

# Overview of **Cash Flow Management**

## How to avoid the **Cash Crunch**



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## What is Cash Flow?

Cash flow is the amount of cash generated from all sources within a specific period of time.

## Cash Flow vs Net Income (profits)

Cash flow is not the same as profits.

*Net income is a great measure of the financial success of your core operations. It shows the extent to which your pricing and volume of activity compare to the expenses you incur to provide your product or service. Significantly, a company does not have to collect from its client in order to have revenues.<sup>1</sup>*

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Cash flow indicates the level of a company's ability to meet its financial obligations. Positive cash flow enables a company to meet payroll, pay suppliers, meet debt payments and make distributions to owners. Cash can be generated by operations, or provided by lenders or owners.

For example, "Positive cash flow of \$500,000 for 2005" means cash balances at the end of the year were \$500,000 higher than cash balances at the start of the year. "Net income of \$500,000 for 2005" means revenues (sales) exceeded expenses by \$500,000 for the year. Understanding the difference between the two and their respective importance is a big step towards shrewd financial management.

The following observations flow from the difference between profits and cash flow

- It is possible for a company to be profitable but have little or no cash
- It is possible for a company to have positive cash flow and still be unprofitable

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<sup>1</sup> Some companies recognize income only when they collect cash. These are cash-basis companies. Companies that recognize income even when they have not collected from clients are known as accrual-basis companies.

## Profitable but broke

How can a company make profits yet have no cash? Contributing factors include

- Poor collections practice – the company recognizes income but is not collecting the cash at a fast enough rate
- Paying suppliers too early
- Servicing loans or purchasing capital equipment

## Cash rich but unprofitable

Positive cash flow in a given year is not necessarily a sign of good financial operations:

- Cash could be provided by owners' equity
- Cash could be provided by loans
- Cash could be provided by one-time activity such as an asset sale

## What is good cash flow?

Cash from owners and creditors is classified as cash from financing activity. Cash that is generated by delivering a product or service is referred to as cash from operations.

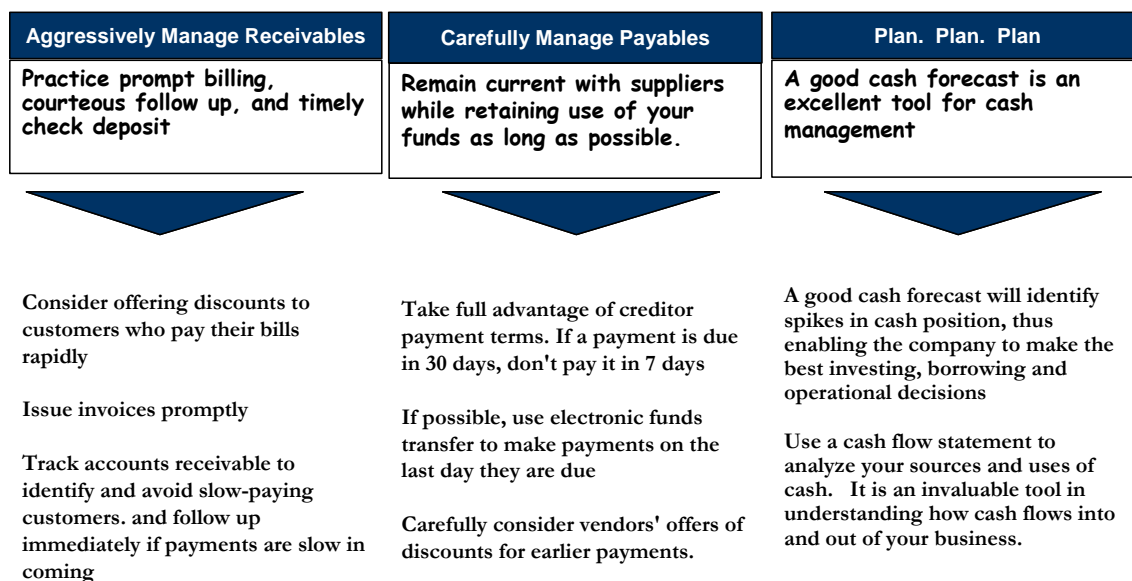
Financing activity is necessary and appropriate in certain circumstances, such as at start up, expansion or recession recovery. However, excessive reliance on such capital infusion will eventually result in business failure. Sustained success is totally dependent on consistent, positive cash flow from operations.

Positive cash flow from operations reflects the following:

- The operation is self-sustaining; it is churning out more cash than it uses
- The company has the option of paying down debt
- The company has the flexibility to strengthen the operations through expansion or process improvements

## Tips for improving cash flow

A company with positive cash flow from operations is a financially healthy business. Here are several steps that will improve the cash flow picture



## Tax Implications of Cash Balances

A cash rich company is better than a cash-strapped company. However, entrepreneurs need to be aware of Internal Revenue Service (IRS) rules regarding accumulated earnings. Cash surplus representing earnings can be distributed to owners or retained in the business. Undistributed cash is not taxed to the owners, so it could be a form of personal tax deferral. If the IRS determines that the business is retaining too much cash they can levy a tax on the retained funds.

According to CCH Tax Research Network, “The basic aim of the accumulated earnings tax ...is to prevent a corporation from accumulating income in order to shelter its stockholders from...taxes that they would have to pay if the corporation's income were distributed to them... Thus, the tax serves to punish any tax-avoidance scheme of deferment of stockholder income. This is accomplished by imposing an additional tax on corporate earnings and profits that are accumulated in excess of reasonable business needs.”

## Conclusion

Cash flow management is one of the main challenges small businesses encounter. An investment of time and expertise might appear costly, but the payback will more than compensate for the incurred costs.

## How we can help

At Generis we are passionate about your success. We are equipped to assist in the following areas:

- Developing a cash management system
- Providing customized and affordable cash improvement solutions
- Monitoring and managing IRS accumulated earnings levels.

Please contact us at **(508) 222-2242** for additional information and a personalized assessment.

## About Us

GFC is a Massachusetts certified consulting company specializing in accounting, finance, and management advisory services to small businesses and individuals who require unmatched service and expertise.

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