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Profit vs Cash

08 September 2017 by Wendy Skinner

There is a question I am often asked as a professional advisor: "I have made a profit this year, so why do I have cashflow problems?"

Making a positive net profit doesn't necessarily mean you will have a positive cash flow.

You will have heard of the common saying "cash is king". Whilst making a profit is a good thing, it is irrelevant if you have insufficient cash to pay your debts as and when they fall due. What are some of the reasons that profit is different from cash?

Accrual versus cash

Net profit is based on accrual accounting, not cash.

Included in the profit and loss are transactions that have not yet been recorded in your bank account. For example, sales that have been invoiced to customers, but you haven't received payment for yet. Similarly, there may be invoices for expenses incurred which are still owing to your suppliers. These transactions are recorded in your profit and loss, but no cash transaction has happened yet.

Assest purchases

When cash is used to purchase assets for a business during the year it is not recorded in the profit and loss. Instead, it will be recorded in the balance sheet as an asset. These types of transactions have been through your bank account, but not the profit and loss.

Loan repayments

Cash is also used to pay business loans. There are two components to loan repayments; principal and interest. While the interest portion of the loan repayment is recorded in the profit and loss as an interest expense, the principal portion is offset against the loan liability recorded in the balance sheet.

Drawings

Drawings are cash withdrawn from the business bank account during the year by the owner. This reduces your cash in the bank, but is not recorded in the profit and loss.

The types of transactions discussed above show the difference between the net profit result and cash on hand. Understanding the difference between the two is the first step to managing and ultimately improving your cash flow. The steps detailed below illustrate that effective cash flow management is a three-step, sequential process.

1. Monitor

In order to effectively monitor cashflow you need access to up to date, reliable information. Accounting systems are very accessible and responsive, and there are many systems available that make it easy to keep your business transactions up to date regularly so you can monitor your cashflow (and your profit).

We assist clients to monitor cashflow by using reporting dashboards. The dashboard reports pinpoint key performance indicators specific to the business.

Some key performance indicators relating to cashflow may include:

Debtor days – the average time to collect payment from customers.

Inventory days – the average number of days that it takes to sell an item of inventory.

Accounts payable days – the average number of days it takes to pay your suppliers.

Cash conversion days – a product of all the above which deter-mines how many days during the sales process that you will be required to fund working capital. It measures the number of days it takes to convert initial cash out to purchase inventory, to final cash collected from the customer.

2. Manage

Once cashflow is being monitored on a regular basis, you will begin to understand the factors that impact positively and negatively on your cash, identifying trends and patterns. Only then can you start to manage and take action to turnaround the negative impacts on your cashflow.

For example, if debtor days are one of the key indicators highlighted by the dashboard and you have noticed an increase over the last couple of months, you can start to question why this has changed.

- Why are customers not paying on time?
- Is anyone following up to request payment or ask the reason why they haven't paid?
- What are your terms of trade?
- Are your terms of trade being ignored by your customer, (or by you)? E.g. Let's say your terms of trade state payment 20th of the month following, with interest on non-paid items. If you are not following up unpaid items after the 20th or not charging interest, then the customer is taking advantage of your lack of process for follow up and using your business as an interest free bank.

3. Improve

Once you are monitoring cashflow and identifying areas that need closer management, then improvements should naturally follow.

One of the key ways to improve cashflow is to minimise the time that cash is tied up in your working capital.

Simply chasing up on one debtor can reduce cash conversions days, sometimes by up to 80 days, or more. If this result is repeated across multiple customers the combined impact on working capital has the potential to be huge.

With a plan in place to regularly monitor, manage, and then take steps to improve, cashflow problems can be quickly identified and rectified. The expression, "we must learn to walk before we can run" is appropriate. In other words, before you can start to make changes to improve your cashflow, (manage and improve), you must first understand what the root of the problem is (monitor). Remember that even a small change can result in material positive outcomes for your business.

Speak to your Baker Tilly Staples Rodway advisor about how you can more effectively monitor, manage and improve your cashflows.

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