WHY CASH FLOW MATTERS

PAGE CONTENTS

2
What is a cash flow forecast?

2
What is the purpose of a cash flow forecast?

3
How to read a cash flow forecast

6
ACTIVITY 1.15.1 Melchester cash flow
What is a cash flow forecast?

A cash flow forecast is a document used to estimate when cash is expected to move in and out of a business. It enables a business to identify its net cash flow position at any given time. A forecast is a look into the future. Businesses, just like individuals, need to keep track of their cash situation.

What is the purpose of a cash flow forecast?

We all need to have some idea of how much money is available to us now, what money is going in when, and what is coming out when. Even someone who is on a very good salary cannot afford to ignore this need to forecast cash inflows and outflows. Think about John’s story to illustrate this. The principles are much the same for a business.

John is single. He earns about £80,000 per year as a sales manager. John loves good quality shoes. He has a big collection of them. Though his friends and family sometimes think that he is a bit mad, the fact is that he can afford them. One day in January, John fell in love with some £200 alligator skin shoes he saw in a shop window. The trouble was, he had a bit of a cash flow crisis. John had spent a great deal of money at Christmas. He had been diving for a week in the Caribbean, and spent a lot on expensive meals. He did not dare spend any more on his credit card and there was only £200 in his bank account to see him through to pay day.

The problem John faces is not a lack of income, but rather a problem of timing. He might decide to delay purchase (a cash outflow) until his monthly pay (a cash inflow) arrives in his bank account.

Just like John, any business, no matter how profitable, should monitor and control cash flow. This is especially crucial for a start-up business. Starting up a business will involve considerable cash outflows. But to begin with at any rate, cash inflows (sales) are likely to be modest. Sales will only build up if customers get to know about the business. This takes time. A cash flow forecast, constructed on a spreadsheet, can help predict cash flow problems and help decide what can be done to minimise or avoid them.
How to read a cash flow forecast

A simple cash flow forecast is shown below. Have a careful look at it before reading further. To help understand what you are looking at, think of the terms “opening balance” and “closing balance” as referring to the bank balance on a bank statement at the beginning and end of a month.

**Melchester Club Ltd.**

Danny and Vikki are an entrepreneurial couple who are planning to open a new bar and live music venue in their home city. They have bought an old warehouse and converted it for the purpose. The cash flow forecast below shows their expected cash inflows and outflows for the first six months, after buying and adapting the building.

<table>
<thead>
<tr>
<th>A CASH FLOW FORECAST FOR THE MELCHESTER CLUB LTD (£)</th>
</tr>
</thead>
<tbody>
<tr>
<td>JUL</td>
</tr>
<tr>
<td>OPENING BALANCE</td>
</tr>
<tr>
<td>CASH INFLOWS</td>
</tr>
<tr>
<td>Ticket sales</td>
</tr>
<tr>
<td>Bar and food</td>
</tr>
<tr>
<td>TOTAL RECEIPTS (A)</td>
</tr>
<tr>
<td>CASH OUTFLOWS</td>
</tr>
<tr>
<td>Bands</td>
</tr>
<tr>
<td>Directors’ salaries</td>
</tr>
<tr>
<td>Wages</td>
</tr>
<tr>
<td>Stock in trade (drink)</td>
</tr>
<tr>
<td>Heat, insurance, telephone etc.</td>
</tr>
<tr>
<td>Marketing</td>
</tr>
<tr>
<td>Bank loan</td>
</tr>
<tr>
<td>TOTAL PAYMENTS (B)</td>
</tr>
<tr>
<td>NET CASH FLOW: (A minus B)</td>
</tr>
<tr>
<td>CLOSING BALANCE</td>
</tr>
</tbody>
</table>
The pair hope to arrange an overdraft to deal with their projected cash flow problems. Vikki is worried about the size of this overdraft. Danny has reassured her that the business should reach break-even level within a year or so, and that the cash position will rapidly improve after that.

As this cash flow forecast shows, the essence of the forecast for each month is that a simple sum is performed:

\[
\text{OPENING BALANCE} \\
\text{PLUS NET CASH FLOW} \ (\text{total sales less total payments or A minus B}) \\
\text{AND OPENING BALANCE FOR THE FOLLOWING MONTH} \\
\text{= CLOSING BALANCE}
\]

What do the row headings on the left hand side of the cash flow forecast show?

**OPENING BALANCE** is the amount of cash available to the business at the start of the month. In this case, the first month shows a zero balance. In other instances you may find an opening balance, perhaps left over from the capital used to set the business up.

**CASH INFLOWS** are the various sources of cash income. In this case we see forecast sales. Any other inflows of cash, such as one-off cash payments raised from the sale of land, will be shown here too.

**TOTAL RECEIPTS** is simply the sum of cash inflows.

**CASH OUTFLOWS** are the various expenses that the business has.

**TOTAL PAYMENTS** is the total of these expenses.

**NET CASH INFLOW** is total receipts minus total payments for a particular month.

**CLOSING BALANCE** is the opening balance plus net cash flow.

You may see a cash flow forecast set out in a slightly different way. For example, the opening balance may be shown just above the closing balance rather than at the top of the forecast. However the cash flow forecast is set out, the way it works is the same. It is crucial that all forecast cash inflows and outflows are shown. They must be shown in the right month. Where a business receives income from credit sales, for instance, the cash will not arrive in the business until some time after a sale has been
made. Where this applies, the sale is not shown on the forecast until the sale is paid for. (Typically, businesses allow one month’s credit). In the same way, purchases of raw materials on credit terms are shown in the month when they are actually paid for, not when the order is placed or the materials arrive.

If the closing balance is negative this will cause the entrepreneur concern. In the example above, this is every month except December. The business will need to plan ahead to consider what effect this may have on the business and what can be done. In the case of the Melchester Club, the business has a predicted cash deficit for quite a long time. If the business has insufficient cash to pay bills, creditors could force the business to close through legal action to recover debts.

Bear in mind that a cash flow forecast does not show the profits of a business. Profit is calculated by deducting annual total costs from annual total sales. The focus with a profit and loss account is a summary of income and expenses over the year. A cash flow forecast, on the other hand, is used for looking at a more detailed, month by month picture - the short term rather than the long term. In a business involved in credit sales and purchases, a cash flow forecast does not show monthly profit.
ACTIVITY 1.15.1 Melchester cash flow

Using the Melchester cash flow forecast above, answer the following quick questions.

1. If the bar and food income was estimated to be £40,000 in December, instead of £50,000, what would the closing balance for December have been? (1)

2. Calculate the opening balance for August, on the basis that July ticket sales were £3000 more than the forecast figures shown here. (1)

3. If bar sales are higher than expected every month, how will this affect cash outflows? (2)

4. Assuming that Danny and Vikki are currently purchasing drinks and food for re-sale on a cash basis every month, explain the advantage of buying this stock on credit instead. (3)