

Cleared funds forecasts

by **Ann Irons**

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This article discusses the need for cleared funds forecasts and also shows how to prepare a simple cleared funds forecast. I would like to emphasise the fact that the Paper 10 Study Guide only requires candidates to be able to prepare a cleared funds forecast. In discussing the need for such forecasts, therefore, I have focused on a practical explanation of how a company treasurer might invest a cash surplus in the money market. This is because the Study Guide also requires candidates to explain the nature of a money market. This article links two parts of the syllabus, those two parts being cash budgeting and investment of surplus funds.

The need for cleared funds forecasts

A cleared funds forecast shows the actual cash available to a company in its bank accounts. If cleared funds are negative, the company has an overdraft for this amount, on which interest will be charged.

At any one time, there will usually be uncleared funds (also referred to as the 'float'). Such cash may be tied up for a variety of reasons. First, there may be a transmission delay, ie a delay between sending and receiving a payment (through the post). Second, there may be a delay between when a payment is received and when it is actually paid into the receiver's bank account. Third, the payment has to go through the bank's clearing system. This can take a number of days. The advantage of electronic payments, of course, is that they are only subject to the third of these delays. The time at which they will become cleared funds can therefore be anticipated with much more accuracy.

Why do we care about whether or not funds have cleared? There are two main possible reasons. First, our business may be in a cash surplus position. If this is the case then there may be large sums of money sitting in our current account that could be invested, thereby earning interest. If we leave them in our current account for even a few days, thousands of pounds of potential interest may be lost. By preparing a cleared funds forecast we can decide whether to put cash on an overnight deposit, or a one week deposit, or even longer.

If I was in the treasury department of a large company I would probably expect to receive a list of money market rates from my preferred agent each morning. Alternatively, I may prefer to deal with the banks directly and search for the best rates available. An agency has a number of banks on its list. The rates the agency offers me are the best of their bank rates less a cut for their margin. In turn, the rates the banks offer will be based on the market rate (between banks) less a cut for the bank's margin. For example, at the time of writing this article, the rates being offered for Sterling by one agency were as follows:

Overnight	One week	One month	One year
4.6%	4.52%	4.51%	4.5%

This compares to the actual base rate, at the time of writing, of 4.5%. It is interesting to see that the rate of interest being offered to an investor actually falls as the time period of the investment increases. This is probably because the expectation is that interest rates may fall in the future in the UK. However, the demand for cash today will also affect the interest rates and, as the overnight rate is 4.6% compared to a base rate of 4.5%, there is obviously a relatively high demand for cash today.

As the treasurer of a large company, I would probably need cleared funds forecasts to be prepared on a daily basis so that I could assess the company's investment choices daily. Perhaps the company is predicted to be in a cash surplus position for many months and needs to consider a whole range of investment options.

The second reason for finding out about cleared funds is if our business is in a cash deficit position. In some ways this makes the need for accurate cleared funds forecasts even greater as the company will be operating within an agreed overdraft limit. Should it exceed this limit without advance agreement, the cost can be high. Since an overdraft is repayable on demand, the bank could call in the overdraft, which could have catastrophic consequences for the business. While a cash rich company may forego interest if it does not prepare accurate forecasts, a cash poor business may go out of business altogether.

It is important to remember that, although we talk of accurate cash forecasting, such forecasts can never be totally accurate. This is because of the variability in the transmission delay and in the delay between receiving and paying in a cheque. Also, for example, a customer may pay a debt later than expected, or unexpected expenditure may arise.

The preparation of cleared funds forecasts

The simplest way to demonstrate how to prepare a cleared funds forecast is to go through a question. I have set one out below.

Table 1: Receipts from customers

Customer name	Credit terms	Payment method	7 November 2005 sales	7 October 2005 sales
P Ltd	1 calendar month	BACS	£300,000	£260,000
Q Ltd	None	Cheque	£360,000	£320,000

Weed Care Ltd

Weed Care Ltd is a manufacturing company producing and selling a range of weedkillers to wholesale customers. It has three suppliers and two customers.

Weed Care Ltd relies on its cleared funds forecast to manage its cash. The information detailed in Table 1 is available.

- P Ltd always makes its payments exactly one month after purchasing goods. Receipt of money by BACS is instantaneous.
- Q Ltd's cheque will be paid into Weed Care Ltd's bank account on the same

day as the sale is made and will clear on the fourth day following this (excluding day of payment).

Now look at Table 2.

Table 2: Payments to suppliers

Supplier name	Credit terms	Payment method	7 November 2005 purchases	7 October 2005 purchases	7 September 2005 purchases
Grass Ltd	1 calendar month	Direct debit	£130,000	£110,000	£90,000
Roots Ltd	2 calendar months	Cheque	£170,000	£160,000	£150,000
Soil Ltd	None	Cheque	£190,000	£180,000	£170,000

- Payments to Grass Ltd are made by direct debit on the 7th day of each month for the previous month's purchases.
- Weed Care Ltd will send out, by post, cheques to Roots Ltd and Soil Ltd on 7 November. The amounts will leave its bank account on the third day following this (excluding the day of posting).

Now look at Table 3.

Table 3: Wages and salaries

	November 2005	October 2005
Weekly wages	£26,000	£36,000
Monthly salaries	£130,000	£120,000

- Factory workers are paid cash wages (weekly). They will be paid one week's wages, on 11 November, for the last week's work done in October.
- All the office workers are paid salaries (monthly) by BACS. Salaries for October will be paid on 11 November.

Other miscellaneous payments

- Every Monday morning, the petty cashier withdraws £500 from the company bank account for the petty cash tin. The money leaves Weed Care's bank account straight away.
- New office furniture will be ordered by telephone on 7 November at a total cost of £1,250. The company's debit card will be used and the amount will therefore leave Weed Care Ltd's bank account on the next day.

Other information

- The balance on Weed Care's bank account will be £350,000 on 7 November 2005. This represents both the book balance and cleared funds.

You have been asked to prepare a cleared funds forecast for the period Monday 7

November to Friday 11 November 2005 inclusive using the information provided. Show clearly the uncleared funds float each day.

Answer approach

You should tackle the question as follows:

1. Set out the pro forma for your answer. Once the pro forma has been laid out, the rest of the question is quite straightforward. Candidates sometimes do poorly in these types of questions because they walk into the exam hall without knowing the pro forma.

Since you are preparing the forecast over five days, you will need six columns - one for each day plus the first column for your narrative. There are four main parts to a cleared funds forecast:

- receipts (from P Ltd and Q Ltd)
- payments (for supplies, wages, salaries, petty cash and office furniture)
- cleared excess receipts over payments (ie the net amount of your receipts and payments). In this section, you should also show your cleared balance brought forward each day and your cleared balance carried forward each day
- uncleared funds float - you should show the total uncleared receipts and payments each day.

The bottom line of the forecast should then be the total book balance carried forward each day. Your pro forma should look like Table 4.

2. You should then begin filling in the numbers by working methodically through the information. The following points should be noted in relation to the question:
 - When calculating the daily receipts from customers and the payments to suppliers, be sure to carefully note the credit terms. If you fail to do this, you will be using the wrong receipts figure and losing easy marks. The payment method is obviously very important too. BACS payments, standing orders and direct debits will generally leave the company's bank account on the date stated. If the payment is a cheque, you will have to read the additional information carefully in order to establish the date when the funds will clear.
 - Similarly, it is essential to read the information carefully for wages and salaries because, as is the case in this question, workers will usually 'work in hand', ie work for some time before being paid and often always have wages owing. This practice discourages workers from leaving jobs without giving adequate notice to their employers.
 3. You should finish the question by completing the following:
 - Cleared excess receipts over payments. This line is simply the receipts less the payments each day. You must then, for each day, add the cleared balance brought forward to this figure. Don't forget to insert the opening balance b/f at the beginning of the week (£350,000). Your
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closing balance each day will then be your opening balance for the next day, just as in a monthly cash budget.

- Uncleared funds float. At the end of each day there may be receipts, for example, that have been paid into the company's account but will not have cleared yet. These are your uncleared funds float receipts. Similarly, cheques may have been sent out, which you know have not been received by the payee yet. These are your uncleared funds float payments. Net the receipts and payments off against each other.
- Total book balance c/f. This is the bottom line of your cleared funds forecast and shows the total of the cleared and uncleared receipts and payments.

Your final answer should look like Table 5.

Table 4

	7 Nov £	8 Nov £	9 Nov £	10 Nov £	11 Nov £
Receipts					
P Ltd					
Q Ltd	_____	_____	_____	_____	_____
Payments					
Grass Ltd					
Roots Ltd					
Soil Ltd					
Wages					
Salaries					
Petty cash					
Office furniture	_____	_____	_____	_____	_____
Cleared excess receipts over payments					
Cleared balance b/f					
Cleared balance c/f	_____	_____	_____	_____	_____
Uncleared funds float					
Receipts					
Payments	_____	_____	_____	_____	_____
Total book balance c/f	_____	_____	_____	_____	_____

Table 5

7 Nov £	8 Nov £	9 Nov £	10 Nov £	11 Nov £
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Receipts

P Ltd	260,000	0	0	0	0
Q Ltd	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>360,000</u>
	<u>260,000</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>360,000</u>

Payments

Grass Ltd	110,000	0			0
Roots Ltd	0	0		150,000	0
Soil Ltd	0	0		190,000	0
Wages	0	0	0	0	36,000
Salaries		0	0		120,000
Petty cash	500	0	0	0	0
Office furniture	<u> </u>	<u>1,250</u>	<u> </u>	<u> </u>	<u> </u>
	<u> </u>	<u>1,250</u>	<u>0</u>	<u>340,000</u>	<u>156,000</u>

Cleared excess receipts

over payments	149,500	(1,250)	0	(340,000)	204,000
Cleared balance b/f	350,000	499,500	498,250	498,250	158,250
Cleared balance c/f	<u>499,500</u>	<u>498,250</u>	<u>498,250</u>	<u>158,250</u>	<u>362,250</u>

Uncleared funds float

Receipts	360,000	360,000	360,000	360,000	0
Payments	<u>(341,250)</u>	<u>(340,000)</u>	<u>(340,000)</u>	<u>0</u>	<u>0</u>
	<u>18,750</u>	<u>20,000</u>	<u>20,000</u>	<u>360,000</u>	<u>0</u>

Total book balance c/f

Total book balance c/f	518,250	518,250	518,250	518,250	362,250
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To summarise, candidates are sometimes worried by cleared funds forecasts, but they are really quite straightforward. If you know the pro forma, and you read the question carefully, you should do well in any question. Cleared funds forecasts are part of the syllabus area of cash budgeting and their use is so vital in the real world that they should not be ignored.
