

IS CASHFLOW MORE IMPORTANT THAN PROFIT?



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The ongoing debate in the world of business and accountancy... what's more important to a company cash or profit?

Without profit the business cannot survive, but profit does not always result in cash flow, and without cash flow the business has trouble operating.

Same old catch 22 ???

Whether you're a small family run business or a large corporate, you won't be able to stay trading for long if you don't have good cash flow. All businesses need to have cash available to pay bills, wages, suppliers, employees and the list goes on, but why is cash flow more important than profit?

Profit is extremely important to any business but profit is completely irrelevant if you're not getting paid for the products or services you've sold, so it's extremely important for the profit to become cash flow as quickly as possible.

Cash flow is the blood line of any business. You need to know how much revenue is generated in order to cover your on going business expenses (rent, payroll, etc). As an entrepreneur, you have either previously dealt with or are dealing with issues that come with starting a business.

In this case, cash flow is much more important, as you need to spend money to build your brand, advertise your products/services, and hopefully acquire customers. You may be able to get by with start up capital for a while (and not be profitable for a short while), but eventually, all companies with low or no profit will cease to exist. I would imagine cash flow and profit are both extremely important, but at this point you need cash flow first, and profit second.

Where to start?

The easiest way to determine where your cash has come from is to prepare a cash flow statement. This usually begins with net income (or profit) for the period and then adjustments are made to net income for any changes in operating, investing, and financing activities over a specified period of time, usually from one year to the next. Once you know where your cash is coming from you can determine what you need to do moving forward, so what you do with the information is what counts!

Then?

So moving forward, how is this assessed? Well the easiest way is to use your statement to prepare a cash flow forecast, this model can be as simple or as complex as you like, depending on the size and nature of your business. The period it covers, again can be tailored to cover either short term or long term depending on what you need. Of course, as accountants we would recommend both and here's why:

- A weekly cash flow tool can be used to identify potential shortfalls in cash balances – for example, if the forecast shows a negative cash balance after the VAT liability is payable then the business needs to ensure it has a sufficient bank overdraft facility, or access to a draw-down on its invoice discounting facility. The model will also determine how long you need this cash for and how quickly it can be repaid.

- A yearly cash flow tool can be used to see whether the trading performance of the business (revenues, costs and profits) turns into cash, and helps to analyse whether the business is achieving the financial objectives set out in the business plan. It will also help you to plan your tax liabilities and seasonal trends.

I'm sure you'll agree, both of these are important to the success of your business.

How can businesses improve cash flow?

There are a variety of methods a business can use to improve its cash flow. One way that is fast disappearing for a lot of small businesses is to have access to good lines of credit. If a business is finding credit harder to come by, then other options need to be explored.

One way to improve cash flow is to offer early settlement discounts, this would give customers a small discount if they were to pay their invoices in full by a certain date. Also check to see how well your customer terms and supplier terms are balanced, for example... "If your average payable is 22 days and your average receivable is 45 days, that's 23 days that you have to float, which means you have to go out and get working capital".

Some companies also manage to stay liquid with invoice factoring which involves selling unpaid invoices on to a 3rd party at a discount. The 3rd party then attempts to collect the outstanding invoice. When they manage to collect the invoice they then forward the remaining money on to the business owner, less any fees that have been agreed for their services.

Another thing a business can do to improve cash flow is to resolve any invoice disputes quickly.

No Cash Flow, No Business

An unprofitable business can survive for a reasonable length of time as long as it has good cash flow; a business that doesn't have good cash flow can be dead within weeks.

When a small business applies for a loan, the bank will consider its credit score and risk and will also look at specifically how the company will repay the loan. The credit score uses the company's past payment history to forecast the likelihood that the company will pay its bills in the future. The cash flow statement, with projections showing how the loan will be used and how that use will benefit the business, is reviewed by the bank to see what will change in the business if the loan is approved.

Cash flow will determine the ability of a small business to repay a loan. That makes this number more important than profit in some ways. A company can have a very small profit, or even a loss, but if the cash flow is sufficient to repay a loan, the business has a better chance of being approved for credit.

And the conclusion?

So - to answer the question - 'profit or cash - which is more important?' - cash is the most important as the business cannot continue to carry on day to day operations in the current market without cash in the bank and you cannot rely on banks to provide an on-going overdraft facility. However the end game for any business is both - as profits are the purpose of being in business and these can only be enjoyed by the business owners if there is sufficient cash to distribute the profits.

If all of this sounds complicated to you please pick up the phone or email us and someone here will be happy to give you more information.