

Do The Math!



Credit, Cash Flow, and Calamity

By Jay Goltz

In this new economic “environment,” it’s even more important to pay attention to our little friend called cash. Many people don’t realize that companies get in trouble not because they are unprofitable but because they can’t pay their bills. This is where the concept of cash flow comes in. To fully understand the difference between profit and cash flow, let’s look at an example.

Say you have a business that grosses \$1 million a year. After you pay yourself, you are left with a profit of 6 percent, or \$60,000. Let’s say it’s the end of the year. If your cash flow matched your profits, you would have \$60,000 sitting in your bank account. That would come in handy because you are going to owe the IRS about \$20,000 in taxes. Depending on how much you made last year, you will either have to pay that as an estimate by December 31 or by April 15 at the latest. Simple enough? Usually not.

In this case, you can’t pay your bills. You are over 60 days with your suppliers, and many of them have put you on C.O.D. Where is your \$60,000? Where is your new car? Where is your vacation? Let’s do the math!

The \$60,000 has been taken hostage. You didn’t notice, but your account receivables have gone from \$80,000 to \$96,000. You used to collect your money in 40 days. Now it’s 48 days due to the economic slowdown. Or because the person who used to call the receivables is on maternity leave and the person filling in (maybe you) isn’t as diligent in calling overdue balances.

Your inventory used to be \$150,000, but now it’s \$194,000. You saved some money by purchasing in bigger quantities. You have about 5,000 feet of moulding left over from a job that used less than you thought, and you reordered some materials that weren’t really out of stock, just out of sight. You also have way more black cap moulding—your most popular frame—than you had last year. Why? Remember when you ran out and yelled at the person who orders, “Don’t ever run out of this moulding again!” You won’t. That person ordered an extra 20,000 feet.

You bought a new \$12,000 saw and paid cash. Some new computer equipment cost another \$15,000 in cash. You also bought a new truck. You financed it for 36 months because they had a low interest deal. The truck is being depreciated over 7 years, so every year you’re spending more cash than you are expensing on your income statement. Let’s say that eats up about \$6,000 per year. And you took

out a bank loan several years ago and this year paid it down about \$10,000. That came out of cash flow.

There are some expenses that help cash flow, in comparison to profit. While depreciation is an expense, it is a non-cash expense. Say that amounts to \$15,000 per year.

Taxes	\$20,000
Receivables	\$16,000
Inventory	\$44,000
Equipment	\$27,000
Truck loan paydown	\$6,000
Bank loan paydown	\$10,000
Total use of cash	\$123,000
Less depreciation (cash flow)	\$15,000
Total reduction in cash flow	\$108,000
Less profit (cash flow)	\$60,000
Net cash shortage	\$48,000

Your payables have gone up \$48,000, so they are effectively financing your business. That is why you can’t pay your bills. This is why companies can run out of cash, even if they are profitable. Here are some ways to avoid this:

1. Always watch receivables. *Always.*
2. Establish inventory levels that are monitored and maintained.
3. Be careful of paying debt down too fast. The truck loan could have been made for 60 months.
4. Consider financing new equipment. The saw and computers could have gotten a term loan or a lease with an option to buy.
5. These days, keep an eye on your credit lines at both your bank and credit card companies. You might want to use your credit or you’ll risk losing it if your bank decides to cut back on lending.

If you don’t understand any part of this example, talk to your accountant. If your accountant can’t explain it to you, *change accountants*. This is not an area where you can afford to fly blind. Cash might be king, but cash flow is a dictator. It will dictate whether or not you sleep at night. ■

Jay Goltz owns Artists’ Frame Service in Chicago, IL, which employs over 80 people at its main framing operation. He has received many business honors and is known for his straight talk on succeeding in business.