

The Wrong Numbers

JOHN MAY THINKS HE HAS THE NUMBER OF AMERICA'S TOP COMPANIES, and that number is \$100 bn. This, he has calculated, is the gap between what the firms in the NASDAQ 100 told us they made, and how much they actually made in the first nine months of 2001. It is also the difference between being able to understand how well a company is doing, and complete ignorance. Indifference is not an option.

Of all the ways to score a business, profitability has had the field to itself for as long as anyone can probably remember. And why not? Businesses are meant to make money. Relying upon profits to measure success should keep life as simple as it should be, give or take \$100 bn.

The problem with profit, though, isn't really the recently exposed voodoo accounting practices which allowed WorldCom, Enron and friends to cook the books, their accountants manufacturing returns with abandon. It's not even that we apparently find it so easy to be duped by so many of them. The problem is that profit without productivity is like lying to the doctor. It always catches up with you in the end. Profit is the wrong number, and productivity the right one to look at if you really want to know how well a company is actually doing as a business.

Compare, for example, the very different fates of two of the world's largest networking equipment companies, Cisco Systems and Marconi. Neither have actually made any money for quite some time, although Cisco is a past master at legally conjuring profits where none actually exist: in 2001, it achieved a monstrous audited loss of \$3 bn. Pro-forma earnings announcements during the year actually claimed a profit of \$0.7 bn – just enough to beat Wall Street expectations and send Cisco shares up a notch or three.

Nevertheless, using their final numbers for 2001–2, revenue per employee was £410,000 (\$500,000) at Cisco. At Marconi, even after many thousands of job cuts, it was £115,000. Guess which company lost over 95% of its shareholder value in the same period and saw its bonds downgraded to junk status? Which is still on the critical list? Productivity at Cisco is more than three times that at Marconi. I know where I'd put my money.

DIRTY BALANCE SHEETS

What's gone wrong with profits? Some of those who accept that pro forma statements are a plague on corporate life also argue, almost convincingly, that it will pass. These are difficult times in the economy, they say. Companies are under so much pressure from volatile stock markets, falling demand and margins squeezed by competition. It's harder than ever, but more important, to turn in good numbers. Surely companies cannot be blamed for taking any legal opportunity to puff up their chests?

It doesn't quite convince. For one thing, it doesn't explain why markets – who surely have nothing to gain by being lied to – continue to let companies get away with it. A better explanation is that, for markets in general, and regulators in particular, getting tough on pro forma earnings is tantamount to admitting that the whole thing is just a legalized racket which has been allowed to get out of control.

This should shock no one. It's hardly a conspiracy in need of an Oliver Stone exposé. The whole business of dirtying your balance sheet in this way is carried out in full public view, mostly. Discovering the great gulf between pro-forma profits and actual audited earnings didn't require John May to plant any hidden cameras or hack his way into secret files. Everything was available for free on the Internet. May, a stock analyst for a US investor service, simply added up the companies' pro forma earnings announcements, which claimed a profit of \$19.1 bn, and subtracted the \$82.3 bn loss which appeared on their audited accounts.

There is also no mystery as to how there could be such a gap between the two sets of numbers. Pro forma accounts (it's Latin for perfunctory) are added up any way the company wants, leaving in or taking out anything which doesn't fit with the story they wish to tell. Audited accounts have no such flexibility. They must be presented the way the government tells you, using official accounting rules and principles. Pro forma accounts distort the truth just because they can.

Nor is there any real attempt to actively hoodwink investors into thinking that pro forma earnings are supposed to be as reliable as audited numbers. The statements are issued with more health warnings than a box of Marlboro. Guidance notes longer than the news itself generally advise readers not to pay any attention to what's written, and certainly not to make investment decisions on profits that may turn out to be, well, losses. To further help us turn a blind eye, the press statements usually include some kind of platitude from a spokesperson along the lines that the numbers offer a guide to 'core operating performance', or 'trading results', unencumbered by any annoying 'exceptional' or 'financial' distractions.

All this gets dangerously close to blaming the victim. It's our fault for not paying enough attention. Silly us, trading equities on the basis of pro forma statements, for daring to think that the numbers mean what they say.

On the other hand, why shouldn't we take pro forma statements seriously? They are legally sanctioned, and almost completely unregulated. They generate hours of coverage on TV and CEOs take time out from running the company to explain them to us. Plus, if companies really didn't want you to pay any attention to these numbers, why bother giving them in the first place?

Pro forma statements have contributed much to the declining worth of the bottom line as the prime indicator of corporate performance. There's worse to come, too. Financial regulators have done less than discourage the deception that is pro forma announcements. Aside from a few bitchy remarks, and one or two public displays of disaffection, the most they have come up with in practical terms is that if you're going to cook the books, at least be consistent about it.

The first person to find this out was, appropriately enough, Donald Trump – the man who wrote in his autobiography that he likes to put in phone calls to people when he knows they're not at their desks, so he can leave a message without having to talk to them.

When Donald craftily left off a one-time charge of \$81 m while keeping in a one-off income of \$17 m in a 1999 pro forma for his casino businesses, the inconsistency cost him an immediate 6% on the share price, less another 11% when the regulator ruled the company had, indeed, practiced to deceive. If, of course, Donald had been consistent in what he was hiding from investors, that would have been no problem at all. His shares, like most others who do this, would probably have gone up.

Never mind. We can still rely on audited accounts to tell us how well companies are doing. Can't we?

THE TRUTH, THE WHOLE TRUTH AND NOTHING

It takes about twenty seconds to register for Motley Fool, one of the new breed of isn't-investing-fun advice and information centres on the Internet. Under the slogan, 'to educate, amuse and enrich', Fool's UK site reassuringly advises that 'reading an annual report is actually very, very, very easy'. It's not clear to whom, though. The recommended method for finding out the simplest thing – like how shares a company has issued ('it's not that difficult') – contains more steps than a Rubik cube solution.

Armed, however, with the authorized data of an annual report, and the clarity of a Motley Fool description, actually determining how much profit, or loss, a company actually made is a simple task. A typical consolidated profit and loss declaration will offer just two numbers – before and after tax. The latter, says the Fool guide, represents 'how much profit is left for shareholders after everyone else has had their slice'. A quick calculation of the profit margin is all you need now. 'Companies with margins of over 15% are usually strong businesses'. Excellent. Couldn't be simpler.

It also couldn't be more naive. One reason the pro forma cookery is tolerated might be that governments, and everyone else, still cling to the common fiction that the profits reported in audited accounts are the terrible truth; that you can really tell how strong a business is by looking at them.

Why do we think audited accounts are any good? Search me.

Those busy boys and girls of Stanford Law School have, for the past six or so years, found time between lectures to maintain a comprehensive database of all lawsuits brought by shareholders against US companies for fiddling their audited results.

At number one in its all-time top ten settlements for companies caught cooking the books, Stanford lists the Cendant corporation. Cendant was created in 1997 by a merger of CUC International and HFS Inc. They are in the consumer credit checking and car parks businesses, amongst other things, operating worldwide.

In April 1998, Cendant discovered that one of CUC's business units had been cooking the books, making up revenues, that kind of thing. An announcement went out one evening, just after the markets had closed for the day. When the markets re-opened, Cendant shares lost nearly



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half their value. The eventual lawsuit which the collected shareholders filed claimed that Cendant's revenues had been overstated by \$100 m in a systematic fraud of their audited accounts. The court agreed, awarding damages against Cendant to a total value of \$3.525 bn. (You read it right the first time.)

Unless WorldCom can top it – unlikely, since they went bankrupt – Cendant are likely to stay at the top of the league for some time longer. Even so, most settlements for securities fraud rarely slip under \$10 m and can easily be ten times that.

Yet, if the courts hope that their firm decisions are helping to keep corporations honest when it comes to their numbers, they will be sorely disappointed. The number of cases and the size of settlements are still rising. There were 487 such filings in 2001, more than twice as many as in a normal year. 2002 looks like being another bumper crop, even without WorldCom.

Audited and pro forma statements may be wide apart in numbers; they may not be so far apart in credibility. This is bad news for everyone, for it finally deprives us of our preferred measure of corporate performance.



THE BOTTOM LINE: NOT PROFIT ANY MORE



The usual answer to these problems is to ask regulators to look at the accounting rules again: it's not what companies say their profits are, but how they say it. Better rules may help, certainly, but not entirely, and not for long.

For one thing, it's not as if the accounting regulations were deep frozen in the 1930s and are just out of date. The rules are always being tweaked, and there have been plenty of well intentioned efforts at international agreements and common practices. New reform proposals to clean up reporting practices come out of the professional bodies all the time, even when they are not being skewered in the media or the courtrooms. But past reforms haven't prevented the abuses we have today. Why should future regimes have any better chance of success?

Declared profits have never been a reliable scorecard for corporate performance largely because they have always been open to interpretation. Any good corporate accountant will tell you that declared profits can be expensive, while being easily and legally hidden. Consequently, you may have very successful, productive, corporations that report very bad – or no – profits on a regular basis.



At the end of the first year of my first business, at the still tender age of 26, I met with my accountant (an honest fellow) to discuss what to do with the profits. 'How much did we make?' I asked. This was a big deal. My head was going to swell in direct proportion to the money made. Came the response, 'How much do you want to make?'

There are all kinds of devices available to you, should you wish to go down this path. Try the very simple device of setting up shell companies, with nothing in them but your tax liabilities. The Republic of Ireland charges much lower duties on corporate profits than does, say, the UK Customs and Excise next door.

Ireland, by no coincidence, turns out to be a very attractive place for many companies legally to declare their profits; the highest contribution to GDP in the whole of the OECD, as it happens. (Tip: incorporate holding company in Dublin, transfer some IP rights, get a dormitory office and someone to answer your phone. Bingo. But I didn't tell you that.)

No regulatory regime will ever completely sterilize accounting practices, or entirely remove companies' room for interpretation. Nor should it: corporations are complex and business life is too varied for such a straight-jacket to be of any use. It would probably be unenforceable anyway. Enron showed just how easy it is to evade complex accounting rules which were designed to fence them in to business practices they did not want to follow. But the executives who practised this deception did not invent creative accounting, the world record for which is still held by Cendant anyway.

Companies, however, still need a way for everyone – including themselves – to measure how they are doing in an objective, agreed and honest way. Profits might have fit the bill, if only we were able to agree how to measure them properly – which we can't.

Whilst companies, accountants and governments continue their occupation of the business TV studios, diligently chewing over the problems of counting profits, the rest of us really need to get on with our lives.

GETTING DOWN TO BUSINESS

If not profits, then what? How can we measure the performance of a company without referring to the money it makes? In the jargon, what are the real fundamentals of business?

There are, perhaps surprisingly, more than a few candidates. Surprising because if something really is, well, fundamental, surely it cannot be

a matter of opinion? And if others beg to differ, what does that say about your so-called fundamental?

Here's a simple experiment to find out, involving yourself and a few consenting adults. It's like a book group, but for people who read balance sheets. Give five friends a copy of the same company report to take home. A week later, ask which of the many performance indicators it offers is the most fundamental to the business concerned. Although they are only allowed to choose one, don't be surprised to receive at least six answers, or seven if you happen to have included someone who works in marketing.

Some poor souls may still feel no need to look any further than the balance sheet for their fundamentals. Profit will almost certainly be there, maybe cash flow, stock price, indebtedness, gross to net margins. We already know that these don't quite cut it as genuinely fundamental measures, and why – they are sophisticated numbers, their calculation too easily manipulated to suit particular purposes; not basic enough.

Others like to rely on non-financial measures. They can get all holistic on you and talk about the fundamental importance of customer satisfaction, or brand, or maybe employee retention – anything you can't point a calculator at.

The point of this experiment is to show that we've got no idea what's really first amongst our principles, and worse still, we may never have. People quite naturally tend to favour those fundamentals which relate to what they think is important about a company: translation, those which show how important what they do is for a company. And their objectives may not just be different to their colleagues – they can openly conflict.

Investors, for example, have a valuation perspective and a technique for putting a fair price on a company which is seasoned to taste. Some might favour long term asset value, or cash reserves, as their fundamental statement of business success. Their interests will readily conflict with a CEO whose compensation is linked to short term stock prices and has an interest in spending money to grow revenues, not saving it to accumulate reserves. His performance measure is share price.

A financial director might favour fundamentals which reflect her concern for the reliable flow of money through the organization, and oppose anything which looks like a risk to this stability. A change to pricing strategy recommended by a marketing department that thinks the world revolves around market share, for example, would lower margins while draining reserves – jeopardising the CFO's idea of good management.



Instead of asking people what they think the fundamentals of a business are, we should give them a list of candidates and ask whose fundamentals they are. But then, maybe they don't qualify to be called the fundamentals at all. Perhaps we should call them the relatives, instead.

MODERN PRIMITIVES

There is, however, a group of people whose perspective on the fundamentals seems, for better or worse, to be distinct from most other people's. This is the small group of people who invest their own money in a company that they also run.

Unlike even heavily incentivized executives, who stand merely not to make a pile of cash, entrepreneurs who have funded their own companies stand to actually lose it. Like Dr. Johnson's noose, the threat does tend to concentrate the mind. Owner-operators are unique in the corporate world, caught between the lines of the balance sheet when it comes to judging the health of their company. And one measure above all seems to hold their attention: productivity. Why?

It is not hard to understand why this should be, but worth saying anyway. Their own money is at stake. Should they attend too much to non-financial measures, like brand values, whilst allowing the balance sheet to become dilapidated, they will know it and feel it first.

If, however, they are confused about the fundamental dynamics of their business, they will fail to make good or timely decisions, threatening their investment and their livelihood even further. These dangers are present in every corporation; in an owner-operated business, they are present in one person.

When one person is running the show and putting their own money on the line – no matter how large or small the company is – the firm tends to have the most stringent cost controls you're likely to find. Cost-control, for example, is synonymous with pursuing productivity; it means the most important decisions in the company are, in effect, those that involve signing a company cheque. This is doubly true if it's your own money – which is why anyone with a big enough slice of their own wealth in a company tends to be absolutely obsessive about it.

When Mr Bruce Wasserstein became head of the troubled Lazard merchant bank in early 2002, he bought enough of the company to make him the second largest shareholder after the founding family interest. By



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any measure, even for a man who once made \$650 m in a single deal, this was no side bet.

Cost control had not been high on anyone's list before he arrived, but it soon was. His first priority was to replace expensive under-performing bankers with equally expensive, but higher performing ones with even greater share-based incentives. Same money, better value: higher productivity.

Wasserstein had other ideas for his company too. He simplified the ownership structure of the business so that everyone knew what their contribution was actually worth, drawing a straight line wherever possible between work and output. Mr Wasserstein is not blindly trying to preserve the cash he has put into the business, but to make it work harder. His idea is to get productivity back into Lazard's operation, and nothing else.

Even in the sophisticated world of investment banking, productivity is about as fundamental a measure of the effectiveness of a corporation as you can conceive: it counts the value created for every hour worked (i.e. revenues minus costs). Productivity is not affected by anyone's perspective or special interest within a corporation. If costs rise out of line with sales, productivity will fall: even if the costs were due to marketing expenses or pay rises to workers. When productivity goes negative, so does the balance sheet, and so might the business.

What people like Mr Wasserstein appear to know, and the rest of us may have forgotten, is that productivity is the only true fundamental. Productivity is objective. Opinions do not count with it, strategies which disregard it are fanciful and likely to fail. Next to productivity, everything else is detail. Depending upon how you look at it, this is either very obvious, or very, very smart. The shame is, it isn't both.

BLESSED ARE THE PIN MAKERS

When the laws of economics have not been suspended by equity markets with a grudge against their own investors, companies have always been formed and sustained solely by the productivity gains they are able to achieve in the way that they divide their labour to make best use of their available resources. It is only relatively recently, with more and more companies listing on public exchanges, that we've developed our taste for those exotic performance indicators which, while popular, are of such poor nutritional value for those looking to measure corporate performance.



Go right back to the beginning, and you'll see why. Adam Smith, who introduced the idea of the division of labour in the 18th Century when corporations were just being invented, realized that anyone who did not grasp this basic fact did not deserve to be in business, and probably would not be for long. He even makes the point in the very first line of *The Wealth of Nations*. 'The greatest improvement in the productive powers of labour', he wrote, 'and the greater part of the skill, dexterity and judgement with which it is anywhere directed, or applied, seem to have been the effects of the division of labour'.

In what must be the earliest example of the business case study, Adam Smith opened *The Wealth of Nations* in 1776 with a look at an unnamed company in which ten people worked together making needles by hand, at a time when the product was sold by weight and a well oiled production line of this size could produce about twelve pounds worth a day. Smith doubted that if the ten pin makers had worked all day on their own, rather than organizing together and dividing the labour, they would have produced more than a couple of dozen pins between them. He watched them making several thousand.

The reason productivity matters so much, and reveals everything there is to know about any business, is the same today as it was in 1776: corporations come into existence in the first place for the purpose of magicking up productivity, and for this purpose alone.

That companies exist to further productivity hasn't always been uncontroversial, although heaven knows why. No one has ever found a better answer, and most enquiries have come round to agree with Smith in the end, albeit with the addition of a few new wrinkles.

In 1937, for example, the Nobel prize-winning economist Ronald Coase argued that firms exist because they divide labour more cheaply than the market would: that is, organization favours productivity more than competition does. Coase was particularly interested in how transaction costs are lowered within companies, compared to going outside to get things done.

This is what he means: if you and I both work for IBM, you should be able to get my help on a project much more cheaply than if I worked for a different firm, in which case you would have put the work out to tender and negotiated contracts. Companies are uniquely suited to organizing people so that the whole can be made to produce more than the sum of the parts. Who in their right mind would slave alone in poverty when



they could get rich working with others? No wonder we don't respect artists.

Coase's theory of transaction costs is now passed around with the butter at most business schools and is chapter one for economics undergrads. A journalist for the *Financial Times* quoted it to me once, and couldn't even put her finger on where it came from. This may be because it's so obviously true, it's easy to forget that someone had to discover it in the first place.

APPLIED PRODUCTIVITY

No theory is worth much unless you can apply it, particularly if you think you've hit upon a universal truth. So let's do that with productivity.

The patron saint of mass production, the Ford Motor Company hasn't always been good at maintaining productivity levels in its plants. It hasn't done too badly though – they are still in business, and many aren't. One reason Ford is still with us is that it always knows to fix productivity first. It did so not very long ago at one major manufacturing plant at Halewood on Merseyside, UK.

Once derided as the worst car factory in the world, Halewood is now a model of productivity. So bad was this place that at one point the UK government had to bribe its owners with £40 m of taxpayers' money not to close it. Today it produces (profitably) the flagship Jaguar 'Executive' car. The people in the plant say the reversal of their fortunes is due to new ways of working, not new workers. There's the soft stuff we're all familiar with: office walls have been knocked down, trust has been established between workers and managers, blah blah. More to the point, everyone is now held accountable to output and quality, with regular evaluations of organization at every level. Efficient working practices are not only enforced but constantly reviewed and refined by the people doing them. They know that faults are their failure, and no one else's. They've learnt to love the division of labour again, and it works.

Halewood is still making cars because the Ford Motor Corporation rediscovered the importance of productivity to staying in business. Frederick Taylor, the founder of modern management science, may well have had this example in mind when writing of '... a complete mental revolution on the part of the working man engaged in any particular establishment



or industry' – except that he wrote this in 1911. Something old, something new.

LARGER NUMBER

Many people in business do not understand productivity – literally. A survey by the research company NOP amongst UK firms recently discovered that 35% thought productivity related solely to the output of workers, while 4% thought it measured output from capital. Everyone else was in-between, including the 25% who hold the exotic point of view that productivity is a measure of customer satisfaction and not an economic or financial number at all. This isn't stupidity, it's just ignorance.

A little education will go a long way. Productivity is not a detail; it's a fundamental – perhaps *the* fundamental. It is business virtue. It is not, really, open to interpretation. It is the ratio between what goes in, and what comes out. It is a simple number, which is better when higher and worrying when lower. Its simplicity is its strength – not an easy thing to assert in a business culture so enamoured with its own ability to find numbers within numbers and think this makes it clever.

VIRTUE, THIS WAY

How, then, to reassert the importance of productivity against the tide of facts of spurious importance?

Pills do come sweeter. The Halewood story contains a warning: even though productivity is in the interest of the business, it may be entirely against the interests of one or more powerful forces in the company. First principles are not known for their popularity. Expect a fight, then, between what's good for the business, and good for some in the company. But who's likely to put up the challenge? Probably, no one.

It's fair to ask, particularly if your company isn't owner-operated, or has a deep pocketed boss like Mr Wasserstein at Lazard. Most companies do not. And even when they do, some owner-operators can prove to be just as inept at keeping their business healthy as any badly directed management team. Look at Robert Maxwell (raided the company pension fund), John De Lorean (dealt cocaine to raise capital), or Alfred Taubman (the con-

victed price-fixing chairman, and controlling shareholder, of Sotheby's). It was their money, too. Self-interest, it seems, is no bar to bad governance.

Looking around the boardroom table, it is immediately clear that no one person has a direct and exclusive interest in productivity. That's the point, of course. It is the measure of measures – a general indicator of activity in the corporation as a whole. No one can own it; everyone does. The IT director may be able to make just as good a case for a budget increase to promote efficient working as could the marketing director who wants to protect margins by spending more on sales promotion. The shareholders sitting as non-executives may prefer to pay off debts, rather than invest in technology, and consider this a worthwhile efficiency gain. It's not looking good for productivity.

It can be done, though. You might as well start with the company report, even the pro forma accounts. Then everyone can separate fact from fiction.

SELF TEST: VICE OR VIRTUE?

Do you agree or disagree with the following statements?

- 1 Numbers never lie.
- 2 The more detail we have about the company, the more we understand our business.
- 3 Financial data is more telling than operational data.
- 4 Profitability is the best measure of the company performance.
- 5 Productivity is an obscure economic term that no one understands and only a consultant would ever use.
- 6 It's more important to use the company report to puff up morale than to portray the current state of the business.

How did you score?

- If you agreed with all the statements, you must have worked for Enron.
- If you agreed with more than half the statements, you have a bad case of this corporate vice. Reread the chapter and try again.



CORPORATE VICES

- If you agreed with half, or less than half, of the statements, there is hope for you. Keep up the good work, and consider acting upon some of the suggestions for business virtue.
- If you agreed with none of the statements, you also should have worked for Enron, and maybe they'd still be here.