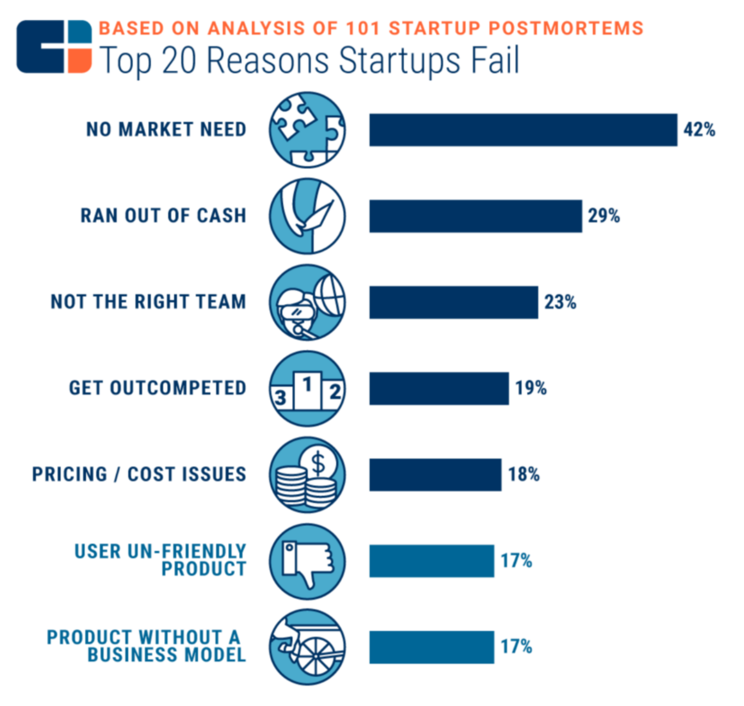
How to Create Cash Flow Statements & Manage Your Cash Flow

Twenty-nine percent of failed startups say they folded because they ran out of cash. This makes cash flow management – or more accurately, mismanagement – the second biggest driver of startup failure, behind only lack of market need, say CB Insights.



Twenty-nine percent of startups cite running out of cash as one of their reasons for failure. See the full graphic on CB Insights.

That said, startups commonly lose money each month, and that's a normal part of startup growth. In the early stages, investors care more about product-market fit and traction than instant return on capital. But that doesn't mean you can have zero cash in the bank. You still need funds to operate your business so you can pay the bills, make payroll, and pay your taxes.

So how should startup founders invest in growth while managing cash flow? Cash flow statements are a big part of keeping cash in the bank while growing. They can tell you how much money you can spend, reveal liquidity to investors, and help you calculate runway.

A Quick Word on Solvency and Liquidity

Before getting into the weeds on cash flow, it's important to understand that a business owner must manage two types of cash needs: liquidity and solvency. Liquidity is the ability to generate cash inflows to pay accounts payable balances and other obligations in the short term (within 12 months).

Solvency, on the other hand, is the process of generating cash inflows over the long term in order to purchase expensive assets, hire staff, and pay down debt (12 months or more).

An effective manager must address both liquidity and solvency.

And now, onto cash flow statements.

What Is a Cash Flow Statement?

A cash flow statement is a financial report that summarizes how much cash goes into and out of your startup in a defined period, including cash flows for operating, investing, and financial activities. Simply put, cash flow statements reveal how changes in balance sheet and income statement accounts affect the amount of cash in the bank.

That doesn't mean cash flow is equivalent to profit. It's possible for a startup to have cash in the bank while having no profit, because the cash comes from sources other than sales, such as investor funding. Conversely, it's possible for a company to have great profits but zero cash in the bank. The statement of cash flows allows business owners to track cash inflows and outflows, regardless of what's on the profit-and-loss statement.

That grounding in cold, hard cash in the bank is what makes the statement of cash flows one of the three most important financial statements for you to have, along with the balance sheet and the income statement. Taken together, these three reports provide a 360-degree view of a business' current financial position. Armed with that info, business owners can make decisions about future activities.

Why You Can Be Profitable on Paper but Cash-Poor

Let's say you call your accountant to prepare the end-of-year tax return. Your accountant tells you that your business earned a big profit this year. This is good news, in theory, but there's a problem: There's no cash in your business' bank accounts. So now you have to pay income tax on the year's profits but have no funds to do so. What went wrong?

The most common reason a profitable firm runs short on cash is a growing accounts receivable or inventory balance. If your business grows sales rapidly but customers take longer to pay, your accounts receivable balance increases. Similarly, if you sell a physical product and sales grow, you'll have to make a bigger cash investment in inventory.

When you generate a profit and notice that your cash balance has declined, check your accounts receivable and inventory balances.

Keeping Up With Cash Flow

If you'd made monthly cash flow statements during the year, you'd know where the money went. The cash flow statement reflects the actual inflows and outflows of cash. It's the only financial statement that can tell you if you are generating enough cash to operate your business.

In businesses using accrual accounting, revenue does not come in at the same time as costs have to go out, and this is where understanding cash flow is critical. You can be profitable on paper, but cash-poor. If that's your position, you could be in danger of losing your business.

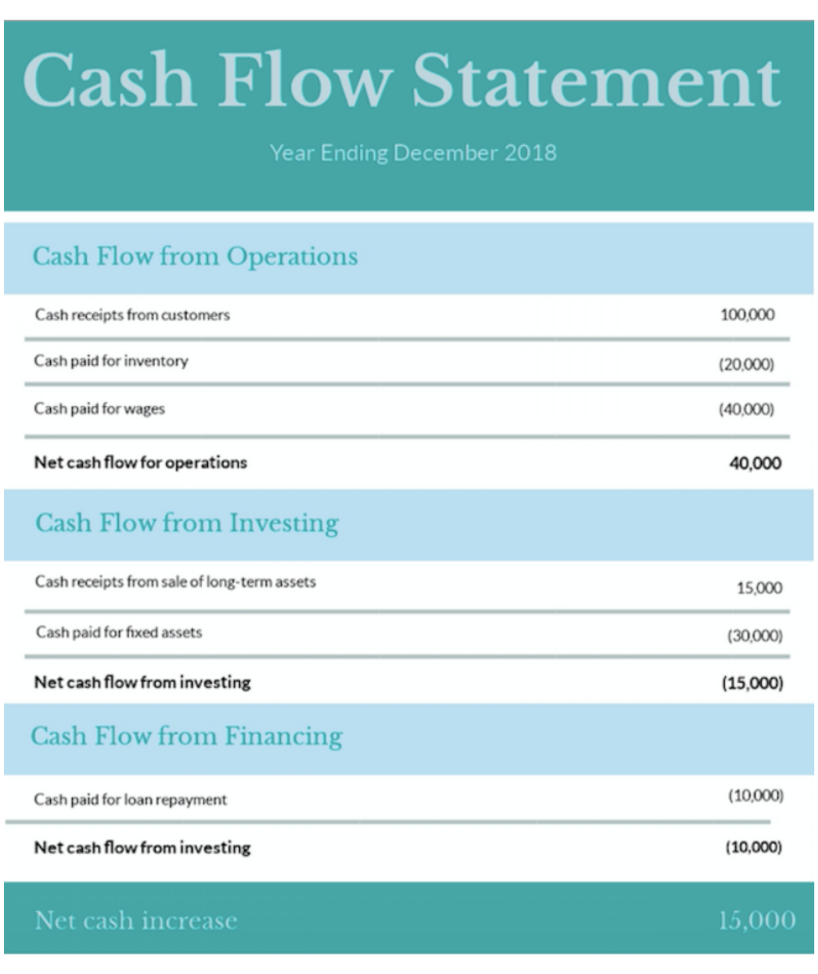
Using Cash Flow to Make Informed Decisions

Using the cash flow statement, startup founders can make informed projections about their company's ability to generate cash in the future and the likelihood of being able to meet financial obligations like loans. It also gives them a timeline for when they need to pitch for more funding. Cash flow statements are also key to calculating burn rate and runway.

For investors, cash flow statements provide a window into a startup's financial health. They also reveal a founder's capacity for intelligent financial management. A company that consistently works to monitor costs, balance cash inflows and outflows, and generate more cash than it spends is a good investment. A startup that burns cash without considering how to pay the bills probably won't interest investors.

What Does a Cash Flow Statement Look Like?

Cash flow statements are divided into three main parts: operating activities, investing activities, and financing activities.



Cash Flow Statement

Year Ending December 2018

Cash Flow from Operations	
Cash receipts from customers	100,000
Cash paid for inventory	(20,000)
Cash paid for wages	(40,000)
Net cash flow for operations	**40,000**
Cash Flow from Investing	
Cash receipts from sale of long-term assets	15,000
Cash paid for fixed assets	(30,000)
Net cash flow from investing	**(15,000)**
Cash Flow from Financing	
Cash paid for loan repayment	(10,000)
Net cash flow from investing	**(10,000)**
Net cash increase	**15,000**

A cash flow statement made using the direct method.

Cash Flow From Operating Activities

Cash inflows and outflows are generated from actual business activities. This section encompasses cash inflows from sales, and cash outflows for payroll payments, expenses, and inventory. The majority of your cash inflows and outflows should be categorized as operating activities.

Cash Flow From Investing Activities

Cash inflows and outflows generated when assets are bought and sold. This might include purchasing a fixed asset, such as machinery, or investing in an intangible asset, such as a patent.

Cash Flow From Financing Activities

Cash coming in from investor funding or bank loans, and going out to cover shareholder dividends or debt payments.

How to Prepare a Cash Flow Statement

There are two ways to prepare a cash flow statement: the direct method and the indirect method. Both calculate cash flows from investing activities and financing activities the same way. The difference between the two methods lies in how operating activities are calculated.

To understand this process, imagine an accountant who is reviewing the company bank account. To prepare a cash flow statement, the accountant goes through each bank transaction and categorizes each cash inflow and outflow into one of the three activities explained above.

Direct Method

The direct method simply lists all of the cash inflows and outflows of a company during a given period. Cash from customers, payroll, interest payments, and supplier payments are noted line by line in a direct cash flow statement.

Indirect Method

In the indirect method, you start out by noting the company's net income from the given period (found on the income statement). You then make adjustments to convert net income (based on accrual-basis accounting) into cash-basis accounting. These adjustments could include adding back noncash expenses, such as depreciation expense, into the net income balance.

Indirect is the most common method of preparing a cash flow statement. It is also the easiest for most startups to use because it uses info already recorded on the income statement. It's also the way most accounting-software tools generate the cash flow statement, and it's how we do it here at Pilot.

Automatically Generate the Cash Flow Statement

If you use software like QuickBooks or Xero to track income and expenses, you already have all the info necessary to create a cash flow statement automatically. To run the statement of cash flows in QuickBooks, just click Reports and enter Statement of Cash Flows in the search field. You can customize the report for different date ranges.

Generating the cash flow statement with the help of a software produces numerous business benefits:

Better forecasting

Software such as QuickBooks comes equipped with features to make cash flow forecasting easier. You can use them to forecast different aspects of your startup's finances – credit card ledgers or accounts receivables, for example – and more accurately forecast future cash flow by activity.

Accurate cash flow forecasting means you can make better business decisions further down the road.

Historical Spending Visualizations

Spending trends can reveal a lot about how well your business is functioning. Producing cash flow statements with a software means you can look back over the quarter, visualize where your money is going, and plan optimization activities.

Plan Growth Activities

Successfully planning growth activities involves getting a handle on net cash flow. Net cash flow helps startup owners figure out how fast they need to grow to meet investment objectives, and set a strategy to do so.

For example, a positive net cash flow figure lets you know you can consider making some riskier business decisions in the name of growth. A negative cash flow means this might not be the time to expand into new product lines or hire employees.

Most accounting software tools allow you to visualize cash flow models automatically, play with different scenarios, and plan for growth.

Managing Cash Flow Proactively

Understanding and preparing cash flow statements is essential to good financial health. But just building statements won't create positive cash flow on its own. To make sure that cash is available whenever it's needed, founders and CFOs need to proactively manage company cash flow by following some best practices:

- Increase operational efficiency by identifying unnecessary expenses and removing them going forward. For example, if you're paying a monthly fee for software that your business isn't using, that's eating into your monthly liquidity. Cut the fat from monthly spending.
- Lease fixed assets instead of buying them. If you're having cash flow problems but need to buy machinery or a vehicle to spur growth, consider leasing the asset until cash inflow is stronger. You'll save on the initial outlay and reduce responsibility for any future wear or tear.
- Calculate accounts receivable turnover to see how efficient you are at getting paid. To calculate AR turnover, determine the net value of your credit sales, and then divide that number by the average amount of money you're owed during that same period. The higher the number, the better you are at getting paid. If the number is low, take steps to remove friction from the invoicing and collections process.
- Delay paying suppliers. Figuring out how long you can wait before making good on vendor invoices will keep cash in your account longer, allowing you to meet monthly obligations. Of course, you want to strike a balance – if you wait too long to pay you may incur late fees or damage your relationship with vendors.

Fundraising and Cash Flow

Proactive cash flow management allows you to maintain enough cash in the bank to pay for month-to-month operating activities. But that's not the only benefit. Cash flow has a direct impact on when you need to raise funding and your chances of success.

Most fundraising cycles take between three to six months to finalize. That means you need to have at least enough cash to cover six months of operations when you start approaching investors. Cash flow projections will help you figure out runway and when to approach investors.

Plus, when investors see you're already proactively managing cash flow, they'll be that much more likely to trust you with their money.

Cash Flow Statements Reveal Future Growth Opportunities

Founders who know how much cash is coming into and out of their business can make better financial decisions than those who focus solely on profit and loss. Cash flow statements empower you to invest wisely, cut the fat from operations, and reach break-even faster. You can also use them to show potential investors that you are serious about meeting financial obligations and will use funding capital for growth activities, not keeping the lights on.

Ultimately, founders and CFOs who are proactive in managing cash flow are more likely to see their startups stick around for the long term.

Need help with cash flow statements? Let Pilot handle that so you can focus on what really matters: making sure your business succeeds.