

# INTRODUCTION

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I am a finance geek. I revel in wading through numbers, formulas, financial engineering, and reporting that I and others of my kind incessantly chase. To me, there is nothing better than a tangle of financial figures waiting to be deciphered by a trained eye. So, as the corporate finance environment swelled in recent years, my work became very exciting. Market volumes multiplied, governance intensified, and the audience engaged. Yippee for me!

But not everyone working in finance is so happy. In fact, many of my colleagues are not so much thrilled as they are agitated. You see, a few decades ago, our work focused on the basic concepts of revenue, expenses, and return. But now, we explore tangential concepts such as embedded risk, evolving value, and variable capital structures. We now need to dig into obscure details of complex financial transactions, first in order to execute such structures within the firm, and then to record the related activities in the financial statements. Certainly, this evolution is exciting for me. But the change has not been easy for everyone. The field of financial professionals who can grasp the advanced necessities has understandably narrowed while the workload has inconveniently multiplied. And I don't need to tell you that this dynamic can all too frequently lead to disaster.

I was initially very distracted by this awkward uncertainty in my professional community. But soon I realized that I was only distracted because I couldn't see the source of the confusion. And so I started to pay attention. I started to watch for standard anomalies—one could call them common pitfalls—in corporate finance. I watched as my colleagues looked to a few easily accessible figures, such as EBITDA, to answer a broad stroke of constituent questions. I watched as the profession nudged the compendium of financial theory into narrower interpretations. And I watched as fewer and fewer financial professionals could say for certain if their firm was building wealth for investors.

This watching became a problem in itself. After a while, I turned from a standard finance geek into a fanatic conspiracy theorist! I could see symptoms of financial cobwebs in the most basic of concepts.

As an example of my obsession, let's for a moment consider the primary figure on today's financial statements—earnings per share, or EPS. This line item, appearing on the income statement, is designed to portray the net profit that the firm produced on behalf of each individual share investment. We all know that when a firm releases its quarterly results, EPS gets the dominant spotlight—it is a number claiming to represent the culmination of firm performance. But why is EPS so important? Should a shareholder really care that the firm made \$1.23 for each of its share holdings? I mean, it's not as if the firm will write checks for \$1.23 on each share! And even if it did, could we be certain that each of those \$1.23 checks would clear the bank?

So you can see that my ponderings became a bit wild. Yet, I still thought I was on to something. What *is* the point of all of corporate finance's masses of numbers and financial reports? Maybe we *do* want to know if those mysterious checks will clear the bank. If these checks clear, then we would know the firm obviously had cash, and cash flow is, after all, the fuel that runs the engines of business. Cash is the ultimate reward, the final word, and the root of market power. Everyone knows that. Right?

Maybe not. Maybe it doesn't matter if a firm produces cash. Some say that *value* is the foundation of business. Value, or the ultimate worth of an enterprise, defines a firm's contribution to its investors. When the value of a firm grows, the value of its shares theoretically also grows, increasing the relative wealth of its investors. Therefore, this alternate view deems *value growth* as the firm's principal goal.

Is anyone confused yet? If value is important and cash flow is less so, does that mean there can be value in a business that does not produce cash?

Well, there is a contradiction of perception here. And, unfortunately, it is not only a trick of financial theory but also a conflict that materializes in market realities. For instance, think about when the dot-com bubble burst or when the subprime lending market hit the wall. All too frequently, investors see value where the cash returns do not support it.

How does this happen? Cash is, in most cases of market turmoil, elusive in following perceived value. The problem seems obvious. But if this circumstance is so clear, why are markets so frequently blindsided by it?

Aha! Maybe my previous whining, posed as a humorous rant about uncleared EPS checks, is actually justified. Something is obviously missing in my profession's quest to build the perfect financial report. I personally believe the missing something is a clear vision relating to the firm's cash flow.

Cash flow is a common reference in today's financial jargon. Yet there seems to be little consistency in how it is used. What exactly is cash flow? Can the entirety of

a firm's cash flow be accurately and concisely measured? If so, can it be usefully interpreted? And, then, what is its relationship to other financial metrics? How does cash flow support the ultimate value of the firm? The answers to these questions are the focus of this book.

Cash flow is easily misinterpreted, mostly because it is very difficult to decipher in today's standard financial reporting as based on accrual accounting. Yet cash flow is crucial to both the creation and the interpretation of these same financial reports. This leaves us with a tangle in the basic fabric of finance. Why does this problem exist?

As we will explore in Chapter 1, accrual accounting is designed to avoid an isolated view to cash-based activity within the firm because accrual accounting endeavors to track and report all rewards and liabilities as they are *created*. A system of cash flow reporting, on the other hand, provides a view to those same rewards and liabilities as they are *settled*. Certainly, each concept cannot exist in isolation. For instance, if a liability is incurred, it must eventually be settled. But at the same time, the ultimate settlement amount must be understood if the value of that liability can be accurately estimated and reported at inception of the accrual.

So this is where the problem originates. Accrual accounting focuses on reporting initial estimates of future value, frequently recording only assumptions of the future cash flows. The standard structure of financial reporting, though, does not clearly disclose the settlement amounts. This, in turn, causes difficulty in generating the initial assumptions of future value. If we can't easily see the cash flow settlements of historical activity, how is the financial accountant supposed to adequately predict the current value of future activity?

As we delve deeper into the framework of cash flow, it will be obvious that knowledge of cash is vital to the workings of corporate finance. However, a view to its true existence can be elusive without guidance. Providing this guidance is the purpose of this book.

This book strives to explain cash flow. It endeavors to synthesize the mechanics of cash positions and cash flows and pulls those two things together to provide a tool for internal financial management. This tool is the Actual Cash Flow™ system.

It is important to understand that cash flow information provides incremental and valuable insight into the firm's financial picture. With the use of cash flow analysis, internal financial management increases its efficiency, control, and communicative power. This is because cash flow is direct and nonmalleable. It is in this that cash flow analysis augments traditional financial reporting.

The book is designed to address three topics related to the internal financial manager's view to cash flow. First, it analyzes why cash flow is important to the firm

and how the related information assists corporate finance professionals with their fiduciary responsibilities. It also explains how cash interacts inside the firm's operations, with special attention given to more complex transactions. And most important, the book explains the Actual Cash Flow system, its basic reporting, and structure for analysis.

To be clear, this book is designed to clarify cash flow for the internal manager. It is not my intention to attack the usefulness of traditional financial reporting for the external user. Nevertheless, after I spent many solitary months writing the first galley manuscripts, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) began a joint project that addresses many of the same themes running through the following chapters. Their project, referred to as the Financial Statement Presentation Project, incorporates the Boards' desire to disallow using only the indirect method in reporting the statement of cash flows, which is a fascinating coincidence. If the initiative (to mandate the use of direct cash flow statements in external financial reporting) progresses, this book could take on a different meaning. Some sections might be interpreted to clarify the usefulness of such a change, but other parts might only divulge problems for its execution.

Chapter 1 initiates the cash flow discussion by examining a growing information gap within today's corporate finance departments. The chapter also clarifies why cash flow information is vital for internal financial management. Chapter 2 outlines the aspects of cash flow and introduces the Actual Cash Flow concept. Chapter 3 then explains why the cash flow metrics that are available through traditional financial reporting do not provide useful cash flow information. This is followed by a mechanical description of how to build the Actual Cash Flow system in Chapter 4. Chapters 5 and 6 look at the attributes of various complex financial vehicles that are found in today's firm and explain the influence of such transactions on the firm's cash flow. Similarly, Chapter 7 reviews the multinational aspects of cash flow analysis. And finally, Chapter 8 brings cash forecasting into the Actual Cash Flow system.

I must now confess that this book is really just a selfish attempt to expel my colleagues' misinterpretation of cash. I have no desire to replace the financial reporting frameworks or to redefine financial theory. My goal is only to provide an alternative perspective on existing concepts that might help my compatriots simplify and interpret any quantity or form of financial activity. Then, when I encounter financial professionals who are drowning in a sea theoretical confusion, I can offer this book. And as a reward, I will be less distracted throughout the rest of my geeky career.