FORECASTING AND MANAGING CASH FLOWS (5.5)

(Chapter 31 - AS level 5.5)

Why is cash important?

If a firm doesn't have any cash to pay its workers, suppliers, landlord and government, the business could go into **liquidation**– selling everything it owns to pay its debts. The business needs to have an adequate amount of cash to be able to pay for all its short-term payments.

The **cash flow** of a business is its *cash inflows* and *cash outflows* over a period of time.

Cash inflows are the sums of money received by the business over a period of time. For example :

- **Sales revenue** from sale of products
- **Payment from debtors**– debtors are customers who have already purchased goods from the business but didn't pay for them at that time
- **Money borrowed** from external sources, like loans
- The money from the **sale of business assets**
- **Investors** putting more money into the business

Cash outflows are the sums of money paid out by the business over a period of time (so costs). For example :

- **Purchasing goods** and **materials** for cash
- **Paying wages**, **salaries** and other expenses in cash
- Purchasing **fixed assets**
- **Repaying loans** (cash is going out of the business)
- By **paying creditors** of the business - creditors are suppliers who supplied items to the business but were not paid at the time of supply

What is the difference between cash and profit?

Profit is the surplus amount after total costs have been deducted from sales revenue. It includes all income and payments incurred in the year. **Cash is the difference between money coming into the business and money going out of the business**. Basically, profit indicates the amount of money left over after all expenses have been paid, cash indicates the money being made and the money being spent by a business.

Additional info :

Products sold on credit are still counted in sales revenue even though no money has been received. Likewise materials bought on credit are still considered costs even though the business technically hasn't spent the money yet

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.

Example of a cash flow forecast for four months :

	AUG($)	SEPT($)	OCT($)	NOV($)	DEC($)
CASH INFLOWS					
Cash Sales	70000	80000	10000	1400	200
Credit Sales	10000	10000	1000	1000	1000
TOTAL CASH INFLOWS	80000	90000	11000	2400	1200
CASH OUTFLOWS					
Wages	20000	20000	20000	20000	20000
Plants and trees purchases	20000	0	0	0	0
Seeds and compost	0	6000	6000	0	0
Heating and water	1000	1000	1000	1000	1000
Bank interest	100	100	100	100	100
Business tax on land	100	100	100	100	100
TOTAL CASH OUTLFOW	41200	27200	27200	21200	21200
OPENING BANK BALANCE	**100**	**38900**	**101700**	**85500**	**66700**
NET CASH FLOW	**38800**	**62800**	**(16200)**	**(18800)**	**(20000)**
CLOSING BANK BALANCE	**38900**	**101700**	**85500**	**66700**	**46700**

The cash inflows are listed first and then the cash outflows. The total inflows and outflows have to be calculated after each section.

The **opening cash/bank balance** is the amount of cash held by the business at the start of the month.

Net Cash Flow = Total Cash Inflows – Total Cash Outflows

The net cash flow is added to the **opening cash balance** to get the **closing cash/bank balance**– the amount of cash held by the business at the end of the month. So :

Closing bank balance = net cash flow + opening bank balance

The **closing cash/bank balance for one month** is the opening cash/bank balance for t**he next month.** (Aug’s closing bank balance of 38,900 is Sept’s opening bank balance.)

The figures in **brackets** denote a **negative balance**, where outflows were greater than inflows (costs were greater than profits.) **Brackets mean we minus instead of adding**.

Uses of cash flow forecasts :

- ❖ **Planning when setting up the business** - the manager needs to know how much cash is required to set up the business. The cash flow forecast helps calculate the cash outflows such as rent, purchase of assets, advertising etc.

- ❖ **Convincing investors** - a statement of cash flow forecast is required by bank managers when the business applies for a loan. The bank manager will need to know how much to lend to the business for its operations, when the loan is needed, for how long it is needed and when it can be repaid.

- ❖ **Managing cash flow** – if the cash flow forecast gives a negative cash flow for a month(s), then the business will need to plan ahead and apply for an overdraft so that the negative balance is avoided (as cash comes in and the inflow exceeds the outflow). If there is too much cash, the business may decide to repay loans (so that interest payment in the future will be low) or pay off creditors/suppliers (to maintain healthy relationships with suppliers).

- ❖ **Helps with decision making** - If negative cash flows appear to be too great, then plans can be made for reducing these – for example, by cutting down on purchase of materials or machinery

Limitations of cash flow forecasts :

- ➢ **Can't always predict the future -** businesses need to make assumptions about the future, but there may be unforeseen developments. For example, a competitors new product might greatly impact the sales and cash inflow of the business

- ➢ **Overestimating sales -** Wrong assumptions can be made in estimating the sales of the business, perhaps based on poor market research. Cash flow forecast only as reliable as the people making it

Potential causes of cash flow problems :

- **Lack of planning -** the business failed to plan enough for certain situations, like a recession or a competitor releasing a new product
- **Poor credit control -** business has a lot of unpaid debts and has done a poor job of keeping track of who owes them money and who they owe money to. **Bad debts** refer to unpaid customers' bills that are now very unlikely to ever be paid. (maybe due to poor management of said bills.)
- **Giving customers too long to pay debts -** businesses will offer trade credit to customers in order to be competitive, but giving customers too long to pay may lead to the business having short-term cash issues

- **Expanding too rapidly** - also know as **overtrading**, when a business starts to expand its operations before having the necessary finance to do so can lead to cash shortages
- **Unexpected events** - cash flow forecasts can't predict the future, so they can't warn you if there's a recession coming or if there's going to be a sudden drop in demand when a new, better product is released

Potential solutions to cash flow problems :

In the **long-term**, to improve cash flow, the business will need to **attract more investors**, c**ut costs by increasing efficiency**, **develop more products** to attract customers and **increase inflows/sales**. However, there are some short-term solutions that can be used :

★ **Increase bank loans** - bank loans will inject more cash into the business, but the firm will have to pay regular interest payments on the loans and it will eventually have to be repaid, causing future cash outflows (short term loans such as overdrafts would be used)

★ **Delay payment to suppliers -** asking for more time to pay suppliers will help decrease cash outflows in the short-run. However, suppliers could refuse to supply on credit and may reduce discounts for late payment

★ **Ask debtors to pay more quickly** - if debtors are asked to pay all the debts they have to the firm quicker, the firm's cash inflows would increase in the short-run. These debtors will include credit customers, who can be asked to make cash sales as opposed to credit sales for purchases (cash will have to be paid on the spot, credit will mean they can pay in the future, thus becoming debtors). However, customers may move to other businesses that still offers them time to pay

★ **Delay or reduce purchases of capital equipment -** this will greatly help reduce cash outflows in the short-run, but at the cost of the efficiency the firm loses out on not buying new technology and still using old equipment.

★ **Debt factoring -** businesses can sell the debts that customers owe them to a third party at a discount so that they can receive cash faster, although less cash than originally planned as it's sold at a reduced price. The third party will then go on to collect the debts of customers and make some profit

★ **Purchase cheaper materials -** will reduce costs, but at the expense of quality?

★ **Sell unused inventory or assets** - however, selling unused inventory may lead to the business being unprepared to match unexpected demand. Can also sell assets like machinery then rent/lease it back. This will get you money quick, but will have to pay the lease money back slowly

★ **Lease rather than buy** - can be cheaper to lease new machinery then outright buying it