# Forecasting and Managing Cash Flows

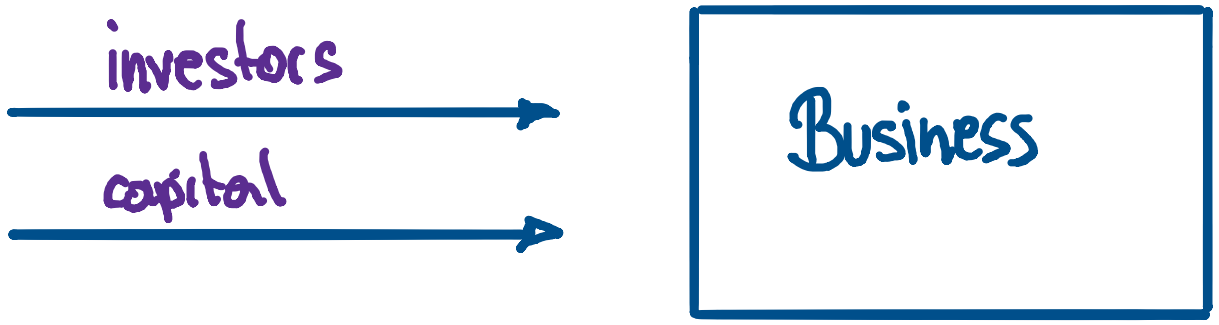
Business – Chapter 31

# Overview

- Importance of cash to business
- ‘Cash flow’ ≠ ‘Profit’
- Evaluate problems of cash-flow forecasting
- Analyse causes of cash-flow problems
- Evaluate methods of solving cash-flow problems

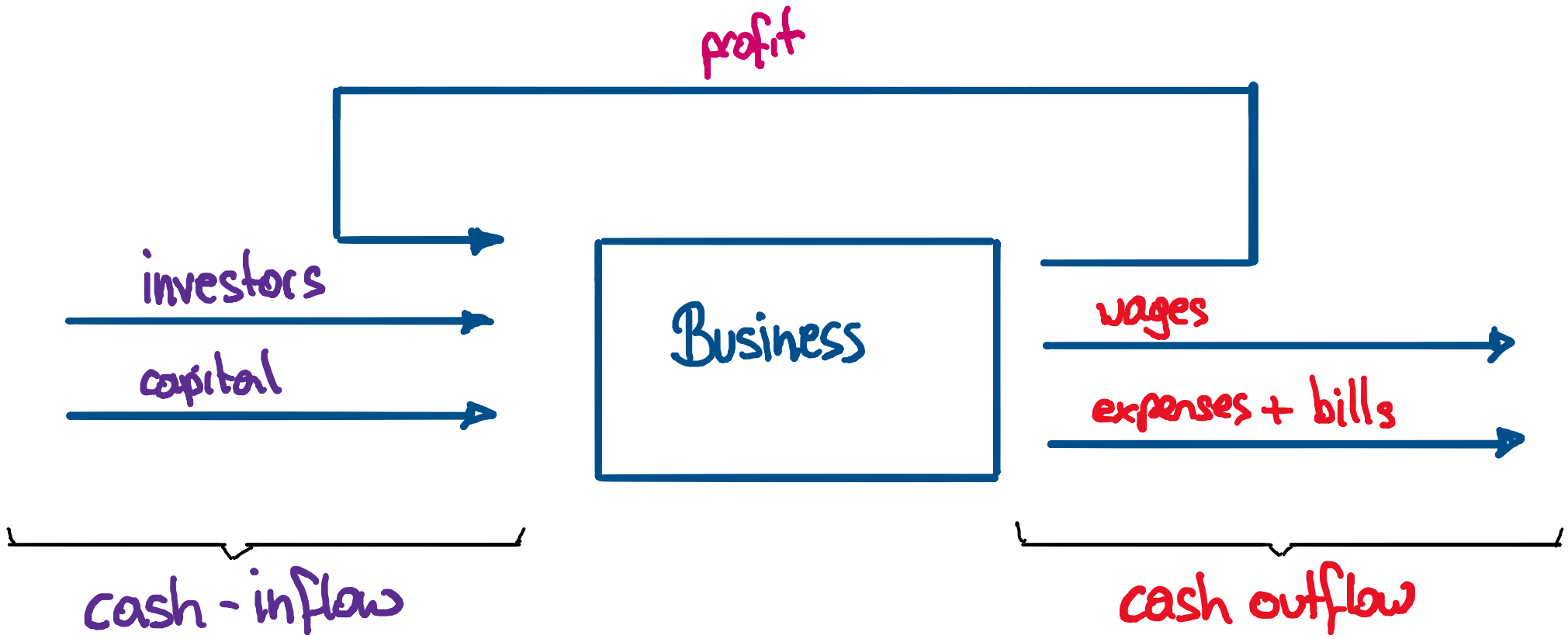
# Introduction

- **Profit**: important in long term (e.g. to attract investments)
- **Cash**: important in short and long term (e.g. pay bills)


investors
capital
Business


investors
capital
Business
wages
expenses + bills


profit
investors
capital
Business
wages
expenses + bills


profit
investors
capital
Business
wages
expenses + bills
cash - inflow
cash outflow

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- Small businesses:
  - Are given shorter credit periods
  - Loss of credibility with banks and other lenders (e.g. short history)
  - Finance is tight in general

# Cash ≠ Profit

- Example 1: *Buy fish from market at sell on a high-street*
  - Cost of fish: $1000
  - Selling price: $2000
  - Profit: $2000 – $1000 = $1000
  - Net cash: cash inflow – cash outflow = $1000
  - Here: cash = profit

# Cash ≠ Profit

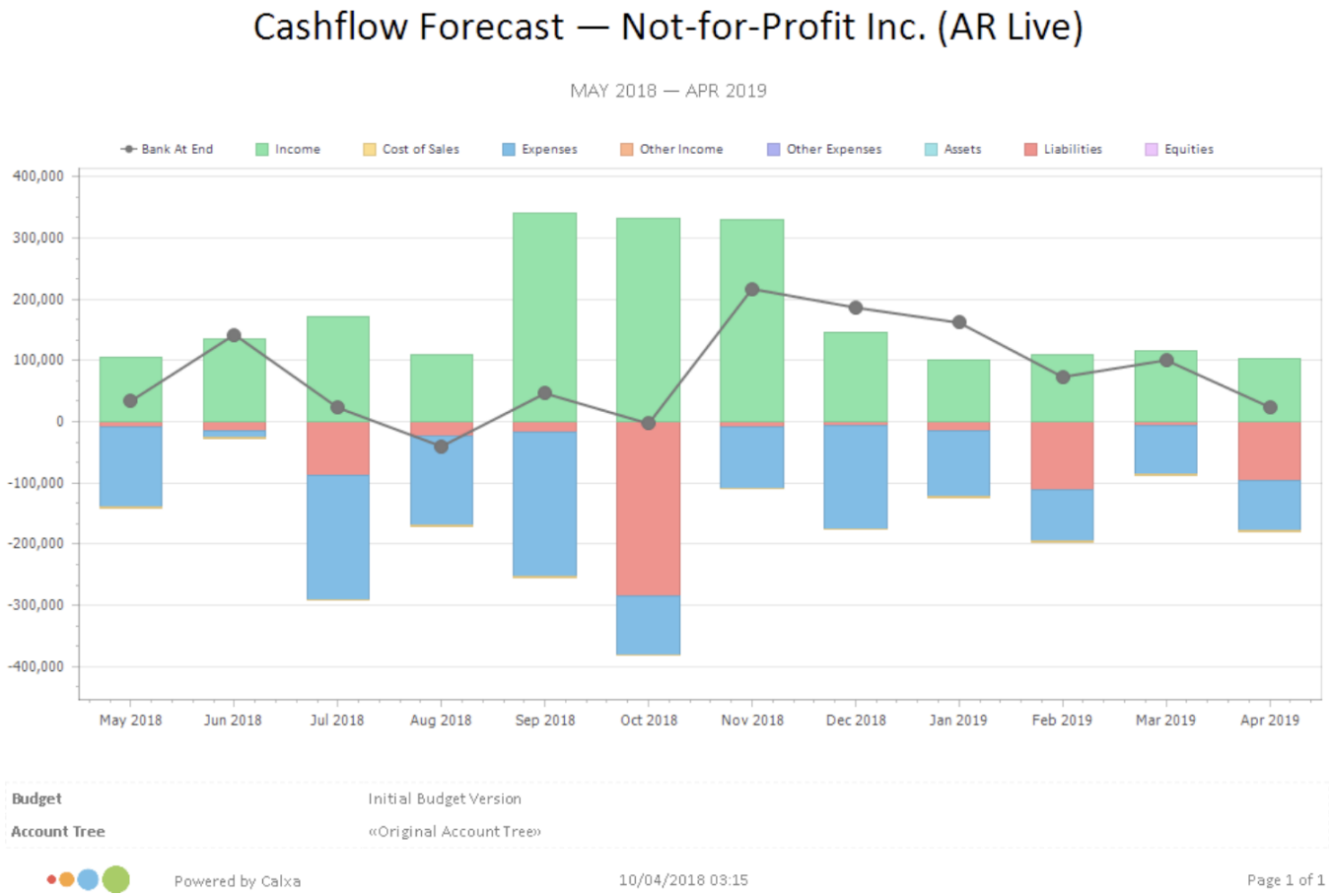
- Example 2: *Buy fresh goods and slowly sell over one month*
  - Cost of fresh goods: $500 (supplier offers 1 month credit)
  - Selling price: $300
  - Profit: $300 – $500 = ($200) → loss of $200
  - Net cash: cash inflow – cash outflow = $300 - $0 (remember the supplier is not paid yet) → positive net cash-flow
  - Here: cash ≠ profit

# Cash ≠ Profit

- Example 3: *Buy jewellery over internet in cash and sell to customers giving them 2 months to pay*
  - Cost of jewellery: $3000 (pays in cash)
  - Selling price: $7000 (payment in 2 months)
  - Profit: $7000 – $3000 = $4000 → profit of $4000
  - Net cash: cash inflow – cash outflow = $0 - $3000 (remember the customer has not paid yet) → negative net cash-flow
  - Here: cash ≠ profit
  - Danger of running out of cash!

# Forecasting cash flow

- Estimating future cash inflows and cash outflows (e.g. monthly)



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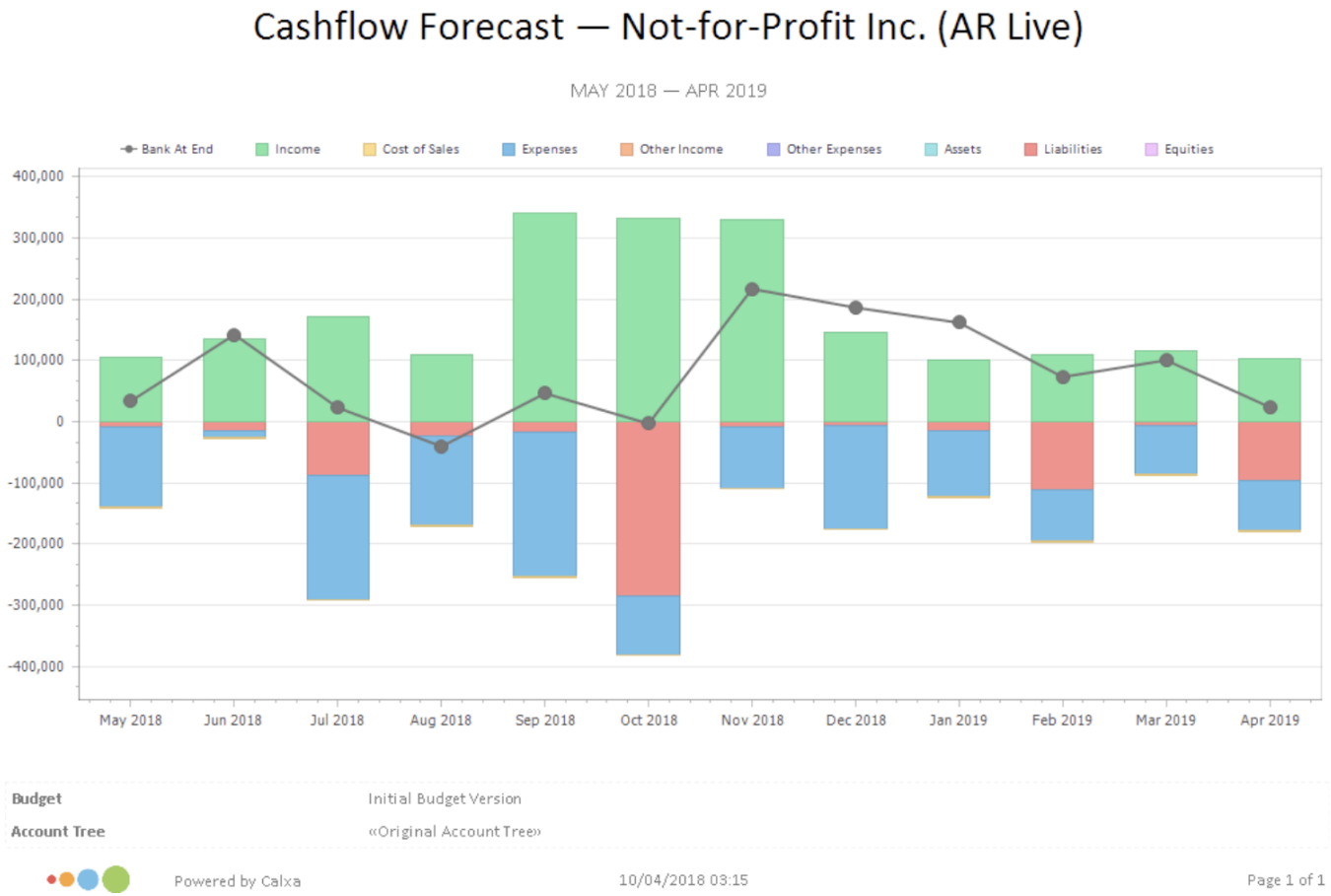


**Cash inflows**

Some components of *cash inflow* are easy to forecast or predict:

- Owner's capital injection
- Bank loan payments (agreed in advance)

Other components are difficult to forecast:

- Sales
- Trade receivables payments (e.g. bad debts)

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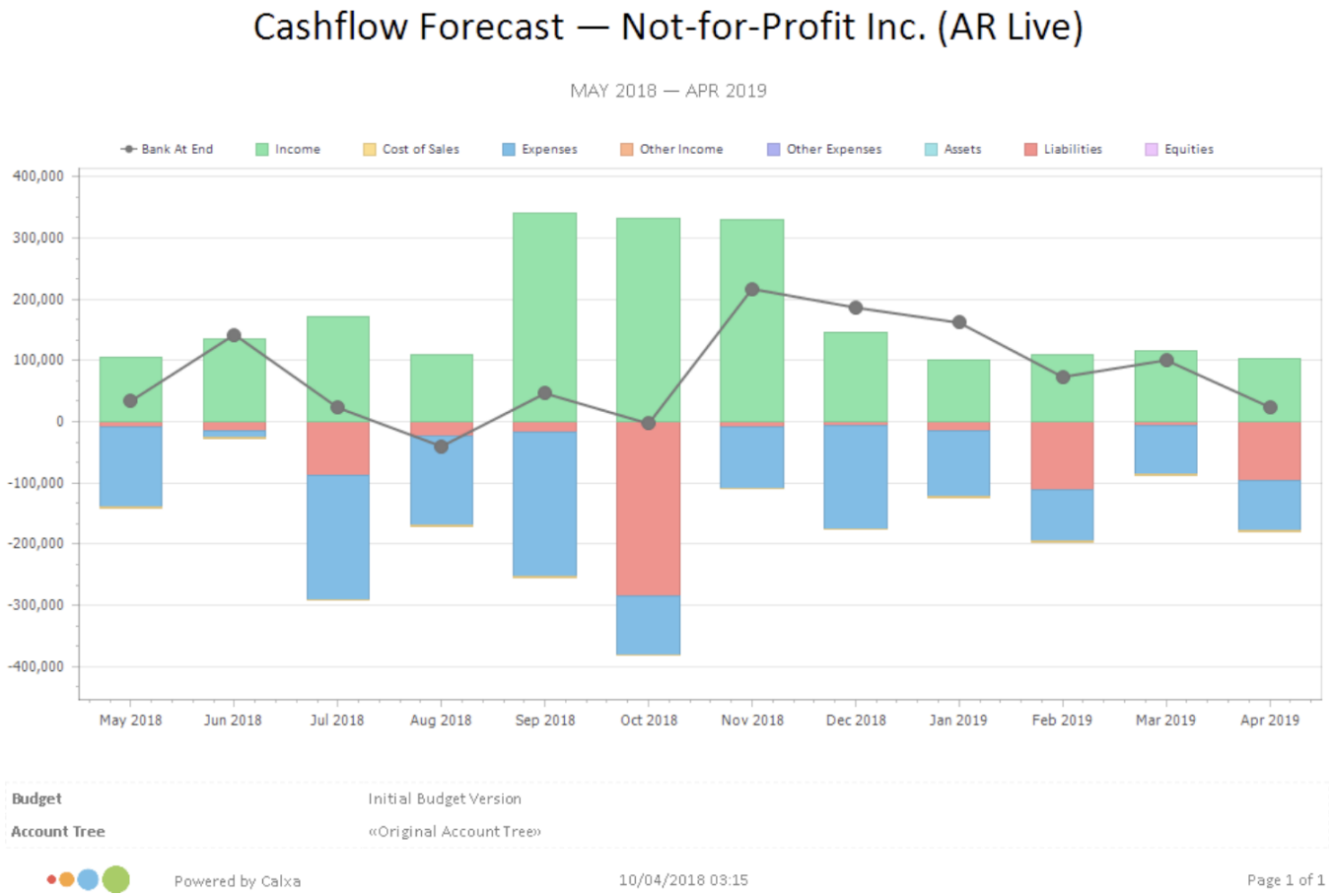


**Cash outflow**

Some components of *cash outflow* are easy to forecast or predict:

- Lease payment
- Annual rent payment (agreed in advance)

Other components are difficult to forecast:

- Electricity, gas, water (depends on production)
- Labour-cost payments
- Variable costs

# Structure of cash-flow forecast

| CASH INFLOWS | All figures in $000 | JAN | FEB | MAR | APR |
|---|---|---|---|---|---|
| | Owner's capital injection | 6 | 0 | 0 | 0 |
| | Cash sales | 3 | 4 | 6 | 6 |
| | Payments by trade receivables | 0 | 2 | 2 | 3 |
| | **Total cash in** | 9 | 6 | 8 | 9 |
| CASH OUTFLOWS | | | | | |
| | Lease | 8 | 0 | 0 | 0 |
| | Rent | 1 | 1 | 1 | 1 |
| | Materials | 0.5 | 1 | 3 | 2 |
| | Labour | 1 | 2 | 3 | 3 |
| | Other costs | 0.5 | 1 | 0.5 | 1.5 |
| | **Total cash out** | 11 | 5 | 7.5 | 7.5 |
| NET CASH FLOW | **Net monthly cash flow** | **(2)** | **1** | **0.5** | **1.5** |
| | **Opening balance** | 0 | (2) | (1) | (0.5) |
| | **Closing balance** | (2) | (1) | (0.5) | 1 |

# Limitations of cash-flow forecasting

- Mistakes can be made in revenue and cost forecasts
- Unexpected costs may occur (e.g. fluctuations in oil prices)
- Wrong assumptions can be made when estimating/forecasting sales

# Causes of cash-flow problems

- Lack of planning
- Poor credit control (e.g. not respecting credit periods)
- Allowing customers trade credits that are too long
- Rapid expansion of business (e.g. overtrading)
- Unexpected events (e.g. breakdown of machines, competitor lowering prices)

# Ways to improve cash flow

1. Increase cash inflows

2. Reduce cash outflows

# Ways to improve cash flow

- Trade receivables
- Creditors or trade payables
- Inventory
- Cash
- Working capital

# Activity 31.3 and 31.6

- Activity 31.3: *Group work*, use bullet-points

- Activity 31.6: Question 3. 12-mark essay. *Individual work*.