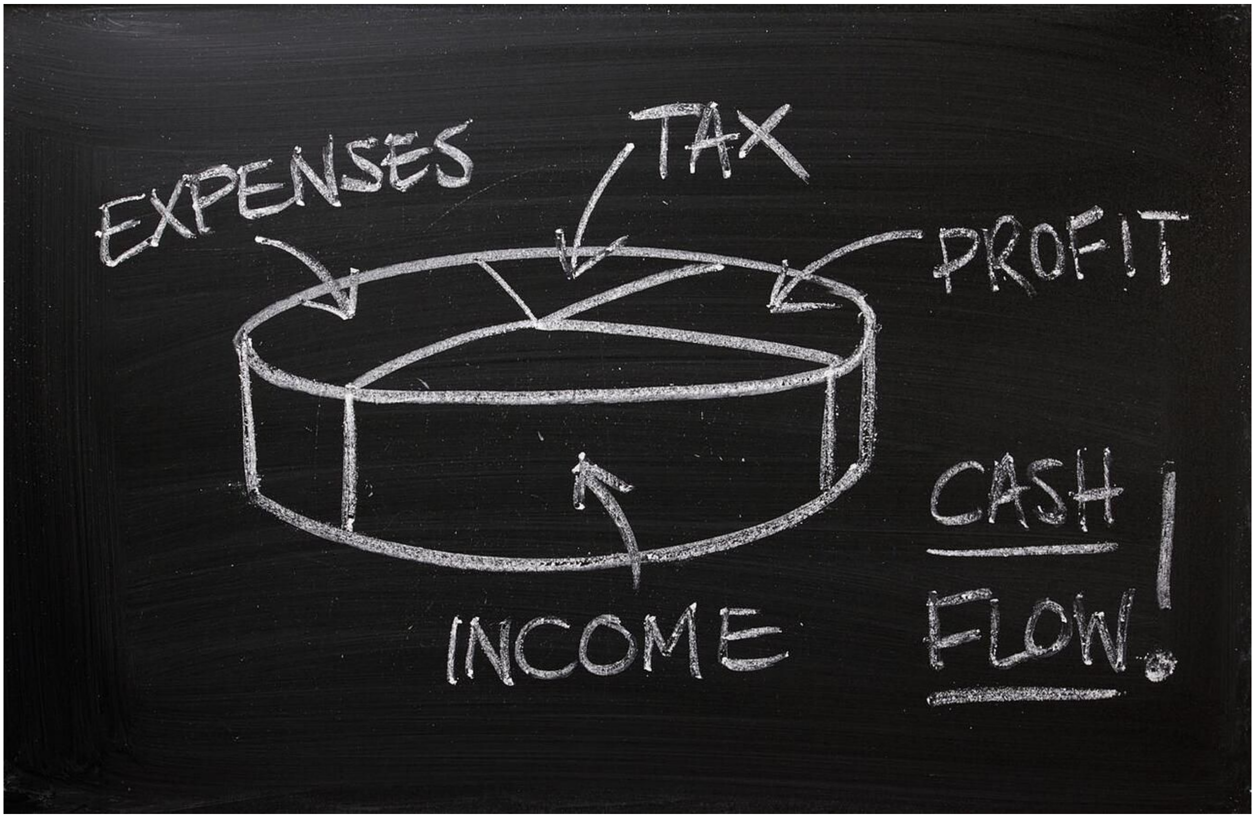
Why Profits Don't Equal Cash Flow

6 min read



Key Takeaways

- To understand where your cash has gone, you must first understand the relationship between profit and cash flow, and how each is calculated.
- Profit is shown on an income statement and equals revenues minus the expenses associated with earning that income.
- Cash flow measures the ability of the company to pay its bills. The cash balance is the cash received minus the cash paid out during the time period.

When small business owners get their monthly financial statements, their eyes quickly focus on the bottom line of the income statement.

If profit is good, their gaze gradually moves to cash in the bank or the cash account on the balance sheet, where they may be surprised to see that cash didn't grow as much as they thought it should.
The owner then asks the question, **"How can I have made a profit but have so little cash?"**

The situation where profit and cash flow are at odds is very common for a small business which must invest in assets in order to grow. The reasons can always be seen on the balance sheet.

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Profit vs. Cash Flow

Profit

Profit is shown on an income statement and equals revenues minus the expenses associated with earning that income. This measures the ongoing sustainability of the company.

Cash Flow

Cash flow measures the ability of the company to pay its bills. The cash balance is the cash received minus the cash paid out during the time period. When cash on hand is negative, the company has spent more cash than it has brought in during that time period.

What's the difference?
Let's look at an example for further clarification.

- Profit for the period = Revenue ($10,000 total sales) less expenses ($5,000) = positive $5,000 profit
- Cash flow for the period = Cash-in ($5,000 cash sales) less cash-out ($5,000 cash paid out) = $0 cash flow

The Blame Game

The positive profits and not so positive cash flow riddle is essentially an accounting issue. The situation can usually be blamed on using cash for things that don't show up on the income statement. Or it's a function of the timing difference of when revenues and expenses are recognized in relationship to their collection and payment.
Accountants generally prepare financial statements using accrual basis accounting. With this method, expenses are reported only when goods or services are completely consumed, regardless of when the bill got paid.
Similarly, revenues are reported only when the product or service has been delivered to the customer and the company has earned the right to receive cash payment, regardless of when we you get paid by the client

Side note: Cash basis accounting, which tracks the movement of cash through a business to calculate net income, would show a more accurate reflection of a business's cash in the bank.
However, this method is not best practice because it shows profitability based on cash flow and doesn't show the true profit of the month. Standard accounting best practice follows the matching principle in which expenses are matched with their associated revenues in a reporting period.

The Reasons for Changes in Cash Flow

Knowing when and how expenses and revenues are recognized on the income statement are key evidence in the negative cash flow mystery. But for the true cash flow story you want to look at the Statement of Changes in Cash Flow.

The cash account in the cash flow statement has three areas to investigate:

- Cash Flows from Operations
- Cash Flows from Investments

- Cash Flows from Financing

To help you in your detective work, here some examples of situations which could be the source of your company's negative cash-flow, positive profit discrepancy.

#1 Investing in Consumables

Your company has spent more in cash than what is expensed by accounting, because the business is investing in consumable products (Cash Flows from Operations).

Let's say a vendor had a sale on an inventory item. You take advantage of the sale and buy $1,000 of the item, but only sell $500 worth of the item during the reporting period.
In this case, your cash account would be reported on the balance sheet as a negative ($500 cash in, minus $1,000 cash out = -$500) but wouldn't show up on the income statement because its not a cost until you sell that product.

#2 Offering Customers Credit

Your business allows its clients to pay for its goods or services via a credit account (Cash Flows from Financing).

When a customer pays on credit the income statement has revenue but there's no cash being added to the bank account. Similarly, any cash down payment will be reflected in the cash account and the balance of the customer's purchase will appear in accounts receivable on the balance sheet.

Meanwhile, the entire sale is recognized as revenue on the income statement, reflecting the legal obligation by the customer to pay for the purchase they made on credit. Therefore, in this scenario, the business could show a hefty profit, but there's been no cash exchanged between the two parties.

#3 Making Investments

Your company is buying equipment, products and other long-term assets with cash (Cash Flows from Investments).

As a growing small business, you are likely to be spending more than you have in profits because the company is investing in long-term assets to fuel its expansion. These purchases typically involve an expenditure of cash.
However, the expense won't be recognized in the same period as the cash outlay. That's because the accounting standard is to expense the long term asset gradually through depreciation over the useful life of the assets.

#4 Repaying a Loan

Your company decides to repay a loan from the bank (Cash Flows from Financing).

When a loan comes due, your business needs to use its cash to repay the bank. That can decrease your cash account substantially. But accounting guidelines only allow the interest from the loan to be deducted as an expense to deduct when calculating profits.
Therefore, the principal payment lowers the cash account, but does not affect profits.

#5 Prepaying an Expense

You purchase insurance or pre-pay rent (Cash Flows from Operations).

When your business makes a payment in advance, more cash was paid out than product consumed during the period. Examples of typical prepaid items are taxes, insurance and rent.

With accrual accounting, only the portion of the prepaid expense incurred during the reporting period will be deducted from revenues. Therefore, cash flow may suffer from the prepayment, but the expenses won't take the same brunt. That scenario enables your business to filter more income to the bottom line for positive profits.

Statement of Cash Flows

To see an accurate picture of your cash flow, you have to consider more than your company's cash disbursements. To understand the disappearing cash magic trick, take a closer look at the statement of cash flows and the changes in the balance sheet.

You'll find your cash in hidden asset accounts like inventory, fixed assets, accounts receivable and prepaid insurance. Or in using cash to pay down debt, such as credit cards, accounts payable or bank loans.

That observation may help you realize that you may need to hold off on more investments and cash outlays – at least until your cash flow is king once again.