

FINANCIAL FOUNDATIONS

An Educational Ebook Series for Small Business Owners

BOOK 10

Income Up, Cash Flow Down

Why profit can rise while cash in the bank goes down.



TLC Business Solutions · Expert Bookkeeping & Accounting Services

Income Up, Cash Flow Down



FINANCIAL FOUNDATIONS SERIES

CHAPTER 11

Income Is Up, Why Is Cash Flow Down?

*Solving the mystery of the profitable business with an empty
bank account.*

TLC BUSINESS SOLUTIONS

Practical accounting guidance for small-business owners

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01 • THE PROFIT-CASH MYSTERY

Solving the Mystery of the Profitable Business with an Empty Bank Account

Your taxes are filed, your accountant is smiling, and your profit-and-loss statement shows a healthy year. And yet — your checking account is gasping for air. You are not alone, and you are not crazy. This is the single most common confusion in small-business finance: the gap between profit and cash.

Profit is a story about **what you earned**. Cash is a story about **what you collected and what you spent**. Those two stories travel on different timetables, and a business can be winning on paper while slowly suffocating at the bank. The income statement records the activity of a period; the bank statement records the actual money that moved. When those two diverge, owners get confused, frustrated, and sometimes frightened.

The good news: the gap between profit and cash is not random. It is created by a handful of predictable, explainable forces. Once you can name them, you can manage them. This chapter walks through the five biggest reasons profit and cash part ways — and the practical steps you can take to keep them closer together.

THE CORE IDEA

Profit is an accounting concept. Cash is a physical reality. A business does not fail because it stops being profitable — it fails because it runs out of cash. The two must be watched separately.

WHAT THE P&L SAYS

+ \$40,000 Profit

Revenue is recorded when earned, expenses when incurred. The statement looks healthy.

WHAT THE BANK SAYS

– \$6,000 Cash

Cash collected minus cash spent in the same period. The account is quietly draining.

Throughout this chapter we will return to one image: profit is the map, cash is the terrain. The map can tell you that you are headed somewhere good — but you still need fuel in the tank to get there.

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02 · TIMING DIFFERENCES

Accrual vs. Cash: Revenue Recognized but Not Yet Collected

Under **accrual accounting**, revenue is recognized when it is *earned* — the moment you send the invoice — not when the money lands in your account. So a \$20,000 invoice you send in December shows up as December income, even if the client does not pay until March. Your P&L says you had a fantastic December. Your bank statement says otherwise. That \$20,000 is sitting in **Accounts Receivable**, not in cash.

The same timing gap works in reverse on expenses. You may record a supplier bill in the month you receive it, but actually pay it 30 to 60 days later. The expense lowers your profit immediately; the cash leaves later. Every timing difference between “when it hits the books” and “when the money moves” is a thread pulling profit and cash apart.

Why this trips up so many owners

Owners read the P&L, see a profit, and mentally spend it. Then the bills come due before the receivables arrive. The business looks profitable but cannot meet payroll. The culprit is not a lack of sales — it is a lag in collection.

THE FIX

Invoice immediately — the clock does not start until the invoice is sent. Track an Accounts Receivable aging report so you know exactly who owes you and for how long. Offer small early-payment discounts to nudge clients sooner. And, critically, run a **cash-flow forecast** alongside your P&L so you can see the timing gap before it bites.

- **Recognize revenue** when earned → appears on the P&L.
- **Collect cash** when the customer pays → appears in the bank.
- **The gap** lives in Accounts Receivable until the invoice is paid.

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03 • DEBT SERVICE

Principal Payments That Don't Show on the P&L

When you make a loan payment, only the **interest portion** appears on your P&L as an expense. The **principal portion** — often the larger chunk of the payment — never touches the income statement. It simply reduces a liability on your balance sheet. So a \$2,000 monthly loan payment might show only \$400 of interest expense on your P&L, while \$1,600 of cash walks out the door invisibly each month.

Profit looks fine. Cash is gone. This is debt service quietly draining liquidity without leaving a trace on the income statement. For a business with several loans — an SBA loan, an equipment loan, a line of credit — the combined principal payments can siphon thousands of dollars a month that the P&L never acknowledges.

ON THE P&L

\$400 Interest

Only the interest slice is recorded as an expense. Profit barely moves.

AT THE BANK

\$2,000 Gone

The full payment — interest plus principal — leaves cash the day it is paid.

Managing the drain

List every loan payment, split into interest and principal, and add the principal back into your cash-flow forecast even though it is not on the P&L. If principal payments are consuming your buffer, talk to your accountant about restructuring or refinancing — spreading payments over a longer term frees monthly cash, even if it costs more interest over time.

REMEMBER

Principal payments are not an expense — they are a transfer from cash to pay down a liability. Your P&L will not warn you. Your cash-flow forecast must.

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04 · OWNER DRAWS & DISTRIBUTIONS

How Personal Withdrawals Affect Business Liquidity

Money you pull out of the business for personal use — whether called an **owner's draw**, a **distribution**, or a **shareholder dividend** — is *not* a business expense. It does not reduce profit. It reduces **equity** and **cash**. So an owner who takes a \$5,000 monthly draw on top of a modest salary can quietly drain the company's cash while the P&L still reports a tidy profit.

This is one of the stealthiest cash-flow killers, because it feels like the money is yours to take — after all, the business is profitable. But profit on paper is not permission to spend. When draws are sized against profit rather than against actual cash, the business becomes the owner's personal piggy bank and runs dry.

Building the right discipline

- **Separate compensation from draws.** Pay yourself a consistent salary or owner's draw treated like any other fixed cost.
- **Plan draws against cash, not paper profit.** Check the bank balance and the forecast first.
- **Schedule distributions.** Take them at planned intervals — quarterly, for example — rather than whenever the mood strikes.
- **Reinvest deliberately.** Leave cash in the business for the inventory, equipment, and reserves that fuel growth.

THE RULE OF THUMB

A draw reduces equity and cash — never profit. If you would not take the draw from the checking account, the P&L should not talk you into it.

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05 · INVENTORY GROWTH

Spending Cash on Stock That Hasn't Sold Yet

Cash you convert into inventory disappears from the bank account but sits on the balance sheet as an asset until the stock sells. Buy \$15,000 of product to capture a volume discount, and your profit is unchanged — but your cash just dropped by \$15,000. The expense is not recognized until the inventory is actually sold, through cost of goods sold. Until then, that cash is locked inside boxes on a shelf.

Slow-moving or obsolete inventory compounds the problem. Cash that should be circulating is frozen in goods that may never sell at full price — and may eventually have to be written down or donated, converting a timing problem into a permanent loss.

ON THE P&L**No change**

Inventory is not expensed until it sells.
Buying more stock does not lower profit.

AT THE BANK**– \$15,000**

The full purchase price leaves cash the day
you pay the supplier.

Keeping inventory from strangling cash

- **Monitor inventory turnover.** Know how many times your stock sells and replaces each year — slow turnover means trapped cash.
- **Avoid over-buying.** A volume discount is only a deal if you would have bought that much anyway.
- **Clear stale stock.** Mark down, bundle, or liquidate before it becomes obsolete.
- **Match purchasing to real demand.** Let sales data, not supplier promotions, drive reorder quantities.

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06 · CAPITAL EXPENDITURES

Large Equipment and Asset Purchases

A \$30,000 delivery van, a commercial oven, or a piece of manufacturing equipment is a **capital expenditure**. It does not hit the P&L all at once. Instead, it is **depreciated** over its useful life — only a slice of the cost appears as an expense each year. But the cash left your account the day you bought it. Your P&L barely flinches; your bank balance drops like a stone.

This is why a business can report a modest profit and simultaneously experience a cash crisis in the same month it buys a major asset. The depreciation expense on the income statement is a fraction of the real cash outlay, so the P&L understates what actually happened to the bank account.

THE FIX

Plan capital expenditures against cash reserves and financing — never against profit. Set up a sinking fund for planned replacements, time major purchases to slow seasons, and weigh financing (so the cash outlay is spread) against paying cash (so you keep future payments off the books).

Capex vs. operating expense — a quick contrast

- **Operating expense** (rent, utilities, supplies): hits the P&L now, cash leaves now. Profit and cash move together.
- **Capital expenditure** (vehicles, equipment, buildings): cash leaves now, but the P&L feels it only gradually through depreciation. Profit and cash diverge sharply.

When you understand this distinction, you stop looking to the P&L to tell you whether you can afford a major purchase — and you start looking at your cash position and forecast instead.

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07 · KEY TAKEAWAYS

The Essentials to Carry Forward

- 1 Profit is not cash.** Profit is earned; cash is collected and spent on different timetables. A business fails when it runs out of cash, not when it stops being profitable.
- 2 Accrual revenue can sit in receivables for months.** Invoice fast, track aging, offer early-payment incentives, and forecast collection timing — don't spend profit you haven't collected.
- 3 Loan principal drains cash without denting the P&L.** Only interest is an expense. Add principal payments back into your cash-flow forecast so the full payment is visible.
- 4 Owner draws reduce equity and cash — not profit.** Plan draws against actual cash, schedule them at set intervals, and reinvest deliberately rather than spending paper profit.
- 5 Inventory and equipment convert cash into assets before it converts back.** Watch inventory turnover, clear stale stock, and plan capital purchases against cash reserves and financing — never against profit alone.
- 6 Run a cash-flow forecast alongside your P&L.** Watch the bank, not just the income statement. When the gap confuses you, that is exactly what your accountant is there to reconcile.



At TLC Business Solutions, we help small-business owners close the gap between profit and cash — with clear reporting, proactive forecasting, and guidance that speaks your language.

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TLC Business Solutions helps small business owners strengthen bookkeeping, accounting, payroll, tax consulting, financial management, and practical decision-making systems so the numbers are clean, useful, and ready for growth.

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