

# Planning your cash flow

BUSINESS COACH SERIES



- Preparing the cash flow forecast
- Keeping on track

# The cash flow process

## The situation

*Money goes out earlier and faster than it comes in. And, because it's easy to run short of cash without realizing it, it's often too late for the owner, the bank, or anyone else to do anything about it. Cash flow planning can't stop a bad business from failing; it can help a solid business succeed.*

## The solution

*At BMO Bank of Montreal®, we are committed to helping Canadian businesses develop and succeed. The purpose of this Business Coach is to help you take control of your company's cash flow.*

Although the concept behind cash flow is simple, there are a number of steps you need to take to budget for and control cash flow, and ensure that your business never runs short of operating funds.

Planning your cash flow is not a task you can afford to leave to others. Only you know all the assumptions you make in operating your business. Although your accountant can provide assistance, it's important that you are familiar with the process.

In this Business Coach, we have included:

- a step-by-step program for developing a cash flow budget
- guidelines for monitoring your budget
- a Cash Flow Budget Planner

It may be useful if you also have *Developing Your Business Plan*, a companion booklet from the Business Coach Series available online from our resource page at [bmo.com/business-resources](http://bmo.com/business-resources)

## The concept

The preparation of a cash flow budget requires that you consider two key factors:

- cash in (receipts)
- cash out (outflows)

To come up with these figures you will have to make a series of assumptions about how your business will be operating. Should your cash outflows be greater than your receipts, then you have an early warning that some action should be taken.

To help you follow the steps in preparing a budget, simply download and refer to the Cash Flow Worksheet at [bmo.com/business-resources](http://bmo.com/business-resources). The assumptions for your particular business may be different, but the principles will be the same.

## STEP 1 Determining cash in

Preparation of the cash flow budget begins with a one-year profit and loss (P&L) budget. If you haven't prepared one, refer to *Developing Your Business Plan*.

The P&L budget is a snapshot of what you expect your operation to look like at a given time. It is based on "accrual" accounting.

- Revenue is recorded immediately when goods or services are sold and expenses recorded when they occur.

This "accrual" accounting does not:

- reflect when the cash is actually received, or
- take into consideration when the expenses for the labour and material that went into sales were actually paid out

Only a cash flow budget will allow you to see the crucial effects of timing differences in actual receipts and disbursements of cash. Therefore, step one is to take your P&L and convert the sales forecasts into cash receipts by month.

1. Prepare an "aged" list of your receivables, showing the actual payment terms being taken. You will see from this "aged" list that sales in one month do not necessarily mean that you will receive all of the cash in that month. Some may be cash sales and the rest credit, extending 30, 60, or even 90 days.

For example, if 20% of your receivables are paid in 90 days, then 20% of your May sales won't be received until August.

2. Consider cash receipts other than those from sales. These could include such items as:

- deposits or progress payments on contracts
- supplier rebates
- insurance or other claims
- new loans negotiated with the bank
- cash injection by a new shareholder or equity partner

## STEP 2 Determining cash out

Generally, there are three forms of cash outflows to consider, although expenses will vary according to the type of business that you operate.

1. **Overhead expenses** are generally "fixed," and consequently don't vary much with the level of sales volume. Usually paid on a monthly basis, overhead expenses include such items as: rent, telephone, salaries, employee deductions, heat and power. Keep in mind that some of these may still change. For instance:

- utility costs can vary with seasons
- holiday close-downs are usually preceded by a double payroll and followed by a partial the following month
- rent charges may include a percent-of-sales component

2. **Cash outlays** for goods and other variable costs are partly determined by sales volume as well as inventory levels and payment terms. Consider this example:

Assume your cost of goods is 50% of your selling price and you have decided to keep a three-month supply of goods on hand.

- If you were forecasting \$200,000 in sales for the first quarter of your fiscal year, you would need \$100,000 of goods (at cost) in inventory at the start of that quarter. However, this does not describe the outflow of cash to pay for inventory.
  - You must consider when the payment for the inventory is actually made. Some of it, such as direct labour in a manufacturing firm, is paid out early. On the other hand, raw materials may be obtained on credit terms ranging from 10 to 90 days or more.
3. **Intermittent expenses** are important and should not be overlooked in cash outflows.

Consider:

- loan payments
- purchase of machinery or equipment
- bid deposits (contracting)
- dividends
- income and other tax installments
- insurance premiums
- major selling trips, training programs
- special projects

## STEP 3 Preparing the cash flow forecast

The best way to help you prepare your own forecast is by taking you through an example worksheet that you can download from [bmo.com/business-resources](http://bmo.com/business-resources). Look at the excerpt from a completed Cash Flow Budget Planner indicating the three months May to July. In this case, the company is a manufacturer.

If your company is another type (*retail, service, contracting, etc.*), you may find you need slightly different Cash In and Cash Out categories. Space is provided to write in items that are relevant to your situation.

For most businesses, a 12-month cash flow budget by month is sufficient. However, for companies with a heavy movement of cash, such as retailers or restaurants, it can be better to budget cash flow by the week, especially for peak seasons.

### WORKSHEET TIPS

- Always date the sheet every time you update or rework it.
- Always write down your assumptions, even though the numbers you actually achieve are bound to be somewhat different.
- After each month's budget figures, there is a blank column for actuals — cash flows are never right on target. Unless there is a major variance, wait two or three months before you rework the budget using the actuals since one changed figure means reworking the whole schedule. (See May figures on the Worksheet side.)

# The cash flow process

*Let's work through the cash flow on the downloaded worksheet planner.*

*The assumptions for your particular business may be different, but the principles will be the same.*

- 1 From the assumptions we find that 10% of sales are expected to be cash. Therefore, \$5,000 of the \$50,000 sales forecast for May (see P&L) is entered. So are 40% of the sales for April (30 days = \$40,000), 30% of sales in March (60 days = \$15,000), and so on, by month.
- 2 Under *Other*, the owner anticipates receiving a supplier rebate in June. There could be other special payments, refunds, insurance claims, a new loan, and so on.
- 3 Now total the *Cash In* for the month. In the example, it comes to \$70,000 in May.
- 4 Under *Cash Out*, from the assumptions we see that the owner has decided to keep approximately four months' inventory on hand. If the owner were a retailer or distributor, this would result in a purchasing schedule only. Since the

business is manufacturing, it involves a production schedule including factory overhead, paying for labour and the purchase of materials. The assumptions are detailed and reflected in the figures.

- 5 The owner makes assumptions on selling and administration based on a breakdown of the selling and administration total shown in the Business Planner.
- 6 Remember to consider long-term and short-term loans: when the interest is to be paid and when principal repayments are due.
- 7 Now total the Cash Out. In the example, it comes to \$74,500 in May.
- 8 Subtract the Cash Out total from your Cash In total, and you will see a cash surplus or deficit for the month. In the example, there's a net deficit of \$4,500.
- 9 Finally, add or subtract the opening cash position to determine the net cash position. In the example, there is a positive cash position of \$1,500.

## Cash flow in action

When you first develop a cash flow plan, you may see figures that surprise you, even frighten you. However, let's see how the plan can help you.

Let's say the company we've used as an example is yours. Assume there was no outstanding loan at the beginning of the year.

- By looking along the bottom line of the Cash Flow Budget Planner you now know that you will need \$33,700 during July. Let's ask the bank for \$40,000 to be safe.
- To get a loan, the bank will want to know about your receivables and inventory. At the beginning of July, receivables of 90 days or less are \$90,000 (90% from June sales, 50% from May sales, 20% from April sales). The inventory level is approximately \$260,000 (March to June production/purchases).

## Using information to your advantage

For the July/August period, you might consider a planned program of:

- speeding up the collection of receivables, possibly by offering cash discounts
- slowing down payables by negotiating extended terms

After August your company will probably have a surplus of cash. You might consider:

- putting the money into bank deposit certificates or other income-earning investments
- paying down payables more rapidly
- repaying debt ahead of time
- renovating or replacing equipment

The purpose of a cash flow budget is to help you operate your business efficiently and successfully. It's an excellent early warning system. We suggest you update yours at least once a month. However, rework the budget only when you have gone way off track for several consecutive months and you are able to make more meaningful assumptions.



# 1. Profit and Loss Forecast

(in thousands of dollars)

(Taken from the Business Coach Series —  
Developing Your Business Plan)

Fill in Months		Month 1 Jan	Month 2 Feb	Month 3 Mar	Month 4 April	Month 5 May	Month 6 June	Month 7 July	Month 8 Aug
<b>Sales</b>	\$	100	50	50	100	50	50	100	200
<b>Cost of Goods Sold</b>		62	34	34	62	34	34	62	119
<b>Gross Profit</b>	\$	38	16	16	38	16	16	38	81
<b>Selling &amp; Admin. Expenses</b>		15	10	11	15	10	11	17	29
<b>Net Profit Before Taxes</b>	\$	23	6	5	23	6	5	21	52

## 2. Assumptions (Condensed version from Developing Your Business Plan)

Cash in (receipts)	
<b>Aged receivables (from sales)</b>	
	10% — current
	40% — 30 day
	30% — 60 days
	20% — 90 days
<b>Other cash receipts</b>	
	Suppliers rebate of \$5,000 due in June
Cash out (disbursements)	
<b>Production/purchasing costs</b>	
	10% is overhead, paid in current month
	45% is materials, paid in 30 days
	45% is labor, paid in current month
	(Plant will be closed for 2 weeks in Aug. but employees will be paid for full month.)
<b>Inventory</b>	
	Kept at four months of sales (at cost)
	<b>Detailed production/purchasing schedule</b>
	March \$60,000
	April \$60,000
	May \$70,000
	June \$70,000
	July \$70,000
	<b>Selling expenses</b>
	Salary and commission is paid monthly. 5% bonus on sales-over-target paid quarterly.
	<b>Administration</b>
	Should be relatively constant except for staff increase in July.
	<b>Bank loan</b>
	Interest paid monthly, average interest rate is 14%.
	<b>Long-term debt</b>
	Principal payment of \$2,000 plus interest due each quarter.

Blank copies of this worksheet are available online at [bmo.com/business-resources](http://bmo.com/business-resources). You may choose to modify the format to suit your business.

### 3. Cash Flow Budget Planner

(in thousands of dollars)

Fill in Months	Month 5 <i>May</i>		Month 6 <i>June</i>		Month 7 <i>July</i>		Month 8 <i>Aug</i>	
<b>Cash in</b>	Budget	Actual	Budget	Actual	Budget	Actual	Budget	Actual
Cash from sales: Current	5	5.3	5		10		20	
30 days	40	38.9	20		20		40	
60 days	15	17.1	30		15		15	
90 days	10	9.4	10		20		10	
Other: <i>Supplier rebate</i>			5					
<b>Total cash received</b>	<b>70.0</b>	<b>70.7</b>	<b>70.0</b>		<b>65.0</b>		<b>85.0</b>	
<b>Cash Out</b>								
Production/purchasing cost								
<i>labour</i>	31.5	31.1	31.5		31.5		31.5	
<i>materials</i>	27.0	27.3	31.5		31.5		31.5	
<i>overhead</i>	7	7	7		7		3.5	
Selling expenses <i>current</i>	4	4	5		8		11	
<i>bonuses</i>		11	3					
Administration expenses	5	5	5		6		6	
Long term <i>loan repayment</i>			2					
Interest on debt long term			1					
<i>bank loan</i>					0.2		0.4	
Other								
<b>Total cash paid out</b>	<b>74.5</b>	<b>75.5</b>	<b>86.0</b>		<b>84.2</b>		<b>83.9</b>	
<b>Monthly Cash Flow Summary</b>								
Cash flow surplus (deficit)								
• monthly	(4.5)	(4.8)	(16.0)		(19.2)		11	
• year to date	(13.5)	(13.8)	(29.5)		(48.7)		(47.6)	
Cash available (or required)								
• beginning of month	60	60	15	12	(14.5)		(33.7)	
• end of month	15	12	(14.5)		(33.7)		(32.6)	

The owner refers again to the profit and loss figures ① worked out in *Developing Your Business Plan*, and makes an assumption ② on the bottom of the Cash Flow Budget Planner. The owner then uses both to complete the cash flow budget ③.

All entries on the **Cash Flow Budget Planner** ③ above are cash. But your starting point is always your sales and expense projections. Remember, \$50,000 sales in one month does not mean \$50,000 cash received in that month. As you can see in this case, the owner is projecting more than \$50,000 receipts in May, mainly because of

higher sales in a previous month. Similarly, while the P&L for May showed cost of goods at \$34,000, actual cash out in month 5 above can now be projected at \$74,500. It's the timing of cash out and cash in that counts — that's why you need to use a **Cash Flow Budget Planner**.





At BMO Bank of Montreal, we are committed to helping Canadian businesses develop and succeed. To this end, we've created a Business Coach Series that provides information and knowledge that can optimize the value of your company's financial resources. The booklets that make up the Series focus on essential areas of financial management allowing you to focus on operating your business more effectively.

## For more information on how BMO Bank of Montreal can help your business:

- talk to your Commercial Account Manager
- call us directly at **1-877-262-5907** or
- log on to **[bmo.com/business-resources](http://bmo.com/business-resources)**

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