WHARTON EXECUTIVE ESSENTIALS

RICHARD A. LAMBERT

FINANCIAL LITERACY

FOR MANAGERS

Finance and Accounting for Better Decision-Making

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Introduction

When Roger Enrico took over as CEO of PepsiCo, he reported mixed news in his first letter to shareholders in the 1996 Annual Report. On the one hand, PepsiCo as a whole reported record sales of $32 billion and record cash flow as well. On the other hand, profits weren't growing and not all of their segments were doing well. In fact, their beverage segment, the heart of their business, was doing poorly outside the United States, losing market share to arch-rival Coca-Cola. PepsiCo had invested billions of dollars in their restaurant segment (Pizza Hut, KFC, and Taco Bell) over the prior five years, yet the return they were achieving was disappointing.

After conducting a thorough analysis of its financial performance, Pepsi began making significant changes to its corporate strategy. They spun off their restaurants into a separate company, Tricon Global Restaurants (now called Yum! Brands) so they could concentrate on their snack and beverage segments. But they didn't stop with that change; the process of evaluating and revising strategy is an ongoing one. Shortly thereafter, they acquired Tropicana and Quaker Oats (who also owned Gatorade). They have continued to make changes to their segments and product lines, and as recently as 2010, they reacquired control of two of their largest bottlers. By 2010, through this series of strategic shifts, PepsiCo's revenue had skyrocketed to nearly $60 billion. Their earnings and their stock price performance have both substantially outperformed the S&P 500 over the period from 1997 to 2010.

These are major corporate-level changes, but the same principles apply at all levels of the organization. Managers must constantly evaluate their firms' strategies to assess how their decisions have been performing, to modify these strategies as conditions change, and to devise new strategies to boost performance in the future. Which activities should we devote more resources to and which should we cut back on? Which resources are not being used effectively? Should we outsource an activity or continue to perform it ourselves? Business decisions like these need to be based on information, and financial statements are a major source of this information.

But many managers don't have a background in accounting and finance, so they don't have the tools they need to answer these questions. They don't understand the reports they are given to help them make these decisions. They either ignore the information completely, they misinterpret what the numbers mean, or they aren't even aware of what isn't in the numbers at all. All of these behaviors are dangerous to your firm's financial health. They are like trying to fly a plane with no instruments and with the windshield fogged up. The goal of *Financial Literacy for Managers: Finance and Accounting for Better Decision-Making* isn't to teach readers how to compile the financials. Leave that to the accounting and finance staffs, the CPAs, and the CFOs; they know all the rules and regulations. Instead, my goal is to teach you how to use and interpret the data they give you. Whether you are an experienced manager, executive, or leader at a public company or private business, regardless of size, mastering financial statements can help you make better decisions and make you more valuable to your firm.

Although accounting statements are filled with numbers, in many ways, accounting is more like a language. Accounting rules provide the mechanism by which business transactions and economic events get translated into numbers. What do the words attached to the numbers mean? Like every field, finance and accounting have their own jargon, and an important part of being able to understand and communicate is learning this vocabulary or language. Income is different from cash. Depreciation doesn't mean how much an asset's economic value has gone down. Liabilities can be good things. Too much cash can be bad. GAAP, NPV, ROA, EBITDA, WACC, leverage . . . What do these terms mean?

Many people are also surprised to learn that financial statements carry a large degree of ambiguity and subjectivity. Just as English majors argue about the interpretation of a soliloquy in *Hamlet*, managers and accountants can disagree regarding the best measure of a company's performance or financial status. The reason for this subjectivity is that accounting statements have to be put together while much is still in process. Although we could eliminate this ambiguity if we waited until the end of the firm's life before we tallied up its profits, this information would be too late to help with decisions that have to be made while the firm is still operating.

To provide more timely and useful information, accounting statements do not just look backward and tell you what happened in the past; virtually every number on a balance sheet or income statement is based in part on estimates of what will happen in the future. Unfortunately, future cash flows and events are never known for sure. This is what opens the door for manipulation by unscrupulous management. Even well-meaning managers are often overly optimistic about their firm's future prospects. To deal with these potential problems, restrictions are placed on what kind of information about the future is permitted to be transmitted through the financial statements. Auditors and other checks and balances exist to limit management's ability to misrepresent the firm's performance, but these elements don't work perfectly because they don't have a crystal ball into the future either. In this book, you will learn how this subjectivity and judgment affects the numbers and about what aspects of the future are incorporated and what others aren't. This will help you learn to read between the lines of financial statements and know when to be skeptical.

Once you better understand accounting and finance, you will also begin to see that the numbers that your firm supplies to external parties (like shareholders or tax authorities) aren't the numbers you want to use to run your firm—and no, the reason doesn't have anything to do with cheating or misrepresentation. At a minimum, you will want more detail about the performance of the individual parts of your company than annual reports and tax returns can provide. In addition, you want data that help you predict how costs and revenues will change if you make different decisions. External reporting systems typically sort items only by their type (for example, production costs are separate from marketing costs), but you would like information within each category to help you understand how your costs behave: what costs are fixed versus variable, what costs are sunk or committed to, what costs are direct versus allocated, and so on.

Finally, the reports provided to external parties like shareholders and creditors are compiled using rules that are regulated by standard-setting bodies.[1] Given that the company already has to compile numbers in a particular way to satisfy these external regulatory demands, many companies choose to use these exact same numbers for internal decision-making purposes also (because it's cheaper than coming up with an additional reporting system). Be careful. These rules are often designed for simplicity, to be conservative, or to achieve other objectives—not to measure your performance or financial position as accurately as possible. I will discuss some of these problems and how they can distort your performance measures.

Another important reason for managers to learn accounting and finance skills is to help them become more valuable participants in discussions of corporate strategy and to be more effective in championing their own ideas. Ultimately, an important part of these decisions is based on what they will do to “the numbers.” Many investment proposals involve spending money now on something that will (hopefully) yield benefits in the future. Therefore, investment decisions are based on predictions about the future and on how these predictions will manifest in term of future cash flows and profits.

Here it is vital to understand what accounting and finance skills can do and what they can’t do. Accounting and finance skills can’t tell you whether an investment in a proposed research and development plan will yield a drug that the FDA will approve. Accounting and finance can’t tell you whether consumers will like the new product you’re thinking of introducing (like New Coke). Accounting and finance can’t tell you whether an acquisition whose success requires blending two completely different corporate cultures (like AOL and Time Warner) will work. Experience and gut instincts are invaluable skills to managers in trying to make these judgments.

What accounting and finance skills can tell you is how big the probability of success needs to be and how big the benefits need to be if things work out in order for the investment to be worth the costs. More generally, accounting and finance provide an economic framework for comparing alternative strategies for how to invest your money in terms of how much value they add to the company. They can help you assess what an acceptable rate of return is. They can tell you how it depends on the riskiness of the strategy. They can tell you how much more a strategy that won’t pay off for many years has to earn compared to an investment that generates its return more quickly.

Moreover, by forcing you to tie your forecasts of future events into income statements, balance sheets, and cash flow statements, the framework of accounting and finance adds discipline to the process. Often managerial projections are fueled more by ego or hope than by reality. Accounting and finance techniques give you an opportunity to assess the reasonableness of the assumptions underlying the predictions and the sensitivity of the predicted results to changes in the assumptions. By forcing you to construct projected income statements, balance sheets, and cash flow statements that are internally consistent, these skills also reduce the risk of leaving something significant out of the analysis completely.

In this book, I will explain:

- The role of balance sheets, income statements, and cash flow statements.
- How these financial statements relate to one another.
- Financial reporting concepts, such as revenue recognition, inventory costing, depreciation, and taxes.
- How to dissect an income statement and balance sheet to understand the drivers of profitability.
- How your capital structure—the mix of debt and equity you use to finance your assets—influences your profits and your risk.
- How you can identify and estimate the relevant costs for decisions.
- How to evaluate investment strategies and conduct discounted cash flow analysis.
- How to put all of this together to develop a coherent business strategy.

Finances affect every aspect of business. Once executives and managers understand the rudiments of financial statements and the tools of financial analysis, managers can understand what is driving revenue, pinpoint where the organization is doing well, and analyze why performance isn't living up to expectations. Gaining a better grasp of financials helps managers know what questions to ask and what to focus on, determine what's most important, and know what to avoid and what to pay attention to. Fueled by better understanding of the drivers of performance, leaders can make better strategic decisions, make changes in the business, and better gauge what to acquire or sell. It's the synergies that arise from merging managerial experience with finance and accounting skills that can generate the most value to you and to your organization. Hence, boosting your own financial knowledge makes good business sense.

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WHARTON EXECUTIVE ESSENTIALS
Financial Literacy for Managers: Finance and Accounting for Better Decision-Making, Second Edition
by Richard A. Lambert, PhD