

# Cash flow management and forecasting | case study



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## 1. Cash flow management

Cash flow management is the process of monitoring, analyzing and adjusting business' cash flows <sup>[1]</sup>. "Cash is king" is the often heard business cliché, yet it is borne out of reality. It is monitoring of actual cash flows against the cash flow projections for the period, analyzing the reasons for variation and then implementing the necessary actions to manage business financials. Cash flow management is based on cash flow projections which is different than profit and loss account and, in times of cash shortage, may be more important (Oxford, 1997).

### Importance of preparing a cash flow forecast

A cash flow forecast shows the projects in flows and out flows of cash in a business. It is an important tool in cash flow management as it helps to identify the gaps in cash over the projected period. Let's look at the importance of cash flow forecast for different stakeholders

- Owner / investor. Cash flow forecast shows the maximum shortfall in cash during the projected period and gives idea about maximum capital funding is required.
- Banks / lenders. It helps in analysing the credit worthiness of the business and matches it with lenders' appetite for risk. It also shows whether business will generate sufficient cash over time to meet repayments.
- Creditors. If business is not in a strong position, creditors like to see cash flow forecast to analyse whether to give stock on credit and under what terms.

## 2. Cash flow forecast

Annexure I shows the cash flow forecast for the year ending 31 Dec 2004. It shows minimum cash balance of £0 in February 2004 and is based on the following assumptions:

1. Sprint X is a high street sport shop with no sales on debtor accounts.  
All sales immediately result in cash in flows.
2. The profits generated are small and hence company pays no tax.

The projected bank balance on 31<sup>st</sup> Dec 2004 is £26, 500. This is because Sprint X has yet to make the stock payments of £12, 500 for December 04 as these are due in January 2004 only.

Though the minimum balance is £0 in February 2004, in reality it might be even lower. The intra-month cash position could be even worse because of the following:

1. The above cash flow forecast of £0 in February 2004 is based on month end. Monthly rent of £2, 500 for March is due on 1<sup>st</sup> March 2004. So the cash balance on 1<sup>st</sup> March 2004 could be as low as -£2, 500.
  2. Payment terms and dates of utility providers and suppliers.
  3. Payment dates of bank charges.
- ### 3. Advantages of using a spreadsheet for cash flow forecasting

Spreadsheet software for personal computers is a powerful tool for cash flow forecasting. Its major advantages are:

1. Arithmetic errors are virtually nonexistent (Horngren, Sundem & Stratton, 1998)

2. It is easier to operate and understand than using professional financial packages. Small business owners don't need to understand financial jargon for building and updating cash flow forecasts.
3. It reduces the tedium of carrying out repetitive calculations. If actual cash flows in a month are different from the projections, it would change the following month end cash flows. Spreadsheet model makes it much easier to update cash flow forecasts.
4. Sensitivity analysis. Spreadsheet cash flow model also makes it more convenient in analysing the impact of variation in different sales and cost elements on the cash flows.

#### 4. Bankruptcy due to cash flow problems

Sprint X could go bankrupt if runs out of cash to make payments to its creditors. Creditors can then take force Sprint X into liquidation.

Sprint X has to order supplies before it can sell them and once it orders and receives deliveries, it is liable to pay whether or not it is successful in selling them. Based on the cash flow projections in Appendix I, John and Mary expanded the business with £2, 500 additional capital for rent payment on 1<sup>st</sup> March 2004.

Suppose sales in both February and March 2004 are £5, 000 less than the budgeted amount. The cost of goods is 60% of sales on average (based on ratio of annual cost of goods to annual sales). Though the cash receipts are lower in February and March, the benefit of lower cash outflows would be seen in March and April only due to one month lag in credit payments.

Appendix II shows the revised cash flow forecast. Sprint X has a negative cash of £5, 000 at the end of February 2004. Even after adding an initial capital inflow of £2, 500, the company is no cash to meet full supplier payments for February and rent on 1<sup>st</sup> March 2004. Under such scenario, both suppliers and landlord can take the company to liquidators.

Even though the company may end year with more cash than initial capital inflow, yet its inability to tide through emergencies may force it into liquidation.

#### 5. Strategies for effectively controlling cash flow problems

1. Regular entry of receipts and payments will keep the cash flow updated and will give owners sufficient time to take care of shortfalls, if any.
2. Analysis of trends will help in taking timely decisions of cost cutting to reduce cash outflows or to plan for higher sales.
3. Owners shouldn't take out cash from the business based on single month's net cash flows. The picture may be distorted due to one month delay in higher stock payments. They should look at the year end figures and maximum cash requirements before taking out any earnings.
4. The company should establish a line of credit with a bank which will not only take care of maximum cash requirements but also leave some headroom for any emergencies.
5. Owners should keep business account separate from personal accounts to get clear cash position of the business.

6. Reconcile monthly bank statements for both deposits made and cheques drawn.
6. Use of financial recording system to manage Sprint X's business finances

Sprint X should fortnightly look at the sales trends and plan future expenditure accordingly. Regularly updation of cash flow forecast based on the latest trends will help in planning for any shortfall in funding gap.

It should also use financial recording system to keep a tab on inventory to prevent excess inventory build-up. This will prevent unnecessary goods write-off and losses. Trends in fashion change very fast and a good company should keep an eye on what is selling and what is just occupying shelf space and requiring unnecessary working capital.

#### **Appendix I – Sprint X's cash flow forecast**

	Jan-04	Feb-04	Mar-04	Apr-04	May-04	Jun-04	Jul-04	Aug-04	Sep-04	Oct-04	Nov-04	Dec-04
<b>Receipts</b>												
Invoiced sales	15,000	20,500	35,000	35,000	35,000	20,000	20,000	20,000	20,000	20,000	20,000	20,000

Payments

Stock		(3,000)	(17,500)	(17,500)	(17,500)	(12,500)	(12,500)	(12,500)	(12,500)	(12,500)	(12,500)	(12,500)
Telephone		(1,000)			(1,000)			(1,000)			(1,000)	
Electricity			(1,500)			(500)	(500)	(500)	(500)	(500)	(500)	(500)
Rent		(2,500)	(2,500)	(2,500)	(2,500)	(2,500)	(2,500)	(2,500)	(2,500)	(2,500)	(2,500)	(2,500)
Wages		(2,000)	(2,000)	(2,000)	(2,500)	(2,000)	(2,000)	(2,000)	(2,000)	(2,000)	(2,000)	(2,000)
Bank loan		(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)	(3,000)
		(10,500)	(26,000)	(26,500)	(25,000)	(21,000)	(20,500)	(21,000)	(20,500)	(20,500)	(21,000)	(21,000)
Net cash flow	4,500	(5,500)	8,500	9,500	14,000	(500)	(1,500)	(500)	(500)	(1,500)	(500)	(1,500)
Opening bank	1,000	5,000	13,500	23,000	37,000	36,500	35,000	34,500	33,000	31,500	30,000	28,500

balance	500	500	000	000	500	000	500	000	500	000	500	000	
Closing													
bank	5,500	0	8,	18,	32,	31,	31,	29,	29,	28,	27,	26,	14
balance			500	000	000	500	000	500	000	500	000	500	000

Appendix II - Sprint X's cash flow forecast with reduced Feb and Mar sales

	Jan-04	Feb-04	Mar-04	Apr-04	May-04	Jun-04	Jul-04	Aug-04	Sep-04	Oct-04	Nov-04	Dec-04
<b>Receipts</b>												
Invoiced sales	15,000	15,500	30,000	35,000	35,000	20,000	20,000	20,000	20,000	20,000	20,000	20,000
<b>Payments</b>												
Stock	(3,000)	(17,500)	(14,500)	(14,500)	(12,500)	(12,500)	(12,500)	(12,500)	(12,500)	(12,500)	(12,500)	(12,500)
Telephone		(1,000)			(1,000)			(1,000)			(1,000)	
Electricity			(1,000)			(500)	(500)	(500)	(500)	(500)	(500)	(500)



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Rent		(2, 500)	(2, 500)	(2, 500)	(2, 500)	(2, 500)	(2, 500)	(2, 500)	(2, 500)	(2, 500)	(2, 500)	(2, 500)
Wages		(2, 000)	(2, 000)	(2, 000)	(2, 500)	(2, 000)	(2, 000)	(2, 000)	(2, 000)	(2, 000)	(2, 000)	(2, 000)
Bank loan		(3, 000)	(3, 000)	(3, 000)	(3, 000)	(3, 000)	(3, 000)	(3, 000)	(3, 000)	(3, 000)	(3, 000)	(3, 000)
		(10, 500)	(26, 000)	(23, 500)	(22, 500)	(21, 000)	(20, 500)	(20, 500)	(21, 500)	(20, 500)	(20, 500)	(21, 500)
Net cash flow	4, 500	(10, 500)	6, 500	12, 500	14, 000	(500)	(1, 500)	(500)	(500)	(1, 500)	(500)	(1, 500)
Opening bank balance	1, 000	5, 500	(5, 000)	1, 500	14, 000	28, 000	27, 500	27, 000	25, 500	25, 000	24, 500	23, 000
Closing bank balance	5, 500	(5, 000)	1, 500	14, 000	28, 000	27, 500	27, 000	25, 500	25, 000	24, 500	23, 000	22, 500

## **Bibliography**

Horngren, C. T., Sundem, G. L. & Stratton, W. O.; “ Introduction to management accounting”, Eleventh Edition, Prentice Hall International, Inc., 1998

Oxford (1997); “ Dictionary of Finance and Banking”, Oxford University Press, Second Edition, 1997.

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[1] <http://sbinfocanada.about.com/cs/management/g/cashflowmgt.htm>