Isaacs Advisory

*Financing Advisory Services*

# Timing is Everything:
## Understanding the Difference Between Profitability and Cash Flow

Many companies spend money quicker than they receive it, and become insolvent—unable to pay their debts. In fact, profitable companies have gone bankrupt because they didn't understand the significance of the relationship between profitability and cash flow.

In its simplest form, profitability typically measures the difference between the selling price of goods and services less what it costs to either make or deliver them. Bankers, lenders, successful business owners, investors, and those in financial circles will tell you that profitability is one of the best known measures of success.

> Have you ever thought, "My company is profitable, but I never seem to have enough cash on hand!"

Cash flow is determined by the timing of precisely when we receive the cash for our sales and actually pay out the cash for our cost of goods, operating costs, and overhead expenses. Companies buy on credit or with payment terms. Cash flow is not the timing of when goods or services were either earned or incurred. An accountant using Generally Accepted Accounting Principles (GAAP) requires that we record or recognize transactions when they legally happen, not when the actual cash is received or paid. Allow me to illustrate:

Let us assume we are going to start a business. We purchase inventory for $1,000 and then sell it for $1,500. Our net income, which is the difference between the sales and purchases, is $500.

Now, consider the two aspects of the timing of the transaction—first, when we receive the money from the customer and second, when we have to pay for the purchases.

Assume the vendor wants us to pay the $1,000 in 30 days and our customer only wants to pay us the $1,500 in 60 days. As you can probably see, the issue here is that we need to pay for the inventory before we actually receive the sales proceeds.

In this example, our business is profitable as we will net $500 in profit, however, it is insolvent as we do not have the $1,000 to pay for the goods when the 30 days comes due.

Companies in "growth mode" often experience cash flow issues as they often need additional cash to order more inventory to fill the increasing sales orders, or require more staff to manage the business  but often the company has to wait for their customers to pay (cash flow). The demands for more inventory or raw materials, more staff, or additional overhead often places a cash-flow burden on the business.

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Businesses typically require working capital to manage the timing difference between receipt and payment of cash. This can come in many forms, ranging from an injection by the shareholders, an operating line of credit with their bank, a working capital loan from an asset-based lender (ABL) or factor financing company.