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Cash budgets

It is vital that a business is aware of their cash position. Many businesses are not obliged to prepare a cash flow statement under accounting rules. This means that most users of accounts have to interpret the financial information using the profit and loss account and balance sheet only.

Why is cash so important?

Businesses need cash in order for them to continue. They need hard cash in order to pay their creditors, employee wages and dividends to their shareholders. Under accounting policies and accounting standards, some adjustments are made in the profit and loss of a business that do not affect cash. Likewise, there are some items that do affect the cash balances but will not have an effect on the profit made for the period as the item will have gone through the profit and loss account. Many of these are purely accounting adjustments, such as depreciation, and will not be entered into the cash budget.

We will start by looking at some of these differences.





Cash purchases, cash sales and expenses paid in cash will all affect both the profit and the cash balance. If a business only had these three types of transactions, the movement in the cash balance from the start of the period to the end will represent the profit that has been made. However, it is highly unlikely that any business would only have these three types of transaction without any fixed assets, loans, drawings or dividends, loans, credit transactions or any period-end adjustments. We are now going to look at a comprehensive cash budgeting example.

The following forecasted information has been provided for the next three months.

- Budgeted sales in units (February 450 units, March 470 units, April 465 units).
- Selling price per unit = £850 (75% of sales are for cash, 15% are received the month after). The
 remaining debt is never received and is written off in the accounts the month after the sale is
 made.
- The company sold 510 units during January.
- Each unit produced uses 2 kilograms of material.
- It costs £75 per kilogram of material.
- There were 80 kilograms in inventory at the beginning of February.
- Closing inventory levels are to increase by 10 kilograms each month.
- A21 pay all their suppliers in cash.
- The company purchase a new machine in February for £70,000. This will be paid for over 20 months. The machine is depreciated at 10% per annum on a straight line basis. Depreciation is accounted for monthly on a pro rata basis.
- Labour costs were £20,000 in January. Due to working regulations, this is currently increasing by 1% each month.

- A dividend is paid to shareholders in March of £12,000
- The opening cash balance at 1 February is £11,500 overdrawn.
- Bank interest of 4% per annum is received monthly and is calculated on the cash figure at the beginning of the month (where there is positive cash balance).
- Interest on overdrafts is at 7% per annum to be charged on a monthly basis (where applicable) and is calculated on the overdrawn balance at the beginning of the month.

Click to display/hide the solution.

Cash budget

	January	February	March	April
Receipts from customers (W1)				
Cash (75% of current month)		£286,875.00	£299,625.00	£296,437.50
Credit (15% of previous month)		£65,025.00	£57,375.00	£59,925.00
Interest received (W3)		£0.00	£827.94	£1,663.53
Cash inflow		£351,900.00	£357,827.94	£358,026.03
Payments				
Suppliers (W2)		£68,250	£71,250	£70,500
Fixed asset (\pounds 70,000 / 20 = \pounds 3,500 per month)		£3,500	£3,500	£3,500
Labour (increasing by 1% each month)		£20,200	£20,402	£20,606
Dividend		£0	£12,000	£0
Interest on overdraft (W3)		£67	£0	£0
Cash outflow		£92,017	£107,152	£94,606
Net cash inflow / outflow		£259,883	£250,676	£263,420
Opening balance		-£11,500	£248,383	£499,059
Closing balance		£248,383	£499,059	£762,479

	January	February	March	April
Sales (W1)				
Units	510	450	470	465
Selling price per unit	£850	£850	£850	£850
Total sales	£433,500	£382,500	£399,500	£395,250
Cash received				
Cash (75% of current month)		£286,875.00	£299,625.00	£296,437.50
Credit (15% of previous month)		£65,025.00	£57,375.00	£59,925.00

	January	February	March	April
Materials (W2)				
Units		450	470	465

kgs required per unit	2	2	2
Material usage (kg)	900	940	930
Opening stock (kg)	-90	-100	-110
Closing stock (kg)	100	110	120
Stock to purchase (kg)	910	950	940
x £75 per kg	£68,250	£71,250	£70,500

	January	February	March	April
Bank Interest (W3)				
Opening balance		-£11,500.00	£248,383.00	£499,059
Interest for month (annual charge / 12) 4%				
or 7%		-£67.08	£827.94	£1,663.53