

Managing Financial Activities

The engine which drives Enterprise is
not Thrift, but Profit.

—John Maynard Keynes,
A Treatise on Money (1930)

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Profitability

What they taught in your MBA finance program:

Profits and ROE are the number-one goal of business.

What they should have taught:

Profits and ROE *are* the number-one goal of business. However, the widespread manipulation of earnings reports to satisfy stock market expectations and the imprecision of ledger costing systems make these measures largely meaningless. Instead, companies should manage from cash flow statement analysis.

DID SOMEONE SAY, LET'S KILL ALL THE ACCOUNTANTS?

Shakespeare's famous quote from *Henry the Sixth, Part II* was actually "The first thing we do, let's kill all the lawyers" (act IV, scene 2). And while that may not be a bad idea, the accounting profession could be considered for similar treatment. Accountants provide disinformation based on concepts that are centuries old, involving account codes and descriptions that have little relevance to twenty-first-century issues.

Profits are a seemingly straightforward concept as presented by most business school accounting professors. You take sales, subtract manufacturing expenses (cost of goods sold) and marketing and administrative expenses, and the outcome is net profits before income taxes. Subtract taxes and divide by the number of common shares outstanding, and you have earnings per share (EPS). Investors and stock analysts

multiply the annual EPS times a benchmark price-earnings ratio (P/E), and a “fair” stock price is calculated. If the result is below the current market price, this may be the time to buy; if it’s above the current price, consider selling.

This sounds so simple that any reasonably intelligent person should be able to do the calculation. However, the only concept that we described that isn’t open to manipulation is the number of common shares outstanding. Everything else is subject to interpretation and occasionally even to fraud. And if earnings are “managed”—to satisfy the investment community or for any other reason—then business decisions that depend on accurate financial statements are inevitably going to be wrong.

Why Profits Matter

By themselves, of course, profits or other dollar amounts (or, for that matter, any denomination of currency) have no meaning. To say that we earned \$1 million last month or last quarter has information value only in the context of the investment required to generate that profit. By common consent, the measure in standard usage is the return on equity (ROE), which represents the return on invested capital, stated as a percentage. A ROE of 12 percent can be compared to possible alternative investments and to returns generated by similar companies in your industry.

As an illustration, the restaurant business earned an average 19.4 percent for the year 2000, while all public U.S. companies reported ROEs of 15.8 percent.¹ But if your restaurant business experienced a ROE of less than the industry average, you probably wouldn’t care if you beat the other American companies. To see the specific results reported by the restaurant group, examine Exhibit 1.1.

Results are obviously very dispersed from the average (or statistical mean) ROE, with the established companies (i.e., McDonald’s) being successful and other chains not doing as well. However, managers of the underperformers have only a very general idea from ROE or profits results that their returns are

EXHIBIT 1.1 Selected Financial Data for Restaurants

Company and Fiscal Year Reported	Sales (\$ million)	Common Equity (\$ million)	ROE (%)
Bob Evans Farms (April 30) ^a	\$1,024	\$462	11.3
Brinker Intl. (June 30) ^a	\$2,474	\$901	17.5
CBRL Group (July 31) ^a	\$1,964	\$846	5.9
CKE Restaurants (Jan. 31) ^b	\$1,785	\$350	Negative
Darden Restaurants (May 31) ^a	\$4,021	\$1,035	19.7
McDonald's (Dec. 31) ^b	\$14,243	\$9,204	21.0
Wendy's Intl. (Dec. 31) ^b	\$2,237	\$1,126	15.5
What A Hamburger! ^c	\$1,200	\$600	13.5

^aFiscal year ending in 2001

^bFiscal year ending in 2000

^cA fictional restaurant chain used in the discussion that follows

inadequate. Below-average returns may be traceable to any of various problems, such as competition, high food costs, changing consumer tastes, or other factors.

BUSINESS SEGMENT RETURN ON EQUITY

Despite the problems in using ROEs or other profit-based criteria, companies often calculate the ROE for each business segment or strategic business unit (SBU). This measure supposedly tells senior management which segments are accomplishing their goals and contributing to the company's overall success and which are underperforming and need attention. If we were managing Wendy's, we might use the industry ROE as a company goal and try to improve underperforming restaurants (or groups of restaurants) that were dragging the company's profit returns.

Strategic Business Unit Assignment of Equity Capital

The calculation of SBU ROE involves the assignment of total equity capital to each segment based on an allocation derived from some readily available standard measure, such as headcount or

sales. Assume that the fictional What A Hamburger! chain had total sales of \$1.2 billion, requiring \$600 million of equity capital. If your SBU or group of restaurants had sales of \$1.2 million, or 0.1 percent of the company total, you might receive a 0.1 percent allocation of equity, or \$600,000. Your costs would drive an SBU profit, and that profit would be used to calculate your SBU ROE. Your SBU profit might be \$75,000, so your SBU ROE would be 12.5 percent (derived from \$75,000 divided by \$600,000).

What A Hamburger's friendly founder and spokesperson, Claire Benjamin, may love your hamburgers, but she might not be as pleased with your 12.5 percent SBU ROE if the company's ROE were 13.5 percent and she's trying to get to 19.4 percent, the industry average. She may send in the engineers, cooks, and accountants, and tell you to hire cheaper help, negotiate harder with suppliers, work longer hours, market the stores through local events, arrange tie-in promotions with movie theaters, or turn up the thermostat to use less air conditioning. Will any of this work?

Variable and Fixed Costs

The income statement items under your direct control are your variable costs of doing business, such as wages and benefits, purchases of food and supplies, and, to some extent, your local sales costs. However, these variable costs—so called because they vary based on levels of sales—are not really that controllable, because certain standards of quality must be maintained.

You can't really order cheaper grades of meat, or wilted lettuce, or rotting tomatoes. Nor can you skimp much on the quality of cleaning supplies, on paper cups and plates, or on napkins. Besides, any savings on supplies may be fairly trivial. Labor costs are "sticky" in that they are subject to minimum wage requirements and, in some jurisdictions, union contracts.

The fixed costs in your restaurants are almost certainly beyond your control. You cannot easily move to a location at a lower rent, you don't set manager and supervisory salaries, and you have little oversight of such expenses as utilities, insurance, and equipment rental (or depreciation). And you will almost

certainly receive an allocation of corporate overhead—for marketing, executive salaries (including Claire Benjamin’s), and general administration—which you are powerless to manage.

Outcome of the Strategic Business Unit Return on Equity

There may be some “wiggle” room on certain costs, but probably not more than a few percentage points. If you aggressively pursue such expense reductions—and we’ll assume that you do drive costs down 2.5 percent—your new SBU ROE will be 17.2 percent (calculated as \$103,125 divided by \$600,000) (see Exhibit 1.2). While you are still under the industry average, you would be doing much better than other What A Hamburger! restaurants or SBUs.

Is this a reasonable way to manage a business? The numerator of the SBU ROE is profits, which is derived from costs over which the SBU manager has little or no control. We have noted several of these expense categories, including the company’s assignment of corporate overhead and certain local fixed costs. The denominator is a totally arbitrary assignment of equity, often based on sales or headcount.

Furthermore, what happens if we continually fail to attain our SBU ROE? Management may decide to close down our restaurants and accept the termination costs to cancel the lease and dismiss employees. However, the corporation’s administrative costs don’t go away: they simply get reassigned to remaining SBUs. Of course, that makes their struggle to meet the target SBU ROE that much more difficult, because the new assignment of corporate overhead to each surviving SBU inevitably increases with fewer

EXHIBIT 1.2 What A Hamburger! Pro Forma Profit Analysis

	Original	Pro Forma after 2.5% Cost Reduction
Sales	\$1,200,000	\$1,200,000
Costs	\$1,125,000	\$1,096,875 ^a
Profits	\$75,000	\$103,125

^aCosts (\$1,125,000) reduced 2.5 percent (\$28,125).

business segments. Before we discuss whether there is a better way, let's focus on inherent problems with ledger accounting.

MANAGED EARNINGS

Although GAAP (generally accepted accounting principles) is considered the foundation of financial reporting, significant latitude is permitted in the calculation of revenues, costs, and income. "Accrual accounting" is based on a sales date rather than the time that a cost is incurred, and a sale is recognized when an invoice is issued and not when cash is received. ("Cash accounting" focuses on the dates these events occur, but is used mostly by small businesses.)

Earnings Adjustments

The problem of assigning costs to sales is not a new problem, and was recognized and dissected as early as 1934 by Benjamin Graham and David Dodd. Renowned for investment commentary, these authors spent about one-quarter of their landmark text *Security Analysis* on understanding and recomputing earnings from published financial reports.² Their suggested adjustments involve:

- Restating nonrecurring income or expenses
- Eliminating any unjustified recognition of income
- Correcting any entries to net worth such as reserve accounts
- Analyzing methods of inventory costing and depreciation
- Adjusting earnings resulting from the operations of subsidiaries and affiliates
- Recalculating income taxes based on the preceding adjustments
- Including or excluding certain unrecorded assets and liabilities

Pro Forma Accounting

Financial results are now subject to various judgments regarding which sales and costs to include or exclude, whether to cap-

italize or expense certain outlays, and where specific activities will be reported. These procedures are generally referred to as pro forma accounting. Here are a few examples; you decide if the accountants made the appropriate choice.

- Have we made a sale if dealers accept delivery of merchandise for which payment isn't due for six months, and then only if the goods are sold to their retail customers? As noted in the prologue, Sunbeam used this technique to pump up its financial results in 1997.
- Is it a sale if invoices haven't even been printed? Some dot.com companies include "unbilled services" in their reported revenues, despite customers' right to terminate contracts at any time with no penalty. Covance and Parexel International used this strategy for fiscal year 2001.³
- Are earnings credible if critical costs are deferred because of sagging revenues? Eastman Kodak cut research and development in 1998 to boost earnings by over 30 percent.
- Is a company being deceptive by taking a large, current write-off to boost subsequent earnings? Cisco and DaimlerChrysler recently have used this technique to make future years' results appear significantly improved.
- Can we rely on profit reports that are smoothed by dipping into reserves? Reserve accounts are special balance sheet accounts established for possible future requirements of the business. High-tech companies often establish reserves to be used in future periods of slowing revenues.
- Do we have accurate data on the cost to produce sales if expenses are labeled as marketing costs rather than as cost of goods sold? Various Internet retailers have mislabeled certain expenses to improve gross margin results (defined as sales less the cost of goods sold).

Recession and Reported Earnings

The 2000–2001 recession has brought a new set of problems with reported earnings. In prosperous times, companies may

attempt to hype current numbers. In a weak economy, a CFO is pressured to take his or her medicine now in the hopes of an early strong recovery and a surge in earnings. Of course, this type of manipulation depends on future positive economic results.

Current losses may be “loaded” by any of the following actions⁴:

- Reduce values of physical assets to lower future depreciation charges
- Increase estimates of bad debts to boost future earnings when remittances are received
- Account for restructuring charges now despite the uncertainty of actual costs
- Postpone the reporting of current-year sales to a future fiscal period to boost revenues

LEDGER ACCOUNTING PROBLEMS

The economic and accounting treatment of assets and expenses can be quite different. For example, we are not permitted to account for our most important resource—people—on the balance sheet, yet the economic value of human resources to high technology and various other businesses is unmistakable. The human capital issue is one of several problems in developing useful financial data. Some others are briefly noted.

- *Rules on depreciation.* Accounting rules determine depreciation and amortization periods rather than the useful life of the capital asset. For example, machinery may have a useful life of 10 years if properly maintained and operated for one shift, or four years if newer equipment replaces it, yet accounting depreciation may be eight years.
- *Aggregation.* Data often are lumped by ledger code without concern for the functioning of a business process. For example, banking fees are reported together rather than by the user strategic business unit (SBU) in the treasury department’s cost center, and will not even be

properly identified if payment is by balance compensation. (“Balance compensation” involves the payment for bank services by balances left on deposit with the bank rather than by direct fee charges. A credit balance is translated to a fee equivalent by the application of a short-term interest rate, usually the prevailing 91-day U.S. Treasury bill rate.)

- *Avoidable costs.* Accounting data may be difficult to evaluate because certain costs may not be avoidable. For example, space may be allocated to an activity at \$25 per square foot. However, if there is no alternative use for that space, should the cost be included in a decision to outsource or eliminate the activity? Computer and telecommunication charges, administrative overhead, and other charges present similar difficulties.

Profits and Business Objectives

Despite the proliferation of accounting information systems and enterprise resource planning (ERP) systems, few complex businesses have hard data on profits by customers, products, and markets. ERP systems link company information through thousands of computerized data tables. Each table uses a series of decision toggles that direct the software to specific decision paths. Enterprise resource planning automates the various tasks required to complete essential business processes in a single package.

In the absence of credible data, SBU managers are forced to rely either on aggregated return numbers from accounting ledgers or on the sell-to-everybody strategy. Sell to everybody involves a shotgun approach, with the manager hoping that universal market coverage will result in an adequate number of profitable sales. Neither approach is particularly effective.

Management should focus its limited resources on carefully constructed business objectives that can yield significant and profitable results. An early step in our consulting engagements is to ask the Peter Drucker questions: Who is your customer? Why does he or she buy?⁵ Companies may be able to answer that question in theory, yet our analysis of sales efforts shows wide deviation from stated business objectives. The smartest

marketing organizations in the world have developed the data and the discipline for their salespeople to walk away from customers who fall outside of the defined market.

APPROACHES TO MEANINGFUL EARNINGS INFORMATION

We have seen that financial statements can be misleading, causing managers (and investors) to rely on results that fail to accurately reflect revenues, costs, and earnings. When the debt and equity markets accept these data and earnings actually were manipulated, shareholders and lenders may lose money. When managers use these data but reported financials are inaccurate, unfortunate business decisions may result.

For this discussion, the securities industry and the SEC can worry about the investment community; we'll concern ourselves about the management of your business. There are two approaches to the development of meaningful earnings information:

1. Regulatory agency action, to curb abuses by requiring adherence to GAAP standards
2. Changing to an alternative procedure, the cash flow statement

Regulatory Action

Arthur Levitt, the Securities and Exchange Commission chairman from 1993 to 2001, committed his agency to attacking financial statement "management," the manipulation of earnings by chief executive officers obsessed with making their earnings numbers. The current SEC chairman, Harvey Pitt, plans to promote an atmosphere that supports more reporting of company information including the value of intangible assets, although the form of this reporting remains to be resolved.

The major problems include restructuring charges, often resulting from closing a business operation; acquisition accounting, how a company handles various acquisition costs; "cookie-jar reserves," money set aside to smooth earnings in future periods; materiality, intentional management misstatements; and revenue recognition, booking sales before accounting rules allow the recognition of revenue.

Levitt's concern was based on numerous well-publicized frauds, including Mercury Finance, Leslie Fay, California Micro Devices, Kidder Peabody, Nine West, Livent, Cendant, and other companies. About half of the frauds related to the recognition of revenue, and several involved multiple techniques to manage reported earnings. Exhibit 1.3 describes what some of

EXHIBIT 1.3 Selected Recent Accounting Frauds

<i>Company</i>	<i>Incident</i>	<i>Period</i>
Leslie Fay	Misstated inventory and sales	early 1990s
California Micro Devices	Inflated and nonexistent sales resulting in charges of stock fraud	early 1990s
Waste Management	Overstated earnings	1992 to 1996 (settled in 2001)
W. R. Grace	Misstated earnings using cookie jar reserves	1993
Mercury Finance	Overstated earnings	1993–1996 (brought in 1997)
Kidder Peabody	Systematic intention to commit broker fraud	1994
Nine West	Revenue recognition	1995 (at time of acquisition of U.S. Shoe)
Underwriters Financial Group (UFG)	Overstated revenues and understated expenses	1995
Bankers Trust	Misappropriated security holders fund required to be escheated	mid-1990s
Livent	Shifting costs between theatrical productions	1998
Cendant	Accounting violations by predecessor CUC Intl.	1998
Rite Aid	Overstated earnings	1998–1999
Enron	Various accounting manipulations; see Introduction	Late 1990s–2001

these companies did. Pitt's approach would attack the long-standing dependency on quarterly earnings per share.

Enforcement agency concern with the manipulation of accounting results is primarily for investor protection. However, managers cannot operate their businesses if basic financial documents are partially fictional, particularly as some or all of the elements of a company's financial statements may be involved. If you can't depend on data on sales, or costs of sales, or net income, or your balance sheet accounts, how can you manage your business?

THE CASH FLOW STATEMENT

The financial statement that provides the most lucid presentation of a company's health does not report EPS, net worth, or ROE. Instead, it uses income and adjustments to income from the balance sheet in the presentation of the cash flow statement. This document is "cleaner" than the income statement because it allows insight into the quality of a company's earnings. While managers and investors are fairly knowledgeable about the income statement and balance sheet, often they are uninformed about the cash flow statement, the one report that is largely resistant to hype or creative accounting.

Components of Cash Flow

There are three major sections in a cash flow statement, although foreign exchange earnings effects also must be reported.

1. *Operating cash flows* show the ledger cash position; non-cash activities that impact income, such as depreciation; and changes in asset and liability accounts that affect cash, such as increases in receivables.
2. *Investing cash flows* indicate such capital activities as the acquisition or sale of equipment, or the company's realized gains or losses in its bond or stock holdings.
3. *Financing cash flows* reflect borrowing or repayment of debt, and stock sales or repurchases.

EXHIBIT 1.4 Significant Cash Flow Statement Adjustments^a

Account	Possible Indication
Operating Activities	
Provision for uncollectibles	Problems with bad debts may indicate sales to poor credits
Accounts receivables	Slowing cash collections
Inventories	Falling cash balances
Accounts payable	Management is delaying payments to vendors
Cash from operations	Cash close to net income indicates quality earnings
Investing/Financing Activities	
Asset sales	Company needs to raise cash
Issuance of debt/common stock	Company needs to raise cash
Equipment or other capital investments	Decline could mean the company is preserving cash to manage earnings

^aAssumes an increase in each account vs. sales.

Companies with prosperous operations will have positive operating cash and negative investing and financing cash. The latter reflects the paydown of borrowings from current operations and the internal financing of capital projects. Companies practicing creative accounting will have a difficult time with the cash flow statement, because cash inevitably reflects negative conditions in income and balance sheet accounts. For example, receivables that rise faster than sales, reflecting slowing business activity and delayed collections on booked sales, will result in a lower operating cash position. The information content of other significant adjustments to net income is described in Exhibit 1.4.

Two Restaurant Examples

We referred to the restaurant business earlier in the chapter, discussing the problems of the fictional What A Hamburger! Actual

companies in the restaurant business provide a real-world look at applications of cash flow statement analysis. Of course, there is the ubiquitous McDonald's Corporation, with nearly 30,000 locations in 120 countries. McDonald's is too large and geographically dispersed to develop meaningful cash flow information for business segment use. Besides, McDonald's can afford a state-of-the-art ERP system!

For illustration purposes, we'll look briefly at two smaller, homogenous operations: Bob Evans Farms and CKE Restaurants. Significant cash flow statement entries for recent fiscal years are shown in Exhibit 1.5.

Bob Evans Farms operates about 450 restaurants in 20 states, serving homestyle meals with country hospitality. Bob Evans showed no particularly notable developments during the two years reported, although there was a significant increase in debt while stock was being retired. As the result, the debt-to-capital

EXHIBIT 1.5 Cash Flow Statements for Bob Evans Farms and CKE Restaurants

	Bob Evans Farms		CKE Restaurants	
	Year Ending April		Year Ending January	
<i>Millions of dollars</i>	2000	1999	2001	2000
Net income	\$52.9	\$57.6	(\$194.1)	(\$29.1)
Depreciation	\$36.5	\$35.4	\$107.0	\$104.4
Changes in working capital	\$3.6	\$10.9	(\$71.4)	(\$25.9)
Other adjustments	\$1.0	\$2.0	\$186.8	\$65.2
Total cash from operating activities	\$93.9	\$105.8	\$28.3	\$114.6
Capital expenditures	(\$96.9)	(\$68.5)	(\$74.7)	(\$263.6)
Other adjustments	\$5.5	\$33.8	\$147.0	\$52.4
Total cash from investing activities	(\$91.3)	(\$34.7)	\$75.0	(\$216.2)
Dividends paid	(\$14.0)	(\$14.1)	(\$2.1)	(\$4.2)
Retirement of stock	(\$81.2)	(\$32.1)	\$0.0	(\$9.0)
Issuance of debt	\$73.9	(\$14.8)	(\$116.5)	\$105.4
Total cash from financing activities	(\$21.3)	(\$61.0)	(\$123.0)	\$91.8
Net change in cash	(\$18.7)	\$10.1	(\$19.6)	(\$9.8)

ratio rose from 4.4 to 16.0 percent,⁶ certainly within the average for the industry of 24.4 percent.⁷

We see that depreciation is well more than half of income, indicating that a significant portion of operating cash flow is from prior-year capital investments in structures and equipment. Bob Evans' ROE performance is driven by slow sales results and some unexpected increases in food costs and promotional expenses. The company continues to spend heavily on new locations and manages its financial and business affairs quite conservatively.

CKE Restaurants does business as Carl's Jr. and Hardee's in 3,500 locations, mostly in the United States. CKE Restaurants had a terrible fiscal year 2001, showing operating losses of nearly \$200 million. Working capital deteriorated by about \$45 million, which primarily reflected an increase in receivables.

However, cash from operating activities was positive, capital expenditures were reduced by \$190 million, and the company is selling off stores to reduce debt and is taking other expense management and marketing actions to improve results. While accounting earnings were a disaster, the actions taken by management appear to reflect their recognition of the problems and possible solutions.

Single-product and many medium-size companies like Bob Evans and CKE can effectively use cash flow statement analysis to monitor financial statement activities and then direct appropriate responses to manage changing business conditions. Because the two companies are homogenous operations, their managements can quickly determine if problems are developing in certain asset, liability, or income statement categories and take remedial action as necessary. (See lesson 2.)

Larger, complex companies like McDonald's will have a more difficult time using cash flow analysis, as operations and financial activities are aggregated for the entire company. However, some large companies are developing reporting systems with financial ledgers organized by product or market sector, and can assign cash and other balance sheet accounts to specific SBUs for cash flow statement purposes.

CONCLUSIONS

Profits sound great in theory but are fairly meaningless when you are attempting to manage a business. Unless you have a very reliable financial reporting system, strategic decisions should not be based on SBU or operating division ledger profits. The continuing focus of the investment and banking communities on the most recent EPS is an unfortunate fact of life, and one that the regulators will be monitoring aggressively. In contrast, management's concern should be on long-term profitability using cash flow statement analysis as a guide.

NOTES

1. All data are from "Corporate Scoreboard," *Business Week*, February 26, 2001, pp. 55–79.
2. Benjamin Graham and David Dodd, *Security Analysis*, 5th ed. Sidney Cottle et al., eds. (New York: McGraw-Hill, 1988), chapters 10–20.
3. Reported in Elizabeth Macdonald, "Catch Me If You Can," *Forbes*, August 6, 2001, p. 58.
4. This section was suggested by David Henry, "Putting on a Grim New Face," *Business Week*, October 15, 2001, pp. 46–47.
5. See Peter Drucker, *The Practice of Management* (New York: Harper & Row, 1954), beginning at p. 54. This book is a classic discussion on how management *should* function.
6. Calculated as \$25.8 million (debt) divided by \$590.5 million (capital) for 1999, and \$92.7 million (debt) divided by \$624.4 million (capital) for 2000.
7. Calculated from 1999 data provided in the S&P Industry Survey for restaurants and dollar-weighted by operating revenues. Excludes companies with less than \$250 million in annual sales and Tricon due to its debt-to-capital ratio of 130 percent.