

Cash in the bank versus profit in the accounts

Illustration

Let's assume you win a contract with a sales price of £9000 and you believe the costs of the project will be £1000 hardware and £3000 labour. You have to pay for the hardware on delivery and you have given your customer 30 days credit, from the date of the invoice, which you can only raise once the job has been completed. We won't complicate things by adding VAT here.

So you are expecting a profit of £9000 less £1000 less £3000 = £5000

- Month 1 you purchase the hardware and account for it as stock
- Month 2 you complete and pay for the work
- Month 3 you invoice the customer
- Month 4 you receive payment

The cash flow looks like this:

	Month 1 Purchase hardware	Month 2 Pay the labour	Month 3 Raise the invoice	Month 4 Receive payment
Cash brought forward from previous month	£0	-£1000	-£4000	-£4000
Cash flow in the month	-£1000	-£3000	£0	+£9000
Cash carried forward at the end of the month	-£1000	-£4000	-£4000	+£5000
Profit and loss account	-£0	-£3000	+£5000	£0

At the end of month 3 you have £5000 profit but have a cash balance of -£4000 (known as a **net cash out flow**).

Only on completion of the job and when the cash has been collected does cash = profit.

Obviously this is a very simplistic view of a business. At any one time you will have a number of contracts at various stages of completion, as well as the day to day running costs of the business, so in reality cash will never be equal to profit.