

## Cash vs. Profit

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### In essence...

There is a fundamental difference between profit and cash which may well be obvious to some, what isn't necessarily clear is how a profitable business still fails; a high percentage of these cases can boil down to cash flow. The saying 'Cash is King' is familiar to a lot of people, it is extremely relevant for small businesses and start-ups, so what's the difference between cash and profit.

### From the top...

One of the key financial reports that businesses monitor and work with is the Profit & Loss Statement (Income Statement); this report monitors the past performance based on your revenue less your expenses. This is useful however it does not necessarily correlate to the level of cash the business has due to the accruals accounting basis.

### Do explain further...

The accruals accounting basis requires items to be recorded in transactional dates, and items outside of the accounting period, tend to be adjusted so the transaction is proportioned between the periods it covers.

This often means transactions are recorded on the date of the invoice and many companies operate with credit terms so payments are made/received on a different date, this starts to create the difference between profit and cash.

Capital expenditure is also completely omitted from the Profit & Loss Statement (these are balance sheet items), so the new machinery you purchased doesn't come off the profit value, rather than a proportion does each year of the useful economic life, which is another difference between cash and profit.

### Profit Adjustments

Profit adjustments are typically depreciation, accruals, prepayments and deferred income/payments. All these are items that adjust your profit and loss account however does not have any impact on your cash balance.

### Working Capital Items

I've touched on the fact that trade credit also creates a difference between profit and cash; placing an order for supplies that you can pay for in 14, 30 or even 60 days later will mean the invoice date is used for the Profit & Loss yet the cash going out happens some time later. The reverse can happen for credit sales and the cash comes in some time later than it is billed for.

Investment in your stock items (or work in progress) is also treated as an asset on your profit and loss which raises your profit level yet as it is stock, you have to sell that and receive your clients payment before it makes a positive impact on your cash. If that stock isn't sold, you never get that cash in!

## Cash & Liquidity

All these differences between these accounting processes means that the profit and loss does not reflect the level of cash you have in your business and available to continue to trade with.

The working capital cycle (stock, suppliers and customers) can have a lot of cash invested in it, you need to ensure you receive your client's payments so you can pay your suppliers and staff, so you can continue to supply to your customers and gain new ones.

If cash runs out and you cannot settle your business debts, you are no longer liquid and it is at this point you need a cash injection if you can arrange it or you need to enter administration. Worst case scenario, the business goes through insolvency practices and is wound up, and another business has failed because of cash flow.

## Cash Flow Forecasts

Don't despair; there is a method for managing your cash. There are three key reports in financial management, the Profit & Loss Statement (Income statement), the Balance Sheet (Statement of Financial Position) and the Cash Flow Forecast, it's the cash flow forecast that monitors your actual cash position now and how you plan to use your cash in the future.

By using this report to track the cash movements of your accounts, you can see how the future is panning out and where you might need to take action to ride out the storm before it becomes a larger problem for the business, for example, below the decline in income means that things are worrying from Dec to Feb, this means alternative finance (e.g. An overdraft or business loan) will be needed until the business recovers.

Cash Flow Forecast (Mth End Balance)												
	Mth 1	Mth 2	Mth 3	Mth 4	Mth 5	Mth 6	Mth 7	Mth 8	Mth 9	Mth 10	Mth 11	Mth 12
	Jun-15	Jul-15	Aug-15	Sep-15	Oct-15	Nov-15	Dec-15	Jan-16	Feb-16	Mar-16	Apr-16	May-16
<b>Income</b>												
Total Income	5,000.00	3,500.00	2,000.00	1,000.00	500.00	0.00	0.00	0.00	250.00	25,000.00	1,000.00	1,200.00
<b>Outgoings</b>												
<b>Fixed Costs</b>												
Total Fixed Costs	3,850.00	3,850.00	3,850.00	3,850.00	3,850.00	3,850.00	3,850.00	3,850.00	3,850.00	3,850.00	3,850.00	3,850.00
<b>Variable Costs</b>												
Total Variable Costs	170.00	100.00	220.00	80.00	200.00	70.00	100.00	190.00	70.00	180.00	60.00	110.00
<b>Total Outgoings</b>	4,020.00	3,950.00	4,070.00	3,930.00	4,050.00	3,920.00	3,950.00	4,040.00	3,920.00	4,030.00	3,910.00	3,960.00
Starting Balance	10,000.00	10,980.00	10,530.00	8,460.00	5,530.00	1,980.00	-1,940.00	-5,890.00	-9,930.00	-13,600.00	7,370.00	4,460.00
Net movement in cash for period	980.00	-450.00	-2,070.00	-2,930.00	-3,550.00	-3,920.00	-3,950.00	-4,040.00	-3,670.00	20,970.00	-2,910.00	-2,760.00
Closing Balance	10,980.00	10,530.00	8,460.00	5,530.00	1,980.00	-1,940.00	-5,890.00	-9,930.00	-13,600.00	7,370.00	4,460.00	1,700.00

## In conclusion...

Although the Profit & Loss is an invaluable report to know and understand, it is important to know that it does not represent the cash in the bank and the funds available to continue trading with. Using a cash flow forecast to monitor the actual cash movements can help prevent issues of liquidity and prevent insolvency.

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If you would like to know more or to discuss any of the above content, the author would love to hear from you, please contact them on [vicki.lamch@pyramissolutions.co.uk](mailto:vicki.lamch@pyramissolutions.co.uk).

Who do you know that would benefit from reading this article or speaking to us at Pyramis Solutions; please do share this information and our contact details.