3.7 Cash flow

Cash flow forecasts

Cash flow is important for the survival of a business. Thus, careful businesses will make a cash flow forecast so they can manage their operations effectively and avoid cash flow problems. A cash flow forecast is a prediction of the future cash inflows, outflows and net cash flow for a specific time period.

Figure 1. A cash flow forecast allows businesses to manage operations effectively.

Credit: cokada, Getty Images

Constructing a cash flow forecast

Using the Chinon Snack Company (introduced in Section 3.7.1 (/study/app/y12-business-management-a-hl-may-2024/sid-351-cid-174702/book/the-difference-between-cash-flow-and-profit-id-39318)) as an example, a cash flow forecast can now be created. The terms in the definition, and others relevant to the construction of a cash flow forecast, are explained below:

Cash inflow is the amount of cash flowing into or earned by the business from sales, debtors and other activities, such as the sale of unused fixed assets or the rent from extra office space.

Cash outflow is the amount of cash paid out by the business for core operations such as raw materials, creditors and electricity and other activities such as legal fees.

Net cash flow is the difference between the total cash inflows and cash outflows. It could be positive or negative. Typically, businesses aim for a positive net cash flow, which indicates that that the company is not facing problems.

Opening balance refers to the amount of cash the business has in the bank at the beginning of the month. If a business is new, then it will not have an opening balance, so this figure would be zero.

Closing balance refers to the amount of cash that the business has at the end of the month. It is the sum of the opening balance and the net cash flow. This closing balance then becomes the opening balance for the next month. This is calculated using the following formula:

Closing balance = opening balance + net cash flow for the month

Table 1. The Chinon Snack Company cash flow forecast ($). (A negative net cash flow figure is indicated by putting it in brackets.)

	January	**February**	**March**	**April**	**May**	**June**
Opening balance	3000	4000	7000	10 500	9000	7000
Cash inflows						
Cash sales revenue	15 000	20 000	23 000	27 000	27 000	34 000
Debtor payments	4000	3000	3000	4000	6000	5000
Other income	0	2000	0	1000	0	0

	January	February	March	April	May	June
Total cash inflows	19 000	25 000	26 000	32 000	33 000	39 000
Cash outflows						
Peanuts	5000	8000	8000	11 000	12 000	12 000
Packaging	1000	1500	1500	2500	4000	4000
Rent	2000	2000	2000	2000	2000	2000
Wages	6000	6000	6000	8000	8000	8000
Suppliers	2500	3000	3500	7000	6000	6000
Utilities	1500	1500	1500	3000	3000	3000
Total cash outflows	18 000	22 000	22 500	33 500	33 500	33 500
Net cash flow	1000	3000	3500	(1500)	(2000)	4000
Closing balance	4000	7000	10 500	9000	7000	11 000

In the above example, the Chinon Snack Company had a good cash flow position from January to March. April and May, however, were not as favourable because the net cash flows were negative. Nonetheless, the company did not face a cash crisis or liquidity problem because the closing and opening cash balances remained positive.

It must be noted that while cash flow **forecasts** are explained above, accountants, at the end of an accounting period or as required, make a cash flow **statement**. A cash flow statement records the actual cash inflows and cash outflows that took place in the period. This is usually tabled alongside the income statement and balance sheet for a comprehensive evaluation of the business's financial position.

International Mindedness

Most countries require publicly held companies to publish financial statements like the statement of profit or loss (income statement or profit and loss account) and statement of financial performance (balance sheet), as you learned about in Subtopic 3.4 (/study/app/y12-business-management-a-hl-may-2024/sid-351-cid-174702/book/the-big-picture-id-39045). Cash flow statements are another required financial statement. Depending on the country's accounting standards, the presentation of cash flow statements may differ somewhat from the example above.

The importance of a cash flow forecast

The predictions from the cash flow forecast can help the company plan in advance to counter any negative developments over a time period. If the business sees in its cash flow forecast that it may have a negative closing balance at the end of one month, it may want to take out a short-term loan to cover any unexpected expenses.

The business can compare the cash flow forecast and the actual cash flows for the period to help with budgeting and marketing decisions for the future. If, for example, there is a negative variance or difference between the forecast and actual sales figures, then the company can implement new advertising strategies for the following year.

Theory of Knowledge

When reading a company's cash flow and other financial statements, people may be swayed positively or negatively by their own perceptions of the company. For example, if they are convinced of a company's future success, they may not scrutinise that company's performance adequately.

- What role do reason and emotion play when analysing financial performance?

Activity

Learner profile: Knowledgeable
Approaches to learning: Thinking skills (transfer)

Figure 2 shows the cash flow forecast for the for-profit entity Nelson, Nelson and Nelson Ltd for the final three months of the year.

Review the cash flow forecast and fill in the missing figures.

150	116	99	4
80	19	41	11

Check

H5P

Figure 2. Calculate the missing figures and complete the cash flow forecast.