3.7 Cash flow

The difference between cash flow and profit

In Subtopic 3.5 (/study/app/y12-business-management-a-hl-may-2024/sid-351-cid-174702/book/the-big-picture-id-39042) you learned about profit and profitability ratios. Profit is simply defined as total revenue minus total cost. Generating profit is necessary for a business to stay afloat and grow over time. Cash flow refers to cash inflows and outflows. Cash inflow refers to the money in ‘cash’ that the company earns from its main operations and other revenue sources, such as the sale of unused fixed assets. Cash outflow refers to the money the company pays for its operations and other irregular expenditure, such as legal fees. Net cash flow is defined as payments received by a business minus payments made. Sometimes you will also see a definition of cash inflows minus cash outflows.

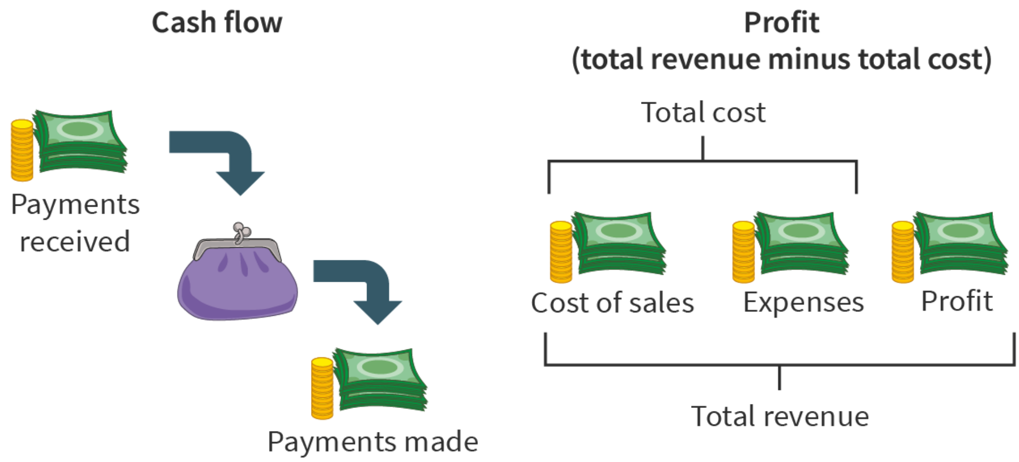

Figure 1. Cash flow versus profit.

Profit and cash flow are closely connected, but show different aspects of a business. It is not uncommon for companies to be profitable and have cash flow problems, as illustrated in the following example.

The Chinon Snack Company earned sales revenue of $50 000 from the sale of packed roasted peanuts, sold in bulk to supermarkets at a cost of $30 000. However, 50% of the sales were on 30-day credit terms, meaning only half of the payment was made at the time of purchase. The company’s cash flow and profitability positions were, therefore as follows:

Profit = total revenue − total cost

= \$50 000 − \$30 000

= \$20 000

However, the company's cash flow position was as follows:

Net cashflow = payments received − payments made

= (50% × \$50 000) − 30 000

= -\$5000

The Chinon Snack Company therefore had a cash crisis. Because of limited cash inflow, it was unable to pay its employees and meet its other obligations. If it had outstanding long-term debt, then the company would be unable to make the payments on its loans. This would mean there was a risk that the bank could sell any assets the company had offered as collateral at the time of borrowing. Unless the company was able to raise some finance through an overdraft, for example, it could become insolvent. This is because, despite the fact that the business calculated a \$20 000 profit, 50% of the sales revenue would only be received the following month.

To help you remember the difference between profit and cash flow, remember that profit refers to the accounting records, while cash flow and sufficient cash is related to the planning and ensuring that payments are made on time.

Figure 2. A business can be profitable and can also have cash flow issues.

Credit: Jeffrey Coolidge, Getty Images

The working capital cycle

Working capital refers to the funds available in the business to meet the needs of its day-to-day operations. It is therefore a very important concept in business because, like cash flow, it affects the survival of the business. You may remember from Subtopic 3.5 (/study/app/y12-business-management-a-hl-may-2024/sid-351-cid-174702/book/the-big-picture-id-39042) that working capital is calculated as follows:

Working capital = current assets – current liabilities

Just to remind you, current assets include cash, debtors and stock. Current liabilities include creditors, overdrafts and short-term loans. When current liabilities are greater than current assets, the business is unable to pay for its ongoing expenses such as wages, raw materials and suppliers. The business will probably stop functioning. Most of the time, there is a time lag between the production and sale of products and when payment is received. This lag causes a negative cash flow. Businesses need to plan for this so they can cover the costs of operations while they are waiting for payment from customers.

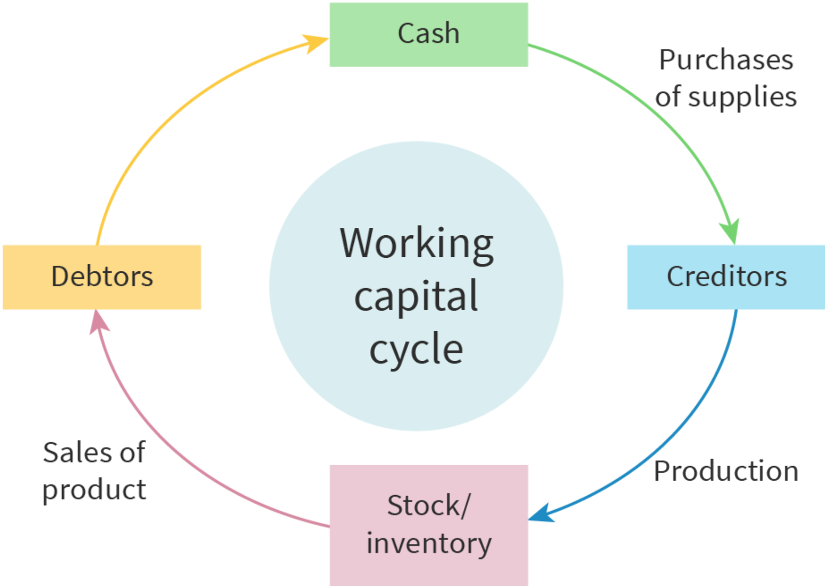

Figure 3. The working capital cycle.

You can see a visual representation of the working capital cycle above. If the business purchases supplies and manufactures its stock, it will pay its creditors (cash outflow), but will not be able to collect payment owed to it by its debtors (cash inflow). So it may face interruptions in the working capital cycle. Planning in advance to try to avoid such potential interruptions is essential for maintaining solvency.