

## “CASH IS A FACT; PROFIT AN OPINION”

Today’s unprecedented negative feedback spiral from media to consumer, with dramatic reporting of “a sickening slide into Economic Depression” could swamp Owner-Managers with “background noise.” In this landscape, the real danger for entrepreneurs is loss of strategic focus. Experience shows that in these periods the most resilient successful Owner-Managers increase their focus and grit (ignoring the background noise as much as possible) on building sustained legacy and an enterprise that all stakeholders can be passionate about. To do that in up or down markets requires sustained, increasing cash flow. Curiously, while earnings are something that are calculated yearly (if for no other reason than to pay your taxes), it is increased sustainable cash flow which leads to sustained increase in Enterprise Value.

Owner-Managers who have on their “Manager’s Hat” constantly hear communications about “earnings.” Public company year-end reports, required SEC disclosures, popular radio/television reporting, and newspaper and magazine articles all report earnings, or even worse, earnings per share. Is there any metric that is less helpful and insightful than reporting earnings per share? The major focus of the now infamous Sarbanes Oxley legislation was to increase “transparency of earnings.” Yet any first year MBA can tell you, and our grizzled experience will confirm, that cash flow, not earnings, is the life blood of all organizations, from which all good things come. Without increasing cash flow, there is no resource for investment in growth, no increased working capital, no possible increase in profit sharing or success sharing plans for stakeholders.

What’s wrong with a focus on historical earnings? First, managements have latitude in the accounting methods that they select, which in and of themselves will result in vastly different reported earnings. Second, earnings do not consider capital requirements, such as, the need for increases in accounts receivable and inventory, or needed capital expenditures. There are multiple methods to establish the cost of inventory, many depreciation methods depending upon the kind of asset and management choice, and countless ways of establishing and defending reserve levels— all subject to management whim, and auditor interpretation and opinion.

Focusing on earnings is a very real problem in manufacturing enterprises, but it is even more misleading in service-oriented enterprises where the assets go home every night. Investment in those businesses is often expressed by adding specialized human capabilities, which is represented by an increase in expenses on the income statement, reducing earnings, and often increasing cash flow!

Don’t lose focus. As much as possible, ignore earnings. Cash Flow as measured by EBITDA plus or minus Capital Changes (Earnings Before Interest, Taxes, Depreciation and Amortization, plus or minus incremental working capital and capital expenditures) is the best metric for an Owner-Managed enterprise’s trend of driving Enterprise Value. We advocate measurement on a pre-interest and pre-tax basis to correct for differences in capital structure.

In times of temporary capital market dislocation like this, all sophisticated long-term investors will return to fundamentals when evaluating investment opportunities in the private transaction market. Allocating resources and energy to your unique organizational strengths, and measuring the outcome of your decisions on the basis of how they will effect long and short-term cash flow generation is about as fundamental as it gets. It will result in an organization that creates and sustains permanent Enterprise Value for all stakeholders, beyond the lifetime of the individual entrepreneur.