The difference between cash flow and profit

Sales and profit are two very different things – as a business owner, you can find yourself without the cash to pay bills despite making sales you knew were profitable. You may also be startled to discover that strong cash flows from sales deliver little profit.

What exactly is cash flow?

A cash flow forecast tracks cash flowing in and out of your business. The timing of these flows enables you to identify cash-rich and cash-lean periods. This helps in making the right decisions, such as when to buy assets or when to prepare for cash shortfalls.

The importance of cash flow

Cash flow is essential to the survival of your business – arguably more so than profit in the short term. Profit may be essential in the longer-term, but in the short-term cash is needed to pay bills and operating costs.

For example, if you're a plumber with good cash reserves, you can survive until your business becomes profitable. However, if your business runs out of cash, you'll need to find a solution quickly to avoid going bankrupt.

A definition of profit

Profit is the money left in your business after all your expenses have been paid. An income statement (also referred to as a profit and loss report) reveals what profit your business made last month or last quarter. Your profit's detailed in two figures, namely:

- Gross profit – what's left from sales after deducting the costs of goods sold or services provided.
- Net profit – what's left from gross profit after operating costs (your business overheads) have been deducted.

Note that net profit still isn't the final 'bottom line' profit until all taxes have been paid.

The significance of profit

All businesses need profit to grow. Your profit can be allocated to (among other purposes):

- Buying more production assets.
- Developing new products, new services, or intellectual property.
- Funding start-up costs for new employees.
- Marketing and business growth campaigns.
- Reducing debt levels.
- Paying dividends to shareholders.

Why cash flow and profit can differ

The gap between a cash flow forecast and an income statement (profit and loss report) reflects the different ways business owners record financial data.

Cash flow forecasts record cash

A cash flow forecast only records actual cash transactions. Cash flow can be boosted by inputs other than sales, such as:

- Capital injections by the owner or investors.
- Cash coming in from loans.
- Cash from selling an asset.

These sources boost cash levels to fund your business but aren't profit.

Profit and loss statements show actual profit

Unlike the cash flow forecast, the income statement includes 'book figure' inputs that don't involve cash outlays but do affect the profit calculation, such as:

- Depreciation expenses on capital assets like equipment.
- Assets written down – such as writing off an uncollectible account receivable owed by a customer.

Explaining discrepancies

These scenarios help explain the gap between cash flow and profit.

Where's the money?

"The income statement shows a $50,000 profit, but the cash in the bank is only a fraction of this. The figures don't match up. Where's the missing profit?"

A common example that can raise this question is a business that buys equipment (a fixed or capital asset) for $40,000.

- The cash flow forecast shows the full $40,000 cash payment when it was made.
- On the income statement, the business will claim only the depreciation amount on a capital asset. However, the profit and loss account shows $4,000 as an expense against sales. This makes the business's net profit seem much higher than the actual cash available in the bank.

Sales are great, so we must be profitable

"We've been extremely busy these past few months. Sales are booming – but I can't see any profit."

Inexperienced business owners can easily confuse 'being busy' with being profitable, but there's a very clear distinction between them. Your profit is always what's left after all costs have been deducted.

If you haven't calculated your selling prices correctly, your 'thriving' business may in fact be operating at a loss. The cash flow may seem great, but the profit and loss account reveals the true picture.

The critical lesson here is to never set your prices until you know all the costs involved. You might end up operating at a loss or at an unsustainably small profit level.

We’ve made many profitable sales but can’t pay our bills

It’s quite possible to run out of cash or go bankrupt by taking on too much business too quickly, even though each sale is profitable. This is called overtrading – and businesses that sell on credit rather than cash terms are more at risk.

Actions that can lower cash flow

Reasons businesses can run out of cash include:

- Excessive withdrawals by the owner(s).
- Purchasing too much inventory relative to sales.
- Taking on more loans than the business can service.
- Buying assets at inappropriate times (such as during a slow period).
- Pre-payments or paying suppliers too soon. If suppliers offer 30 days, it makes sense to take advantage of the full credit period.

Cash flow is about timing

Cash flow is all about the timing of money inflows and outflows.

If you expend significant cash to pay operating expenses and miscalculate the actual time to collect customer receivables, or your business is poor at collecting on overdue accounts, you can easily use up all your cash paying suppliers and other bills while waiting to collect amounts owed by customers.