

PROFIT V CASHFLOW –which is more critical?

Among the jargon thrown around by those involved in the accounting and finance fields are these two commonly used phrases. I know you've heard of them both –but you may not have developed an appreciation for the difference. What I'm sure you have discovered, is that you frequently get to the end of the year to be told by your CPA that you've achieved a profit and now owe some tax – to which you promptly reply “so if I made a profit, where is all the money?”

This scenario occurs if you don't pay attention to the money as it comes into your possession. In simple terms it looks like this:

1. Gross Sales. The money your customers give you to bank
2. Cost of Sales. Also called COGS or Cost of Goods Sold. This is the amount you paid (or need to pay) your vendor for the items sold.
3. Gross Profit. The amount left over after deducting the COGS from Gross Sales.
4. Expenses. Operating costs such as advertising, wages and rent
5. Net Profit. The amount left after deducting expenses from your Gross Profit.
The average US store makes somewhere between a 0.9% and 12% Net Profit i.e. a \$1m store makes between \$9,000 and \$120,000 profit.

An example of an average month's revenue and profit:

1. Gross Sales. \$70,000
2. Cost of Sales. \$35,000 (at Keystone, the COGS and GP are the same).
3. Gross Profit. \$35,000. Fig.1 less Fig.2
4. Expenses. \$33,800. The average US jewelry store loses money (or breaks even) for 9 months the year
5. Net Profit. \$ 1,200. Fig.3 less Fig.4 leaves a modest profit for the month.

So what is the difference between profit and cash-flow? There are four main factors that affect your cash-flow. They are:

1. How you get paid i.e. cash (incl. credit cards), layaway or on account

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2. How you pay i.e. in advance (you own the stock), memo (the vendor owns the stock)
3. How you manage your purchases or re-orders
4. Unexpected/unbudgeted expenses

See how quickly your cash-flow can be affected using the example above:

1. Cash In \$60,000 due to a large item sold on Layaway
2. Purchases \$25,000 for Memo goods sold last month
\$15,000 others items purchased last month that are due for payment this month = \$40,000 in total purchases
3. Cash Left \$20,000 after paying for purchases i.e. Fig. 1 less Fig.2.
4. Expenses \$33,800 as per the budget
5. Net Cash-flow **-\$13,800**. Even though you made a small \$1,200 profit, your overdraft or line of credit has gone up by \$13,800 ... and that's assuming your expenses didn't increase and you didn't purchase any more than you sold at cost.

This highlights how many businesses become unstuck with their cash-flow because they forget about their future cash-flow requirements.

Failing to manage cash flow is the single biggest reason for the failure of most small businesses

One way to understand this and manage it better is to separate the money (cash) into two piles as it comes in. One pile is the COGS which is the money you need to pay for the goods you have sold (or the replacement ones) and the other pile is the Gross Profit which is the money you need to pay wages and rent. If you don't separate them, you will inevitably use some of your Gross Profit to buy additional unbudgeted stock thereby robbing you of Net Profit for your retirement and lifestyle needs. And your CPA still says you made a profit and need to pay tax!

The COGS pile is managed using an Open to Buy budget and the Gross Profit pile is managed using an Expense budget such as QuickBooks.

Unlike many businesses, jewelry retailing offers the advantage of positive cash-flow because most revenue is received at the time of sale yet most expenses are not due until at least a month later. But, this is a double edged sword without careful planning and attention to the implications of what is owed in the future.

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