

# **FINANCIAL INTELLIGENCE**

**A Manager's Guide to Knowing  
What the Numbers Really Mean**

**KAREN BERMAN  
and JOE KNIGHT**

**with John Case**

**HARVARD BUSINESS SCHOOL PRESS  
BOSTON, MASSACHUSETTS**

## Cash Is a Reality Check

“C ompanies hit the skids for all sorts of reasons,” wrote Ram Charan and Jerry Useem in *Fortune* in May 2002, a time when a lot of companies were hitting the skids, “but it’s one thing that ultimately kills them: they run out of cash.” Most managers are too busy worrying about income-statement measures such as EBITDA to give cash much notice. Boards of directors and outside analysts sometimes focus too heavily on the income statement or the balance sheet. But, they noted, there is one investor who watches cash closely: Warren Buffett. The reason? “He knows cash is hard to fudge.”<sup>1</sup>

Warren Buffett may be the single greatest investor of all time. His company, Berkshire Hathaway, has invested in scores of companies and achieved astonishing results. From January 1994 to January 2004, Berkshire Hathaway’s Class A stock compiled an amazing compound annual growth rate of 17.9 percent; in other words, it rose an average of about 18 percent every year for ten years. How does Buffett do it? Many people have written books attempting to explain his investing philosophy and his analytical approach. But in our opinion it all boils down to just three simple precepts. First, he evaluates a business based on its long-term rather than its short-term prospects.



### Owner Earnings

Owner earnings is a measure of the company's ability to generate cash over a period of time. We like to say it is the money an owner could take out of his business and spend, say, at the grocery store for his own benefit. Owner earnings is an important measure because it allows for the continuing capital expenditures that will be necessary to maintain a healthy business. Profit and even operating cash flow measures do not. More about owner earnings in the toolbox at the end of this part.

Second, he always looks for businesses he understands. (This led him to avoid dot-com investments.) And third, when he examines financial statements, he places the greatest emphasis on a measure of cash flow that he calls *owner earnings*. Warren Buffett has taken financial intelligence to a whole new level, and his net worth reflects it. How interesting that, to him, cash is king.

### WHY CASH IS KING

Let's look at that third element of the financial statements, cash, in more detail. Why target cash flow as a key measure of business performance? Why not just profit, as found on the income statement? Why not just a company's assets or owners' equity, as revealed by the balance sheet? We suspect Warren Buffett knows that the income statement and balance sheet, however useful, have all sorts of potential biases, a result of all the assumptions and estimates that are built into them. Cash is different. Look at a company's cash flow statement, and you are indirectly peering into its bank account. Today, after the dot-com bust and the financial-fraud revelations of the late 1990s and early 2000s, cash flow is once again the darling of Wall Street. It has become a prominent measure by which analysts

evaluate companies. But Warren Buffett has been looking at cash all along because he knows that it's the number least affected by the art of finance.

So why don't managers pay attention to cash? There are any number of reasons. In the past, nobody asked them to (though this is beginning to change). Some senior executives themselves may not worry about cash—at least, not until it's too late—so their direct reports don't think much about it, either. Folks in the finance organization often believe that cash is *their* concern and nobody else's. But often, the reason is simply a lack of financial intelligence. Managers don't understand the accounting rules that determine profit, so they assume that profit is pretty much the same as net cash coming in. Some don't believe that their actions affect their company's cash situation; others may believe it, but they don't understand how.

There's another reason, too, which is that the language in the cash flow statement is a little arcane. Charan and Useem in their article were advocating a simple antidote to financial fraud: a "detailed, easily readable cash-flow report" required to be given to the board, to employees, and to investors. Unfortunately, no one, to our knowledge, has taken up the suggestion. So we are left with conventional cash flow statements. Most of these, however detailed, are hard for a non-financial person to read, let alone understand.

But talk about an investment that pays off: if you take the time to understand cash, you can cut right through a lot of the smoke and mirrors created by your company's financial artists. You can see how good a job your company is doing at turning profit into cash. You can spot early warning signs of trouble, and you will know how to manage so that cash flow is healthy. Cash is a reality check.

One of us, Joe, learned about the importance of cash when he was a financial analyst at a small company early in his career. The company was struggling, and everyone knew it. One day the CFO and the controller were both out golfing and were unreachable. (This was in the days before everybody had a cell phone, which shows you how



old Joe is.) The banker called the office and talked with the CEO. Evidently, the CEO didn't like what he was hearing from the banker and felt he had better talk to someone in accounting or finance. So he passed the call to Joe. Joe learned from the banker that the company's credit line was maxed out. "Given that tomorrow is payday," the banker said, "we're curious about what your plan is to cover payroll." Thinking quickly (as always), Joe replied, "Um—can I call you back?" He then did some research and found that a big customer owed the company a good deal of money and that the check—really—was in the mail. He told the banker this, and the banker agreed to cover payroll, provided Joe brought the customer's check to the bank the minute it arrived.

In fact, the check arrived that same day, but after the bank closed. So first thing the next morning, Joe drove to the bank, check in hand. He arrived a few minutes before the bank opened, and noticed that a line had already formed. In fact, he saw that several employees from his company were already there, holding their paychecks. One of them accosted him and said, "So you figured it out too, huh?" Figured what out, Joe asked. The guy looked at him with something resembling pity. "Figured it out. We've been taking our paychecks to the bank every Friday first break we got. We cash 'em and then deposit the cash in our own banks. That way, we can make sure the checks don't bounce—and if the bank won't cash them, we can spend the rest of the day looking for a job."

That was one day Joe's financial intelligence took a big leap upward. He realized what Warren Buffett already knew: it's cash that keeps a company alive, and cash flow is a critical measure of its financial health. You need people to run the business—any business. You need a place of business, telephones, electricity, computers, supplies, and so on. And you can't pay for all these things with profits, because profits aren't real money. Cash is.

## Profit $\neq$ Cash (and You Need Both)

**W**hy is profit not the same as cash coming in? Some reasons are pretty obvious: cash may be coming in from loans or from investors, and that cash isn't going to show up on the income statement at all. But even operating cash flow, which we'll explain in detail later, in chapter 16, is not at all the same as net profit. There are three essential reasons:

- *Revenue is booked at sale.* One reason is the fundamental fact that we explained in our discussion of the income statement. A sale is recorded whenever a company delivers a product or service. Ace Printing Company delivers \$1,000 worth of brochures to a customer; Ace Printing Company records revenue of \$1,000, and theoretically it could record a profit based on subtracting its costs and expenses from that revenue. But no cash has changed hands, because Ace's customer typically has thirty days or more to pay. Since profit starts with revenue, it always reflects customers' promises to pay. Cash flow, by contrast, always reflects cash transactions.



- *Expenses are matched to revenue.* The purpose of the income statement is to tote up all the costs and expenses associated with generating revenue during a given time period. As we saw in part 2, however, those expenses may not be the ones that were actually paid during that time period. Some may have been paid for earlier (as with the start-up we mentioned that had to pay for a year's rent in advance). Most will be paid for later, when vendors' bills come due. So the expenses on the income statement do not reflect cash going out. The cash flow statement, however, always measures cash in and out the door during a particular time period.
- *Capital expenditures don't count against profit.* Remember the toolbox at the end of part 3? A capital expenditure doesn't appear on the income statement when it occurs; only the depreciation is charged against revenue. So a company can buy trucks, machinery, computer systems, and so on, and the expense will appear on the income statement only gradually, over the useful life of each item. Cash, of course, is another story: all those items often are paid for long before they have been fully depreciated, and the cash used to pay for them will be reflected in the cash flow statement.

You may be thinking that in the long run cash flow will pretty much track net profit. Accounts receivable will be collected, so sales will turn into cash. Accounts payable will be paid, so expenses will more or less even out from one time period to the next. And capital expenditures will be depreciated, so that over time the charges against revenue from depreciation will more or less equal the cash being spent on new assets. All this is true, to a degree, at least for a mature, well-managed company. But the difference between profit and cash can create all sorts of mischief in the meantime.

## PROFIT WITHOUT CASH

We'll illustrate this point by comparing two simple companies with two dramatically different profit and cash positions.

Sweet Dreams Bakery is a new cookies-and-cakes manufacturer that supplies specialty grocery stores. The founder has lined up orders based on her unique home-style recipes, and she's ready to launch on January 1. We'll assume she has \$10,000 cash in the bank, and we'll also assume that in the first three months her sales are \$20,000, \$30,000, and \$45,000. Cost of goods are 60 percent of sales, and her monthly operating expenses are \$10,000.

Just by eyeballing those numbers, you can see she'll soon be making a profit. In fact, the simplified income statements for the first three months look like this:

	January	February	March
Sales	\$20,000	\$30,000	\$45,000
COGS	<u>12,000</u>	<u>18,000</u>	<u>27,000</u>
Gross profit	8,000	12,000	18,000
Expenses	<u>10,000</u>	<u>10,000</u>	<u>10,000</u>
Net profit	\$ <u>(2,000)</u>	\$ <u>2,000</u>	\$ <u>8,000</u>

A simplified cash flow statement, however, would tell a different story. Sweet Dreams Bakery has an agreement with its vendors to pay for the ingredients and other supplies it buys in thirty days. But those specialty groceries that the company sells to? They're kind of precarious, and they take sixty days to pay their bills. So here's what happens to Sweet Dreams's cash situation:

- In *January*, Sweet Dreams collects nothing from its customers. At the end of the month, all it has is \$20,000 in receivables from its sales. Luckily, it does not have to pay anything out for the ingredients it uses, since its vendors expect to be paid in thirty



days. (We'll assume that the COGS figure is all for ingredients, because the owner herself does all the baking.) But the company does have to pay expenses—rent, utilities, and so on. So *all* of the initial \$10,000 in cash goes out the door to pay expenses, and Sweet Dreams is left with no cash in the bank.

- In *February*, Sweet Dreams still hasn't collected anything. (Remember, the customers pay in sixty days.) At the end of the month, it has \$50,000 in receivables—January's \$20,000 plus February's \$30,000—but *still* no cash. Meanwhile, Sweet Dreams now has to pay for the ingredients and supplies for January (\$12,000), and it has another month's worth of expenses (\$10,000). So it's now in the hole by \$22,000.

Can the owner turn this around? Surely, in March those rising profits will improve the cash picture! Alas, no.

- In *March*, Sweet Dreams finally collects on its January sales, so it has \$20,000 in cash coming in the door, leaving it only \$2,000 short against its end-of-February cash position. But now it has to pay for February's COGS of \$18,000 plus March's expenses of \$10,000. So at the end of March, it ends up \$30,000 in the hole—a worse position than at the end of February.

What's going on here? The answer is that Sweet Dreams is growing. Its sales increase every month, meaning that it must pay more each month for its ingredients. Eventually, its operating expenses will increase as well, as the owner has to hire more people. The other problem is the disparity between the fact that Sweet Dreams must pay its vendors in thirty days while waiting sixty days for receipts from its customers. In effect, it has to front the cash for thirty days—and as long as sales are increasing, it will never be able to catch up unless it finds additional sources of cash. As fictional and oversimplified as Sweet Dreams may be, this is precisely how profitable companies

go out of business. It is one reason why so many small companies fail in their first year. They simply run out of cash.

### CASH WITHOUT PROFIT

But now let's look at another sort of profit/cash disparity.

Fine Cigar Shops is another start-up. It sells very expensive cigars, and it's located in a part of town frequented by businessmen and well-to-do tourists. Its sales for the first three months are \$50,000, \$75,000, and \$95,000—again, a healthy growth trend. Its cost of goods is 70 percent of sales, and its monthly operating expenses are \$30,000 (high rent!). For the sake of comparison, we'll say it too begins the period with \$10,000 in the bank.

So Fine Cigar's income statement for these months looks like this:

	January	February	March
Sales	\$ 50,000	\$75,000	\$95,000
COGS	<u>35,000</u>	<u>52,500</u>	<u>66,500</u>
Gross profit	15,000	22,500	28,500
Expenses	<u>30,000</u>	<u>30,000</u>	<u>30,000</u>
Net profit	<u>\$(15,000)</u>	<u>\$(7,500)</u>	<u>\$(1,500)</u>

It hasn't yet turned the corner on profitability, though it is losing less money each month. Meanwhile, what does its cash picture look like? As a retailer, of course, it collects the money on each sale immediately. And we'll assume that Fine Cigar was able to negotiate good terms with its vendors, paying them in sixty days.

- In *January*, it begins with \$10,000 and adds \$50,000 in cash sales. It doesn't have to pay for any cost of goods sold yet, so the only cash out the door is that \$30,000 in expenses. End-of-the-month bank balance: \$30,000.
- In *February*, it adds \$75,000 in cash sales and still doesn't pay anything for cost of goods sold. So the month's net cash after



the \$30,000 in expenses is \$45,000. Now the bank balance is \$75,000!

- In *March*, it adds \$95,000 in cash sales, pays for January's supplies (\$35,000) and March's expenses (\$30,000). Net cash in for the month is \$30,000, and the bank balance is now \$105,000.

Cash-based businesses—retailers, restaurants, and so on—can thus get an equally skewed picture of their situation. In this case Fine Cigar's bank balance is climbing every month even though the company is unprofitable. That's fine for a while, and it will continue to be fine so long as the company holds down expenses so that it can turn the corner on profitability. But the owner has to be careful: if he's lulled into thinking that his business is doing great and he can increase those expenses, he's liable to continue on the unprofitable path. If he fails to attain profitability, *eventually he will run out of cash.*

Fine Cigar, too, has its real-world parallels. Every cash-based business, from tiny Main Street shops to giants such as Amazon.com and Dell, has the luxury of taking the customer's money before it must pay for its costs and expenses. It enjoys the "float"—and if it is growing, that float will grow ever larger. But ultimately, the company must be profitable by the standards of the income statement; cash flow in the long run is no protection against unprofitability. In the cigar-store example, the losses on the books will eventually lead to negative cash flow; just as profits eventually lead to cash, losses eventually use up cash. It's the *timing* of those cash flows that we are trying to understand here.

Understanding the difference between profit and cash is a key to increasing your financial intelligence. It is a foundational concept, one that many managers haven't had an opportunity to learn. And it opens a whole new window of opportunity to ask questions and make smart decisions. For example:

- *Finding the right kind of expertise.* The two situations we described in this chapter require different skills. If a company is

profitable but short on cash, then it needs financial expertise—someone capable of lining up additional financing. If a company has cash but is unprofitable, it needs operational expertise, meaning someone capable of bringing down costs or generating additional revenue without adding costs. So not only do financial statements tell you what is going on in the company, they also can tell you what kind of expertise you need to hire.

- *Making good decisions about timing.* Informed decisions on *when* to take an action can increase a company's effectiveness. Take Setpoint as an example. When Joe isn't out training people in business literacy, he is CFO of Setpoint, a company that builds roller-coaster equipment and factory-automation systems. Managers at the company know that the first quarter of the year, when many orders for automation systems come in, is the most profitable for the business. But cash is always tight because Setpoint must pay out cash to buy components and pay contractors. The next quarter, Setpoint's cash flow typically improves because receivables from the prior quarter are collected, but profits slow down. Setpoint managers have learned that it's better to buy capital equipment for the business in the second quarter rather than the first, even though the second quarter is traditionally less profitable, just because there's more cash available to pay for it.

The ultimate lesson here is that companies need both profit and cash. They are different, and a healthy business requires both.