1-1-2015

# Why cash flow is more important than profit

Aretha Boex
*University of Nebraska at Omaha*, aboex@unomaha.edu

# Why cash flow is more important than profit

*It is quite possible for a company to report profits but go out of business. It is also possible for a company to be profitable and not be able to grow, secure financing or attract investors.*

Many equate the success of a company to its reported profits. While profits are good, they do no adequately represent the financial standing of a firm. It is quite possible for a company to report profits but go out of business. It is also possible for a company to be profitable and not be able to grow, secure financing, or attract investors. There are a couple of reasons why cash flows are a better indicator of a company's financial health.

## Cash is King

Profit figures are easier to manipulate because they include non-cash line items such as depreciation expenses or goodwill write-offs. Under generally accepted accounting principles (GAAP) businesses can use non-cash expenses such as depreciation and amortization to offset large capital expenditures.

Cash flow statements, on the other hand, provide a more straightforward report of the cash available. In other words, a company can appear profitable "on paper" but not have enough actual cash to replenish its inventory or pay its immediate operating expenses such as lease and utilities.

If a company cannot purchase new inventory, it will slowly become unable to generate new sales. If a company cannot afford its operating expenses, it will eventually go out of commission. Either way, "Cash is King" in keeping a business alive.

## Cover the gap between receivables and payables

Another important consideration is that profit reports are based on sales income. The main issue here is that the recorded revenue is often greater than the amount of actual cash received from sales. When sales are on credit, the collection period on accounts receivable can last 2-3 months. This means that the company needs to have enough cash on hand to float its operations for the duration of the collection period.

Using the previous examples, this means having the cash equivalent of 2-3 months' worth of operating expenses and inventory purchases on hand. In the likely event that a firm also makes purchases on credit, accounts payable become another important factor to consider. To be sustainable, a business has to pay special attention to its cash cycle and make sure to cover the cash gap between receivables and payables.

If the business goes out of cash, operations will simply cease. This further illustrates why cash flows provide a better sense of the financial situation of a business.

## Why lenders look at cash flow

Assuming that a firm has enough cash to maintain its current level of operation, most business owners want to grow their company. If cash is king in sustaining ongoing business operations, it becomes that much more vital when considering expansion. Sales growth is great… unless it results in the total depletion of cash. Companies should prepare for cash outlays to considerably exceed cash inflows during the early stages of expansion. In fact, to be able to generate a growth in sales, businesses must first be able to afford an expansion in capacity. This increased capacity can come in the form of additional personnel, equipment, new locations, more inventory, etc. Either way, the company has to be able to remain in operation until its cash flows stabilize and become positive.

*Companies should prepare for cash outlays to considerably exceed cash inflows during the early stages of expansion.*

Business owners may think that securing commercial financing will solve the growth dilemma. It is not that simple. Lenders expect regular repayments on the financing they provide. As such, lenders rely on a company's current and projected cash flows to determine whether it will be able to afford the additional debt.

Overall, understanding a company's cash situation is crucial to making sound business decisions. Owners must strive to understand and always be in-touch with the cash aspect of their enterprise, regardless of the profits reported. Fortunately, business owners do not have to do it alone. They can work with their bookkeeper or accountant to review how cash circulates through their business. They can also take advantage of the Small Business Development Centers available to small businesses and aspiring entrepreneurs throughout the United States and its territories.

SOURCES

Fulmer, J. G., Jr., Finch, J. H., Smythe, T. I., Jr., & Payne, T. H. (2002). Growing sales and losing cash: Assisting your small-business customer with cash flow management. Commercial Lending Review, 17(4), 14-19.

Glassman, J. K. (2012). Go With the Cash Flow. Kiplinger's Personal Finance, 66(8), 16-18.

Osgood, W. R. (2004). Common Sense Cash Flow Management. Strategic Management Learning System Workbook 1. Knowledge Institute, Inc.

## About the author

Aretha Boex is the Omaha center director of the Nebraska Business Development Center. She manages the small business consulting program and leads a team of professionals who provide direct technical assistance to owners and potential owners of small businesses. She brings extensive experience in management consulting, business planning, financial analysis and small business loan applications. Aretha is a Certified Economic Development Finance Professional through the National Development Council. She holds a Master of Business Administration and a Master of Science in Management Information Systems from the University of Nebraska at Omaha.

nbdc
NEBRASKA BUSINESS DEVELOPMENT CENTER®

## About the Nebraska Business Development Center

NBDC is a cooperative program of the U.S. Small Business Administration (SBA) and the College of Business Administration at the University of Nebraska at Omaha (UNO). NBDC partners with the University of Nebraska at Kearney, Southeast Community College, Wayne State College, Mid-Plains Community College and Chadron State College to provide consulting and business support services from offices in Omaha, Lincoln, Kearney, Grand Island, North Platte, Wayne, Auburn, Scottsbluff and Chadron. Learn more about NBDC at nbdc.unomaha.edu