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53. The importance of cash flow

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Introduction: Cash flow is of vital importance to a business. One saying says: "Revenue is vanity, cash flow is sanity, but cash is king". This means that whilst it may look better to have large inflows of revenue from sales, the most important focus for a business is cash flow.

Resources and methods: Many businesses may continue to trade in the short- to medium-term even if they are making a loss. This is possible if they can, for example, delay paying creditors and/or have enough money to pay variable costs. However, no business can survive long without enough cash to meet its immediate needs.

Cash inflow and outflow. Cash comes into the business (cash inflows), mostly through sales of goods or services and flows out (cash outflows) to pay for costs such as raw materials, transport, labour, and power. The difference between the two is called the net cash flow. This is either positive or negative. A positive cash flow occurs when a business receives more money than it is spending. This enables it to pay its bills on time. A negative cash flow means the business is receiving less cash than it is spending. It may struggle to pay immediate bills and need to borrow money to cover the shortfall.

Liquidity. Businesses aim to provide greater financial returns than the level of interest earned by simply placing the cash in a bank. They can also hold too much cash. Cash does not earn anything so holding too much cash could mean potential losses of earnings. The cash situation is referred to as the liquidity position of the business. The closer the asset is to cash, the more 'liquid' it is. Deposit accounts at a bank or stock that can easily be sold are liquid. Assets such as buildings are the least liquid. Liquid assets are those that are most easily turned into cash.

Results: Cash flow is always important but especially when it is not easy to obtain credit. When the economy is in recession, financial service providers are reluctant to lend

money. Borrowing also becomes more expensive as interest rates are raised to partially offset the risk of the borrowers not paying back loans.

Controlling cash. Controlling cash is essential and management accountants deal with a range of cash issues:

- ensuring that sufficient cash is available for investment by not tying up cash in stock unnecessarily
- putting procedures in place for chasing up outstanding debts
- controlling different levels of cash outflows in relation to the size of the business.

For example, a car repair garage buys parts and tires whilst a hairdresser buys shampoos, equipment and pays for power. In each case, if the business has cash problems it may be slow to pay its bills to suppliers. This creates further cash problems which spread throughout the economy. If small suppliers are not paid they may go out of business. This in turn may affect businesses further up the ladder.

Conclusions: The cash flow statement provides information regarding inflows and outflows of cash of a firm for a period of one year. Therefore cash flow statement is important on the following grounds.

1. Cash flow statement helps to identify the sources from where cash inflows have arisen within a particular period and also shows the various activities where the cash was utilized.
2. Cash flow statement is significant to management for proper cash planning and maintaining proper matching between cash inflows and outflows.
3. Cash flow statement shows efficiency of a firm in generating cash inflows from its regular operations.
4. Cash flow statement reports the amount of cash used during the period in various long-term investing activities, such as purchase of fixed assets.
5. Cash flow statement reports the amount of cash received during the period through various financing activities, such as issue of shares, debentures and raising long-term loan.
6. Cash flow statement helps for appraisal of various capital investment programmes to determine their profitability and viability.

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