Cash Flow Forecasting

Economic Assessment:

- Consider whether the project is the best among other options
- Prioritize the projects so that the resources can be allocated effectively if several projects are underway
- The economic assessment can be done by the following ways:
  - ✓ Cost-benefit analysis
  - ✓ Cash flow forecasting
  - ✓ Various cost-benefit evaluation techniques

We have already discussed about the cost benefit analysis. In this session, we are going to discuss about the Cash flow forecasting.

Cash flow forecasting

As important as estimating the overall costs and benefits of a project is producing a cash flow forecast which indicates when expenditure and income will take place. It estimates overall cost and benefits of a product with respect to time.

- Negative cash flow during development stage.
- Positive cash flow during operating life.

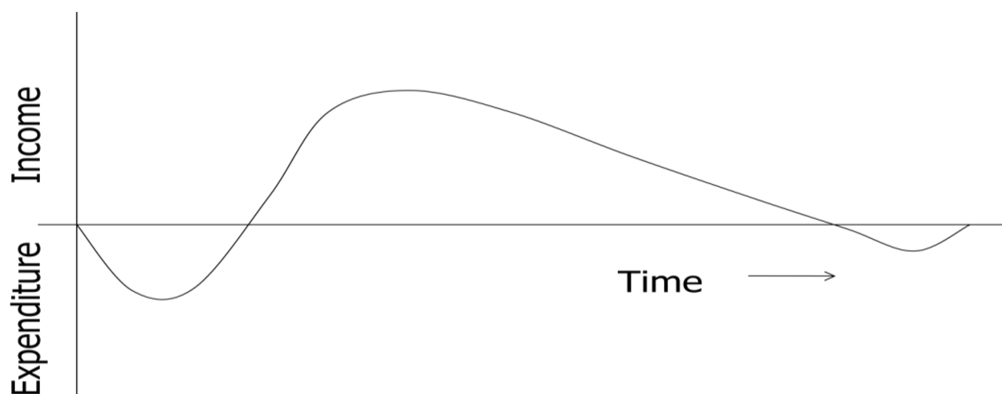
During development stage

- Staff wages
- Borrowing money from bank
- Paying interest to bank
- Payment of salaries
- Amount spent for installation, buying hardware and software

Income is expected by 2 ways.

- Payment on completion
- Stage payment

The difficulty and importance of cash flow forecasting is evidenced by the number of companies that suffer bankruptcy because, although they are developing profitable products or services, they cannot sustain an unplanned negative cash flow.



When estimating future cash flows, it is usual to ignore the effects of inflation. Forecasts of inflation rates tend to be uncertain. Moreover, if expenditure is increased due to inflation it is likely that income will increase proportionately.

Example:

The following table illustrates cash flow forecasts for three projects. In each case it is assumed that that the cash flows take place at the end of each year. Here negative values represent expenditure and positive values represent income.

Year	Project1	Project2	project3
0	-100000	-1,000,000	-120000
1	10,000	2,00000	30,000
2	10,000	2,00000	30,000
3	10,000	2,00000	30,000
4	20,000	2,00000	30,000
5	100000	3,00000	75,000

Cash flow forecasting or **cash flow management** is a key aspect of financial management of a business, planning its future cash requirements to avoid a crisis of liquidity.

Cash flow forecasting is important because if a business runs out of cash and is not able to obtain new finance, it will become insolvent. It is no excuse for management to claim that they didn't see a cash flow crisis coming. So in business, "cash is king". Cash flow is the life-blood of all businesses—particularly start-ups and small enterprises. As a result, it is essential that management forecast (predict) what is going to happen to cash flow to make sure the business has enough to survive. How often management should forecast cash flow is dependent on the financial security of the business. If the business is struggling, or is keeping a watchful eye on its finances, the business owner should be forecasting and revising his or her cash flow on a daily basis. However, if the finances of the business are more stable and 'safe', then forecasting and revising cash flow weekly or monthly is enough. Here are the key reasons why a cash flow forecast is so important:

- Identify potential shortfalls in cash balances in advance—think of the cash flow forecast as an "early warning system". This is, by far, the most important reason for a

cash flow forecast.

- Make sure that the business can afford to pay suppliers and employees. Suppliers who don't get paid will soon stop supplying the business; it is even worse if employees are not paid on time.
- Spot problems with customer payments—preparing the forecast encourages the business to look at how quickly customers are paying their debts. Note—this is not really a problem for businesses (like retailers) that take most of their sales in cash/credit cards at the point of sale.
- As an important discipline of financial planning—the cash flow forecast is an important management process, similar to preparing business budgets.
- External stakeholders such as banks may require a regular forecast. Certainly, if the business has a bank loan, the bank will want to look at the cash flow forecast at regular intervals.

Components that Should be Considered when Developing a Cash Flow

Forecast Development of Cash Forecasting Procedures

Cash forecasting procedures should be developed so that the most current information (such as accounts payable and accounts receivable) is reflected in the forecasts and that the forecasts are as accurate as possible. One component that should be considered is a cheque-clearing system that can derive statistics from the accounts payable system, and the bank clearing data.

Computerized Forecasting System

Information systems should be in place to ensure the current information can be gathered and updated promptly for accurate cash forecasts. Cash management systems and procedures should make use of appropriate and modern administrative practices. Staff involved in these positions should have the ability to work and maintain these systems.

Long-Term Cash Flows

Both short and long-term cash forecasts should be prepared to support short and long term investment decisions. It is important for those purchasing and selling investments to know when to match the maturity dates with the dates of cash requirements or surpluses. The cash forecasting system should provide at least a one-year rolling cash forecast that should be constantly updated for changes. The annual cash flow forecast will be changed to include all cash inflows in addition to outflows.

Variance Reporting of Cash Forecasts

Significant variances between actual and forecasted cash flows should be measured, monitored, and reported on an on-going basis to management. The performance indicators should be included in the appropriate program overview. The variances should be recorded and explained – what caused the variance to happen, along with solutions if required to correct

the variance, and establish actions to avoid a recurrence if required.

Steps to Preparing a Cash Flow Forecast

1. Examine previous years monthly financial data

- For an accurate prediction, previous monthly financial data should be examined when forecasting the succeeding year's potential receipts and disbursements.

2. Design a cash flow work sheet

- Helps organize cash flows through projected receipts and accounts receivable.

3. Consider cash flow receipts

- For new operations (i.e. programs), the average monthly revenues of a similar size municipality or operation in Nova Scotia can be compared as a benchmark.
- For existing operations, receipts from the same month in a previous year, adjusting for any current circumstances for that month in the succeeding year.
- Cash receipts can be predicted by taking into consideration tax bill due dates, tax sale dates, and expected payment dates of transfers from other governments.

4. Consider cash flow disbursements