

## How to Use Your Financial Statements to Improve Cash Flow

By James Adams, Senior Financial Analyst, Sageworks, Inc. and Brian Hamilton, CEO, Sageworks, Inc.

In business, as in most endeavors, passion is a key ingredient to success. Entrepreneurs who genuinely enjoy sales, operations, and customer service are much more likely to build profitable firms than individuals who are simply “going through the motions” of business in the name of making money. But even the most enthusiastic managers will enjoy much greater success if their passion is governed by sound financial discipline, which stems from an understanding of their financial statements.

There is plenty of debate about the relative value of the three main financial statements: income statement, balance sheet and cash flow statement. Certainly all are important, but for small companies, the cash flow statement may be the most critical. The cash flow statement is a marriage of the two other financial statements: It combines operating activities (shown in the income statement) with changes in balance sheet accounts to show how the business’s cold cash is “flowing.”

The section of the cash flow statement labeled “cash flow from operations” is definitely the most important because it represents how much cash a company is generating from its core operations. The cash flow statement accounts for profits and losses, as well as any “working capital” changes--fluctuations in current assets and current liabilities, such as accounts receivable and accounts payable; two important metrics to help [determine if your business is healthy](#).

Let's look at an example. Say your business has revenues of \$1000 for a given month, but all the merchandise was sold on credit (meaning that you didn't actually receive the cash in that period). Now say total cash outlays were \$750 for the period. In this case, your income statement would report a “profit” of \$250 (\$1000 in total revenues less \$750 in expenses). Fair enough.

Meanwhile, however, “cash flow from operations” *dropped* by \$750. That's because the business had to pay \$750 in cash expenses but did not collect any offsetting cash from customers. (An increase of \$1000 to accounts receivable balances the books.)

Now consider the flip side. Say your company pulls in \$2000 in cash revenues but shelled out \$4000 in expenses--only \$1000 of which was paid in cash during the period, with the rest being “financed” via accounts payable. In this case, the income statement shows a loss of \$2000--that's \$2000 in sales less \$4000 in expenses--yet the company generated \$1000 in positive cash flow from operations.

How? Remember, you received \$2000 in cash but paid out only \$1000 in expenses, leaving \$1000 in cash left over. This drama plays out in the cash flow statement, which would show \$2000 in losses offset by a \$3000 increase in accounts payable.

### Managing Your Cash Flow

The lesson here is clear: *Managers must manage their working capital accounts to maximize cash flow.*

Bart Justice, President of Secure Destruction Service, a full-service shredding and document destruction company in Huntsville, AL was concerned about the business’ financial well-being several years ago. After an analysis of his financial position which took into account how his cash flow was trending, Justice decided to take a few basic steps: he decreased collection times for

receivables, negotiated more favorable terms on vendor payables, and refinanced existing bank credit to increase cash on hand.

By turning the data available to him in his financial statements into actionable steps to improve cash flow, Secure Destruction's cash situation quickly improved. "Instead of managing cash flow on a day-to-day basis, I could look at cash weekly, and then finally monthly," Justice cheerfully observes.

Two of the three actions that Justice took to improve his cash flow were related to "aging" accounts--receivables, inventory, payables, etc. Generally speaking, reports on these accounts should be reviewed regularly. Additionally, there are a range of other things a business owner should consider in an effort to manage cash flow:

- 1. Offer different credit terms to different customers.** Most small businesses don't think to do this.
- 2. Get access to short-term credit.** Small businesses often don't have predictable cash flows. Having access to short-term credit--such as credit cards, home equity lines and credit lines from a bank--can make all the difference when weathering sudden shortfalls in ready cash.
- 3. Prepare realistic monthly forecasts.** Entrepreneurs are inherently optimistic--an admirable quality, and all the more reason they should create clear-eyed forecasts for the coming months. There are plenty of easy-to-use software tools available.
- 4. Make a personal budget.** Entrepreneurs need not only mind the shop's cash drawer; they also have to keep their households financially sound. Put another way, the business has to throw off at least as much cash as the entrepreneur needs to live. This might sound like an obvious point, but it's one that often gets lost in the excitement and mayhem of running a small company.

Cash is a company's lifeblood. Managing it is something that all entrepreneurs can do effectively--that is, if they want to stay in business.

**About James Adams, CFA:** James Adams is a Senior Analyst at [Sageworks](#) a financial information company, and Inc. 500 honoree. Adams is also the author of *Waffle Street: The Confession and Rehabilitation of a Financier*, a humorous examination of money, banking, and economics by a hedge fund (and foodservice) professional. Adams began his career with Protective Life Insurance Co. and Jefferson-Pilot Financial, serving as a corporate bond analyst at both companies. Subsequently, he was a vice president at a \$30 billion money management firm. Adams received his MBA from the University of North Carolina's Kenan-Flagler Business School and a BS in Analytical Finance and Accounting from Wake Forest University.

**About Brian Hamilton:** Brian Hamilton is the co-founder and CEO of [Sageworks](#), a financial information company, and Inc. 500 honoree. Hamilton is an original co-developer of "FIND" (Financial Information into Narrative Data), Sageworks' core artificial intelligence technology which converts financial numbers into plain language. FIND is the basis of the [ProfitCents](#) and [Sageworks Analyst](#) applications that are used by financial institutions and accounting firms throughout North America and the United Kingdom. Brian Hamilton holds an MBA degree from Duke University and a bachelor's degree from Sacred Heart University, where he graduated summa cum laude. Brian is a noted expert in finance who has been published and quoted in most major national media outlets.

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