Exercise walk-through

Cash-flow forecasting and working capital ▪ 5.2

eXercise

You must be able to

- explain why a profitable business can run out of cash
- calculate net cash flow and the closing balance
- explain ways to solve a cash-flow problem

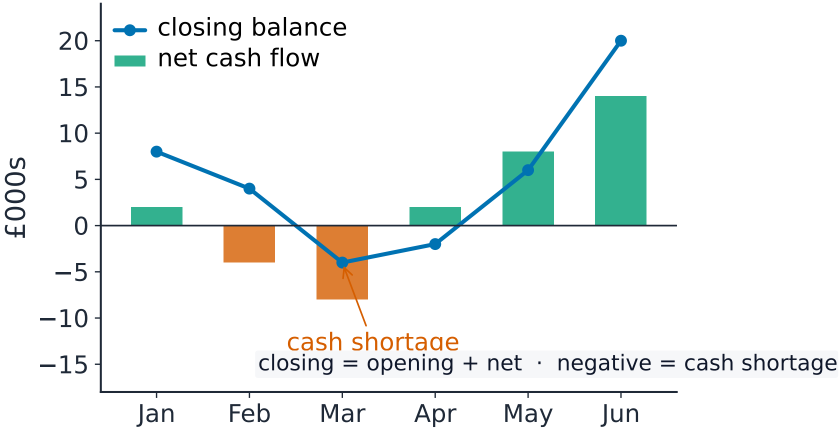
Method — A cash-flow forecast

$$\text{net cash flow} = \text{inflows} - \text{outflows} \qquad \text{closing balance} = \text{opening balance} + \text{net cash flow}$$

- **Worked:** inflows \$15,000, outflows \$11,000, opening \$3,000 $\rightarrow$ net $= \$4{,}000$, closing $= \$7{,}000$.
- **Cash $\neq$ profit:** a profitable firm can run out of cash if customers have not paid yet.
- **Working capital 营运资金** $=$ current assets $-$ current liabilities.
- **Solve a shortage:** arrange an overdraft, delay paying suppliers, ask customers to pay sooner, sell spare assets.

Answer shapes: K + App + An + Ev (a justified judgement, for "do you think" questions).

Method — A cash-flow forecast



A cash-flow forecast warns of a shortage early

Method — A cash-flow forecast

sources of finance

internal
(from inside)

retained profit
sale of assets
owners' savings

external
(from outside)

share capital, loans
overdraft, leasing
trade credit,
crowdfunding

Finance splits into internal and external, short-term and long-term sources

Practice 2.1 ▪ 2 marks

Define the term *net cash flow*.

Solution 2.1

Method: A cash-flow forecast

Worked steps

the difference between cash inflows and cash outflows over a period (2 for a clear definition; 1 for a partial idea).

Practice 2.2 ▪ 2 marks

A month opens with \$5,000. Inflows are \$18,000 and outflows are \$20,000. Calculate the closing balance.

Solution 2.2

Method: A cash-flow forecast

Worked steps

net cash flow $= \$18{,}000 - \$20{,}000 = -\$2{,}000$; closing $= \$5{,}000 + (-\$2{,}000) = \$3{,}000$ (2; award 1 for a correct method with the wrong figure).

Practice 2.3 ▪ 1 mark

State one reason a profitable business might run out of cash.

Solution 2.3

Method: A cash-flow forecast

Worked steps

any one of: customers have not paid yet; too much stock bought; too much spent on assets at once (1).

Exam-style 3.1 ▪ 2 marks

Identify two ways a business could solve a cash-flow problem.

Solution 3.1

Method: A cash-flow forecast

Worked steps

any two of: arrange an overdraft; delay paying suppliers; ask customers to pay sooner; sell spare assets; cut spending $(1 + 1)$.

Exam-style 3.2 ▪ 6 marks

Explain two benefits to a business of producing a cash-flow forecast.

Solution 3.2

Method: A cash-flow forecast

Worked steps

[6] For **each** of two benefits: K 1 + An up to 2 — e.g. *spot a shortage early*: the forecast shows a future shortage → the firm can arrange finance in time → it avoids running out of cash. *Plan and control*: it shows when money is tight → the firm can delay spending. Maximum 3 each.

Exam-style 3.3 ▪ 6 marks

A business has forecast a cash shortage next month. Do you think arranging an overdraft is the best way to solve it? Justify your answer.

Solution 3.3

Method: A cash-flow forecast

Worked steps

[6] Both sides + judgement. **For an overdraft:** it is fast and flexible, covering a short gap until cash comes in. **Against:** it charges high interest, and if the shortage is large or long-term, better solutions are chasing debtors or cutting stock. **Judgement (Ev):** an overdraft is good for a short, small shortage, but a deeper problem needs better working-capital management — it depends on the size and length of the shortage.