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How can a startup be profitable & still run out of cash?

New entrepreneurs often confuse profit and cash. Understanding the difference can be critical to your success. After all, it is possible for your company to be profitable and yet still run out of cash. And it is even possible to be unprofitable and have plenty of cash.

Making a profit is one good indicator of whether or not your company is successful. Having cash determines whether the company will be alive, i.e., whether the company will survive so it can be successful or unsuccessful. To help you understand the difference, let's examine the two concepts.

1. Profit

Revenue (aka sales) is what you record on your financial books when you sell a product or service to a customer. For example, if you sell a 2,000 bottles of wine for $25 each to customers during a month, you record $50,000 in revenues for that month.

If it cost you $10,000 to produce those bottles of wine (by the way, that's called *cost of goods sold*) and you paid rent and salaries during the month of, say, $25,000 during that month, **your profit for the month will be $15,000**, i.e., subtract your cost of goods sold and expenses from revenues.

2. Cash

A company can gain cash in four ways:

- By receiving payments from customers when you sell them products/services.
- By receiving payments from lenders when you apply for a loan.
- By receiving funds from investors.
- By receiving cash for selling fixed assets. [Very rare for a startup company]

A company can lose cash in a variety of ways:

- Cost of goods sold or expenses. By making payments to suppliers.
- By making payments to lenders on a loan.
- Stock repurchase. By the company returning outstanding stock back to the treasury. [Very rare for a startup company]
- Buying assets. By paying cash for the purchase of fixed assets.

3. How Cash Can Exceed Profit

Many scenarios can demonstrate how you can be unprofitable and yet have cash. Let's look at some. In all the following cases, assume that at the beginning of the aforementioned month, your checking account had a balance of $0 (which might be the case if you just started the company). Let's again say you sold 2,000 bottles of wine for $50,000 and made a profit of $15,000.

- If you have negotiated "net 60" terms with your suppliers, you will still owe them $35,000 and you will end up with $50,000 in the bank at the end of the month (even though you had a profit of just $15,000).
- On the other hand, if you took out a loan during the month of $40,000, you will end up with $55,000 in the bank at the end of the month.
- On the other hand, if you accepted an investment during the month of $200,000, you will end up with $215,000 in the bank at the end of the month.

In all these cases, your profit is $15,000, but your cash was quite different, specifically, $50,000, $55,000, and $215,000, respectively.

4. How Profit Can Exceed Cash

Many scenarios can demonstrate how you can be profitable and have much less (or even no) cash. Let's look at some. In all the following cases, assume that at the beginning of the aforementioned month, your checking account had a balance of $0 (which might be the case if you just started the company). Let's again say you sold 2,000 bottles of wine for $50,000 and made a profit of $15,000.

- If 500 of those bottles were sold to a customer that had negotiated "net 30" terms with you, that customer will still owe you $12,500 by the end of the month (by the way, that's called your *accounts receivable*). You will have only $2,500 in the bank at the end of the month (even though you had a profit of $15,000).
- If you still owed $1,000 to a cork supplier from a previous purchase you had made (by the way, that's called your *accounts payable*) and decided to pay it this month, you will have just $14,000 in the bank at the end of the month (even though you had a profit of $15,000).
- If you decided to purchase a major piece of equipment for $10,000, you would be unable to subtract that amount from your revenues, but you would have to spend the cash. Thus you'd have just $5,000 in the bank at the end of the month (even though you had a profit of $15,000).
- If you are a B2B company, and your customers (who are businesses themselves) are having cash problems, as is often the case during difficult economic times, so they may delay their payments to you. If half of your customers have failed to pay you by the end of the month, you will have $25,000 less than you expected. That means you will end up with a negative balance in your checking account, something that banks frown upon. Before long, you could be out of business.

In all these cases, your profit is $15,000, but your cash was quite different, specifically, $2,500, $14,000, $5,000, and minus $10,000, respectively.

In summary

The difference between cash and profit is not subtle. Many companies have been forced out of business due to lack of cash even though they were profitable. Understanding the difference and planning ahead is essential to prevent disasters.