

Cash Flow Forecast: What Is It, Examples, Challenges, and Benefits



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According to a survey completed by U.S. Bank and SCORE, the number one reason why small businesses fail is poor cash flow management skills or poor

understanding of the cash flow process.

While your products may be flying off the shelves, if you don't know how much cash on hand your business actually has, you and your business will likely suffer the consequences.

The best way to head off a cash crisis is to prepare a cash flow forecast. A well-prepared cash flow forecast helps businesses predict potential issues months in advance, which allows for a more proactive approach.

New businesses, start-ups, and established businesses will all benefit from creating a cash flow forecast.

What Is Cash Flow?

■ What is Cash Flow



Cash flow represents the amount of cash and equivalents that flow into and out of a business.

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Before we explain what a cash flow forecast is, let's take a moment and discuss cash flow.

Cash flow represents the amount of cash and equivalents that flow into and out of a business.

Any time a customer pays an invoice represents cash flowing into the business while paying a vendor or supplier represents cash that is flowing out of the

business.

Along with standard cash inflow from sales, businesses may also have incoming cash flow from investments, royalties, licensing agreements, or outgoing cash flow from everyday expenses as well as investing activity, loan payments, or tax payments.

What Is a Cash Flow Forecast?

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A cash flow forecast estimates the amount of cash that a business expects to flow into a business as well as the amount that is expected to flow out of the business. It also known as a cash flow projection.

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A cash flow forecast estimates the amount of cash that a business expects to flow into a business as well as the amount that is expected to flow out of the business.

A cash flow forecast is also known as a cash flow projection, with the two terms often used interchangeably.

A cash flow forecast can be created for a specific period of time or an entire accounting period.

For instance, smaller businesses that have limited cash flow may find it useful to create a cash flow forecast on a weekly basis, though many businesses prepare a medium-term or longer-term cash flow forecast, making any adjustments to the document as needed.

A cash flow forecast, particularly a longer-term forecast must be a fluid document since circumstances such as unexpected economic downturn or an increase in supply costs can all impact your cash flow forecast.

For example, Jane runs a small grocery store. While business is good year-round, Jane's store is in a well-traveled tourist area, so her sales are always much higher during the late spring and summer months.

While preparing her cash flow forecast, Jane can confidently estimate increased revenues for those months, which makes it a great time to also plan for any extensive repairs since she knows that cash flow will be good during those months.

And while her revenue does stay steady the other months, she'll make sure that she's only spending her normal amount of cash during those months.

Like the example above, when creating your cash flow forecast, be sure to take historical data into consideration.

What Is the Relationship Between a Cash Flow Forecast and a Cash Flow Statement?

There is a distinct relationship between a cash flow forecast and a cash flow statement.

Both are used to display cash inflow and outflow of a business.

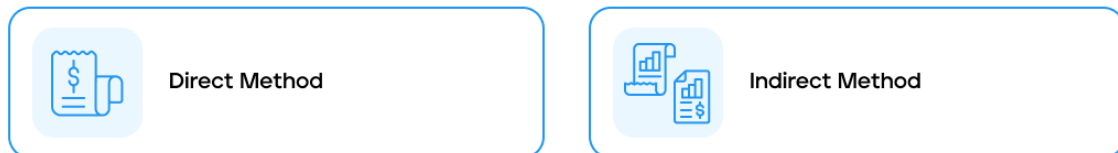
However, a cash flow forecast uses historical data to estimate future inflows and outflows, while a cash flow statement provides a historical look at cash flow activity for a specific period.

A cash flow statement can be created by your accounting software application or ERP, while a cash flow forecast is usually prepared using a cash flow forecast template or a Microsoft Excel spreadsheet, though more advanced accounting software applications may be able to assist in the cash flow forecast preparation.

What Are the Types of Cash Flow Forecasts?

There are two major methods used to forecast cash flow:

■ What Are the Types of Cash Flow Forecasts



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1. **Direct Method** - The direct method is typically used for short-term cash flow forecasting. The direct method uses estimated cash receipts and accounts payable totals to forecast cash flow and is generally used to determine if cash is sufficient to fund working capital.
2. **Indirect Method** - The indirect method is frequently used for longer-term cash flow forecasting, making it the preferred method for business planning. The indirect method uses historical data found on financial statements like the balance sheet and income statement, and can also derive estimates from working capital totals.

The direct method is typically the more accurate method since it uses current accounts payable and accounts receivable balances in the forecast.

However, the direct method is only useful for ninety days at the most, with estimates used beyond that point.

What Are the Steps to Creating a Cash Flow Forecast?

What Are the Steps to Creating a Cash Flow Forecast



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The cash forecasting process is fairly straightforward, with seven steps you can follow to create a cash flow forecast.

Be sure to have current financial statements handy, and for long-term forecasting, make sure that other staff members are involved in the process.

1. Reconcile Your Bank Accounts

If you're planning on creating a cash flow forecast for the last quarter of 2023, you'll need to first reconcile your September bank statement to obtain your opening cash balance.

If you're using accounting software automation that automatically downloads bank transactions, you can use the ending balance as your opening cash balance.

2. Estimate Sales

If your sales are mainly cash, you'll want to use the last few months as a

reference point. If you mainly sell on credit, you'll want to use a percentage of your invoice totals for the month.

For example, if you have \$70,00 in credit sales in September and the majority of your customers have Net 30 terms, you'll want to estimate around 80 % of \$70, 000 or \$56,000.

3. Estimate Other Revenue

If you typically receive interest payments or payments on other income such as royalties, leases, or rental income, you'll want to estimate that as well.

4. Estimate Expenses

Estimating expenses can get tricky. While some expenses such as rent and utilities typically don't change that much from month to month, others such as inventory, wages, and postage and shipping can change based on sales numbers.

It can be helpful to use historic numbers from prior years when estimating expenses.

5. Estimate One-Time Expenses

Include some one-time expenses in your long-term cash flow forecast.

While you can't predict a market downturn or catastrophic flood, you can set some funds aside for unplanned expenses.

6. Calculate Your Cash Flow Balance

Add your beginning balance and your estimated income for the month. Do the same for expenses, and when complete, subtract your expense totals from income. This is your cash flow for the month.

7. Bring Your Cash Flow Total Forward

Once you have your cash flow total for the month, the total will be your beginning cash balance for the following month.

What Is an Example of a Cash Flow Forecast?

Emily owns a small business that sells custom jewelry. Because Emily knows her sales increase during December, she estimates her sales revenue accordingly.

Inventory is also up in the expenses category in October because she purchased more raw materials to prepare for the increased sales in December.

Cash Flow Forecast 10-1-2024 to 12-31-2024				
	10-2024	11-2024	12-2024	Total
Opening Cash Balance	10,725	17,895	23,895	32,045
Cash Inflows				
Cash Sales	5,700	4,900	9,100	19,700
Credit Sales Collections	12,220	11,950	15,100	39,270
Interest	350	350	350	1,050
Loan Payments Received	2,500	2,500	2,500	7,500
Total Cash In	20,770	19,700	27,050	67,520
Cash Outflows				
Rent	1,500	2,000	2,000	5,500
Inventory	3,500	3,000	3,100	9,600
Utilities	1,100	1,100	1,100	3,300
Payroll	6,000	6,100	6,200	18,300
Insurance	500	500	500	1,500
Loan Repayments	1,000	1,000	1,000	3,000
Total Cash Out	13,600	13,700	13,900	41,200

Cash at Month-End	17,895	23,895	32,045	
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This is an example of direct forecasting. It would be more difficult for Emily to accurately predict future cash flows past December, so she would use historical totals for those months as a basis for estimating cash flow.

What Are the Benefits of Cash Flow Forecasting?

■ What Are the Benefits of Cash Flow Forecasting



Once you create your cash flow forecast, the information can be used in a variety of ways.

• **Improved Decision Making**

Creating a cash flow forecast allows business owners to make more informed decisions.

For instance, spending can be reduced when cash inflows drop, while owners can plan to execute larger projects when cash flow is expected to increase.

• **It Can Help Secure Loans and Lines of Credit**

Having a strong cash flow forecast in hand can help expedite the loan process or help you obtain a line of credit for your business.

Creating a cash flow forecast can also help you decide whether you should pursue outside funding at all.

• **It Can Help Control Spending**

Spending money is a necessity for any business. But there is a good time and a bad time to spend money.

Knowing when spending is less likely to negatively impact your business is one of the most important benefits of preparing a cash flow forecast.

• **Helps To Pinpoint Potential Issues**

Creating a cash flow forecast allows you to pinpoint potential problem areas and address them before they become a much bigger issue.

For instance, a cash flow forecast allows you to view how much you're collecting from your credit customers and whether their payments are being received on time.

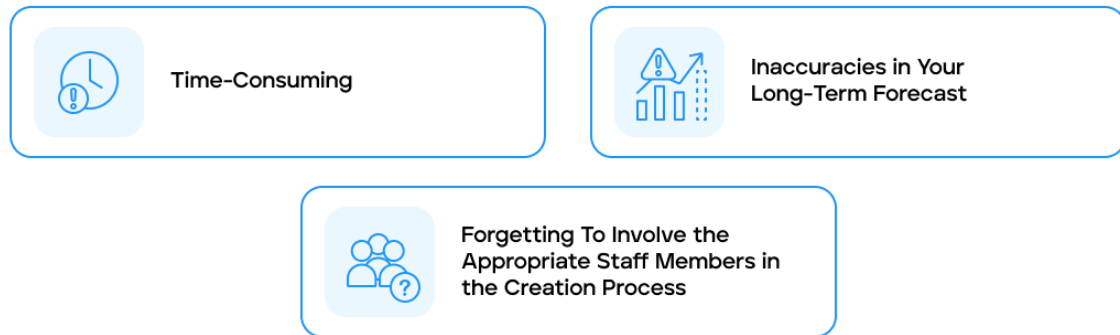
If not, you can address that issue with the accounts receivable department or the customer directly.

• **It Helps Your Business Set Realistic Goals**

If you've been toying with adding or reducing staff, creating a cash flow forecast allows you to see the impact both of those decisions will have on your overall business operation.

What Are the Challenges of Cash Flow Forecasting?

■ What Are the Challenges of Cash Flow Forecasting



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Despite the many benefits, cash flow forecasting does present some challenges.

• **Time-consuming**

If you're creating a cash flow forecast using the direct method, you'll need to pull information such as your current accounts payable and accounts receivable balances from your financial statements.

You'll also have to estimate any expenses that you don't have entered or haven't received yet and review your outstanding AR balances to determine which customers you believe will pay their bills on time.

Using an automated accounting software application can do much of the work for you, but if you're still using a manual system, be prepared to spend a considerable amount of time creating your cash flow forecast.

• **Inaccuracies in Your Long-Term Forecast**

While indirect forecasting is useful for planning long-term goals, it's also difficult to accurately predict cash inflows and outflows more than three months out.

Using historical data can help, but it's impossible to plan for unforeseen events like natural disasters. And it's not just disasters.

A change in the economy, increased competition, and higher supplier prices can render your cash flow forecast useless.

• **Forgetting To Involve the Appropriate Staff Members in the Creation Process**

To create an accurate cash flow forecast, particularly a long-term forecast, all of the necessary stakeholders must be involved.

For example, if you don't involve the accounting department, you won't know that customer payment terms have been changed.

If you don't involve the sales team, you won't know that they're planning on launching a new line next year. Involving the appropriate parties will help ensure that your long-term forecast is as accurate as possible.

Using Manual Data for Your Cash Flow Forecast

If you're pulling your numbers from an accounting software application, you can be comfortable in the knowledge that the numbers are accurate.

That's not always the case if you're using a manual accounting system.

Drawing numbers and estimates from manual accounting ledgers takes an inordinate amount of time and doesn't always guarantee that the numbers you're relying on are accurate.

What Is Free Cash Flow and How Do I Forecast It?

Free cash flow is a calculation that represents the amount of cash generated by a business after subtracting cash outflows for operations and capital expenditures.

While a cash flow forecast is used internally by businesses, the free cash flow calculation is one often used by lenders and investors to help determine the liquidity and overall value of a company.

Free cash flow is calculated by adding non-cash expenses, subtracting an increase in working capital and capital expenditures.

The formula to calculate free cash flow is:

■ The Formula To Calculate Free Cash Flow



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Net Income + Non-Cash Expenses - Increase/Decrease in Working Capital - Capital Expenditures

Each of these will have to be calculated separately.

For example, you'll have to obtain your net income totals from your income statement, calculate non-cash expenses such as depreciation and amortization, calculate working capital totals such as changes in AR, AP, and Inventory totals between accounting periods, and obtain your capital expenditure totals for the appropriate accounting periods.

Once this is complete, you can calculate free cash flow.

Why a Cash Flow Forecast Is Essential for

Your Business

Managing the financial health of your business starts with knowing your cash position at all times.

Spending a few extra moments creating a cash flow forecast lets you know if you have enough cash on hand to manage the ups and downs of being a business owner.

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