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HYDE Valuations, Inc.

We Value Both Real Estate and Businesses
Including Machinery & Equipment

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NET PROFIT OR CASH FLOW?

I recently reviewed a business appraisal that used net profit after tax instead of net cash flow in its income approach. This is a big problem … especially when using the build-up method to derive the discount rate (the typical way it is done). This caused me to again consider the fact that many people do not seem to realize that there is a large difference between net profit and net cash flow.

The primary reason net profit or net profit after tax is not used to determine the fair market value of a business is quite simple. Net profit is an accounting concept! It is calculated using revenue less cost of goods sold and operating expenses. A business does not pay its bills using net profit!

Cash flow, often referred to as net cash flow, essentially represents the difference between cash received and cash paid out over a period of time, often a year. The easiest way to visualize cash flow is to look at a cash flow statement prepared by a CPA. Here is an example:

STATEMENT OF CASH FLOWS		
		Year
GROSS CASH FLOW		
	Net Income	235,000
+	Depreciation and Non-Cash Expenses	205,582
=	Gross Cash Flow	440,582
PLUS: OPERATING CASH SOURCES		
Increase	Payroll Taxes Payable	34,483
Increase	Sales Tax Payable	2,830
Decrease	Prepaid Insurance	3,633
Decrease	Stockholder Loans	59,885
=	Total Operating Cash Sources	100,831
LESS: OPERATING CASH USES		
Decrease	Accounts Payable	29,575
Decrease	Accrued Interest	175
Decrease	Property Taxes Payable	3,197
Increase	Accounts Receivable	29,951
Increase	Inventory	88,901
=	Total Operating Cash Uses	151,799
NET OPERATING CASH FLOW		389,614

NON-OPERATING CASH SOURCES		
Increase	Long Term Debt	85,000
=	Total Non-Operating Cash Sources	85,000
NON-OPERATING CASH USES		
Increase	Fixed Assets	56,213
Decrease	Long Term Debt	251,150
Decrease	Owner's Equity	88,595
=	Total Non-Operating Cash Uses	395,958
NET INCREASE (DECREASE) IN CASH		78,656
	Ending Cash Balance	555,606
	Beginning Cash Balance	476,950
NET INCREASE (DECREASE) IN CASH		78,656

Note that in the example, an increase in payables constitutes an increase in cash sources (i.e. borrowing from a vendor) and an increase in accounts receivable constitutes an increase in cash uses (i.e. a sale was made, but not yet paid for!).

Unfortunately, businesses cannot write a check on accounts receivable. They must wait until a receivable is actually collected (and the check clears!) before funds can be used to pay its bills. Businesses, especially in tight economic times, must keep a close eye on their accounts receivable. This usually means watching its accounts receivable aging and taking action to collect funds owed before they become well overdue. This is often a problem especially when a "good" customer experiences financial difficulties and becomes late on its payments. The "relationship" must be weighed and decisions made about how to proceed – obviously it is desirable to hang onto old customers and work with them through tough times, but if they go under, funds owed their vendors (accounts receivable to the former seller) are essentially an unsecured loan and are frequently not ever collected. Good communication and careful management of the accounts receivable is critical in these difficult times.

Another area of concern is the amount of funds tied up by a business in inventory. While many businesses require inventory to make sales, the length of time money is tied up in inventory often is quite important. There is a balancing act that must take place between having sufficient inventory to meet customer's needs and having too much inventory, especially inventory items that do not turn very quickly. There are a number of accounting procedures used to track and follow inventory. My favorite is FISH -- this stands for First In, Still Here! Not a great system, but one that occurs quite frequently in many small businesses.

In the cash flow statement example above, the most important line to check is the amount called "Net Operating Cash Flow." If this line is consistently negative, the business is in real trouble!

Valuations play a part in strategic transactions, tax, and many litigation matters. For additional information or advice on a current situation, please do not hesitate to call. **We value both real estate and businesses including machinery & equipment.**

Sincerely,

Paul R. Hyde, EA, MCBA, ASA, MAI
Enrolled Agent – Enrolled to Practice Before the IRS
Master Certified Business Appraiser
Accredited Senior Appraiser – Business Valuations
Designated Member – Appraisal Institute (MAI) & Certified General Real Estate Appraiser
Accredited Senior Appraiser – American Society of Agricultural Appraisers (Personal Property)

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