3.4 Cash flow

Name: _____ Class: _____ Date: _____ **Total: 20 marks**

KEY WORDS cash-flow forecast • working capital • net cash flow • closing balance • overtrading • liquidity

Objective

Build the skills to answer exam questions on **cash flow** : the difference between profit and cash, the working capital cycle, **cash-flow forecasts** , and strategies to deal with cash-flow problems.

You must be able to:

- explain the difference between profit and cash
- explain the working capital cycle
- construct and interpret a cash-flow forecast
- explain the causes of cash-flow problems
- evaluate strategies to improve cash flow and to deal with a cash-flow problem

1 Key knowledge and worked examples

■ Cash flow

Profit = revenue − costs over a period; **cash** is the money the firm actually has. A firm can be **profitable but short of cash**, e.g. if customers pay on credit, or it spends heavily on stock or equipment. A firm that runs out of cash can fail even when it makes a profit. **Overtrading:** growing too fast, so cash runs out paying for stock and wages before customers pay.

Working capital = current assets − current liabilities. **Working capital cycle:** cash → buy materials → make goods → sell (often on credit) → receive cash. The longer the cycle, the more cash is tied up.

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Cash-flow forecast: a month-by-month estimate of cash coming in and going out.

row	meaning
cash inflows	cash sales, payments from debtors, loans, owner's capital
cash outflows	wages, rent, stock, loan repayments, equipment
net cash flow	inflows − outflows
opening balance	last month's closing balance
closing balance	opening balance + net cash flow

Causes of cash-flow problems: overtrading, giving customers too long to pay, poor stock control, seasonal demand, unexpected costs, falling sales.

strategy	example	drawback
reduce outflows	delay payments to suppliers, lease instead of buy, cut costs	suppliers may refuse credit; quality may fall
improve inflows	shorter credit for customers, cash discounts, sell surplus stock	customers may go elsewhere; lower margins
find extra finance	overdraft, short-term loan, sale and leaseback, owner's funds	interest costs; loss of assets

Answer shapes: fill in the forecast row by row → identify the problem months → match a strategy to the cause → judge.

2 Practice

2.1 Distinguish between cash and profit. [2]



2.2 Define **working capital**. [2]

current assets – current liabilities

2.3 Complete the cash-flow forecast: find the net cash flow and the closing balance for each month. [4]

$	January	February	March
cash inflows	12 000	10 000	8 000
cash outflows	14 000	9 000	13 000
net cash flow			
opening balance	5 000		
closing balance			

2.4 Explain **one** reason why a profitable business may run short of cash. [2]



3 Exam-style questions

3.1 Harbour Café is a seaside café. Its cash-flow forecast for the winter is shown ($). In December it plans to buy a new oven for $3,000. In winter there are few tourists.

Discuss how Harbour Café could deal with its forecast cash-flow problem. [10]

$	Oct	Nov	Dec	Jan
cash inflows	9 000	6 000	7 000	4 000
cash outflows	8 000	8 000	11 000	8 000
net cash flow	1 000	−2 000	−4 000	−4 000
opening balance	4 000	5 000	3 000	−1 000
closing balance	5 000	3 000	−1 000	−5 000

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Solutions

Marking: **M1** a correct method, **A1** the correct answer, **B1** an independent mark.

Each answer shows the steps, then the **result**.

2.1

cash: the money actually held by the business or in its bank account at a point in time; profit: revenue minus costs over a period, which may include sales on credit not yet paid

2.2

current assets minus current liabilities; the money available for day-to-day running of the business

2.3

net cash flow: January −2 000, February +1 000, March −5 000; closing balance: January 3 000, February 4 000, March **−1 000**

2.4

e.g. it sells on credit, so revenue is counted as profit before cash arrives / spends heavily on stock or equipment / overtrading; explained: outflows (wages, suppliers) must be paid before cash from customers comes in

3.1

award up to [10]: the closing balance becomes negative in December (−1 000) and worse in January (−5 000); causes: seasonal fall in sales; the oven purchase; delay or lease the oven: removes the $3,000 outflow, but may limit menu or raise long-term costs; overdraft for the winter months: flexible and repaid in summer, but interest costs; cut outflows: fewer staff hours or a shorter opening time in winter, but may lose regular customers; raise inflows: winter promotions, events, takeaway service; negotiate later payment with suppliers; judgement, e.g. delay the oven and arrange a small overdraft, as the problem is seasonal and short-term

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