Using Your Financial Statements to Drive Operational Performance

An SBTI White Paper

Let's Go On A Treasure Hunt!

Everyday companies create and file mandatory financial statements.

They are the ultimate arbiters of performance. They are the scorecard that evaluates the quality of all decisions and actions taken in the reporting period.

The startling fact is barely anyone can read them and fewer understand them. Most people in the organization have no clue to how their day-to-day actions create money for them or their stakeholders.

Here is what this e-book is about:

- We CONVERT BORING NUMBERS into an EXCITING STORY
- The STORY has 3 AMAZING CHARACTERS who engage in eternal CONFLICT
- We boil down the statements into 4 BUILDING BLOCKS
- The STORY is revealed in 5 EASILY MASTERED CHAPTERS
- We use the BUILDING BLOCKS AND STORY to create a TREASURE MAP
- We embark on a TREASURE HUNT to reveal HIDDEN RICHES

The Power of Story

"Scratch the surface in a typical boardroom and we're all just cavemen with briefcases, hungry for a wise person to tell us stories" - Alan Kay, HP Exec and founder of Xerox Parc

Here's a free secret—No-one other than your CFO or CPA really understands the financial statements!! Go figure. (Of course many pretend they understand them).

Because they represent the outcome of all decisions taken during a set period they are the ultimate scorecard. However, they were not designed as a communication tool and are like hieroglyphics to most of us—completely bewildering. We suspect they were created just so CPA firms could make money!!!

Most people like stories and can relate to them. When drama and emotion are added to facts, a great deal of passion can be elicited from an audience, as illustrated by English novelist E.M. Forster when he wrote:

Fact: The Queen did die. The King died.
Story: The Queen died. The King died of a broken heart.

If corporate leaders can link their financial ideas into a narrative, they can move hearts, minds and even entire organizations.

Financial statements are the ultimate cache of facts about performance, and they represent all decisions and activities over the prior reporting period. Those are powerful messages that are hiding in a format so technical that they are lost to the people who matter most – those responsible for moving the company forward on a daily basis.

Told as a story, however, financials create an emotional experience that will ultimately speak to and inspire a greater number of employees, empowering them to make better decisions that improve long term financial performance.

Meet Our 3 Characters: Revenue is Vanity, Profit is Sanity & Cash is King.

Every great story has intriguing characters blessed with strengths, flaws and opinions. The Financial Story has three, depicted in the phrase, Revenue is Vanity, Profit is Sanity & cash is King. As you get to know their personalities you may want to reflect who plays these roles in your own company. Let's meet them:

Vanity: Better known as Sales Revenue, Vanity is an excitable fellow. Full of confidence and bluster, the eternal optimist, he believes if given the resources and authority he can win any deal, dominate any market and double the sales of the company. In fact, he often believes the company undervalues his role; if a greater investment were made in his realm, he could sell his way out of any troubled waters.

Sanity: The bottom line, for which there is little compromise. Sanity's ultimate goal is maximum profitability for the company. He sees the world in black and white -- and hates being in the red!

The King: He may not truly rule the empire, but his mission is to protect the company's coffers. It takes a very persuasive argument to pry loose any cash for investment in one of Vanity or Sanity's pet projects; he avoids paying out cash at all costs, and will lovingly count and hoard any cash he receives.

Each of these characters has tremendous influence over one another. Their dynamics create the fabric of an intricate conflict, the resolution of which can bring the company to its knees or to greater market share.

Basic Story: Let's see how our characters develop in a 3 act story that is typical in many companies

Act I: Growth is not always the answer

Vanity has been leading the charge to expand the business. He was brought in two years ago to turn around the fortunes of this company, Treasure Map Incorporated, which has seemingly lost its way. The once proud headquarters looks less shiny, the flowerbeds of the formerly well-manicured gardens are full of weeds, and the parking lot is full of potholes. A bolt is missing from one of the parking signs, and it is hanging upside down. You can faintly read its words: Employee of the Month.

The last twelve months have been trying for Vanity. He has worked long hours and most weekends. He recruited a new sales team, which has lifted the company's sales by almost 20 percent, and he is feeling pretty happy with his efforts. In anticipation of a big bonus he has already rewarded himself with a cobalt blue Aston Martin.

Vanity is by nature self-absorbed. He's also unable to master the financial spreadsheets that abound in Treasure Map Inc. He sees the "bigger picture" and tires of hours spent in budget meetings where all they seem to do is argue over whether the numbers are correct.

"The important thing," he says, loudly enough for the junior executives to hear," is that business is coming in, product is going out, and our sponsorship of the Little League was a smashing success."

Vanity glances at his calendar. Ouch. Another budget meeting Monday morning.

Sanity's reaction to Vanity's performance is something less than adulation, because profitability has not grown with the growing revenue. He sits on the compensation committee, and he's depressed because he will have to tell the organization for the fourth year in a row that there will be no bonuses.

Sanity has avoided raising this with Vanity for two reasons. First, he doesn't want to dampen Vanity's enthusiasm, which is key to winning new business. Second, he is a bit apprehensive, because Vanity can get very emotional. He can rise to anger as quickly as he can turn on the charm. Sanity is frustrated that no one but he seems to place any importance on the numbers. After all, numbers cannot lie.

Sanity knows that superior growth only occurs when profit growth is in excess of revenue growth. He knows that in a great company profitability should be up significantly if new revenue is quality revenue. When it isn't, he suspects there is something amiss with Vanity's efforts. But he can't quite put his finger on it.

Sanity is concerned that profitability as a percentage of sales is less than the year before. The answer likely lies in expenses or pricing, both of which might help Sanity understand whether Vanity's revenue generation tactics strengthen the company or instead bring in business with prices that or too low or spending that is too high.

What's obvious to Sanity is that Vanity hosted a five-star dinner for a long list of prospects and then took his sales team to the beach in Cabo St. Lucas in celebration of meeting their quotas. The cost of revenue has gone up sharply.

Sanity spent Sunday revising the latest forecast and intends to take everyone through his 42-page report in the budget review on Monday.

The King is beside himself with worry.

His current quandary: the company shows outstanding growth, but cash flows are negative. He wasn't expecting that, hadn't planned for it, and is not altogether clear how it happened. How is so much cash leaving the business? How will he tell the shareholders? They have seen sales continue to rise and are expecting a significant dividend, but the King hasn't got the cash. The King worries about the reputation of the Kingdom. If he doesn't have a good story to tell he knows they will come for his head.

END ACT I

Act 2: Conflict

On Monday morning the King enters the budget meeting with Vanity and Sanity. Their agreed objective is to develop a clear picture of the current quarter and what they need to communicate to the employees and shareholders. This is always a difficult time of the years because bonuses are being decided. In the past few years they have not had the funds to pay people for their performance and have lost critical talent to competitors.

Sanity, who has been gathering intelligence and is more than ready to share his perspective on the King's questions, begins with a monologue on working capital.

"The working capital story," Sanity explains, "examines how much money the business uses to support every dollar of sales revenue we make. In this case, for every dollar of revenue that Vanity sells, we consume nearly a quarter of it just to keep the business going and it is increasing"

Sanity shows the King one of the key components of working capital, accounts receivable, have skyrocketed – in fact, by a factor of 50%. This disparity is the King's lament, as this jump is being funded by his precious cash flow.

And without cash flow, the King cannot reduce company debt; he may even need to increase debt in order to make payroll and settle with suppliers. He cannot seek acquisitions or invest in Research and Development. He is, in effect, held hostage by the financial condition of the business. He agrees with Sanity, there can be no bonus payments this year.

Illuminated by the balance sheet and Sanity's insight, the King is out for blood to recapture the millions of cash that has left the business. He turns is fiery glare on Vanity and demands answers.

Vanity is at the end of his tether. He has started to wise up that he won't be able to fund his new car payments –he has increased sales and now he's the bad guy?

"OK I've had enough!" he explodes. "You know what - I don't have the first clue how this business makes money. All I know is how to close a deal and that is what I've focused my team on. I place all my attention on my sales revenue number. I dread these budget reviews as I can't make sense of all these spreadsheets and how all of the minute details interact with each other. Working capital and Balance Sheet terms--you may as well be speaking Greek to me!"

Sanity rocks back in his chair, knocking a steaming mug of coffee all over his pristine papers yet is oblivious to the sticky pool of fluid dripping on his neatly pressed khakis. He is flabbergasted.

"How can you not understand the numbers? They are obvious—much more so than the black art of selling which is the real mystery! We are legally obliged to create the financial statements and they are the representation of all of our decisions". "Vanity, your lack of financial acumen scares me!"

Vanity is affronted at the challenge to his intelligence. He stands up and readies to leave the boardroom but cannot stop himself hissing a derogatory response – "if you looked up from those reports for long enough you'd begin to appreciate what it takes to win and retain new clients – you know the most common objection I get is whether we are financially viable and I can't say you are giving me much confidence to handle their onslaught!"

"Stop!" shouts the King! "We are all on the same team. You guys have given me a blinding insight on how we can change our corporate fortunes" The King appears so animated that Vanity and Sanity retreat to their seats and look at him quizzically.

END ACT II

Act 3: Resolution and the Beginning of the Treasure Hunt

The King removes his crown and stares imperiously at the 42-page budget spreadsheet. "To be honest Vanity, I sympathize with you. We spend too much time putting these spreadsheets together and not enough time thinking about how our business makes money. What I just realized is if this team is having such difficulty then the rest of our employees must be even more confused. Sanity, what do you think?" The King and Vanity wait apprehensively—they know Sanity spends a lot of his time locked in his office creating these reports and worry that he will take their criticizing them as a personal blight on his performance.

"I agree! Of course I take pride in their creation and I want to make sure they are correct. But it takes 11 others and me a lot of time to collect the data from our 3 divisions. Not all of them are on the same IT system so we have to manually re-enter the data to get it all in a common format. Once we have done that we have to create the report and each division wants it displayed in a different way. I spend my entire month going from one meeting to another, one review to the next, and then the next cycle begins. I'd really like to spend more time analyzing the profitability of Vanity's deals to understand which are the best for our company. I'd like to know which customers and customer groups pay on time and consume less of our precious cash in the form of working capital. Perhaps this is heresy, but I think if we grew at a slower rate but the quality of our revenues was higher our overall business might be healthier and we could pay a bonus and a dividend".

Vanity nearly falls off his chair in surprise! "Wow, I thought you were really wedded to those reports and I felt you used them to beat me up! I could really use your financial acumen to help me find and structure the best deals".

"All right," announces the King. "Let's focus on the overall story and not the minutiae of the numbers. I believe we have buried treasure within this company and we need more people trying to find it. Let's create a "Treasure Hunt". We can educate people in the story we want to create and give them basic ideas on how to identify clues and build a map to get there. This way we get everyone to participate and we demystify how our business really makes money.

END ACT III. CURTAIN

Epilogue: The King is in his counting house counting out his money

- taken from an old English nursery rhyme "Sing a Song of Sixpence"

What a difference the last six months have made. Armed with the story and the treasure map the entire organization is engaged in the exciting drama of the business. Employees have gone from being predictable to becoming surprising. They show up to meetings with ideas for improvement as opposed to getting an after the fact dressing down from their superiors on why the numbers were not what they were supposed to be.

Vanity has been transformed. Frankly he is quite relieved that he hasn't got to just blindly chase sales volumes at any cost. His team has risen to the challenge and is using latent talents to come up with innovative value propositions allowing them to target the right markets and securing a better price premium. His performance bonus allowed him to finance his new ride!

Sanity has more people understanding his challenges and he is seeing higher margins. His relationship with Vanity and the King is at an all-time high! He has a new lease of life having been freed from the tyranny of endless budget meetings.

The King is delighted that the cash position is strong. In the past he had found it incredibly difficult to explain the many ways cash was consumed in the interaction of the income statement and the balance sheet. The power of the simple story has changed that. Most importantly, his cash position is predictable, allowing him to effectively borrow and give consistent dividend payments to the loyal shareholders.

The most surprising thing is the employees really identified with the story. Many appreciated for the first time how their daily activities help the company make money and to help the King (and their kingdom) make cash which can be paid to shareholders and in the form of bonuses!

The quarterly investor calls have gone well; the market understands their strategy better and has a higher belief in them. The stock price is up!

The Four Building Blocks of the Financial Statements

OK forget those tiresome and complicated sheets that comprise the income statement, the balance sheet and the statement of cash flows. We are going to skinny them down to their essence—to their basic meaning:

1. The Money Making Machine (aka the Income Statement)
2. The Wealth Creation Engine (aka the Balance Sheet)
3. The Story (aka the Drama)
4. The Discovery and Treasure Block (aka the Booty)

Money Making Machine	Wealth Creation Engine	The Story
Gross Profit	Investment	Revenue (Growth)
Operational Profit	- Cash Resources	Profitability
Retained Profit	- Non Cash Resources	Working Capital
	Funding	Cash and Funding
	- Debt	R.O.C.E.
	- Equity	

Discovery & Treasure

1. The Money Making Machine (aka the Income Statement)

This is the domain of Vanity and Sanity. Vanity creates the lifeblood of the business and generates the sales. In concert with Sanity (who manages Cost of Goods Sold) they convert these revenues into ***Gross Profit***.

Operating expenses (like Selling, General & Administration costs) are subtracted to get to a net income number or ***EBIT***—Earnings Before Interest and Taxes or ***Operating Profit***

The obvious next step is to subtract the cost of using Other People's Money, commonly known as debt, and taxes to leave us with Net Income.

It's still not the final number in the MONEY MAKING MACHINE. The Board or owners may decide to share part of the net income with their shareholders in the form of dividends. What's left is called ***Retained Profit***.

The key factor here is Retained Profit is the EQUITY FUEL that goes onto our WEALTH CREATION ENGINE. The more profit we make the more fuel we can put in our engine.

2. The Wealth Creation Engine (aka the Balance Sheet)

The boring accounting version of the Balance Sheet is very unhelpful for making decisions. It is hinged (balanced) around assets and liabilities and makes most people get blurred vision. The basic equation is Equity = Assets - Liabilities.

This is the KING's domain and he has created the WEALTH CREATION BLOCK. It is hinged around things managers are accountable for, namely the components of FUNDING and INVESTMENTS. (see diagram)

FUNDING has two parts – DEBT and EQUITY

There are only two places the KING can go if he needs more money to fund the INVESTMENTS required by VANITY & SANITY.

- OTHER PEOPLE'S MONEY (debt)
- OUR OWN MONEY (equity)

The second component of the WEALTH CREATION BLOCK is INVESTMENTS.

This has two parts:

- CASH RESOURCES
- NON CASH RESOURCES

How simple is that!

As the Wealth Creation Engine has to balance, when Investments grow so must Funding. They are always the same size.

Now you see what the KING does. In order to grow revenues in the Money Making Machine, Vanity & Sanity ask the King for Investments (like working capital—inventory and receivables and maybe some hard assets like buildings).

If the investment required is greater than his cash reserve in his cash resource pool, the King must increase funding—he either uses the equity fuel from the Money Making Machine or he goes and borrows Other People's Money in the form of Debt. Of course he will need to pay interest on this Debt. He will need to consider both Risk and Return.

Let's look at Risk for a moment—if Vanity and Sanity's new venture creates more Equity fuel than the Investments required—no brainer—no risk at all. If their venture requires a multi year investment and a lot of debt then the King's Risk goes up.

Now let's take Reward. If the King borrows money at 10% and the venture generates a 20% return it would be an adequate return.

The biggest worry the King has is the PREDICTABILITY of the return. If he takes on multi year debt he wants to know he will get a solid return every year. It pains him if he gets a big return one year and low return the next as he will get squeezed on cash. The King has to think about both short and long term consequences and wants Vanity & Sanity to be assured of their market position and appreciate his balancing act.

You see the dance of the 3 characters and how the Money Making Machine feeds the Wealth Creation Engine which in turn generates investments to service the Money Making Machine.

3. The Story Block (aka the Drama)

Let's add some drama to our story and see how our characters interact to create the story flow. The STORY block that has 5 CHAPTERS.

Chapter 1: All about Growth

This is the sole domain of Vanity and is all about growth in sales revenues. That growth can be positive, negative, or flat from one period to the next.

Chapter 2: All about Superior Profitability

Both Vanity and Sanity collaborate in this chapter. We specifically call out EBIT or Operating Margin as a percentage of revenues. In this way we can look at the QUALITY of our revenues independent of absolute revenue growth. For example, Vanity's total sales may have increased. However Sanity may see our profitability percentage may have gone down. This tells us that revenue growth did not convert to superior profitability.

Chapter 3: The Hunger Index

This chapter has a special emphasis on working capital and is the domain of the King but is influenced by Vanity and Sanity. It tells us how hungry our wealth creation engine (balance sheet) is. It reports the percentage of every dollar of sales revenues that is consumed by working capital. We want a lean mean wealth creation machine. If it is fat and bloated it consumes much of the King's precious cash.

Chapter 4: All about Cash

Cash matters. Investors invest with cash and expect superior cash returns. Chapter 4 is the outcome of the first three chapters. When organizations are short of cash they will often go straight to this chapter. They will fail. They need to examine what Vanity, Sanity and the King are doing in the first three input chapters.

Chapter 5: All about Returns

Specifically Return on Capital Employed or ROCE This is the outcome of the first 4 chapters. It is the measure of value creation and tells us for every dollar we invest in our business what return we get on that dollar.

4. The Discovery and Treasure Block (aka the Booty)

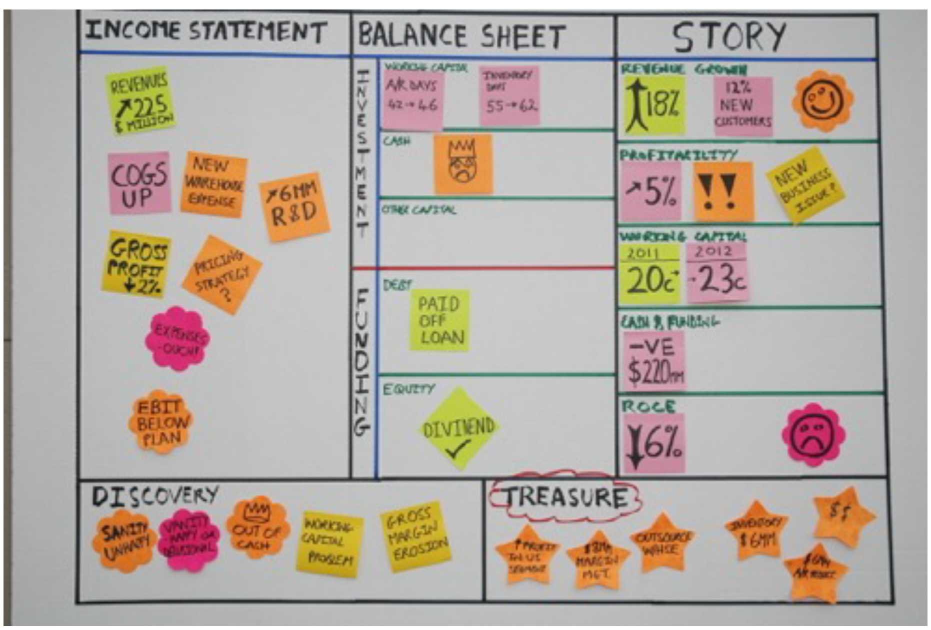
This block follows the clues illuminated by our characters and set out like breadcrumbs in the story block. They lead to the discovery and retrieval of buried treasure.

The fascinating thing is that this treasure is buried within your own company. It lies there in the form of hidden costs, wasted cash and seemingly attractive revenues bolstered with high levels of working capital. This treasure is not being mined for two reasons. First, it is invisible to most people and by default no-one is working on it. Second, the few that have an inkling it exists can't rally the rest of their organization to go after it in a concerted way.

Armed with the Story and the Treasure Map you and your colleagues can go and mine it.

The Treasure Map

Let's road test these elements to create a Treasure Map. Here is one from a recent workshop we conducted:



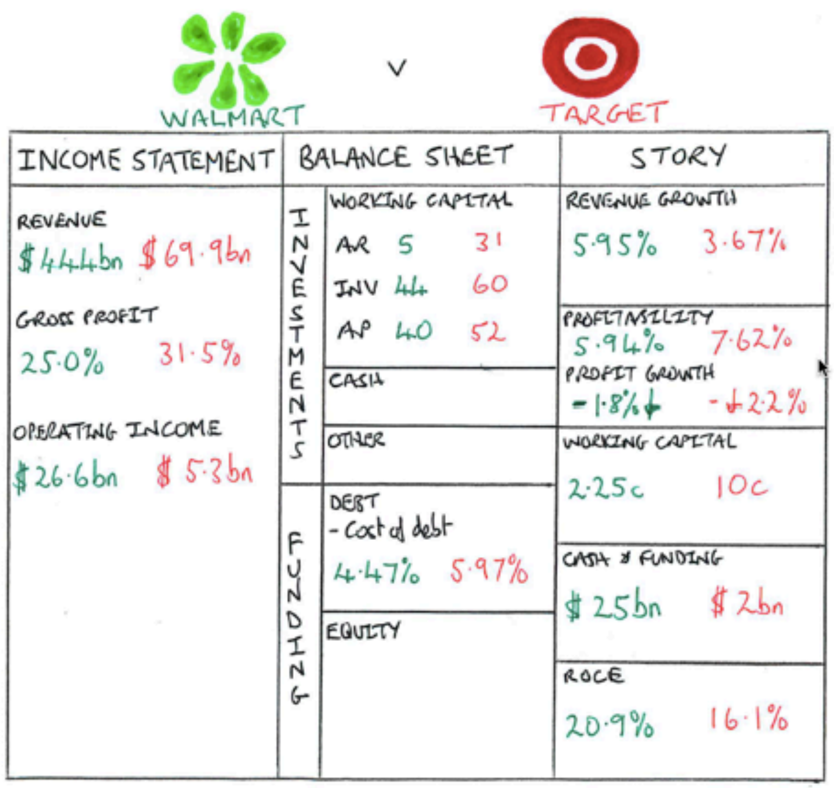
You can see several clues in the Income Statement or Money Making Machine —Vanity increased sales but Sanity is unhappy with the margin.

The King is unhappy as the Hunger Index has increased from 20c in 2011 to 23c in 2012! It is eating his precious cash!

As you see from this highly visual, non spreadsheet like map the group session identified significant sources of hidden treasure and generated clues to even further riches!

Now let's take the world's largest company, Walmart and compare them to Target. We chose Walmart because their financial statements run to 70 pages and we defy anyone without an advanced CPA qualification and years of experience to distill them into something meaningful.

So here goes with data from their 2012 financial year:



Chapter 1 tells us they have both delivered increased sales in a difficult climate; Walmart appear to have done a good job in growing by 5.95%.

In Chapter 2, it looks like both companies have had a tough year with EBIT declining in both companies. Walmart has down a better job of slowing that decline.

Chapter 3 is by far the most intriguing. For every sales dollar Walmart makes they only consume 2.25 cents in working capital whereas Target consumes a whopping 10 cents out of every dollar!

Examination of the key levers of working capital makes the story even clearer:

Walmart have instituted policies that allow them to collect cash from their customers

(Accounts Receivables) in as few as 5 days. They are primarily a cash business and when you shop in a Walmart store your money travels straight into their vault!

However, they do not treat their long-suffering suppliers with the same expediency. In fact suppliers (Accounts Payable) have to wait 40 days to be paid.

Think of it this way, they hold inventory for 44 days and get paid 5 days later for a total time of 49 days. So after receiving products form their suppliers, they ship it to their stores, stock it on their shelves and have it in their customer's baskets 49 days later. Payments are completed at the end of 49 days. As they pay their suppliers for the cost of that inventory after 40 days, they only have to finance their inventory for 9 days. If you want to think of it simplistically, Walmart almost gets all their sales revenues before they have to pay their suppliers. This is very low risk for them.

Most critically, nearly all of their EBIT converts into cash. Walmart's strategy is to have "every day low prices". Because of their working capital efficiency they can accept lower margins (EBIT%) than Target and turn it into cash to fulfill their commitment "to return value to shareholders through dividends and share repurchases".

This strategy was well articulated by their CEO:

"We want everybody to be selling the same stuff and we want to compete on a price basis and they will go broke 5 cents before we do"

Target on the other hand has to wait 26 days longer than Walmart to get money from their customers and they hold their inventories for 16 days longer. This costs money and cash is not flowing to the king's coffers.

You know that cashflow in Chapter 4 is an outcome of the first three chapters. We know Vanity's revenues grew, Sanity converted them to superior profitability, working capital was minimal in Chapter 3 so Chapter 4 is going to be a huge success story for Walmart. In fact their operating cashflow was over $25 billion versus Target's $2billion.

Finally, Chapter 5 sums it up for us. Walmart's combination of quality money making and efficient wealth creation engine generated over 20% return on capital employed. Their cost of debt is 4.47%. In simplistic terms for every dollar they borrow they convert it to over $4.

Target borrows at 5.97% and returned 16.1%. For every dollar they borrow they convert it to $ 2.70

So in a few minutes you have decoded the strategies of two of the world's largest companies without needing a CPA in accounting or a Masters in Business Strategy!

Summary

There is an amazing story hidden within your financial statements:

1. The Statements are a dry set of numbers that belie the great drama that exists in all organizations. Looking beyond the numbers we find 3 personalities, Vanity, Sanity and King in eternal conflict
2. The mystery of the 3 statements has been unraveled and simplified in the Money Making Machine and the Wealth Creation Engine
3. There are 5 easily mastered chapters that reveal the story
4. The characters, building blocks and story are used to create the Treasure Map
5. You can turn your boring financial reviews into exciting Treasure Hunts to find the Booty!

We hope we have brought the statements to life and you can all embark on exciting adventures leading to the retrieval of hidden riches!!!!