Cash flow forecast

What is a cash flow forecast and why is it important?

A cash flow forecast is a part of an enterprise's financial forecast. It seeks to anticipate cash movements into the future and is therefore of considerable importance. Management of cash is the single most important aspect of any organisation's financial management. If an organisation runs out of cash it will cease to exist.

If there is a choice between producing a cash flow forecast or a profit forecast it should be the cash flow forecast that you prioritise. However, it is best practice to do both. The information shown on the two forecasts differs and both are required to understand how well an enterprise will perform in the future.

What are the differences between a profit and cash flow forecast?

A profit forecast tests the assumption that the trading activities of an enterprise will be profitable and sustainable in the long term. It allows the entrepreneur, stakeholders, supporters and most importantly potential funders, to conclude whether the enterprise will be able to deliver what it claims and whether it is worth supporting.

The cash flow forecast identifies the timing of cash movements in and out of an enterprise. This helps to identify the funding required for the enterprise to deliver the profit forecast. It takes into account the initial funding to start the enterprise or project and identifies future cash requirements to cope with shortfalls due to trading or seasonal fluctuations.

It also allows the identification of cash resources required to support, or scale up, trading activities through the purchase of fixed assets or recruiting more staff etc.

What are the causes of these differences?

There are a number of causes for the differences between the two types of forecast. The main ones are:

- Timing differences
- VAT
- Treatment of capital expenditure
- Treatment of loans
- Treatment of investments
- Treatment of corporation tax

Timing Differences

A profit forecast reflects when you project that a sale or asset will be created and when a purchase or liability will be created. This is when you predict that you will deliver a service or product and invoice your customer for payment.

Similarly, you may be on the receiving end of a request for payment for goods or services (a liability).

In reality, you do not receive money as soon as you issue an invoice, nor do you pay out as soon as you receive a request for payment (informed of a liability). This leads to a timing difference between the profit forecast and the cash flow forecast. The latter reflects the most likely time that there will be a movement of cash.

Examples of cash flow timing differences

- Cash receipts (cash flow forecast) may lag behind the income (in the profit forecast) by one or more months (reflecting the reality of commercial operations).

- Similarly, you may well settle liabilities later than the date incurred in the profit forecast.
- The cash flow should reflect the actual payment month of utilities, e.g. quarterly in advance or arrears. These liabilities may be shown in a different phasing on the profit forecast. It is common practice to show utility payments equally across the year in the profit forecast.
- Timing differences may also affect other liabilities such as insurance, professional fees, business rates, audit and accountancy fees etc.

See the profit and cash flow illustration below

VAT

VAT impacts the cash flow forecast but is not included in the profit forecast. The reason for this is that VAT is collected on behalf of HM Revenue & Customs and is not a trading activity and so is excluded from the profit forecast. So your profit forecast ignores VAT but the cash impact has to be shown in the cash flow forecast (see **the illustration below).**

Capital expenditure

Purchases of fixed assets or items of capital expenditure are shown as incurred in the cash flow. However, these are not shown in the profit forecast. The reason for this is that capital expenses have a long term use and the profit forecast attempts to show the cost of using these items for the benefit of the business over the expected life of the asset.

For instance, a PC may be expected to last three years so the profit forecast will show the cost of the PC purchase spread over that period. This is done by introducing an expense line in the profit forecast called depreciation. Depreciation is excluded from the cash flow as the cost of the capital item has already been captured in there. (See **the illustration below).**

Loans

Loans are not trading items, i.e. they are not something generated because of your enterprise activity. For this reason they are excluded from the profit forecast as are any repayments that are made. Another way of looking at this is that the loan is not your money but belongs to the lender. So the loan and the repayments will only be included in the cash forecast. (See **the illustration below).**

Investments

Investments are treated in the same way as loans. They appear in the cash forecast only. (See **the illustration below).**

Corporation tax

If your enterprise is starting to generate profits your profit forecast should reflect the tax liability for each month that there is a profit. However, corporation tax is payable up to nine months after the year end. So the cash flow will only show the cash impact of corporation tax in the following year. (See **the illustration below).**

The various differences between the cash forecast and the profit forecast are captured in a balance sheet. Money not received is included as a debtor; money not paid is included as a creditor. (Read our guide on Balance sheets for further information).

Profit and cash flow example

The example overleaf shows how the profit forecast and cash forecast can be quite different and give a more rounded picture of how an enterprise is going to operate into the future:

Profit forecast

Income	Jan	Feb	Mar	Apr	May
Sales	10,000	5,500	7,000	16,000	10,000
Expenditure					
Salaries	3,000	3,000	3,000	3,000	3,000
Employers NIC	360	360	360	360	360
Subcontractors	2,000	1,000	1,400	3,200	2,000
Utilities	500	500	500	500	500
Depreciation **(9)**	250	250	250	250	250
Total Expenses	6,110	5,110	5,510	7,310	6,110
Profit/(loss) before tax	3,890	400	1,490	8,690	3,890
Tax (illustrative)	(1,167)	(120)	(447)	(2.607)	(1,167)
Profit after tax	**2,723**	**280**	**1,043**	**6,083**	**2,723**
Cumulative Profit	**2,723**	**3,003**	**4,046**	**10,129**	**12,852**

Cash flow forecast

Income	Jan	Feb	Mar	Apr	May
Investment received **(1)**	25,000				
Loan **(2)**	10,000				
Cash received **(3)**			10,000	5,500	7,000
VAT **(4)**			1,750	963	1,225
Total Cash received	**35,000**	**0**	**11,750**	**6,463**	**8,225**
Salaries (net) **(5)**	2,100	2,100	2,100	2,100	2,100
PAYE & NIC **(6)**		1,260	1,260	1,260	1,260
Subcontractors **(7)**		2,000	1,000	1,400	3,200
Utilities **(8)**	1,500			1,500	
Fixed asset purchase **(9)**	15,000				
VAT **(10)**	2,888	350	175	508	560
HM Customs & Excise **(11)**				(1,663)	
Loan repayment **(12)**		500	500	500	500
Total cash expenditure	**21,488**	**6,210**	**5,035**	**5,605**	**7,620**
Cash movement in month **(13)**	13,512	(6,210)	6,715	858	605
Opening cash balance **(14)**	0	13,512	7,302	14,017	14,875
Month end cash balance	**13,512**	**7,302**	**14,017**	**14,875**	**15,480**

1. Investment – this only impacts the cash flow and not the profit forecast.
2. Loan - this only impacts the cash flow and not the profit forecast.
3. Cash received – here the customers are paying two months after the sales invoice is issued.
4. VAT – The enterprise is registered for VAT so it will have charged VAT to its sales (which is not shown in the profit forecast) so when the cash is received it includes VAT at 17.5%.
5. Salaries - are paid in the month incurred but only the net amount, i.e. they exclude PAYE. The amount shown is what your employees actually receive.
6. PAYE & NIC – theses are paid to HM Revenue & Customs on the 19th of the following month.
7. Sub contractors – these are paid the month after the receipt of an invoice from them.
8. Utilities – in reality, utilities are paid quarterly in advance – so here it is shown that three months worth of utilities are paid every quarter.
9. Fixed asset – this has a cash impact only; the profit forecast shows depreciation which has no cash impact.
10. VAT – VAT is payable on the payments to sub contractors, utilities and fixed asset purchases. VAT on expenditure does not impact on the profit forecast.
11. HM Customs & Revenue – VAT is accounted to the tax authorities quarterly. So the VAT received is netted off against VAT paid for January, February and March. The difference, in this case a recovery from HMRC, is shown as a cash receipt.
12. Loan repayment – as with loans received this has a cash impact only and does not appear in the profit forecast.
13. Cash movement – this is the difference month by month between the cash received and the cash spent.

14. Opening cash balance – here we are assuming that the enterprise has no cash to start with and the investment and the loan have allowed it to start trading. The monthly cash movement plus the opening cash balance gives the monthly cash balance. The previous month's closing cash balance is the current month's opening cash balance.

Further information

Read our guide on Balance sheets:
www.bllondon.com/SocialEnterprise/Fundingandfinance/Financialplanning/Balancesheets.aspx

Read our guide on Profit forecasts:
www.bllondon.com/SocialEnterprise/Fundingandfinance/Financialplanning/Profitforecasts.aspx