

A white lab coat is shown from the chest up, with a blue stethoscope draped around the neck. Underneath the lab coat, a striped shirt and a tie made of US dollar bills are visible. A gold coin is on the right side of the lab coat, and a silver coin is on the left side.

Stick Out Your Balance Sheet and Cough

Best Practices for Long-Term
Business Health

Gary W. Patterson • The FiscalDoctor®

STICK OUT YOUR BALANCE SHEET AND COUGH:
Best practices for long-term business health

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4 The Internal Exam: Five Areas Where Risk Can Lurk

While numbers in and of themselves are neutral, the way they are interpreted can be misleading. According to a 2002 *Electronic Business* article, “A full 17% of respondents admitted that their CEOs had pressured them to misrepresent results at least once.”

Without pointing fingers, could your financial statements, projections, and results use a more accurate interpretation? Besides giving you a more accurate picture of your company’s financial fitness, an accurate understanding will have a major side benefit over the next year. The better you understand your company’s real position, the more accurate the information will be that you depend upon to run your business. Depending upon how they are treated at your company, I’ve identified five areas that can either provide strategic benefits going forward if corrected, or be landmines where risk may be lurking in your company, if ignored. Let’s make lemonade from lemons, if any of these issues still exist at your company.

How does your company stack up to these statements?

1. My business does not accurately know who its 10 most profitable customers are.
 True False
2. Occasionally my business capitalized expenses that created an asset with what now may be a questionable recorded value.
 True False

3. My company does not know how changes at one of our top 10 customers may affect our company's bottom line.
 True False
4. My business has an asset it would be better off selling at a loss to free up cash to pursue a more promising opportunity.
 True False
5. My business paints an overly optimistic picture of our company to a customer, vendor, or financing source.
 True False

1. The Value of Knowing Your Most Profitable Customers

How many times have you asked or been asked some version of this question: *If you find out who our 10 most profitable customers are, could you please let me know?* I can't tell you how many times I've heard top executives ask this question. Like a well-kept family secret, companies often can't accurately identify their 10 most profitable customers. Some companies may define their top 10 customers in terms of those with the largest revenue. At some point in the company's history that might have been a reasonable approach. In this case, there are reasonable time frames when the product line does not have to be very wide, customer service issues may be minor, margin erosion has not begun, and even costs of production are reasonably stable.

However, as your business becomes more complicated or more competitive requiring new or more modern software programs and/or incompatible record keeping systems, the business may not have the money to immediately upgrade information systems and must get by for now with what they have. In those cases, I've found that accurately knowing the 10 most profitable

customers means digging a little deeper to get a better understanding of the numbers.

For example, I once worked with a steel company that had invested in software and hardware systems that could handle high volume manufacturing of a limited number of products with a limited choice of options. When the industry became much more competitive, customers demanded a wider range of customized product options, including color, length, and width. The more competitive environment meant they needed better operating information to become more cost effective while still meeting new and wider customer demands.

The information systems that worked well in the past could not meet these new customer demands. The company had not funded investment in new manufacturing systems or new data systems. Normally inside such companies, people solve these problems with unofficial Excel spreadsheets. Excel's flexibility solves the lack of flexibility inside the official system. After all, customers want their product delivered their way, how they need it, and when they need it, and do not care how the company's internal information system works.

However, even if the accounting department can deliver the financial statements and reports required by the SEC, management must have the right information to run the business successfully. If this is "offline" in a spreadsheet on a manager's laptop instead of in "the system," the information may not be easily accessible or in a format that is easily usable. Or it may take time and energy to integrate the spreadsheet data with the "online system" data. (Think of the last discussion or meeting you attended where a manager insisted they he or she couldn't get the information he or she was requesting.) Whatever the situation, there are clearly more costs associated with both providing the customized services to the client and accessing and presenting the data for management.

Often, the short-term answer is to throw bodies at the problem. Sometimes the mid-range solution is to get the right eight people in a room for a day and see what information is needed and how it can be delivered. That can initiate the process to obtain needed information and help clear red tape for management and their teams. Whatever level of access to this information your company has, I strongly recommend regularly obtaining the information about your most profitable customers. We will examine this issue in more detail later in this chapter. After all, you would be hard pressed to find anyone who disagrees with the statement that customers are the lifeblood of his or her business.

2. Question Today the Ongoing Value of Capitalized Items

Would you feel better about the issue of capitalization if you saw examples of how large companies with access to award-winning systems still make monumental mistakes when they misread the market? For example, Cisco had world-class information systems and processes for financial reporting and operational controls in place when it wrote off \$3 billion of inventory in 2001. In a series of widely discussed articles about how a write-off of such magnitude could occur with a company that has such sophisticated systems, Cisco's executives admitted they misread the market downturn. At least Cisco made an honest, but embarrassing, mistake, but I wonder how many other companies would openly acknowledge such an error.

Another example is Fannie Mae. In business parlance, what Fannie Mae did is sometimes called "cooking the books" – not a good thing to do. Fannie Mae made highly questionable valuation decisions, not just once but twice. But the clean up team who was brought in to right the wrong appears to have made even more expensive and questionable actions than the "bad" people they had replaced. Possibly, the motives of the second

team were less questionable than the motives of the first team and were closer to reckless risk taking than unethical behavior. Nonetheless, the net result was that in November 2008, Fannie Mae indicated that it would write off \$20 billion in tax-related assets.

While it may be several years before we have better indications of the total costs to shareholders and taxpayers of today's financial institutions' failures to make tough decisions, we never will know the real total cost of these wrongdoings. Companies of all sizes have legitimately capitalized some item in the past that should be regularly questioned. All of us have read the horror stories of write-offs that in hindsight raise questions that often were not valid or even a factor when they originated.

If you have reserves, allowances or estimates for loss, it is a worthwhile hedge against downside risk to take a more critical look at them now and at least once a year going forward. When bad things happen to good companies, some of the reasons those things were not corrected earlier can be tremendously embarrassing later, when the bad things are on the front page of the *Wall Street Journal*. Why do you think incoming presidents of turnaround situations scrutinize everything and clean house—sometimes referred to as writing off everything including the kitchen sink? They would rather embarrass the outgoing leader than be the subject of embarrassment in the future.

3. Analyze Your Top Ten Customers' Profits

Companies that accurately know the profitability of sales of their top 10 customers often fail to surmount the next hurdle: *How will your company be affected when the profitability of your top customer decreases?* There is always a time when one of your top 10 customers will drop off your "A list." Consider that buggy whip manufacturers were profitable customers for some businesses until automobiles became the standard. Rather than

laugh at that comparison, review how the product or service your company provides might become the buggy whip of tomorrow for one or more of your current best customers.

Even if you know your 10 most profitable customers, you still can be caught unaware if you do not have some understanding of how changes in your customers' business will impact your business. A company that has no clue who its most profitable customers are cannot even begin to estimate the damaging impact on their own company when their top customers' profits decline. The takeaway lesson here is to understand that your top 10 customers will change over time, so it's up to your management team to continuously analyze customer data to ensure you're serving the *right* 10 best customers at all times and recognize that adjustments need to be made to those customer accounts that have fallen off the A list.

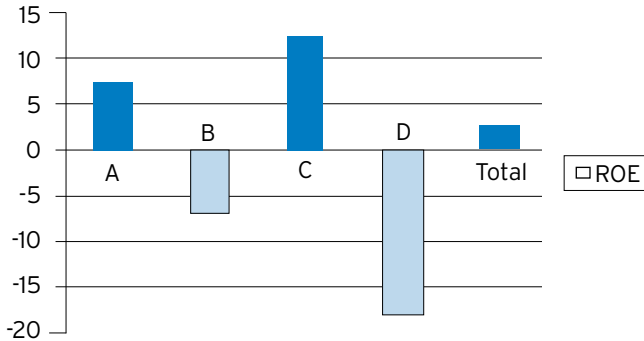
4. The Company Would Be Better Off Selling the Asset

Has your CEO, CFO, or financial department ever mentioned that the company has to keep losing money on a branch, service, or product because it can't afford the financial loss it would have to record to dispose of the asset? I've been privy to such discussions many times in corporations of all sizes. What happened to companies in those circumstances is that they either did not fully understand the real value of their assets, or they chose to look at their assets through rose-colored glasses.

A smaller-scale version of this situation occurs when a business fails to look at return on equity related to assets or departments. Many companies have one or more assets that can be associated with a band-aid solution, or assets that should be sold (even at a loss) and reinvested in another opportunity. This can be particularly true when the executive bonuses are mainly a function of the absolute dollar level of profitability, with limited influence from return on equity or similar measurements.

Let's use our "magic decoder ring" on a statement all too often heard. You (another person or company) would be better off selling stock, the asset, or even in some cases, the company, and just putting the money in treasury bills. In fact, I know of a situation where the subsidiaries of a holding company earned 2% on equity when the prime rate was 4%.

Return on Equity % by Subsidiary and In Total



Company X	ROE
A	7.5
B	-7.0
C	12.5
D	<u>-18.0</u>
Total	2.5

After viewing the chart, compare your business. Then ask, *What situation or valuation in our company are we looking at through rose-colored glasses?* A similar area where you might look for the rose-colored glasses within your company is your capital expenditures program (CAPEX). For those of you who are saying your company has a mechanism that investment proposals meet threshold rates, how often does someone

report back convincingly that the actual investment return met or exceeded the level projected to get the funding? I suspect the answer is not as often as you think!

5. My Business Paints an Overly Optimistic Picture to Our Customers, Vendors or Finance Sources

How many companies have painted an overly optimistic picture to a customer, vendor, or financing source? According to *ADP Screening and Selection Services* “44% of Americans lie about their work history.” (One well-publicized example was the case of Marilee Jones, who was the admissions director at Massachusetts Institute of Technology. While she claimed to have degrees from Albany Medical College, Union College and Rensselaer Polytechnic Institute, it turned out that she falsified her academic degrees: She had no degrees from any of them.) If any of those 44% work at your company, might they stretch the truth a little while representing your company?

The effects of this are extremely hard to quantify. When does puffery become misrepresentation? Murphy’s Law suggests not knowing your company’s real equity and risk areas will be a problem at the most inopportune time. Just take a look at all the items someone like me will ask for during a due diligence process and follow-up to see if your company’s rough areas remain hidden. Also, if the numbers are clear, then it’s more difficult to misrepresent them – whether intentionally or not.



Coming Up

In the next chapter, we will take a closer look at decision makers’ number one obsession – access to cash.

Internal Exam Risk Checklist

- Know the value of your customers
- Question the ongoing value of a capitalized item
- Make adjustments to your top 10 customers list
- Identify assets that may need to be sold
- Know your company's true equity and risk areas



R12 Do You Have a Question?

To talk with Gary Patterson about your business: This book covers a range of issues for high-growth companies and enterprise risk management concerns. A number of these issues can be discussed or researched in much more detail. If you have an issue you would like to discuss or suggestions for another book or service, please go to

www.fiscaldirector.com/contact.html

and let Gary know how you prefer to be contacted. While you're at the contact page, request a free copy of the FiscalDoctor's Due Diligence Checklist, which is useful for operational assessments and enterprise risk management.



For updates on enterprise risk management: Gary Patterson blogs about ERM and other timely business concerns at:

www.fiscalclinic.com

To apply these Best Practices to your business: Gary Patterson can:

- Work with companies, worldwide on short-term or retainer-based projects
- Discuss your business problems, questions or comments
- Facilitate strategy or planning sessions
- Develop one-on-one coaching or mentoring
- Give a tailored speech on issues relevant to your situation
- Introduce his affiliates to your company
- Estimate the cost of what you don't know