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Introduction

This book explains (as no other) finance and accounting from a strategic perspective and not from the sources of transaction data – the important but often downplayed bookkeeping; not from trying to understand the disparate aspects of the accounting and reporting process in some ad hoc manner but from the stance of the prime use of accounting, which is to plan, implement and track strategies through modelling and financial reporting both internal and external. This book thus gives a coherent and focused understanding of finance and financial statements anchored on the premise that finance, accounting and accountants are there to serve businesses – to be the core tool for identifying, modelling and delivering strategy and therefore business success and sustainability.

There are many purposes of financial reporting. Historically, the purpose of bookkeeping and preparing balance sheets was to control, the need for control being a key driver to create and set out the rules for single- and then double-entry bookkeeping, a system designed among other things to prevent the excesses of rogue traders (does anything ever change?) but also to assist owners in knowing where their expanding businesses were heading.

As industry blossomed in the 19th century and management and ownership of capital (invested money) grew apart, stewardship of assets under management became a prime reason for reliable (audited) accounts, and this remains true today. The latest thinking on the purpose of finance and accounting, particularly financial reporting, is to be found in a term coined by the IASB (International Accounting Standards Board) Framework – 'decision useful', a clear but inelegant term. The economist mindset which pervades accounting standard setters and accounting academics pushes the idea of what 'decision useful' might mean beyond sensible limits, and could even be blamed for causing moral hazard, for example when valuing assets and liabilities. Examples are to be found where 'fair values' have to be adopted:

> Should not a liability have a single fair value, being the amount you have to repay in full to settle the debt? Possibly, but a fair value may be a lower amount of liability where the 'market' indicates so.

or

> Should the fair value measurement of a non-financial asset take into account a market participant's ability to generate economic benefits by using the asset in its highest and best use?

These examples indicate that accounting today is more sophisticated (in a complex and complicated manner) than many would suppose. Strategies may be hidden or prevented by accounting practice.

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But you may well be wondering what the history of bookkeeping and accounting theory has to do with strategy. It is the author's view, supported by years of observing the best (and worst) companies both large and small, that successful companies have a very clear understanding of the prime reason for the finance function and its outputs, namely to quantify, implement and track delivery of strategies with the clear aim of achieving the company's objectives.

Accounting and financial statements may be the domain of the accountant but they do not belong to the accountant. The purpose of accountants and much of the responsibility of the finance director or chief financial officer is to be the servant of the business – to keep the records, ensure the safe custody of assets and limitation of liabilities, and then to report your activity and business to you – the managing director, chief executive officer, production, sales or other board member or senior manager; responsibility for understanding the figures and tracking your strategy then passes to you!

This book therefore aims to explain what you can expect to get out of the reports, the figures, the models for *your* business. Accountants produce reports and form the business models, but these are not *their* figures but yours – you *must* understand them.

This book leads you to the quantification of your strategy or supports your questioning of others' strategies. If you are going to win the battle, any strategy ought to be quantifiable. The book explains how your strategy can be revealed and then measured with numbers – currency values – in monetary terms.

Many companies' strategies are explained as actions that will achieve the desired goals or often vaguer 'visions' – but business strategies will be manifest in financial statements – greater or less income, higher or lower costs, thus higher or lower profits – with resultant increases/decreases in net assets and cash flows. Numbers will reveal the success or failure of strategy. More importantly, financial models can clearly demonstrate where a particular strategy might lead.

All the chapters of this book are focused on finance as record keeper and predictor of business strategies – clear figures allow no hiding place.

The majority of books on finance for non-accountants focus of clarifying jargon, myth busting, explaining terminology, explaining why accountants have their rituals; they do not explain that finance is the revealer (or illuminator?) of strategy.

Strategically, why is anyone in business? Successful and long-lived (sustained) companies understand the reasons. When directors (maybe under the influence of their short-termist shareholders) lose sight of why they are in business, ego, indolence or incompetence leads to value if not company destruction.

Companies will cease to exist without sales or revenue streams, but also costs – both operating and capital – have to be managed. Finance is at the heart of any business – businesses would not exist without the pumping of cash through the business and the consequent recording of the flows.

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Order of the chapters

The order is to address firstly what the words 'strategy' and 'financial strategy' mean, why we need clear objectives and what these might be. This also starts to put in place the relevance of the balance sheet and income statement with respect to managing business strategies. Chapters 1 and 2 deal with these issues.

A thorough understanding of the three principal financial statements, the balance sheet, statement of financial position and income statement, how they are compiled and what rules pertain is vital if financial strategy is to be reported and the effects of strategic decisions understood – Chapters 3 and 6.

As well as understanding the purpose, the meaning and how to interpret the principal financial statements, it is essential to know what the law requires, 'law' being company law, governance rules and GAAP (Generally Accepted Accounting Principles) – these topics are covered in Chapters 4 and 5. For many executives the ability to interpret figures is their prime aim and Chapter 7 focuses on how strategies may be revealed by interpretation of financial statements.

For some executives, cash generation and use are the only financial strategies they understand or need, but whatever your strategies, cash flows will be involved – Chapter 8.

Management accounting, internal reports and business models outline the modelling and internal reporting that can be done to understand the effect that strategies might have and monitor the chosen strategies – Chapter 9.

Budgeting of operations, that is, budgeting revenues and costs, is a universally adopted process by which both revenue and costs are planned and controlled. Revenue maximization and cost reduction will inevitably be continuing strategies in any sustainable business – Chapter 10.

Investing money is a strategy by itself, the aim being to make a return on investment; thus, understanding the techniques of capital budgeting or investment appraisal is essential for any executive – Chapter 11.

The structure of the balance sheet, how much borrowing or leverage you have, will affect returns to investors but also increase or decrease risk. This is pure financial strategic decision-making and for some, the only strategy they are interested in – Chapter 12.

Chapter 13 aims to summarize the many strategies and techniques for identifying, planning, tracking and hopefully delivering your chosen strategies. It aims to answer the question: 'What are the paths to sustainable success?'

Terminology used in this book

A principal barrier to understanding finance, never mind strategy, is the terminology used by finance folk. Not only does terminology change between countries but it also develops over time. New and updated standards with new terminology are being continually developed and issued, converging between countries and jurisdictions wherever possible.

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Owing to US pre-eminence in commerce and financial markets, there is a natural tendency to adopt US terminology: obvious examples are United Kingdom – stocks, United States – inventories; and United Kingdom – gearing, United States – leverage.

This book defines and explains the current (and other contemporary) terminology commonly used in the United States and United Kingdom with reminders of alternative terms where deemed appropriate. The inescapable point is that wherever you are based and whatever statements you are perusing, you will be faced with different terms; one essential skill to learn is to be bi- if not multi-lingual with respect to accountants' speak.

In a similar vein, there are several conventions as regards sign, that is, expressing numbers as positive or negative. The fundamental bookkeeping convention is that there are the two signs, debit and credit (+ or –), but as explained in Chapter 4 these take on a different guise when they are used in the balance sheet compared to when they are used in the income statement. In the balance sheet (statement of financial position) a debit or debtor is an asset – in everyday language, a good thing to have – and generally will be unsigned or without brackets ( ). Whereas a liability, a credit, or better, a creditor, is not a nice thing to have: people do not like having debts – see how confusing accountants can be! Liabilities in the balance sheet are often shown bracketed or possibly with a minus sign.

The thinking behind debits and credits switches through 180 degrees when used in the income statement or profit and loss (P&L) account; that is, amounts arising from income or sales are 'good' and recorded as credits and normally unsigned and un-bracketed. Whereas expenses, while inevitably necessary, are 'bad' and may be signed minus, although in fact the most common convention is to leave them unsigned as with income, leaving you the reader to understand that costs are the opposite of sales – not too deep!

I hope you are now clear? The practical problem is that different conventions are used and you will have to comprehend them when looking at any financial statements or management reports. Throughout this book I use a range of common terminology and sign conventions that you may meet, with the intended purpose that you will not be at all fazed by whatever is put in front of you. We accountants can be somewhat maverick; an example I once faced when given a report by a management accountant was:

Less: *(–3,000)*

the –3,000 being in red! What could this mean? Well, in my view it is a quadruple negative, but when asked why he had been so thorough with sign convention the accountant replied, 'I am trying to be helpful.' Amen to that.

There is a glossary of terms where synonyms are given along with an indication of the currently 'popular' favourite word.

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Structure of the chapters

Introduction to the accounting statement/topics

Links between the statement/topics and financial strategy

'Within this chapter we will cover the following topics:'

Order and logic – to aid putting the subject into context and how it relates to financial strategy

The body of the text

Conclusion – the important lessons and strategic links in the chapter

Revision and learning pointers

How you might use this book

The aim of the book is to enable executives to understand all aspects of finance, particularly how finance reveals all types of business strategies and how they may be implemented, tracked and modelled, and therefore the book can be read from beginning to end. However, you may have an urgent need to understand some aspect of accounting, reporting or finance and therefore you can turn to the chapter or chapters that address your needs.

Most chapters have revision and learning pointers which are aimed at reinforcing your understanding. There are also web links to assist you further.

The analytical and computational spreadsheets are available for download from **www.koganpage.com/editions/executive-finance-and-strategy/9780749471507**

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What is strategy? What does financial strategy mean?

01

This chapter addresses the task of defining financial strategy, in the process clarifying usage of the many terms associated with 'strategy' and 'strategic'. Strategy and strategic are much-overused words, as is evidenced by 'winning strategy', 'strategic thinker', 'strategic appointment', 'strategic direction', 'strategic supplier' and so on.

When we hear the word 'strategy' we run into a range of meanings, quite incorrect usage, vagueness and misunderstanding. At the outset we need to be clear as to what the words 'financial' and 'strategy' really mean; what is meant by the individual words and therefore the term 'financial strategy'. This in turn leads us to pose the question: 'Why be in business?'

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Content, order and logic of this chapter

Within this chapter we will cover the following topics:

- Definitions of 'financial', 'strategy' and 'strategic'
- Further strategy-related definitions
- What is business strategy?
- What is *the* objective of financial strategy?
- Why be in business?

Order and logic

Words are used loosely and at times given perverted meanings and thus we should be careful to define what we mean by 'financial' and 'strategy' and how these words relate to business strategies and other common business

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Normally used in the phrase 'mission statement'. Mission statements vary from the succinct and clear to the obscure. Mission statements and their place in supporting financial strategy are often seen as being the guide for the company in the years ahead.

With respect to financial strategy one thing is clear: a mission needs a strategy and supporting tactics, but above all it does need a purpose, an objective (or a goal!).

Mission statements

- how an organization provides value to stakeholders, for example by delivering returns to investors or types of products or services to attract customers;
- a declaration of an organization's core purpose; a mission statement should answer the question, 'Why do we exist?'

Mission statements are often vague and fail to reveal the truth as to why the entity exists. Here is one description of what a mission statement might contain:

A mission statement should:

1. define what the company is about;
2. be broad enough to allow for creative growth;
3. distinguish the company from all others;
4. serve as framework to evaluate current activities.

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Defining what the company is about is admirable – *if* it really does; why does the company exist? The others could be helpful but will often be answered in a vague manner.

Here is another example of a mission statement which illustrates that often mission statements are focused only on one aspect of business, in this case sales:

A mission statement consists of three essential components:

Target or key market – who is your target client or customer?

Offerings – what products or services do you provide to that client?

Distinction – what makes your product or service unique so that a customer will chose your company?

Financial strategies can be clearly set out in a carefully crafted mission statement. Mission statements can be helpful when focusing on strategies, but again as long as they are not vague. A specific financial strategy could be sold to management and employees as a mission.

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Motive

- a reason for doing something.

This is not a commonly used term but one I like to use, particularly when asked to assist with improving budgets. Too often we are told that there are clear budget objectives when in fact the reason for budgeting is not simply to achieve an objective but to achieve some (hidden) objective. More generally, a good question to ask the instigator of a financial strategy is 'What are your motives?' along with 'Are they really aligned with the stated objectives?'

Tactic

- an action or strategy carefully planned to achieve a specific end: a device for accomplishing an end;
- commonly tactics is the deployment of forces or actions in some specific instance of applying strategy.

Common thinking is that a tactic is an action taken to further a strategy. The first definition above indicates that even wordsmiths seem to confuse tactic with strategy. In this book, tactic will be taken as an action or device for accomplishing a strategy; the term sub-strategy is also used, meaning a strategy (aligned) with and contributing to the principal strategy.

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Target

- a goal to be achieved;
- to aim at or for.

A synonym for goal but useful when implementing strategies, eg sales, where sales people may be excited by the idea of sport – taking aim, winning.

Values

- principles that guide an organization's external and internal conduct.

Core values are often summarized in the mission statement or in a separate statement of core values.

Vision

- something seen in a dream, trance, or ecstasy; especially: a supernatural appearance that conveys a revelation;
- the ability to think about or plan the future with imagination or wisdom.

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It is of course the second definition that successful CEOs believe they have the power to comprehend and reveal to lesser mortals; however, 'vision' is often used in far too vague a manner.

To be useful, an overall vision of where an entity should be in, say, 10 years should have clear objectives to which strategies can be linked.

The issue as regards financial strategy is: 'Does the overall financial strategy or individual strategies and tactics conflict with stated company values?'

What is business strategy?

Business strategy is a relatively modern notion. We cannot go back to Victorian times or to the beginning of the 20th century, but it is clear that the early entrepreneurs did not have the benefit of an MBA or a Master's in strategic thinking and did not mull over terms such as 'competitive advantage'; however, they did identify opportunities – a gap in a market; they identified new or improved products; they were innovative. Without sales or revenues a business will eventually cease to exist.

Thus, is *the* business strategy to sell and, if so, should financial strategies focus principally on sales? Why did the business giants of a century ago invest their time and money? Was it because there was a market for their goods and services? Most assuredly so. Was it because they had a strategy? Because a business model told them to go for it? No doubt they had a strategy and tactics to deliver it, and also a model in their heads if not on paper. But above all their driver was to make money, to make a return on their investment.

Business strategy is nothing without finance: finance binds the business and a business is bound by finance.

So what does strategy mean when used in a financial context? Are strategies revealed by financial reports and models that lead to improved results that will make more money and profit? Yes. Are there reports that reveal efficient use of capital, plant and equipment – strategic utilization? Yes. Are there reports that can reveal appropriate levels of working capital, inventories and receivables etc? Yes. Are there reports that reveal appropriate levels of borrowing, gearing or leverage, strategically structured balance sheets? Yes.

Financial strategies are to be found pervading every part of a business. Or is it rather that, as indicated above, finance merely reveals or can model the effect of physical strategies? It would seem obvious to most that using a machine continually to produce products that generate revenues, cash and profits is a good strategy – financial reports only reveal and quantify the effect of applying this physical strategy. It would seem obvious to most that holding only the inventories that will be sold soon is a good strategy – financial reports and models only reveal and quantify the effect of applying this physical strategy.

The examples above of reporting the physical or practical strategies are all related to the operational activities of running the business. You could

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argue that there are no financial strategies but rather indicators, revealers or illuminators of strategy.

The above examples of physical, operational strategies will all deliver enhanced results to shareholders. However, a 'true' financial strategy that will deliver enhanced results to shareholders could be purely structural, an example being a private equity strategy. Private equity investors will have every intention of, and should be highly committed to, improving performance, what might be termed operational financial strategies as above. However, the private equity financial strategy that really delivers to investors is the structural financial strategy – the gearing up of the balance sheet, aided and abetted by the currently favourable tax treatment.

Returning to the above definitions of 'finance' and 'strategy', financial strategy means to plan or scheme to achieve an objective – a financial objective. But what is this financial objective or goal? What is any financial strategy meant to achieve?

There are many related terms used when discussing strategy and some are reviewed and put into context below. All of them have links with financial strategy but the one that is core or essential when considering any financial strategy is: 'What is the objective?'

Objective, aim, goal or even vision (as long as it is not vague and potentially mirage-like) – exactly what is a strategy meant to achieve?

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What is *the* objective of financial strategy?

This book resolutely focuses on ROI (return on investment, also termed ROCE – return on capital employed) as being *the* prime goal of a business, all other objectives and goals being secondary or supportive. This turns thinking on its head: the company is now driven by finance – making a return through pointing out physical actions/strategies that will deliver the components of the ultimate financial strategy, that strategy being to make the best return for shareholders or investors.

Chapter 2 demonstrates this 'truth' with simple numerical examples. Readers will no doubt dissent, but if this chapter results in thought and discussion as to what your company's objectives and supporting strategies really are, that is good. In today's world, one unfortunate side effect of well-intentioned political correctness is that businesses may be forced to be deceitful, not to be honest as to their true motives and intentions. These debatable comments are further explored in later chapters.

There are many feasible financial strategies but for clarity and to aid understanding, financial strategies may be classified as two distinct types:

1 *Operational financial strategy*, meaning plans (physical strategies) as identified, reported and implemented using financial models, measures and responses. The strategies that plan, report and deliver results: profits, cost reductions, efficiencies and so on.

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Without an operational financial strategy there is no continuing business. Operating strategies may have to be very nimble, responsive to the sudden changes faced by many industries today, for example in the service sector.

Operating strategies may be very consistent and boring – but they still need to exist and to be constantly monitored and improved if possible.

2 *Structural financial strategy*, meaning plans to finance the business in an efficient and effective manner. Examples are gearing up a balance sheet, leasing as opposed to purchasing equipment, and factoring debts. Unless you are large and powerful or have generous and willing friends and supporters (as you must have to be able to work a private equity strategy), financial strategy is very much constrained by external parties, in particular funders – the banks.

The two distinct types of financial strategy give rise to many different approaches with aims that should be complementary or aligned (to use another overused word). The overall operational or structural strategy will have sub-strategies or tactics to aid its delivery.

The chapters that follow refer to how the topic relates to operational or financial strategy, or both. This will help you to understand the importance of the accounting statement or practice being studied. Their place in applying tactics and delivering strategy should be clear. The problems and limitations of reports and practices will also become evident – you must know what prevents a tactic working and a strategy being delivered.

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Why be in business?

This is *the* fundamental question that all stakeholders (that passé term) should ask and is explored in Chapter 2. Stakeholders can be: investors, individuals, pension funds etc; employees; suppliers and customers; governments keen on economic activity; and so on.

This question is not asking 'Why does a business exist?' – that is to be found in history – but rather where is your business heading: what are the objectives for the future? In this book the question is being asked from the perspective of the investor – the committed long-term investor.

We now have 'corporate philosophers' questioning 'why be in business' and the like, but being 'philosophers' they have to be clever and dismiss the notion of making money (or rather 'returns' if they can comprehend the difference) as too simplistic. We are all philosophers and will have done our own critical thinking and hold deep views on many matters, but this book is about finance and strategy; yes, there is more to life than numbers and money, but numbers give a perfectly defined focus for our actions.

We would soon be bogged down in politics with both a large and small 'p' if we looked at finance and accounting from all the other stakeholders'

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Financial strategy Why be in business?

02

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What is financial strategy? The question 'Why be in business?' has to be answered in order to reveal just what successful financial strategies are and what they deliver.

I have asked the question 'Why be in business?' over many years. The number one reply from hundreds of directors and managers is 'to make money', to which I reply, 'That is a vital "sub-objective"' – not as a put-down but rather pointing to the fact that making money without reference to what, if any, money has to be invested is at best misguided.

What does making money with respect to investment mean? A simple example is that £100 deposited in a bank will ensure a 'safe' return of, say, 3 per cent. That is your rate of return on investment (ROI), or your return on capital employed (ROCE) – the percentage return on capital – in this case employed by the bank. The bank will lend at 4 per cent or more, and thus make a return on your money – capitalism in action.

Content, order and logic of this chapter

Within this chapter we will cover the following topics:

- What do successful companies say?
- How does making a return on investment link with strategy?
- Making a good return is the objective, but what exactly is ROI?
- How does making a return on investment link with strategy?
- Strategic drivers of ROI.

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Order and logic

As indicated in Chapter 1, companies and their executives may be confused about the meaning of the words they use. Nearly all will have strategies, but, if they exist, the objectives that the strategies are meant to arrive at are not always clearly stated. We start out by identifying what unquestionably successful companies understand by the question 'Why be in business?' Return is the key and therefore the meaning of this term and its drivers have to be understood.

What do successful companies say?

What is your strategy? Too often strategies emanate or are derived from 'visions'.

Who first uttered 'We have a corporate vision' – a well-meaning CEO? My jocular advice is that if your CEO has a vision, maybe it is time to call the doctor!

Your vision or mission may be clear in your mind, but how can it be manifest? Phrases and words are often misinterpreted or capable of having a myriad of meanings, but numbers cannot be denied. Finance and accounting reports and models can quantify visions and mission objectives in undeniable amounts. Questions to be answered include:

- What is adding shareholder value?
- Where does your financial strategy lead?
- What is the outcome of your strategy to be?

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> In a wide-ranging interview about the future of capitalism, Jack Welch, former CEO of GEC, was asked what he thought of 'shareholder value as a strategy'. His response was that the question on its face was a dumb idea.

Shareholder value is an outcome – not a strategy. Quite right, as the first definition of strategy says that 'strategy is a plan of action or policy designed to achieve a major or overall aim' – that aim being to add shareholder value.

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Investopedia – definition of 'shareholder value'

The value delivered to shareholders because of management's ability to grow earnings, dividends and share price. In other words, shareholder value is the sum of all strategic decisions that affect the firm's ability to efficiently increase the amount of free cash flow over time.

Investopedia, 2014

That is a definition with many facets. I would define adding shareholder value as delivering returns on investment by dividend payments and/or increasing over time the real worth of the business backed by real value arising from the identifiable and physical net assets of the business.

Both definitions may be clearer when we consider the need to make a return on investment and look at some simple models below.

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How does making a return on investment link with strategy?

Let us be clear as to what strategy means. Two definitions of strategy were given in Chapter 1: (1) a plan of action or policy designed to achieve a major or overall aim; (2) the art or skill of using stratagems in endeavours such as politics and business. The first is clear and thus we need to understand how finance can reveal and allow modelling of policy to achieve an overall aim. The second definition is also clear but does require an understanding of what 'stratagem' means, and here we have some fun:

- a cleverly contrived trick or scheme for gaining an end;
- skill in ruses or trickery;
- an adaptation or complex of adaptations that serves or appears to serve an important function in achieving success.

Thus, if you believe (2) to be the better definition of strategy you are siding with quite a few in business who, through dubious marketing strategies, off-balance sheet financing strategies and so on, intentionally wish to mislead. This book does not condone such strategies – but they do exist and we need to be aware of them, as they may affect your strategy.

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What successful companies say

Successful companies understand the need to generate returns and the drivers of returns. Here are some extracts from company annual reports with the key drivers highlighted:

ExxonMobil: consistently generates *strong income* from a highly efficient capital base, as demonstrated by our *return on average capital employed* performance versus our competition. We are proud to be a leader in providing reliable, affordable energy in a safe and environmentally responsible manner, enabling us to continue to deliver long-term value to our shareholders.

British Petroleum: You will be able to measure the effects of active portfolio management, as we invest more in our areas of strength and *generate cash* through further divestments.

You will be able to measure the contribution of new upstream projects with *higher margins*, as they come on stream over the next three years.

British Telecom plc: We aim… to *drive shareholder value* by… providing excellent customer service, building future networks and becoming more agile.

DeutscheTelekom: With all our successes, we have not lost sight of one objective: to pay you, our shareholders, an attractive *return on your capital* in the form of an appropriate dividend.

Verizon: A longer-term view of our performance over the period from 2006 to 2008 shows Verizon's *total return* growing by 35 per cent, as compared with a decline of 23 per cent for the Standard & Poor's 500.

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Most references are to 'return'. GE of the United States sets out its prime current strategy – growth is seen as paramount. We shall consider later the many sectors and companies that live in an environment of low or no growth, but where making a return still applies.

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CASE EXAMPLE GE Works – 2012 Annual Report

Strategy is about making choices, building competitive advantage and planning for the future. Strategy is not set through one act or one deal. Rather, we build it sequentially through making decisions and enhancing capability. As we look forward, it is important that investors see the Company through a set of choices we make for the purpose of *creating value* over time.

First, we have remade GE as an 'Infrastructure Leader' with a smaller financial services division. We like infrastructure markets because they are *growing* and because they utilize GE capabilities in....

Second, we are committed to allocating capital in a balanced and disciplined way, but with a clear priority *for dividend growth*.

Third, we have significantly increased investment in organic growth, focusing on R&D and global expansion. In doing so, we have invested ahead of our competition. We believe that investing in technology and globalization is key to *gaining market share*.

Fourth, we have built deep customer relationships based on an outcomes oriented model. *Our growth* is aligned with customer outcomes, and our products improve their productivity.

Fifth and finally, we have positioned GE to lead in the big productivity drivers of this era. This is important for *growing our margins*.

GE Works, 2012

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Now that you have read the above extract, can you see any themes?

There are not simply themes but a very clear message that good returns have to be made, with the resultant ability to pay dividends and grow shareholder value. Growth and sales growth are vital. However, it must be said that if you are in a growing sector, growth of returns will, or ought to, follow. However, not all of us are fortunate to be in a growth sector – many businesses are pedestrian but essential to economies.

The drivers of return are pointed out – good margins, lower costs, higher sales and wise investment. Efficient operation and improvements using the latest technology are a must.

Are these successful companies not saying what you intuitively know?

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TABLE 2.2 ROI textbook figures

$\text{ROI} = \frac{10}{50} = 20\%$	
$\% \text{ Profit} = \frac{10}{100} = 10.00\%$	$\frac{100}{50} = \frac{2}{1} =$ Asset turnover or Asset utilization ratio

The 10 per cent profit margin is an average figure. Many businesses would be delighted with such a high margin, eg construction companies, whereas other businesses would find this unacceptably low.

The 2:1 asset turnover (sales to capital employed) again may seem very low – a whole year's sales (from the P&L account) in relation to what is needed as investment to deliver the sales. While this is a typical figure for many businesses, it is sector specific and can be quite different depending on 'strategy'. For example:

- If you are a 'utility' – telecoms, electricity generation – this figure may well be below 1:1 as a huge amount of capital employed is required to generate sales.
- If you outsource production, this will be a much higher ratio.

But let us accept the textbook figures for now. At this stage it is the messages on revealing strategies that matter.

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An arithmetical proof of a high-return strategy

Before considering the drivers for making good returns further, let's look at the arithmetical outcome of delivering consistent returns. The delivery of consistent and high returns leads to the delivery of real shareholder value increases, as this model demonstrates.

The model shown in Table 2.3 assumes at the start: 100 is invested; a return of 20 per cent is made; 33 per cent of the annual profit is paid out as dividend (a return of 7 per cent to the investors); 67 per cent of the annual profit is reinvested in capital employed (acquisitions, new machines etc); and (unrealistically!) there is no taxation.

The assumption is that such investments will also generate 20 per cent returns. The model proceeds and the capital employed increases in a geometric progression until by year 7 the business has double the capital employed in the business (shareholder value) and investors receive a 14 per cent dividend on their original capital of 100.

So why does every CEO not deliver real growth in shareholder value? It is just a matter of arithmetic!

Well, the market, competitors or the economy may not allow a 20 per cent return, there may not be unlimited growth in sales, and capital invested may be invested unwisely.

It is the latter 'sin' that has undoubtedly most often been committed by CEOs over the years: 'We must grow – invest – capture market share etc.' We shall

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ii. Higher sales/volume strategy

This strategy, with margin reduced to 10 per cent (Table 2.5), is a classic mistake made by sales people who go for sales volume at the expense of lower margins.

TABLE 2.5 ROI effect of higher sales

ROI = $\frac{13}{50}$ = 26%	
% Profit = $\frac{13}{130}$ = 10.00%	$\frac{130}{50} = \frac{2.6}{1}$ = Asset turnover or Asset utilization ratio

The return is maintained by better utilization of the capital employed – the low-cost airlines are premised on this strategy.

iii. Lower margin/higher sales volume strategy

The return can be the same as in the base model (Table 2.6).

TABLE 2.6 ROI effect of lower margins but higher sales

ROI = $\frac{10}{50}$ = 20%	
% Profit = $\frac{10}{160}$ = 6.25%	$\frac{160}{50} = \frac{3.2}{1}$ = Asset turnover or asset utilization ratio

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You can lose or give up margin as long as volume follows. Compare a low-cost supermarket with the traditional UK supermarkets: they live with lower margins and also benefit from the low-cost outlets having much more efficient (lower) capital employed, that is, simpler but yet effective stores.

iv. Lower capital employed strategy – 'cheap is good!'

Properly managed, with aligned physical strategies you can end up with higher returns than the base model (Table 2.7).

TABLE 2.7 ROI effect of lower capital employed and invested

ROI = $\frac{10}{45}$ = 22%	
% Profit = $\frac{10}{100}$ = 10.00%	$\frac{100}{45} = \frac{2.222}{1}$ = Asset turnover or Asset utilization ratio

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v. *Life-cycle costing/whole-life costing strategy*

It may sometimes be sensible to spend more on capital employed – eg low-maintenance/low-energy-consumption equipment if the cost reductions and thus higher margins over the years outweigh the higher capital employed (Table 2.8). A constraint here is finding the initial cash!

TABLE 2.8 ROI effect of higher capital employed but with lower operating costs

$\text{ROI} = \frac{14}{60} = 23\%$	
$\% \text{ Profit} = \frac{14}{100} = 14.00\%$	$\frac{100}{60} = \frac{1.667}{1} =$ Asset turnover or Asset utilization ratio

If not already evident, this example illustrates the point that the two sub-ratios cross-multiply to give ROI. Thus strategy drivers are also interlinked and may be contradictory in practice.

vi. *High gearing strategy*

A funding strategy or purely financial strategy – the private equity magic!

Here the focus is not on the return the physical capital employed makes – the higher the better – but rather it is the ability to borrow that 'gears up' the return to the shareholders. As long as you can borrow (you need to have friends as the private equity folk seem to have) at a rate lower than that which the capital employed in the business delivers, you are on to a winner.

The example in Table 2.9 has 50 of capital employed, 10 of operating profit and sales of 100. Assume 40 of the 50 capital invested is funded at 8 per cent: interest on this must be paid, so net profit is down to 6.8 per cent and return to 14 per cent. However, shareholders have only to put in 10 – so their return is 68 per cent.

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TABLE 2.9 Effect on shareholders return by gearing

50	CAP EMP	10%	Return from capital employed	10.0
40	LOANS	8%	Interest to be paid	3.2
10	EQUITY			
			Net profit after interest	6.8
$\text{ROI} = \frac{6.8}{50} = 14\%$				
$\% \text{ Profit} = \frac{6.08}{100} = 6.08\%$		$\frac{100}{50} = \frac{2}{1} =$ Asset turnover or asset utilization ratio		
But shareholders' ROI is $\frac{6.8}{1} = $ **68%**				

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The 6.8 per cent profit is that available to shareholders after interest has been paid.

To see just how magical gearing can be, Table 2.10 shows the above example reworked with only 1 out of 50 being equity – great if you have friends that will lend to you!

TABLE 2.10 Effect on shareholders' return of exceedingly high gearing

<table>
<tr><td>50 Cap employed
49 Loans
1 Equity</td><td>10% Return from capital employed 10.00
8% Interest to be paid 3.92

Net profit after interest 6.08</td></tr>
<tr><td colspan="2">$\text{ROI} = \frac{6.08}{50} = 12\%$</td></tr>
<tr><td>$\% \text{ Profit} = \frac{6.08}{100} = 6.08\%$</td><td>$\frac{100}{50} = \frac{2}{1} =$ Asset turnover or Asset utilization ratio</td></tr>
<tr><td colspan="2">But shareholders' ROI is $\frac{6.08}{1} = 608\%$</td></tr>
</table>

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Capital structures and pure financial strategies are considered further in Chapter 12.

It is hoped that these *simple* examples are just that – the messages are clear. It would seem that many managers, and CEOs for that matter, forget or maybe do not know the results of the indisputable arithmetic of these simple models.

We cannot finish the book here – the question 'Why be in business?' has been answered but the detail and complexity (real and imagined) of the balance sheet and P&L numbers have to be understood, as do budgeting and flow forecasting to aid sensible operation and investment.

Conclusion

Understanding finance and the interrelationship of financial statements is essential when identifying strategies and managing delivery of strategy. The drivers for a successful strategy are to be found in the financial drivers:

Operational:

- high margins;
- low costs of operation;
- high sales volume and prices;
- efficient use of assets.

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Investment:
- minimum necessary investment.

Funding/capital structure:
- efficient funding structure.

These financial drivers lead to making the most advantageous and sustainable return on investment.

Strategy in general terms and specifically in financial terms is tempered by political and other constraints – these constraints *must* be understood and accommodated.

In the chapters that follow, many of the financial statements and practices are relevant to more than one strand of strategy and will sometimes give rise to conflicts – such conflicts *must* be understood.

Revision and learning pointers

This chapter does not have any specific interpretation or calculation exercises; however, you may like to replicate the spread sheets shown in the tables above – spread sheets are great instructors.

Have a look at the accounts of your own company, competitors or any company that attracts your interest and see what they say about strategy.

Have a look at a target company's last five or more years' accounts and consider whether the strategies identified in the past have come to fruition, and if not, why not.

Thinking about and discussing the questions below may be an essential early stage when identifying what your company's or organization's strategy is to be, and understanding the constraints of your chosen strategic path.

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Questions

- What other reasons are there for being in business apart from purely making a return?
- What other issues affect strategies apart from finance?
- What constraints are there on going for a purely 'make a high return' strategy?

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Basic financial reports and concepts

03

Understanding financial statements, concepts and conventions is a necessity if we are to know where we are, how we got there, and as a base for projecting where we might be. Financial statements can be used as a base for controlling strategies.

A prime aim of the book and specifically this chapter is to help you understand the principal financial statements – the statement of financial position (the balance sheet) and income statement (P&L account) – as the tools they are. The laudable aim of US and international accounting standards is that the statements are to be useful in making economic decisions. Here is the introduction to the IASB (International Accounting Standards Board) Conceptual Framework:

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> It (the IASB Board) believes that further harmonization can best be pursued by focusing on financial statements that are prepared for the purpose of providing information that is useful in making economic decisions. The Board believes that financial statements prepared for this purpose meet the common needs of most users. This is because nearly all users are making economic decisions, for example:
>
> (a) to decide when to buy, hold or sell an equity investment.
>
> (b) to assess the stewardship or accountability of management.
>
> (c) to assess the ability of the entity to pay and provide other benefits to its employees.
>
> (d) to assess the security for amounts lent to the entity.

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The balance sheet shows both the amounts of, and the disposition of, net assets available to operate the business and how these net assets are funded, by borrowings or equity (shareholders' funds). It is essential to know the assets at your disposal and the liabilities that will have to be met when planning, delivering and monitoring operating strategy, particularly efficiency.

The P&L account/income statement tells you about revenues/sales costs and resultant profit or loss. Chasing sales, reducing costs and targeting a profit number can all be sub-strategies that lead to higher profits and thus returns. Understanding the income statement and the tactics to manage and improve profit is a must.

The P&L account, now formally called the Income Statement, is based on cash flows but with the addition of income and costs being accrued, that is, income earned or costs incurred but not settled in cash being included.

The importance of cash records and reports

The importance of information about an entity's cash flows is made clear in this GAAP extract:

> Information about a reporting entity's cash flows during a period also helps users to assess the entity's ability to generate future net cash inflows. It indicates how the reporting entity obtains and spends cash, including information about its borrowing and repayment of debt, cash dividends or other cash distributions to investors, and other factors that may affect the entity's liquidity or solvency. Information about cash flows helps users understand a reporting entity's operations, evaluate its financing and investing activities, assess its liquidity or solvency and interpret other information about financial performance.

A cash flow analysis should reconcile profit or loss and net cash inflow or outflow of cash for a period.

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Cash flow reports – illustration

The P&L account for a business for the year ended 31 December 20XX shows that the business has made a profit of 3,000. It might be expected that as this is a very simple and straightforward business there will be a cash or bank balance of 3,000. Note that the word *cash* is very often used in businesses small and large when in fact the money will be in one or more bank accounts.

The business has made sales of 30,000 and incurred costs of 25,000 plus a depreciation charge of 2,000. The P&L account for the year is shown in Table 3.1.

Cash movements relate to trading but also include capital transactions, that is, balance-sheet-related transactions. In this case there was a loan of 10,000 taken out, 1,000 repaid and a van purchased – all capital items (Table 3.2).

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TABLE 3.1 P&L account

Profit & Loss account	
Sales	30,000
Expenses	25,000
Depreciation	2,000
Profit	3,000

TABLE 3.2 Cash book – a simple cash flow statement

Cash book	
In	Out
10,000 Capital – loan	22,500 Expenses paid
	9,000 Purchase van
23,000 From sales	1,000 Loan repaid – capital
33,000	32,500
500	**Balance**

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Further, the sales and expenses were not all received or paid as cash immediately, 7,000 of sales being due after the year-end – debtors or receivables and 2,500 expenses were due to be paid in the following period. Also, the van was used for one year and the cost of it wearing out while being 'consumed' is estimated at 2,000; this is not a cash cost, as the cash outflow took place when the van was purchased for 9,000 (depreciation is discussed in more detail in Chapter 5).

It is vital in a business of whatever size to track cash, as a deficit that cannot be funded short or long term inevitably leads to insolvency and bankruptcy. At the highest level, the CFO and executives need to have reliable summary cash reports.

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TABLE 3.3 Reconciliation of profit amount with final cash amount

Reconciliation	
Cash	500
Debtors	7,000
Van net	7,000
Expenses to be paid	–2,500
Loan oustanding	–9,000
Balance profit due to owner	3,000

The net effect of the differences between occurrence of P&L transactions and the receipt or payment of cash plus the other balance sheet movements in cash is that in this simple illustration the business has a closing cash balance of 500 rather than 3,000, which is the profit figure. The principal reason is, of course, the 7,000 outstanding from customers less the 2,500 owing to suppliers, but there are also the other capital movements.

Another important exercise and statement that the CFO, if not executives, ought to review is a reconciliation between profit and cash (Table 3.3).

Cash flow reports do not require additional record keeping; they may be produced by appropriately summarizing and classifying cash book entries or by identifying the movements between the beginning and ending balance sheets (adjusting for non-cash movements).

This simple example does illustrate the important point that cash records (the mirror of the entity's bank statements) do not readily distinguish between 'capital' and 'revenue' transactions:

- capital – relating to the balance sheet;
- revenue – relating to the P&L account.

The word 'capital' crops up in many places in finance, for example share capital, capital expenditure, capitalized expenses, capital employed; the clear inference from all of these is that the item is a balance sheet item and not considered to be directly related with trading. The word 'considered' is used as there will be different views on what is capital or not and 'directly' is used as there are very often links between the balance sheet and trading – the P&L account, again leading to views on what is capital or not. This reveals, as if you were not aware, that accounting is subjective: there are conventions, even sometimes rules, but subjectivity remains, and being aware of the subjective areas is essential if financial strategy is to be properly understood.

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Cash flow forecasts

Larger entities have to produce cash flow statements at year ends or interim period ends but will also focus on the cash position and projections by use of a cash flow forecast.

Internal cash flow statements or reports often take the form of a short-term, eg one year, cash flow forecast, with the starting point being the cash position today. A sensible format is to distinguish between capital inflows and outflows and revenue inflows and outflows, as is the case with published statements of cash flows considered in Chapter 8.

Bedrock concepts

The fundamental or bedrock concepts are the 'accruals' or matching concept and the going concern concept. They are explained and discussed in much more detail in Chapter 5, but they must be introduced now as the accruals concept underlies the distinction between cash reports and the P&L account and the going concern concept is fundamental to the amounts shown in the balance sheet.

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Going concern – a fundamental concept, also termed an underlying assumption

The financial statements are normally prepared on the assumption that an entity is a going concern and will continue in operation for the foreseeable future. Hence, it is assumed that the entity has neither the intention nor the need to liquidate or curtail materially the scale of its operations, the significance of this being that balance sheet asset values will hold good.

Accruals or matching concept

Cash receipts and payments may well underlie the greater part of recorded income and expense and for a very simple cash business the entire records. But even simple and small businesses and certainly large entities will owe and be owed money. Thus a cash picture of a business is needed to manage cash flow and balances, but reporting results or performance has to include sales made but not settled in cash and expenses incurred but not paid in cash, the idea being to match a defined period's income with its expenses and thus reveal the (accrued) profit or loss.

Income statement – the P&L account

The P&L account summarizes the income, revenue or sales, and costs or expenses for a period.

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Income statements – P&L accounts

A P&L account is a statement of sales less costs for a period, normally one year or sub-periods thereof. It shows sales (also called turnover, income or revenue) less costs (or expenses) grouped in various ways, the end result being the net profit or income of the business for the period stated. In its simplest format a P&L account starts with sales or income from which all costs or expenses are deducted, and the net result is a profit, when costs are less than sales, or a loss when costs exceed sales:

Profit & Loss Account for the period *ended* _ _ _	
Sales, income or revenue	900
–	
Costs or expenses	(810)
=	
Net profit or (loss)	90

In accounting terms, a profit or loss is the result of deducting all costs for a period from all income for the defined time period. While this is in essence a very simple concept and thus statement, it will be obvious that the correct inclusion of income and costs is critical. The correct 'cut-off' between periods is critical.

A very common practice is to distinguish between costs of purchased items, costs of manufacturing or other direct costs of providing goods or services, and the general, indirect or overhead costs of running a business:

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Profit & Loss Account for the period *ended* _ _ _	
Sales income or revenue	900
–	
Cost of sales	(690)
=	
Gross profit	210
–	
Expenses/overheads	(120)
(grouped together either for management purposes or to meet statutory requirements)	
=	
Net profit before tax	90

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