

Is it possible to have made a profit and have no cash essay examples

[Business](#), [Company](#)



In the modern world of business one cannot underestimate the importance of the relationship between profits and cash flows. History might provide us with the examples, when profitable companies go bankrupt because of lack of cash (Osborne, 1984), while other businesses continue their operation by increasing debt and having positive cash flow despite huge losses in the income statement. Any entity which strives for sustainable growth and effective performance should try to maintain positive levels of both profits and cash flows (Hongren, 2005). Although modern industries present many companies whose cash reserves are much lesser than their profits, it is viable to understand that weak cash position constitutes a serious threat for the survival of any entity, as cash is the “lifeline” of a company (Hongren, 2005).

Before we start examining relationships between profits and cash flows we need to outline the definitions of two terms. According to Pyle (1981), “profit is the difference between the purchase and the component costs of delivered goods and/or services and any operating or other expenses”, while cash flows explain the changes that occur in the firm’s cash balance during a given time period (Hongren, 2005). International accounting standards segment cash flows in 3 types: cash flow from operating activities (CFO), cash flow financial activities (CFF) and cash flow from investing activities (CFI). Remarkably, profits are not affected by CFF and CFI, and it is one of the reasons reason why cash levels may greatly differ from bottom line. For instance, a company may invest cash in new plants and equipment (decreasing cash) or make a loan (increasing cash), but none of these procedures will change company’s profits.

Relationship between CFO and profit is also very important. Consider the situation: company's January sales are \$50, 000 , total cost is \$35, 000. \$20, 000 of sales were cash, the other \$30, 000 were on 90-day credit. According to accrual method of accounting, January's profits would be \$15, 000.

However, cash account increases only by \$20, 000 instead of \$50, 000, and this money is not enough to cover all the expenses. Consequently, company is facing a liquidity crisis and is under threat of bankruptcy, as it is unable to meet its obligations against suppliers. This example underlines the importance of managing cash streams for any company. Financial officers should adequately leverage accounts payable and accounts receivable to avoid cash shortages.

It goes without saying, that while analyzing company's profits, one has to pay attention to its cash flow position. According to (Hongren, 2005), analysts use the relationship between cash flow from operations and net income as one of a set of indicators that address the issue of earnings quality. High quality earnings suggest that revenues should not be recognized prematurely and expenses should not be deferred inappropriately. A ratio which estimates the earning's quality is calculated by dividing cash flow from operating activities by net income. Normally, the ratio should be higher than one. If the ratio is less than one, it may indicate that company's earnings are of " bad" quality and that the risk of cash flow crisis is rising.

There are several financial indicators which usually help in analyzing company's cash flow position and liquidity (Pyle, 1981). Quick ratio (acid-test ratio) measures company's ability to repay its current liabilities. Accounts

receivable turnover estimates how effectively a company is collecting debt from its customers, in other words, how fast customers are providing real cash for the products and services. On the contrary, accounts payable turnover measures company's effectiveness in repaying its short term obligations. Since accounts payable and accounts receivable greatly influence the amount of cash a company has at its service, it is vital to control these indicators to maintain strong cash position.

It is difficult to say with confidence how much cash exactly should a company have in order to be strong and sustainable. Too little cash results in risk of inability to cover short-term obligations, while too much cash indicates the inefficient management of current assets (i. e. free cash could be invested in risk-free securities to produce a greater output). Small and fast growing companies experience cash shortages more often than others. Rapidly increasing sales result in increasing labor costs and inventory, and usually a young company has insufficient funds to cover all the expenses. Keeping this in mind, if a company is experiencing a liquidity crisis, there are few ways to improve its cash position. First, it shall improve its collection of receivables. Increasing the accounts receivable turnover ratio by negotiating new contracts with customers will result in faster collection of cash, and therefore will improve cash position. However, negotiating new contracts may indirectly decrease sales, as usually customers are more reluctant to buy products from companies which do not provide sales on credit. Secondly, a company might decrease its accounts payable turnover ratio by negotiating new contracts with suppliers. If a company manages to extend its credit agreements with suppliers, it will have more free cash on hand, and

its cash position will be improved. Decreasing accounts payable turnover might also have a negative effect on business, as suppliers tend to charge higher fees from companies which repay their debt for a longer period. All in all, it becomes clear that it is possible for a company to be profitable, but have a lack of cash, and business world is full of such examples. This is mainly because of expansion of credit payments in the world markets. However, lack of cash may be a threat to the company's solvency, and this means that in the short run, cash is more important than the profit. Efficient management of payables and receivables might bring strength to company's cash position by balancing payments from the customers and payments to the suppliers. In addition, cash position might be strengthened if distribution of free cash is carried out wisely. For instance, in order not to lose cash from risky investments, investment decisions should be well founded and reasonable. In order to increase amount of cash companies might attract bank loans, however they should be aware that if there is too much free cash on company's accounts, the usage of assets becomes inefficient.

Reference List

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