Pacific Islands Private Sector Organisation

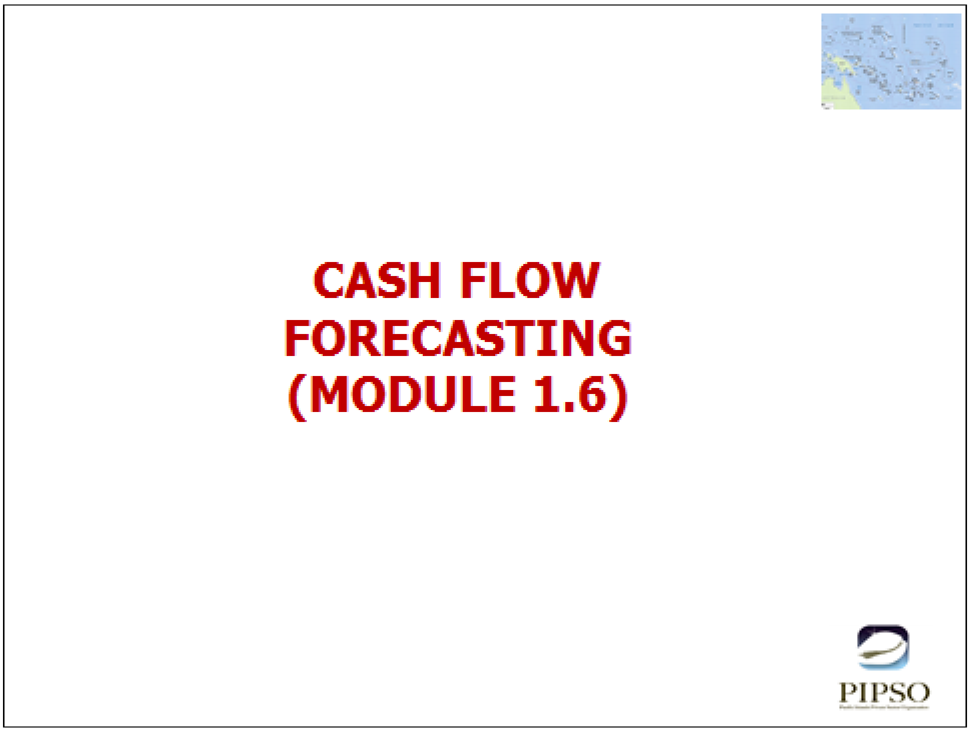
January 1

CASH FLOW FORECASTING

2014

This Module looks at cash forecasting on a monthly basis as a part of a cash budget. It introduces cash management procedures & offers tips on improving the cash conversion cycle. Finally, participants are given the opportunity to prepare a cash flow forecast for 6 months & make some observations about it.

MODULE 1.6



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PURPOSE

In this Module the focus is on the future. Business planning requires the owner/manager to forecast revenues & expenses, asset purchases & sales &meeting external obligations to pay creditor &loan obligations& owner drawings from, or additions to, capital.

At its most basic level financial planning involves a cash forecast. For more detail on budget preparation in a range of industries, refer Level 2, Module 2.3, Budgets.

- The first step in the cash management cycle is the keeping of records to monitor actual cash inflows & outflows.
- The second step in the cash management cycle is the preparation of a cash forecast based on known & expected business activity.
- The third step is the use of the forecast to plan for the needs of working capital, assets & liabilities
- The fourth step is to reforecast the cash flow after allowing for the adjustments considered necessary to implement the plan, e.g. to recognise any changes in the working capital, asset movements & borrowings or repayment.
- The fifth step is to take whatever actions the plan requires, e.g. negotiate credit terms from suppliers, arrange asset purchases or sales &/or approach a lender/investor if funds are required.

This is not the end of the process, just the end of the forecast preparation portion of a larger cycle, refer Level 2, Module 2.3, Budgets.

This Module covers the process up to step 3 together with discussion on step 4 above only.For management, however, this step is perhaps the most important as a primary purpose of a forecast is to determine actions required or desirable to improve or alter a cash flow.

Step 5 is about taking action based on the best planning management can provide. It deals with issues/problems that may not be resolved by internal management of resources. Refer Level 3, Business Planning for further discussion.

On completion of this Module participants should appreciate the role of cash budgeting & forecasting for a small business. Participants should also benefit from the advice offered to assist with the management of accounts receivable, accounts payable, inventories & banking.

CASH FORECASTING

Remember our business goals? These were:

1. Profit
2. Service
3. Social
4. Growth

To achieve these goals, we need to plan. They will not just happen. A cash forecast is the minimum requirement for forward planning applying the principles we learned in Module 1.1.

S - Specific: goals should be focused and well defined

M - Measurable: what does success look like?

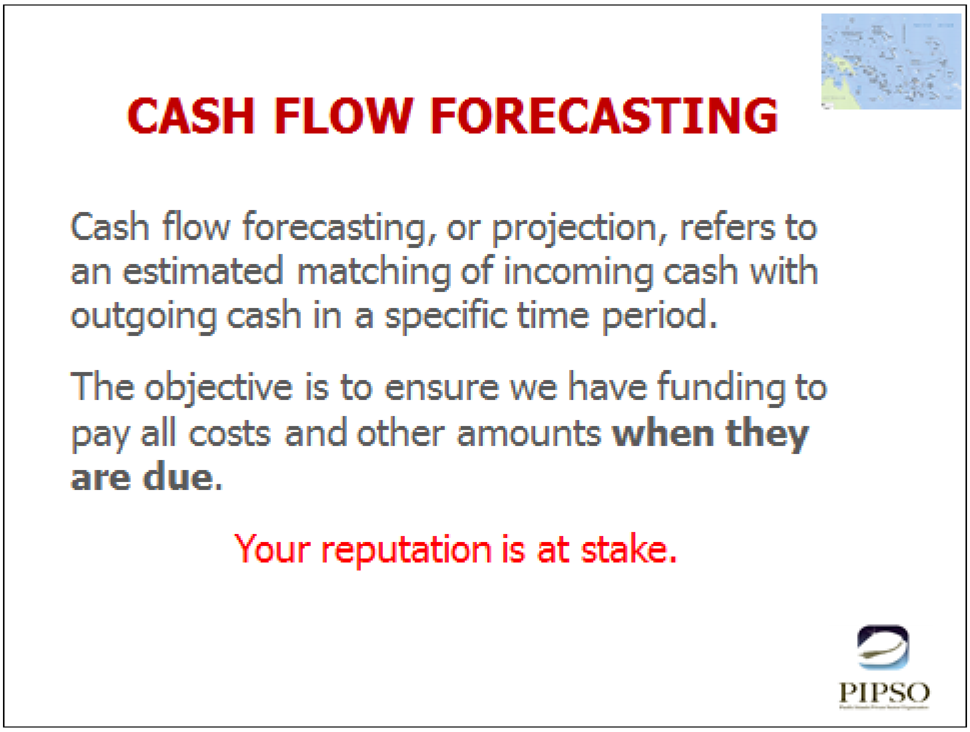
A - Achievable: goals should be realistic

R - Responsible: who is accountable for delivery of the business goal?

T - Timely: a timeframe should be set when the goal is to be completed

Thecommentary that follows centres on the creation of a business cash forecast that projects the business cash flow as best the proprietor can estimate, not a personal one. Remember that these are not the same. From prior modules we are already aware that separation of business & private activities &active cash management is the first step toward business planning.Passive or inactive management leads to stagnation at best & failure at worst. A forecast should recognise the impact of the cash conversion cycle&make active management of cash flow easier.Check all calculations & make sure the forecast accurately represents expectations.

Having prepared the forecast, what is its message(s)? If you do not read the messages, why do the plan? If it is your business, the messages should be understandable. Act on them if they are.

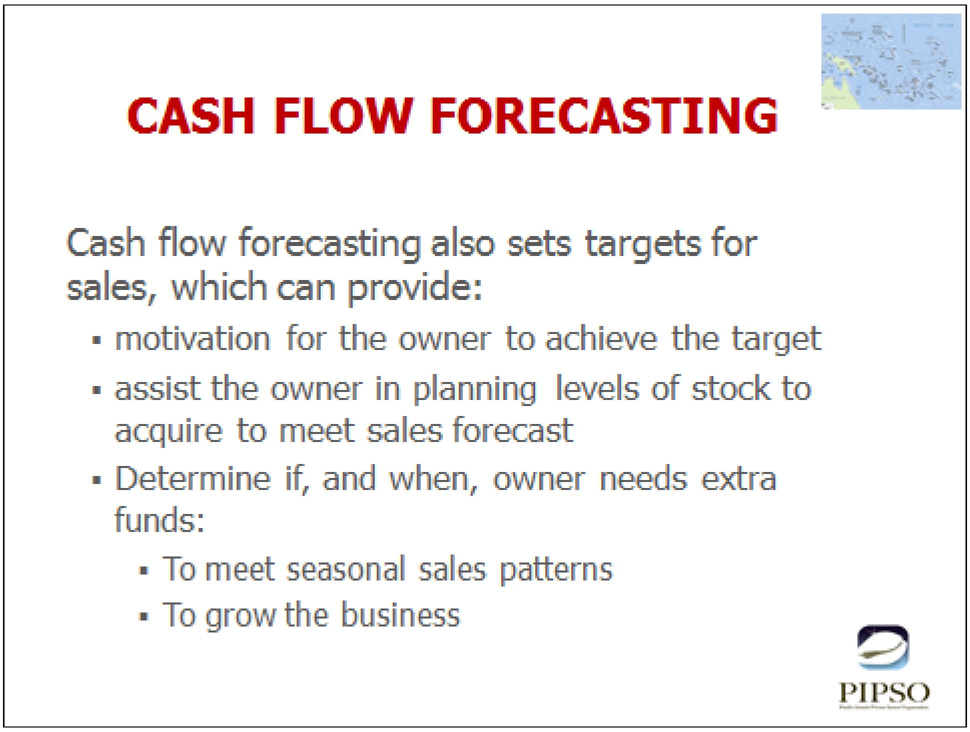


The content of a cash flow forecast shouldinclude **ALL** fixed &variable, frequent & infrequentforecast inflows & outflows on a monthly basis for the period of the forecast, usually 12 months. Detailed forecasting on adaily or weekly basis is also useful in some situations where there is a distinct pattern of inflows & outflows, e.g. a coffee shop, tavern, retail store or other business catering to customers who are paid fortnightly or during a period of celebration where cash flows will rise dramatically.

A business cash forecast should:

- Include a forecast of all receipts & payments
- Be based on the expected timing of the cash flow, in & out
- Be split into relevant periods, daily, weekly or monthly
- Project cash flows for a relevant period
- Include business cash flows only

The forecast is a tool for management decision making only. It will show financial strengths & weaknesses of the business, but the business owner must take any necessary corrective actions.



At the risk of repetition, a forecast is only as good as the information in it, so make it the most accurate that you can at the time of preparation. Being too conservative may mean missing opportunities by underestimating cash available. Being too optimistic may result in a shortage of cash at an inopportune time.

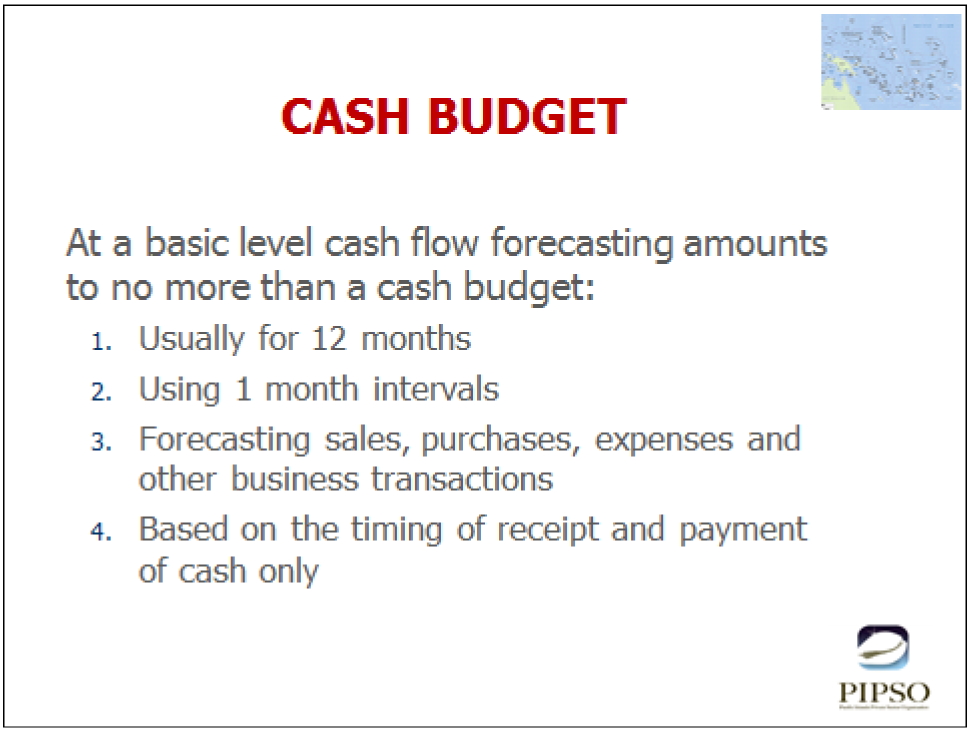
Rubbish in means rubbish out.

Given its sensitive nature, the information provided is for the benefit of the owner/manager & is therefore confidential.

When forecasts are used for dealings with third parties, banks & investors, care needs to be taken because the owner(s) & their businessmanagement will be judged by the reliability of the forecasts over time.

The owners &the business's credibility is at stake.

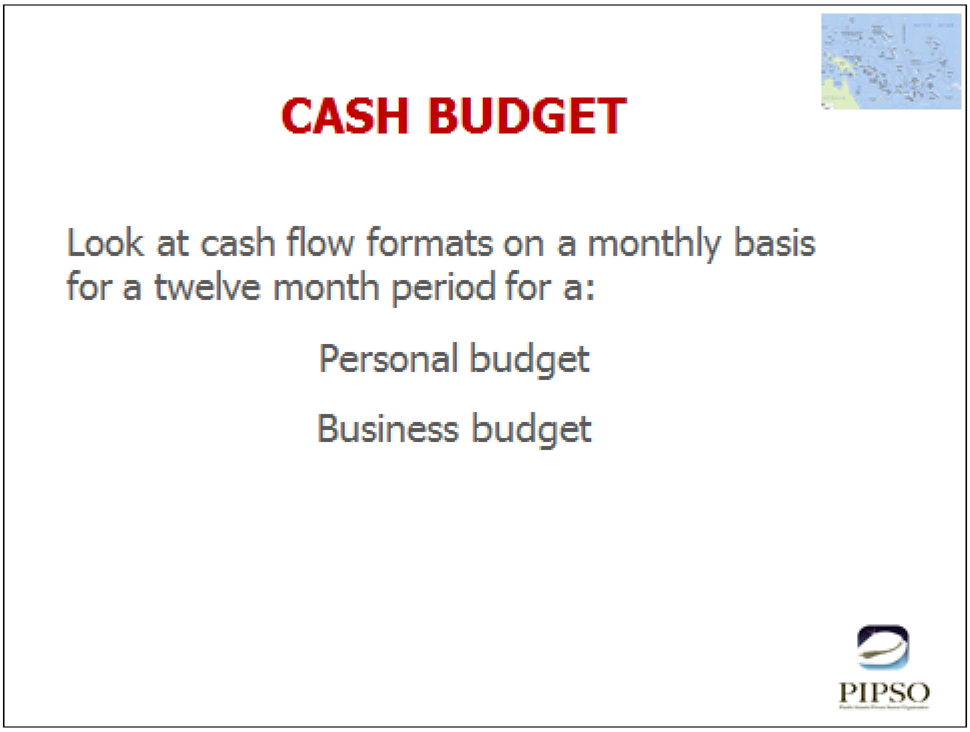
CASH BUDGET



For a start-up business try forecasting for three months; then extend it to six months. The target is a 12 months forecast or budget, whether cash or otherwise. In uncertain time reduce the length of the forecast & extend it as confidence grows.

IMPORTANT:

1. **Receipts from debtors & payments to creditors are only included whenreceipts &payments are expected, not when the purchase or sale that gives rise to the debt occurs**
2. **Any abnormal transactions, e.g. sale of assets, borrowings, capital injections or drawings anticipated, must also be included in the forecast**



At a minimum, **a personal cash budget** for a period of time will include:

- Income from all sources
    - Salaries/wages from the business or elsewhere
    - Business drawings
    - Other income receivable
- All expenses, preferably grouped as follows:
    - Fixed regularexpenses, e.g. rent or mortgage
    - Variable regular expenses, e.g. food
    - Fixed infrequent expenses, e.g. insurance
    - Variable infrequent expenses, e.g. holiday

Consider your personal situation. What are your sources of income & outgoings? Make your own personal list for inflows & outflows. Use the template provided & add or subtract items in the list based on personal relevance.

For anyone who has not done a forecast (budget) before, a weekly budget is a good start. From that a monthly budget can be developed. Monthly budgets can be done on a weekly basis (four or five weeks a month) or a daily basis (28 to 31 days a month).

A business cash forecast/budget should **NOT** include any private items other than capital injections & drawings or dividends. All outgoings from the business to the owner(s) should simply be treated as private drawings or dividends. Owners may, of course draw salaries.

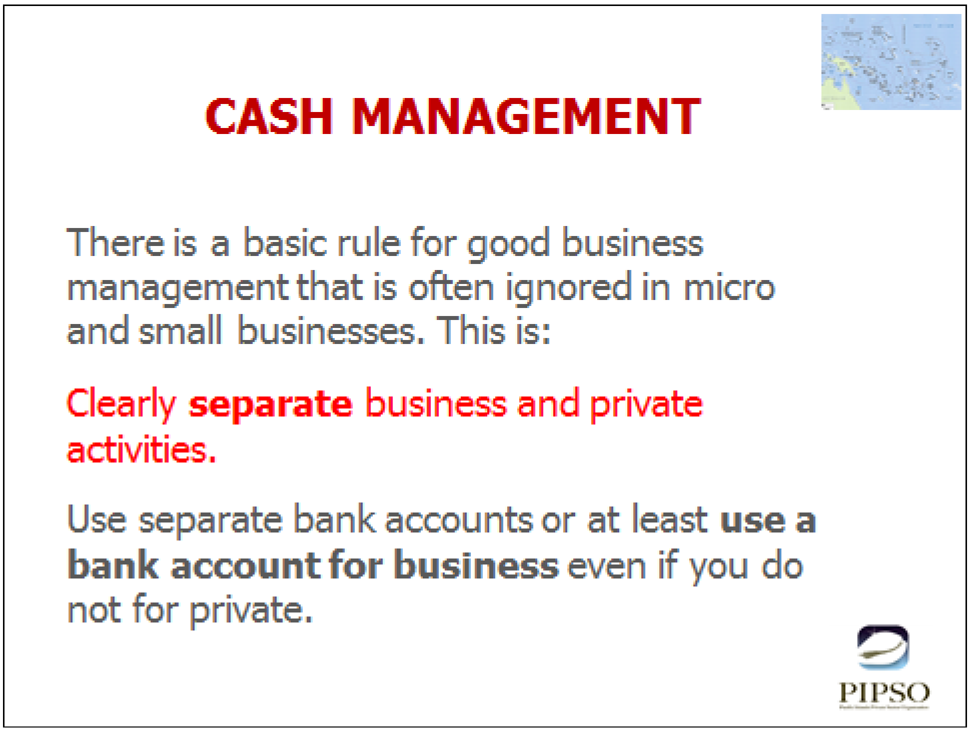
Typically, a business budget will include:

- Inflows
    - Sales, cash & credit on receipt of cash

    - Any other business revenues
    - Other inflows
        - Capital injections
        - Non-current asset sales
        - Receipt of loan funds
- Outflows
    - Cost of goods sold
        - Purchases
        - Freight inward
        - Customs duty
    - Other expenses
        - Sales & marketing
        - Administration
        - Financial
    - Drawings or dividends paid to owner(s)
    - Repayments ofloansprincipal
    - Purchases of non-current assets

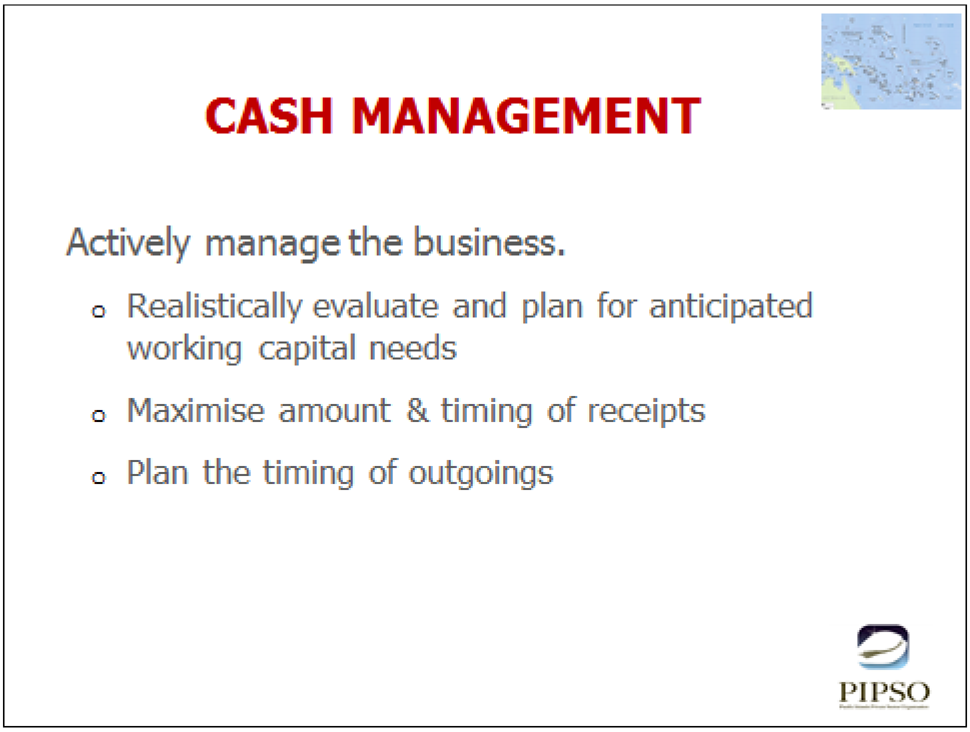
Where applicable, VAT receivable & payable should be included in the forecast.

CASH MANAGEMENT



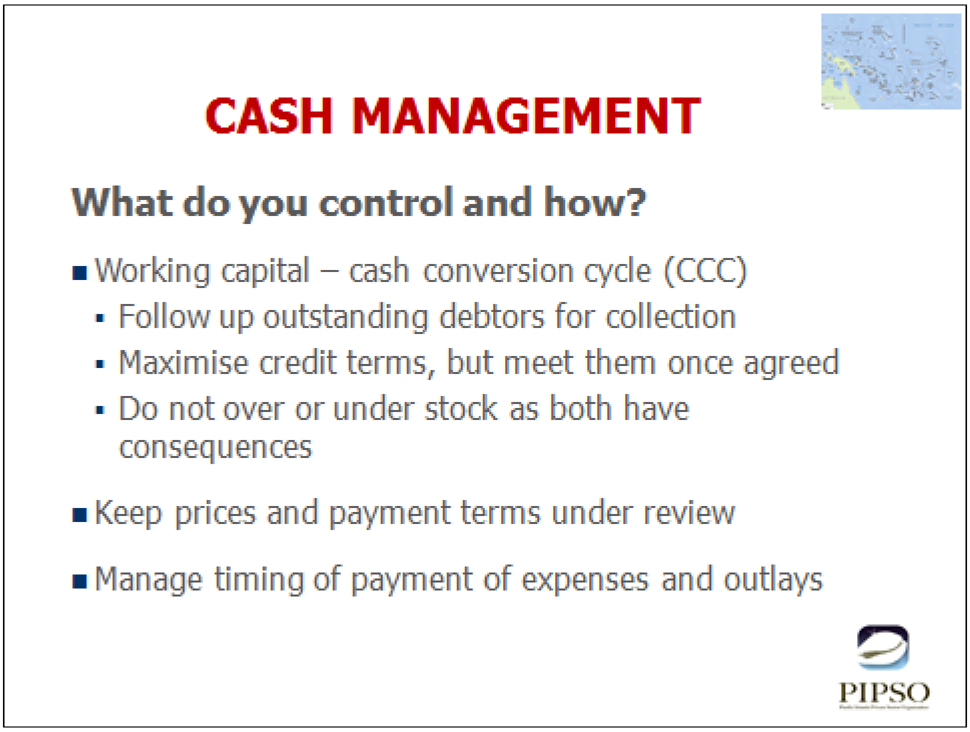
Note: it is very important to separate business & private activities.

The best way to do this is through the use of a business bank account, whether or not you use one for your private affairs. All business monies in & out should flow through the account.



As already pointed out, a forecast is only as good as the information contained therein, so be neither conservative nor too bold. It is possible to also forecast high & low cash flows (to look at upside & downside expectations), time permitting if so desired.

Once done the forecast becomes a planning tool to be used to see if funds are available for other activities that business owner may have which are flexible as to timing in order to manage working capital& investment decisions. Conversely it may highlight a cash shortfall that needs to be plugged by reducing outflows or raising external funding. If so the time to act is now, not when the business runs out of money.



What actions can a business owner take to manage cash, once the forecast has been prepared?

Working capital

Understand your cash conversion cycle & maximise the opportunities it provides. Some actions that may be taken are:

- Follow up debtors regularly, do not assume payments will be received (more detail follows)
- Maximise credit terms, but once agreed, meet them.
- Be aware of outlays & expenses to manage payments within the business cash flows available
- Knowing when any cash shortfalls may occur in advance allows a business to prepare for it &/or negotiate funding to cover the temporary need before it becomes a problem.

TIPS TO IMPROVE CASH CONVERSION CYCLE

IMPORTANT:

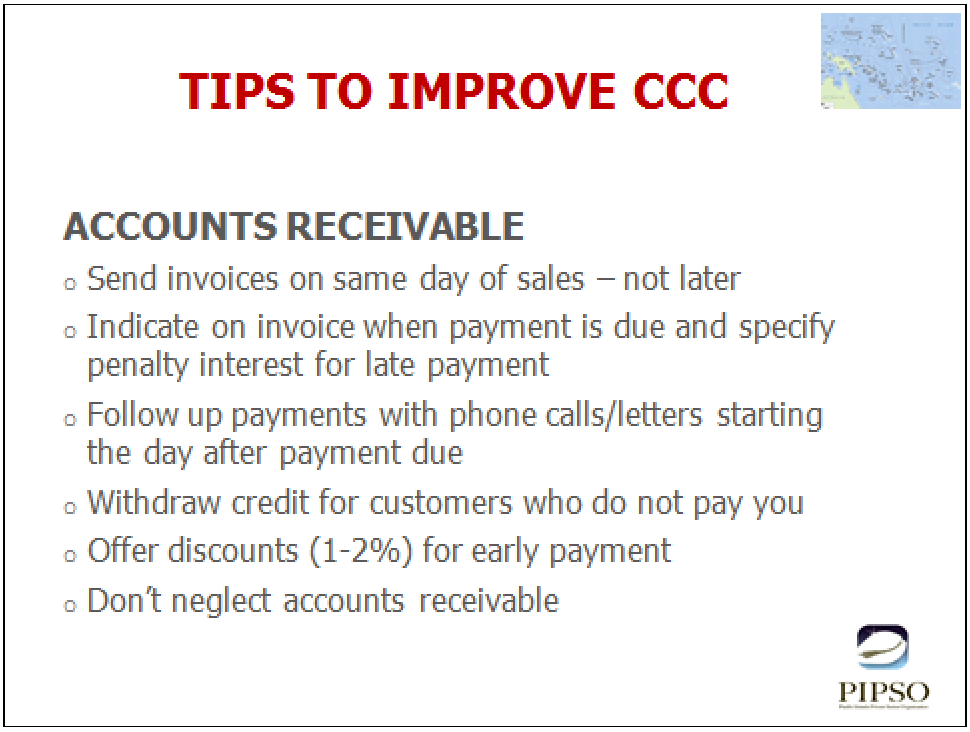
1. **Work through the following slides slowly**
2. **Use the example of an invoice to illustrate dot points 2 & 5 of tips**
3. **Ask participants what their practice is.**
4. **Seek participant input wherever possible or offered**
5. **Invite suggestions & comments from participants before moving from one slide to the next**

The following slides provide some guidance on actions to manage the components of working capital:

1. Debtors
2. Creditors
3. Inventory
4. Cash

NOTE FOR FACILITATOR

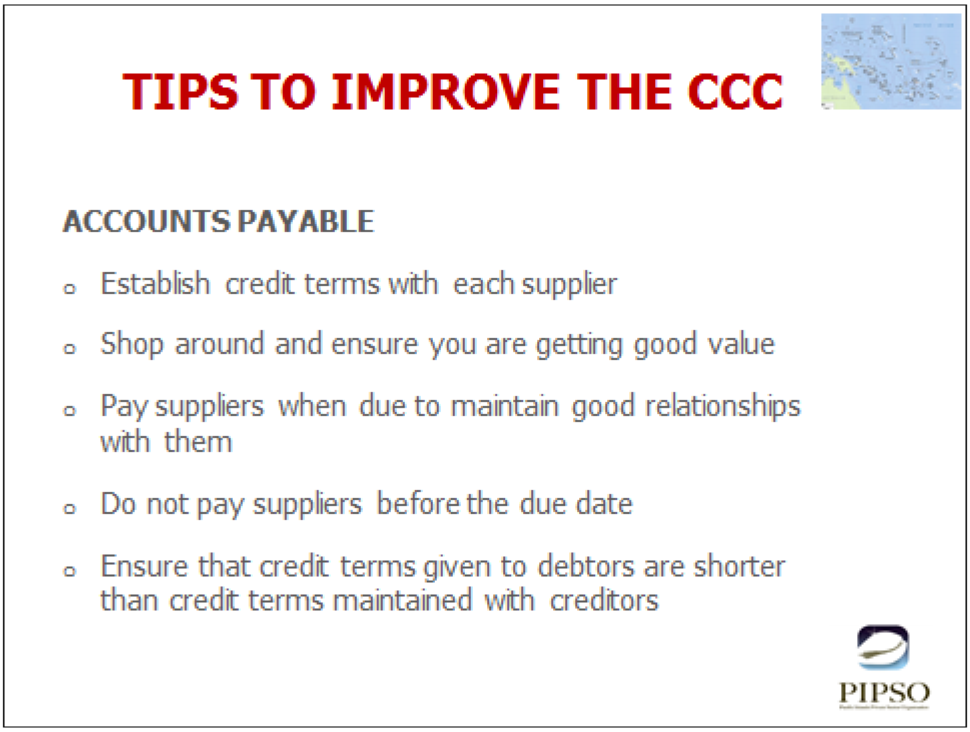
Before revealing the slide, ask participants what they think that they can do to speed up payments from debtors?



A business owner must be sufficiently hard-nosed when it comes to debt collection. Procedure needs to be clear & followed meticulously.

Facilitator should remind participants of the consequences of being generous with family & friends here. Business is business. Charity & generosity have a price/cost for the business. This needs to be acknowledged.

Family & friends need to understand that their behaviour can jeopardise your business. This is bad for you & ultimately them also.

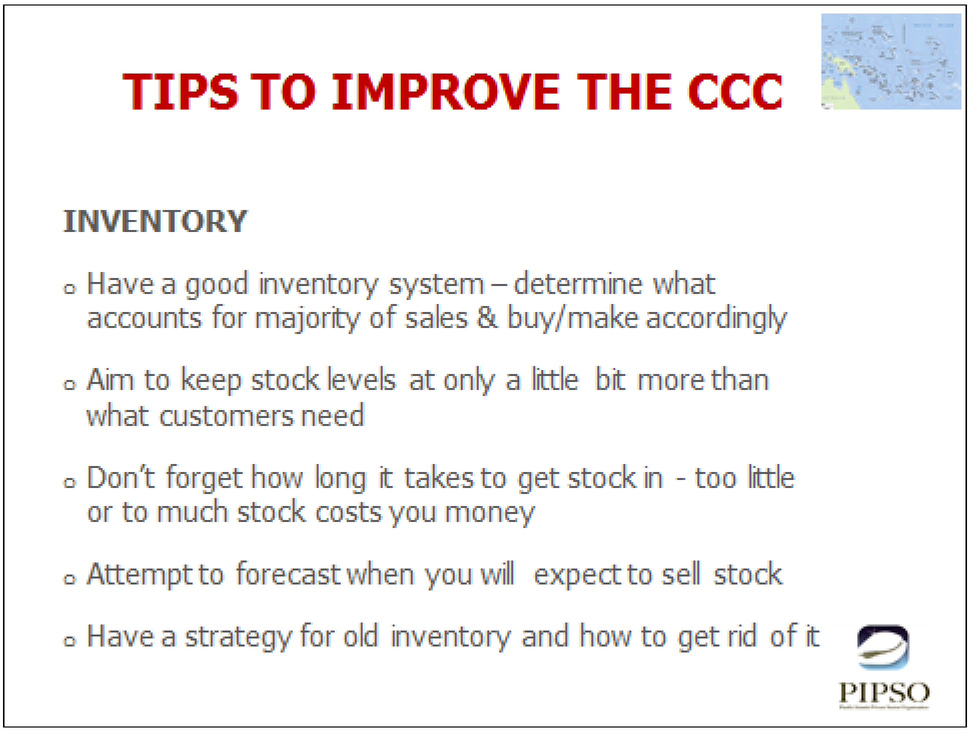


When it comes to payments, meet all obligations when due, do not early &do not late.Seek credit where it is available; maximise it.

It the event that cash flow is insufficient to meet an obligation, contact the creditor, or bank to explain the situation & negotiate a variation before you default or fail to make the payment & the other party issues notices & comes to you.Work with your creditors. Don't ignore them.

Take credit wherever it is available. It is the only free funding you will get in business.

When making payments, your reputation & credibility is at stake.



Inventory management is all about managing the level within acceptable upper & lower boundaries. Both overstocking & understocking have negative financial & business consequences. The management decision making issues are:

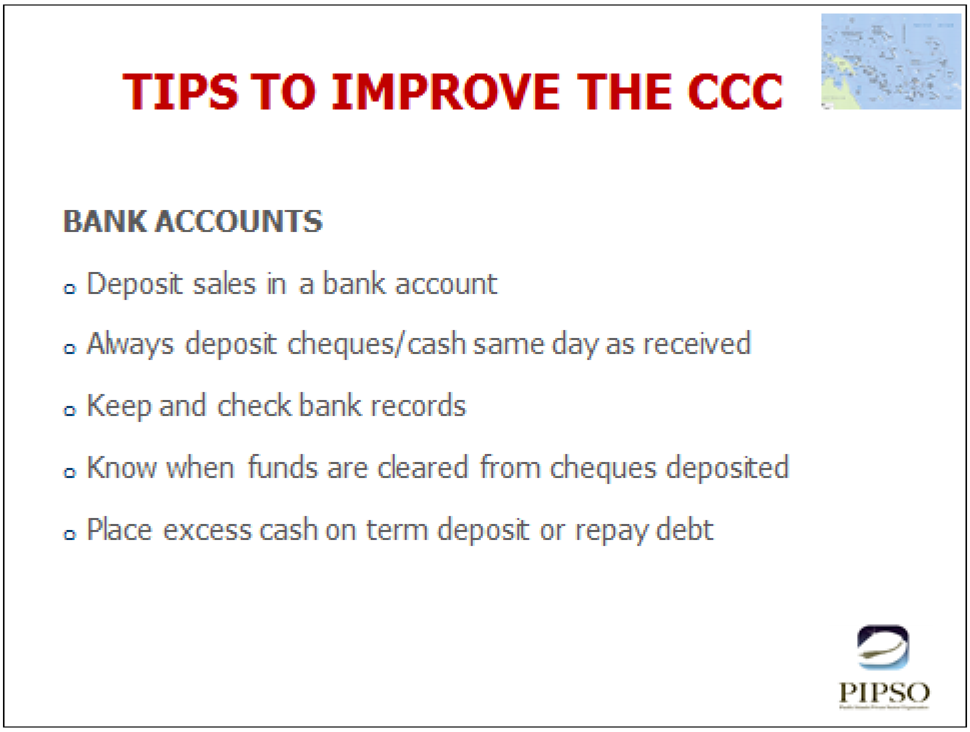
1. Maintaining inventory within the determined upper & lower levels.
2. The inventory level at which to reorder
3. The quantity to reorder

The inventory management strategy & practices that a business uses should reflect the complexity of the business & the characteristics of the item stocked, including:

- Physical size of the items
- Financial cost of items
- Cost of storing items
- Turnover of items stocked
- Time it takes to order & restock

Micro/small businesses may not require a perpetual inventory system, but this also limits the businesses ability to manage its inventories with a high level of precision. It is possible to run a perpetual inventory system for some items, but not all items, & this should be considered by an owner who is using only a periodic methodbut is finding it less than satisfactory.

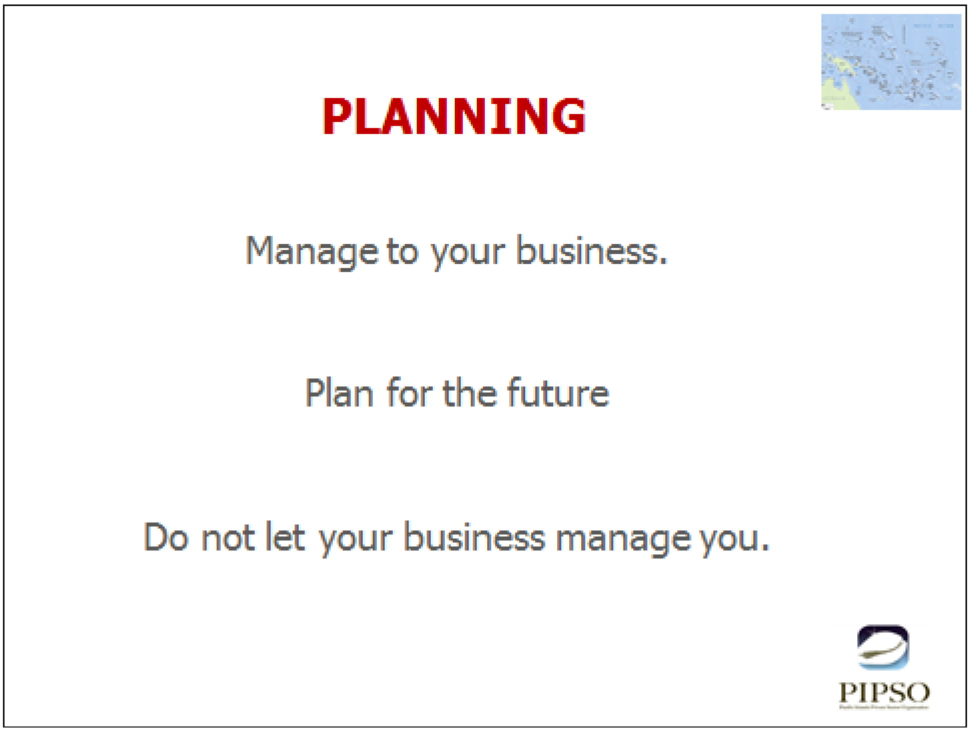
A perpetual system provides much better information & control for the management of inventoryprovided the resources & time commitment are available.



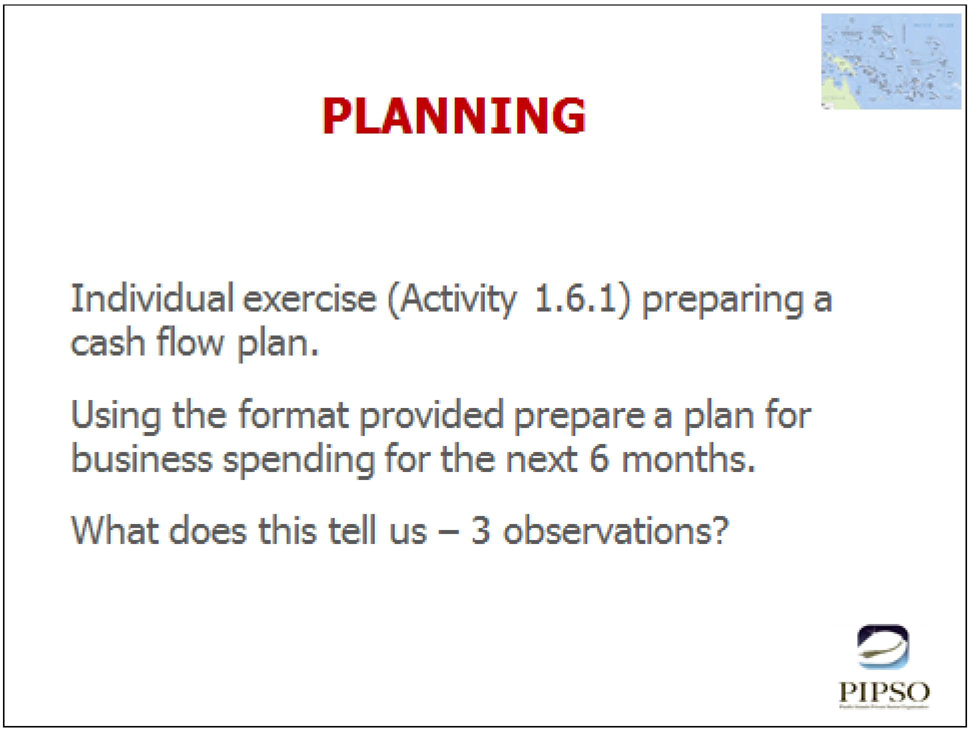
When it comes to cash management the most important tips are:

- Have a business bank account
- Having opened a business bank account, use it exclusively for that purpose
- Put all business receipts through the business bank account
- Do not use cash from the business without putting it through the business account as it will get overlooked when assessing business activity in the process
- Make sure to keep all business documentation on amounts in & out of the bank account
- The sooner funds are in the account, the sooner they are available for use in the business
- Don’t let surpluses built up in the bank account; is there a way to get some advantage, i.e. a discount for prompt payment of a creditor or interest on a bank deposit?

PLANNING



The message here is clear enough; managing requires planning followed by actions. The reverse is a lack of planning means an absence of management& inactivity.



IMPORTANT:

Before participants begin Activity 1.6.1, the following points should be

- Monthly cash flows are provided for the six-month period, separated by commas, for:
  - Cash sales
  - Sales debtor collections
  - Stock purchase payments
- Closing cash position each month equals the opening cash position for the following month

NOTE FOR FACILITATOR

Activity 1.6.1 is designed to allow participants to do some data input, either individually or sharing with others at their table& discuss their observations in groups & reach some conclusions

The facilitatoris to directparticipants to keep this activity interactive. Participants may need to be reminded of the following before they complete the calculations:

- The opening cash position for the six months is the same as the opening cash position for the first month
- The closing cash position for the six months is the same as the closing cash position for the last month
- Completing the cash flow forecast is the easy part of the question; what observations can be made based on the forecast?

Once participants all have the correct cash flow, the facilitator should give some more time for group discussion of the issues & then ask each table to appoint a person to advise the table's observations.

Finally, undertake a general all in discussion after group discussion& add any observations overlooked.

Activity 1.6.1

<u>ON THE CASH FLOW PLAN PROVIDED TO YOU:</u>

Complete the forecast six (6) months of data entry.

Make sure you balance each month as you proceed.

A “0” should be inserted into all fields that have no requested data.

<u>Data to enter is listed below:</u>

<u>CASH RECEIPTS</u> **<u>Tick off as you go</u>**

<u>Cash Sales</u> – $5,000, $16,900, $17,235, $19,000, $22,000 & $7,500 ☐

<u>Sales Debtor Collections</u> - $10,400, $11,200, $12,000, $8,800, $10,000 & $2,200 ☐

<u>Proceeds from Asset Sales</u> – March $15,500 and April $30,000 ☐

<u>Capital Contributions</u> – March $38,500 and April $3,500 ☐

<u>Other Receipts</u> – March $1,500 ☐

<u>CASH PAYMENTS</u>

<u>Stock Purchase Payments</u> - $5,451, $6,500, $12,420, $13,320, $10,200, $10,500 ☐

<u>Operating Expense Payments</u> – all months to record $4,000 ☐

<u>Loan Repayments</u> – all months to record $750 ☐

<u>Capital Expenditure Payments</u> – January $2,000 and May $6,000 ☐

<u>Owner’s drawings</u> – the owner draws $4,000 out of the business every month ☐

<u>Other payments</u> – May $1,950 only ☐

OBSERVATIONS

Make three (3) observations about the cash flow trends from the cash flow plan prepared.

1. ____

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2. ____

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3. ____

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Cash Flow Plan

	JAN	FEB	MAR	APR	MAY	JUN	TOTALS
CASH RECEIPTS							
- Cash sales							
- sales debtor collection							
- proceeds from asset sales							
- capital contribution							
- other receipts							
Total Cash Receipts							
- stock purchase payments							
- operating expenses payments							
- loan payments							
- capital expenditure payments							
- owner's drawings							
- other payments							
Total Cash Payments							
NET CASH FLOW							
OPENING CASH POSITION	3,000						
CLOSING CASH POSITION							

ANSWERS TO ACTIVITIES

Activity 1.6.1

Prepare a cash flow plan - Answer							
			Cash Flow Plan				
	JAN	FEB	MAR	APR	MAY	JUN	TOTALS
CASH RECEIPTS							
- Cash sales	5,000	16,900	17,235	19,000	22,000	7,500	87,635
- sales debtor collection	10,400	11,200	12,000	8,800	10,000	2,200	54,600
- proceeds from asset sales	0	0	15,500	30,000	0	0	45,500
- capital contribution	0	0	38,500	3,500	0	0	42,000
- other receipts	0	0	1,500	0	0	0	1,500
Total Cash Receipts	15,400	28,100	84,735	61,300	32,000	9,700	231,235
less CASH PAYMENTS							
- stock purchase payments	5,451	6,500	12,420	13,320	10,200	10,500	58,391
- operating expenses payments	4,000	4,000	4,000	4,000	4,000	4,000	24,000
- loan payments	750	750	750	750	750	750	4,500
- capital expenditure payments	2,000	0	0	0	6,000	0	8,000
- owner's drawings	4,000	4,000	4,000	4,000	4,000	4,000	24,000
- other payments	0	0	0	0	1,950	0	1,950
Total Cash Payments	16,201	15,250	21,170	22,070	26,900	19,250	120,841
NET CASH FLOW	(801)	12,850	63,565	39,230	5,100	(9,550)	110,394
OPENING CASH POSITION	3,000	2,199	15,049	78,614	117,844	122,944	3,000
CLOSING CASH POSITION	2,199	15,049	78,614	117,844	122,944	113,394	113,394

Observations

1. Cash has risen from $3,000 to $113,394 by the end of the period. Why? Business is getting ready for a large outflow, i.e. purchase of an asset, their premises, or another business.
2. Assets sold & capital injected while owner continues to draws monthly. Why? A major asset purchase or business expansion is about to happen as suggested in 2 above.
3. There appears to be a seasonal pattern of sales peaking in April/May.
4. Stock purchases rise & fall with or just ahead of sales.
5. Stock purchases in last 2 months are high relative to sales, but they are not high enough to indicate a need for the cash build up that has occurred.
6. Ask owner why a salary is not being drawn in lieu of drawings to get tax benefit. Is the business is a sole trader or partnership?