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a newsletter on practical strategic planning and action
issue #16: are your financial statements an anachronism?

editor's message

We take for granted the format of today's financial accounting systems. However, the world has changed since those systems were put into place, and often the information they produce is not nearly as helpful as it could be. This month in Strategic Planning, we'll look at the shortcomings of today's financial statements, and in Strategic Action, we'll give you some suggestions on what to do about them. Our Industry Snapshot makes some observations on corporate boards and our Reading List features *Private Capital Markets* by Robert T. Slee.

strategic planning

What's Wrong with Today's Financial Statements?

The basic concept and form of the financial statements used today date back over 500 years to the merchants of Venice, Italy. It was then that the concepts of double entry accounting, general ledgers and balance sheets were recorded by a monk named Luciano Pacioli. The tools of the Venetian merchants actually served well throughout the Industrial Era. The key drivers of industrial business—inventories, machinery, plants and land—are clearly reported on today's balance sheets.

(An interesting history of accounting is available on the website of the Association of Chartered Accountants in the U.S. at www.acaus.org/acc_his.html)

But the business models of many of modern companies (and many of our clients), are not at all well represented in today's financial statements. There are essentially no inventory or fixed productive assets on the balance sheet of service companies because their products and work processes are intangible. Neither is the creation or reproduction of software clearly described through the traditional methods of accounting for inventory or fixed assets. A company's most important assets in the post-industrial world are often intangible and, therefore, excluded from the balance sheet.

Clearly, over time the field of accounting will adapt its systems to our changing economy. People such as NYU Accounting Professor Baruch Lev are doing extensive work on how to put dollar values on intangible assets (pages.stern.nyu.edu/~blev/). However, the role of the accounting profession as a keeper of universal standards means that they must act carefully and fairly—so change will not come quickly.

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For now, we are all on our own. We need to develop our own ways of measuring, managing and communicating the value of our intangible assets. If you face this challenge, read on in Strategic Action for some ideas on what you can do in your own company.

-Mary Adams (adams@trekconsulting.com)

strategic action

What Can You Do About the Shortcomings in Today's Financial Statements?

Most of us should not waste our time worrying about how the accounting world can address these shortcomings in the current standards. But we do have to deal with the consequences. The lack of standardized presentations of the full productive capacity of most companies—both tangible and intangible—is a problem at many levels. It limits the decision-making capacity of managers and Boards of Directors of most modern companies. It is also a barrier to fair valuation by investors or potential merger partners.

So, what can you do? Our advice is to come up with a summary presentation to supplement your financial statements that fully displays all of your organization's intangible assets. Essentially, you have two choices:

- Create a unique reporting system, along the lines of a corporate “dashboard” or “balanced scorecard” (although the latter is not specifically oriented to intangible assets). While this approach lets you custom-fit a system to your business, it does not allow comparisons across business divisions or between different companies. You also run the risk of missing important issues or metrics.
- Adopt a standardized system, such as the IC Rating™, which uses a consistent set of criteria to analyze the “intellectual capital,” of a business unit or company. This approach gives you a complete picture of all intangible assets and is comparable across business units, but it does not afford the same kind of customization as a home-grown system.

However you decide to proceed, it is important to develop a balance of information between internal and external metrics as well as quantitative and qualitative data. Trek has been helping its clients create their own measurement systems for years, and we still see value in both approaches. The IC Rating™ system is a relatively new addition to our offerings, and we will be telling you more about it over time. If you would like more information in the meantime, please feel free to contact me.

- Michael Oleksak (oleksak@trekconsulting.com)

industry snapshot

Corporate Boards

We recently had a meeting with a company's board of advisors for an introductory discussion about the company's strategy. We used a two-page summary of the company's product offerings and the structure of its market/competition. After our meeting, several members commented that they had a new understanding of the business, even though they had served on the board for several years. Their reaction surprised us all a bit. But we took a few lessons away from the experience:

- Take a step back. We all get mired in the day-to-day challenges—at the board level, at the management level, and at the personal level. The biggest challenge in today's world is not information; it is synthesis. That's why a "big picture" discussion can be so valuable.
- Take into account your board's background. Except for one or two people who are from the same or a related industry, most board members are usually from different businesses. So you really do need to educate them about the essentials of your business. By the way, there is huge value in having people from other industries—it brings a fresh perspective and allows in "stupid" questions that an industry insider would be embarrassed to ask. These kinds of basic queries can be the source of new ideas and innovation.
- Manage the role of the board. They should help you at both a strategic and a tactical level, but mostly at the strategic level. They should help you form your business model, manage your competitive position, and build for the future. Along the way, they can help you with the day-to-day challenges. But, don't get stuck just talking about the day-to-day; a board is too valuable a resource for that.

Can you explain your business model and competitive position in one or two pages? Now is as good a time as any to take a step back and give it a try. As we found out, you might learn something.

reading list

*Private Markets: Valuation, Capitalization
and Transfer of Private Business Interests*

By Robert T. Slee

Rob Slee spoke at a recent conference Trek attended on building private company wealth, produced by the Alliance for Corporate Wealth. Mr. Slee is the President of Robertson & Foley, a mid-market investment bank in Charlotte, NC. He is an interesting guy, and this is the first of several books he has planned.

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This book is written much like a textbook and is quite dense. It has numerous, detailed chapters in three sections: approaches to private business valuation, private company capital structure (including all kinds of lending and investing), and modes of business transfer. If you want a comprehensive source on the basics of all these topics, this is a great volume.

If you are familiar already with the basics of the private market, you still should know about this book. Snee is trying to shake up the business education world. He says that business schools teach finance that is based on corporate finance theories, such as capital asset or option pricing models, which are relevant to only the largest public companies in the U.S. These theories are irrelevant to most of the remaining companies, which make up most of the U.S. economy. He makes the case with this book that different theories reign in private markets, and that there is much room for improved understanding of these important and increasingly efficient economic systems. For more information on this book, visit www.robertsonfoley.com/book.html.

announcements

Mary Adams was quoted in Aqua Magazine (www.aquamagazine.com) on managing relationships with your bankers:

"Any surprise is bad for a banker. Even if it's a good surprise, bankers worry that if they were surprised by something good, they could be surprised next time by something bad."

In next month's issue, we will ask the question, "Do you have a compelling strategy story?"

about trek consulting

Since 1999, Trek Consulting has helped CEO's of early stage and middle market companies to face challenges of growth, change and succession. Our hallmarks are fresh information, disciplined analysis and practicality. We help you create specific action plans with metrics tied to revenues, costs or corporate value. Then we follow up to help you keep on track and/or adjust your plans as circumstances change.

Our clients report improved market focus, increased revenues, better margins and lowered costs. To learn more about Trek Consulting and how we can help you improve your company's results, visit us on the web at www.trekconsulting.com or call us at 781-729-1008.

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