Ten things you need to know about cash flow

Ian Marcousé provides a framework of ten concepts for your finance revision

1 Cash inflow

The flows of cash into the firm's bank account that come from cash sales and the settlement of bills from customers who receive credit.

Example: Supergroup plc sells Superdry clothes through its own shops for cash and sells to retailers such as Debenhams and House of Fraser on 60 days' credit. In addition to cash and credit sales, cash inflows can arise from: selling assets for cash, cutting stock (inventory) levels, getting a medium-term bank loan and getting a new injection of share capital investment.

Advantage: the higher the cash inflow, the more quickly negative cash balances can be eliminated — bringing the business from 'in the red' to 'in the black'.

Disadvantage: even if cash inflows are high, that's no help if cash outflows are higher. Ultimately, net cash flow is a more important matter.

2 Cash outflow

The flows of cash from the firm's bank account: paying suppliers, paying the wage bill, paying utility bills such as electricity and water and paying one-off costs for decoration, equipment or machinery.

Example: having taken out a loan 3 years ago, it may be time for a company to repay the bank. This might entail a £500,000 cash outflow over and above usual monthly outflows. Failure to find the cash might result in court action and insolvency.

Advantage: cash outflows can be tightened by tougher negotiations with suppliers, e.g. getting them to agree to wait longer to be paid.

Disadvantage: if the business allows cash outflows to move ahead of cash inflows, net cash flow will turn negative, pushing the bank balance down — perhaps into the red.

3 Net cash flow

The balance between cash in and cash out, usually measured on a monthly basis.

Example: if a month's cash inflows are £38,000 and the cash outflows are £32,000, the net cash flow is +£6,000 for the month: Cash flow = Cash in – Cash out

Advantage: calculating monthly net cash flows shows the pressures that are affecting the overall cash balances (i.e. the strength or weakness of the company's overall cash position).

Disadvantage: net cash flow only shows what is happening within a single month. Looking at this alone may enable a business to ignore future financial problems, so a cash flow forecast is needed, which looks at least 12 months ahead.

4 Cumulative cash

The accumulation of cash in a firm's bank account as monthly cash flows are added to previous bank balances.

Example: Spartex Ltd had £12,000 in its bank account at the end of August 2015. In September the net cash flow was +£2,400. So the cumulative cash total for the end of September was £14,400.

Advantage: this total can be compared with the company's overdraft facility to see how secure (or insecure) its liquidity position really is. If Spartex Ltd has a £15,000 overdraft facility agreed with its bank, its £14,400 cumulative cash position gives it a liquidity cushion amounting to £29,400.

Disadvantage: a healthy-looking cumulative cash position can soon be damaged if monthly net cash flows are consistently negative.

5 Boosting cash flow

When the cash flow forecast shows a period of negative cash flow, it is vital to take action in advance to boost the cash position. This shouldn't include an overdraft, which is a way to cope with poor cash flow, not an action to boost it. Main methods: cut stocks, cut credit to customers; take longer credit periods from suppliers, sell assets for cash and speed up production (to shorten the time between your cash going out and the customer paying up).

Example: pre-Christmas 2013 Debenhams ran 'all stock discounted' days of up to 50% to cut stock (inventory) levels. It also said that suppliers would have to wait longer to get paid. Both actions were to boost cash flow.

Advantage: well-planned actions to boost cash flow help you without harming stakeholders, e.g. close discussions with suppliers.

Disadvantage: sudden decisions to boost cash flow can leave stakeholders such as customers and suppliers feeling resentful.

6 Cash and seasonality

If cash flow is tough for all new firms, it is doubly so for those with highly seasonal sales. Seasonality means sales form an irregular, if relatively predictable, pattern of demand, affected by factors such as Christmas (toys), Valentine's Day (chocolates) and summer (swimwear).

Example: Cadbury only sells Creme Eggs for the period from Christmas to Easter, so sales are only made for 4 months of the year. This means monthly cash inflows are zero on this brand for most of the year — thank goodness for Cadbury's Dairy Milk.

Advantage: measuring and allowing for seasonal factors ensures that seasonal cash flow lows can be factored in.

Disadvantage: in some markets seasonality cannot be known, partly because seasonality is mixed up with weather. Wall's knows it'll sell more ice cream in summer than winter, but the demand pattern depends on the weather. A cold summer might be very disappointing.

7 Cash and rapid growth

Rapid growth places great strains on cash flow. Today's growth in demand requires extra cash outflow today to produce those orders — but today's cash inflow is based on the lower sales of 2 or 3 months ago (because of the long credit periods demanded by retailers).

Example: Boots demands 105 days' credit (3 and a half months) from its suppliers, so a fast-growing producer of a new asthma drug will struggle to cope with waiting so long to be paid at a time when its cash outflows are rising rapidly.

Advantage: for retailers, rapid growth can be good for cash flow, because customers pay cash today, but payments to manufacturers can be delayed (as in the case of Boots).

Disadvantage: manufacturers are the businesses that suffer most from rapid growth, creating the cash flow problems outlined above.

8 Cash flow at start-up

When a new business starts up, gaining distribution often requires offering long credit periods to retailers, while suppliers demand to be paid in cash, i.e. no credit. These cash flow pressures come on top of the expensive start-up costs.

Example: in May 2015 an independent burger/milkshake restaurant opened in Merton Park, London. It took 5 months of building work to get it ready, and a cash investment of £240,000. A week after it opened sales were below breakeven, as locals had not noticed it.

Advantage: a few companies start with healthy cash flow, such as providers of insurance: today you take people's money and you only pay out in the future when people make insurance claims.

Disadvantage: some businesses have a particular problem at start-up. A London shop selling and engraving sports trophies took 3 years to develop enough repeat buyers to reach breakeven.

9 Cash flow forecasting

Sales forecasting is hard enough, but cash flow forecasting is even harder, as it requires not only a forecast of sales revenues, but also of the costs of doing business plus any changes expected in the timing of cash inflows and outflows.

Example: when a business is about to launch a new product it must carefully plan for the cash flows on that launch as well as the ongoing business. This may prove tricky.

Advantage: for new small firms, cash flow forecasting is likely to be highly inaccurate. Over time, the business should learn more about its customers and suppliers and start to forecast with greater accuracy.

Disadvantage: cash flow forecasts (like economic forecasts) cannot allow for unexpected shocks, such as the financial collapse of a major customer. Regular cash flow forecasting should never fool anyone into believing that the future has been brought under control.

10 Cash flow crisis

A cash flow crisis is a period when there is a real danger that you won't be able to pay your bills. A failure to pay staff wages or suppliers' bills threatens the future of the business.

Example: after winning the FA Cup in 2008, Portsmouth FC admitted in late 2009 that it was unable to pay its players. Administration in 2010 and 2012 led to the entire playing staff leaving the club.

Advantage: it could be said that a cash flow crisis forces a business to cut back on wasteful spending and become more efficient.

Disadvantage: a cash flow crisis forces a business to cut back on everything that is not essential in the short term. For a football club this might mean scrapping its youth development system.

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