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## STARTING WITH THE LANGUAGE OF FINANCE AND CASH FLOWS

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Chapter 1 dives headfirst into two critical topics that will be on full display throughout this book. First, I provide a crash course on the language of accounting and finance. Simply put, in order to master reading (covered in my book *How to Read a Financial Report*), writing (covered in my book *How to Write a Financial Report*), and understanding financial statements and reports, it is essential that you learn the basic jargon.

Second, understanding how businesses generate and consume cash is a topic that is of critical importance and always on full

display. As such, the second half of Chapter 1 dives right into the importance of cash flow, which is expanded upon further in Chapter 3, with even more insight provided in Chapters 12 and 15. True to our primary mission of translating complex accounting and financial concepts into simple and easy-to-understand tools and ideas, cash flows, the lifeblood of every business, is positioned with added reverence throughout this book to ensure that you remember the golden rule of operating a business: Never, ever run out of cash!

# A Crash Course in the Language of Accounting and Finance

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If you're heading to France or Italy, it goes without saying that you should brush up on the basics of French or Italian because being able to communicate in the local dialect can improve your travel experience. The same goes for accounting and finance. If you can at least master some basic terminology, it will be less of a struggle to understand financial statements. This section of the chapter covers two buckets of terminology, basic and advanced.

## ***Basic Terminology***

Basic terminology is primarily associated with communicating the results of financial statements (from an accounting perspective), with a heavy weighting toward the income statement. Below, I've provided a sampling of the most commonly used basic accounting and financial terminology:

- ◆ Top line: A company's net sales revenue generated over a period of time (e.g., for a 12-month period).
- ◆ COGS or COS: Pronounced like it is spelled; stands for costs of goods sold (for a service-based business or company that sells both products and services) and costs of sales (for a service-based business). COGS or COS tend to vary directly (or in a linear fashion) with the top-line sales revenue.
- ◆ Gross profit and margin: Sometimes used interchangeably, gross profit equals your top line less your COGS or COS. The gross margin (a percentage calculation) is determined by dividing your gross profit by the top line.
- ◆ Op Ex: A broad term that is short for operating expenses, which may include selling, general, administrative, corporate overhead, and other related expenses. Unlike COGS or COS, Op Ex tends to be fixed in nature and will not vary directly with the top-line sales revenue.
- ◆ SG&A: Selling, general, and administrative expenses. Companies may distinguish between Op Ex and SG&A to assist parties with understanding the expense structure of its operations in more detail.
- ◆ Bottom line: A company's net profit or loss after all expenses have been deducted from net sales revenue. Being *in the black* indicates that a net profit is present and being *in the red* indicates that a net loss was generated.
- ◆ Breakeven: The operating level where a company generates zero in profit or loss. It can also be used to identify the amount of sales revenue that needs to be generated to cover all COGS/COS and Op Ex.

- ◆ Contribution margin: You may hear companies reference the term *contribution margin*. What this generally refers to is the profit generated by a specific operating unit or division of a company (but not for the company as a whole). Most larger companies have multiple operating units or divisions, so the profit (or loss) of each operating unit or division is calculated to determine how much that specific unit or division contributed to the overall performance of the entire company.
- ◆ Cap Ex: Cap Ex stands for capital expenditures and is a calculation of how much a company invested in tangible or intangible assets during a given period (e.g., for equipment, machinery, new buildings, investments in intangible assets, etc.).
- ◆ YTD, QTD, MTD: These are simple and stand for *year to date*, *quarter to date*, or *month to date*. For example, a flash report may present QTD sales for the period of 10/1/24 through 11/15/24 (so management can evaluate sales levels through the middle of a quarter).
- ◆ FYE and QE: These two items stand for fiscal year-end and quarter-end. Most companies utilize a fiscal year-end that is consistent with a calendar year-end of 12/31/xx (which would make their quarter-ends 3/31/xx, 6/30/xx, 9/30/xx, and 12/31/xx). Please note that several companies utilize FYEs that do not follow a calendar year-end to match their business cycle with that of a specific industry. For example, companies that cater to the education industry may use a FYE of 6/30/xx to coincide with the typical operating year for schools or colleges (which tend to run from 7/1/xx through 6/30/xx).

### *Advanced Terminology*

Advanced terminology tends to be centered in references to financial concepts that are focused on cash flows, forecasts, projections, and financing topics (i.e., raising capital such as securing loans or selling equity in a company). With that said, here's a summary listing of advanced terminology to reference.

- ◆ EBITDA: This is one of the most used (and abused) terms in finance today and stands for *earnings before interest, taxes, depreciation, and amortization*. A shorter version that is also used frequently is EBIT or *earnings before interest and taxes*. The reason for EBITDA's popularity is that capital sources want to clearly understand just how much earning a company can generate in the form of operating cash on a periodic basis. EBITDA strips out interest, taxes, and depreciation and amortization expense (both noncash expenses) to calculate what is perceived to be a company's ability to generate internal positive cash flow (which is widely used when evaluating the value of a company and its ability to service debt).
- ◆ Free cash flow: FCF is closely related to EBITDA but takes into consideration numerous other factors or adjustments such as the need for a company to invest in equipment or intangible assets on a periodic basis (to remain competitive), the required or set debt service the company is obligated to pay each year (for interest and principal payments), any guaranteed returns on preferred equity, and other similar adjustments. FCF can be a highly subjective calculation based on the estimates and definitions used by different parties.

- ◆ **YOY:** YOY stands for a year-over-year change in financial performance (e.g., sales change for the current 12-month period compared to the prior 12-month period).
- ◆ **CAGR:** This stands for compounded annual growth rate and represents a financial calculation that evaluates a financial performance over a number of periods (e.g., sales increased at a CAGR of 15.5 percent for the five-year period of 2019 through 2024).
- ◆ **Sustainable growth rate:** This calculation estimates a company's maximum achievable growth rate by using internal operating capital (i.e., positive cash flow) only. When a company exceeds its sustainable growth rate, external capital such as loans or equity from new investors may need to be secured to support ongoing operations.
- ◆ **Debt service:** Total debt service includes both required loan interest and principal payments due over a period of time.
- ◆ **B2B and B2C:** A company that sells primarily to other businesses is B2B (business to business), whereas a company that sells primarily to consumers is B2C (business to consumer).
- ◆ **Burn rate:** A burn rate is generally used for newer businesses or start-ups that have not achieved profitability and are “burning” a large amount of cash. The burn rate calculates the amount of cash burn a company is incurring over a specific period, such as a month or a quarter. If a company has a burn rate of \$250,000 a month (before generating any sales), then an investor could quickly calculate that this company would need \$3 million of capital to support it for one year.
- ◆ **Runway:** The runway calculates how much time a company has before it runs out of cash. In our example, if the company has \$1 million of cash left and is burning \$250,000 per month, it has a remaining runway of four months.
- ◆ **TTM and FTM:** TTM stands for *trailing twelve months* and FTM stands for *forward twelve months*. These figures are often used by parties to help understand a company's annual operating results that are not in sync with its FYE (e.g., how much sales revenue was generated for the period of the QE 9/30/19 through the QE 6/30/20, 12 months of operating history). TTM and FTM can be especially useful when evaluating companies that are growing rapidly or have experienced a recent significant change in business.
- ◆ **C-suite:** The C-suite represents the group of company executive management team members whose titles include the word *chief*. This would include the chief executive officer (CEO), chief operating officer (COO), chief financial officer (CFO), chief technology officer (CTO), chief marketing officer (CMO), chief investment officer (CIO), and other designated chief executive management positions as determined by a company.

Throughout the remainder of this book, I will reference these concepts frequently, so you may want to bookmark this section to help refresh your memory as needed. There's no harm in returning to these lists when you're swimming with the financial sharks out in the open water. There's nothing worse than looking over-matched because you can't even understand basic accounting and financial terminology.

## Starting with Cash Flows

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Every book that I've written, either by myself or with my dad, has emphasized the importance of three critical concepts that are absolutely essential to understanding financial reports and financial statements. These are

1. Cash flows
2. The big three financial statements
3. How financial statements are interconnected. To avoid disappointing you, I start by emphasizing the importance of cash flow, a concept well worth repeating again and again.

*Savvy business managers, lenders, and investors pay close attention to the cash flows generated by a business. Simply put, cash inflows and outflows represent the heartbeat and pulse of every business. Without a steady heartbeat and healthy pulse of positive cash flows, a business would soon have to go on life support—or alternatively, die.*

Given the importance of generating cash flows, we cover this topic out of the gate before we jump into discussing the income statement, the balance sheet, and the statement of cash flows (the big three financial statements, covered in chapter 2). However, we would also like to remind you of this simple logic when understanding the big three financial statements. That is and if you remember one important concept for each financial statement, it should be these:

1. *Understand* the income statement,
2. *Trust* the balance sheet,
3. Most importantly, *rely* on the statement of cash flows.

As you work through this book, it will become readily apparent as to why it is essential to not only understand a company's cash inflows and outflows, but also understand how to use this information to better ascertain the financial performance and reliability of a company's overall financial performance.

## Summary of Cash Flows for a Business

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A business's cash inflows and outflows appear and are reported in a summary of cash flows, most often referred to as the statement of cash flows (one of the big three financial statements covered in Chapters 2 and 3). For our example company introduced in Exhibit 1.1, we use a technology business (a fictitious business I've named QW Example Tech, Inc.) that has been operating for many years. This established business has historically generated a profit on an annual basis but, more recently, hit a bit of a bump in the road as the company pivoted its business interests toward selling more software products and fewer hardware products. Equally important, the company maintains a solid financial condition to ensure the business has ample liquidity and cash to support ongoing operations. The company has a good credit history, and financial lending groups extend loans to it on competitive terms. Its present stockholders would be willing to invest additional capital in the business, if needed.

None of this comes easily, as most business owners will attest. It takes a strong management team and sound business model to generate consistent profits, manage and secure capital (both debt and equity), and for lack of a better term, stay out of financial hot water. Many businesses fail these imperatives, especially when the going gets tough, whether it be from difficult macro-economic conditions, increased competition, or rapidly changing customer demands.

For the remainder of this book, I will use our fictitious example company, QW Example Tech, Inc., as the basis for

presenting, reading, and analyzing financial information, statements, and reports. Multiple years of financial information will also be presented to assist with providing more insight into how to better understand and read financial statements. To add some intrigue and twists to this book, our fictitious example company will be presented in three separate case studies (summarized in depth in Chapter 5), including a base case, a simple case, and an aggressive case. The cases depict the same company and the same financial transactional activity for the year, but under different management at the C-suite level and at the level of the management team responsible for the accounting and financial function.

If you would like to leap ahead and dig into our fictitious example company and gain a complete understanding of each case study, then please jump to Chapter 5. If you would prefer a quick refresher course on the importance of cash flows, the big three financial statements, and financial statement connections, then Chapters 1 through 4 have been designed especially for you.

Before I provide a more detailed explanation of the cash inflows and outflows summarized in Exhibit 1.1, please keep these three points in mind:

- ♦ First, the format presented in Exhibit 1.1 is not within the guidelines dictated by GAAP (i.e., Generally Accepted Accounting Principles) but rather has been simplified for ease of review

## EXHIBIT 1.1 – UNAUDITED SUMMARY OF CASH FLOWS—SIMPLE FORMAT, BASE CASE (SEB)

*Dollar Amounts in Thousands*

<b>Summary of Cash Flows</b>	<b>12/31/2023</b>
<b>For the Fiscal Year Ending</b>	
<b>Cash Flows from Profit-Making Activities</b>	
From sales of products & services to customers, which includes some sales made last year	\$ 58,261
For acquiring products & services that were sold, or are still being held for future sale	\$(19,650)
For operating & other expenses, some of which were incurred last year	\$(33,888)
For interest on short-term and long-term debt, some of which applies to different years	\$ (407)
For income tax, some of which was paid on last year's taxable income	\$ (438)
<i>Net cash flow from profit-making activities during year</i>	<u>\$ 3,879</u>
<b>Cash Flows from Other Sources and Uses</b>	
From increasing amount borrowed on interest-bearing notes payable, net of repayments	\$ 3,000
From repayments of loans and other amounts borrowed during the year	\$ (2,240)
From issuing additional capital stock (ownership shares) in the business	\$ 2,500
For building improvements, new machines, new equipment, and intangible assets	\$ (5,500)
For distributions or dividends to stockholders from profit	\$ (250)
<i>Net cash decrease from other sources and uses</i>	<u>\$ (2,490)</u>
<b>Net Cash Increase (Decrease) during Year</b>	<u>\$ 1,389</u>

and understanding. This is why the header to Exhibit 1.1 references financial information and not a financial statement. In Chapter 2, we present a formal statement of cash flows in Exhibit 2.3 that is within the guidelines established by GAAP. Of course, one consistency between the exhibits will be that the

change in cash between the two years will be exactly the same (which should be expected).

- ◆ Second, note that the caption describes this as *unaudited*. This reference is always extremely important to keep in mind

because, when a qualified third party (e.g., a CPA firm) is retained to audit financial information, the report issued will clearly state that the financial information has been audited. If no mention is made to the financial information being audited or it clearly states that the financial information is unaudited, this usually indicates the financial information has been prepared internally by the company. This is not to say the financial information is incorrect and/or inaccurate but rather indicates that it has not been examined, evaluated, or audited by an independent third party, so the risk of errors or omissions may be increased.

- ◆ Third, in Exhibit 1.1 we reference profit in lieu of income for ease of presentation and understanding. It is important to keep in mind that for most businesses, profit or net profit is synonymous with the term income or net income, which I use interchangeably throughout the book.

Exhibit 1.1 summarizes the company's cash inflows and outflows for the year just ended 12/31/23 and shows two separate groups of cash flows.

Presented first are the cash flows of its profit-making activities—cash inflows from sales and cash outflows for expenses. Second up, we present the other cash inflows and outflows of the business—raising capital from loans or the sale of stock, repaying borrowings, investing capital in assets, and distributing some of its profit to shareholders.

We assume you're fairly familiar with the cash inflows and outflows listed in Exhibit 1.1. Therefore, we are brief in describing the cash flows at this early point in the book:

- ◆ The business received \$58,261,000 during the year from selling products and services to its customers. It should be no surprise that this is its largest source of cash inflow. Cash inflow from sales revenue is needed for paying expenses. During the year, the company paid \$19,650,000 for the products and services it sells to customers while incurring sizable cash outflows for operating expenses (\$33,888,000), interest on its debt (borrowed money of \$407,000), and income taxes (\$438,000). The net result of its cash flows of profit-making activities is a \$3,879,000 cash increase for the year—an extremely important number that managers, lenders, and investors watch closely.
- ◆ Moving on to the second group of cash flows during the year, the business increased the amount borrowed on notes payable by \$3,000,000, repaid \$2,240,000 of borrowings during the year, and its stockholders invested an additional \$2,500,000 in the business. Together these three external sources of capital provided a net of \$3,260,000, which is in addition to the internal \$3,879,000 cash from its profit-making activities during the year. On the other side of the ledger, the business spent \$5,500,000 for building improvements, new machines and equipment, and intangible assets. Finally, the business distributed \$250,000 in the form of a dividend to its stockholders.
- ◆ The net result of all cash inflows and outflows is a \$1,389,000 cash *increase* during the year. It should be noted that when you see an increase in cash, you shouldn't jump to any conclusions. In and of itself, a net increase in cash is neither good nor bad. You need more information than appears in the summary of cash flows to come to any conclusions about the financial performance and situation of the business.

## What Does Cash Flows Summary *Not* Tell You?

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In Exhibit 1.1 we see that cash, the all-important lubricant of business activity, increased \$1,389,000 during the period (in this case, a year). In other words, the total cash inflows exceeded the total of cash outflows by this amount for the period. The cash increase and the reasons for it are vital information. The summary of cash flows tells us part of the story, but cash flows alone do not tell the whole story. A business's managers, investors, lenders, and other stakeholders need to know two additional pieces of information that are *not* reported in an organization's summary of cash flows. They are:

1. The profit earned (or loss suffered) by the business for the period, which is reported in the income statement.
2. The financial condition of the business at the end of the period, which is reported in the balance sheet.

Now, hold on. Exhibit 1.1 just informed us that the net cash increase from sales revenue less expenses was \$3,879,000 for the year. This may lead you to ask, "Doesn't this cash increase equal the amount of profit earned for the year?" No, it doesn't. The net

cash flow from profit-making operations during the period does not equal the amount of profit earned for the period. In fact, it's not unusual for these two numbers to be very different.

Profit is an *accounting-determined* number that requires much more than simply keeping track of cash flows. The differences between using a checkbook to measure profit and using accounting methods to measure profit are important to understand. Cash flows during a period are *hardly ever* the correct amounts for measuring a company's sales revenue and expenses for that period. To summarize: Profit cannot be determined from cash flows.

Furthermore, a summary of cash flows reveals virtually nothing about the *financial condition* of the business. Financial condition refers to the assets of the business matched against its liabilities at the end of the period. For example: How much cash does the company have in its checking account(s) at the end of the year? From the summary of cash flows (Exhibit 1.1) we can see that the business increased its cash balance by \$1,389,000 during the year, but we cannot determine the company's ending cash balance. More importantly, the cash flows summary does not report the amounts of assets and liabilities of the business at the end of the period.

## Profit Is Not Measured by Cash Flows

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The company in this example sells both products and services on credit. The business offers its customers a short time period (e.g., 30 days) to pay for their purchases. Most of the company's sales are to other businesses, which demand credit. (In contrast, most retailers selling to individuals accept credit cards, debit cards, and other forms of immediate electronic payments instead of extending credit to their customers.) In this example, the company collected \$58,261,000 from its customers during the year. However, some of this cash inflow was for sales made in the *previous* year. And some sales made on credit in the year just ended had not been collected by the end of the year.

At year-end, the company had *receivables* from sales made to its customers during the latter part of the year. These receivables should be collected early next year (hopefully). To clarify, some cash was collected from last year's sales but some cash was not yet collected before the year ended, so the total amount of cash collected during the year differs from the amount of *sales revenue* for the year.

Cash disbursements during the year are *not* the correct amounts for measuring expenses. The company paid \$19,650,000 for products and services that could be sold to customers. At year-end, however, many products were still being held in *inventory*. These products had not yet been sold by year-end. Only the cost of products sold and delivered to customers during the year

should be deducted as an expense from sales revenue to measure profit. Don't you agree?

Furthermore, some of the company's product costs had not yet been paid by the end of the year. The company buys on credit and takes several weeks to pay its bills. The company has *liabilities* at the year-end for recent product purchases and operating costs. Further complicating the situation, the company makes cash payments during the year for operating expenses and interest and income tax expenses, but these are not the correct amounts for measuring profit for the year. At the end of the year, the company has liabilities for *unpaid expenses*. The cash outflow amounts shown in Exhibit 1.1 do not include the unpaid expenses at the end of the year.

In short, cash flows from sales revenue and for expenses are not necessarily the correct amounts for measuring profit for a period of time. Many types of cash flows take place too late or too early so they cannot be used to correctly measure profit for a period. Correct timing is needed to record sales revenue and expenses in the right period. The amounts of cash flows caused by sales and expenses could turn out to be fairly close to the correct accounting amounts—or they could be vastly different. Even slight differences between the cash flow amounts and the correct accounting amounts can cause problems.

## Cash Flows Do Not Reveal Financial Condition

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The cash flows summary for the year does not reveal the financial condition of the company. Managers certainly need to know which assets the business owns and the amounts of each asset, which can include cash, receivables, and inventory, among others. Also, they need to know which liabilities the company owes and the amounts of each.

Business managers are responsible for keeping the company in a position to pay its liabilities when they come due. In other words, managers have to keep the business *solvent* (able to pay its liabilities on time) and *liquid* (having enough available cash to meet its needs). Furthermore, managers have to know whether assets are too large (or too small) relative to the sales volume of the business. A company's lenders and investors want to know the same things.

In brief, both the managers inside the business and the lenders and investors outside the business need a summary of a company's

financial condition (its assets and liabilities). They also need a profit performance report, which summarizes the company's sales revenue, expenses, and profit for the year.

In this chapter, we have explained that a cash flows summary has its limits—in particular, it does not report profit and does not present the financial condition of a business. Nevertheless, a cash flows summary is useful. A different version of Exhibit 1.1 is one of the three primary financial statements reported by every business, which is the statement of cash flows (further discussed in Chapter 2). But in no sense does a cash flows summary take the place of the profit performance report (i.e., the income statement) or the financial condition report (i.e., the balance sheet). The next chapter introduces these two financial statements as well as a more formal statement of cash flows (compared to what has been presented and discussed in this chapter).

## A Few Additional Thoughts to Keep in Mind

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Over the past century (and longer) the *accounting profession* has developed. One of its main functions is to prepare and report business financial statements. A primary goal of the accounting profession has been to develop and enforce accounting and financial reporting standards that apply to all businesses. In other words, there is an authoritative rule book that businesses should obey in accounting for and reporting profit, financial condition, and cash flows. The established rules and standards are collectively referred to as *generally accepted accounting principles* (GAAP). Businesses are not free to make up their own individual accounting methods and financial reporting practices and should strive to develop and maintain GAAP-based accounting and financial information and reporting systems (applied on a consistent basis). However, two key points need further clarification as it relates to preparing GAAP-based financial statements:

- ◆ First, pay close attention to the word *should*. That is, companies should make every effort to develop and maintain accounting systems that are in compliance with GAAP. Here's the *but*: You would be amazed at how many businesses (especially smaller and medium-sized private businesses that are not as sophisticated) will make an attempt to develop and maintain a GAAP-based accounting system and do a fairly good job, but often are not 100% in technical compliance with GAAP (for any number of reasons).

- ◆ Second, companies are provided leeway to interpret and apply different accounting methods and guidelines that have been established by authoritative bodies. For example, different GAAP accounting methods have been established to value inventory, including LIFO, FIFO, average cost, and standard cost. I won't bore you with the details explaining the difference between these inventory valuation methods, as the key concept to remember is that similar companies operating in the same industry may in fact use different accounting methods to value basically the same asset (i.e., inventory).

If explaining the basic concept of GAAP previously isn't confusing enough, here's some additional nuggets to chew on as it relates to things getting more complicated these days.

Presently, in the United States, there are continuing developments to adopt separate rules for private companies versus public companies and for small companies versus larger companies. As both an author of numerous accounting and financial books and as a full-time consulting fractional CFO, I can say that I wholeheartedly agree with these efforts as requiring certain smaller and private companies to apply highly technical accounting concepts that do not have a material impact on a business is a step in the right direction. A primary goal of accounting should be to calculate and present the fair economic performance of a company over a period of time (or at a period end). Burying certain businesses in

accounting concepts, rules, and guidelines that are overly complex or technical is, without question, counterproductive.

Furthermore, efforts to harmonize American accounting and financial reporting standards with those of other countries keep slogging along. There has been a lot of standardization.

Yet, there are several areas of accounting and financial reporting in which there are differences between countries. From time to time throughout this book, I provide more insight into the changing landscape of accounting and financial reporting standards and how it may impact different businesses.