BOOKKEEPERS KNOWLEDGE BASE

Edition 34

Cash Flow Forecasting

INTRODUCTION

Lack of cash flow can be fatal for businesses. The planning of cash flow can be the difference between a business surviving, and going bankrupt. Cash Flow Forecasts are one tool that a business can employ to plan their cash flow. Bookkeepers are in an excellent position to undertake the preparation of Cash Flow Forecasts due to their in-depth understanding of the operational aspects of small business. Not only will you be performing a vital role in ensuring liquidity within the business, but you will also be value adding to your own menu of services you offer your clients.

This article will show you how to prepare a Cash Flow Forecast and, in doing so, will cover the following topics:

- The need for constant cash flow
- The importance of cash flow forecasting
- How to prepare a Cash Flow Forecast
- Cash Flow Forecast case study
- Cash flow Tips.

THE NEED FOR CASH FLOW

Cash is the cornerstone of a business. All businesses need to ensure they have sufficient cash, at a particular time, to pay their bills. Cash is needed constantly in order to discharge a wide range of payment obligations which arise from many sources, including:

1. Tax Office

- Superannuation: Businesses that have employees are required to contribute 9% of each employee's earnings base to a complying superannuation fund or retirement savings account (RSA). This obligation arises each quarter (every three months).

- GST: GST is collected by business on behalf of the Government. GST collected by businesses must be forwarded to the Tax Office. Depending on your reporting cycle, a business must be able to forward these GST amounts (less any GST credits owing to you) by the due date of your monthly or quarterly activity statement, or your annual GST return.

- Pay-as-you-go (PAYG) Tax Instalments: PAYG Instalments are paid during the year, and are designed to cover a businesses income tax liability for the year. These amounts are due at the same time as your activity statement. In a businesses' first year of operation, it is not required to pay instalments. Instead, the whole income tax liability of the business will be paid in full at the end of the year.

- Fringe Benefits Tax (FBT): If you provide fringe benefits to your employees, you may have to pay FBT. Any FBT payable will usually be paid in quarterly instalments at the same time that your activity statement is due.

- PAYG amounts withheld from wages: If a business makes payments to employees, company directors or office holders; makes payments under labour hire arrangements; makes payments under voluntary agreements; or makes payments where an ABN is not quoted, they must withhold tax. For most small businesses, these withheld amounts must be forwarded to the Tax Office when your activity statement is due.

2. Suppliers

Depending on the terms of payment, money owed to creditors or suppliers can be due in 14, 30, 60 or 90 days. Maintaining healthy relationships with these parties, as well as a good reputation, requires that you have cash available so you can make these outstanding payments, and make them on time.

3. Employees

An employer is legally required to pay a range of benefits to its employees. These benefits can include salary and wages, annual leave, long service leave, sick leave, commissions and allowances. Failure to make payments owing can result in legal action, and will almost certainly be fatal for any business.

4. Insurance

Insurance is an essential part of operating a business. Some forms of insurance are compulsory, while other insurance requirements vary depending on the industry. Essential insurance will normally include, fire; loss of gross profit; public liability and employee liability. A business can not operate without having the cash to make these payments.

IMPORTANCE OF CASH FLOW FORECASTING

Because cash is the cornerstone of business, planning your cash flow is vital. Studies suggest that the failure to plan cash flow is one of the leading causes of small business failure. To this end, a Cash Flow Forecast is a crucial cash management tool for operating your business effectively. Specifically, a Cash Flow Forecast tracks the sources and amounts of cash coming into and out of your business over a given period.

It enables you to foresee peaks and troughs of cash amounts held by your business, and therefore whether you have sufficient cash to fund your debts at a particular time. Moreover, it alerts you to when you may need to take action – by discounting stock or getting an overdraft, for example – to make sure your business has sufficient cash to meets its needs. On the other hand, it also allows you to see when you have large cash surpluses, which may indicate that you have borrowed too much, or you have money that ought to be invested.

In practical terms, a Cash Flow Forecast can also:

- make your business less vulnerable to external events in the economy, such as interest rate rises;
- reduce your reliance on external funding;
- improve your credit rating;
- assist in the planning and re-allocation of resources; and
- help you to recognise the factors that have a major impact on your profitability.

At this point, a distinction should be drawn between budgets and Cash Flow Forecasts. While budgets are designed to predict how viable a business will be over a given period, unlike Cash Flow Forecasts, they include non-cash items, such as depreciation and outstanding creditors. By contrast, as stated above, a Cash Flow Forecast focuses on the cash position of a business at a given period. Non-cash items do not feature. In short, budgets will give you the profit position; Cash Flow Forecasts will give you the cash position.

Cash flow forecasting can be used by, and be of great assistance to, the following entities:

- business owners
- start-up businesses
- financiers
- creditors.

Bookkeepers are therefore well placed to assist any or all of the above parties through giving an understanding of, and the preparation of, Cash Flow Forecasts.

THE CASH FLOW FORECAST

A Cash Flow Forecast is usually prepared for either the coming quarter or the coming year. Whether you choose to divide the forecast up into weekly or monthly segments will generally depend on when most of your fixed costs (such as salaries, for example) are incurred. When you are making forecasts it is important to use realistic estimates. This will usually involve looking at last year's results and combining them with economic growth, and other factors unique to your line of business. When forecasting overheads, the Profit Budget can be used.

Usually a forecast will list:

- receipts
- payments
- excess receipts over payments (with negative figures displayed in brackets)
- opening balance
- closing bank balance.

At this point, it should be noted that there are several different ways to structure the actual Cash Flow Forecast. The sample we have adopted below is taken from the Queensland Small Business website at www.smartsmallbusiness.qld.gov.au : *Annual Cash Flow Forecast.*

Irrespective of the design of the Cash Flow Forecast is the need to ensure that cash receipts and cash payments are accurately recorded in the nominated period.

SAMPLE CASH FLOW QUARTERLY FORECAST:

Cash Inflow	**Month**	**Month**	**Month**
Sales **(A)**	$	$	$
Sales of Assets			
Capital Injection			
Other Sources			
Total Cash Inflow **(B)**	$	$	$
Cash Outflow			
Purchases **(C)**	$	$	$
Overheads			
Accountant's Fees			
Advertising			
Bank Charges			
Cleaning			
Commission Paid			
Credit Card Fees			
Discounts Allowed			
Electricity and Gas			
Fees and Licences			
Freight Out			
Insurance			
Interest			
Lease Payments			
Legal Fees			
Motor Vehicle Expenses			
Postage/Telephone Fax			
Printing and Stationery			
Rent and Outgoings			
Repairs and Maintenance			
Security			
Superannuation			
Training Costs			
Travel Expenses			
Wages (Net)			
Other Expenses			
Travel Expenses			
Wages (Net)			
Other Expenses			
Total Overheads **(D)**	$	$	$
Other Items			
Drawings (by Owners)			
Loan Principal Repayments			
Purchase of Fixed Assets			
PAYG (Instalments)			
PAYG (Withholding)			
GST Payments			
Other Payments			
Total (Other Items) **(E)**	$	$	$
Total Cash Outflow **(F)**	$	$	$
Net Cash flow **(G)**	$	$	$
Opening Balance **(H)**	$	$	$
Funds Available			

Sample Debtors Analysis (people who owe you money)

Estimated Monthly Sales	**Month**	**Month**	**Month**
January	$	$	$
February	$	$	$
March	$	$	$
Monthly Cash Inflow from Sales (A) $	**$**	**$**	**$**

Steps for filling out Debtors Analysis:

1. Calculate your Estimated Monthly Sales and place in the first column.
2. Receipts from Cash Sales are entered into the month in which they occur.
3. Receipts from Sales on Credit are entered into the month of receipt e.g. sales on 30 days would be entered into the month after the sale.
4. Add each month column to calculate the Monthly Cash Inflow from Sales.

Sample Creditors Analysis (people you owe money)

Estimated Monthly Purchases	**January**	**February**	**March**
January	$	$	$
February		$	$
March			$
Monthly Cash Outflow from Purchases (C) $	$	$	$

Steps for filling out Creditors Analysis:

5. Calculate your Estimated Monthly Purchases and place in the first column.
6. Payments for cash purchases are entered into the month in which they occur.
7. Purchases for credit are entered into the month of payment e.g. purchases on 30 days would be entered into the month after the purchase.
8. Add each Monthly column to calculate the Monthly Cash Outflow from Purchases.

CASH FLOW FORECAST CASE STUDY

BAC Concreting Pty Ltd decided to prepare a Cash Flow Forecast for the third quarter of the 2005-2006 financial year. It based its sales forecasts on the sales it made for the same period last year, and has also factored in the general economic climate. It based its overheads on its profit budget. It had an opening balance of $40,000 as at 1 January 2006.

It has made the following quarterly predictions, in relation to the Cash Flow Forecast:

- **Sales:** $85,000 of stock and services
  (January $25,000; February $30,000; March $30,000)
- **Sale of Assets:** $112,000 sale of cement trucks and mixers
  (January $31,000; February 71,000; March $10,000)
- **Capital Injection:** $51,000 injection of cash
  (February $51,000)
- **Other Sources:** $3,000 of interest received
  (January $3000)
- **Purchases:** $39,000 of stock and other purchases
  (January $12,000; February $17,000; March $10,000
- **Overheads:** $84,000
  (January $27,000; February $40,000; March $17,000)
- **Other items:** $19,000
  (January $6,500; February $7,000; March $5,500)

Step 1 – Cash Inflow

I. Having calculated the Monthly Cash Inflow from Sales, BAC records the monthly figures on the Debtors Analysis spreadsheet.

II. These amounts ($25 000; $30 000 and $30 000) are then transferred to the Quarterly Cash Flow Forecast at **(A) "Sales".**

III. The Sale of Assets ($31 000; $71 000; $10 000); Capital Injection ($51 000); and Other Sources ($3000) amounts are recorded at their respective labels on the Quarterly Cash Flow Forecast.

Note: for the purposes of this example, we have recorded monthly totals only. These would be broken down into smaller sub-categories.

IV. The above amounts (all amounts in Step 1) are then added together and the total is recorded at **(B) "Total Cash Inflow"** on the Quarterly Cash Flow Forecast.

Step 2 – Cash Outflow

I. Having calculated the Monthly Cash Outflow for Purchases, BAC records the monthly figures on the Creditors Analysis spreadsheet.

II. These amounts ($12 000; $17 000; $10 000) are then transferred to the Quarterly Cash Flow Forecast at **(C) "Purchases".**

III. The Overhead amount can usually be derived from your Profit Budget. This amount should then be divided down into monthly amounts (taking account of when expenses are actually paid (e.g. electricity is usually payable quarterly). These monthly amounts ($27 000; $40 000; $17 000) are recorded at **(D) "Total Overheads"** on the Quarterly Cash Flow Forecast.

IV. The other items (examples of which are displayed on the Cash Flow Forecast) amounts ($6 500; $7 000; $5 500) are totalled and recorded at **(E) "Other Items"** on the Quarterly Cash Flow Forecast.

V. The above amounts at **(C) (D) (E)** (all amounts in Step 2) are then added together and the total is recorded at **(F) "Total Cash Outflow"** on the Quarterly Cash Flow Forecast.

Step 3 – Net Cash Flow

I. BAC then subtracts **(F)** from **(B)** and records the result at **(G)** on the Quarterly Cash Flow Forecast.

Step 4 – Opening Balance

I. The opening balance ($40 000) is then recorded at **(H) "Opening Balance"** on the Quarterly Cash Flow Forecast.

Step 5 – Cash at Bank

I. **(G) "Net Cash Flow" + (H) "Opening Balance" = (J) "Funds Available"**

QUARTERLY CASH FLOW FORECAST FOR BAC CONCRETING JANUARY – MARCH 2006

Cash Inflow	**January**	**February**	**March**
Sales **(A)**	$25 000	$ 30 000	$30 000
Sales of Assets	$31 000	$ 71 000	$10 000
Capital Injection		$ 51 000	
Other Sources	$ 3 000		
Total Cash Inflow **(B)**	$59 000	$152 000	$40 000
Cash Outflow			
Purchases **(C)**	$12 000	$ 17 000	$10 000
Overheads			
Accountant's Fees			
Advertising			
Bank Charges			
Cleaning			
Commission Paid			
Credit Card Fees			
Discounts Allowed			
Electricity and Gas			
Fees and Licences			
Freight Out			
Insurance			
Interest			
Lease Payments			
Legal Fees			
Motor Vehicle Expenses			
Postage/Telephone Fax			

Printing and Stationery			
Rent and Outgoings			
Repairs and Maintenance			
Security			
Superannuation			
Training Costs			
Travel Expenses			
Wages (Net)			
Other Expenses			
Travel Expenses			
Wages (Net)			
Other Expenses			
Total Overheads **(D)**	$27 000	$40 000	$17 000
Other Items			
Drawings (by Owners)			
Loan Principal Repayments			
Purchase of Fixed Assets			
PAYG (Instalments)			
PAYG (Withholding)			
GST Payments			
Other Payments			
Total (Other Items) **(E)**	$ 6 500	$ 7 000	$ 5 500
Total Cash Outflow **(F)**	$45 500	$ 64 000	$32 500
Net Cashflow (G)	**$13 500**	**$ 88 000**	**$ 7 500**
Opening Balance **(H)**	**$40 000**		
Funds Available (J)	**$53 500**	**$ 88 000**	**$ 7 500**

BAC Debtors Analysis (people who owe you money)

Estimated Monthly Sales	**January**	**February**	**March**
	$25 000		
		$30 000	
			$30 000
Monthly Cash Inflow from Sales (A)	**$25 000**	**$30 000**	**$30 000**

BAC Creditors Analysis (people you owe money)

Estimated Monthly Purchases	**January**	**February**	**March**
	$12 000		
		$17 000	
			$10 000
Monthly Cash Outflow from Purchases (C)	$12 000	$17 000	$10 000

A DOZEN CASH FLOW TIPS

The following tips are ones which you can use in your own bookkeeping practices, as well as providing to clients for better cash flow management:

1. Reconsider the terms on which you deal with customers
If a customer:

- refuses to pay;
- can not pay;
- can not pay the full amount

you should perhaps consider the terms on which you deal with that customer. For instance, to protect yourself against future non-payment, you might like to only deal with that customer on a 'cash on delivery' basis. Decisions in this regard should be made on a case-by-case basis.

2. Send Invoices Immediately
By delaying the filling out of your invoices until the end of the week or the end of the month, for example, you are unnecessarily creating cash flow problems for yourself. When you make the supply, send out the invoice!

3. Banking amounts that you receive
By banking amounts as soon as you receive them, you will be better able to monitor your true cash situation at any point in time. Not banking amounts leads to estimation and confusion as to the true cash position of your business.

4. Pay-by-date
It is common for invoices to state that payment is due 'within 30 days', for example. By specifying the 'pay-by-date' (for example, 'pay by March 20') you will know more precisely when you will actually receive payments.

5. Discounts for Early Payers
Offer discounts to customers who pay early. A word of caution – it is important to strike a balance between a reasonable discount, and your desire for early payment. Offering sizeable discounts for money that may have been paid in full a few days later anyway, will end up causing its own cash flow problems! In most cases, it is best to keep the discounts small, and require the payment well before the due date.

6. Insurance for Debtors
If you are a business that relies heavily on a few clients, you should consider taking out insurance. By insuring against the failure of your major debtors, you can safeguard against their potential collapse. Such a collapse can have a devastating effect on your cash flow.

7. Increase your time to pay
Try to get creditors to extend their due dates for payment. For example, from 14 days to 30 days; from 30 days to 60 days; or from 60 days to 90 days. Any extra time that you have to pay amounts owing, is effectively interest-free money. It also allows you to collect your money before paying amounts owed.

8. Charge Deposits
Consider charging deposits for significant orders. Not only does this guarantee at least part payment, but also makes customers think twice before cancelling their orders for goods that are in the process of being made available.

9. Excess Stock
Businesses need to make sure that they do not have excessive stock. Ideally, businesses should aim to have enough stock to keep customers happy and not have (if applicable) your store looking empty. Beyond that, any excess stock is merely tying up cash.

10. Be Flexible
- If you own your own business, you may need – when cash is sparse – to adjust the amount you pay yourself.
- Offer customers a variety of methods by which to pay your company. These include EFTPOS; B-PAY etc.

11. Be Alert to the External Environment
Businesses do not operate in a vacuum. Business owners, and those responsible for cash flow, need to be conscious of the business environment in which they operate. Watch out for trends in respect of inflation, interest rates, insurance premiums, as well as any trends or softness in the market in which you operate.

12. Prepare a Cash Flow Forecast!