# 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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