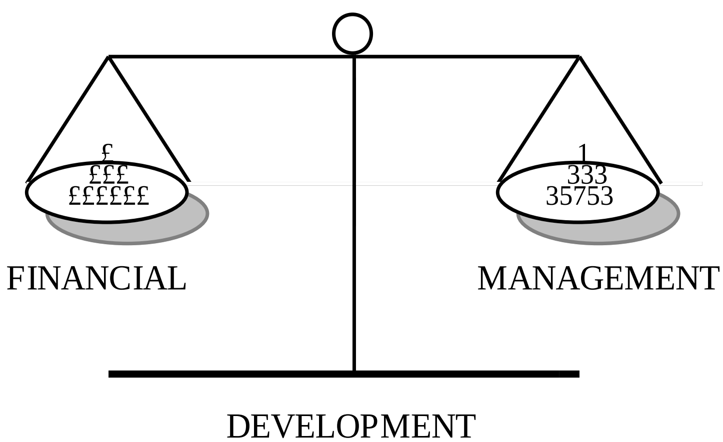
FINANCIAL MANAGEMENT DEVELOPMENT

DISCUSSION TOPICS

NO 801

THE UNBALANCED BALANCE SHEET



ONE OF A SERIES OF GUIDES FOR

FINANCIAL MANAGEMENT DEVELOPMENT

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This is one of a series of documents produced by David A Palmer as a guide for managers on specific financial topics to assist informed discussion. Readers should take appropriate advice before acting upon any of the issues raised.

THE UNBALANCED BALANCE SHEET

FINANCIAL DATA CAN BE MISLEADING

One of the great dangers of financial data is that, if misused, it actively encourages otherwise sane managers to indulge in insane activities. The Balance Sheet, the Profit and Loss Account and the Cash Flow Statement have their place as indicators of the financial health of a business, but are no substitute for common sense. Many managers believe finance is a science. It is not ..... It is an art with beauty in the eye of the beholder. The use of financial data is full of traps for the unwary. The Balance Sheet does not show the value of the business. The Profit and Loss Account does not show the impact of a company's activities on its value to the shareholders over a period. The Cash Flow Statement is not a reliable indicator of commercial performance.

NEGATIVE CASHFLOW IS GOOD, POSITIVE CASHFLOW IS BAD?

It is easiest to dispose of the last of these myths first. Cash Flow is a direct result of both trading and investment decisions. It is perfectly possible to be investing more cash than is being produced by trading. Whilst long term this is not a sustainable position, it is perfectly acceptable for short periods of time. It is reasonable to use "operational cashflow" as a measure of business success. However, you first have to define "operational" which is not a concept where even two accountants are likely to agree - let alone the rest of the world. Try deciding if Capital Expenditure is operational or not.

Any new venture will probably require a cash outflow in its early years. The accountant who suggests that cash flows should always be positive will never invest in anything other than the bank account. This is a perfectly acceptable activity. Even more acceptable is the reaction of shareholders who would prefer to keep the money in their own bank account rather than paying company directors or accountants to invest it for them. Producing a positive cashflow is relatively easy. All you do is sell some assets, preferably those omitted from the Balance Sheet, like customers and call it franchising or returning to core values.

THE BALANCE SHEET LACKS THE SPARK OF LIFE

Both the Balance Sheet and the Profit and Loss Account are power tools. They serve a purpose and in the right hands can be extremely useful in determining the financial stability of an organisation and its trading results for a period. In the wrong hands, used in the wrong way they can and do lead managers astray. It is no coincidence that the accounting profession struggles to cope with accounting for goodwill. By its very nature goodwill does not fit the normal conventions of historic cost accounting. It has not been explicitly paid for and it represents the future not the past.

Once you breach the conventions of historic cost accounting and incorporate revaluations in a Balance Sheet you end up with a bastardised version of what accounting is all about. Provided no one attempts to use a Balance Sheet as a statement of value, but treats it purely as a list of unexpired costs (i.e. assets) and unfulfilled obligations (i.e. liabilities), no great harm is done. Once a Balance Sheet is corrupted by property revaluations, brand valuations and attempts to account for purchased goodwill it begins to lose its meaning. Some organisations, particularly in the entertainment industry have even dared to value people. Thus football clubs treat players as assets. In accounting this is heresy, in real life it is sensible but dangerous.

The danger lies in managers, investors and others believing that Balance Sheet is a valuation statement. It is not and it is unlikely to ever be one. The biggest asset for most organisations is its people. Thus even a football club, which values its playing staff as fixed assets or stock, may fail to recognise the value of its managerial and administrative staff. They may be difficult to value in historic cost accounting terms. However they have a value and the organisation would be worse without them. There seems little point in attempting to put a value on players and failing to put a value on other people. Accountancy firms, merchant banks, advertising agencies and others might be advised to consider the value of Human Assets in their internal accounts if not in published data. Estimating the true value of a Robert Maxwell, Nick Leeson or Fred Goodwin might be an interesting exercise. Such interesting exercises might have helped those at Enron, WorldCom, RBS, Northern Rock and Arthur Andersen, since once you start evaluating what are the real sources of profit you sometimes find that the profit appears to be coming from nowhere. This may lead you to question its existence.

Brand Valuations give rise to much the same problem. Many organisations now value their Brands in the Balance Sheet. They believe that this protects them from take-over because otherwise naive shareholders would fail to recognise the true value of the organisation. This insults the intelligence of the average shareholder who for years has looked at return on capital as shown in historic cost accounts and ignored it. The shareholders look to return on investment which, crudely put, will be equivalent to corporate earnings per share divided by the amount paid by the shareholder per share. Note that this is the real Earnings per Share, not some created "Earnings before exceptionals, dilution, or any other cost which might reduce it." The EBITDA approach of earnings before interest, tax, depreciation and amortisation has never been popular at the household level. (Try ignoring your tax, mortgage interest, the decline in value of the car and the need to provide for retirement when deciding on disposable income!) Although it may help analysts compare returns from different companies it is not a measure of real returns.

The fact that accountants, stockbrokers and others conspire to confuse the shareholder by taking this simple ratio, turning it upside down and calling it PE, does not make the figure any less valuable. Goodwill is defined as the difference between the tangible assets in the Balance Sheet and the market capitalisation. Thus the shareholder, by holding a share rather than selling it in situations where the share price is greater than the asset value per share, is effectively already accounting properly for the people, the brand names, the customer and supplier relationships, etc. which form the spark of life which differentiates the dead corporate assets from the live, continuing corporate being.

THE PROFIT AND LOSS ACCOUNT IS A CONTRADICTION IN TERMS

Having disposed of the Balance Sheet and the various comic attempts to use it for a purpose for which it was never designed, we can turn our attention to the Profit and Loss account. Surely no one can argue that the profit figure for a year is anything other than a true reflection of management performance? After much hollow laughter and a period of reflection certain facts will become obvious. The first is that the Profit and Loss Account imperfectly reflects trading performance and does not show the true nature of the change in value of the shareholders' funds. We have already seen how market capitalisation gives a guide to the value of the corporate entity. Trading performance is only one feature of the change in the value of the company. The implications of investment activities and environmental changes are just as important.

The continued treatment of marketing, training and research as charges against income will result in short term earnings being capable of manipulation merely by increasing or reducing expenditure under these and similar headings. The manager who spends up to budget for fear of having his budget cut next year is no different from the Managing Director who invests heavily in research and development in a good year and cuts back in a bad one. They are not necessarily acting in the interests of the organisation. This failure to identify the true assets also leads to a failure to reflect the impact of any increase or decrease in their value on the trading results.

UNDERSTANDING IS THE SOLUTION

The answer to the problem lies in education. Managers need to understand the Profit and Loss Account and Balance Sheet, but they also need to know what they do not contain and why therefore, it maybe perfectly appropriate to show a reduced profit when there has been heavy investment for the future in training activities or research. It is surely no coincidence that some of the world's largest companies are those which spend a considerable percentage of income on research. If a pharmaceutical company were to dramatically cut research and development its earnings would increase many times. However, investors would quite rightly sell their shares, because future profitability, the main basis for a share's value, would have been destroyed.

Most companies have extremely sophisticated financial accounting systems and rightly so. They provide a key control mechanism on money which is a major corporate asset. Those same companies may have few formal controls over their "non financial" assets. Headcount is frequently reported monthly at board meetings. There is normally a grudging nod of approval when it falls. Whereas acquisitions and disposals of plant and machinery are the subject of detailed Discounted Cash Flow analysis and tax planning, similar decisions on staff are sometimes decided on no more than gut feel - "Let's impose a headcount ban" or "Let's cut staff by 10%". Presumably news that all the staff had left would be greeted with delight for the resulting cost saving.

Rarely do monthly Board Papers include regular data on training activities or succession planning. The financial data is voluminous, the personnel data rarely features. Although the recent emergence of Marketing and Public Relations has increased management's understanding of the corporate image as an asset, few companies have gone further than reviewing outdated statistics on market share. There is a need to develop methods of valuing People, Image, Brands, etc. and identifying activities which add to or detract from the value. Companies like BP, Shell, AstraZeneca and Unilever need to consider the true costs of failing to recognise Intangibles such as reputations with environmentalists, Government health departments and consumers. The benefit of recognising them and reporting on changes is not a "pretty" Balance Sheet, but the fact that by monitoring progress a company can ensure Shareholders' asset values are enhanced.

Financial information is a vital part of the toolkit which managers need to diagnose problems and take corrective action. It only gives part of the picture. The impact of computerisation has enabled financial data to be produced faster and in great detail, but the principle of customer first has not been followed. Information tends to follow financial accounting rules - precise, historic, and auditable. What is needed is management information to help manage the business, not infinite varieties of details regarding outdated costs. Corporate Strategy documents frequently get this balance right, with corporate goals and key financial and non-financial indicators. Finance directors have to change their approach to assist the other functions to quantify their activities but not to excessive levels of accuracy.

The Best can be the enemy of the Good. Attempts to use Cash Flow Return on Investment, Economic or Shareholder Value Added and the like, often founder on a spurious wish for precision. Financial Accounting approaches of accuracy and controllability are inappropriate for the inexact science of Business Management. The true Corporate Balance Sheet will never balance but good management will want to keep the scales wobbling rather than seeing the organisation tip over.

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David is an experienced financial professional who has devoted his skills to management training in practical understanding and utilisation of financial information. A Graduate, Chartered Accountant, and Associate of the Institute of Taxation, he is also a Member of the Chartered Institute of Personnel and Development and has been an Ordained as a Deacon in the Catholic Church.

He has worked as a Financial Controller and Company Secretary in the Finance industry and as a Director of Finance and Administration in the Computer Services industry. Since 1990 he has conducted management development programmes for over forty major organisations including Arla Foods, Blue Circle, BP, CSC Computer Sciences, Conoco, Ernst & Young, Lloyds Bowmaker, Royal Mail, Unilever and Zeneca. He also runs programmes for the Leadership Foundation and the management teams at a number of Universities. International training experience includes work in Belgium and Holland for CSC, in Denmark, Kenya and the Czech Republic for Unilever, in Holland and the US for Zeneca, in Dubai for Al Atheer, in Bahrain and Saudi Arabia for Cable & Wireless.

He specialises in programmes in financial management for both tactical and strategic decision making. In addition he has run courses in acquisition evaluation (The Economist, Eversheds, Blue Circle and Hays Chemicals) and in post-acquisition management (Unilever). All training is specifically tailored to the needs of the organisation with the emphasis on practical applications to enhance profitability and cashflow. He has developed material for delivery by in-house personnel (Royal Mail, Lloyds Bowmaker and Conoco), computer based training packages (The Post Office, Unilever and BP), and post course reinforcement self-study workbooks (CSC and Zeneca). He has also produced a training video on Cashflow Management.

He is a prolific writer of case studies, role plays and course material. He has also published articles on the financial justification of training, financial evaluation of IT investment proposals, the use of Activity Based Costing and Customer Profitability statements, commercial considerations for consultants, the need for taxation awareness training for general managers, evangelisation and Christian business ethics.

Many of his generic documents are freely available on his website:
FinancialManagementDevelopment.com including papers on Charity Management.

In addition to his Diaconal work in the Church, he has held a number of voluntary positions including University, College and School Governor, Hospice Treasurer and Trustee of various charitable institutions. He continues to provide ad hoc commercial advice to several other charitable organisations. He has been married for over 35 years and has one daughter and three granddaughters.

This series of papers is designed to help managers by providing a basic understanding of key financial concepts to assist them in their work. It is provided at no cost since this knowledge is a Gift from God and thus to be shared (Matthew 10:8).

