LET'S GET TECHNICAL

Gareth John turns his attention to cashflow forecasts – and sets a task to test your knowledge

"Great news!" announced my Finance Director in our last board meeting. "Last month we had a record level of invoiced sales." "That's fantastic!" I said. "Let's pay a big bonus to everyone to celebrate." "We can't do that," she quickly replied, "we haven't got enough cash in the bank. Most of those sales haven't actually been paid for yet."

Liquidity
They often say that 'cash is king' in business, and I have certainly always been as interested in the cash position of my businesses as in the profit that they are generating. Businesses that fail often do so because of poor cash flow rather than poor sales, especially if a large proportion of sales are on credit. If you haven't received enough cash from these credit customers you may not be able to pay your rent, your staff or your suppliers, meaning that the business will become insolvent. This cashflow position of a business is often described as its liquidity and is an important aspect of studying AAT.

Cashflow forecasting
One common approach to monitoring liquidity in a business is to draw up regular cashflow forecasts. These differ from profit forecast in that we are not interested in when transactions such as sales and purchases occur, only in when the cash movement either into or out of our bank account happens. This can often be more complex and time consuming and will involve considering both cash receipts (from customers, asset disposals, interest received to name a few) and cash payments (to suppliers, staff, the taxman and the like).

Let's think about how we can deal with the cash receipts from sales made by the business.

Cash versus credit sales
Most businesses will see a split of sales made between those for cash (immediately settled on the date of the transaction) and those on credit terms (settled at a later date). Cash sales will be paid for in the same month as the sale is actually made, with no delay to the cashflow.

So, for example, if total sales in January are £100,000 with 10% for cash and the rest on credit, there would be £100,000 x 10% = £10,000 cash sales (which would be received in January) with the remaining 90% of sales (to make up to 100%), or £90,000 on credit.

Payment pattern of credit sales
Credit sales often then add an extra dimension of complexity in that these customers may pay at different times. Some may pay quite quickly, and some may take far longer, which will delay the cash receipt. From above, if 30% of credit sales pay in the same month as the sale is made, 50% in the month following the sale and the remaining 20% two months after the sale we would end up receiving:

– £90,000 x 30% = £27,000 in January (along with the £10,000 of cash sales)
– £90,000 x 50% = £45,000 in February
– £90,000 x 20% = £18,000 in March

It's worth checking that £27,000 + £45,000 + £18,000 = £90,000 total credit sales.

Dealing with discounts
As a way of encouraging credit customers to pay their balances quickly (which improves the liquidity of the business) they may be offered early settlement discounts. Although this should result in cash being received faster it means that we won't receive the full value of sales made.

Let's say that credit customers settling in the month of the sale receive a 2% settlement discount, it would mean that we actually only receive 98% of the value of the sales being paid for. So in January we would actually only receive £27,000 x 98% = £26,460. Note that we don't need to put the discount allowed of £540 (£27,000 x 2%) anywhere in our cashflow forecast, it's just not included in the cash receipt.

Dealing with irrecoverable (or bad) debts
One of the potential drawbacks of making credit sales is that we may never be paid what the customers owe us. In a similar way to discounts, we just need to reduce the value of cash receipts to reflect any irrecoverable debts.

So let's say we had been told that 30% of credit sales pay in the same month as the sale, 50% in the month following the sale and only 15% two months after the sale – 30% + 50% + 15% only comes to 95%, implying that 5% of sales are irrecoverable. This means that we would end up receiving only £90,000 x 15% = £13,500 in March.

Why don't you have a go at this example task. When you have finished you can see me talk through my solution at www.firstintuition.co.uk/category/aat

The following sales are anticipated by Rosalyn's business over the next five months:

Month 1	£200,000
Month 2	£220,000
Month 3	£240,000
Month 4	£260,000
Month 5	£280,000

Some 20% of sales are made on cash terms with the remaining sales being made on credit. Of these credit sales 20% pay in the same month as the sale, 50% will pay in the following month and 25% will pay two months after the sale was made. All other credit sales are considered to be irrecoverable. The credit customers who pay in the same month as the sale will receive a 5% early settlement discount.

Requirement: Prepare a cash budget for receipts in months 3, 4 and 5 PQ

• Gareth John is a tutor/director with First Intuition and helps to manage their AAT distance learning programme. He was PQ's Accountancy Lecturer of the Year in 2011