Become a High-Performance Company

It takes more than creating value to lead with the best—you have to sustain it for the long haul.

By Derrick Lilly

Financial reporting may be a monthly routine or a quarterly requirement, but it's also one of your best strategic planning tools. In fact, with the right metrics in place, financial reporting is your key to better business decisions and long-term value creation.

"Most non-financial users of financial statements look at them and think, 'Okay, if revenues are greater than costs and expenses then all is well.' And, if it happens to be more than last year, they think they're doing really well, but we need to shatter that myth," says Marian Powers, Ph.D., Kellogg School of Management's Allen Center for Executive Education at Northwestern University in Evanston, Ill., an instructor for the Illinois CPA Society's Center for Corporate Financial Leadership, and a director of the CPA Endowment Fund of Illinois. "A common misunderstanding is that earnings are all that's important because the marketplace puts an emphasis on it. But whether or not current earnings are more than last year does not determine whether or not your organization created value."

While earnings-per-share, net income, and price-to-earnings ratios are popular measures, on their own they reflect little in terms of value creation.

So what measure matters?

Finding Value's Number

Truthfully, no single metric will fit all situations. What really drives value creation are fundamentals. You need to compile and analyze multiple metrics to gain the best understanding of whether your organization's fundamentals are creating shareholder or company value.

Powers offers financial metrics that are linked to value creation and on which high-performance companies excel. They are derived from several in-depth studies that analyzed the financial performance of thousands of global companies. These organizations provided insights into not only key metrics, but also the strategies used by the highest performers and the most sustainable value creators.

"There are six key numbers and four key ratios to observe. If a company focuses on these, you can tell at a high level whether the firm is moving successfully towards value creation," she explains.

The key numbers are revenue, net income, cash flows from operations, total assets, total liabilities and total equity. And the key ratios are asset turnover (assets/revenue), profit margin (net income/revenue), cash-flow yield (cash flow from operations/net income) and debt-to-equity ratio (total liabilities/total equities).

"High-performance companies consistently do well on these numbers; if a company is not performing well on these ratios then a deeper dive into the six key numbers is warranted," says Powers. "When you examine the items that contribute to these figures, you can identify the changes and strategies warranted as a result of the performance." Although, she adds, "It's not just the accountant that needs to understand these numbers; the entire leadership team needs to understand how these ratios and the underlying amounts link to value creation, and evaluate them in the context of the organization's goals."

With the right data in hand, Powers suggests that organizations create internal performance benchmarks, "regardless of whether they're a for-profit or not-for-profit, public or private, with global, national or local operations."

To identify your ratio benchmarks follow these three steps:

1. Look back at historical figures over a time period that includes the best and worst years—and chart out performance over this time to reveal performance ranges and trends.
2. Where possible, find comparable measures within your specific industry to understand how your performance stacks up against industry peers.
3. Look forward and set performance targets for a one- to three- or one- to five-year timeframe based on your analysis of steps 1 and 2.

With benchmarks in place, you're off to a solid start for identifying value creation opportunities. However, while we know the performance measures on which high-performance companies excel, this knowledge doesn't give the whole picture.

"Performance measures provide the steering, guiding an organization to execute the strategies and plans it has established. The goal of every business should be to achieve superior long-term return on investment. Without this goal as a primary anchor for performance measures, companies lack the discipline that will help them make good decisions," says Mark L. Frigo, Ph.D./CPA/CMA, director of the Center for Strategy, Execution and Valuation, Kellstadt Graduate School of Business, Ledger & Quill Alumni Distinguished Professor of Strategy and Leadership at DePaul University, Chicago, and an instructor for the Illinois CPA Society's Center for Corporate Financial Leadership.

Put the Numbers to Work

So where do you start? According to Frigo, organizations need to accept that their existing performance measures may have flaws, and that there may not be a quick fix.

Powers adds that, "Finance leaders need to reexamine their financial statements and determine what kind of information is provided to decision-makers, and if best practices to communicate financial information across the organization are being followed.

"If users don't understand it, they won't use it or worse yet it will be used incorrectly," she continues. "CFOs and controllers need to consider, 'What are the best practices for presentation of financial information for decision-making?' and, 'How do we bring greater clarity and reduce the confusion about what the numbers mean?' Also, 'What are some things we can do in the way we deliver and communicate the information?'"

Next, Frigo emphasizes that from the top down management must focus on value creation and strive to motivate and guide its organization's activities towards that focus.

"CFOs can provide a strategic perspective on the financial performance measures. One of the strengths of high-performance CFOs is their ability to connect the strategy of the organization with the financial reports, and articulate how the organization intends to create shareholder value. They also need to be able to articulate how the organization intends to protect shareholder value (enterprise risk management)," he says.

"Finance leaders need to be strategic financial advisors who understand and make the case for value creation as a strategic goal for their organizations," adds Powers. "They can help the users of the information understand what the strategies are, and help management and staff focus their attention on the right things."

What's Right is Right

Defining what's right for an organization is influenced by matters of internal culture, goals, performance measures and, most importantly, management. But Frigo offers some universal advice: "Commit to ethically maximize financial value. Companies that abide by this rule show better financial results over long-term periods. Those that don't live by this guiding principle are some of the worst financial performers ever."

The difference between high performers, the mediocre and the worst performers often comes down to, "Doing the right things (ethical business conduct) for the right reasons (driving superior and sustainable return on investment)," which is why after extensive research into the activities of thousands of high-performance companies, it's a leading aspect of the Return Driven Strategy™ framework developed by Frigo and Joel Litman, and described in their book, *DRIVEN: Business Strategy, Human Actions and the Creation of Wealth*. The framework was developed to describe the pattern of strategic activities that have been proven to lead to superior and sustainable high performance. It helps organizations to focus on the activities that will produce superior return on investment, while limiting the risk of shareholder or company value destruction.

When organizations are creating their strategies for sustainable and ethical value creation, Frigo emphasizes the need to follow these five critical factors:

1. Commitment to ethically create shareholder value
   Conduct business within the ethical parameters of your constituents and communities, and commit to creating shareholder value by focusing on achieving superior long-term return on invested capital.
2. Target and fulfill otherwise unmet customer needs
   This avoids commoditization and drives superior returns by providing high value for customers. Mediocre companies tend to lose focus on their customer needs and are unable to align their offerings with the changing needs of customers.
3. Target and dominate the right customer groups
   Target customers with similar needs where the company has distinct competitive advantage, and become the dominant provider of those needs. As Peter Drucker, the "Father of Modern Management," said to former GE CEO and Chairman Jack Welch, "Be number one or number two in the industry or get out."
4. Innovate your offerings to better fulfill customer needs
   Innovation risk is the biggest risk faced by companies today and will stifle their ability to rebound from the recession. Innovation risk is the inability to change your offerings to better fulfill changing customer needs before your competitors do.
5. Disciplined performance measures which can drive sustainable shareholder value performance
   Stop counting and start measuring. Performance measures must be highly aligned with the tenets and foundations of the Return Driven Strategy framework. In today's business environment, performance measures should also include key risk indicators for effective strategic risk management.

Lastly, Powers urges organizations to be mindful of their weighted average cost of capital. "Many companies are not earning a return above their cost of capital (COC)," she says. Often, the focus on profit return dominates decision-makers' strategies. Instead, high-performance organizations stay focused on the finish line, "which is achieving a satisfactory cash return on their invested capital (ROIC)."

Frigo offers two simple benchmarks for this: Is your return on invested capital greater than your cost of capital ? (Is the spread between ROIC and COC increasing, stable or declining?) And, is growth accompanied by maintaining the ROIC-COC spread?

If turning your company into a high performer with clear goals for sustainable value creation is your mission, there's never been a better time to start. "All companies should do a strategy audit in 2010 to assess how well their business strategy is aligned with sustainable shareholder or company value creation," Frigo advises. "Following the financial crisis, most business strategies have become obsolete; they need to be reset." □

Find Value in Education

If making better business decisions, driving value creation and gaining higher returns are top of mind, these upcoming executive education courses led by educators Mark L. Frigo, Ph.D./CPA/CMA and Marian Powers, Ph.D. and offered through the Illinois CPA Society's Center for Corporate Financial Leadership can shed light on the strategies you'll need.

Developing and Executing Strategies for Growth & Profitability: The Return Driven Strategy™ Framework
Led by Mark L. Frigo, Ph.D./CPA/CMA, "Return Driven Strategy provides a clear and practical pathway to develop a business strategy aimed at achieving maximum long-term wealth creation for your company."

Using Financial Statements to Drive Better Business Decisions
Led by Marian Powers, Ph.D., this course will help you "Discover how you can enhance your role as a strategic business partner to help your company drive better business decisions through effective design, analysis and communication of financial statements."

Designing and Using a Balanced Scorecard Framework
Led by Mark L. Frigo, Ph.D./CPA/CMA, "This course will help you to design and use a Balanced Scorecard and Strategy Maps to align performance measures and targets to drive superior performance."

For more information and for schedules, visit ccflinfo.org.