How to Forecast Cash Flow

Business Information Factsheet BIF058
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Here for Business

Introduction

A cash flow forecast predicts the flow of money in and out of a business over a specified time. It is an important management tool that helps with business planning. This factsheet explains the importance of forecasting cash flow and describes the structure and content of a cash flow forecast. It explains how to prepare a forecast and how to use it to monitor cash flow. It also introduces key accounting concepts including fixed, variable and capital costs, working capital and cash cycle.

Cash flow forecasting

A cash flow forecast shows how and when a business expects to receive and make 'cash' payments over a given period of time. 'Cash' includes direct debit and electronic transfers to and from the business's bank account. Cash flow forecasts are usually projected over a period of six or twelve months, although it is possible to look at shorter periods, such as a week or month, if necessary.

Cash flow forecasts can be used as a management decision-making tool to help identify:

- How much initial cash investment a start-up business requires.
- When a business may need other finance, such as an overdraft or loan.
- The level of loan repayments a business can afford to make each month.
- When a business will be able to spend cash in the future, for example, for taking on a new employee or paying for a marketing campaign or the purchase of capital equipment.
- When cash flow problems may occur once a business is trading and as it grows.

The layout of a cash flow forecast

A cash flow forecast has three main sections:

- Receipts - cash flowing into the bank account.
- Payments - cash flowing out of the bank account.
- Net cash flow/closing balance - the total amount of cash in the bank account at a particular point in time.

Receipts	January	February	March	April	May	June
Cash sales	£2,000	£18,000	£22,000	£26,000	£28,000	
Other income	£10,000	£0	£0	£0	£0	£0
Total receipts	£12,000	£12,000	£18,000	£22,000	£26,000	£28,000
Payments						
Credit purchases	£7,000	£9,000	£12,000	£14,000	£16,000	£17,000
Wages	£3,000	£3,000	£5,000	£5,000	£5,000	£5,000
Office expenses	£2,000	£1,000	£1,000	£1,500	£1,000	£1,000
Finance and tax payments	£0	£500	£500	£650	£650	£650
Capital expenditure	£3,000	£0	£0	£0	£0	£0
Total payments	£15,000	£13,500	£18,500	£21,150	£22,650	£23,650
Net cash flow	(£3,000)	(£1,500)	(£500)	£850	£3,350	£4,350
Opening cash balance	£0	(£3,000)	(£4,500)	(£5,000)	(£4,150)	(£800)
Closing cash balance	(£3,000)	(£4,500)	(£5,000)	(£4,150)	(£800)	£3,550

Table 1
(Figures in brackets denote a negative balance.)

Receipts

This section shows the sales income received by the business that has been paid into in the bank account. Receipts are always recorded in the month the business expects to receive the money.

If a business offers its customers a period of credit, there will be a delay between issuing an invoice and receiving the money in the bank account. For example, if customers have 30 days to pay their bill, the money from sales invoiced in January should be paid into the bank account in February. These payments would be entered in February on the cash flow forecast.

If a business is registered for VAT (Value Added Tax), the VAT charged on sales and paid by customers should be included in the receipts section. VAT is money that is collected on behalf of HM Revenue & Customs (HMRC). This money does not belong to the business and should be put aside for paying back to HMRC. See BIF234 An Introduction to VAT (Value Added Tax) for more information.

Any money that is expected to come from non-trading sources can be recorded under 'Other income'. This can include bank loans, shareholder investment and grants.

Payments

This section includes all the cash payments made by a business. The cash flow forecast should record when the business expects to make payments out of its bank account.

Table 1 provides five example payment categories that can be changed for a particular business. For example, these categories could be further divided as follows to help the business identify the different costs it has:

- Credit purchases - payments to suppliers and sub-contractors, and marketing activities (advertising, publicity, PR and merchandising).
- Wages - salaries, Pay As You Earn (PAYE) and National Insurance, and pension contributions.
- Office expenses - rent, business rates, telephone and internet, utilities, insurance, stationery and post.
- Finance and tax payments - bank charges, loan repayments, quarterly VAT payments and lease payments.
- Capital expenditure - office equipment, furniture and cars.

Net cash flow/closing cash balance

The net cash flow shows the total cash receipts minus total cash payments for each month. Net cash flow is added to the opening balance to give the closing cash balance at the end of each month.

The closing cash balance is the amount of cash a business has available at that point in time and should correspond with the bank statement.

In the example in Table 1, the business receives £2,000 of sales income in January as well as a £10,000 cash injection, but pays out £15,000 in costs, resulting in a negative (or overdrawn) balance of £3,000 at the end of January. As the business trades, it continues to have a negative cash flow over the next two months and shows a maximum cash deficit of £5,000 at the end of March. It is only in April that cash receipts start to exceed payments and the business starts to generate a positive cash flow. It takes until June for there to be a positive cash balance.

For this business to be able to trade, it would need an additional £5,000 of cash invested when it starts trading or the owner would have to make arrangements with their bank for an agreed overdraft facility of at least £5,000.

Factors to consider when preparing the forecast

There are several factors that need to be considered when preparing a cash flow forecast:

Sales forecast

To forecast cash receipts accurately, weekly or monthly sales income needs to be forecast. For a start-up business this will be based on market research and will be included in the business plan. If a business has been trading for some time it will have historical sales data on which to base its sales forecast, as well as a clearer picture of how its market is performing. The rate at which sales are turned into cash depends on whether a business offers credit to its customers. See BIF236 How to Forecast Sales for further information.

Types of business costs

When preparing a cash flow forecast, it's important to understand the three main types of costs a business incurs:

- **Variable costs** - These alter directly in relation to the sales a business makes. They include raw materials used in production processes or goods bought in to be resold, all of which can be linked to the sales forecast.

- **Fixed costs** - These do not vary directly in relation to sales. Fixed costs may be incurred on a regular monthly basis, such as wages and salaries, insurance, business rates or a car lease, or they may be paid quarterly in advance, such as rent.

- **Capital costs** - These relate to the purchase of physical business assets (such as computers or a vehicle) and usually occur less frequently than fixed and variable costs.

Credit terms

Many small businesses offer some form of trade credit to their customers, with trade accounts normally operating on a 30- to 60-day credit period. The length of time it takes customers to pay has a significant effect on a business's cash flow. A business can also benefit from obtaining credit terms from its suppliers.

It is important to define a clear credit policy to customers and to understand what credit terms are available from suppliers, in order to forecast when the business will receive cash into its bank account and when it will need to make payments out of its bank account. See BIF067 Establishing a Trade Credit Policy for further information.

Cash is not the same as profit

Profit is an accounting concept, but for the practicalities of running a business on a daily basis, having sufficient cash to pay for purchases and expenses is always the single most important issue. A business may generate profit from the items it sells, or the service it delivers, but it can only operate if it has sufficient cash in the bank to pay its bills.

For example, someone who runs an office furniture store will have to purchase stock in advance. If they pay £250 in cash for a table and sell it to a business customer for £500 on credit they will make a gross profit of £250. This is the difference between the cost price of the item and its selling price. However, the business can only benefit from this profit when, and if, the customer actually pays for the goods. The cash flow forecast would predict that the money will be paid 30 days after the invoice but if the customer fails to pay, the cash will not be available for the business to spend.

Late payment is a big issue, especially for small firms, so it is important to have processes in place for chasing payment of invoices on a regular basis. See BIF422 Credit Control for more information.

The need for working capital

In the example above, the office furniture business paid £250 to its supplier, but it also needs to fund the daily costs incurred in running the business and paying for further stock. If these costs amount to £200, the business needs a total of £450 to operate the business before the customer pays. This is the 'working capital' required by the business and equates to the cash needed to fund its day-to-day operations. If a business does not have the cash available to fund its day-to-day operations it may need to seek additional finance, such as a bank loan or overdraft, or seek alternative methods of funding the business.

Cash cycle

The cash cycle is a term used to describe the connection between working capital and cash movements in and out of a business, and is usually measured in days or months. Small firms typically purchase goods and services before they are in a position to make a sale to their customers, particularly firms in manufacturing and retail.

A business may buy raw materials from its suppliers on one month's credit terms and then hold them in store for one month until they are used by the production department. This production cycle is very short, but the finished goods may be held for one month before they are sold. If customers usually take two months to pay their invoices, this means there would be a gap of three months between the business paying its suppliers for the raw materials and receiving cash from its customer (debtor):

The cash cycle would be:

	Months
Raw material stock turnover period	1
Less: credit taken from suppliers	(1)
Finished goods stock turnover period	1
Debtors' payment period	2
Cash cycle	**3**

Table 2

For example, if the business purchases its raw materials on 1 January, the sequence of events would be as follows:

Event	Date
Purchase of raw materials	1 January
Issue of materials to production (one month after purchase)	1 February
Payments made to suppliers (one month after purchase)	1 February
Sale of finished goods (one month after production begins)	1 March
Receipt of cash from customer (two months after sale)	1 May

Table 3

The cash cycle is the period of three months from 1 February, when payment is made to suppliers, until 1 May, when cash is received from the customer. This will determine the amount of working capital required by the business.

If a business can shorten its cash cycle, it can reduce the amount of money needed to fund its working capital.

How to set up a cash flow forecast

A variety of methods can be used to set up a cash flow forecast:

- Manual preparation.
- Spreadsheets.
- Forecasting tools.
- Accounting software.

The most common method is to use a standard spreadsheet, which makes it easy to change the numbers to amend and refine the forecast.

There are seven key steps to take when setting up the forecast:

- **Step 1** - Produce a sales forecast for the next 12 months. Estimate the split of credit and cash sales and the credit period taken by customers so that sales receipts are put in the correct month.
- **Step 2** - Establish whether any other cash will be received. This includes money invested in the business, as well as loans and grants if applicable.
- **Step 3** - Determine the goods/stock that needs to be bought in order to reach the sales forecast. Suppliers may want to receive cash payments with the order upfront, but after a month or two may be willing to set up a trade account and the business would then be able to settle its bills after 30 days.

- **Step 4** - Identify any other regular monthly cash payments. These include payments of salaries, marketing costs, operating costs, vehicle running costs and any other sundry expenses.

- **Step 5** - Identify any one-off expenditure, such as fixed asset purchases.

- **Step 6** - Set out the cash flow forecast month by month for a full year. Always ensure the figures correspond to when payments are expected to be made.

- **Step 7** - List any assumptions as a reminder of how the figures in the forecast have been reached. For example, the payment terms and length of the cash cycle.

Reviewing the forecast

It is important to review a cash flow forecast on a regular basis, and at least monthly. At the end of each month the forecast should be compared with what has actually happened in the business.

In the cash flow forecast in Table 4, the difference (variance) between the forecast and actual receipts and payments has been recorded. Where the actual value recorded is worse than the forecast value, this is shown as a figure in brackets.

Cash flow forecast	January			
	Forecast	Actual	Variance	Notes
Receipts				
Sales receipts	£2,000	£5,500	£3,500	Early payment discount offered to customers
Other income	£10,000	£10,000	-	Start up capital
Total receipts	£12,000	£15,500	£3,500	
Payments Purchases	£7,000	£11,000	(£4,000)	Credit accounts slow to establish with suppliers.
Wages	£3,000	£3,000	-	
Office expenses	£2,000	£3,000	(£1,000)	More sundry items needed than expected.
Finance and tax	£0	£300	(£300)	Overdraft arrangement fee from bank.
Capital expenditure	£3,000	£2,500	£500	Negotiated better deal on office furniture.
Total payments	£15,000	£19,800	(£4,800)	
Net cash flow	(£3,000)	(£4,300)	(1,300)	
Opening cash balance	£0	£0	–	
Closing cash balance	(£3,000)	(£4,300)	(£1,300)	

Table 4

The actual cash flow figures should be compared against the forecast figures. If there are significant differences, the cash flow forecast should be updated to reflect any changes in assumptions, such as about how quickly customers will pay, or how soon suppliers need to be paid.

Hints and tips

- It can be useful to use 'what if' scenarios when creating a cash flow forecast. For example, what would happen to cash flow if sales were 10% higher or lower than the forecast?
- It is important to be cautious when forecasting, especially in the first few months of trading. It is better to expect slow payment by customers and receive the cash more quickly.
- Any business should aim to have a contingency reserve of cash to cover unexpected costs or a sudden shortfall in receipts.
- A monthly forecast does not take account of timing factors within each month. During a month that shows a small positive cash balance at the start and finish of the period, a business may suffer a large negative balance in the middle of the month if a large payment has to be made before sales income has been received.
- It can be useful to talk to an accountant or bookkeeper as early as possible to make sure the cash flow forecast has covered all the potential incomings and outgoings of the business.

Further information

BIF004 Writing a Business Plan
BIF030 How to Keep a Manual Cash Book
BIF038 Choosing and Using an Accountant
BIF040 Sources of Finance for Starting a Business
BIF051 Controlling Costs
BIF054 Costing and Pricing a Product or Service
BIF067 Establishing a Trade Credit Policy
BIF234 An Introduction to VAT (Value Added Tax)
BIF236 How to Forecast Sales
BIF422 Credit Control

Useful contacts

ICAEW (The Institute of Chartered Accountants in England and Wales) is a professional body representing chartered accountants. There is a searchable directory of accountants on its website.
Tel: (01908) 248250
Website: www.icaew.com

ICAS (The Institute of Chartered Accountants of Scotland) is a professional body representing chartered accountants. Its website includes a directory of Chartered Accountants in Scotland.
Tel: (0131) 347 0100
Website: www.icas.com

Chartered Accountants Ireland represents accountants in Ireland and offers a 'Find a Chartered Accountant' directory on its website.
Tel: (028) 9043 5840 (Northern Ireland office)
Website: www.charteredaccountants.ie

The Institute of Certified Bookkeepers (ICB) is a professional body representing bookkeepers and offers a 'Find a Bookkeeper' directory on its website.
Website: www.bookkeepers.org.uk

Cobweb Information Ltd, YBN, 7 & 8 Delta Bank Road, Metro Riverside Park, Gateshead, NE11 9DJ. Tel: 0191 461 8000 Website: www.cobwebinfo.com