Cash flow forecasting and working capital

- Cash is a liquid asset
- The cash flow of a business is the cash inflows and outflows over a period of time
- The business will experience major problems if the business runs short of cash, such as being unable to pay workers, being unable to produce goods and services or even lead to liquidation
- Liquidation is whereby a business sells up everything it owns to pay for its debts

Cash inflows

Cash inflows are the sums of money received by a business during a period of time. Here are five of the most common ways of cash inflow:

- Sale of products for cash
- Payments made by debtors
- Borrowing money from an external source
- Sale of assets
- Investors

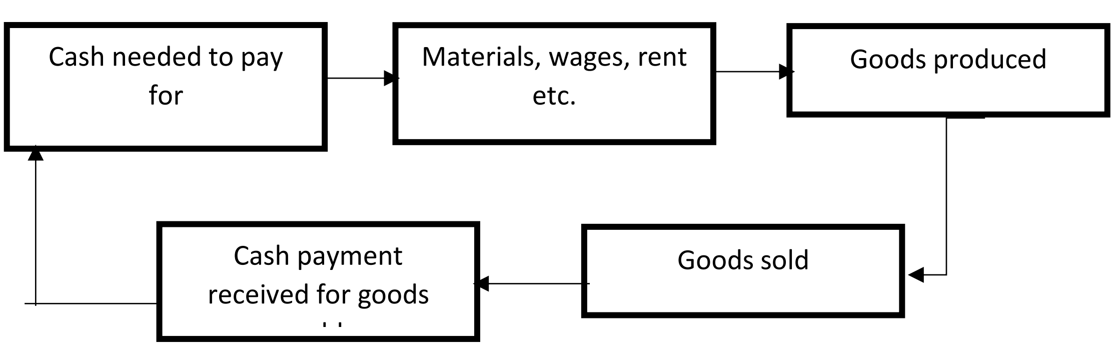
Cash outflows

Cash outflows are the sums of money paid out by a business during a period of time. Here are five if the most common ways of cash outflow:

- Purchasing goods or materials for cash
- Paying wages, salaries and other expenses in cash
- Purchasing fixed assets
- Repaying loans
- Paying creditors of the business

Cash flow cycle

A cash flow cycle shows the stages between paying out cash for labour, materials etc. and receiving cash from the sale of goods



The difference between cash flow and profit

Cash Flow

- Cash is needed to pay expenses
- Cash flow is not the same as profit
- Cash is received from customers, but also from bank loans and sale of assets and shares
- Cash flow problems can occur from overtrading or giving too much credit
- Cash is the most liquid asset
- Lack of cash can cause a liquidity problem

- Profit is the surplus after total costs have been subtracted from sales revenue
- Can profitable businesses run out of cash? Yes-and this is a major reason for business failing. It is called insolvency

- How is this possible:
   i. Allowing customers too long a credit period perhaps to encourage sales
   ii. Purchasing too many fixed assets at once
   iii. Expanding too quickly and keeping a high inventory level

Cash flow forecasts

A cash flow forecast is an estimate of future cash inflows and outflows of a business, usually on a month-by-month basis. This then shows the expected cash balance at the end of each month. A cash flow forecast can be used to tell the manager:

i. How much cash is available for utilities, paying loans or purchasing fixed assets
ii. How much the bank needs to lend to the business to avoid insolvency
iii. Whether the business is holding too much cash which could be put to a more profitable use

Uses of cash flow forecasts

- Starting up a business
- Running an existing business
- Keeping the bank manager informed
- Managing cash flow

Calculations of cash flow forecasts

- Opening cash or bank balance is the amount of cash held by the business at the start of the month
- Net cash flow is the difference, each month between inflows and outflows
- Closing cash or bank balance is the amount of cash held by the business at the end of each month. This becomes next month's opening cash balance

$$Net\ Cash\ Flow = Cash\ inflow - Cash\ outflow$$

$$Closing\ Balance = Opening\ Bank\ Bakance + Net\ Cash\ Flow$$

- A positive net cash flow will increase the closing balance
- A negative cash flow will reduce the bank balance
- Each closing bank balance becomes the opening bank balance

How can cash flow problems be overcome?

Method of overcoming cash flow problem	How it works	Limitations
Increasing bank loans	Injects more cash into the business	Interest must be paid, reducing profits. Loans will have to be repaid, leading to cash outflow
Delaying payments to suppliers	Cash outflows will decrease in the short term	Suppliers could refuse to supply or offer low discounts
Asking debtors to pay more quickly- insisting on only cash sales	Cash inflows will increase in the short term	Customers may take their custom to another business which offered trade credit
Delay or cancel purchases of capital equipment	Cash outflows for purchase of equipment will decrease	The long term efficiency of the business could decrease without up-to-date equipment

Long term solutions for improving cash flow

- Attracting new investors by selling more company shares
- Cutting costs and increasing efficiency
- Developing new products that will attract more customers

The importance of working capital

Working capital is the capital available to a business in the short term to pay for day-to-day expenses

$$Working\ capital = current\ assets - current\ liabilities$$

- Working capital us the life-blood of a business
- Having enough working capital assists in raising the credit reputation of the business
- No business can run effectively without a sufficient quantity of working capital
- Have an advantage of being able to buy raw materials at discounted rates, and discount/implement special customer orders

Working capital maybe held in different forms:

- Cash is needed to pay day-to-day costs and buy inventories
- The value of a firm's debtors is related to the volume of production and sales. To achieve higher sales there may be need to offer additional credit facilities

- Having low inventories may suspend production, having to high inventories may result in opportunity costs

- The overall success of a business depends upon its working capital position. So, it should be handled properly because it shows the efficiency and financial strength of a company