

UDHNA CITIZEN COMMERCE COLLEGE &

SPBCBA & SDHGCBCA&IT

TYBCOM SEM-6 CH- CASH BUDGET

ADVANCED ACCOUNTING & AUDITING-8

THEORY

Cash Budget: Definition

The **cash budget** is an estimate of cash receipts and their payment during a future period of time. It deals with other budgets such as materials, labor, overheads, and research and development.

The cash budget is an indicator of the probable cash inflows and outflows. When payments exceed income, proper cash management will be enforced. When there is a surplus, expenditure is less than income, and a decision about how to use the surplus must be made.

Cash Budget: Explanation

The cash budget is a type of budget that estimates cash inflows and the use of cash during a specific period. Here, the sources of cash include receipts from debtors, bill receipts, interest as loans, dividends on shares, and other incomes from the sale of fixed assets.

On the other hand, examples of cash utilization include payments to creditors, payment of assets purchased, and daily routine payments such as wages, rent, postage, telephone, and entertainment expenses.

The **cash budget** shows the budgeted cash receipts and cash disbursements for a future period of time. The cash inflows and cash outflows are brought together in a cash budget to show the expected cash flows of the company.

Significantly, the summary of estimated cash flows presented in a cash budget enable companies to make plans about the future availability of cash. Financial plans are drawn up to anticipate periods of high and low cash availability.

Large cash balances imply that the **business** has not earned the best **rate of return**. Low cash reserves mean that the business will be unable to meet its dues.

In general, companies should have an adequate cash balance to meet the forecasted cash requirements, plus additional reserves to meet unforeseen contingencies.

Advantages of Cash Budget

1. Improved Cash Flow Management:

- **Detail:** A cash budget helps businesses track their cash inflows and outflows meticulously. This enables them to manage their cash flow effectively, ensuring that they have sufficient cash to meet their short-term obligations and operational needs.
- **Example:** By maintaining a cash budget, a retail store can anticipate periods of high cash outflows (such as during inventory restocking) and plan accordingly to ensure they have enough cash on hand to cover these expenses without disrupting daily operations.

2. Enhanced Financial Planning:

- **Detail:** A cash budget provides a clear picture of the company's future cash needs and resources. This aids in better financial planning and helps in setting realistic financial goals.
- **Example:** A manufacturing company can use a cash budget to plan for capital expenditures such as purchasing new machinery. By understanding their cash position, they can decide the best time to make such investments without straining their cash flow.

3. Prevention of Cash Shortages:

- **Detail:** One of the primary benefits of a cash budget is that it helps in identifying potential cash shortages in advance. This allows businesses to take proactive measures, such as arranging for short-term financing, to avoid liquidity crises.
- **Example:** A small business can use a cash budget to foresee a potential cash crunch during an off-peak season and arrange for a short-term loan to cover operational expenses until revenues pick up.

4. Better Decision Making:

- **Detail:** With a cash budget, management has accurate data on the company's cash position, which helps in making informed decisions regarding investments, expenditures, and other financial matters.

- **Example:** A company might decide to delay a non-essential project after reviewing their cash budget, prioritizing essential expenditures and ensuring the business remains financially stable.

5. **Cost Control:**

- **Detail:** A cash budget allows businesses to monitor and control their expenses effectively. By comparing actual expenses against the budget, businesses can identify areas where they are overspending and take corrective action.
- **Example:** A company can use a cash budget to track marketing expenses and realize they are exceeding their budget in advertising. This prompts them to revise their marketing strategy and control costs.

6. **Facilitates External Financing:**

- **Detail:** Having a well-prepared cash budget can enhance a company's credibility with banks and financial institutions. It demonstrates financial discipline and planning, making it easier to obtain loans or other forms of external financing.
- **Example:** A startup seeking a business loan can present their cash budget to the bank, showing their projected cash flows and repayment capacity, which increases their chances of securing the loan.

7. **Ensures Timely Payments:**

- **Detail:** A cash budget helps businesses plan for timely payments of their obligations, such as salaries, rent, and suppliers' bills, thereby maintaining good relationships with stakeholders.
- **Example:** A company can use its cash budget to schedule salary payments and avoid any delays, ensuring employee satisfaction and maintaining workforce morale.

8. **Supports Investment Planning:**

- **Detail:** With a cash budget, businesses can identify periods of cash surplus and plan for investments or savings accordingly. This helps in optimizing the use of available funds.
- **Example:** A business might find through their cash budget that they have surplus cash during certain months. They can invest this surplus in short-term financial instruments to earn additional income.

9. **Facilitates Performance Measurement:**

- **Detail:** By comparing actual cash flows with the budgeted figures, businesses can measure their performance and identify deviations. This helps in evaluating the effectiveness of financial strategies and making necessary adjustments.
- **Example:** If a company's actual cash inflows consistently fall short of budgeted inflows, management can investigate the reasons, such as declining sales, and take corrective actions to improve performance.

10. **Encourages Efficient Resource Allocation:**

- **Detail:** A cash budget encourages businesses to allocate their resources efficiently by prioritizing expenditures and investments that provide the most value.

- **Example:** A company can use its cash budget to allocate funds to high-priority projects that offer the best return on investment, rather than spreading resources thin across multiple lower-priority initiatives.

Limitations of Cash Budget

1. Forecasting Accuracy:

- **Detail:** The accuracy of a cash budget heavily relies on the accuracy of the cash flow forecasts. Estimating future cash inflows and outflows can be challenging, especially in dynamic and uncertain business environments. Any errors in forecasting can lead to inaccurate budgets, which may result in cash shortages or surpluses.
- **Example:** A retail company might forecast higher sales during the holiday season, but if actual sales fall short of expectations, the cash budget may show a surplus that doesn't materialize, leading to liquidity issues.

2. Inflexibility:

- **Detail:** Cash budgets are typically prepared for specific periods, such as monthly, quarterly, or annually. However, unexpected changes in business conditions or external factors may require adjustments to the budget. A rigid cash budget may not accommodate such changes effectively.
- **Example:** A manufacturing company might face unexpected increases in raw material costs due to supply chain disruptions. If the cash budget is not flexible enough to adjust for these changes, it may lead to cash flow problems.

3. Time-Consuming Preparation:

- **Detail:** Preparing a detailed and accurate cash budget can be time-consuming and resource-intensive. It requires collecting and analyzing data from various departments, which can be challenging for large organizations with complex operations.
- **Example:** A multinational corporation with multiple business units and diverse revenue streams might find it challenging to consolidate cash flow data and prepare an accurate cash budget within a short time frame.

4. Short-Term Focus:

- **Detail:** Cash budgets often focus on short-term cash flow management, typically covering periods of up to one year. While this is useful for managing day-to-day liquidity, it may not address long-term financial planning and strategic goals effectively.
- **Example:** A technology company planning a major research and development project may need to look beyond the short-term cash budget to ensure adequate funding for the project's duration and future commercialization.

5. Assumption Dependence:

- **Detail:** Cash budgets are based on various assumptions about future cash flows, such as sales projections, payment schedules, and expense estimates. If these assumptions prove to be incorrect, the budget's accuracy and reliability are compromised.

- **Example:** A company might assume that all customers will pay their invoices within 30 days. However, if customers delay payments, the actual cash inflows will differ from the budgeted amounts, causing cash flow discrepancies.
6. **Limited Insight into Profitability:**
- **Detail:** While a cash budget provides valuable information about cash flows, it does not provide a complete picture of the company's overall profitability. It focuses on cash receipts and payments but does not account for non-cash expenses such as depreciation and amortization.
 - **Example:** A construction firm might have positive cash flows from ongoing projects, but if it incurs significant non-cash expenses, the actual profitability may be lower than indicated by the cash budget.
7. **Overemphasis on Liquidity:**
- **Detail:** A cash budget prioritizes liquidity management, which is crucial for short-term survival. However, excessive focus on maintaining high cash balances can lead to missed investment opportunities and suboptimal use of resources.
 - **Example:** A company with a consistently high cash balance might miss out on potential investments in growth opportunities, such as expanding into new markets or acquiring new technology, due to the conservative cash management approach.

Methods of Preparing Cash Budget

1. **Receipts and Payments Method**
2. **Adjusted Profit and Loss Method**
3. **Balance Sheet Method**
4. **Working Capital Method**

1. Receipts and Payments Method

Detail: The Receipts and Payments Method, also known as the direct method, involves listing all expected cash receipts and payments over a specific period. This method provides a clear picture of the cash inflows and outflows, making it easier to manage cash flow on a day-to-day basis.

Steps:

1. **Identify Cash Inflows:** List all sources of cash receipts, including sales revenue, loans received, interest income, and other cash receipts.
2. **Identify Cash Outflows:** List all expected cash payments, such as purchases, salaries, rent, utilities, loan repayments, and other cash expenses.
3. **Calculate Net Cash Flow:** Subtract total cash outflows from total cash inflows to determine the net cash flow.
4. **Adjust for Opening Cash Balance:** Add the opening cash balance to the net cash flow to determine the closing cash balance.

2. Adjusted Profit and Loss Method

Detail: The Adjusted Profit and Loss Method, also known as the indirect method, involves adjusting the net profit for non-cash items and changes in working capital. This method is useful for understanding how operating activities impact cash flow.

Steps:

1. **Start with Net Profit:** Begin with the net profit as shown in the profit and loss statement.
2. **Add Non-Cash Expenses:** Add back non-cash expenses such as depreciation, amortization, and provisions.
3. **Adjust for Changes in Working Capital:** Adjust for changes in current assets and current liabilities, such as accounts receivable, inventory, and accounts payable.
4. **Consider Other Cash Flows:** Include other cash inflows and outflows that are not part of the profit and loss statement, such as capital expenditures, loan repayments, and dividends.

3. Balance Sheet Method

Detail: The Balance Sheet Method involves analyzing changes in the balance sheet accounts to determine the cash flow. This method provides a comprehensive view of how different components of the balance sheet affect the cash position.

Steps:

1. **Prepare Opening and Closing Balance Sheets:** Prepare the balance sheet at the beginning and end of the period.
2. **Calculate Changes in Accounts:** Calculate the changes in each balance sheet account, such as assets, liabilities, and equity.
3. **Analyze Cash Flow Impact:** Determine the cash flow impact of changes in each account. Increases in assets or decreases in liabilities usually indicate cash outflows, while decreases in assets or increases in liabilities indicate cash inflows.

4. Working Capital Method

Detail: The Working Capital Method focuses on the changes in working capital components (current assets and current liabilities) to determine the cash flow. This method helps in understanding how changes in working capital affect the cash position of the business.

Steps:

1. **Calculate Changes in Working Capital:** Identify the changes in current assets and current liabilities, such as accounts receivable, inventory, and accounts payable.
2. **Adjust for Non-Cash Items:** Add back non-cash expenses such as depreciation, amortization, and provisions.
3. **Include Operating Cash Flow:** Consider the cash flow from operating activities, such as sales and purchases.

4. **Determine Net Cash Flow:** Combine the changes in working capital with the operating cash flow and adjustments for non-cash items to determine the net cash flow.