Don't get mislead by all that financial information

By Malcolm McDonald, Emeritus Professor at Cranfield School of Management, Professor at Warwick, Henley, Aston, Bradford Business Schools and the Sino-British College USST Shanghai, and Chairman of Malcolm McDonald Consulting

There are 12 times more accountants per capita in the UK than in Germany. Which country, I wonder, is more successful economically?

Let's remind organisations that their real value resides in their relationship with their markets and their customers, not in their tangible assets.

The first crucial point I want to make in this article is that most of the financial information is pretty pointless in the absence of market-based information.

Let's start by having a quick look at the financial information in Tables 1 and 2 (although this is based on a real company and although it I quite a large company, it nonetheless illustrates well the point I wish to make).

InterTech's 5 Year Profit Performance						
Performance (£ million)	Base Year	1	2	3	4	5
Sales Revenue - Cost of goods sold	£254 135	£293 152	£318 167	£387 201	£431 224	£454 236
Gross Contribution - Manufacturing overhead - Marketing & Sales - Research & Development	£119 48 18 22	£141 58 23 23	£151 63 24 23	£186 82 26 25	£207 90 27 24	£218 95 28 24
Net Profit	£16	£22	£26	£37	£50	£55
Return on Sales (%)	6.3%	7.5%	8.2%	9.6%	11.6%	12.1%
Assets Assets (% of sales)	£141 56%	£162 55%	£167 53%	£194 50%	£205 48%	£206 45%
Return on Assets (%)	11.3%	13.5%	15.6%	19.1%	24.4%	26.7%

Table 1: Profit performances (fictitious figures based on the context of a real company)

InterTech's 5 Year Market-Based Performance						
Performance (£ million)	Base Year	1	2	3	4	5
Market Growth	18.3%	23.4%	17.6%	34.4%	24.0%	17.9%
InterTech Sales Growth (%) Market Share (%)	12.8% 20.3%	17.4% 19.1%	11.2% 18.4%	27.1% 17.1%	16.5% 16.3%	10.9% 14.9%
Customer Retention (%) New Customers (%) % Dissatisfied Customers	88.2% 11.7% 13.6%	87.1% 12.9% 14.3%	85.0% 14.9% 16.1%	82.2% 24.1% 17.3%	80.9% 22.5% 18.9%	77.0% 29.2% 19.6%
Relative Product Quality Relative Service Quality Relative New Product Sales	+10% +0% +8%	+8% +0% +8%	+5% -20% +7%	+3% -3% +5%	+1% -5% +1%	0% -8% -4%

Table 2: Market-based performances (fictitious figures based on the context of a real company)

All facts and figures in this publication are presented in good faith and on the basis of information before us at the time of writing.

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(continued)

Without going into too much detail, the headlines are (approximately):

- A doubling of sales over a five year period
- A doubling of gross contribution
- A quadrupling of net profit
- A doubling of return on sales
- An increase in asset turnover
- A tripling of return on assets

On the face of it, this looks like a brilliant performance, until you look at the market-based information in Table 2, over the same five year period:

- The market grew faster than InterTech every year
- InterTech's market share dropped from 20.3% to 14.9%
- They used to keep almost 90% of their customers. Now they are losing over 20% every year
- Dissatisfied customers (from market research) have risen from. 13.6% to 19.6%
- InterTech used to have a superior product. Now it is the same as their competitors'
- Their service quality is negative in the market place
- Their new product sales compared with the market are negative

Even the stats about their lack of customer retention is misleading, because a quick glance at table 3 below shows that Intertech's customer retention is best (even though it isn't good) in the worst segment in the market whereas its worst performance is in the best segment (only 11% of all sales, but almost 25% of all industry profits).

	Total Market	Segment 1	Segment 2	Segment 3	Segment 4	Segment 5	Segment 6
Percentage of market represented by segment	100.0	14.8	9.5	27.1	18.8	18.8	11.0
Percentage of all profits in total market produced by segment	100.0	7.1	4.9	14.7	21.8	28.5	23.0
Ratio of profit produced by segment to weight of segment in total population	1.00	0.48	0.52	0.54	1.16	1.52	2.09
Defection rate	23%	20%	17%	15%	28%	30%	35%

Table 3: Measurement of customer retention by segment profitability

The whole point of this little case history is that:

- InterTech did well financially in a rapidly-growing market
- Over the five year period, their market/customer performance was truly appalling
- Their awful market performance was hidden by the financial reporting
- Soon after this market matured, InterTech almost went out of business

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So, financial information tells the directors very little about a firm's underlying performance, especially in growth markets, where Mickey Mouse or Donald Duck ought to be capable of making profits. But since such growth markets are hard to find today, the directors desperately need market-based information in order to assess the health and prospects for their organisation.

The second point to make about P&L Accounts is that there is only one line for revenue and lots of other lines for costs. The reason for saying this is that the whole point of this blog (i.e. how to generate profitable revenue) is not captured in board meetings and typically, the discussion of directors revolves around costs.

The third point relates to the pointlessness of Balance Sheets. Just look at Tables 4, 5 and 6 below:

Balance Sheet	
Assets	Liabilities
Land Buildings Plant Vehicles etc.	Shares Loans Overdrafts etc.
£100 million	£100 million

Table 4: Balance sheet (scenario A, with fictitious figures based on the context of a real company)

Balance Sheet	
Assets	Liabilities
Land Buildings Plant Vehicles etc.	Shares Loans Overdrafts etc.
£100 million	£900 million

Table 5: Balance sheet (scenario B, with fictitious figures based on the context of a real company)

Balance Sheet	
Assets	Liabilities
Land Buildings Plant Vehicles etc. Goodwill £800m	Shares Loans Overdrafts etc.
£900 million	£900 million

Table 6: Balance sheet (scenario C, with fictitious figures based on the context of a real company)

As you know, the purpose of a Balance Sheet is that it should balance (i.e. the left side – what we own – should match the sources of finance). These are labelled Assets and Liabilities.

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The problem occurs when a predator offers you £100 million and of course, you refuse and eventually settle for a sale price of £900 million. The problem now, of course is that the Balance Sheet no longer balances. This doesn't present a problem to accountants, however, as a sneaky little balancing factor is now added, labelled 'goodwill' – in this case £800 million. What this £800 million balancing figure is, of course, the size of the mistake made by accountants in valuing our company and the first time the size of the mistake comes to light is when someone buys us!

Yes, of course I know and understand the international financial rules (having been Chairman of a global brand valuation company), but the point I am making here is that tangible assets in most organisations rarely represent the real value of the company, which resides in brands, relationships with customers and the like and these frequently do not appear on Balance Sheets.

One of the best examples of this is shown in Table 7.

Intangibles	
P and G paid £31 billion for Gillette, but bought only £4 billion of tangible assets	
Gillette brand	£4.0 billion
Duracell brand	£2.5 billion
Oral B	£2.0 billion
Braun	£1.5 billion
Retail and supplier network	£10.0 billion
Gillette innovative capability	£7.0 billion
Total: £27.0 billion	
Source: David Haigh, Chairman of Brand Finance, Marketing Magazine, 1 April 2005	

Table 7: Intangibles

Proctor and Gamble (no idiots!) paid £31 billion for Gillette, but got only £4 billion of tangible assets.

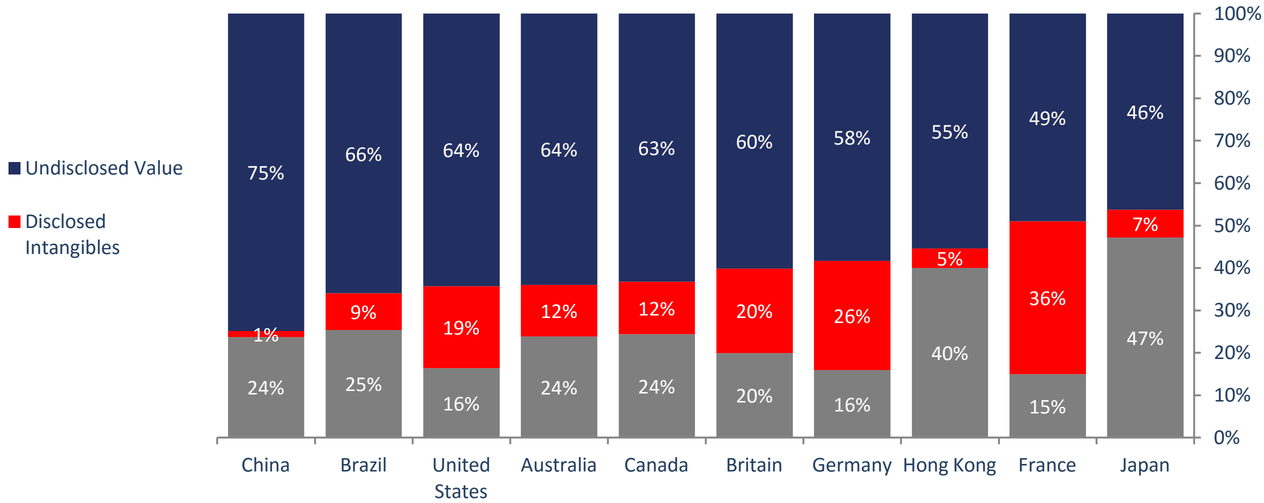

Figure 1 shows that in the USA, 73% of all corporate value resides in intangible assets, whilst in the UK it is 64%. Interestingly, the global intangible value of all quoted companies is 53%. The whole point in providing these figures is to remind organisations that their real value resides in their relationship with their markets and their customers, not in their tangible assets.

Reference

Based on "Malcolm McDonald on Marketing Planning, 2nd edition, Kogan Page 2016"

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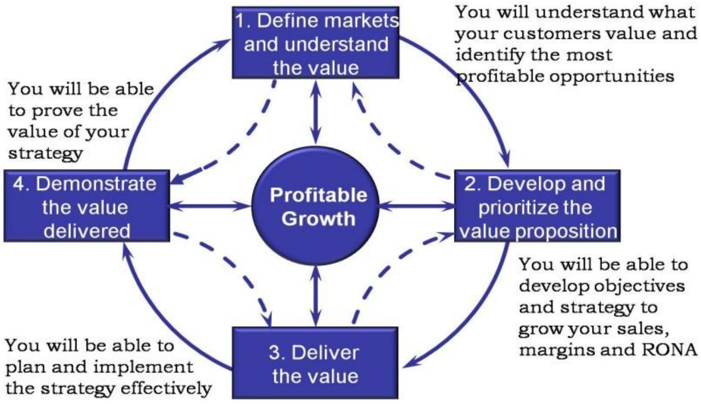
Malcolm McDonald Consulting Ltd. is a strategic sales and marketing consulting business.

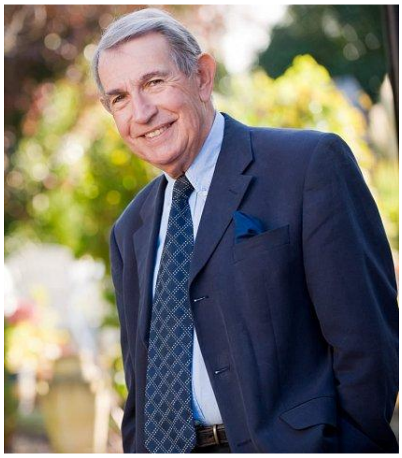
With our end-to-end interactions, from Board level to internal project team, we help companies create value through getting the fundamentals right in strategic sales and marketing, all within budget and the agreed deadline.

Professor McDonald and his team of consultants work with the Boards and internal teams of executives from a number of the world's leading multi-nationals on all continents.



Malcolm McDonald is Emeritus Professor of Marketing at Cranfield University, and Visiting Professor at Henley, Warwick, Aston and Bradford Business Schools. He authored over 40 books on marketing and key account management.

Coming from a background in business which included a number of years as Marketing Director of Canada Dry, Malcolm has successfully maintained a close link between academic rigour and commercial application. He has consulted to major companies from the UK, Europe, USA, Far East, South-East Asia, and Africa, in the areas of strategic marketing and marketing planning, market segmentation, key account management, international marketing and marketing accountability.



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