# Understanding the difference between cash flow and profit

## It's useful to know the difference between the cash flowing into your business and your net profit, which ultimately is what you are taxed on.

Why? It's often a common misunderstanding when it's time to pay tax. You've worked hard all year, placed everything back into the business and haven't drawn a cent. As far as you are concerned, you've earned zero. But the accountant says the business has made a profit and now you have to pay tax!

How can that be?

Another common problem is where a business is profitable, but it runs out of cash and can no longer pay its bills.

The difference:

**Cash flow** is simply the cash that comes in and goes out of your business each day. Money in, money out.

**Profit** is what the CRA will tax you on from your end of year accounts of your business operations. It's calculated by adding up all revenue and subtracting all expenses, leaving a profit balance.

Let's take a look at an example: you start your business and have sales of $100,000 with running costs of $60,000 during the year,and you buy a $40,000 piece of machinery.

As far as you are concerned, you've made zero profit ($100,000 sales – $60,000 expenses – $40,000 machinery).

But that's CASH FLOW, not PROFIT.

As the machinery will last more than a year, you must depreciate the asset over time, and you can't deduct the whole lot at once. If the rate of depreciation is 10%, then the cost will be $4,000 for the year ($40,000 times 10%).

Your profit will now be $100,000 less $60,000 in expenses less the $4,000 depreciation, which equals $36,000. You will need to report to the CRA a $36,000 profit and pay tax on that amount.

Even though you have zero in the bank!

### Purchase of inventory

You spend $40,000 to buy new inventory/raw materials the day before the end of the financial year:

You can't claim the whole $40,000 as an expense, as you can only count inventory/raw materials that has been used during the year.

In this example from one day to the next, you won't have sold or used any of the inventory. So when you complete your end of year accounts, you won't be able to claim any of the new purchases as an expense to be deducted.

Watch out for buying large amounts of inventory (often suppliers have sales and offer good deals) at the end of the year unless you have a cash surplus you don't need.

### How to avoid an end of year surprise

To better balance the difference between cash flow and profit:

- Plan to purchase new assets at the start of your financial year, not the end
- Only spend cash on capital items if it's surplus
- Unless it's a great bargain and you have the cash, don't buy large amounts of inventory at the end of the year
- Try and pay for items over time to keep your cash intact
- Ask suppliers if you can buy inventory on consignment (you only pay for it when you sell it)
- Lease don't buy assets if they're not used all the time
- Identify virtual warehousing or being able to integrate your inventory needs online so you only buy what you need, when you need it
- Be careful not to draw too much from the business during the year

Remember to plan for the dates when your business's taxes are due. A large tax bill is difficult to pay if you haven't planned in advance for it, especially if it arrives at a time when your cash reserves are low.

### Profit importance

By no means should you ignore your profit situation or shift your focus entirely to cash flow. The trick is to balance it out. For example, if you've got a strong cash flow position, then you might be able to offer leniency to late-paying customers in order to keep their business.

## Improving your cash flow

One of the best ways to improve cash flow is to shorten your cash cycles – reduce the amount of time your business goes without cash:

- Make sure you get paid fast – If you can avoid invoicing (and chasing customers for payment) so much the better. We have payment solutions you can make use of, such as mobile and online options.
- If you do have to invoice, provide incentives for customers to pay early, such as a discount.
- Check their credit history – It's in your best interest to check out who you're offering credit to, especially if you're invoicing. That way you minimize your risk of extending credit to customers who have a history of non-payment.

## Summary

It's important to remember that cash flow and profit are two very different things – as a business owner, protect yourself by having the cash to pay bills while making sales you know are profitable.