Chapter 8: Cash flow planning

What is meant by cash flow?

Cash is a **liquid asset**, meaning that i can be spent on goods and services any time. Many business experience **cash flow problems**, meaning that they do not have enough cash to do what they want to do. **Cash flow** means "the flow of money**in** and **out** of a business". These are ways cash flow can occur:

Cash inflows:

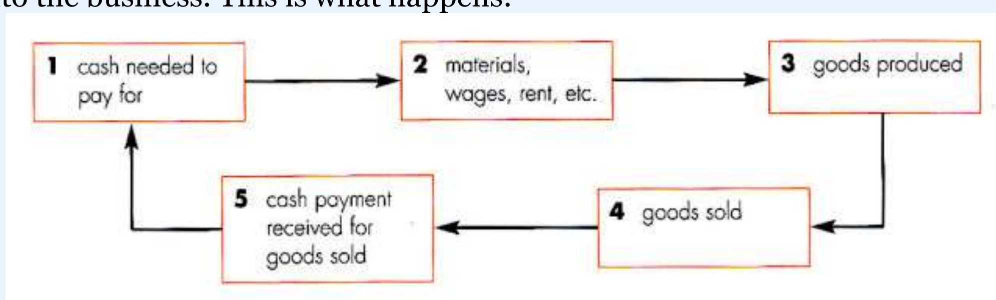
- **Sale** of **goods** for cash.
- **Payment** from debtors.
- **Borrowing** from a source (but will inevitably lead to cash outflow in the future).
- **Sale** of unwanted **assets**.
- **Investment** from investors: shareholders and owners

Cash outflows:

- **Purchasing goods** for cash.
- **Payment** of wages, salaries and others in cash.
- **Purchasing** fixed **assets**.
- **Repaying loans**.
- **Repaying creditors**.

Cash flow cycle

A **cash flow cycle** explains the stages that are involved in the process of cash out and finally into the business. This is what happens:



The longer it takes for cash to get back to the business, the more they will need**working capital** to pay off their short-term debts. This cycle also helps us understand the importance of **cash flow planning**. This is what happens when a company is short on cash:

- Not enough to pay for materials, therefore sales will fall.
- The company will want to insist customers on paying in cash, but they might lose them to competitors who let them pay in credit.
- There could be a **liquidity crisis** when it does not have enough cash to pay for **overheads** (bills, rent, etc.) and the business might be forced to close down by its creditors.

Managers need to plan their cash flow so that they do not end up in these positions.

Cash flow is not profit!

First we need to examine the formula for cash flow:

Cash flow = Cash inflow - Cash outflow

However, when calculating profit, we also take into account **credit** that debtors owe us. Therefore, a company might make $20,000 in profit but only $10,000 is received in cash because half of it is payed by credit card.

This creates something known as **insolvency**:

- Profitable business could run out of cash because of various reasons. This is called **insolvency** and it is one main reason why businesses fail.
- This can be because of several reasons:
  - Allowing customers **too long** to **pay** back, so that they will not have paid off the debts yet by the time the business has**run out** of **cash**.
  - Purchasing **too many assets** at once.
  - Producing or purchasing too much **stock/inventory** when**expanding** too quickly. This is called **overtrading**.

Here is an example of a **cash flow statement**:

	January	February	March
Opening bank balance (A)	10,000	15,000	(5,000)
Cash inflows (B)	35,000	45,000	50,000
Cash outflows (C)	30,000	65,000	40,000
Net cash flow (D) (= B − C)	5,000	(20,000)	10,000
Closing bank balance (= A + D)	15,000	(5,000)	5,000

As you can see, the closing bank balance in February is negative, which means that it has become **overdrawn**.

Cash flow forecasts

Because of the aforementioned problems, it is important for the manager to get an idea of how much cash will be available for which months. A **cash flow forecast**can tell the manager:

- How much cash is available for paying bills, loans and other fixed assets.
- How much the bank might need to lend to avoid insolvency.
- Whether the business has too much cash which could be more useful if used.

Uses of cash flow forecasts:

- **Starting up a business**: In the first months of a business, a lot of capital will be needed to set it up properly. The problem is, not everybody realises that the amount of money they needed is much more than they had expected. Therefore, a cash flow forecast will give them a better idea of how much money will be needed.

- **Keeping the bank manager informed**: It needs to be shown to the bank to inform it of the size of the needed loan/overdraft, when it is needed, how long it is needed and when it could be repaid. Only then will the bank give you a chance to get a loan.
- **Running an existing business**: It is important to know the cash flow of a business so that loans could be arranged in advance in order to get the least **interest** possible. If a firm has cash flow problems and goes to the bank for a loan for the next day, it will charge high interests because it knows that the business has no choice. Also, if a business exceeds the**overdraft limit** without informing the bank, it could be asked to repay the overdraft immediately and could result in closure of the business.
- **Managing cash flow**: If a business has **too much cash**, it should put the cash to some good **use** quickly. Some examples of this is: repaying all loans for **less interest**, paying creditors immediately to get**discounts**.

How can cash flow problems be solved?

Here are some steps to solve cash flow problems:

- Arrange for future loans with the bank when you anticipate **negative cash flow**.
- **Reduce** or **delay** planned expenses until cash is available, e.g. ask to pay in credit.
- **Increasing** forecasted cash **inflow**, e.g. by getting a part-time job.