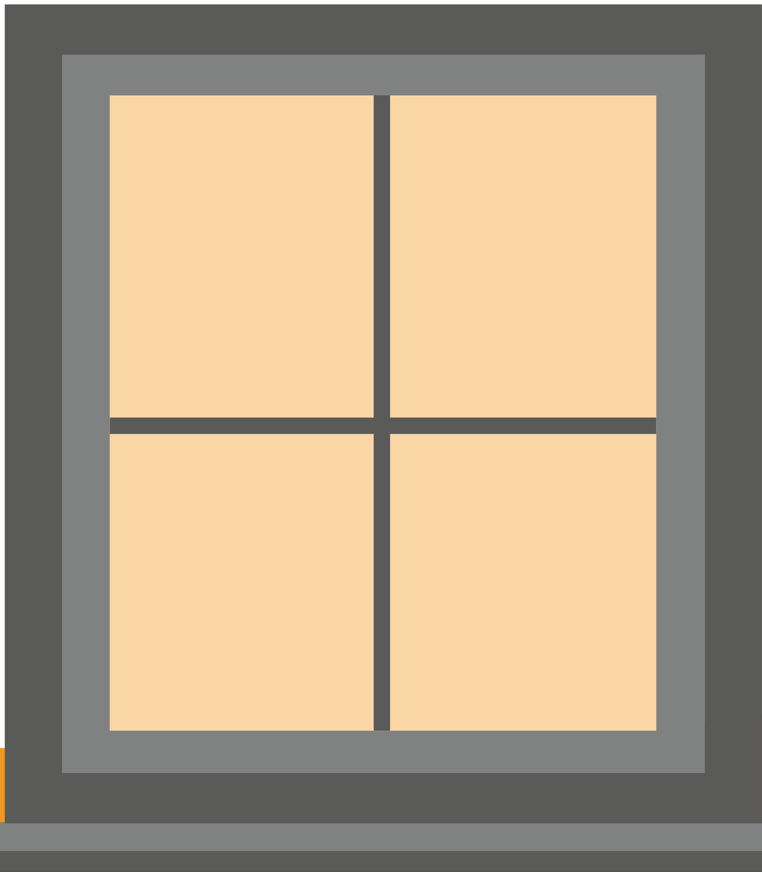

Chapter 8

Cash Flow Statements and Forecasts

How can I use a cash flow statement to assess the liquidity of my organisation?

Businesses must produce an audited cash flow statement at the end of each financial year to show how much cash the business has. This sets out all the cash that came into the business, and all the cash that flowed out, over the course of the year.

A cash flow statement shows how much cash the business has at a particular point in time

It also shows all of the cash that flowed into and out of the business during the year

Allows liquidity to be assessed

How does my organisation use a cash flow forecast to avoid potential liquidity problems?

Overall, a cash flow statement will allow investors, creditors, suppliers and employees to assess the organisation's liquidity and know whether it can pay its bills or not.

Cash is not the same as profit, because although sales increase profit straight away, they do not improve the business' cash balance until customers have paid their invoices. Similarly, expenses that the business incurs immediately reduce profit, but do not reduce the business' cash balance until it has settled its bills.

A business needs to make detailed plans setting out exactly how much each of its departments will spend, and how much cash it can raise to make these payments.

Cash is different from profit because:

Sales increase profit straight away, even when invoices have not been paid

Expenses reduce profit straight away, even if they have not been paid

The business draws up budgets for each of its departments so that they will be able to control their expenditure and meet the targets the business has set. Budgeting co-ordinates the different departments so that they work together to meet the business' strategic objectives.

Budgets allow each department to plan its income and expenditure.

A central part of the budgeting process is to produce a cash flow forecast. This predicts all the cash that will come into the business and all the cash that will flow out of the business, over the next year. It helps the business to analyse if it will have enough cash to pay its bills at different times throughout the year.

A simple cash flow forecast starts by listing all the organisation's receipts or cash inflows expected in the next month.

X-AMPLE might predict that in January, it will receive £500,000 in cash sales, benefit from a decrease in debtors who owe it money of £300,000, and take out a loan of £1m, so its total receipts would be £1.8m.

Cash Flow Forecast for X-AMPLE Ltd Commencing 1st January 2017		
	January	February
RECEIPTS	£	£
Cash sales	500 000	
Decrease in debtors	300 000	
Loan	1 000 000	
Total receipts	1 800 000	
PAYMENTS		
Stock	(300 000)	
Wages	(600 000)	
Dividends	(200 000)	
Total payments	(1 000 000)	

NET CASH FLOW	700 000	
Opening Balance	200 000	900 000
Closing Balance	900 000	

After this, the organisation's payments or cash outflows are listed.

X-AMPLE may estimate that it will need to settle invoices of £300,000 for stock it has purchased, pay £600,000 for wages, and pay dividends of £200,000, so its total payments would be £1.1m.

PAYMENTS		
Stock	(300 000)	
Wages	(600 000)	
Dividends	(200 000)	
Total payments	(1 000 000)	
NET CASH FLOW	700 000	

Net cash flow equals total receipts minus total payments, so X-AMPLE's net cash flow would be £1.8m minus £1.1m, which gives £700,000.

This means that £700,000 more cash is predicted to flow into the business than out of the business. Therefore, X-AMPLE's cash balance will increase.

Net cash flow = total receipts – total payments

1.8m – 1.1m = £700 000

If X-AMPLE were to start the month with an opening balance of £200,000, it would finish the month with a closing balance of £900,000. This is because the closing balance equals the opening balance plus the net cash flow.

	January	February
	£	£
Opening Balance	200 000	900 000
Closing Balance	900 000	

The business ends one month with a certain closing balance, which then becomes the opening balance for the next month. X-AMPLE would start February with £900,000 cash.

A negative net cash flow means that, overall, more cash is flowing out of the business than is coming in. The organisation would finish with less cash than it started with, that month. Therefore, its closing balance for that month would be less than its opening balance.

Negative net cash flow –
overall, cash is flowing out of the business.

If this were to continue, its cash balance could become negative, indicating that it is needing to spend more cash than the business has in the bank. It would face a liquidity crisis and would have to close down.

Negative cash balance – the business needs to spend more cash than it has, leading to a liquidity crisis – and potential closure.

By preparing a cash flow forecast in advance, the business will be able to plan ahead and can arrange a loan or raise equity to finance any shortfall.