Edexcel (B) Economics A-level

Theme 1: Markets, Consumers and Firms

1.6 Revenues, Costs, Profits and Cash

1.6.4 Business survival and cash flow

Notes

Distinction between profit and cash flow and the importance of cash flow to businesses

Profit only considers income and expenses at one point in time. Cash flow considers the movement of money into and out of the business. It is more in line with reality than profit, because it considers cash flow at the time the movement of money takes place.

Some businesses do not have money available immediately, so their cash flow has dried up. This causes some firms to close down, even if they are making large profits, because of their lack of available cash. Therefore, cash-flow management is an important skill.

There is no correlation between profit and cash flow. A firm might have a negative cash flow where profits are high and a positive cash flow when profits are low (or even with a loss).

Profits are not spent in a firm, whereas cash is. Firms making a lot of profit might be forced to close because they could not afford to cover their expenses, since all of their cash was tied up in assets. When firms need to make a payment, such as for wages, bills and raw materials, they need liquid cash. This is a positive cash flow.

In the short to medium term, firms might still trade if they are making a loss. This could be by delaying payments to creditors. However, to survive in the long term, firms need to be able to cover their variable and immediate costs.

Forecasting and interpreting cash flow

A cash flow forecast can predict the net cash flow over a future period of time. It estimates the money which will enter and leave the bank account. This aims to estimate the net balance at the end of each period of time, such as per month.

The following table outlines a basic cash flow forecast.

Thousands of £s	January	February	March	April
Cash available	20	15	5	10

at the beginning of the month				
Cash inflows	25	20	15	20
Cash outflows	30	30	10	10
Net cash flow	-5	-10	5	10
Cash available at the end of the month	15	5	10	20

Use of a cash-flow forecast to identify credit requirements and minimise risk

A cash flow forecast can be used to identify where a business is spending more than it can afford. If a firm predicts it will have insufficient cash available at the end of the month, it can ensure there is a sufficient overdraft facility available. It can also outline whether the firm's activities are generating cash and whether the firm is achieving its objectives.

Having sufficient funds to cover expenditure is important for firms, but particularly for small and medium sized firms.

The forecast can warn firms before there is a shortfall in cash, so they can take the necessary precautions. It ensures money is coming in on time from consumers, and that suppliers and employees are being paid on time. Moreover, stakeholders, such as shareholders and banks, might request a cash flow forecast. This is especially the case when the firm has taken a loan from the bank.