A Business Owner GPS Case Study

Help! I'm Making Money, but My Bank Account is Losing Money

Your financial sheets can tell you why

By Scott R. Weaver

Sometimes I tell my clients, "There are two ways to fail: failure by failure and failure by success." Failure by failure is usually pretty obvious. Some company becomes dysfunctional for some reason and goes out of business with dismal losses. Failure by success is much harder to tell when it is happening, but still results in the same dismal losses.

This Case Study covers two companies, actual clients, who were on the verge of failure by success. Each company on the outside looked very successful. The operations were well-run, happy employees, stellar revenues, and happy customers. But underneath, in the shadows of the Financial Sheets, lurked problems that had festered and now threatened the very survival of these companies.

This is a case study of why you, the business owner, should monitor every month (or sooner) the three standard financial sheets that are reported by most accounting software. In these reports are the clues to stop and prevent problems in operations and financial activities. This is also a case study of what got you to success will not guarantee future success.

Two Companies

Company #1 – Manufacturing Industry, widget manufacturer, 10 employees, and revenues of $1 Million.
Company #2 – Transportation Industry, truck broker company, 15 employees, and revenues of $5 Million.

What the Two Owners had in Common

Excellent Company Operations

- Both owners were running the day-to-day operations and had outstanding employees.
- Each one were experts at providing their services and was key to the success of their company.
- Each company had good revenues coming in and excellent customer relationships.
- Each owner had very good memories and could calculate "profit" for each order.
- Both companies and owners were running at maximum capacity.

Struggling Bank Accounts

- Each month, the owners saw the money in their bank accounts decrease.
- One owner masked the decrease in bank accounts with loans.
- The truck broker owner started working four hours a day in customer sales to make up the decreases in bank accounts.

Quick Review of Financial Sheets

Most accounting software, such as Quickbooks, Sage, GNUCash, and many more, report company financials in three sheets, aptly named, "Financial Sheets". These sheets show the entire business financials, including loans, book value, equipment, investments, payouts, etc.

Profit and Loss (P&L) Sheet – This captures the financial performance of the company operations. It shows the familiar equation: Net Income = Revenues - COGS - Expenses. Note, Net Income is not your company's profit.

Balance Sheet – This sheet captures the value of company assets (what stuff is owned), liabilities (what is owed to others), and equity (owners/shareholders value).

Cash Flow Sheet – This captures the company's cash in and cash out. It has three sections:

- Cash flow from Operating Activities
- Cash Flow from Investing Activities
- Cash Flow from Financial Activities

Reviewing Company #1's Financial Sheets

The owner only looked at the P&L Sheet (it looked great!) and the (stomach turning) bank statements. During the investigation, the company's financial sheets were created in QuickBooks by the company's bookkeeper.

P&L Sheet – Net Income was positive every month in the last 18 months since the pandemic. The dollar amounts put the company in the top 25% in their industry for revenue and company size.

Balance Sheet – Company financial problems started to show here. Cash in the bank was less than two months of expenses. This is bad for a manufacturing company who pays for materials before getting paid by customers. The loan amounts were on the edge of being unhealthy, artificially lowering the true value of the company.

Cash Flow Sheet – Here is where the source of the cash problem showed. The Cash Flow from Operating Activities was generating a good amount of cash. Cash Flow from Investing Activities showed careful and smart strategy of equipment purchases. However, it was the Cash Flow from Financial Activities that was dragging down the company. Loan payments were an issue, but not too bad. The company would be cash-flow positive if not for one thing.

Several years before, the owner bought out his company partner. The transaction was done on the personal side for tax purposes, with the company paying a large, monthly buy-out amount. This is a common strategy handled by CPA firms.

In the owner's mind, the partner buy-out was "off-books" and no need to be concerned because it was personal. However, on the company books, the buy-out amount looked like an owner's draw (taking money out of the company) every month and not recorded as an expense.

So, the company drained its savings and used loans to cover up the negative cash-flow.

Reviewing Company #2's Financial Sheets

The owner only looked at the COGS (Cost of Goods Sold) section of the P&L Sheet for the company's profit generation indicator. Every sale had 75% or more gross margins. This approach had always worked in the past as the company grew fast. The numbers looked great, but the bank statements were horrible. This week's revenue paid for expenses incurred three weeks ago. For the analysis, Scott created the financial sheets in QuickBooks.

P&L Sheet – Gross income (Revenues minus COGS) was great. In the last 18 months, total revenue grew nearly $2 million. However, Net Income showed losses in five months in the last year. IT expenses and software subscriptions were high, but not high enough to account for the bank account leakage.

Balance Sheet – Of course, there were problems. Namely, low cash amounts and aging Accounts Payable, but these were symptoms of the problem.

Cash Flow Sheet – Here is where the source of the cash problem showed. Cash Flow from Investing Activities showed several ongoing purchases of IT equipment and expensive enterprise software. The equipment purchases helped with the depreciation expenses at tax time, but capital purchases did not show up on the P&L sheet.

During the company's fast growth, doubling revenue in two years, the owner over spent on IT equipment, software upgrades, and software subscriptions. This over spending did not happen overnight, but the company's fast growth mentality did not have any spending boundaries. This resulted in digging a financial hole faster than revenue growth could fill it.

Corrective Action Plans

Each owner needed to take action to save their company. Remember that these companies were operating at maximum capacity and generating very good revenue for their size. The options were limited because any reduction in revenue by decreasing expenses would make the negative cash-flow worse.

Company #1, the owner of the company refinanced the partner buy-out monthly amount to reduce the hidden expense. They also increased revenue capacity by raising prices, letting go of low-value customers, and targeting higher-margin customers.

Company #2 owner immediately stopped new IT purchases, dropped several software up-sale packages, and sold off several redundant office equipment. The owner also used the revenue growth to hire a new sales manager to free up time to run the entire company, just not the sales team.

Key Take-a-Ways

- Be on the lookout for Failure-by-Success.
- What got you to success will not necessarily get you to the next level.
- Monitor all three of the standard Financial Sheets for profitability and operations performance.
- Find expert help if operations, revenue, and profits are out of sync. Take immediate action if there is dysfunction and contradictions between bank accounts and business operations.

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