

UNIT 4

9 Household and business manager: Finance

Learning objectives

In this chapter you will learn about:

- 1 Cash flow forecasts and how to analyse them
- 2 Sources and uses of finance for households and businesses

Cash flow management: household and business

Summary of cash flows		
	Household	Business
Inflows	Wages/salaries	Cash sales
	Child benefit	Debtor payments
	Welfare payments	Loans
	Loans	Sale of fixed assets
	Interest earned	Capital/grants
Outflows	Mortgage payments	Cash purchases
	Rent	Creditor payments
	Insurance premiums	Business expenses, e.g. rent
	Food and clothing	Buying fixed assets
	Heating and fuel	Repaying loans
	Household expenses	Paying taxes
	Holidays/entertainment	

Reasons for drawing up a cash flow statement or household budget

- Creates a plan for and allows the control of cash flows
- Ensures that we do not run out of cash
- Identifies future shortages of cash so that we can deal with them
- Identifies needs for finance in the future
- Identifies future cash surpluses, which can be used to best advantage

Steps involved in analysing cash flow forecast

- 1 Examine the net cash for each month.
- 2 If there is a surplus, there is no problem.
- 3 If there is a deficit, you must examine the effect of this deficit on the closing cash position for the month.
- 4 If the closing cash is negative, then the net cash deficit for the month will have to be corrected so that there is a positive figure for closing cash.
- 5 Examine ways to correct the net cash deficit for the month.

Top Tip!

You must be able to analyse a sample cash flow forecast, identify problems and suggest ways of solving these problems. Make sure you know the methods to resolve cash deficits.

Ways to resolve net cash deficits

- Cut down on planned expenditures, especially ones that are non-essential or discretionary.
- Defer payments to creditors.
- Try to earn extra income to make up any cash shortfall.
- Spread out the payment of large expenditures over a period of time so that they do not affect one period too heavily.
- Borrow money (overdraft) to cover any cash shortage.
- The purchase of fixed assets should be financed by term loans, hire purchase or leasing.
- Bring in additional cash by getting the owner to invest more capital, especially to finance large capital expenditures (e.g. new factory).



Exam question

- 1 In September 2008, Buttercup Garden Centre prepared the following cash flow forecast.

Cash Flow Forecast of Buttercup Garden Centre - October to December 2008				
	October	November	December	Total
	€	€	€	€
Receipts				
Cash Sales	12,500	9,500	10,000	32,000
Credit Sales	2,000	1,500	3,500	7,000
Total Receipts	14,500	11,000	13,500	39,000
Payments				
Cash Purchases	1,000	2,500	4,000	7,500
Credit Purchases	5,000	2,000	1,000	8,000
Wages	6,000	6,000	7,500	19,500
Equipment	12,000	–	–	12,000
Total Payments	24,000	10,500	12,500	47,000
Net Cash	(9,500)	500	1,000	(8,000)
Opening Cash	3,000	(6,500)	(6,000)	3000
Closing Cash	(6,500)	(6,000)	(5,000)	(5,000)

- (i) Explain the benefits to Buttercup Garden Centre of preparing a cash flow forecast.
- (ii) Based on the information provided above, outline how Buttercup Garden Centre could improve the cash flow position of its business. (2009, 20 marks)

Sample answer

Suggested Solution

(i)

Benefits of cash flow forecast

- (a) Identifying the timing and sources of cash inflows
- (b) Identifying the timing and sources of cash outflows
- (c) Establishing net inflows/outflows – business can then plan effectively to meet cash shortages/or alternatively consider their options in relation to a large cash surplus

- (d) Provides a benchmark against which actual performance can be compared, aiding financial control
- (e) Access to finance from financial institutions

(ii) Improvements to cash flow position

Purchase of equipment – capital expenditure

Buttercup Garden Centre plans to purchase and pay for equipment, using cash flow in October 2008. Equipment is an item of capital expenditure and will most probably be used in the business over a period of a number of years. Buttercup should consider taking out a medium-term loan to pay for the equipment – this would ease their cash flow position considerably, and provide access to badly needed cash.

Access to credit/bank overdraft

Buttercup Garden Centre will need to negotiate a bank overdraft with its local bank. If trade continues as per the month of December, and there are no changes in overheads or other unforeseen expenses, it will take at least another five months to clear the forecasted deficit of €5,000.

Credit control

Information provided in the cash flow forecast for Buttercup Garden Centre shows that:

- Cash sales are expected to decrease, while the level of credit sales is expected to increase over the three-month budgeted period.
- Cash purchases are expected to increase, while credit purchases are expected to decrease over the three-month period.

Both sales and purchase forecasts are putting pressure on cash flow, and the availability of cash. Buttercup needs to review its credit policy – decrease cash purchases if possible and increase cash sales.

Control of overheads

Wages increase from €6,000 to €7,500 (25% increase) from October to December, yet sales fall in the same period. Buttercup Garden Centre needs to review and control the amount of money spent on wages.

Marking scheme

- Two benefits of CFF: 2 x 5 marks (5 = 2 + 3)
 - 2 marks for naming the benefit
 - 3 marks for explaining/developing/example
- Two improvements to CFF: 2 x 5 marks (5 = 2 + 3)
 - 2 marks for identifying the improvement
 - 3 marks for explanation/illustration

Note: purchase of equipment is a compulsory point

Sources and uses of finance: household and business

Short-term finance (less than 1 year)

	Household	Business
Sources	Bank overdraft Unpaid expenses Credit cards	Bank overdraft Creditors Unpaid expenses Factoring debts
Uses	Buying clothes, food, services Day-to-day household expenses	Purchase of stock Payment of wages Payment of expenses

Medium-term finance (1–5 years)

	Household	Business
Sources	Medium-term loan Leasing Hire purchase	Medium-term loan Leasing Hire purchase
Uses	Cars, home improvements, appliances (e.g. TV)	Vehicles, machinery, office equipment

Long-term finance (more than 5 years)

	Household	Business
Sources	House mortgage Savings	Owner's capital Retained earnings Debenture Grants Venture capital
Uses	House purchase House extension	Purchase of land, buildings Large capital expenditures

Top Tip!

You should be able to give examples of **sources of finance to match particular uses** and explain why they should be matched in this way.

Questions

Higher Level long questions

- 'Managing a business is similar to managing a household in the areas of finance and taxation.'
Discuss this statement, using examples to support your answer. (20 marks)
- Business cash flow forecast of Ton Ltd

	January	February	March	Total
	€	€	€	€
Receipts	40,000	50,000	55,000	145,000
Payments	38,000	53,000	57,500	148,500
Net Cash	2,000	(3,000)	(2,500)	(3,500)
Opening Cash	2,500	4,500	1,500	2,500
Closing Cash	4,500	1,500	(1,000)	(1,000)

- Explain why a business would prepare a cash flow forecast.
- In which month(s) does the above business have a problem? Outline possible reasons why.
- Suggest two things that the business can do to help solve the problems. (1999, 20 marks)

- Balden Ltd prepared the following cash flow forecast:

2007	January	February	March	Total
	€	€	€	€
Receipts	70,000	55,000	80,000	205,000
Payments	80,000	45,000	55,000	180,000
Net Cash	(10,000)	10,000	25,000	25,000
Opening Cash	3,000	(7,000)	3,000	3,000
Closing Cash	(7,000)	3,000	28,000	28,000

- Why would this cash flow forecast be prepared by Balden Ltd?
- How might management deal with the financial issue highlighted in this forecast?

(2007, 20 marks)

4 'Managing finance is most important in households and in business.'

Identify the similarities and the differences involved in managing finance in a household and in a business.

Key-points!

- How to analyse a cash flow forecast
- Sources and uses of finance for a household or business

Key-definitions!

cash flow forecast: A plan of cash inflows and outflows which allows a firm to manage its cash and avoid cash shortages in the future.

hire purchase: A method of financing the purchase of an asset over a period of years by paying instalments. On the last payment the buyer owns the asset, not before.

household budget: A plan of the cash inflows and outflows that allows a household to manage its cash and avoid cash shortages in the future.

leasing: A method of financing assets which involves paying on a regular basis for the use of the asset over a set period of time.

long-term finance: Funding for a business for a period of more than five years.

medium-term finance: Sources of money to acquire assets for a period of one to five years, namely hire purchase, leasing and term loans.

mortgage: A long-term loan used to purchase a house where the house is used as security for the loan.

overdraft: A short-term loan from a bank operated through a current account. The account holder can take more money out of the account than was lodged up to an agreed limit.

short-term finance: Sources of money to finance the day-to-day running of a business over a period of less than one year, e.g. trade credit, bank overdraft.

term loan: Borrowing from a bank for between one and five years with repayments made in instalments over the time period.