

Profit Versus Cash Flow

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Most small to mid-size business owners don't feel that their Financial Statements fairly represent the business operation. They get frustrated when their banker closely scrutinizes the "numbers" to determine the ability of the company to repay a new loan request. The main culprit behind the owner's frustration stems from the confusion over profit versus cash flow.

Why is it that so many profitable companies have little or no cash in their accounts and yet other unprofitable companies can have lots of cash? This drives business owners crazy and leads many to suspect that Financial Statements do not properly reflect the company's circumstances.

There are two primary financial statements for any business, the Balance Sheet, which measures assets and liabilities between periods (typically monthly) and the Income Statement or Profit and Loss Statement, as some refer to it, which measures a company's operating performance.

Cash flow is measured as a result of an interaction between these two statements, which can be confusing. For this reason, most accountants prepare a third statement called, "Statement of Cash Flows", which ties the Balance Sheet and Income Statement together and reconciles beginning cash with ending cash in the company bank accounts for a specific period of time.

Statement of Cash Flows

The above referenced Financial Statement typically consists of three categories:

- **Cash Flow from Operations**
- **Cash Flow from investing activities**
- **Cash Flow from Financing Activities**

Cash Flow from Operations considers only the "cash received" from sales and "cash paid-out" for expenses relating to sales. Therefore, net income or profit is adjusted for any "non-cash" items like depreciation, a tax provision enabling companies a way to re-build cash to update or replace fixed assets needed to make future sales. It also considers the difference between selected balance sheet items at the beginning of the period versus those balances at the end of the period. For example, a reduction between Beginning Accounts Receivable and Ending Accounts Receivable is "cash collections" and or write-offs for sales that will never be collected. This same procedure is used to compare beginning versus ending accounts like Accounts Payable, Inventory, Pre-paid Expenses, Accrued and Deferred Expenses like salaries and taxes, which may show as expenses on the Income Statement but will be paid at a later date. The end result is a calculation that adds all of these account balance differences to determine if net cash was "generated" from operations (collections exceeded cash expenses) or "used" by operations (cash expenses exceeded cash collections) for the period.

Cash Flow from Investing Activities considers changes in Fixed Asset balances like trucks, machinery and equipment etc. In other words, did the company spend money to buy new assets or bring in money from selling off old assets?

Cash Flow from Financing Activities considers any new borrowings or loan reductions made during the period as well as cash distributions to stockholders for example.

Finally, the “net cash” generated or used for each segment is summed and that “cash” amount is added to the cash balance at the beginning of the period. The resulting number will tie into the company’s actual cash balance on the last day of the period.

Growth vs. Mature/Declining Industries

So, why do some profitable companies have no cash while unprofitable companies may have lots? Growth companies typically make profits and re-invest their cash to match their increasing sales trends. They tend to borrow heavily during times of revenue expansion. As a result growth companies often have large profits but little cash. On the other hand, many mature or declining industries have declining profits but lots of cash. The reason for this is somewhat apparent – when you are not facing a future with growth prospects, you don’t borrow and you don’t re-invest in new assets. Therefore, these companies tend to horde their cash and/or pay out substantial distributions or bonuses to their stockholders.

The Cash Flow Game is complex and represents a delicate balance to maintain adequate cash on hand, make investment in new assets and re-pay debt.