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Exam-style question

The dangers of positive cash flow

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Check your answer to the question on pp. 30–31 of the magazine. This question relates to the AQA specification.

Sample answer

A cash flow forecast is a prediction of cash flowing into and out of a business over a period of time. A benefit of using cash flow forecasting is that it allows for the targeting of short-term finance. ChargedUp could have invested in staff and production facilities during the pandemic in order to make its new sanitising stations, as this was a completely novel business objective from its original mobile phone charging idea. Consequently, the forecast may have helped provide Tilmouth with clear objective costs and revenue information with which to negotiate with investors such as banks over the amount of funding required to start this new venture. As a result, CleanedUp would have been able to more accurately predict the production costs of each sanitising station based on fixed and variable costs and relate this to the potential sales revenue for each unit sold, convincing investors that there would be a clear profit margin and return on their investment.

However, Tilmouth's cash flow forecast may have been unreliable due to a lack of accurate data. The product was based on a novel situation, the pandemic, for which there would be little or no primary research available on the needs of the market for hand sanitising products. Therefore, predictions of cash inflows and outflows may have been seen by investors as based on little evidence from which to lend CleanedUp the funds to build up its manufacturing and marketing of its new hand sanitiser. This may have led to a significant hole in the business' capital requirements needed to create and launch the new product, meaning that the risk of failure was significantly increased.

The cash flow forecast may have also been used by Tilmouth as an early warning system to resolve issues such as higher than expected costs of raw materials to create the sanitisation stations. In CleanedUp's case the cash flow forecast may have highlighted more quickly the need to ramp up manufacturing and distribution capabilities due to the unprecedented demand for such stations, as shown by the £1 million revenue made in the first week of operation. As a result, Tilmouth may have been able to match demand for his products more closely with production while ensuring costs were kept to a minimum. For example, he could have purchased machines capable of higher levels of production instead of offering staff more overtime, which is usually a much greater cost to the business.

However, due to the cash flow forecast comparison with actual cash flow being by its nature time lagged, Tilmouth would always be looking at data that is out of date. Even if he spotted the massive revenue of £1 million in his first week, which is likely to be significantly higher than his cash flow forecast, the business would still have had to source machinery and labour to produce more hand sanitisers, which clearly cannot be achieved in a short timeframe without significant increases in costs. As a result, the business would have to decide whether it should make an opportunity cost decision of

hiring and training staff quickly, which would likely lead to significant increases in cash outflow in the short term. Another option would be to take a longer period of time to recruit and train new staff, possibly missing out on cash inflows as CleanedUp would then be unlikely to keep up with demand.

Cash flow forecasts are excellent tools for start-ups such as ChargedUp to raise venture capital on, as they show potential investors what the quantitative costs and revenues are for introducing mobile charging stations. Clearly Tilmouth's cash flow forecast and the detailed business plan supporting this new venture convinced a significant amount of investment (£3.5 million); it was probably seen as realistic with its initial objective of going live in 250 shops. However, it is debatable as to how valuable the cash flow forecast was for CleanedUp due to how quickly this new business venture had to be set up to solve key issues facing shops and other businesses in relation to the pandemic. Besides some cursory secondary research on perhaps how many businesses may need sanitising stations, the cash flow forecast may have been based very much on guesswork. In this type of situation, Tilmouth's entrepreneurial skills in convincing investors of the benefits of the business and the business's ability to achieve positive cash flow are more likely to have been the major factors in allowing the business to start trading.

Sample examiner comment

Mark: 16/16 (Level 4 — an excellent response fully focused on the question)

Thorough knowledge and understanding are shown of the benefits of cash flow forecasts to CleanedUp/ChargedUp.

Application is shown through the use of appropriate context applied to the question. Coherent and logical analysis is linked together, looking at the relevant importance of internal and external causes of business failure to a range of business situations, using context-based quantitative and qualitative data for competing arguments.

An evaluation of competing arguments with context is used to support a judgement about the relative benefits of cash flow forecasts to CleanedUp/ChargedUp.

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