Forecasting Cash Flows

Cash flow

Cash flow describes the movements of cash into and out of a business

When you look at the bank statement of any business, you soon realise that cash flow is a dynamic and often unpredictable part of business life.

In business, cash is always on the move…

- **Cash flows into the bank account** when customers pay for their sales, when a loan is received from the bank, interest is received or when assets are sold
- **Cash flows out of the bank account** when suppliers are paid, employee wages and salaries are paid; interest is paid to the bank and so on

You need to be able to distinguish between:

- **Cash inflows:** movements of cash **into** a business
- **Cash outflows:** movements of cash **out of** the business

The difference between the **cash inflows** and **cash outflows** during a specific period (e.g. a week, month) is known as the **"net cash flow".**

The challenge for any business (particularly a start-up) is to ensure that it manages its net cash flow to ensure that it does not run out of money.

Main types of cash inflow and outflow

The main types of cash flow can be summarised as follows:

Cash Inflows

- Cash sales
- Receipts from trade customers
- Sale of spare assets
- Investment of share capital
- Personal funds invested
- Receipt of bank loan
- Government grants
- Receipts from factoring

Cash Outflows

- Payment of wages & salaries
- Payment of suppliers (e.g. raw materials, stocks)
- Buying equipment
- Interest on bank loan or overdraft
- Payment of dividends
- Repayment of loans
- Payment of leasing or hire purchase rentals
- Income tax, VAT & Corporation tax

Why start-ups suffer cash flow problems

Start-ups and small businesses are especially vulnerable to cash flow problems. Here are some of the main reasons:

Firstly, it takes time before the business makes its first sales – the **pre-trading period** often involves incurring costs without getting any revenue in return.

For example, before it can begin to trade, a new shop has to pay for:

- Shop-fitting and merchandise to fill the shelves (stocks)
- The initial rent of the shop (note – it might be possible to negotiate a rent-free period)
- The wages of shop staff to get the store ready for trading

Suppliers may also demand immediate or early payment from the start-up as the business has not developed a track record for paying bills on time.

A new business usually has to spend up-front on expenses such as marketing and product development. The development phase of coming up with a new product may take some time – research, design, testing and similar activities all consume cash without generating any revenues.

Finally, the new business will not have reserves of cash built up from profitable trading – an important source of cash known as "**retained profits**".

During the early months of trading, therefore, a start-up business faces its most significant challenges in managing cash flow. Without careful management and planning of cash, the business may run out of money. You can probably see why cash flow problems are a major cause of business failure amongst start-ups.

The cash flow forecast

The cash flow forecast **predicts** the net cash flows of the business over a **future period.**

The forecast estimates what the cash inflows into the bank account and outflows out of the bank account will be. The result of the cash flow forecast is an estimate of the bank balance at the end of each period covered (normally this is for each month). An example of a simple cash flow forecast is shown below:

£'000	Jan	Feb	Mar	Apr	May	Jun
Cash at start of month	25	20	15	5	10	20
Cash inflows	20	25	20	15	20	25
Cash outflows	25	30	30	10	10	20
Net cash flow	-5	-5	-10	5	10	5

Cash at end of month	20	15	5	10	20	25

A business uses a cash flow forecast to:

- Identify potential shortfalls in cash balances – for example, if the forecast shows a negative cash balance then the business needs to ensure it has a sufficient bank overdraft facility
- See whether the trading performance of the business (revenues, costs and profits) turns into cash.
- Analyse whether the business is achieving the financial objectives set out in the business plan (which will almost certainly include some kind of cash flow budget)

Why the cash flow forecast is so important

If a business runs out of cash and is not able to obtain new finance, it will become **insolvent**. It is no excuse for management to claim that they didn't see a cash flow crisis coming.

So in business, "cash is king". Cash flow is the life-blood of all businesses – particularly start-ups and small enterprises. As a result, it is essential that management forecast (predict) what is going to happen to cash flow to make sure the business has enough to survive.

Here are the key reasons why a cash flow forecast is so important:

- **Identifies potential shortfalls in cash balances in advance** – think of the cash flow forecast as an "early warning system". This is the most important reason for a cash flow forecast
- **Makes sure that the business can afford to pay suppliers and employees.** Suppliers who don't get paid will soon stop supplying the business; it is even worse if employees are not paid on time
- **Spot problems with customer payments** – preparing the forecast encourages the business to look at how quickly customers are paying their debts. Note – this is not really a problem for businesses (like retailers) that take most of their sales in cash/credit cards at the point of sale
- **As an important discipline of financial planning** – the cash flow forecast is an important management process, similar to preparing business budgets
- **External stakeholders such as banks may require a regular forecast.** Certainly if the business has a bank loan, the bank will want to look at cash flow forecasts at regular intervals

Main causes of a cash flow problems

A **cash flow problem** arises when a business struggles to pay its debts as they become due.

Note that a cash flow problem is not necessarily the same as experiencing a cash outflow. A business often experiences a net cash outflow, for example when making a large payment for raw materials, new equipment or where there is a seasonal drop in demand.

However, when cash flow is consistently negative and the business uses up its cash balances, then the problem becomes serious.

The main causes of cash flow problems are:

Factor	Why It Causes a Cash Flow Problem
Low profits or (worse) losses	There is a direct link between low profits or losses and cash flow problems. Remember - most loss-making businesses eventually run out of cash
Over-investment in capacity	This happens when a business spends too much on production capacity. Factory equipment which is not being used does not generate revenues – so is often a waste of cash
Too much stock	Holding too much stock ties up cash and there is an increased risk that stocks become obsolete (i.e. it can't be sold)
Allowing customers too much credit	Customers who buy on credit are called "trade debtors" Offering credit to customers is a good way to build revenue, but late payment is a common problem and slow-paying customers put a strain on cash flow
Overtrading	This occurs where a business expands too quickly, putting pressure on short-term finance. For example, a retail chain might try to open too many stores too quickly before each starts to generate profits
Seasonal demand	Predictable changes in seasonal demand create cash flow problems – but because they are expected, a business should be able to handle them

Taking action to improve cash flow

The best way to improve cash flow is to have a reliable and up-to-date cash flow forecast. This provides the information which highlights the main cash flow issues.

In terms of actions which management can take, here are the main options:

Cut costs – by far the most important method of improving cash flow. Every business can identify savings in non-essential costs if it looks hard enough. The recent credit crunch and recession has proved that businesses can take drastic actions to cut overheads and other costs, which immediately reduces cash outflows.

Cut stocks: reduce the amount of cash tied up by buying and holding raw materials or goods for resale. This can be done by (a) ordering less stock from suppliers and/or (b) offering discounts on stocks held to encourage customers to buy (ideally for cash).

Delay payments to suppliers – a dangerous game, but widely used in business. By taking longer to pay bills owed, a business can reduce cash outflows (at the risk of damaging relationships with suppliers though).

Reduce the credit period offered to customers – this is easier said than done. By asking customers to pay for their purchases quicker, a business can accelerate cash inflows. However, there is no guarantee that customers will agree. They may need to be given a financial incentive, such as a prompt-payment discount.

Cut back or delay expansion plans – many of the biggest cash outflows occur when a business is expanding (e.g. opening new offices or shops, adding a production line or factory). By delaying this expansion, cash can be conserved in the short-term.