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# **Finance for non-financial managers**

MTD Training

# Finance for Non-financial Managers



Finance for Non-financial Managers

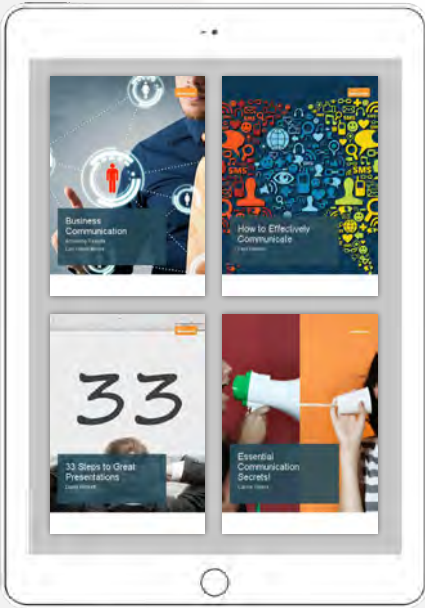
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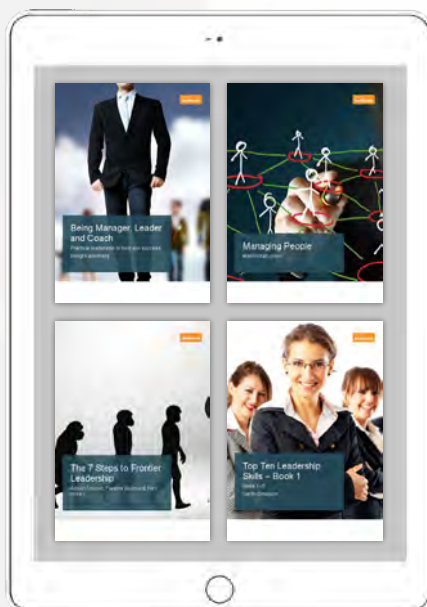


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# Preface

Today's managers need to be more commercially aware more so than ever before. Even if they do not have to manage budgets or finances themselves as part of their role they still need to understand about the financials of a company, what it all means and the impact of their actions on the bottom line.

In this textbook you'll receive a thorough grounding that explains what all of the financial statements of a company means from a "non finance" point of view. Explained in easy to understand language, you will soon gain a great insight into the finance aspects of a company even if you have no direct input into the financials yourself.



Sean McPheat, the Founder and Managing Director of management development specialists, MTD Training is the author of this publication. Sean has been featured on CNN, BBC, ITV, on numerous radio stations and has contributed to many newspapers. He's been featured in over 250 different publications as a thought leader within the management development and training industry.

MTD has been working with a **wide variety of clients** (both large and small) in the UK and internationally for several years.

MTD specialise in providing:

- In-house, tailor made management training courses (1–5 days duration)
- Open courses (Delivered throughout the UK at various locations)
- Management & leadership development programmes (From 5 days to 2 years)
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MTD provide a wide range of management training courses and programmes that enable new and experienced managers to maximise their potential by gaining or refining their management and leadership skills.

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# 1 Introduction

## 1.1 Understanding Finance Basics

People can spend a lifetime studying the principles of finance in the business world. The financial situation of an organization is impacted by every decision made and every action taken. In fact, you could argue that everything a business every does is actually somehow a financial activity. For example, you lose a customer and it impacts revenue. You spend money on a marketing campaign that has a huge return and you've made a positive financial investment. If you don't keep your team members on task, you're effectively wasting company resources.

You could argue that everything a business does is actually somehow a financial activity.

Non-financial managers in an organization can still benefit from understanding finance because they will then be aware of how their decisions impact the overall financial health of the organization. They can become more conscientious about their decision making and their operations in order to help the organization's bottom line. If you are a small business or an independent entrepreneur, understanding the basic principles of finance could mean the difference between your business surviving and thriving or failing. You need to understand how to read a budget, create a budget, and to invest your resources to get the maximum benefit that you can.

## 1.2 Three Basic Finance Principles

If you want to be financially aware, even as a non-finance manager, you have to be able to look at your actions and the actions of your team in terms of basic financial principles. You don't have to assign a dollar value to every activity, but you should think in large terms about how your decisions will impact the financial well-being of the business.

Remember too that there are both direct and indirect impacts on the organization's finances. For example, you might deny a customer a credit on their bill that they feel they deserve because you are saving money for the organization. But if that customer leaves your organization for the competition, you have indirectly impacted the company's finances in a negative manner because you have lost the future revenue that the customer would have provided.

You don't have to assign a dollar value to every activity you undertake, but you should think in large terms about how your decisions will impact the financial well-being of the business.

There are three basic principles that form the framework for all corporate finance:

- **The Investment Principle**

Every business invests assets and incurs debts of some sort, even if the debt is in the form of equity owned by the owner or a partner.

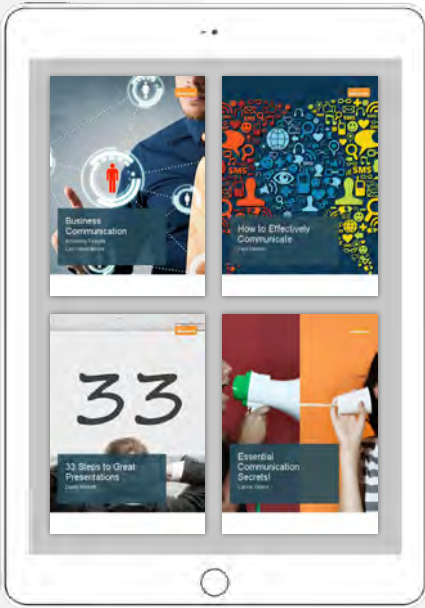
- **The Financing Principle**

Businesses can finance their operations with a mixture of tools that include investments in assets or borrowing money such as through loans or bonds. Or, they could sell stock if they are publicly traded. This mixture can depend on several things such as legal issues, the business' willingness to take on risk, and the capital available versus the capital needed.

- **The Dividend Principle**

A successful business will eventually need to return some money to its investors. This could be the owner taking some cash out of the till or it could be in the form of stock dividends. Again, it depends on many characteristics of the business such as legal form and requirements, size, and what those receiving the dividends prefer.

In essence, the way an organization manages its finances is guided by these three principles. However, the way in which the principles are applied will vary greatly from organization to organization.



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### 1.3 Basic Finance Terms

Finance has its own “lingo.” In order to help you understand what is explained in the rest of the ebook, you should have some basic terms under your belt. Figure 1 lists some of the most commonly used terms in corporate finance.

|                  |  |
|------------------|--|
| Assets           | Items owned by the business (see Capital Assets, Current Assets and Fixed Assets)  |
| Bonds            | Certificates of debt which are issued by an organization in order to raise funding. The bond holder earns a fixed rate of interest (usually) and the bond must be repaid by a specific date. |
| Capital          | Assets available to be invested with the intention of creating new assets.   |
| Capital Assets   | Tangible property that is not easily converted into cash. Capital assets are usually held long-term and include things like buildings, equipment, and other owned items.                     |
| Capital Budget   | The plan a company has to finance existing or new capital assets. Organizations usually have a capital budget and an operating budget. (See operating budget).                               |
| Current Assets   | The company's total of cash, accounts receivable, and other assets that could be converted into cash within a year. This is the money usually used for day-to-day operations.                |
| Debt Financing   | Creating capital by incurring debt such as by selling bonds or notes.  |
| Equity           | 1) The total of a company's assets minus its liabilities<br>2) Ownership interest in a corporation in the form of stock  |
| Expenses         | Any cost of operating the business   |
| Fixed Assets     | Long-term, tangible assets that are used by the business and that the organization does not plan to convert to cash in the current or next fiscal year.                                      |
| Liabilities      | A financial obligation such as debts, claims, or losses  |
| Operating Budget | A projection of estimated income and expenses during a specific period. An operating budget is short-term, usually for one year, while a capital budget is long-term.                        |
| Revenue          | Income generated as part of the operations of the organization before liabilities are subtracted.  |

**Figure 1:** Basic Finance Terms

### 1.4 Overview of the Ebook

#### 1.4.1 Financial Information Every Organization Needs

We'll start the conversation about finance by looking at the kind of information that every organization has to keep track of regarding their financial transactions. We'll discuss:

- The importance of the three main financial reports:
- The Balance Sheet
- The Income Statement
- The Cash Flow Statement

- The main tools of bookkeeping, including:
- What a Chart of Accounts is, how it is organized, and why it matters
- The General Journal
- The General Ledger

#### 1.4.2 The Balance Sheet

In the next chapter, we'll take a closer look at the Balance Sheet. We'll examine:

- How one is created
- What information it includes
- What it tells you
- What it doesn't tell you

#### 1.4.3 The Income Statement, The Cash Flow Statement

In the following two chapters, we'll look at the same information for the Income Statement and the Cash Flow Statement as we did for the Balance Sheet. By the end of this discussion, you should understand the difference between the statements as well as how they are related.

#### 1.4.4 Understanding Budgets

In this chapter, we'll look at budgets as more than just a document that describes the way that revenue will be allocated and spent by the different departments. It's also a policy document that states the organization's priorities and demonstrates how the organization plans to use its resources to accomplish them.

#### 1.4.5 Pricing

Determining how to set prices is one of the most challenging and important decisions that an organization can make. We'll look at how prices are set and what elements should be considered when determining how to position an organization's products and services from a price point of view.

#### 1.4.6 Applying Your Knowledge

This final chapter will take the theoretical information you've learned in the previous chapters and will discuss ways that any manager can apply the knowledge in their decision making and day to day operations.

## 2 Financial Information Every Organization Needs

### 2.1 Introduction

Since the goal of all businesses is to maximize profits, the management team needs information to help them navigate financial decisions. All businesses produce financial statements that provide different information about the organization's financial health. That information is used by the senior managers to make important decisions regarding the organization's future. The three main financial statements that are produced are:

- The Balance Sheet (also called a Statement of Financial Condition or Statement of Financial Position)
- The Income Statement (also called a Profit and Loss Statement, Statement of Operations, or Statement of Earnings)
- The Cash Flow Statement

If you are a manager, you will want to be familiar with these documents so that you can read and interpret the information. Then you can apply that information to operating your own division or department. In the following chapters, we'll look at each of these statements individually to understand:

- How the statement is created
- How to read the statement
- What the statement tells you, and just as importantly –
- What the statement does not tell you

However, none of these financial statements can be created without information from your organization's accounting or bookkeeping information.

### 2.2 Bookkeeping (Accounting)

Bookkeeping is the act of keeping up with the changes in an organization's accounts. Every time your organization performs a transaction of any kind, the accounts (books) change. For example, if you operate a retail establishment and you make a sale, the inventory of that item or items decreases and the amount of your cash increases. Various ledgers and journals are used to track these changes. Those ledgers and journals are then used to create the financial statements listed above.

Accounting has one very fundamental equation:

$$\text{Total Assets} = \text{Total Liabilities} + \text{Equity}$$

In other words, what the company has in value is the difference between what they own and what they owe. It works the same for you as an individual. Your net worth is the total of your assets minus any debt that you owe. For a business, there are usually just more assets and liabilities to calculate.

To see this more easily, just rewrite the equation as:

$$\text{Equity} = \text{Total Assets} - \text{Total Liabilities}$$

In either version of the equation, what will happen when a transaction occurs? At least two of the factors will change for any transaction. So, for example, if your equity increases, your assets must have increased or your liabilities must have decreased – or both. Accounting is the process of tracking all of these changes in the financial equation. The accountant or bookkeeper must then be able to record the information and report the information in ways that are helpful for those that are making decisions about the operations and direction of the organization.

## 2.3 Chart of Accounts

The tool used to track the changes described above is the Chart of Accounts. A business has specific accounts within their chart which correspond to the assets and liabilities that the organization has. For example, some accounts in the chart of accounts for a temporary agency might be:

- Assets:
  - Cash
  - Accounts Receivable
  - Equipment
- Liabilities:
  - Salaries
  - Benefits
  - Advertising
  - Accounts Payable

However, there are usually dozens – if not hundreds – of accounts under both assets and liabilities. It depends on how the organization tracks all of their finances. For example, if you work for a large corporation with multiple departments, you will have more accounts in your Chart of Accounts than if you are a one-man consulting firm.

In conventional accounting, all of the accounts the company uses are grouped together by like categories and then are numbered according to a standard format. The conventional numbering system is:

- Assets 101–199
- Liabilities 200–299
- Equity 300–399
- Revenue 400–499
- Expenses 500–599

Some organizations might use 600s for expenses. And an organization can also add account identifiers to further subdivide an account. For example, you could have an expense account 501 for “utilities” and add identifiers for each utility so that it might look like this:

- 501001 – Gas
- 501002 – Power
- 501003 – Water
- 501004 – Waste Disposal



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Or, an organization with multiple departments that also budgets and tracks expenses by departments could use sub-identifiers to denote an expense for each department. So, for example, perhaps all utilities for the organization start with a 501, then all the Marketing department utility expenses add a sub-identifier of 001, followed by another sub-identifier to denote the actual expense. So, let's imagine you're looking at all the charges for waste disposal across multiple locations. It could look like this:

- Marketing: 501004-001
- IT: 501004-002
- Training: 501004-003

Another way of dividing the chart of accounts is to have the first part of the account number identify the source of the fund that is used to pay for the expense or the destination fund of where the revenue will be going. You see this when an organization has regulations that limit or define how revenue needs to be used. For example, if your organization has received a government grant, you may have to use that grant only for specific activities. You can use your chart of accounts to help you track the expenses you use that grant money for, which will make your life easier if you have to demonstrate your use of the grant funds.

## 2.4 The General Journal (Original Book of Entry)

The General Journal is used to record transactions that occur. Today, this is usually done electronically with financial software, but of course it used to be done in a large written journal. In order to record transactions correctly, you need to know the rules accountants used called "transaction analysis." The two rules are:

- Asset and Expense accounts increase with a debit and decrease with a credit.
- Liability, Equity, and Revenue accounts increase with a credit and decrease with a debit.

Imagine that you purchase a computer with \$600 in cash and \$1200 store credit. An example of a General Journal entry for this transaction is shown in Figure 2.

Notice that the purchase of one item required an entry for three different accounts. You can see the name of each account under "description" and the number of the account under column 'F'. The General Journal is kept in chronological order, which can be very helpful if you need to look back over the history of your transactions.

However, there is one glaring piece of information that is missing on the General Journal. You don't see any information about the balance in each account that you have impacted. For example, just by looking at the General Journal, you don't have any idea how much cash you have left after the purchase of the computer. To track the changes in account balances, your accounting team uses a General Ledger.



## GENERAL JOURNAL

PAGE 2

| FY20XX |    | Description  | F   | Debit | Credit |
|--------|----|--|-----|-------|--------|
| Nov    | 22 | Equipment  | 144 | 1,800 |        |
|        |    | Cash   | 101 |       | 600    |
|        |    | Accounts Payable   | 200 |       | 1,200  |
|        |    | Purchase of Computer with \$600 cash and \$1200 store credit |     |       |        |

**Figure 2:** Example of General Journal Entry

## 2.5 The General Ledger

The General Ledger is organized by ledger accounts. There is one ledger account for each account in your Chart of Accounts. The accountant will take the information from the General Journal and post it to each of the General Ledger accounts that were affected by the transaction. Again, this is normally done electronically today, with software that automatically posts to the ledger accounts each time you enter a transaction in the General Journal. But just to be sure you understand how the information is posted, let's look at an example of how we would post to the ledger accounts from the General Journal entry in our example from Figure 2 again.

## GENERAL JOURNAL

PAGE 2

| FY20XX |    | Description  | F   | Debit | Credit |
|--------|----|--|-----|-------|--------|
| Nov    | 22 | Equipment  | 144 | 1,800 |        |
|        |    | Cash   | 101 |       | 600    |
|        |    | Accounts Payable   | 200 |       | 1,200  |
|        |    | Purchase of Computer with \$600 cash and \$1200 store credit |     |       |        |

You're going to want to post to three accounts:

- Equipment (144)
- Cash (101)
- Accounts Payable (200)

Figure 3 shows the three entries you would make in the General Ledger.

#### GENERAL LEDGER

##### Equipment Account #144

| FY20XX |    | Description | F  | Debit | Credit | Balance |
|--------|----|-------------|----|-------|--------|---------|
| Oct    | 31 |             |    |       |        | 4,200   |
|        |    |             |    |       |        |         |
| Nov    | 22 | Computer    | J2 | 1,800 |        | 6,000   |

#### GENERAL LEDGER

##### Cash Account #101

| FY20XX |    | Description | F  | Debit | Credit | Balance |
|--------|----|-------------|----|-------|--------|---------|
| Oct    | 31 |             |    |       |        | 3,700   |
|        |    |             |    |       |        |         |
| Nov    | 22 | Computer    | J2 |       | 600    | 3,100   |

#### GENERAL LEDGER

##### Accounts Payable Account #200

| FY20XX |    | Description | F  | Debit | Credit | Balance |
|--------|----|-------------|----|-------|--------|---------|
| Oct    | 31 |             |    |       |        | 800     |
|        |    |             |    |       |        |         |
| Nov    | 22 | Computer    | J2 |       | 1,200  | 2,600   |

**Figure 3:** Examples of General Ledger Account Entries

To read the entries, here is an interpretation of the information:

- The first entry in each ledger shows the balance from the previous month
- In Column F, the reference is to the page in the General Journal (J for Journal, 2 for the page number) where the item was recorded.

Now that the information is posted, the financial statements that need the information can be prepared.



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# 3 Balance Sheet

## 3.1 Introduction

Now you've seen how the day-to-day recording of transactional information is recorded. But how do you put it into a format that can help you see the financial state of the organization? This is where the Balance Sheet comes in. It is a 'snapshot' of the finances of the business at one given time. The information given includes what the business owns and what it owes.

There are three sections to the Balance Sheet:

- Assets – the items of value owned by the company
- Liabilities – the company's obligations, whether to pay for or provide goods or services at a future date
- Equity – remembering our equation from Chapter 2, equity is the amount of net assets (assets – liabilities)

A Balance Sheet gets its name from the fact that the total of the assets listed must equal the total of the liabilities and equity – in other words, the two sides of the sheet must balance. For an example of a Balance Sheet, see Figure 4. It's a relatively simple example, since most businesses will have many more accounts under their assets, liabilities, and equity categories on their Chart of Accounts. But you can get the basic idea for how the information is shared via the Balance Sheet.

## 3.2 What a Balance Sheet Tells You

There is good information on the Balance Sheet, such as:

- A summary of the organization's assets and the claims against those assets as of a specific date.
- Information about the organization's current ability to pay its current debts. You can only tell at the moment, for the liabilities that the accounting team has already entered into the financial system. If a large liability were to be incurred tomorrow, the financial picture could shift significantly.
- The information shows how the organization is positioned to keep going with the day to day business operations. For example, the assets listed give you some idea of what you have available right now to keep trying to generate new assets (new revenue).
- The Balance Sheet also shows what claim the owners have against the business' assets. Of course, this is conditional on the other liabilities being satisfied.

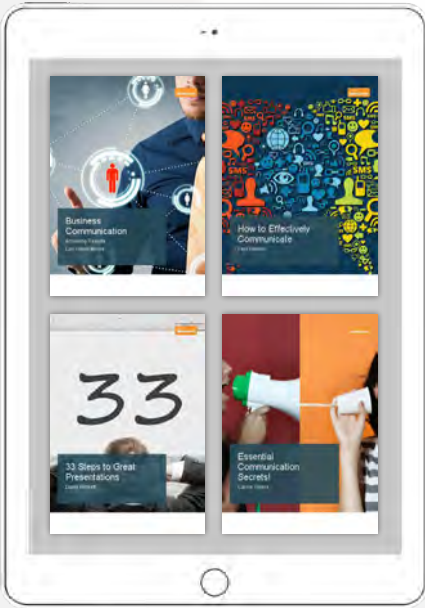
| ABC Enterprises         |               |                                       |        |               |
|-------------------------|---------------|---------------------------------------|--------|---------------|
| Balance Sheet           |               |                                       |        |               |
| As of November 30, 20XX |               |                                       |        |               |
| Assets                  |               | Liabilities                           |        |               |
| Cash                    | 8,500         | Bank Loan                             | 5,000  |               |
| Inventory               | 14,000        | Accounts Payable                      | 1,200  |               |
| Accounts Receivable     | 2,200         | Total Liabilities                     |        | 6,200         |
| Equipment               | 4,600         |                                       |        |               |
|                         |               | <b>Equity</b>                         |        |               |
|                         |               | Paid in Capital                       | 15,000 |               |
|                         |               | Retained Earnings                     | 8,100  |               |
|                         |               | Total Equity                          |        | 23,100        |
| <b>Total Assets</b>     | <b>29,300</b> | <b>Total Liabilities &amp; Equity</b> |        | <b>29,300</b> |

Figure 4: Sample Balance Sheet

### 3.3 What the Balance Sheet Doesn't Tell You

Of course, there are several parts of the financial picture that are not included in the Balance Sheet. For example, the Balance Sheet does not tell you:

- How any profits were made. For that information, you'd need to look at the Income Statement.
- Which assets creditors have claims against. For example, if you are financing equipment, your creditor has a claim against that equipment until it is paid.
- What kind of capital investment was made. You might assume that we're talking about cash, but instead, the owner or owners might have purchased a building that is not necessarily convertible back to cash (at least not immediately).
- What value the business would have on the market place. For example, if the owner purchased that building for \$50,000 10 years ago, it might be worth twice that now. Or, it could even be worth less if the real estate market has suffered since then.



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# 4 The Income Statement

## 4.1 Introduction

During the fiscal year, any organization will have changes in its finances. The changes could be positive or they could be negative. But the senior management of an organization will want to know the answers to questions like:

- How well are we doing financially?
- Are we earning a profit?
- Are we running at a loss?
- How is our profit in comparison to the competition?
- Are we likely to continue earning profit?

To answer these and similar questions, you can use an Income Statement.

## 4.2 Elements of the Income Statement

Whereas the Balance Sheet offers a snapshot of an organization's finances at one given point in time, the Income Statement looks at incoming revenue and outgoing expenses over a period of time. For the Income Statement we use the following definitions:

- Revenue – incoming assets in return for sold goods or services (cash or accounts receivable, for example).
- Expenses – outgoing assets or liabilities incurred (accounts payable, inventory sold or supplies used, for example).
- Net Income – the difference between Revenue and Expenses.

With all of this information, the Balance Sheet shows you whether you are generating a profit or you are operating at a loss. For an example of a Balance Sheet, see Figure 5.

| Widget Works, Inc.                    |         |  |
|---------------------------------------|---------|--|
| Income Statement                      |         |  |
| For the Month Ended February 28, 20XX |         |  |
| <b>Revenue</b>                        |         |  |
| Sales Revenue                         | 9,700   |  |
| Consulting Revenue                    | 2,000   |  |
| Investment Revenue                    | 550     |  |
| <b>Expenses</b>                       |         |  |
| Salaries                              | 3,800   |  |
| Benefits                              | 400     |  |
| Rent                                  | 800     |  |
| Utilities                             | 325     |  |
| Supplies                              | 675     |  |
| Inventory                             | 2,000   |  |
| Depreciation                          | 875     |  |
| Total Expenses                        | 8875    |  |
| <b>Net Income</b>                     | \$3,375 |  |

Figure 5: The Income Statement

The bottom figure on the chart in Figure 5 is the Net Income. This is the difference between the organization's assets and its liabilities. It is the amount by which the equity of the organization increases or decreases in a given period. This amount would also be recorded in an equity account, also called a Retained Earnings account, depending on the type of organization yours is. This takes us back to the Balance Sheet. Remember the sample Balance Sheet created for ABC Enterprises in the last chapter? Here it is again. Notice where the Retained Earnings amount is listed.



| ABC Enterprises         |               |                                       |        |               |
|-------------------------|---------------|---------------------------------------|--------|---------------|
| Balance Sheet           |               |                                       |        |               |
| As of November 30, 20XX |               |                                       |        |               |
| Assets                  |               | Liabilities                           |        |               |
| Cash                    | 8,500         | Bank Loan                             | 5,000  |               |
| Inventory               | 14,000        | Accounts Payable                      | 1,200  |               |
| Accounts Receivable     | 2,200         | Total Liabilities                     |        | 6,200         |
| Equipment               | 4,600         |                                       |        |               |
|                         |               | Equity                                |        |               |
|                         |               | Paid in Capital                       | 15,000 |               |
|                         |               | Retained Earnings                     | 8,100  |               |
|                         |               | Total Equity                          |        | 23,100        |
| <b>Total Assets</b>     | <b>29,300</b> | <b>Total Liabilities &amp; Equity</b> |        | <b>29,300</b> |

It's important to realize that just because the organization has a positive Net Income for the month, that doesn't mean that they have that amount in cash available. Income can include more than just cash, such as interest earned from investments or financing could also be included as Retained Earnings. In order to know exactly what cash is still available at the end of the month, you would create a Cash Flow Statement. We'll look at how to do that in the next chapter.

### 4.3 What an Income Statement Tells You

The income statement tells you:

- The main sources of income earned
- Secondary sources of income earned
- Some information about the organization based on the categories of revenue that are listed. For example, “Sales Revenue” tells you that the organization sells a product or service, while “Fees Earned” would tell you that the organization is a professional service provider of some kind.
- What items have no value left for the company because they are expenses – they will not generate any new income for the organization
- Whether or not the organization is operating with a loss or if they are operating with balanced revenues and expenses



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## 4.4 What an Income Statement Does Not Tell You

We've already mentioned in our discussion of Income Statements some of the things that it does not tell you. But here is a full list. An income statement does not tell you:

- Any prediction for future net income. The Income Statement is a historical document in the sense that it tells you what has already happened. It cannot be relied upon as a predictor of what will happen in future accounting periods.
- The exact amount of net income that was generated during the period the Income Statement covers. Even if the statement is very well prepared by the best accountants, it is impossible to accurately account for everything. For example, imagine that you spend \$2,000 on a telephone marketing campaign to tell your clients or customers about an upcoming special you are offering. If you generate \$8,000 in sales the next month, you cannot say that the marketing campaign generated that \$8,000 in total. You may have some customers who would have come to you anyway – who might not have even seen the advertisement. Or, you might have customers that received the advertisement, but didn't buy from you until the second or third month after the advertisement. The revenue for those sales would be attributed to the months in which they occurred, even if it was generated by efforts made several months before.
- Actual profit. Since revenues are not able to be fully, accurately reported in the accounting period, neither can profit be calculated to 100 percent accuracy. Plus, you also can't calculate what is called True Profit. This is the difference between what expenses the organization has incurred and what assets have been invested
- The amount of cash on hand. As we mentioned before, Net Income does not mean cash. It only means the excess revenue over expenses in a specific period. Remember that incoming cash could be used for more investments or to buy more assets, or it could actually be received in a month other than when it was generated.

# 5 Cash Flow Statement

## 5.1 Introduction

The Cash Flow Statement is where we track cash coming into and going out of the business. Again, this is done for a specific period of time. To understand the Cash Flow Statement, we first need to introduce a few more finance terms.

- **Cash-based accounting**

In cash-based accounting, all transactions are recorded when the cash is actually received or spent. You would include payments or received funds in the form of cash, check credit card payments, debit card payments, electronic transfers, or any other means of payment. For tracking cash-flow, this is the easier of the two accounting systems.

- **Accrual-based accounting**

With accrual-based accounting, you record all transactions when they occur, even if no cash has changed hands. For example, if you were to sell something to a customer on store credit, you would give the customer the product immediately, but you wouldn't receive payment for the item until they make it at a later date. This system is not good for tracking actual cash flow. For example, you could make thousands of dollars of sales so that you have a great deal of money showing as revenue on your Income Statement, but you could have zero dollars in the bank! If your organization uses accrual-based accounting, creating the Cash Flow Statement is more complicated. It will require that you look at your Net Income and determine what portion of it was actually cash. Then you will have to add and sub out the changes in accounts that do not have an impact on cash, such as depreciation.

- **Depreciation**

Considered a non-cash expense, depreciation is the reduction in value of an asset that occurs over time. Depreciation could be due from use, wear and tear, age, or irrelevance. For example, the computer you buy today will not be worth what you paid for it in five years. Instead, it will gradually depreciate until it either reaches the end of its life or it becomes completely useless for the operation of the business. Depreciation has to be included in financial statements as a cost in order to represent the true value of the organization's assets.

## 5.2 Cash Flow Categories

The Cash Flow Statement typically analyzes cash flow in three different categories:

- Operations
- Financing
- Investing

Figure 6 demonstrates the main sources of incoming cash and the common uses for cash income.

| Forms of Cash                        | Common Use(s) of Cash                  |
|--------------------------------------|--|
| Operations                           | Cash Dividends                         |
| New loans                            | Loan Repayment                         |
| New stock issues or owner investment | Stock repurchase                       |
| Property or equipment sale           | Property or equipment purchase         |
| Sale of capital or long-term asset   | Purchase of capital or long-term asset |

**Figure 6:** Sources and Uses of Cash Income



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### 5.3 Preparing the Cash Flow Statement

To prepare the Cash Flow Statement, you will need to look at the difference between the Balance Sheets from the beginning and the end of the accounting period. You will also need to look at the Net Income from the same period. Table 7 shows a sample of a Cash Flow Statement with a twist – the fourth column tells you where the information came from.

|                                    |          |          |   |
|------------------------------------|----------|----------|---|
| AnyCom                             |          |          |   |
| Statement of Cash Flow             |          |          |   |
| For the month ending January, 20XX |          |          |   |
| Cash Flow from Operations          |          |          |   |
| Net Income                         | \$6,700  |          | Both from the Income Statement  |
| Depreciation                       | 250      |          |   |
| Increase in Accounts Receivable    | -400     |          | From the differences between the December and January Balance Sheets  |
| Decrease in Inventory              | 1,500    |          |   |
| Decrease in Accounts Payable       | -625     |          |   |
| Net Cash Flow from Operations      |          | \$7,425  |   |
|                                    |          |          |   |
| Cash Flow from Investing           |          |          | The difference between the equipment entry in December 31 and January 31 minus equipment depreciation for the month. The negative entry indicates an equipment purchase of \$2,200. |
| Equipment Purchase                 | -\$2,200 |          |   |
| Net Cash Flow from Investing       |          | -\$2,200 |   |
|                                    |          |          |   |
| Cash Flow from Financing           |          |          | From the difference between the December and January Balance Sheets   |
| Loan Payments                      | -\$800   |          |   |
| Net Cash Flow from Financing       |          | -\$800   |   |
|                                    |          |          |   |
| Net Increase (Decrease) in Cash    |          | \$1,200  |   |
| Cash in the Beginning of Period    |          | \$4,400  |   |
| Cash at the End of the Period      |          | \$6,600  | Equals the amount on the January 31st Balance Sheet   |

**Figure 7:** Sample Cash Flow Statement with Information on Source

The amount given for the increase in cash is, at least partly, due to the conversion of accrual accounts into actual cash value.

At this point, you should be able to understand where the amounts in the financial statements come from and how to read the statements. However, you should also realize that it can take years to learn and fully understand accounting and bookkeeping processes. As you get more practice reading (and possibly creating) these statements, you will find it easier to do.



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# 6 Understanding Budgets

## 6.1 Introduction

A budget may be a guideline regarding your expenses and revenues, but it is more than that. It is actually a policy statement that your organization is issuing. Think for a moment about your own budget. Where do you spend your money? What does that say about you? For example, do you value education enough to pay for it for your children? Do you value your car enough to keep a car payment? Or do you value security more so you actually invest a great deal in savings? Your personal budget would tell an observer information about you, just as an organization's budget will tell you a great deal about an organization. For example, the budget can tell you:

- How the organization is structured – usually an organization's budget is divided into individual budgets for each department or division. In many budget documents, each division or department's budget will include information about the size of the team and even the team's objectives for the budget year.
- What the organization values – how much does the organization pay its employees? How much money is budgeted for benefits and retirement plans? Does the organization value training and developing its employees? What about new research and development or marketing? In an overview sense, how much budget a certain activity or group is allocated gives you a sense of the organization's values and priorities.
- What the organization wants to invest in – if there are new activities or projects proposed, those have to be budgeted for as well. If the organization's budget is full of allocations for new activities, you can determine what type of direction the organization might be headed in. For example, are they investing in higher-technology? Or are they investing in new market segment activities? You can tell a lot about the organization's strategies by where they are investing their money.
- How much debt the organization has taken on – the budget will include payments for debt servicing. This could tell you something about how the organization has invested in the past and whether or not those investments seem to be paying off. This could be an indication of how well the organization manages its finances.
- Where the organization may struggle to reach its objectives – you will realize this the first time that your budget gets cut or the first time you feel that you don't have the budget you need to meet the corresponding objectives. You may have to negotiate with your senior management to explain why you feel that your budget is insufficient to reach your objectives. If they agree, they will either need to increase your budget or decrease your objectives.



- Where the organization might be weakest – the budget can give you a few clues about where the organization may struggle. For example, if they have not allocated sufficient money to technology upgrades, they may not be able to keep up with the competition when the latest advances roll out onto the market. Or, if they don't invest in training for employees, they may face less productive, less satisfied employees, which could result in high, costly turnover.
- Where the organization might be strongest – along the same vein, you can see where the organization will be fully funded to meet the competition head on. If your organization maximizes funding for customer service representatives, your organization should then develop the reputation for having a high level of customer service.

A budget is actually a policy statement that your organization is issuing regarding its values and goals.

## 6.2 Approaches to Budgeting

You may be required to develop and submit a budget proposal for your own department or division. When you are determining how to create your budget, there are three common practices:

1. Take last year's budget and, depending on orders or your subjective view of the year to come, either add to it or cut from it to arrive at a satisfactory budget for the new year. This is a rather random method, since it is not informed by what you hope to achieve in the coming year as far as the growth of your organization.
2. Use the coming year's predicted sales as the basis for the budget. In this case, businesses may have already determined that your division receives a set percentage of the sales goal for the year. However, doing so means that the organization is relatively confident that its sales predictions are correct. If you are basing them on last year, and last year was a slow year, then you might end up with less funds than you need in order to keep up with the sales that actually occur. If last year was a banner year, then you might end up with more budgeted costs than actual sales. In either case, the accurate prediction of your future sales is important for using this method.
3. The third common method is called 'blank-page' budgeting. This is usually considered to be the best approach by budget professionals because it allows you to start from scratch and use your identified objectives and priorities as the basis for the budget you create. In this scenario, you look at the coming year's objectives and then you examine what you will need in your budget in order to achieve those objectives.

No matter what method you choose, you will probably have to propose your budget to management in order to get approval. It is a good idea to give management a few options. So you should create a minimum budget, a target budget, and a stretch budget.

### 6.2.1 Minimum Budget

This is the bare essentials, rock-bottom amount that you can see being required to achieve the lowest level of your objectives. It's important that you truly define what you will be able to do with this budget, and more importantly, what you will NOT be able to do. This makes it clear to management what level of risk they are taking if they only agree to fund your budget at the minimum level.

### 6.2.2 Target Budget

This is the level of a budget that you feel is the bare minimum in order to fully support the established objectives for the coming year. You are saying with this budget that you can commit to helping achieve the stated objectives as long as you have this amount of funding. Again, you need to clearly delineate what you would be able to provide at this level. Make it realistic, achievable, and as accurate as possible because if you get the full target budget, you will be held to what you have promised.



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### 6.2.3 Stretch Budget

In this funding scenario, you are itemizing what additional level of objectives you can meet if you have this higher level of budget. Don't be surprised if you do not receive this level of budgeting – it's entirely possible that the rest of the organization simply couldn't handle a higher level of performance than what the stated objectives will provide. For example, if you stated that you could increase sales by 10% with your stretch budget, that would mean that everyone involved in supporting the sales team would need to be able to handle that additional 10% of customers, as would customer service, shipping and delivery, or any other departments that interact with customers.

## 6.3 Reading the Budget

A budget provides information on planned expenses and revenues over a given time period, usually one year. As you read the budget, you will see that:

- It is broken into categories corresponding to your Chart of Accounts. Each account will be represented by a line or lines on the budget, which is why they are called “budget line items.”
- There is a column for the amounts that were budgeted for each line item
- There is a column for the amounts that were actually spent (or earned) for each line item
- It might show the budget deviation in another column
- It might show the previous years' budget information for each line item

Budget deviation is important because it helps you to determine how accurate your budgeting actually was. The larger the deviation, the more you need to reevaluate your budget. For example, if you expected to earn \$10,000 in one month but you only earned \$8,000, you might have to readjust your budget for future months. Especially if significant deviation continues to occur.

# 7 Pricing

## 7.1 Introduction

If you are involved in determining pricing, it can be one of the most vital aspects of applying your understanding of finances. But it can also be one of the most challenging activities that you do. You need to price your products and services competitively, but at the same time set them high enough that you cover your costs and provide yourself and any other workers with a salary. But there is more to pricing than just covering your costs and overhead. The strategy that you use to price your products and services depends on the type of industry you are in, the competition you have, the activity in the market itself, and several other factors that we will examine in this chapter.

## 7.2 How Important is Price?

In your situation, for your company, in your market, how important is price going to be? For example, if your main benefit that you are offering the customer is that you offer a discount off of what your competition offers, you are always going to have to offer that discount. But if your market position is that you offer luxury products, designer items, or exclusive opportunities, you will be able to charge a higher price for what you are offering. Your price needs to be consistent with however your product is 'positioned' in the market place.

## 7.3 Demand for the Product or Service

Do you have an understanding of how your price will affect demand for your product or service? If you do any market research that involves identifying your potential customers, what are they likely to be willing to pay for your product or service over the competition's? If you raise your price 10%, what percentage of customers will you lose? If the answer is none, then raise the price. If the answer is 50%, you will want to rethink that pricing strategy. You can determine a lot by studying your competitors' pricing, but you also might want to hire a market research firm for more detailed information.

## 7.4 Your Environment

In some cases, your pricing will be influenced by factors in your environment that are entirely out of your control. For example, there may be government or other legal restrictions on what you are allowed to charge. Or, you might be in a market where everyone else is charging a much higher price than you are and suddenly charging something too low will make customers suspicious about the quality of your product or service. If competition is hot, hot, hot, will a reduction in your price trigger the competition to cut theirs as well? You might not want to start a price war if you're not willing to see it through to the end.

## 7.5 Pricing Strategies

There are several other pricing strategies for you to consider. A few popular ones include:

- **Maximize the quantity sold.** If you can get a good reduction on the costs of production by maximizing the number produced (known as economy of scale), then you might want to just sell as many products as you can even if it means a smaller return on each individual item. This can be a powerful strategy for penetrating new markets as well.
- **Target return pricing.** In this scenario you determine your price by first deciding what you want your Return on Investment (ROI) to be. This can be important if you have investors that you have promised a specific return on their investment, or if you have invested your own money in your company and you need to recover that investment in a specific amount of time.
- **Value-based pricing.** Using this strategy, you determine what the value is that the customer places on the product or service and charge accordingly.

For example, if you produce something that will cut a customer's costs or increase their revenues, you may be able to charge a higher rate, even if it only cost you 10% of that price to produce it. In many cases, this can be the most profitable way to price products and services because it is dependent on what people are willing to pay rather than what you had to spend to produce or deliver your offering.



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- **Popular price points** – These are prices which people are conditioned to paying or are conditioned to perceiving as value for their money. Examples include 99 cent menus at fast-food restaurants, or prices like \$19.99 or \$49.99. Even if a popular price point is lower than where you would have otherwise set your price, you might make up for it by increasing the volume of sales that you receive.
- **Fair pricing** – In this strategy, you are charging a price that is within the range of what a customer considers to be a fair price for that product or service. Even if you are the only provider in your area, customers will resist you if they perceive your prices as ‘price gouging.’ If you choose this strategy, you should set your prices by doing market research to make sure that your potential customers will consider your pricing to be fair for what you are offering.

It may take some time for you to identify the best pricing strategy for your business, but eventually you will learn what the market and your customers will accept as a price for your product or service and you will be able to price accordingly.

To be financially aware, you also want to pay attention to what price you are paying for goods or services that you need for the company. The price you pay is the investment that you have to be able to recover. But understanding the strategies behind pricing may also help you to determine the best provider for your needs.

# 8 Applying Your Knowledge

## 8.1 Introduction

When you are managing your team, there are certain tasks that you do simply because the ongoing survival of the organization requires it. However, there are times that you might take on a project that is out of the normal scope of operations. In either case, there is room to examine the way you operate from a perspective of commercial awareness. Every decision you make can have an impact on the financial status of the organization or the relationships it has with its clientele. For example, if you choose to start a new project, you will spend man hours on the project that are lost to your pre-existing operations. Have you fully understood what the true impact of that project would be, even if you add no new expenses?

When you look at what you do in this way, you may find room for improvement, elimination, or even expansion of certain operations as ways to operate more efficiently. In this chapter we'll examine some ways to look at your operations and determine whether or not you can make some changes to operate in a more effective or efficient manner.

## 8.2 Defining Your Reasons

The first and vital step of being commercially aware in operations is to accurately define what you are currently doing. Why do you do what you do in the first place? Why are you doing it? Why are you considering adding a new project to your current activities? If you can't clearly define your reasons for what you do as well as your desired goals and objectives for any new project, you will waste a great deal of time and resources unnecessarily.

You can formally define your operations with a team charter or definition document. It includes multiple sections of information and serves more than one purpose for you. First, it clearly shows the need for your existing operations (or the lack of need for certain aspects), or any benefits that you will receive in return for new projects. It sets the parameters of what can be expected in terms of contribution and performance from your team – and just as importantly, what is outside of the scope of your team's operations. If you are including a new project in your plan, once it is approved, it also confirms agreement that you will have the stated resources you need to complete the plan. And finally, the document serves as a master plan while you are working with your team.

If you can't clearly define your reasons for what you do as well as your desired goals and objectives for any new activity, you will waste a great deal of time and resources unnecessarily.

### 8.3 Background

Here you examine what has brought you to the current state of operations that you are performing as well as the reasons any new project has been proposed. What has happened in the organization or in your field that has prompted the need for you to take action? Think about:

- Description of the current state of affairs
- Any external market shifts requiring change, such as legal changes requiring compliance
- Explanation of recent internal events leading to the proposed change
- Description of a newly identified opportunity that requires change in order to adopt it, such as a new target market
- Any other overview information that helps you understand the environment you are operating within

### 8.4 Objectives

In order to define objectives, start by asking yourself the questions below regarding your overall goals:

- What are we trying to achieve?
- By when are we aiming to achieve it?
- What, specifically, are the goals, and why are they important to the organization?
- What will success look like?



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It's not enough just to identify your objectives. You also need to have a specific set of criteria by which you will measure your success in meeting your objectives. How will you determine how well your team is doing? How will you know if you were not successful? In order to answer those questions, you need to determine exactly what it is that the organization hopes to gain from your department's operations.

For example, if one of your goals is to retain customers, how will you measure this? If one of your goals is to increase revenue, that's simple enough. But what exactly do you mean by increasing revenue? Increasing revenue without increasing costs? Increasing the per-customer revenue or increasing revenue by increasing the customer base? The former may not raise your operational costs as much as the latter. Knowing what your objectives are and how you will measure your success in achieving them is a fundamental aspect of commercial awareness.

You also need to prioritize your objectives. Which ones are vital to the organization's continuing success? Those are the ones that you have to focus on – period. But then there are the objectives that would improve your team, your work environment, or your standing in the market or against the competition. Some of them will not be as vital as others. You need to determine which of your objectives would have the most negative impact on the organization as a whole if you were to fail to meet them and then focus your resources accordingly.

## 8.5 Scope of Operations

The scope of operations is the range of activities that your team will undertake. It is an agreed-upon area of focus that sets a sort of 'boundary' around your activities. For example, if you were to decide to do a project that was a review of your HR system, what exactly does that mean? What kind of review? What divisions? All of the functions or just some of them? Does that include a full review of benefits and salary scales as well? Will you be looking at reclassifying positions and reorganizing people – or even possibly eliminating positions?

You define the scope based on your objectives, but there is another way to think about scope. Particularly for some projects or activities, you could ask yourself the question, "What do we have the authority, clearance, agreement, or support to accomplish?" The answer to this question will help you to define the scope of your activities within the parameters of your company's organizational structure.

What do you have the authority, clearance, agreement, or support to accomplish?

There are several other questions that you could answer in regards to your scope, depending on what your role is and what your own senior management team expects. Consider whether or not you need to include some of the answers to these questions:

- If we face a problem, are we solving it or just identifying possible solutions for others to select from? Coming up with the solution could be one project and implementing it a second, separate project, or they could be one in the same.
- What are the standards of performance we will apply to our scope of activities? In other words, is there a code of ethics, generally accepted professional standards, or other guidelines that we will adopt for our team? What existing company policies guiding our work standards will apply?
- Are we (you, your colleagues, your supervisors and above) agreed upon what we are meant to achieve? Without clear agreement and shared understanding, you are leading yourself towards serious problems.

## 8.6 Operational Constraints

If scope is one form of boundary on your activities, constraints are another. Every division will have some form of constraints, simply because of the fact that our resources are finite and our willingness to expose our organization to risk is limited as well. Whereas we might want to spend two years researching our new product idea, testing it, and getting it to the marketplace, our competitors might get theirs there faster and we might suffer in market share as a result. So another way to look at constraints is to consider the realities around your resources and your level of willingness to be exposed to risk. You then may have to make a difficult decision regarding what to sacrifice and what to preserve.

Constraints are another form of a boundary on your work because our resources are finite and our willingness to expose our organization to risk is limited.

### 8.6.1 Understanding Resources

In this sense, the term 'resources' refers to people, equipment, and money. As we know, we have a limited supply of all of our resources. But it's important to understand what these constraints on our resources are because they impact the amount of work that we are able to do, the amount of time we have available, and the cost of completing particular activities or projects. For many of us, estimating and understanding the use of external resources (contractors, suppliers, government officials, etc.), is easier than estimating and understanding the requirements and cost of using our own internal people or resources for a project.

To demonstrate this, let's look at the costs involved with the use of people as a resource. Time is money since everyone is probably paid for what they are doing at your organization. You also may not have the needed expertise inside your organization to successfully complete a highly technical or specialized project or activity. So your costs for people could include:

- The cost of a 'fill-in' employee for each person while they work on the a new activity or project
- The cost of lost productivity on other projects or activities for each person working on a new project
- The cost of training involved for your resources to be able to work on a new activity or project (or ongoing activities and projects)
- The cost of hiring a technical expert or support staff

In this sense, resources refers to people, equipment, and money.

There are also a finite number of hours in the day and a limit to the amount of work that you can accomplish in that time. The amount of work that you can achieve is dependent on the number and complexity of your objectives as well as your performance criteria. For example, if you have one objective and you've been approved to just get it done to a minimum satisfactory level, chances are that will be a lot less work than if you were told the objective must be completed to a superior level of quality or if you have multiple objectives that need to be completed.



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There is usually going to be a tradeoff between your resources, the time you have to use them, and the work output that you can produce. You could also say that the amount of work that is required is dependent on the number of resources that are needed and the time that is needed to complete the objectives. This could be a literal calculation, such as:

$$\text{Number of resources} \times \text{Time worked} = \text{Work Output}$$

This equation can actually help you think through your resource needs and constraints in several different ways. You know that if you have more people, either the work output will increase or you can keep the work output the same and decrease the amount of time required to complete your objectives. If we decrease the work output, we can also decrease either the time or the number of people we need, or both.

Since each resource has an associated cost, your simple cost equation for a particular activity would look like this:

$$\text{Cost of Resources} \times \text{Work} = \text{Total Cost}$$

So to reduce our costs without reducing the work amount (and, we assume, work quality), you would need to reduce the cost of the resources used either by the number of people, the level of people, or the time that they work.

What is the point of this discussion? It's to show that keeping your resources focused on the work at hand will reduce the time you need people to work and will, in turn, reduce the cost of your operations. It also shows how important it is to properly estimate the time it will take to complete your objectives. If you don't take these resource constraints into account when determining your operations, you will either end up over budget, over deadline, or you will risk failing to achieve your objectives at all.

### 8.6.2 Performance Criteria

As described in the last section, performance criteria affect the resources that you need. The higher the criteria that you are expected to meet, the higher the cost will be to achieve your objectives. When you are truly financially aware, you understand how different levels of performance will affect your costs.

Remember, though, that there are also indirect costs of reducing performance criteria. If you are rolling out a new product and you decide that you will limit end-to-end testing in order to reduce the cost of the project, you may very well end up with higher costs after the launch because of a system failure or mass customer complaints. So, as a manager it is important to see how your performance criteria determination can impact the organization directly and indirectly..

### 8.6.3 Time

Looking back at our earlier discussion and formulas, we know that time also affects the cost of our operations, and time constraints may also impact the availability of necessary resources. But there is one point to make about time that we haven't made yet. It is that the quality of the resource, or people, that you have for performing your operations may affect your time needs as well. If you have two well-qualified people on your team, they may be able to do the same work as four un-qualified people.

The higher the performance criteria that you are expected to meet, the higher the cost will be to achieve your objectives.

So consider being willing to pay a higher price for team members if it will save time in the long run. On the other hand, if you aren't concerned about the amount of time it takes to achieve your objectives, you could hire cheaper, unqualified help. Of course, this poses a risk to the quality outcome as well.

If you have well-qualified people on the team, they may be able to work smarter – and faster – than if you have less-qualified people on board.

## 8.7 Understanding Risk

An important part of financial awareness is to understand how your decisions could expose your organization to risk. A risk is defined as anything that would have a negative impact on your organization or the achievement of its primary objectives. For example, a risk could be any delay that would make you miss deadlines. A risk could be that you are expecting a certain amount of revenue from the quarter in order to continue operations, and something could impact your ability to earn that revenue. Or, someone else in the organization could decide they need your technical support person more than you do and attempt to pull them from your team.

A risk is defined as anything that would have a negative impact on your organization or the achievement of its primary objectives.

No organization is entirely without risk. However, you can greatly minimize your exposure to risk if you address identifiable risk factors as part of your operational planning. You can then prioritize which risks you want to dedicate your attention to based on the likeliness that they will happen and the impact on your ability to achieve your objectives if they should happen. To decide which risks to work towards ameliorating, we can use what is called a Risk Impact / Probability Chart. In order to interpret the chart, you need to know the following definitions:

- **Probability** – The likelihood of a specific damaging event (risk) actually happening expressed as a percentage. You can have a probability range of greater than zero and less than 100 percent probability. It cannot be zero because then you would be talking about something that isn't actually a risk. And it cannot be 100 percent because that would no longer be a risk – it would be a guaranteed, certain event.
- **Impact**: The magnitude of the affect if the risk does occur. Every risk has a negative impact, but some will have a greater impact than others. An impact can be defined in terms of loss of revenue, increased cost, increased time, decreased quality, or some other critical aspect of the parameters of your operations.

These two factors represent the axes on a graph that represents the level of risk an event poses. See Figure 8 for an example of a Risk Impact / Probability Chart.

Let's examine situations at the four corners of the chart:

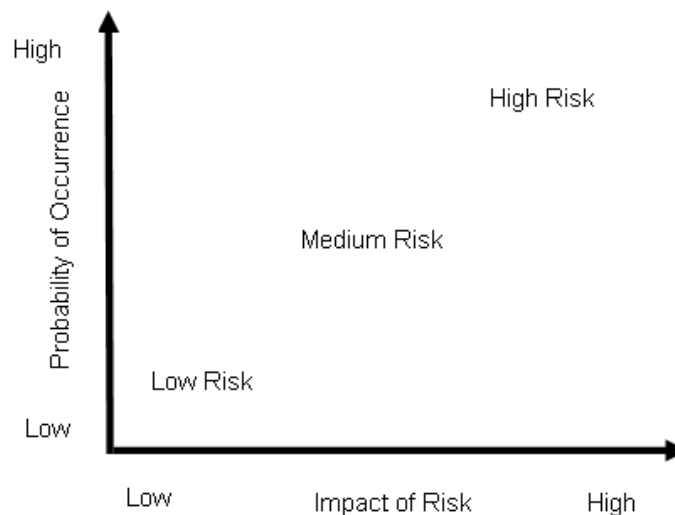
- **Low Impact & Low Probability** – In this corner, the risk is unlikely to happen and even if it did happen, there would be a small impact. Risks that fall in this corner can sometimes be ignored – particularly when there are higher impact, higher probability risks that you need to be focusing on.



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**Figure 8:** Risk Impact / Probability Chart

- Low Impact & High Probability – Risks in this corner are of medium concern. They are likely to arise, but you handle them and then move on. You might be able to predict some of them, but probably not all of them. Still, reducing the probability of these risks ahead of time where you can will still save your time and resources.
- High Impact & Low Probability – Risks in the bottom right corner of the chart are not likely to happen, but if they do happen they will have a significant impact on your operations. Examples include budget cuts, loss of a team member, or sudden urgency in reaching an objective. You will want to spend time predicting what impacts this type of risk would have and creating contingency plans if one of these situations occur.
- High Impact & High Probability – In this corner you have the most damaging and the most likely risks. You must make preventing or averting these a top priority if you are to have any chance of moving the team (and perhaps the organization) past them if they happen. These are the things that, if they happen and you're not prepared for them, would put your success in serious jeopardy.

Obviously, not every risky event will fall neatly into a corner of the graph above. You will have to determine how risk averse you need to be based on the overall importance of the objectives you are pursuing. For example, even if there is a low probability of something happening but it would result in loss of life, you will probably want to ensure that you pay attention to that risk anyway.

Understanding risks gives you the opportunity to make your senior management aware of the risks as well, so that if something does happen you know that you did your best to present all the possible risks before moving ahead. You may also get feedback that has you adjust the rest of the plan, say, if management is more risk averse than you expected.

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