

# 5.2

## BUDGETING; CASH FLOW FORECASTS

- Introduction To Budgets And Cash Flow Forecasts
- Cash Flow Forecasts
- Budget And Cash Flow Exercises
- Cash Flow Exercises

# INTRODUCTION TO BUDGETS AND CASH FLOW FORECASTS

A cash flow forecast shows the anticipated income and expenditure of the business and resulting surplus or shortfall which will occur each month. While a thorough knowledge of your business profitability is vital, it is even more important to know the state of the business cash flow i.e. where your money is, where it is coming from and where it is going to. Many businesses fail because they fail to control their cash flow.

## Reasons For Producing A Cash Flow

A cash flow can be used as follows:

- It establishes how much money is needed and when it will be needed
- It helps to ensure that capital expenditure is properly controlled (e.g. the 'what if' situation)
- It encourages efficient use of resources through budgeting and the analysis of over and under spending
- It helps with facing facts and decision making

Remember, as this forecast monitors cash movements, the figures must include VAT, whether or not you are VAT registered and some income and expenditure will be treated differently from the profitability forecast.

## Notes On Producing Cash Flow Forecasts:

- Estimate the money to be received each month. These figures should be directly related to any agreed payment terms i.e. sales created in January may generate a payment in March
- Show money introduced by the partners or shareholders as capital
- Include grants, etc.
- Calculate total of all receipts expected
- Estimate the money to be spent each month. These figures should be directly related to the timing of payment for goods and service i.e. sales created in January may have generated material costs in the previous November
- Remember payments that are made on a monthly or quarterly basis e.g. telephone. Spread your payments to even out cash flow
- Do not show any rent/rates/power costs, unless these relate to premises specifically taken for the business
- Show all significant expenditure items separately and remember to include, where appropriate:
  - Commissions and other bank charges
  - Repayment of bank loans and interest
  - Repayments to be made on hire purchase or other similar finance agreements
  - Purchases of plant, machinery, tools etc. (whether new or second hand)
  - Your drawings

Should you show a significant negative closing balance in successive months after taking into account any initial capital injection, you will need to review your assumptions or, alternatively, consider how you will find the shortfall.

The cash flow is probably the single most important document in your business plan - it is the document that will receive the most scrutiny by any investor or lender. Some examples of income and expenditure are given below.

## Income - Sales

Income from sales is the most important source of income and the most difficult to estimate. Two of the things you should bear in mind when trying to estimate your monthly sales figures are the age of your business and seasonal variations. If you are a new business you will need time to build up your trade. Your sales forecast should reflect this. It is advisable to begin with low monthly figures i.e. be conservative or 'realistic'.

You should separate cash sales and cash from debtors.

### Cash

Cash from sales is cash you would expect to receive immediately after you sell your products. If your business is a shop, for example, most of your sales will be cash ones. If you are registered for VAT enter the figures you would expect to receive including VAT. In this context 'cash' includes cheque and credit card payments.

### Debtors

If you sell your product or service but will not receive payment at once, either because you have sent out invoices or have agreed a credit facility, you will have to allow for this. These customers who owe you money are known as debtors. You should aim to get payment for your invoices as quickly as possible, but most of your customers will expect to delay payment of your invoice by at least one month. It is the month in which you expect to receive the money that is most important, not the date you expect to sell the product. Again, if you are VAT registered enter the figure you expect to receive inclusive of VAT.

### Other Income

Apart from sales there may be other sources of income that flow into your business:

**Personal savings** : Any money you are going to invest from your own savings

**Grants** : If you expect to receive any grants enter the amount you expect to get

**Loans** : Loans may come from other people or organisations such as banks or specialist social enterprise loan funds

## Outgoings Or Expenditure

### Stock And Raw Materials

The stock figure should include initial stock purchases and the subsequent replenishment of stock. The stock figure should bear a direct relationship to the sales figures i.e. if you buy an item for £25 and intend to sell it for £50. Then the stock should represent 50% of sales. A distinction needs to be made between your cash purchases and your credit purchases.

**Cash :** This is straightforward entry if you have to pay cash immediately for purchases from suppliers. The figure will be entered in the month of purchase.

**Credit :** It is the month you expect to pay your suppliers which is more important, not the month you bought the supplies. Remember the longer you delay paying supplier's invoices, the better it can be for your cash flow. A realistic assumption for your cash flow will be that you will not have to pay your supplier's invoices until one month after you receive them.

### Rent

Enter the amount of rent you will pay in the months you will have to pay it. Some landlords expect three months rent in advance.

### Business Rates

Enter the amount of the business rate in the month(s) when you expect to pay it. Do not forget you can opt to pay your rates monthly over a ten month period.

### Heating/Lighting

These bills will be paid quarterly in arrears. As with domestic bills you may be able to delay payment by up to one month.

### Insurance

Decide what insurance's you will need for the business and establish how much they will cost. If you can spread payments, do so.

### Vehicle Costs

When estimating your vehicle cost include not only the actual cost of the vehicle, (if on hire, purchased or leased) but also all the other costs e.g. road tax, insurance, repairs, renewals, petrol, etc. If purchased outright, see 'capital allowances' under taxation.

### Loan Repayments

Most bank loans are repaid by fixed monthly amounts spread over an agreed period. The interest rate may be either fixed or varied depending on the agreement you make with the bank. Remember to include interest payable in your cash flow.

### Bank Charges And Interest

Bank charges will vary depending on the usage of the account. If your cash flow shows an overdraft requirement then include the interest charges on the overdraft and the arrangement fee. Where possible, try to negotiate a period of free banking.

### Professional Fees

Obtain quotes from professional organisations such as solicitors, accountants, etc. for any professional work required and build into your cash flow the cost of their services based on their quotations. Try and negotiate the timing of payments to suit your business. This could take the form of a retainer.

### Capital Equipment

Make a list of all the equipment required to run your business then obtain prices for all items. Establish what you need to obtain at the outset and what could be bought later on in the year then budget accordingly. Consider the options of obtaining these items by outright purchase, hire purchase, leasing, etc. One advantage of hire purchase and leasing is that the cost can be spread over a specified period and this can aid your cash flow. The interest incurred has to be considered.

### Wages (If Appropriate)

Make a list of the staff that will be required and work out what is an acceptable wage to pay them. Build the wage cost into your cash flow and do not forget to add the cost of national insurance.

### Stationery/Printing

Include into your cash flow the costs of all stationery and printing requirements for the rest of the year.

### Telephone/Fax

Include telephone and fax charges for the year. Remember to build in extra costs for the initial installation. The cost should also include rental charges.

### Advertising, Promotion, Marketing And PR

The amount allocated for this should correspond to your marketing plan. Do not underestimate these costs as there will be a direct relationship between this item and your sales.

### Consumables/Miscellaneous

These are costs made up of all the other expenditure that you are likely to incur e.g. toiletries, tea, coffee, stamps, etc.

### VAT

If you are VAT registered, calculate the VAT you will charge your customers in any three month period and the VAT you will have to pay on your purchases and expenses. Calculate the difference between the two - this is the amount you will have to pay to H.M. Revenue and Customs (HMRC) with your VAT return.

## Interpreting The Cash Flow

Once your receipts and expenditure have been estimated for each month of the year, you will then be in a position to establish your cash flow and interpret what it is telling you. The cash flow should show the monthly totals for:

- Total inflow i.e. the sum of all the income received for each month
- Total outflow i.e. the sum of all expenditure incurred for each month
- The net cash flow i.e. the difference between your total income and total expenditure
- The opening balance each month
- The closing balance each month

## Opening Balance

This shows how much should be in your business bank account at the start of the month. When starting up you should put the figure of available funding or capital into the cash flow as its 'opening balance'.

## Closing Balance

Work out the closing balance for the month by adding any opening bank balance to the total receipts and deducting from this the total payments figure. The closing bank balance becomes the opening bank balance automatically at the start of the next month. The closing balance figure for each month is very important: if it's a minus figure it means you may have to make use of an overdraft facility or plan a sales drive for the months preceding it to avoid 'going into the black'. The cumulative figure tells you whether your bank balance gets bigger or smaller over a period of time and highlights the duration of any borrowing requirements.

## Assumptions

When preparing a cash flow, you should provide details to explain any figures in the cash flow which are not self explanatory, for instance what calculations are your sales figures and prices based on? Remember that while you may understand all the ins and outs of your business, another reader may not.

# CASH FLOW FORECASTS

## 1 : The Future

A cash flow forecast looks to the future. It allows you to forecast what will come into the business and when. It predicts when bills will have to be paid, and allows you to set aside money to budget for that.

## 2 : Budgeting

A cash flow forecast is a budget. If you record the real figures (the 'actual') next to your predictions, you will be able to see how you're doing, and whether you need to change your actions - either increase trade or slow it down to match your expectations.

## 3 : When Things Happen

'When' things happen is all important in the cash flow; write down when you expect to receive money, for instance, not when the goods go out. If you buy equipment in May and expect to pay for it in June, for instance, the figure goes in the 'June' column, not May.

## 4 : Isn't It All Guess Work?

Most of the figures you write down will be guesses. However, you may have good reasons for arriving at them. For instance, next year's heat and light bills may be similar to last year's, (if the business hasn't expanded much), and the wages may be how much you've already agreed to pay. If figures need explaining, add 'Notes' to the cash flow, so that the reader (a Bank Manager, for instance) can understand your reasons. For instance, a figure of £100 for

'Travel' may be based on using a certain van, doing a particular number of miles per month, and allowing annual figures for insurance and maintenance. Explain this.

## 5 : Income

'Income' has to include all in-goings, whether donations, sales, grants or loans. If this is your first year of operation, you may wish to put 'start up' costs before the first month's column; otherwise, put it in with the other first month in-goings. Income may vary from month to month: trading may be seasonal, also, trade may build up in time.

## 6 : Expenditure

'Expenditure' covers everything you have to pay out. The biggest item is usually 'stock', though it may be called 'cost of sales' or 'cash purchases'. The other main items are wages and costs of running premises.

## Remember

- If sales go up, costs usually go up also
- Some bills are paid monthly, some quarterly, some annually
- Seasonal factors: e.g. fuel bills go up in winter!
- Loan repayments usually include interest too
- Depreciation is an expense (cost of replacing equipment)
- 'Drawings' are your own minimum income, not staff wages

# BUDGET AND CASH FLOW EXERCISES

## Exercise 1 : Income And Expenditure Budget

Budgeting involves two processes: predicting income and expenditure in a particular period and allocating available finance to meet current and future needs. Community-based projects usually do this on an annual basis for the year ahead, but rarely analyse expenditure while it is happening. They exercise only limited control of their finances.

Draw up two budgets for the Wood 'N' Tops project (one for Year 1, the other for Year 2) based on the following information, using the sheet provided.

### Year 1 (Costs Per Year)

#### Staff Costs

2 part-time workers get £3,000 in wages, inclusive of employer's national insurance. It makes volunteer payments of £1.50 to 50 trainees an average of 6 times per month in the 8 months beginning September. It pays £3 per day expenses to a volunteer joiner who trains 20 days per month for 6 months beginning in September.

#### Office Costs

Stationery : £200  
Postage : £180  
Telephone Rental : £80  
Telephone Calls : £240  
Printing : £120

#### Utilities

Gas : £160  
Electricity : £300  
Water Rates : £0

#### Premises Costs

Rent : £1,200  
Rates : £80  
Repairs : £100  
Painting : £200  
Insurance : £250

#### Travel Costs

The project runs a van to collect free and other furniture. It costs £500 for diesel; £300 insurance and tax; £200 repairs and tyres.

#### Equipment Costs

New Equipment : £300  
Repairs : £50

#### Advertising And Promotion

The project advertises monthly in a local newspaper costing £20 per month. It holds an Open Day each year with a budget of £200.

#### Legal And Professional Costs

Solicitor : £0  
Accountant : £200

#### Petty Cash

Beverages : £100  
Postage : £40  
Miscellaneous : £100

#### Income

Furniture Sales : £3,000  
Grant : £11,000  
Donations : £200  
Removals : £800

### Year 2 (Costs Per Year)

All costs rise 10%. To balance income and expenditure, how much must the grant be increased to?



## Income And Expenditure Budget

	Year 1	Year 2
<b>Income</b>		
Furniture sales		
Grant		
Donations		
Removals		
<b>Total</b>		
<b>Expenditure</b>		
Wages and national insurance		
Volunteer payments		
Trainer		
Stationery and printing		
Postage and telephone		
Heat and light		
Rent and rates		
Repairs and painting		
Insurance		
Operating van		
New equipment and repairs		
Advertising and promotion		
Accountant		
Miscellaneous		
<b>Total</b>		
<b>Income/Expenditure</b>		
<b>Surplus/Deficit</b>		

Answers can be found in the appendix on page 416

## Exercise 2 : Cash Flow Forecast

A budget can tell you how much money you should be allocating to a particular kind of expenditure in any period. But it cannot tell you **when** expenditure occurs or income is received. This is the job of the **cash flow forecast**.

Draw up a cash flow forecast using the information provided for year 1 **only**.

- 1 : The financial year begins in April.
- 2 : Grant is paid quarterly in arrears.
- 3 : Workers are paid monthly throughout the year. Volunteer payments occur 6 times a month for 8 months beginning in September. The joiner trains an average of 20 times a month for 6 months beginning September.
- 4 : Stationery purchases occur twice a year in January and July. Postage is £15 per month. Telephone rental is paid quarterly in advance beginning in April. Telephone bills are an average of £60 per quarter, paid in arrears. There is a one-off bill for printing in November.
- 5 : Gas and electricity are paid quarterly in arrears.
- 6 : Rent is paid monthly. Rates are £10 per month starting in June. Repairs are done in January, painting in July. Insurance is paid in May.
- 7 : The project has a diesel account. They pay quarterly in arrears. Tax and insurance is paid in March. Repairs occur in February.
- 8 : The project is buying a jig saw for £300 in August. It will need to be repaired in December.
- 9 : The project advertises in a local newspaper costing £20 per month. The Open Day is in July.
- 10 : The accountant is paid in March.
- 11 : There is an allowance of £20 per month for petty cash.
- 12 : The project earns £300 per month from furniture sales September - May, £100 per month June - August and a donation of £200 in October.

Answers can be found in the appendix on page 417

# CASH FLOW EXERCISES

## Exercise 1

Draw up a cash flow forecast for the Wood 'N' Tops furniture project for 'Year 2', using the 'Year 1' figures from the budgeting exercise but with the following changes for 'Year 2':

**Sales** will increase in value by 5% per quarter beginning in April

**Grant** will be cut to £5,000 per year

**Diesel** costs will increase 10% beginning April

**Utilities** costs will increase 10% beginning June

**Wages** costs will increase 7% beginning August

**Volunteer payments** will be made to 50 trainees, 10 days per month for 9 months beginning in September

**Volunteer joiner** will receive £5 per day, 15 days a month for 6 months

What is the financial position of Wood 'N' Tops now?

Does it have a deficit at the bank?

When is the first month this occurs?

## Exercise 2

Wood 'N' Tops has decided it must generate new income for the project. It has asked the finance committee (trainees) to draw up a cash flow forecast based on the following assumptions:

**New equipment** will be bought in April costing £5,000, requiring a bank loan of £5,000 available from April

**Bank loan** will cost £5,766 over 3 years (£167 per month capital repayments for 30 months, £21 per month interest repayments for 36 months)

**Capital repayments** begin in month 6 while **interest repayments** begin April

**New income** of £1,700 per month will begin in August

Has the financial position of the project improved?

Does the project have a positive balance at the bank?

When does this occur?