Building a Cash Budget

by Sophia

WHAT'S COVERED

In this lesson, you will learn about the importance of forecasting and budgeting. Specifically, this lesson will cover:

1. Receipts

The broader field of cash flow forecasting is integral to ensuring organizational liquidity. Maintaining cash receipts over a given time frame enables organizations to have cash at hand in a predictable fashion, thus allowing them to reinvest in business operations to avoid the opportunity cost of having unused cash and cash receivables. Forecasting cash inflows and outflows in advance is a primary role of corporate financiers and accountants, and enables efficient use of existing assets to capture maximum competitive value in the marketplace.

The direct method of projecting incoming cash flow is through understanding cash receipts and disbursements of the time period being projected.

- **Receipts** generally refer to the collection of accounts receivable, which are the payments of paying customers over time. Receipts also refer to the returns off of short-term investments as well as the sale of various assets. There are other potential incoming cash flows that also fall under receipts, which are worth noting on a case by case basis.
- **Disbursements** are outgoing cash flows during a short-term business operation. These can quite accurately project accounts payable, payroll costs, dividend payments, interest payments, and other short-term alterations to existing cash flow. By comparing receipts with disbursements, the overall available cash flow can be derived.

As with all forecasting, shorter term forecasts are generally more certain than longer term forecasts. Short-term forecasts can be quite accurate, as the various accounts receivable, accounts payable, short-term investments and short-term costs are often relatively established, both contractually and operationally. In shorter term situations, most forecasting is done through implementing what is known with the probability that these obligations will be met.
With longer term forecasting, it can be useful to consider past averages over time. Larger organizations can look at their average cash receipts over the past few years, and couple that with growth trajectories to project what level of cash inflow is likely over a given time frame.

TERMS TO KNOW

Receipts

Potential sources of incoming cash over a given time frame.

Disbursements

Money paid out or spent.

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2. Payments

Why is cash flow forecasting important? If a business runs out of cash and is not able to obtain new financing, 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 payments describe cash flowing out of a business. These cash payments can result from operating activities, investment activities and financing activities.

Types of Cash Flow Activities	Examples
Operating Activities	Suppliers for inventory or other supplies Employees for wages Government for taxes Lenders for interest on borrowed money
Investing Activities	Purchase of capital assets Purchase of bonds/notes or shares of other entities Loans to other entities
Financing Activities	Payments of dividends to the company's own shareholders Redemption (repurchase) of company's own shares Repayment of principal and interest on company's own bonds or notes

BIG IDEA

Generally speaking, normal operating activities refer to the cash effects of transactions involving revenues and expenses that impact net income. Cash payments must be made for relevant expenses.

The cash disbursement cycle is important to consider when analyzing cash payments. This is the total time between when an obligation occurs and when the payment clears the bank. A company's objective regarding the cash disbursement cycle should be to increase the cycle time, or delay making payments until they are due.

A firm may delay payments by:

- Mailing checks from locations not close to customers. This will increase the mail time, or mail float, within the disbursement cycle.
- Disbursing checks from a remote bank. This will increase the time required for the payment to clear the bank.
- Purchasing with credit cards so that the time required for making payment is much longer. By using a credit card, you will receive a bill at the end of the month payable in 30 days. This creates more processing time or processing float.

Therefore, when a company manages cash flow cycles, it tries to control three types of float times:

1. Mail float, or the time spent for a payment in the mail.
2. Clearance float, or the time spent for a payment to clear the bank.
3. Processing float, or the time required to process cash flow transactions.

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3. The Forecast Budget

Financial planning is a critical financial tool for funding profitable operations and dividing existing organizational assets optimally to pursue revenue maximization. The forecast budget will project what cash flows will be needed for each organizational process, and how those cash flows will be utilized over a fixed period of time. If there is a problem with liquidity during an operational period, it can result in huge opportunity costs (i.e., an organization being unable to capture an existing opportunity in the market).

There are a number of ways to approach financial forecasting for a cash budget. A cash budget is all about **liquidity**, and therefore forecasting what available liquidity will be required over a given period is the primary input for forecasting budgets. There are a number of different approaches, though most of them rely on understanding the inputs required for various business operations.

The inputs include the following cash obligations during regular operations:

- Payroll
- Payment of accounts payable
- Dividends
- Interest on debt
- Sourcing raw materials

It’s also worth noting that various cash inflows will occur during a given time period.

> ↱ EXAMPLE Accounts receivable, short-term financing options, and various other sources of income may directly convert into usable capital. However, budgeting should either build these into the current budget forecast or utilize them during the next calculation of budgetary requirements.

Types of Cash Forecasting	Description
The Direct Method	At its simplest, cash flow forecasting and budgeting can be computed directly based off of fixed information over a short time frame. This works particularly well for consistent businesses that run routine operations with limited risk-taking and diversification in process.
The Adjusted Net Income Method (ANI)	The adjusted net income method starts by calculating operating income (EBIT or EBITDA) and adding/subtracting short-term changes in the balance sheet, such as those that occur to inventories, payable, receivables and other short-term. This gives the organization some idea of what short-term cash flows are typically required during an operational period.
Pro-forma Balance	Pro-formas are financial statements created in advance as a projection or estimation of what that document will look like after the financial period is finished. By using a pro-forma balance

Sheet Method	sheet for the upcoming period being budgeted for, the short-term assets and liabilities (if accurately projected) will underline the amount of cash that should be set aside for budgeting purposes.
Accrual Reversal Method	A third option for projecting cash budgets is accrual reversal. This process relies on statistical distributions, reversing large accruals, and projecting cash effects via algorithms. This method requires a good deal of data and statistical skill, and is best utilized for mid-term forecasting (unlike the direct method, which is much better for a shorter time frame). The advantage of this method is that it is often accurate to the day or week, enabling high accuracy.

TERM TO KNOW

Liquidity
Availability of cash over short term: ability to service short-term debt.

SUMMARY

In this lesson, you learned about the process and importance of forecasting cash flow. Effectively forecasting cash flow means avoiding opportunity costs associated with unused cash on the one hand and preventing a liquidity crisis on the other. To do this, businesses must have a good sense of their cash **receipts** and **payments**. A cash **forecast budget** can be prepared using one of several possible methods.

Best of luck in your learning!

TERMS TO KNOW

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