Free Cash Flow provides three management disciplines: (1) managing to Free Cash Flow, not EPS; (2) focusing outward on key business drivers, not inward on budget variances; (3) using six integrated reports to fast focus on critical opportunities and issues.

Free Cash Flow: A Two-Hour Primer for Management and the Board

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A Two-Hour Primer
For Management and the Board

George C. Christy, CFA

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Introduction

Look at your email inbox and the inbox sitting on your desk. How many internal company reports - budget reports, sales reports, production reports, progress reports, problem reports - arrive in your inboxes each month? How much time do you spend each month reviewing these reports? How much time do you spend each month communicating with your colleagues by email, phone or in person about the reports? The aggregate company-wide hours invested in the production, analysis and discussion of company reports represents a significant allocation of management time. Not only are you and your colleagues inundated with a helter-skelter hodgepodge of management reports, but many of the reports focus on financial metrics that do not maximize company valuation. *Free Cash Flow* provides three disciplines you can use to manage your company to maximum valuation:

1) Company valuation is maximized by managing to Free Cash Flow, not to GAAP net income.

2) Company valuation is maximized by focusing *outward* on key business drivers, not *inward* on profit center budget variances.
3) Company valuation is maximized by placing all critical internal and external data into a concise report for each of the company's key business drivers so that management can *fast focus* on key trends, issues and opportunities.

Chapter 1 highlights some frequently abused financial vocabulary, defines Free Cash Flow and then enumerates the advantages of using Free Cash Flow as your company's primary financial management tool. Chapter 2 addresses the fundamental flaws in the conventional annual budget exercise and lays the groundwork for the rest of the book. Chapters 3 through 8 provide six sample management reports that incorporate the three disciplines listed above. It will be up to you to modify the six sample reports to fit the specific needs of your company, but at least you will not have to start with a blank page. Chapter 9 is a brief wrap-up and conclusion.

There is a one-page Glossary after Chapter 9. You may wish to make a copy of it and have it handy as you read the book.

Chapter 1
Free Cash Flow

GAAP was never intended to be a *management* tool.

The Securities Exchange Act of 1934 gave the SEC the statutory authority to establish financial accounting and reporting standards for publicly-owned companies. All publicly-owned companies in the U.S. must file quarterly financial statements consistent with both the SEC's requirements and with Generally Accepted Accounting Principles (GAAP). Since 1973, the SEC has delegated the promulgation of GAAP accounting rules to the Financial Accounting Standards Board (FASB). The FASB has always considered investors and creditors – *not* company management - as the primary users of GAAP financial statements. In formulating GAAP rules, the FASB does not focus on what accounting information is needed by company management to manage the company efficiently and effectively in order to maximum valuation. GAAP financials are designed to give outside investors and creditors a snapshot of a company's financial condition at a particular point in time.

Your company's outside investors and creditors have no choice but to depend on GAAP - you have a choice.

If your company is publicly-owned, it must issue quarterly financials in complete accordance with GAAP. GAAP matches expenses with revenues so that external users such as investors and creditors are not misled if they pick up the latest company financials and draw conclusions based only on one or two periods of financial results.

But you are not an external user. You do not need to be "protected" by GAAP's averaging and smoothing of your company's financial results. You do not need to be distracted by GAAP's complex structure and countless accruals.

Why should you use GAAP in managing your company when (1) you do not have to do so and (2) there is a superior metric you can employ not only to maximize your company's long term valuation but also to minimize your company's exposure to risk. The superior metric is Free Cash Flow (FCF). Before we define Free Cash Flow and explain why it is superior to GAAP as a management tool, we need to consider several other "cash flow" terms that are frequently abused in the financial world.

First, by "cash flow" we do not mean EBITDA.

EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) is frequently used as a proxy for cash flow in structuring acquisitions and other corporate finance transactions. EBITDA is not an adequate proxy for cash flow because it (1) includes non-cash expenses in the "Earnings" component; (2) excludes cash required for working capital investment and (3) excludes cash required for long term investments such as capital expenditures. Those who rely on EBITDA are essentially saying it does not make any difference whether a company generating $10 million in operating income requires $2 million or $4 million in additional working capital and capital expenditures to increase sales by 20%. EBITDA and EBITDA multiples are not only flawed shortcuts – they are also unnecessary shortcuts when you are analyzing your own company because you have access to all company data. Only after seeing what EBITDA does *not* tell you about your own company's financial operations can you fully appreciate what EBITDA does not tell you about other companies' cash flows. The next time someone shows you EBITDA multiples in support of an acquisition price, beware. Make sure the target's working capital and long term investment requirements are explicitly addressed in the valuation calculations.

Second, by "cash flow" we do not mean the GAAP Statement of Cash Flows. The GAAP "Cash Flow" is a cash flow statement *in name only*.

The GAAP Statement of Cash Flows accompanies the income statement and balance sheet in a public company's quarterly financial disclosures. While the Statement of Cash Flows provides some information not provided by the income statement (the most important is the period's depreciation expense) and by the balance sheet, the GAAP Statement of Cash Flows has several serious problems. GAAP rules allow companies substantial latitude in classifying items in the "operating", "investing" or "financing" sections of the Statement. For example, a company that finances new equipment with a capital lease is not required to include the cost of the new equipment in either the investing section of the report or in the financing section (the amount must be disclosed in a footnote). Another example: some companies classify insurance reimbursements for fixed asset losses (resulting from a fire, flood, etc.) in the "operating cash flow" section rather than in the "investing" section and some companies do the reverse. Another example: in 2005, some Fortune 500 companies were ordered by the SEC to reclassify the sale of their captive

finance units' receivables from "investing" to "operating", thereby reducing "operating" cash flow. Another example: if a company sells a division and receives a tax benefit from the sale, that tax benefit appears in the "operating" section rather than in the "investing" section. Another example: so many public companies had been incorrectly classifying cash flow from discontinued operations that the SEC in early 2006 was forced to allow companies to issue corrections that required no restatements. There are many more examples.

The GAAP "Cash Flow" is nothing more than a reconciliation of the change in the balance of the "Cash and Cash Equivalents" account to the changes in the other balance sheet accounts (and indirectly to the numbers in the income statement). Both the GAAP balance sheet and income statement are riddled with accruals, some of which are disclosed and some of which are not disclosed.

Free Cash Flow has none of the disadvantages of EBITDA and the GAAP Statement of Cash Flows. Free Cash Flow captures all cash flows in and out of the company, is not distorted by accrual items, and includes changes in working capital and capital investments.

Free Cash Flow = Revenues MINUS cash expenses PLUS non-revenue cash receipts PLUS or MINUS cash changes in working capital MINUS capital expenditures

We include only cash expense and income items because *only cash* funds the payroll, pays suppliers and taxes, funds customer receivables and inventory, buys equipment, pays the rent or mortgage and funds dividends and your bonuses.

The "Free" in Free Cash Flow means that after the company funds cash expenses and the changes in receivables, inventories and fixed assets required to generate the revenues, the remaining cash flow is "free" to be used for whatever management decides is best for the company. Wall Street analysts and investment bankers typically exclude interest expense and debt principal repayments from Free Cash Flow in order to focus on a company's core operating cash flows. We include interest expense and other financing fees but exclude loan principal repayments in our definition of Free Cash Flow. Principal repayments will be captured in an important ratio included in the Corporate Report in Chapter 7.

The following table lays out a reconciliation of Free Cash Flow with the GAAP income statement. It begins at the top with (I): a sample GAAP

income statement for a company with Revenues of $10,000 and Operating Income of $1,000 (for simplicity's sake we exclude taxes and interest income/expense). Then in (II) we convert the GAAP income statement into a cash operating statement by adjusting the GAAP operating income of $1,000 so as to remove non-cash expenses as well as cash payments not expensed. The adjustment examples listed here are just several of many accrual items that need to be removed from the GAAP income statement. Because Operating Cash Flow is only a partial picture of a company's cash flow chain, in (III) we include the net *change* in the working capital accounts (only Accounts Receivable, Inventory and Accounts Payable are included for now) as well as capital expenditures and asset sales. Now the cash flow chain is complete because it combines the company's margins (i.e., the cash operating results) with the company's utilization of capital (i.e., the cash change in working capital and the capital expenditures). You can not only analyze your company's historical performance with Free Cash Flow, you can also construct Free Cash Flow projections to see how various "what if" scenarios affect product, project or company cash flows.

Reconciliation of GAAP Income Statement and Free Cash Flow

(I) GAAP Income Statement		
Revenues	$10,000	100%
Cost of Sales	7,000	70%
Gross Profit	3,000	30%
Selling	300	3%
G&A	1,500	15%
R&D	200	2%
Total Operating Expenses	2,000	20%
Operating Income	1,000	10%
(II) GAAP Income Statement Converted to Operating Cash Flow		
Add non-cash expenses in GAAP Income Statement		
Depreciation	500	5%
Product warranty accrual	300	3%
Other non-cash expenses	200	2%
Sub-total	1,000	10%
Subtract cash payments not expensed in GAAP Income Statement		
Warranty costs incurred	-200	-2%
Other	-100	-1%
Sub-total	-300	-3%
Operating Cash Flow	1700	17%
(III) Reflect Cash Impact of Working Capital Change and Capex		
Increase in Inventory	-300	-3%
Increase in Receivables	-200	-2%
Decrease in Accts. Payable	-100	-1%
Change in Working Capital	-600	-6%
Drill Press	-200	-2%
Computers	-200	-2%
Sale of Vehicles	100	1%
Total Capex	-300	-3%
Free Cash Flow	800	8%

Unlike GAAP net income, Free Cash Flow is simple and transparent. Because Free Cash Flow is devoid of the accrual estimates and judgments of the GAAP income statement, what you see in Free Cash Flow reflects what is actually happening in the company. The GAAP income statement reflects countless accounting assumptions, estimates, and predictions - all executed in a valiant attempt to match expenses and revenues. A few examples of these estimates are depreciation, bad debt reserves, warranty cost reserves, restructuring expense reserves, inventory obsolescence reserves, pension fund returns, and customer discount estimates. While individual accruals may be too small to matter, accruals in the aggregate are often material in their impact on earnings per share. When that is the case, accruals can distort and obfuscate financial results more than they enhance stability and consistency.

It is no surprise that in 2005 almost 1,200 public companies had to issue restatements of their GAAP financials. In other words, after the CEO and CFO signed off on the financials, after the outside auditors signed off, after the Board of Directors signed off, after the quarterly earnings press release was issued, after the 8 – K was filed and after shares were bought and sold on the basis of the reported yet flawed financials, 1,195

companies had to issue 1,796 separate corrections to their financial statements. GAAP, with more than 10,000 pages, is not as long as the U.S. tax code but it is too complex to be useful as a management tool. Setting aside the tax effects of the 1,796 corrections, how many of the corrections do you think affected actual cash flow?

In designing your internal management reports, the farther you stray from cash flows and unit volumes, the weaker, less useful and possibly more misleading is the linkage between your management reports and what is really happening inside your company. It is pointless to combine your GAAP income statement numbers and your product unit volume numbers in the same analysis. But cash flow numbers and unit volume numbers go together very nicely. The sample reports provided in this book will hopefully give you practical suggestions on this critical point.

Free Cash Flow has the entire company cash and valuation chain – revenues, margins, working capital and capital expenditures - in one comprehensive formula.

The GAAP income statement provides revenues but the margins are distorted by a host of accrual items. Also, the GAAP income statement

says nothing about the working capital and long term investments required to generate the revenues. You must refer to the GAAP balance sheet and "cash flow" statement to calculate the working capital and fixed asset changes. Free Cash Flow provides more useful information than the GAAP statements and does so in one concise formula – not in three pages. A management team that can aim the Free Cash Flow formula like a laser at not only overall company operations but also at individual products and customer relationships has a substantial advantage over its competitors floundering in accrual fog.

Free Cash Flow facilitates a disciplined focus on the overall cash implications of your business decisions.

By focusing on Free Cash Flow, you become more sensitive to the cash implications of your decisions and are therefore less likely to manage the company into a cash flow bind. In addition, using outside capital is often necessary but always expensive. The more effective your company's cash flow management, the less outside capital you must use, the fewer capital provider restrictions you must satisfy, the less interest you must pay, the less of your company's equity you must share with others. All of

the foregoing "less" items translate into more valuation for your company.

Maximizing Free Cash Flow maximizes your company's options and opportunities. Maximizing GAAP earnings can maximize trouble.

The greater your Free Cash Flow at a given level of revenues, the greater your company's ability to take advantage of opportunities such as developing new products or building a new plant. Strong cash flow gives you more flexibility. Weak cash flow reduces your choices and puts the company on the defensive. Weak cash flow also creates a bunker mentality that discourages risk-taking and aggressive exploitation of market opportunities. Excessive focus on earnings per share may temporarily increase your stock price, but not for long to the extent the stock price is dependent on flawed accrual estimates. David Henry's outstanding *Business Week* article, "Fuzzy Numbers," is one of the best reviews in recent years of accrual abuses *permitted* by GAAP. "According to … Richard G. Sloan of the University of Michigan Business School and Scott Richardson of the University of Pennsylvania's Wharton School, … companies making the largest

(accrual) estimates - and thus reporting the most overstated earnings – initially attract investors like moths to a flame. Later, when the estimates prove overblown, their stocks founder. They lag, on average, stocks of similar companies by 10 percentage points a year, costing investors more than $100 billion in market returns. These companies…have higher incidences of earnings restatements, SEC enforcement actions, and accounting related lawsuits, notes Neil Baron, chairman of Criterion Research Group ….”[1]

Academic research on company valuation long ago concluded that a company's stock price is determined by the stock market's assessment of the company's *expected cash flows*, *not* by the company's historical or expected GAAP earnings.

GAAP EPS as a valuation tool has long been discredited by academic research. While the research articles are too technical to deal with here, a number of valuation authorities have written readable books that draw on the original research. For example, Dr. Alfred Rappaport, Professor Emeritus of Northwestern University, is the author of *Creating Shareholder Value*, a leading book on financial management. Professor

Rappaport explains that expected cash flows, rather than GAAP earnings, is the primary determinant of stock prices. He also points out that public company announcements regarding changes in accounting methods do not affect stock prices unless there are also changes in expected cash flows.[2]

McKinsey & Company's Tim Koller, Marc Goedhart and David Wessels are the authors of *Valuation, Measuring and Managing the Value of Companies*. They assert: "Share prices are determined by long-term cash flows."[3] The authors also show that earnings announcements affect stock prices only when the news suggests long-term cash flows will be affected. Changes in accounting practices that do not affect long-term cash flows do not affect stock prices. Koller, Goedhart and Wessels state: "The market is not interested in accounting choices; investors care about underlying performance."[4]

Earnings per share (EPS) and the price/earnings ratio (PE) remain the dominant language of Wall Street research reports but a growing number of sell side analysts and institutional investors employ Free Cash Flow in their valuation models.

The brokerage firm research analysts (the sell side analysts) provide target prices and buy / hold / sell recommendations on the stocks they cover. The analysts' research reports are used by individual investors as well as by institutional investors (the buy side) who do not have their own research analysts or choose to use brokerage firm research reports to supplement their own research efforts.

Sell side analysts use PE multiples (the Price/Earnings Ratio EQUALS the stock price DIVIDED by the earnings per share) to derive target stock prices from their estimates of future earnings per share. Over the next five to ten years, the Wall Street analyst corps will experience the retirement of the baby-boomer analysts. Most baby-boomer analysts will be replaced by Chartered Financial Analysts (CFA's) and MBA's, both of which have been schooled and drilled in Free Cash Flow. While the new sell side analysts will still communicate with investors using EPS and PE, most will also derive stock valuations using a Free Cash Flow model.

Because of the rapid growth in the institutional investment management business in recent years, there has been a strong demand for new buy side analysts and portfolio managers. Many of these new positions have

been filled by MBA's and / or CFA's. Like the new sell-side analysts, most of these new hires have been taught in business school or in the CFA curriculum to use Free Cash Flow in their valuation analysis. The impact of the recent MBA's and CFA's and their Free Cash Flow valuation models has probably been stronger on the buy-side than on the sell-side because the rapidly growing buy-side has undoubtedly hired many more MBA's and CFA's in recent years than has the shrinking sell-side. It is only a matter of time before most of the larger firms on the buy-side employ Free Cash Flow as an important tool in their valuation metrics (and the sell-side will follow their clients, the buy-side, in adopting Free Cash Flow).

A number of major Wall Street investment management firms have made substantial investments in sophisticated software in order to circumvent some of the problems with GAAP accounting.[5] This software strips away the GAAP accruals in public company financial statements in order to calculate Free Cash Flow. These Wall Street firms are not investing in special software to eliminate the impact of the depreciation expense on earnings per share! They have concluded the aggregate impact of the many non-cash items in the GAAP income statement are materially

distorting the financial results of public companies. Wall Street firms are convinced they can make money for themselves and their clients by removing the GAAP veil to find Free Cash Flow.

Most LBO firms, private equity firms and hedge funds use Free Cash Flow models when they evaluate investments in private and public companies.

LBO firms, private equity firms and hedge funds have accounted for an increasing share of the M&A market. These financial buyers typically employ cash flow models in assessing current and future valuations of prospective investments. Why? They have learned, sometimes the hard way, that GAAP numbers are problematic at best and misleading at worst. They use Free Cash Flow because that is the best way to evaluate the potential of an investment to produce the required rate of return. Also, these investors frequently use debt to acquire complete or partial ownership of a company. Their analysis of a company's ability to generate Free Cash Flow to repay the debt is an important part of their due diligence analysis.

Warren Buffett uses cash flow rather than GAAP earnings to value

companies. In Robert G. Hagstrom's *The Essential Buffett*, we learn: "Through the years, financial analysts have used many formulas for calculating the intrinsic value of a company. Some are fond of various shorthand methods: low price-to-earnings ratios, low price-to-book values, and high dividend yields. But the best system, according to Buffett, was determined more than 60 years ago by John Burr Williams in *The Theory of Investment Value*. Paraphrasing Williams' theory, Buffett tells us the value of a business is the total of the net cash flows (owners' earnings) expected to occur over the life of the business, discounted by an appropriate interest rate."[6]

Hagstrom also paraphrases Warren Buffett making the same point in even stronger language: "Buffett reminds us that the value of any stock has nothing to do with its price-earnings ratio, or price-to-book ratio, or dividend yield. The only way to determine the value of a stock, or any other investment, is by discounting to present value all the future cash flow streams."[7] After Warren Buffett evaluates a target company's cash flows and buys the company, do you think he manages the acquired company to GAAP EPS or to cash flow?

While using Free Cash Flow to manage your company has compelling

advantages, GAAP will remain for the foreseeable future the accounting standard for public company financial statements. But just because the FASB (staffed by CPA's anointed by the SEC to write the accounting rules) and the SEC itself (staffed by securities lawyers and CPA's whose training and experience does not include corporate valuation or managing a business) stipulate the rules your company must follow in reporting its financial results to the public, that does not require you to use GAAP to manage your company. Of course, if you wish to defer to accountants and securities lawyers on the subject of business management and valuation, that is your privilege. But first consider this: in deciding whether to finance your company, bankers and professional investors subject your company to a cash flow analysis and make their decisions on the basis of the projected cash flows, not on your company's historical and projected earnings per share. We have a 2 – 2 tie score here: two groups of highly paid professionals (the CPA's and the securities lawyers) sponsor GAAP while two other groups of highly paid professionals (the bankers and professional investors) prefer to use Free Cash Flow. Question: which side do you think knows more about corporate valuation? Go ahead, break the tie.

Q&A

Question: How much difference does it make to use Free Cash Flow rather than GAAP EPS as my company's primary management tool? Why should I take the risk of trying to persuade my board that it will make a difference and that the difference justifies the time and dollars we would have to spend in order to do it right?

Answer: Only you can answer your question. You need to decide how much of a difference it will make for your company if you implement some or all of the recommendations in this book. One way to answer the question is to start in small steps. After you finish the book, ask your CFO to prepare a side-by-side comparison of your company's GAAP net income and Free Cash Flow over an appropriate timeframe (there is additional information on calculating Free Cash Flow in Chapter 3). There are also sample peer comparisons in Chapter 8 that may shed light on the relative strengths and weaknesses of your company as compared to some of your competitors. Start small and work with Free Cash Flow using the sample reports provided later in the book.

Question: In the long run, do not GAAP EPS and Free Cash Flow end up more or less in the same place? Why reinvent the wheel if you are only dealing with a minor timing issue?

Answer: If you are talking about an accrual accounting income statement and a cash statement eventually ending up at the same place, the answer is "No, not in the real world." For example, if depreciation were the only GAAP accrual and the company had only one depreciable asset, then once the asset were fully depreciated the income statement and the cash statement would be the same. But a "going concern" does not have only one accrual. In any year there are numerous accrual accounts being debited and credited. And what may be "more or less the same place" for one accrual will not be for the other accruals. More importantly, a management team that year after year allocates resources and measures success in terms of Free Cash Flow will deliver a superior long term valuation compared to a management team that lives by GAAP net income and EPS.

Question: Our analysts and institutional investors grill us about quarterly

earnings per share. If Free Cash Flow is so important, why don't they emphasize it?

Answer: They are speaking the language of the Street. They are not your financial analysis instructors. The next time you meet with analysts or institutional investors, ask them about their views on EPS and Free Cash Flow as (1) valuation analytics and (2) management tools to maximize valuation. Is EPS or Free Cash Flow more important in their valuations and what are their reasons?

Question: Should not Free Cash Flow include total working capital and total fixed assets? By including only changes in working capital and period capital expenditures, you seem to be ignoring a large chunk of capital.

Answer: If there are no changes in any of the working capital accounts in a period (compared to the previous period), working capital will neither generate nor consume cash. Free Cash Flow captures only changes in net working capital because only changes affect cash flow.

The same is true for Capex.

Question: Why should private companies adopt Free Cash Flow?

Answer: First, managing your company to Free Cash Flow will maximize your ability to do the things you most want your company to do. You cannot buy equipment or make your payroll with GAAP net income. Second, if you manage your business year-in and year-out to maximize Free Cash Flow rather than revenues or net income, you will be maximizing the price at which you eventually sell your business. Buyers pay for cash flow, not GAAP net income. Further, if you sell your company to a buyer who finances the purchase with debt, the buyer and the buyer's financing source(s) may be able to support a higher price based on their assessment of the acquired company's ability to generate cash flow to service the acquisition financing. Net income does not fund interest and principal payments – only cash flow does. If you sell your company to a financially sophisticated buyer (Fortune 1000, private equity firm, LBO firm) they will use Free Cash Flow in their primary valuation model. If you take your company public, you will be given a

higher price because the Street will use Free Cash Flow to value your company's shares.

Question: You point out that Wall Street firms have paid for software that strips out GAAP accrual changes in order to estimate Free Cash Flow. This means that the SEC has not done its job in regulating public company financial disclosure requirements. It is obvious that individual investors who do not have access to the Street software analyses are not on a level playing field with these Street firms and their clients. Why has the SEC not required public companies to add to the income statement a two line disclosure of the net impact of the period's accrual changes on earnings and earnings per share?

Answer: Good question.

Question: If the SEC were to require public companies to disclose the impact of accrual changes, what would be the relative benefit of this new requirement to investors, particularly individual investors, as compared to the benefits of Sarbanes-Oxley (SOX)?

Answer: Good question.

Question: What would the relative cost to public companies of this new disclosure requirement be compared to the costs of Sarbanes-Oxley?

Answer: Good question.

Question: What if the SEC were to require public companies to include a Free Cash Flow report with their quarterly financial reports? Investors would then be able to better understand a company's real cash flows.

Answer: Good idea.

Question: Surely the combination of the accrual impact disclosure and a Free Cash Flow statement in each quarterly report would provide more value to investors than much of SOX?

Answer: Absolutely.

Question: Doesn't the SEC usually wait for Congress to react to scandals like Enron and Worldcom rather than take the initiative? By then the political pot is boiling over and reasoned debate is difficult. As long as SEC Commissioners are almost all securities attorneys, can we expect substantive progress toward disclosure transparency? If a majority of the Commissioners were former institutional investors, do you think we would have a more level investment playing field? At least there would be greater transparency in public company financial disclosures.

Answer: You've got that right.

Chapter 2
Fast Focus Outward

The annual budget is the primary management performance tool in corporate America. Once each year, the development of the annual budget's assumptions, revenue and earnings' targets consume a massive amount of management time. The collective hours allocated to the creation of the annual budget are exceeded only by the countless hours devoted by management to the monthly and quarterly budget reviews. Each budget report is reviewed, analyzed and discussed in numerous meetings throughout the company. The most attention is given to the budget variances, especially each profit center's negative variances against plan.

In addition to the monthly budget reports, countless reports are distributed throughout the course of each month to management. Most of these reports provide data specific to the subject of the report - monthly sales numbers, accounts receivable delinquencies and charge-offs, headcount, production data - and are usually presented in a format

unique to the subject. In order to design a management decision-making tool that is focused both on Free Cash Flow and the key business drivers, we must start from scratch and build a new Management Information Package.

The new Management Information Package uses Free Cash Flow, not GAAP net income, to measure performance and establish goals.

Chapter 1 explained why Free Cash Flow is superior to GAAP net income as a management tool. Free Cash Flow is too important as a value-building management tool to be buried in a monthly avalanche of internal reports. The Free Cash Flow discipline must be front and center in your Management Information Package.

The new Management Information Package focuses on the company's key business drivers rather than the conventional budget's focus on the company's internal business units.

The conventional budget format appears as if it were intentionally designed to concentrate management's focus inward into the company's business units. Is a company's long term success determined by how

well its internal profit centers and cost centers adhere to the annual budget? The absence of negative budget variances is not indicative of a sustainable business strategy. A zero variance company can enter an endless tailspin in the time it takes to say “We made budget!”

A company’s long term success is determined by its ability to meet its customers’ needs while selling competitively priced products and services for more than the cash required to produce and deliver the products and services. There is no question that variance management and accountability are an important element of management. The question is: where should management spend *more time* - looking inward at budget variances or looking outward at its markets and major customers? Everything else being equal, management teams that give priority to the major drivers of their business will generate superior results when compared to the results of the variance experts.

The new Management Information Package provides the critical information needed to efficiently and expeditiously manage each major business driver as well as key corporate metrics.

An effective Management Information Package maximizes

management's ability to focus quickly on the most important issues and promptly make sound decisions supported by the relevant facts and judgments. The important management information on your company's primary business drivers that is worth talking about, writing about and meeting about should not be scattered in a variety of reports that appear in your inboxes at different times throughout the month. The key information should appear before you in *one concise, integrated package*. Only if your company produces one concise, integrated Management Information Package is it practical to have a focused senior management meeting to review, assess, debate and decide what action needs to be taken regarding the company's primary business drivers.

There should be one management meeting – not a sales meeting and the next day a budget review meeting and a day later a production meeting and two days later a strategy meeting followed the next week by a new product meeting. The more disparate reports and meetings, the more difficult it is to identify and stay focused on the top priorities. The more reports and meetings, the more difficult it is to co-ordinate the different disciplines and organizational units in the company. The more narrowly focused each report and each meeting, the more difficult it is to see

cross-divisional patterns and trends that require senior management attention. The more reports and meetings, the easier it is to implement hidden agendas and deflect questions and challenges to "the other meeting." The fewer reports and meetings, the more difficult it is for senior management to spend time on subjects that do not merit senior management time.

The format of the individual business driver reports and the overall company reports should be consistent - you should be able to easily move from one report to another and see the relationships between the individual driver numbers and the aggregate corporate numbers. An effective Management Information Package accelerates management's *focus speed*. The faster and more focused the interaction between management and the right information, the faster management sees and exploits opportunities, sees and overcomes challenges, sees and minimizes risks. A company's focus speed can be a potent competitive advantage.

The new Management Information Package will not replace the conventional budget. The new report package will displace the conventional budget as the company's *primary* performance

management tool. Public companies have no choice but to report their financial results using GAAP numbers. But for most companies, the GAAP budget process can be largely confined to headquarters staff. Everyone else in the company can concentrate on increasing the company's valuation rather than spending too much time on negative budget variances.

Free Cash Flow uses two business drivers in the Management Information Package: (1) the company's major products or services (the highest selling products or services) and (2) the company's major customers (the largest customers ranked by sales). Most business-to-business companies derive a large portion of their revenues from a relatively small number of their products. The same holds true for customers. If it's not a case of 80/20 (80% of revenues are derived from 20% of customers), it may be 70/30 or 60/40. By focusing most of your time on your company's major customers and major products / services, you will be concentrating your most limited resource (your time) on your company's most important opportunities and issues.

Why have major customers and major products / services been chosen as the primary drivers in the Management Information Package? To be sure,

major customers and products do not qualify as "business drivers" in the academic sense. But if you can have before you all of the critical information about each of your major customer relationships and each of your major products / services, you can quickly identify what needs to be done to make sure your company's Free Cash Flows are protected and increased. By focusing most of your time and efforts on your most important customers and products, you will optimize the company's overall results and eventually the company's valuation.

Of course, the above definition of "business driver" does not hold for all companies. Rather than use major customers, some companies may prefer to categorize their revenues by direct sales, distributors, government, Internet, etc. Similarly, retail firms deal directly with consumers, so major customer does not apply. Some retail companies use POS data to group retail customers. Other retail options would be major stores, major regions, or major channels such as stores, catalogue and website sales.

As you review the report samples that follow, you may think some of the report data should be graphed. Graphs can help you see trends and make quick comparisons, but try to limit the number of graphs. The key

advantage of the *Free Cash Flow* report format is simple: the critical data on each major business driver is on one page, so it is much easier for you to see the interrelationships of the various metrics.

The new report package does not have to be a monthly report – your business may well be better served by some other schedule. You may also want to see certain pieces of information on a more frequent basis than the scheduled Management Information Package.

The next chapter covers the Major Product Report and in so doing lays the foundation for the other reports in the book.

Free Cash Flow provides three management disciplines: (1) managing to Free Cash Flow, not EPS; (2) focusing outward on key business drivers, not inward on budget variances; (3) using six integrated reports to fast focus on critical opportunities and issues.

Free Cash Flow: A Two-Hour Primer for Management and the Board

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