FACTFILE:
GCE PROFESSIONAL BUSINESS SERVICES

UNIT AS 3: FINANCIAL DECISION MAKING – CASH FLOW

Rewarding Learning

Learning Outcomes

Students should be able to:

- define the term cash flow;
- Understand the distinction between cash flow and profit;
- Understand the purpose of a cash flow forecast;
- Understand the importance of cash flow forecasting for financial decision making;
- Construct and complete a cash flow forecast for a business, including receipts (cash inflows), payments (cash outflows) and opening and closing bank balances for a business;
- Analyse a cash flow forecast; and
- Analyse the benefits and limitations of cash flow forecasting for a business.

Cash Flow

Definition

Cash flow is defined as the net movement in cash, taking into consideration the cash inflows and cash outflows within the business at a given point in time.

Difference between cash flow and profit

In a business, the cash flow only includes the amounts of cash received (e.g. sales revenues) or paid out (e.g. expenses).

The calculation of profit includes non-cash expenses (which are not therefore included in a cash flow forecast) such as bad debts written off and/or depreciation. Profit is also subject to 'accounting adjustments' which means that the profit/loss for the financial period may not necessarily be the same amount as the closing cash balance as at the end of the financial period.

Importance of Cash Flow Forecasting for Financial Decision Making

- Facilitates decision making – allows managers to make decisions, e.g. expenditure decisions, credit control decisions.
- Enables greater coordination – allows departmental managers to coordinate business activities to ensure sufficient cash is available to fund business activities, e.g. enables financial managers to plan the financing of production equipment to allow production targets to be achieved in the next financial period.
- Improves communication – a cash flow forecast

enables managers to communicate with each other which enables greater awareness of organisational and departmental activities/ goals, e.g. a finance manager can demonstrate the impact of debt finance on operating cash flows compared with the outright purchase of an asset such as vehicles.

- Enables control – mangers can review actual business activities against the forecast. Cash surpluses can be managed effectively to generate additional income; however cash deficits can potentially be avoided, thus reducing bank charges/financing costs and making the business more effective.

© conicBestiary/iStockThinkstockPhotos

Types of cash flows

There are various types of budgets including:

- Cash inflows: monies received by a business e.g. cash sales, trade receivables and other income;
- Cash outflows: monies paid out by a business e.g. purchases of goods for resale, trade payables, expenses and payments for non-current assets.

Construction of a cash flow forecast

Each forecast period usually starts with an opening cash balance. This can be stated or may typically be the balance brought forward from the previous budget period.

All cash inflows are determined for each revenue source (e.g. cash sales, trade receivables, oth-er income) and totalled for each forecast period. Note that trade receivables will often include a 'time lag' which simply means that the amount actually received may differ from the period in which the original sale occurred.

Cash outflows are determined for each item of expenditure (e.g. cash purchases or payments, trade payables, payments for purchase of non-current assets, payments to providers of capital and other expenditures) and totalled for each forecast period. Note that trade payables will often include a 'time lag' which simply means that the amount actually paid may differ from the period in which the original purchase occurred.

Each forecast period usually ends with a closing cash balance. This may be positive (i.e. cash inflows being greater than cash outflows) or negative (i.e. cash inflows being less than cash out-flows). This closing cash balance is usually carried forward (as the opening balance) to the next forecast period.

Purpose of Cash Flow Forecast

A Cash Flow Forecast may be used as follows:

- Facilitates future planning to avoid a cash deficit;
- Can assist in setting product prices;
- Can assist in managing daily cash flows and 'peaks' and 'troughs' in cash flow cycle;
- Can alert managers to additional action to improve sales or revenue collection strategies;
- Cash flow data may be useful to a bank when considering the lending decision of a business and related credit limits;
- Can assist managers in future investment decisions and ensure optimal use of surplus cash flows.

Typical Analysis of a cash flow forecast

On deeper analysis of a cash flow forecast, a professional business services adviser may suggest the following ways of improving the financial position of a business:

- Reduce sales prices as a way of increasing sales quantities which might lead to an increase in sales, which in turn leads to increase sales revenues;
- Avoid large one-off payments when cash flow levels are generally low, e.g. the outright purchase of a non-current asset such as new vehicle, or factory equipment;
- Spread the cost of purchase of a non-current asset using alternative sources of finance, e.g. leasing or hire purchase;
- Negotiate payment terms with suppliers enabling the business to spread the payments over a longer time period;
- Reduce inventory levels and/or encourage early settlement of trade receivables;
- Reduce operating costs, re-negotiate supplier contracts and tenders in order to conserve cash.

Benefits and Limitations of Cash Flow Forecasting

Benefits:

- Cash Flow Forecasts facilitate improved planning and control of business activities;
- Cash Flow Forecasts enable managers to forecast future cash flows more accurately;
- Cash Flow Forecasts allow managers to anticipate 'peaks' and 'troughs' in the cash cycle and take corrective action;
- Cash Flow Forecasts consider the timing of payments and receipts and assists co-ordination of business activities.

Limitations:

- Cash Flow Forecasts are estimates and may not be entirely accurate;
- Cash Flow Forecasts are subject to inaccuracies as the data may change due to a number of external factors beyond the control of business managers, for example: changes in economic conditions, changes in interest rates, seasonal fluctuations and global events;
- Cash Flow Forecasts consider cash payments and receipts only – they ignore substantial non-cash expenses of a business.

Questions

1. Define the term 'cash flow'.

2. Explain the impact of the term 'time lag' on a monthly cash flow forecast.

3. Greeno Limited planned to produce and sell 1,000,000 onions for 10p each, resulting in £100,000 sales revenues in the last financial period. At the year end, the manager reported that 10% of sales revenue was still outstanding. Calculate the total trade receivables outstanding and explain one reason why this may have arisen.

4. Ice-Cool Limited planned to produce 20,000 iced lollipops, using 2,000 litres of milk, costing a total of £200,000. During the trading period, the supplier agreed to allow Ice-Cool Limited to make a payment on account every 3 months. How much was the final payment due at the end of the forecast period?

Case Study

'MyPhone', a local mobile phone shop, had sales of £800 in March and £800 in April. Forecasted sales for May, June and July are £1,000, £800 and £1,000 respectively. The shop has an opening cash balance of £600 as at May 1st. As a business adviser to the owner, you have been asked to (i) draft a cash flow forecast for the months of May, June and July; and (ii) analyse the forecasted cash position. The following information is known:

(i) 100 per cent of the firm's sales are for cash.
(ii) The firm receives other income of £11 per month.
(iii) The firm's purchases, all for credit, are £600, £700 and £100 for the months of April, May and July respectively, being paid for in the month after the month of purchase.
(iv) Rents are £33.55 per month.
(v) Wages and salaries are 20 per cent of the previous month's sales.
(vi) Advertising costs amounting to £12.45 will be paid in May.
(vii) Repayment of loan totalling £900 is to be paid in May.
(viii) A cash purchase of equipment costing £666 is planned for July.
(ix) A government grant for development of the premises of £115 is due in July.

Case Study - Suggested Solution

MyPhone Mobile Phone Shop
Cash Flow Forcast.

	May £	**June £**	**July £**
Cash flows in:			
cash sales	1000.00	800.00	1000.00
other income	11.00	11.00	11.00
government grant			115.00
total cash flow in	1011.00	811.00	1126.00
Cash flows out:			
trade payables	600.00	700.00	
rent	33.55	33.55	33.55
wages	160.00	200.00	160.00
advertising	12.45		
loan repayment	900.00		
equipment			666.00
other expenses			
total cash flow out	1706.00	933.55	859.55
opening balance	600.00	-95.00	-217.55
add cash flows in	1011.00	811.00	1126.00
	1611.00	716.00	908.45
less cash flows out	1706.00	933.55	859.55
closing balance	-95.00	-217.55	48.90

Analysis:
- Avoid cash deficits by postponing (i) loan repayment; trade payables
- Increase cash sales in June by £

Useful Sources For Further Study:

www.investni.com/news/index.html

www.tutor2u.net

Marcousie, I., et al., (2014), Business Studies for A Level, 3rd Ed., (pp. 91-97; 123-127), Hodder Education, London, UK.

McAree, D., (2009), 3 Best Things To Do At A-Level Business Studies.

McAree, D., (2010), 4 Minutes To Pass A-Level Business Studies.