

# I. Section One: Classifying and “Spreading” the Data

## A. Why do we “spread” financial statements?

1. To make conservative reclassifications of certain balance sheet accounts
  - a. Assets – when in doubt, move from current to non-current
  - b. Liabilities – when in doubt, move from non-current to current
  - c. Equity – if unsure of subordinate status, classify as liability
2. To simplify the format by combining multiple years of financials into a few pages
3. To facilitate orderly computation of ratios and cash flow data for use in credit analysis

## B. Tips and Traps

1. NEVER take the previous spread and just add a column of new data. ALWAYS examine the previous financial statements and accuracy of previous spread. The last analyst “owns” the accuracy (or lack thereof) of historical data.
2. Order of columns generally are reversed in accountant-prepared statements
  - a. Accountants – most recent period ⇔ oldest period
  - b. Bankers (and the rest of the world) – oldest period ⇔ most recent period
3. With automated programs, be careful where the asset or liability “feeds” the UCA cash flow model math
  - a. Recurring or operating should feed operating cash flow
  - b. Non-recurring or non-operating feed non-operating cash flow
4. Automated programs allow you to ignore common banker adjustments, such as

Never show negative **cash**. First, combine it with any positive cash or cash equivalents. Remaining negative balance should be shown as a current liability: an overdraft or an addition to either trade payables or line of credit. Be consistent with prior years and be careful since the “footings” (total assets) will change.

Be as strict as possible with **receivables** classified as “trade” by eliminating receivables from related parties (not related to sales or exchanges of goods), employee advances, etc.

Show **prepaid assets** (correctly classified by accountants as current) as non-current – these generally have little or no value to anyone other than the business being spread.

Examine footnotes and other data to correctly classify **loans**. Accountants include anything with a maturity  $\leq 12$  months as “short-term debt” even if it is the remaining payments on a long-term loan that has a balloon or bullet maturity and is expected to be renewed.

Carve out an estimated or imputed **current maturities of long-term debt** from the total **long-term debt**, if not already provided, and place this estimate in current liabilities

Generally, amounts **due to related parties** should be a current liability, and amounts **due from related parties** should be non-current assets – since the same or similar parties control both ends of the contract, it can be changed at will or on demand. Be careful to find and to isolate these accounts.

A portion of **depreciation** is often embedded in cost of goods sold.

Enter **dividends** in proper place or retained earnings reconciliation will not balance. Some dividends are **distributions to the owners** (of pass-through entities, such as S corporations and LLCs) that reimburse the owners for personal income taxes due on the pass-through income, or sometimes additional compensation/salary. In such cases, it may be appropriate to spread some of all of the distribution as **income tax expense** and/or **salary**.

5. **ALWAYS reconcile retained earnings**
6. The name should be input EXACTLY as shown on statement, including words like “and subsidiary” or “combined” or “consolidated” – check for historical consistency of the format of presentation

## II. Section Two: The Balance Sheet & Key Ratios

### A. Classification of **asset** accounts

<b>Current Assets</b>	
Cash	Includes unrestricted cash and cash equivalents intended to be converted to cash; usually with original maturities of three months or less, such as commercial paper and short-term certificates of deposit.
Marketable Securities	Liquid and short-term investments such as listed stocks and Treasury bills; can be included in account labeled <i>cash and cash equivalents</i> .
Accounts Receivable	Amounts due currently from customers under standard invoice terms, in payment for goods and services; usually reported net of an allowance for uncollectible accounts.
Allowance for Uncollectible Accounts	Also called <i>allowance for bad debts</i> , an amount management believes is not collectible from customers; a contra account, subtracted from gross accounts receivable to yield a net amount management does believe is collectible
Inventory	Merchandise purchased for resale, or finished goods manufactured and held for sale, together with related raw materials and work-in-process.
Other Current Assets	Accounts such as income tax refunds receivable, current receivables from non-customers, certain prepaid expenses for which benefits will be realized in the current period. Lenders often reclassify most of these accounts to non-current for spreading purposes.
<b>Investments &amp; Other Long-Term Assets</b>	
Investments in Affiliated Companies	Cost of the company's ownership of other companies, not wholly owned and not consolidated; indicates more control but substantially less liquidity than investments in marketable securities.
Cash Value of Life Insurance	Amounts that could be realized by cashing in life insurance policies, often reclassified as current for spreading purposes.
Rental Properties	Real estate or equipment held by the company to rent as income producing property; not used in the company's generation of products or services; usually reported net of accumulated depreciation.
Notes Receivable and Due From	Amounts owed to the company pursuant to promissory notes, such as notes due from officers, notes receivable from sales of assets, or note receivable related to resolution of accounts receivable that are delinquent.
Restricted Cash	Deposits not able to be withdrawn currently or not available for unrestricted use, such as escrow accounts, sinking funds, or long-term certificates of deposit.
Other Non-Current Assets	Such as prepaid expenses for which benefits will be realized after one year; deferred income tax benefits applicable to future periods.
<b>Fixed Assets</b>	
Property and Equipment	Fixed assets used in the company's generation of goods and services, including land, buildings, machinery and equipment, and office furniture, equipment and fixtures; amounts, including both assets owned and those financed with capital leases, are shown <i>gross</i> and <i>net</i> , after subtracting accumulated depreciation.
Accumulated Depreciation	The sum of amounts expensed to date as depreciation for each asset carried in property and equipment, except that land is not depreciated.
<b>Intangibles</b>	
Goodwill	Cost in excess of businesses acquired, adjusted periodically for any re-valuations of those assets.
Other Intangibles	Assets such as patents, copyrights, trademarks, brands, formulas, franchise rights, operating rights and mailing lists; listed net of accumulated amortization or adjusted periodically for any re-valuations of those assets.

**B. Classification of liability accounts**

<b>Current Liabilities</b>	
Overdrafts	A negative cash position at the bank on the company's books.
Notes Payable	Amounts owed to banks under promissory notes, commercial paper obligations and sometimes to other creditors such as suppliers.
CMLTD	Scheduled principal payments on long-term debt during the next year.
Accounts (Trade) Payables	Credit provided by suppliers, arising from the shipment of goods and raw materials from suppliers on open account.
Accruals	Amounts expensed on the income statement but not yet paid; can include wages payable, if not listed separately.
Income Taxes Payable	Current taxes payable, often broken down into amounts due from the current year and any current portion due of deferred taxes.
<b>Long-Term Liabilities</b>	
Long-Term Debt	Amounts due after one year, including bank loans, mortgages, bonds, debentures and obligations under capital leases.
<i>Due to</i>	Amounts owed to employees, officers, shareholders, subsidiaries, parent or other affiliated entities or persons; usually classified as a current liability for spreading purposes.
Deferred Taxes	Taxes that have been accrued on income reported in financial statements but not yet reported to the IRS, often arising from timing differences in the recognition of depreciation expense.
Subordinated Debt	Obligations that are secondary (or <i>junior</i> ) to other obligations, or a claim for payment only after holders of the primary (or <i>senior</i> ) debt obligations are partially or fully paid; used for spreading purposes only for debts subordinated to the lender and under acceptable conditions. Further, if from the officers or owners of the company, moved from liabilities and added to total equity.

**C. Classification of net worth accounts**

Capital Stock	The par value of the company's stock, usually an arbitrary figure like \$1 per share times the number of shares. Includes all classes of stock, including preferred stock.
Additional Paid-In Capital	The amount of money received by the company, in excess of par value, when the various shares of stock were initially sold.
Retained Earnings	Accumulated profit that has been retained and not paid out as dividends.
Treasury Stock	Cost to repurchase shares from investors. Shares remain "outstanding" but held by the company "in the treasury" and reduce net worth.

**D. Liquidity Measures/Ratios** – Liquidity is simply how fast an asset can be converted to cash without significant loss in value. For businesses, liquidity provides financial flexibility. While a strong cash component within current assets is desirable for most small businesses, larger businesses should be utilizing cash management services to minimize idle cash when an operating line of credit is available.

1. **Current Ratio (x)** = Current Assets ÷ Current Liabilities  
How much current assets can shrink in value before they would be inadequate to cover current obligations.
2. **Quick Ratio (x)** = (Current Assets – Inventory) ÷ Current Liabilities  
How much current assets, excluding inventory (which can be difficult to liquidate) can shrink in value before they would not cover current obligations.
3. **Working Capital (\$)** = Current Assets – Current Liabilities  
Dollar amount of possible current asset shrinkage before it would be inadequate to cover current obligations.

**E. Leverage Ratios** show levels of financial risk borne by creditors versus owners. Also, businesses with high leverage tend to have a larger interest expense component that adversely affects profits, especially in a period of increasing interest rates.

1. **Debt to Worth (x)** = Total Liabilities ÷ Owners' Equity [Owners' Equity = Net Worth]  
Proportion of borrowed money and obligations to outsiders compared to the owners' investment. Generally, a lower ratio indicates a better margin of protection provided by assets relative to the corresponding liabilities, therefore less risk to creditors.
  2. **Tangible Leverage (x)** = Total Liabilities ÷ Tang. Net Worth [TNW = NW – Intangible Assets]  
Computes the proportion of liabilities to net worth, but reduces net worth for the value of intangible assets, which are the least liquid and of questionable value.
- F. These balance sheet ratios are “point-in-time” measures, so be careful that the underlying asset and liability balances are fairly representative of ongoing levels during a year. This is a strong argument for exploring and understanding interim financial statements, especially for seasonal businesses.

### III. Section Three: The Income Statement and Key Ratios/Measures

#### A. Multi-step income statement classifications

<b>Income Statement</b>	
Gross Sales (or Gross Revenues)	Total billings, receipts of cash or accounts receivable in exchange for the products and services of the business
Returns and Allowances	Discounts allowed (for prompt payment), and adjustments or refunds for goods returned by customers
Net Sales	Gross sales less any returns and allowances
Cost of Sales (or Cost of Goods Sold)	Costs to produce goods or services sold during the period, including materials, labor and other costs incurred directly in the production or service process – sometimes including depreciation and other operating expenses that can be allocated
Gross Profit	Net sales less cost of sales
Operating Expenses	Selling, general and administrative expenses not allocated to cost of sales, plus special classifications such as research and development, but excluding interest expense
Operating Profit	Gross profit less operating expenses
Other Income	Revenues not from the sale of goods or services, such as interest income or gain on sales of fixed assets
Other Expense	Miscellaneous expenses, including interest expense, not classified elsewhere
Profit Before Tax	Operating profit plus other income less other expenses
Income Tax	Federal (and state, if any) taxes on income reported for the period, whether current or deferred
Profit After Tax	Profit before tax less income tax
Extraordinary Items	The aftertax effect of accounting changes or of income or expense clearly outside the ordinary course of business
Net Income	The final, “bottom line” profit after accounting for all revenues, expenses and taxes

- B. **Sales Growth (%)** = (Current Year Net Sales ÷ Previous Year Net Sales) – 1.00
- C. **Profitability Ratios** simply express various subtotals in the income statement as a percentage of sales.
1. **Gross Profit Margin (%)** = Gross Profit ÷ Net Sales
  2. **Operating Profit Margin (%)** = Operating Profit ÷ Net Sales
  3. **Pretax Profit Margin (%)** = Pretax Profit ÷ Net Sales
  4. **Net Profit Margin (%)** = Net Profit ÷ Net Sales  
Compare profitability from year to year as sales levels change; expenses can move from overhead (operating expenses) to cost of goods sold, or vice versa.

- D. **Cash Flow Measures** derived from the income statement show the ongoing success or failure of a business model and management's ability to execute it. In accrual-based accounting, these cash flow measures match the costs expended over a period of time (to generate revenue) against the revenue earned in the same period; they largely ignore whether the revenue actually was collected or expenses actually paid (essentially a working capital or cash management function) because these can distort the result (sometimes greatly and sometimes intentionally) by a well-timed or unusual cash collection or payment.
1. **Gross Cash Flow (\$)** = Net Profit + Depreciation + Amortization\*
  2. **EBIT (\$)** = Pretax Profit + Interest Expense
  3. **EBITDA (\$)** = Pretax Profit + Interest Exp. + Depreciation + Amortization\*
  4. **EBIDA (\$)** = Net Profit + Interest Expense + Depreciation + Amortization\*
- \*amortization of intangible asset values, if any; not loan principal amortization

#### **IV. Section Four: Efficiency and Debt Coverage Ratios**

##### **A. Efficiency Ratios**

1. **Total Asset Efficiency** = Sales ÷ Total Assets  
Measures total asset utilization and should be compared to similar firms. Generally, it is better to produce more sales dollars with fewer assets.
2. **Accounts Receivable Turnover (days)** = (Accounts Rec. x 365) ÷ Net Sales  
Shows the average time it takes to collect invoices (receivables). Compare to selling terms to see how the company manages to billing process – from timely preparation of invoices to monitoring of past dues.
3. **Inventory Turnover (days)** = (Inventory x 365) ÷ Cost of Goods Sold  
Measures the average time it takes to acquire or manufacture inventory, plus the time until units are sold. It is important to consider industry and production cycle.
4. **Accounts Payable Turnover (days)** = (Accounts Pay. x 365) ÷ C of G Sold  
Shows the average time the company waits to pay its vendors. Compare to vendor terms and see how well the firm uses this “free” source of funds.

##### **B. Debt Service Ratios**

1. **Gross Cash Flow Coverage (x)**: Gross Cash Flow ÷ CMLTD  
Shows the ability of net income plus non-cash charges to cover current amounts of loan principal due in the coming year.
2. **Interest Coverage (x)**: (Pretax Profit + Interest Expense) ÷ Interest Expense  
Shows the ability to meet interest payments; important if firm has lines of credit or other “interest only” debt. Often paired with traditional cash flow coverage for analysis purposes.
3. **Fixed Charge Coverage (x)**: EBITDA ÷ (CMLTD + Interest Expense)  
Blends the first two ratios, and is useful if most loan payments are “P&I” and are known, but statements do not break out CMLTD. Denominator can be derived similar to consumer lending situations. The numerator adds back income tax expense. Some bankers even add back rent expense (or other fixed charges) to BOTH the numerator (to get EBITDAR) and denominator.
4. **Cash Flow Leverage (x)**: Total Funded Debt ÷ EBITDA  
Total Funded Debt includes all borrowed money and loans, plus any “off balance sheet” items like letters of credit and undrawn amounts on lines of credit. This shows how many years it would take the company to repay all borrowed funds and commitments at the current pace of “cash flow” or EBITDA. Very popular in the venture capital and investing world, banks should limit loans to a 4.0x level of Funded Debt to EBITDA. Over that amount, the firm needs additional capital to fund itself.

## Recent FASB Changes

### Revenue Recognition – ASC 606

In May of 2014, FASB and the International Accounting Standards Board (IASB) issued joint guidance about recognizing revenue in contracts with customers. While the U.S. guidance (ASC 606 in GAAP) has many features, the key issue is that revenue should be recognized when an entity satisfies each performance obligation by transferring control of the promised goods or services to the customer. Goods or services can transfer at a point in time or over time, depending on the arrangement. The guidance provides specific criteria for performance obligations that are satisfied over time.

Prior to ASC 606, guidance about GAAP revenue recognition lacked consistency across industries and between GAAP and IFRS, and failed to address certain types of arrangements. The new standard is aimed at reducing or eliminating those inconsistencies, thus improving revenue comparability and eliminating guidance gaps. As amended in 2016, the ASC 606 standard was effective in 2018 (including interim periods therein) for most calendar year-end public business entities. The new standard became effective for in 2019 for nonpublic calendar year-end firms, and effective in interim periods in 2020 as otherwise afforded to private companies.

### Lease Accounting – ASC 842

Starting in 2019 for public companies and 2021 for private firms, new lease accounting rules will require lessees to recognize a right-of-use asset and lease liability for virtually all leases, similar to IFRS treatment.

Under the old FASB 13/ASC 840 rules, a lease must be capitalized (appear on lessee's balance sheet similar to a purchase and loan) if any apply

- Lease transfers ownership to lessee at end of lease term
- Lease contains purchase option at bargain price (<FMV)
- Lease term  $\geq$  75% of property's estimated economic life
- PV of lease payments  $\geq$  90% of property FMV

An operating lease (rent on income statement only) does not meet any of the above conditions.

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- Lease contains purchase option at bargain price (<FMV)
- Lease term  $\geq$  75% of property's estimated economic life
- PV of lease payments  $\geq$  90% of property FMV
- *Lease transfers control of the underlying asset to lessee*
- *Underlying asset is very specialized and expected to have no alternative use to lessor at end of lease*

And there are very few exceptions where a lease is operating (not capitalized)

- Leases of short duration ( $\leq$  12 months at commencement) and do not include purchase option that lessee is reasonably certain to exercise
- Leases of biological assets, including timber
- Leases of intangible assets, including licenses of internal-use software
- Leases to explore for or use minerals, oil, natural gas, and similar, non-regenerative resources
- Leases of inventory or of construction in progress

Issues for bankers and businesses include

- Will real estate owners take on more risk by changing leases to 12 months?
- Will more customers balk at reviews and audits in order to use cash accounting and avoid this hassle?
- **No change in cash flow or SCF**, since ASC 842 requires lessees to report the single expense associated with an operating lease as an operating activity
- No significant change in net income, since in most cases, lease expense will be replaced by imputed interest expense and imputed depreciation
  - Imputed depreciation is now a cash expense and should not be “added back” for EBITDA
- Fixed Charge Coverage using EBITDAR in numerator should not change
- **The right-of-use asset and related lease liability will increase balance sheet leverage**
- Many customers (non-public and not using accrual accounting) may not be making any changes, pending the ultimate stance by the IRS



The Wall Street Journal, Tuesday, January 7

## New Year Could See Accounting Changes

By MARK MAURER

The Financial Accounting Standards Board will evaluate two weighty issues in 2025 on how companies report their performance metrics and research and development spending as it looks to refill its slate of potential new rules.

The accounting standard-setter for U.S. companies and non-profits recently requested public feedback on the next batch of issues it should prioritize, with a deadline at the end of June.

The board will determine whether to add the issues raised to its standard-setting or research agendas over the next year and beyond, Chairman Rich Jones said in an interview.

The body expects to finalize new rules on accounting for software costs, environmental credits and government grants in 2025, Jones said. The FASB's standards, which can take years to come to fruition, can saddle companies with a greater compliance burden but also give more technical clarity, while

providing investors with new corporate details.

Notably, the FASB could dive into two hot-button accounting topics: companies' use of financial key performance indicators, or KPIs, and their accounting for intangible assets such as drug development, cryptocurrency or brands.

"You're seeing us really explore what, depending on the direction those projects take, could be a very significant shift in financial reporting," Jones said.

Earnings before interest, taxes, depreciation and amortization, or Ebitda, and free cash flow, which is the money a company has left over after paying operating and capital expenses, are not defined under U.S. accounting rules. Measures such as net income, revenue, earnings per share and diluted earnings per share are defined.

The FASB is getting input on whether investors and others would benefit from moving a measure like Ebitda into finan-

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## FASB Eyes Accounting Changes

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cial statements and creating a standard definition companies could use, even if they made non-GAAP adjustments to it. If companies were to deviate from that definition outside of their financials, the Securities and Exchange Commission or other regulators might require them to disclose their rationale, Jones said.

"Do I think there's something we could do there? My own view is absolutely," Jones said. "I'm eager to see what we learn from our stakeholders."

Several KPIs companies mention outside of the financial statements are considered non-GAAP, meaning they go beyond U.S. generally accepted accounting principles. The project, if added to the standard-setting agenda, would mark the FASB's first major effort to tackle non-

GAAP accounting.

Defining which types of companies should have a particular KPI in their financials would be an important part of the analysis, Jones said. "You might argue that Ebitda is a better measure for a manufacturer but not a very good measure for a financial institution," Jones said.

Companies rely increasingly on these measures, sometimes to present an overly optimistic picture of profitability. Some companies' earnings news releases regularly feature adjusted Ebitda and adjusted free cash flow, which are non-GAAP staples.

Executives usually say focusing on core operating earnings is the most accurate way to depict financial performance to investors, but their approach may vary. "Sometimes, clients are surprised by how much freedom they have in terms of what they can do with their KPIs," said Kern Roberts, head of Chatham Financial's global accounting

advisory team.

Most investors use their own adjusted version of companies' KPIs. The FASB should require companies to consistently disclose the inputs to KPIs such as the amortization amount used in a company's Ebitda calculation, said David Gonzales, senior accounting analyst at Moody's Ratings and member of a FASB

advisory group. "It would cut down a lot of our time trying to understand and find these things in financial statements," Gonzales said.

Another major project is to improve how companies account for and disclose intangible assets, or any asset they can't touch. The FASB is getting feedback on either pursuing one broad accounting model for all intangibles or grouping assets from different industries together into similar buckets like the development of software and medicine. Existing guidance on intangibles covers specific areas such as software, R&D

and certain industries.

The project would also evaluate ways to make it easier for investors to compare earnings for companies that grow through acquisitions with those that grow organically.

Companies will likely have mixed views on the prospect of adding more of these assets to their balance sheet, potentially making it one of the FASB's more controversial projects, said Scott Ehrlich, managing director at Mind the GAAP, an accounting training and consulting firm. "You're going to have a subset of companies that welcome an opportunity to finally reflect an asset on the balance sheet for what is really driving the value of the company," Ehrlich said. "Other companies may be less enthusiastic about it because the cost of valuing and recognizing the intangible probably isn't worth the benefits that they're obtaining."

The FASB in recent weeks has asked the public to say by April and May if they want new rules on KPIs and intangibles, respectively, after having researched the issues the past few years. In 2025, it expects to decide whether to proceed.

### Project would mark its first major effort on non-GAAP reporting.

The Wall Street Journal, Monday, January 6

## 'Rule of 40' Is in Fashion for Software Firms

The financial threshold is held up as a mark of success in the sector, but it often means less than it appears

Like hemlines and haircuts, stocks go in and out of fashion. So do the ways companies communicate their performance to investors. Whatever numbers investors want to see, management will supply them, especially if they can be easily tailored to look flattering.

For so-called SaaS companies, selling software as a service, a favorite metric nowadays is something called the "Rule of 40." The first thing to know is it isn't a rule, because there is no standard definition for what it means. For some companies it has become a big deal to claim membership in the "Rule of 40 club" nonetheless.

In general, the rule holds that a company's revenue growth plus its profit margin should be 40% or greater. So if a company has 20% revenue growth and a 20% margin, it gets to be in the club. Same for 40% growth and no margin, or 30% growth and a 10% margin.

Brad Feld, a venture-capital investor, popularized this notion with a blog post back in 2015 called "The Rule of 40% For a Healthy SaaS Company." The term's first appearance in a company's Securities and Exchange Commission filing was in 2017, going by the results of a database search on the SEC's website. A 2021 study by McKinsey, the consulting giant, is credited for helping spread its usage and showed that the market rewarded companies with higher val-

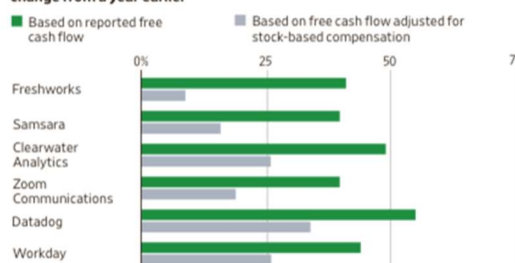
uations if they are at or above the Rule of 40.

Here is where it starts to fall apart: While revenue has a standard meaning, there is no consensus on which measure of profit companies should use to calculate the margin component. Should it be operating income? Net income? Cash flow? Maybe some nonstandard version of earnings or cash flow? The numbers that companies are showing lack comparability because they aren't apples-to-apples, and the companies often don't show their math.

But say everyone could agree on a particular margin metric to use for the calculation. The traditional one that McKinsey recommended was free cash flow. This typically is defined as operating cash flow, which has a standard definition, minus capital expenditures. Even then, the metric's usefulness starts to crumble. Done this way, the rule favors companies that rely heavily on stock-based compensation to pay their employees, while punishing those that don't and instead pay more heavily in cash. That is because free cash flow, like operating cash flow, excludes stock-based pay, which is a real cost that counts in companies' reported profits.

David Zion, founder of Zion Research Group and a longtime accounting and tax analyst, in a December research note did his own Rule of 40 calculations for North

Revenue growth plus free cash flow margin, change from a year earlier



Note: Based on third quarter 2024. Reported free cash flow equals cash flow from operations minus capital expenditures. Source: Zion Research Group

American application-software companies with stock-market values of greater than \$1 billion. For this exercise, he took the sum of revenue growth plus free-cash-flow margin using the latest reported four quarters. Of the 98 companies in the group, 33 of them met or beat the Rule of 40. However, when he adjusted free cash flow to treat stock-based pay as an expense, only 11 companies still met or beat the Rule of 40 under both methods. They included Palantir Technologies and Constellation Software.

At Freshworks, for instance, during the company's recent earnings call, Chief Executive Dennis Woodside said, "adding our reve-

nue growth and free-cash-flow margin for Q3, we exceeded the Rule of 40 in the quarter." Indeed, Zion calculated that its Rule of 40 number was 41%, which put Freshworks at No. 29 on his ranking out of the 98 companies. Revenue growth was just over 20%, and so was free-cash-flow margin.

But when Zion adjusted Freshworks' margin figure to treat stock-based pay as an expense, its Rule of 40 number fell to 9% and its ranking dropped to No. 76. The reason: Its stock-based pay exceeded its free cash flow. In other words, if that compensation had been paid in cash instead of stock, Freshworks' free cash flow would have been

negative, and its free-cash-flow margin would have been negative 11%.

Similarly, Workday's chief executive, Carl Eschenbach, at an investor conference last May said "we're a Rule of 40 company." Using free-cash-flow margin for the calculation, Zion showed its Rule of 40 number was 44% for the previous four quarters, but it was 26% if stock-based compensation was treated as an expense.

The reason that any of this matters, Zion says, is that the market has been rewarding companies with higher valuation multiples if they are at or above 40%, as McKinsey found in its study. However, it appears the market may not be distinguishing consistently between higher-quality and lower-quality Rule of 40 numbers.

"A big drop in the rankings for a company indicates to us that its Rule of 40 ranking is driven more by financial engineering (how employee compensation is financed) than its peers," Zion wrote in his note. Thus a big question for investors, he said, is "How much are you willing to pay for a Rule of 40 company that is primarily there because of how they've decided to finance their employees' compensation?"

Better yet, until there is some consensus on how to do this number, just 86 the rule.

—Jonathan Weil

+ Cash Flow from Operating Activities	Statement of Cash Flows (SCF) subtotal
+ Interest Expense Adjusted for Tax Deductibility	Interest Expense x (1 – tax rate)
– Unfinanced CAPEX	SCF: Fixed Asset Expend. – Incremental LTD
= C&I Banker Free Cash Flow	

## Three-Step View of the Financial Analysis Process

- General practice physicians
  1. Nature of patient
    - Age, sex, etc.
  2. Measurements of health
    - Height, weight, others
    - Trends
    - Appropriate levels
  3. Diagnosis of “problems” if any
- Lender equivalents
  1. Nature of business
    - Manufacturer, service, etc.
    - Accounting (cash vs. accrual)
    - Stage in business life cycle
  2. Measurements of financial “health”
    - Various ratios and trends
    - Appropriate levels
  3. Diagnosis of “problem” (loan request) in terms of cash flow
    - Why is cash or loan needed?
    - How will it get repaid?

## Global Analysis Overview

