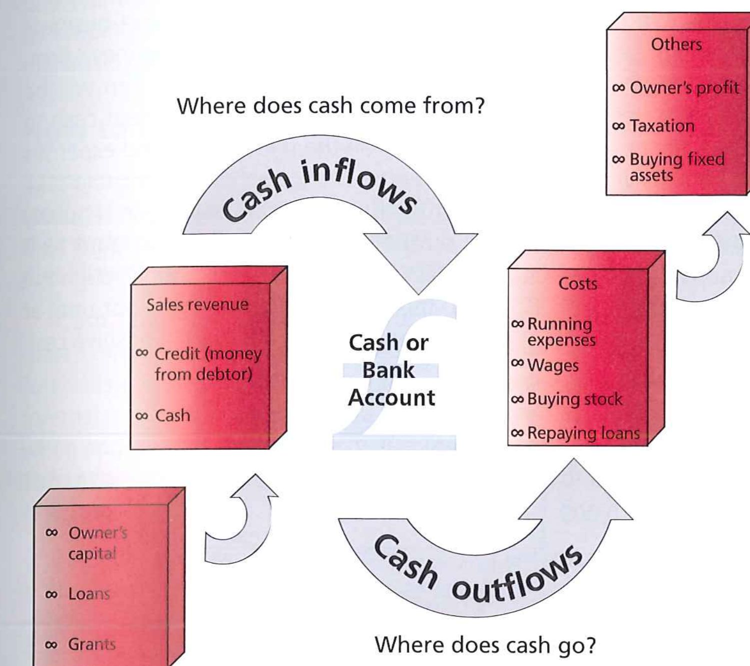

Figure 13.1 An example of a cash flow chart for a new business start-up

Key terms

Cash flow The cycle of money that enters and leaves a business as it makes and receives payments.

Cash flow forecasts Detailed estimates of when and how much cash is expected to flow into and out of a business.

Cash inflows Money received by a business from sales, investments or loans.

Cash outflows Money that leaves a business through paying for wages, materials, marketing, fixed assets, and so on.

Credit terms The amount of time someone is given to settle their account. Many businesses attract more customers by enabling them to 'buy now, pay later', for example, in three months' time.

The nature of cash flow

Every business needs direction; even a brand new start-up needs to consider what its objective is. Once an aim, objective or target of a business has been determined and agreed, a business needs to ensure that it actually has the finances in place to execute its plans. All new businesses face large **cash outflows** before any **cash inflows** can be forthcoming from customers.

Failure to have cash available to pay for costs, suppliers, contractors, licences or advertising/marketing of their product, may easily cause loss of customers and put any business behind competitors, or at worst lead to an inability to continue trading at all.

Consider any new business venture; it faces an immediate problem in that it has to have the finance to pay for all the items needed to start the business, such as:

- premises
- vehicles
- machinery
- stock
- equipment
- furniture.

This is not to mention stationery like letterheads and business cards, and any initial marketing costs to promote the new firm. Alongside this it is unlikely that huge amounts of custom will be generated immediately, so the business also needs sufficient cash to ensure it can keep running and pay all the bills, wages and expenses until the business has started to attract enough clients. It could take weeks, months or even longer for funds to start flowing in regularly from customers, depending on the start-up in question. Figure 13.2 demonstrates an example of this for a new business. Even though the business starts with £20,000, this is insufficient and it is not until at least month seven that the business starts to generate a positive cash flow.

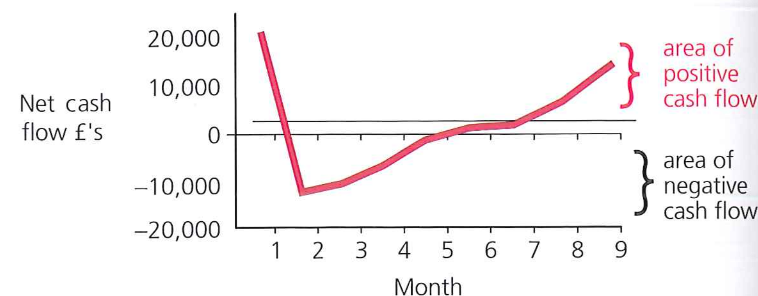

Figure 13.2 Example cash flow chart for a new business

Cash thus passes in and out of a business in a continuous cycle; if the supply of cash into a business is less than the amount flowing out, the business's bank account will become under pressure and eventually become overdrawn. If this situation persists or deepens the business can run out of cash as the banks refuse to lend any more and the business becomes bankrupt or liquidates as it cannot meet its financial commitments.

Preparing cash flow forecasts

Drawing up a cash flow forecast helps a business to maintain its position so that sufficient funds are available to finance its day to day operations. More small businesses in the UK fail as a result of poor cash flow than any other reason including lack of profits.

Preparing cash flow forecasts is a form of proactive management. All businesses are aware that the delay between the outlay on materials, stock and wages and the receipt of sales income can cause difficulties. So, rather than waiting for cash flow problems to arise and then trying desperately to solve them (reactive management), a skilled manager can anticipate the need to maintain a good cash position and actively plan in advance using cash flow forecasting.

A cash flow forecast is a detailed examination of a company's expected future cash inflows and outflows over a future period (such as one year ahead). They are usually calculated on a monthly basis and, by keeping a running total of the business's anticipated bank balance, managers can highlight times when cash difficulties may arise.

How to forecast cash flow

Banks encourage their business account holders to draw up cash flow forecasts. Banks produce a range of information and material to help their customers with forecasting; some, for example, provide templates that allow firms to compile cash flow forecasts online.

> **Guru's views**
> 'Happiness is a positive cash flow'
> –*Fred Adler,* venture capitalist

Cash flow forecasts are constructed using historical information (past company data or researched data for new ventures) and the forecasts contained in their budgets or business plan. The cash flow forecast is then constructed based on the predicted information of how, when and in what form money will come into and out of the business. This is done by estimating the amount and timing of cash inflows and cash outflows.

For new business start-ups most of their information must come from research, such as using market research to establish the likely number of customers and how much they would be willing to pay to forecast sales. Research can also be done in advance into the cost of premises, assets and likely running expenses. And potential suppliers of stock can be contacted to provide brochures, price lists or quotes. Researching a business carefully can massively reduce the risk of inaccurate cash flow forecasting.

CASH INFLOWS

Cash inflows are the monies received by a business. Cash inflows can come from a variety of sources, such as the examples below.

Sales revenue

These are payments from customers for goods bought. An important distinction is cash and credit sales. For cash sales, payment is received at once and hence the company can use it immediately. Whereas, with credit sales the customer is given a set amount of time to pay – the **credit term**. This could be anything from 30 days to deals like 'buy now, pay in 12 months' used by furniture retailers, for example, Northern Upholstery or Courts. In these instances, although the company has sold the goods, they need to be aware that they will not receive the cash for their own use perhaps for a considerable period of time and so the cash flow forecast needs to reflect when the company will actually receive the money as an inflow into its account.

Loans

Although they have to be paid back, the initial taking of a loan results in a cash inflow into the businesses account. Businesses can predict when they need to take loans, how much and what the purpose of the loan is, and so again this can be built into any forecast cash flow. However, in many cases the loan will have been taken for a specific purpose, such as purchasing new machinery, and so this money may become a cash outflow fairly rapidly as well.

Grants

Inflows of cash can be received from local, national or European government. These are often awarded to help companies create jobs or promote environmental protection. Unlike loans, grants do not have to be repaid at a later date.

Capital

This is money paid into a business by its owners, for example, the money initially invested by the owners to start the business or the funds received by a limited company when it sells more shares.

CASH OUTFLOWS

This is money paid out by the business, that is, leaving the business's account, and can occur due to payments for:

- purchases of stock or raw materials
- heat, light and water bills
- rent and rates on premises
- distribution expenses
- research and development
- telephone bills
- wages and salaries
- buying fixed assets
- interest on loans
- administration expenses
- advertising
- taxation.

Many of the above costs, such as wages and salaries, heat, light and water, are regular payments and as such are easy to forecast even if they are expected to increase; for example, employees may expect a wage rise in June. One-off or large payments such as purchasing a fixed asset should have been well planned and researched before happening and again can be easily included.

Other categories of expenditure exist, such as cleaning, stationery or repair costs. The actual categories for each business will vary depending on the type of industry. Also consider that businesses will often purchase items on credit terms as well as sell them.

The structure of a cash flow forecast

Because cash is so important to the survival of a business, businesses must constantly and carefully monitor their cash flow position. To do this, many businesses produce cash flow forecasts for the months or year ahead. They are made up of three sections:

- cash inflows
- cash outflows
- the running balance.

The cash flow forecast displays a calculation of the net effect of the cash inflows and outflows on the business's bank balance usually on a monthly basis, that is, it shows how much money the company anticipates it has (or has not) got in its bank account at the end of each month.

For example...

A cash flow forecast like Figure 13.3 would be compiled by taking information and forecasts from budgets and by using historical data. The calculations are made in the lines numbered 1–5. Lines 1 and 2 are simply the respective totals of the cash inflows and outflows. Lines 3–5 are the calculation of the running balance: the business's closing bank balance at the end of each month is forecast by adding the net cash flow (which might be a negative number, of course) to its starting bank balance.

Figure 13.3 demonstrates, for example, that in May the business's cash inflows (£136,700) were greatly exceeded by the cash outflows (£161,704), mainly due to the purchase of a new fixed asset, such as new machinery. This causes the business to actually go overdrawn by £1,980, and the business would have needed to arrange this in advance with their bank or one of their payments may not have been honoured. It can be seen, though, that by the end of the following month a positive cash flow is re-established.

	April	May	June	July
Cash inflows				
Sales	126,300	126,700	127,300	117,200
Loans	30,000	nil	nil	nil
Capital introduced	nil	10,000	nil	nil
(1) Total cash inflow	156,300	136,700	127,300	117,200
Cash outflows				
Purchases	20,136	20,144	20,176	20,700
Wages and salaries	42,080	42,720	43,680	43,520
Heat and light	800	800	800	800
Water	500	500	500	500
Telephone	1,120	1,120	1,120	1,120
Advertising	28,700	10,000	3,000	3,000
Administration expenses	19,240	19,870	20,100	20,000
Distribution expenses	6,400	6,550	6,720	6,680
Purchase of fixed asset	nil	60,000	nil	16,200
(2) Total cash outflow	118,976	161,704	96,096	112,520
Running balance				
(3) Opening bank balance	(14,300)	23,024	(1,980)	29,224
(4) Net cash flow (1 – 2)	37,324	(25,004)	31,204	4,680
(5) Closing bank balance (3 + 4)	23,024	(1,980)	29,224	33,904

Figure 13.3 An example of a cash flow forecast

Activity

Complete this cash flow forecast, by calculating the missing figures indicated by question marks. You can find a copy to download or print at **www.collins.bized.co.uk**

	May	June	July
Cash inflows			
Start-up capital	5,000		
Sales revenue		1,000	?
Total receipts	?	1,000	**1,200**
Cash outflows			
Payments			
Insurance	100	100	100
Stock purchases	0	650	780
Miscellaneous	50	50	50
Rent	1,000	1,000	?
Electricity			100
Telephone			75
Marketing costs		20	24
Shop fittings	?		
Water			150
Total payments	**3,150**	?	**2,279**
Total receipts	5,000	1,000	1,200
Total payments	3,150	?	2,279
Net cash flow	?	?	?
Opening balance		1,850	1,030
Closing balance	**1,850**	?	?

Why businesses forecast cash flow

A major benefit of cash flow forecasting is that it enables managers to anticipate periods when cash flows may be high or low, thereby indicating periods when cash might be available for spending and investment or, more importantly, periods when cash is likely to be tight.

Cash flow forecasting is not just a defensive activity. It brings a number of positive benefits for a business, including:

- ensuring liquid assets are available to meet payments and maintain working capital
- identifying periods of cash shortfall so remedial action like overdrafts can be arranged
- identifying periods of cash surplus so high-cost items can be purchased at little risk
- highlighting periods when large expenditure is not possible, so businesses may have to consider spreading payments for fixed assets over monthly instalments
- limiting the amount of borrowing and minimising interest payments, as a cash flow forecast should enable a business to borrow only the sum that it needs

- highlighting cash surpluses that can be more profitably invested elsewhere
- supporting applications to lenders by demonstrating that funds would be available to meet interest and capital repayments on loans.

By completing a cash flow forecast using a spreadsheet, the business can also model 'what if' situations. For example, the spreadsheet can automatically calculate the cash implications of offering consumers longer credit periods.

LIMITATIONS OF CASH FLOW FORECASTING

- Cash flow forecasts are only estimates. Sales may be lower than forecast or costs may be higher. A wide range of factors will affect the accuracy of the forecast.
- It is impossible to forecast every item of expenditure 100% accurately.
- The cash flow statement may reveal a cash problem, but may give little indication of the underlying causes (although, at least, management will be aware of the problem).
- Management must use cash flow forecasts as a working tool. Once a cash flow forecast has been prepared, it should be monitored regularly and updated to take into account changing economic circumstances, such as rising interest rates.

Further material and resources relating to this section can be found at **www.collins.bized.co.uk**. Keep checking for updates.