Forecasting Cash Flow

Business Information Factsheet

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Introduction

A cash flow statement is one of the three key financial statements, along with the profit and loss account and the balance sheet. The cash flow statement summarises receipts to and payments from the business and it links the other two statements.

Annual accounts always include a cash flow statement, although historic cash flow statements are much less useful than the other two statements in providing information essential for effective financial control.

A cash flow forecast, however, is one of the most important management accounting tools, providing an estimate of the business's cash requirements for the next trading period. In particular, a cash flow forecast enables you to anticipate potential liquidity problems and then make arrangements to reduce spending, to speed up payment by those who owe you money, to borrow more working capital or to inject more of your own money.

For businesses seeking investment, the cash flow forecast is an important part of the business plan, highlighting how much investment is needed and pinpointing when it is needed.

This factsheet explains the importance of forecasting cash flow and describes the structure and content of a cash flow forecast. It explains how to prepare a forecast and how to use it to monitor cash flow.

The cash flow forecast

A cash flow forecast is not a budget, although the two are closely related. A budget is a target – it is what you hope will happen, in terms of both sales and expenses, during a specified period – but a forecast is what you predict will actually happen.

A cash flow forecast shows how and when a business expects to receive and make cash payments over a given period of time. 'Cash' includes direct debit and electronic transfers to and from the business's bank (and any other) accounts. Cash flow forecasts are usually projected over a period of six or twelve months, although can cover just a few weeks or several years, and can utilise days, weeks, months or years, depending on the level of detail required.

Non-cash items, such as depreciation, are not included in the cash flow forecast, but capital expenditure, which is not shown in the profit and loss account, should be included. It is important to understand that 'receipts' and 'payments' are not the same as 'income' and 'expenditure'. When you invoice a sale, it can be recorded immediately in the profit and loss account. But until the cash is received, there is a corresponding entry of 'debtor' on the balance sheet. The cash flow forecast shows when you expect to actually receive the cash.

Similarly, if you buy raw materials on credit, you will charge materials to the profit and loss account immediately, with a corresponding 'creditor' entry on the balance sheet. The cash flow forecast shows you when you expect to pay out the cash for those materials.

A cash flow forecast has three main sections:

- **Receipts** – all the money flowing into the business – from sales, loans and any other source.
- **Payments** – all the money flowing out of the business – from paying suppliers, paying overheads, repaying loans and any other requirement.
- **Net cash flow/closing balance** – the total amount of cash in the business at a particular point in time.

Receipts	**January**	**February**	**March**	**April**	**May**	**June**
Cash sales	£2,000	£12,000	£18,000	£22,000	£26,000	£28,000
Other income	£10,000	£0	£0	£0	£0	£0
Total receipts	**£12,000**	**£12,000**	**£18,000**	**£22,000**	**£26,000**	**£28,000**
Payments						
Credit purchases	£7,000	£9,000	£12,000	£14,000	£16,000	£17,000
Wages	£3,000	£3,000	£5,000	£5,000	£5,000	£5,000
Office expenses	£2,000	£1,000	£1,000	£1,500	£1,000	£1,000
Finance and tax payments	£0	£500	£500	£650	£650	£650
Capital expenditure	£3,000	£0	£0	£0	£0	£0
Total payments	**£15,000**	**£13,500**	**£18,500**	**£21,150**	**£22,650**	**£23,650**
Net cash flow	(£3,000)	(£1,500)	(£500)	£850	£3,350	£4,350
Opening cash balance	£0	(£3,000)	(£4,500)	(£5,000)	(£4,150)	(£800)
Closing cash balance	(£3,000)	(£4,500)	(£5,000)	(£4,150)	(£800)	£3,550

Table 1

(Figures in brackets denote a negative balance.)

Receipts

This section shows the sales income received by the business. Receipts are always recorded in the month the business expects to receive the money. When a business makes a sale, it issues a sales invoice. The amount (net of VAT, if you are registered for VAT) is recorded in the profit and loss account. When the money (including the VAT) is actually received, it is recorded as a receipt. The cash flow forecast aims, therefore, to show the expected timing of when cash from sales will be received.

Any money that is expected to come from non-trading sources can be recorded under 'Other receipts'. This can include bank loans, shareholder investments and grants.

Payments

This section includes all the cash payments made by a business. The cash flow forecast should record when the business expects to make payments.

When a business incurs an expense, it usually records that expense (net of VAT, if registered for VAT) in the profit and loss account. Occasionally, the expense may relate to something a long way in the future, in which case the recording in the profit and loss account may be delayed. The cash flow forecast, however, records the cash (including the VAT) leaving the business. As with receipts, the cash flow forecast aims to show the expected timing of payments being made by the business.

Table 1 shows payments split into five categories, but you should use whatever categories you find most convenient. You might want any, or all, of:

- Employee wages.
- Premises costs.
- Insurance.
- Marketing.
- Packaging.
- Transport.
- Administration and office costs.
- Repairs and renewals.
- Professional fees.
- Bank charges.
- Loan repayments.
- Capital expenditure.

Two categories require more explanation: raw materials and stock. These are only shown in the profit and loss account when the goods into which they have gone are sold. However, the payment needs to be shown on the cash flow forecast when it actually occurs (and unsold goods will be shown on the balance sheet).

If the business is registered for VAT, you should show input VAT (with receipts), output VAT (with payments) and the balance being paid (quarterly or annually) to HMRC. If the business is operated as a limited company and pays corporation tax on chargeable profits, this should also be included.

Net cash flow/closing cash balance

The net cash flow shows the total cash receipts minus total cash payments for each month. Net cash flow is added to the opening balance to give the closing cash balance at the end of each month.

The closing cash balance is the amount of cash a business has available at that point in time and should correspond with the bank statement.

In the example in Table 1, the business receives £2,000 of sales income in January, as well as a £10,000 cash injection, but pays out £15,000 in costs, resulting in a negative (or overdrawn) cash balance of £3,000 at the end of January. As the business trades, it continues to have a negative cash flow over the next two months and shows a maximum cash deficit of £5,000 at the end of March. It is only in April that cash receipts start to exceed payments and the business starts to generate a positive cash flow. It takes until June for there to be a positive cash balance.

For this business to be able to trade, it would need an additional £5,000 of cash invested when it starts trading, or the owner would have to make arrangements with their bank for an agreed overdraft facility of at least £5,000.

Factors to consider when preparing the forecast

There are several factors that need to be considered when preparing a cash flow forecast:

Sales forecast

To forecast cash receipts accurately, weekly or monthly sales income needs to be forecast. For a start-up business, this will be based on market research and will be included in the business plan. If a business has been trading for some time, it will have historical sales data on which to base its sales forecast, as well as a clearer picture of how its market is performing.

Credit terms

Many small businesses offer some form of trade credit to their customers, with trade accounts normally operating on a 30- to 60-day credit period. The length of time it takes customers to pay has a significant effect on a business's cash flow. A business can also benefit from obtaining credit terms from its suppliers.

Cash is not the same as profit

Profit is an accounting concept, but for the practicalities of running a business on a daily basis, having sufficient cash to pay for purchases and expenses is always the single most important issue.

A business may generate profit from the items it sells or the service it delivers, but it can only operate if it has sufficient cash in the bank to pay its bills. Thus, 'working capital' is required by the business and equates to the cash needed to fund its day-to-day operations.

If a business does not have the cash available to fund its day-to-day operations, it may need to seek additional finance, such as a bank loan or overdraft, or alternative methods of funding the business.

Cash cycle

The 'cash cycle' is a term used to describe the connection between working capital and cash movements in and out of a business and is usually measured in days or months.

Small firms typically buy goods and services before they are in a position to make a sale to their customers, particularly firms in manufacturing and retail. If a business can shorten its cash cycle, it can reduce the amount of money needed to fund its working capital.

Reviewing the forecast

It is important to review a cash flow forecast on a regular basis, and at least monthly, although businesses that are struggling are known to review as frequently as daily.

At the end of each month, you should compare the actual cash flow with the forecast figures. If there are significant differences (known as 'variances'), then you may need to take remedial action to avoid a cash crunch or becoming insolvent (because you are unable to pay your debts as they fall due).

You should also periodically consider whether the cash flow forecast needs to be updated, for example to reflect changes in assumptions, such as about how quickly customers will pay, or how soon suppliers need to be paid. The cash flow forecast can help you to identify:

- How much cash investment is required, for example, to start in business or at a critical investment point.
- When a business may need additional finance, such as an overdraft or loan.
- The level of loan repayments and interest that can be afforded by the business.
- When a business will be able to spend cash in the future, for example, to cover the costs of an additional employee or paying for a marketing campaign or buying capital equipment.
- When cash flow problems may occur once a business is trading and as it grows.

Related factsheets

BIF051 Controlling Costs
BIF054 Costing and Pricing a Product
BIF236 Sales Forecasting
BIF422 Credit Control

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