Chapter 6: Understanding Your 3 Key Documents

UNDERSTANDING BUSINESS FINANCIAL STATEMENTS

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As a business leader and manager, you have several tools or "things" to help you do your job. Each of them is very important, and brings a unique quality to your organization. Understanding what they are, how they are organized, the nature of each one, and the unique attribute of each will help you better manage your business. Below is a description of the four most basic.

Information

Information includes very high level, organization-wide direction such as mission, vision, values, strategies, etc. This high level direction is broken down into more tactical information such as objectives, metrics, key performance indicators, and supporting policies. Tactical information is developed even further to support day-to-day operations such as procedures, work instructions, and plans. Additional information that supports the business is likely to include laws and regulations, the market, customers, competitors, suppliers, etc. This information can take the form of traditional paper, files, posters, etc., or electronic documents.

Keys to good information management;

- Accurate and Organized
- Protected and Secured
- Accessible and appropriately Communicated
- Followed by Employees

> Summary and unique quality – information provides direction at a strategic level, tactical level, and to support day-to-day operations.

Employees

Employees are the heart of the organization. They bring judgement, individual knowledge, energy, motivation, collaboration, and teamwork. They use the business information to provide them with direction at all levels. While many human resource topics need to be managed, such as recruitment, training, performance, payroll and benefits, safety, and others, the key to success with people is leadership.

Keys to good employee management;

- Leadership that Directs and Inspires
- Activities that Involve and Engage
- A Culture that Empowers

> Summary and unique quality – employees bring energy, and there is no substitute. Without it, everything else comes to a standstill.

Money & Financials *(the topic of this lesson)*

Money is used as a common denominator in business. Nearly all business related activities and components can be referred to in terms of money. Information, salaries and labor costs, training, safety, equipment, facilities, sales, raw materials, etc. can all be measured (with differing levels of accuracy) with money. Organization financials are also used to measure business performance such as revenues, expenses, profits, assets, liabilities, and equity. Because money is relatively universal, it's used to compare different companies, industries, and economic conditions. Financial statements are like a "blood test" for the business. They can tell you the relative health of the organization, and give you data to make good decisions.

Keys to good financial management;

Summary and unique quality – financials are a common denominator and consistent way to measure business performance.

- Good and timely Data reflected in Financial Statements
- Understanding what the Financial Statements are telling us
- The ability to be Proactive and/or React to Changing Conditions
- Having the Discipline to follow Financial Plans

Material - Equipment & Facilities

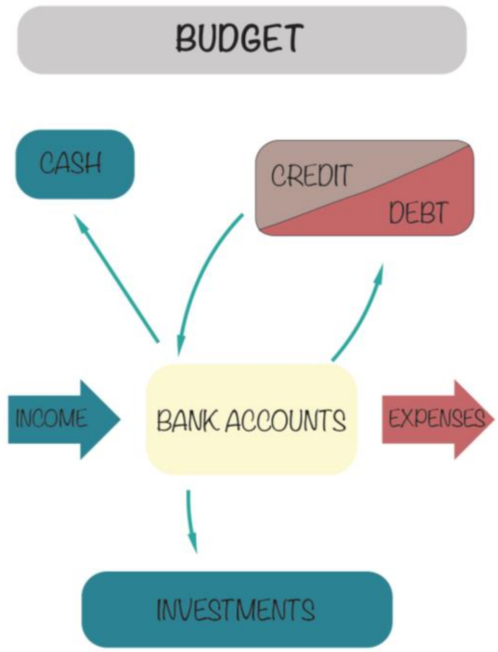
Material such as equipment and facilities is the most tangible asset of most businesses. It is used to enable, enhance, and multiply the efforts of employees. It is also usually defined by the industry within which the business operates and the products and services the business produces. Material often times requires large sums of capital investment (money) in order to acquire. Because of the advances in technology, equipment is ever changing and in some industries requires continual updating.

Summary and unique quality – material enables, enhances, and multiplies the efforts of employees.

Keys to good equipment & facilities management;

- Establish and maintain Safe working conditions
- A good Return on Investment (ROI) analysis before purchase
- Meeting expected levels of use in order to generate acceptable output and return
- Total Productive Maintenance Programs to ensure performance and value

Financial Basics



- See the Financial Overview diagram.
- The four basic financial statements elaborate and further detail each of the elements of the Financial Overview diagram.
- These statements are not mutually exclusive to the elements on the diagram, but rather overlap, connect, and have an impact on each other.

The diagram above illustrates one way of looking at the basics of an organization's financials. In a very over simplified example, it begins with money coming into the organization and moving into bank accounts. Expenses are paid and leave the business. If income exceeds expenses, there will be cash available and investments can be made. If expenses exceed income, the organization will need to acquire debt in order to remain in business, as long as they have good credit. Of course, the financial objective is to have more income than expenses and thus increasing profitability and business value.

Income Statement

The Income Statement is also known as Profit & Loss (P&L) and Statement of Financial Activities. It captures financial data regarding what the business "did" over a period of time – in the past. Typically covers periods of one month, one quarter (three months), and one year, but can cover any period of time.

The top begins with Revenue that is income usually from sales of products and/or services. These revenues are sometimes broken out into specific families of products or services. In manufacturing operations, where the costs of production materials is a significant cost of the overall price of the product (reflected in Revenues), Cost of Goods Sold (COGS) is taken out below, and close to the revenues. This allows the reader to recognize Gross Profit before Operating Expenses are considered.

After Revenues less COGS (Gross Profit), Operating Expenses are listed. They will include things like salaries and payroll, insurance, rent, supplies, etc. Expenses that correlate directly to sales are considered "variable", while those that do not are considered "fixed", or "overhead". Total Operating Expenses are summed. Gross Profit less Total Operating Expenses results in Operating Income. Other Income and/or Expenses, not related to operations are then included. The "Bottom Line" is then calculated and labeled "Net Income".

Opportunities for improving the "Bottom Line" will include increasing Revenues and/or decreasing Expenses.

Balance Sheet

The Balance Sheet is also known as Statement of Financial Position. It captures financial data regarding what the business "has or had" at one point in time – in the past or nearly at present. The three main elements of a Balance Sheet are Assets, Liabilities, and Equity.

Assets are things that have value to the business. At the top and left of the Balance Sheet begins a list of Assets. These assets are in order of most to least liquid. Most common assets are cash, accounts receivable, inventory, investments, buildings and equipment, land, and goodwill.

Liabilities are obligations that reduce the financial value of the business. Liabilities are positioned either on the right of the Balance Sheet or just below the Assets. Liabilities are listed from top to bottom in order of when payment of principle is due. The most common Liabilities are accounts payable, short-term notes payable, wages payable, taxes payable, long-term notes payable, and bonds payable.

Equity is simply the difference between Assets and Liabilities. It is shown on the right hand side of the Balance Sheet and below Liabilities. The business' financial objective is to increase Equity (Balance Sheet) which originates from positive Net Income (Income Statement). Most common forms of Equity are stock and retained earnings.

Other opportunities to improve the Balance Sheet are to have the Assets be "earning", such as well managed inventory, effective equipment use, and interest income. Also, minimizing the costs associated with Liabilities such as interest expenses.

Cash Flow Statement

There are several different types of Cash Flow Statements. The included worksheet represents one very useful format. It is used to track cash activities and positions from the past, and project future cash activities and positions. Because cash is used to pay expenses and make investments in the business, it is important that cash be managed well.

The Cash Flow Statement has similar characteristics of the Income Statement, in that it tracks money (Cash only) coming into and leaving the business. But the Cash itself is an Asset which is a part of the Balance Sheet.

One of the Cash Flow Statement's greatest uses in business operations is having a projection of the cash position at different points in the future. This can help the business leader make informed decisions on paying expenses, making investments, or owners withdrawing Cash. It can also give them a "heads-up" to potential cash problems in advance.

Budgets

A budget is a statement that represents what a business "expects to do" financially. It looks at both the past and the future. A budget also looks similar to an Income Statement, but across the top usually identifies the full Year's Budget, the Year-to-Date (YTD) Budget, Year-to-Date (YTD) Actual, and Year-to-Date (YTD) Variance.

This statement compares financial expectations to actuals, for both Revenues and Expenses. An individual department within the business may only receive the line items that apply to that part of the organization. Budgets, much like all other financial statements, will help business leaders make informed decisions with respect to managing the business. It can show what parts of the organization are performing well, and what areas need improvement.

Other Related Topics

- Metrics – Help businesses measure performance in often non-financial, quantifiable ways using things like leading and lagging indicators.
- Ratios & Competitiveness – Can help a business compare their performance with others in their industry.
- Efficiency – Financial data can be used to calculate the return on investments (ROI) which is often an indication of how well the organization is being operated.
- Cost Accounting – The financial topic concerning the determination of true costs to produce a product or deliver a service with special emphasis on the allocation of overhead.
- Break-Even & Finance – Topics revolving around new business ventures and ways to pay for them.
- Insurance – Protecting assets and in many cases, complying with the law.
- Taxes & Audits – Managing the expense of doing business in the country, state, or local area, and the associated validation of following the law.
- Risk Management – Using several types of data, including financial, to mitigate risk while still working to achieve an objective.
- Business Valuation – The process of predicting what someone is willing to pay for a business, and understanding the variables associated with what will change that value.

SAMPLE INCOME STATEMENT - PROFIT & LOSS STATEMENT

For the period 1 August 2018 to 31 August 2018 (What the company "**did**".)

					Notes
Sales Revenue:					
		Total			
	Less:	*Returns & Allowances*			
		Sales Discounts			
		Total		( )	
	Net Sales Revenue				
Cost of Goods Sold (COGS):					
	Beginning Finished Goods Inventory				
	Cost of Goods Manufactured				
	Cost of Goods Available for Sale				
	Ending Finished Goods Inventory		( )		
Cost of Goods Sold (COGS):				( )	
Gross Profit:					
Operating Expenses:					
Total Operating Expenses:				( )	
Operating Income:					
Other Income &/or Expenses:					
Net Income:					

SAMPLE BALANCE SHEET

As of 31 August 2018 (What the company "**has**" at one point in time.)

Assets

Current Assets:	
Total Current Assets -	
Investments:	
Fixed Assets:	
	( )
Total Fixed Assets -	
Intangible Assets:	
Total Intangible Assets -	
Other Assets:	
Total Other Assets -	
Total Assets:	

Liabilities

Current Liabilities:	
Total Current Liabilities -	
Long-Term Liabilities:	
Total Long-Term Liabilities -	
Total Liabilities:	

Stockholders' Equity

	( )
Total Stockholders' Equity:	
Total Liabilities & Stockholders' Equity:	

SAMPLE CASH FLOW STATEMENT						
6-Month - 2018 (Can be historical or future.)						
	July	August	September	October	November	December
Cash, Beginning						
Operations						
Cash Reciepts from:						
*						
*						
*						
Cash Paid for:						
*						
*						
*						
*						
*						
*						
*						
*						
*						
*						
*						
*						
*						
Net Cash Flow from Operations:						
Investing Activities						
Cash Reciepts from:						
*						
*						
Cash Paid for:						
*						
Net Cash Flow from Investing:						
Financing Activities						
Cash Reciepts from:						
*						
*						
Cash Paid for:						
*						
Net Cash Flow from Financing:						
Total Cash, Ending						

			Calendar Year 2019 **Budget**	Year to Date (YTD) **Budget**	Year to Date (YTD) **Actual**	Year to Date (YTD) **Variance**
SAMPLE BUDGET						
For the period 1 January 2019 to 31 December 2019 (What the company "**plans to do**".)						
Sales Revenue:						
		Total				
	Less:	*Returns & Allowances*				
		Sales Discounts				
		Total				
	Net Sales Revenue					
Cost of Goods Sold (COGS):						
Gross Profit:						
Operating Expenses:						
Total Operating Expenses:						
Operating Income:						
Other Income &/or Expenses:						
Net Income:						