Harvard Business School Online

A Manager's Guide to Finance & Accounting

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As a manager, every decision you make has financial implications. An intuitive understanding of finance and accounting can take you from simply performing your job duties to understanding the greater impact your actions have on your organization's financial health. It can benefit you no matter your industry, whether it's:

Engineering: Engineering is a project-based field, in which attention to detail is highly valued. Understanding the costs and benefits of each component of a project can make you a more effective manager.

Marketing: Whether you're projecting future traffic flow to your company's website or tracking the number of new customers driven by your latest blog post, you're using financial skills and concepts to excel as a marketer.

Sales: As a sales manager, knowing how to read a financial statement and use financial terminology can help you understand the rationale behind your company's goals.

Human Resources: If you're an HR manager, a familiarity with finance and accounting can enable you to facilitate meaningful cross-departmental conversations and advocate for your budget to hire or train employees.

Healthcare: A foundational knowledge of financial principles and concepts can inform decisions to purchase emerging technologies or fund new research that equips your organization to better support its patients.

These are just a handful of ways financial literacy can pay off in your profession.

Throughout this guide, you'll expand your knowledge of finance and accounting by learning about the differences between the two disciplines, the financial skills all managers need, and how taking an online course can help you achieve your educational goals and accelerate your career.

Finance vs. Accounting: What's the Difference?

Finance and accounting are terms often used interchangeably. While both are related to the administration and management of an organization's assets, each has a different scope and focus. When it comes to evaluating the financial health of your company or department and making strategic financial decisions, it's important to have a working knowledge of both disciplines.

Here's a look at the key differences between finance and accounting.

1. The Scope and Focus

Finance and accounting operate on different levels of the asset management spectrum. Whereas accounting provides a snapshot of an organization's financial situation using past and present transactional data, finance is inherently forward-looking—all value comes from the future.

In accounting, insight into a firm's financial situation is
Financial performance
gained through what's known as **the accounting equation**, which is typically displayed as:

ASSETS = LIABILITIES + OWNERS' EQUITY

The equation consists of three components:

- **Assets:** Anything a company owns with quantifiable value
- **Liabilities:** Money a company owes to a debtor, such as outstanding payroll expenses, debt payments, rent and utilities, bonds payable, and taxes
- **Owners' equity:** The net worth of a company, or the amount that would be left if all assets were sold and all liabilities paid; this money belongs to shareholders, who may be private owners or public investors

The accounting equation must *always* balance—the assets on the left should equal the claims against those assets on the other side. It's a fundamental means for determining whether a company's financial records accurately reflect the transactions carried out over a period.

When assessing performance through the lens of finance, cash is king. Unlike accounting's reliance on transactional data, finance looks at how effectively an organization generates and uses cash through the use of several measurements.

Free cash flow is arguably the most important one, which examines how much money a company has to distribute to investors, or reinvest, after all expenses have been covered. It's a strong indicator of profitability and can be used to make present-day investment decisions based on an expectation of future payoff.

2. How You Measure Financial Performance

This difference in scope underscores a contrast between the underlying principles of accounting and finance.

The accrual method of accounting, followed by most organizations, records transactions as they're agreed upon, as opposed to when they're completed. It allows for transactions to be made with credit or deferred payments and operates under the idea that revenues and costs will smooth out over time to more accurately depict economic reality. This makes it possible to compare year-over-year growth of a company's revenues, costs, and profits without factoring in one-off events or seasonal and cyclical changes.

Finance rejects that idea, believing that the best way to measure economic returns is to calculate the cash a company can produce and leverage, which depends on when that cash is exchanged—rather than just agreed upon.

3. How You Assess Value

Another difference between the disciplines is their approach to value. In accounting, a conservatism principle is often applied, which suggests that companies should record lower projected values of their assets and higher estimates of their liabilities. Under this doctrine, if you don't know the value of something precisely, you count it as zero. Doing so helps businesses avoid overextending themselves by underestimating the value of assets and overestimating the liabilities they owe.

This is handled much differently in finance, which employs an analytical process, known as **valuation**, to determine the worth of a company, project, or asset. The gold standard is **discounting**, which is applied to a series of cash flows over a period of time. The **discount rate**, represented as a percentage, accounts for opportunity cost, inflation, and risk, and brings the value of a future stream of cash to its present value.

Both finance and accounting are useful for assessing a company's position and performance. By understanding the underlying principles of each discipline and how they contrast, you can develop greater financial intuition and make better business decisions.

Next, you'll learn about the essential financial skills every manager should have.

Financial Skills All Managers Should Have

A practical knowledge of finance and accounting is an indispensable part of any manager's toolkit. With well-developed financial skills, you can understand how your actions impact your organization and advocate for yourself and your team when weighing in on company-wide financial decisions.

Here are five financial skills you need to be a better manager and decision-maker.

SKILL 1: FINANCIAL STATEMENT ANALYSIS

Financial statements offer a window into the health of a company, which can be difficult to gauge by other means. While accountants and finance specialists are trained to read and understand these documents, many business professionals are not. The effect is an obfuscation of critical information.

To understand a company's financial position, you need to review and analyze several financial statements: balance sheets, income statements, cash flow statements, and annual reports.

The Balance Sheet

A **balance sheet** is a financial document designed to communicate exactly how much a company or organization is worth—its "book value." It achieves this by listing and tallying all of a company's assets, liabilities, and owners' equity as of a particular reporting date.

Typically, a balance sheet is prepared and distributed on a quarterly or monthly basis, depending on the frequency of reporting as determined by law or company policy.

The Purpose of a Balance Sheet

Balance sheets serve two very different purposes, depending on the audience reviewing them.

When a balance sheet is reviewed *internally*, it's designed to give insight into whether a company is succeeding or failing. Based on this information, policies and approaches can be shifted: doubling down on successes, correcting failures, and pivoting toward new opportunities.

When a balance sheet is reviewed *externally*, it's designed to give insight into the resources available to a business and how they were financed. Based on this information, potential investors can decide whether it would be wise to invest. External auditors might also use a balance sheet to ensure a company is complying with any reporting laws it's subject to.

It's important to remember that a balance sheet communicates information as of a specific date. By its very nature, a balance sheet is always based on past data. While investors and stakeholders may use a balance sheet to predict future performance, past performance is no guarantee of future results.

The Contents of a Balance Sheet

The information in a balance sheet is most often organized according to the accounting equation: **Assets = Liabilities + Owners' Equity.**

While this equation is the most common formula for balance sheets, it isn't the only way of organizing the information. Here are other equations you may encounter:

OWNERS' EQUITY = ASSETS - LIABILITIES

LIABILITIES = ASSETS - OWNERS' EQUITY

A balance sheet should always *balance*. Assets must *always* equal liabilities plus owners' equity. Owners' equity must *always* equal assets minus liabilities. Liabilities must *always* equal assets minus owners' equity.

If a balance sheet doesn't balance, it's likely the document was prepared incorrectly. Errors are usually due to incomplete or missing data, incorrectly entered transactions, erroneous currency exchange rates or inventory levels, miscalculations of equity, or miscalculated depreciation or amortization.

Here's a more detailed breakdown of the items that fall under the components of a balance sheet: assets, liabilities, and owners' equity.

Assets

An **asset** is anything owned by a company that holds inherent, quantifiable value. A business could, if necessary, convert an asset into cash through a process known as **liquidation**. Assets are typically tallied as positives (+) in a balance sheet and broken down into two further categories: current assets and non-current assets.

Current assets typically include anything a company expects it will convert into cash within a year, such as:

- Cash and cash equivalents
- Prepaid expenses
- Inventory
- Marketable securities
- Accounts receivable

Non-current assets typically include long-term investments that aren't expected to convert into cash in the short term, such as:

- Land
- Patents
- Trademarks
- Brands
- Goodwill
- Intellectual property
- Equipment used to produce goods or perform services

Because companies invest in assets to fulfill their mission, you must develop an intuitive understanding of what they are. Without this knowledge, it can be challenging to understand the balance sheet and other financial documents that speak to a company's health.

Liabilities

A **liability** is the opposite of an asset. While an asset is something a company owns, a liability is something it owes. Liabilities are financial and legal obligations to pay an amount of money to a debtor, which is why they're typically tallied as negatives (-) in a balance sheet.

Just as assets are categorized as current or non-current, liabilities are classified the same way.

Current liabilities typically refer to any liability due to the debtor within one year, which may include:

- Payroll expenses
- Rent payments
- Utility payments
- Debt financing
- Accounts payable
- Other accrued expenses

Non-current liabilities typically refer to any long-term obligations or debts that will not be due within one year, which might include:

- Leases
- Loans
- Bonds payable
- Provisions for pensions
- Deferred tax liabilities

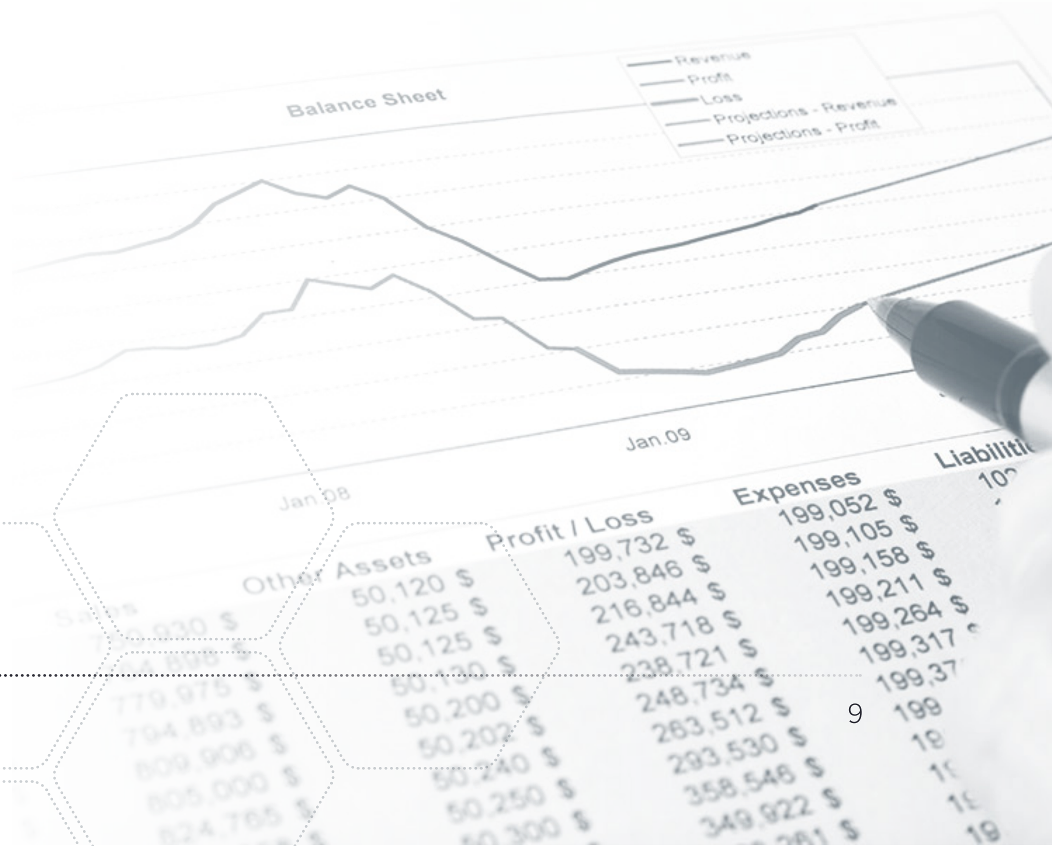
Liabilities may also include an obligation to provide goods or services in the future.

Owners' Equity

Owners' equity, also known as **shareholders' equity**, typically refers to anything that belongs to the owners of a business after liabilities are accounted for.

If you were to add up all the resources a business owns (the assets) and subtract all of the claims from third parties (the liabilities), the residual left over is the owners' equity.

Owners' equity typically includes two elements. The first is money, which is contributed to the business in the form of an investment in exchange for some degree of ownership—typically represented by shares. The second is earnings that the company generates over time and retains.



BUSINESS INSIGHT

A Balance Sheet Example

By looking at this balance sheet, you can extract vital information about the health of the company being reported on.

This balance sheet tells you:

1. The reporting period ends on June 30, 2020, and compares against a similar reporting period from the prior year.
2. The company's assets total $60,173, including $37,232 in current assets and $22,941 in non-current assets.
3. The company's liabilities total $16,338, including $14,010 in current liabilities and $2,328 in non-current liabilities.
4. The company retained $45,528 in earnings during the reporting period, slightly more than the same period a year prior.

Company A

As of June 30, 2019 and June 30, 2020 (In US$ thousands)

Assets

NON-CURRENT ASSETS	(1) JUNE 30, 2020	JUNE 30, 2019
BRANDS	$ 255	$ 302
CUSTOMER RELATIONS	71	84
LEASEHOLD RIGHTS	537	585
CAPITALIZED EXPENDITURES	631	-
GOODWILL	64	64
BUILDINGS AND LAND	805	804
EQUIPMENT, TOOLS, FIXTURES AND FITTINGS	18,326	16,589
LONG-TERM RECEIVABLES	628	608
DEFERRED TAX RECEIVABLES	1,624	1,234
TOTAL NON-CURRENT ASSETS	22,941	20,270
CURRENT ASSETS	**JUNE 30, 2020**	**JUNE 30, 2019**
INVENTORY	15,213	13,819
ACCOUNTS RECEIVABLE	2,207	2,337
TAX RECEIVABLE	477	-
OTHER RECEIVABLES	1,056	1,375
PREPAID EXPENSES	1,136	1,110
SHORT-TERM INVESTMENTS	2,995	6,958
CASH AND CASH EQUIVALENTS	14,148	14,319
TOTAL ASSETS	(2) **$ 60,173**	**60,188**

Liabilities and Shareholders' Equity

NON-CURRENT LIABILITIES	JUNE 30, 2019	JUNE 30, 2019
PROVISIONS FOR PENSIONS	$ 377	$ 377
DEFERRED TAX LIABILITIES	1,951	950
TOTAL NON-CURRENT LIABILITIES	2,328	1,327
CURRENT LIABILITIES	**JUNE 30, 2020**	**JUNE 30, 2019**
ACCOUNTS PAYABLE	4,234	4,307
TAX LIABILITIES	-	1,851
OTHER LIABILITIES	2,765	2,428
ACCRUED EXPENSES AND OTHER DEFERRED REVENUE	7,011	6,171
TOTAL LIABILITIES	(3) $ 16,338	$ 16,084
SHAREHOLDERS' EQUITY	**JUNE 30, 2020**	**JUNE 30, 2019**
SHARE CAPITAL	$207	$207
RESERVES	(1,900)	(487)
RETAINED EARNINGS	45,528	44,384
TOTAL SHAREHOLDERS' EQUITY	43,835	44,104
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	(4) **$ 60,173**	**$ 60,188**

The Income Statement

An **income statement**, also known as a **profit and loss (P&L) statement**, summarizes the cumulative impact of revenue, gain, expense, and loss transactions for a given period. The document is often shared as part of quarterly and annual reports, and shows financial trends, business activities (revenue and expenses), and comparisons over set periods.

The Purpose of an Income Statement

An income statement tells the financial story of a business's activities. Within an income statement, you'll find all revenue and expense accounts for a set period. Accountants create income statements using trial balances from any two points in time.

From an income statement and other financial documents, you can determine:

- Whether the business is generating a profit
- If it's spending more than it earns
- When costs are highest and lowest
- How much it's paying to produce its product
- If it has the cash to invest back into the business

Accountants, investors, and business owners regularly review income statements to understand how well a business is doing in relation to its expected performance and use that knowledge to adjust their actions. A business owner whose company misses targets might, for example, pivot strategy to improve in the next quarter. Similarly, an investor might decide to sell an investment to buy into a company that's meeting or exceeding its goals.

The Contents of an Income Statement

While all financial data helps paint a picture of a company's financial health, an income statement is one of the most important documents a company's management team and individual investors can review because it includes a detailed breakdown of income and expenses over the course of a reporting period. This includes:

- **Revenue:** The amount of money a business takes in during a reporting period
- **Expenses:** The amount of money a business spends during a reporting period
- **Costs of goods sold (COGS):** The cost of component parts of what it takes to make whatever it is a business sells
- **Gross profit:** Total revenue less COGS
- **Operating income:** Gross profit less operating expenses
- **Income before taxes:** Operating income less non-operating expenses

- **Net income:** Income before taxes less taxes
- **Earnings per share (EPS):** Division of net income by the total number of outstanding shares
- **Depreciation:** The extent to which assets (for example, aging equipment) have lost value over time
- **Earnings before interest, taxes, depreciation, and amortization (EBITDA):** A measure of a company's ability to generate cash flow that's calculated by adding net profit, interest, taxes, depreciation, and amortization together

These categories may be further divided into individual line items, depending on a company's policy and the granularity of its income statement. For example, revenue is often split out by product line or company division, while expenses may be broken down into procurement costs, wages, rent, and interest paid on debt.

Income Statement Analysis

There are two methods commonly used to read and analyze an organization's financial documents: vertical analysis and horizontal analysis.

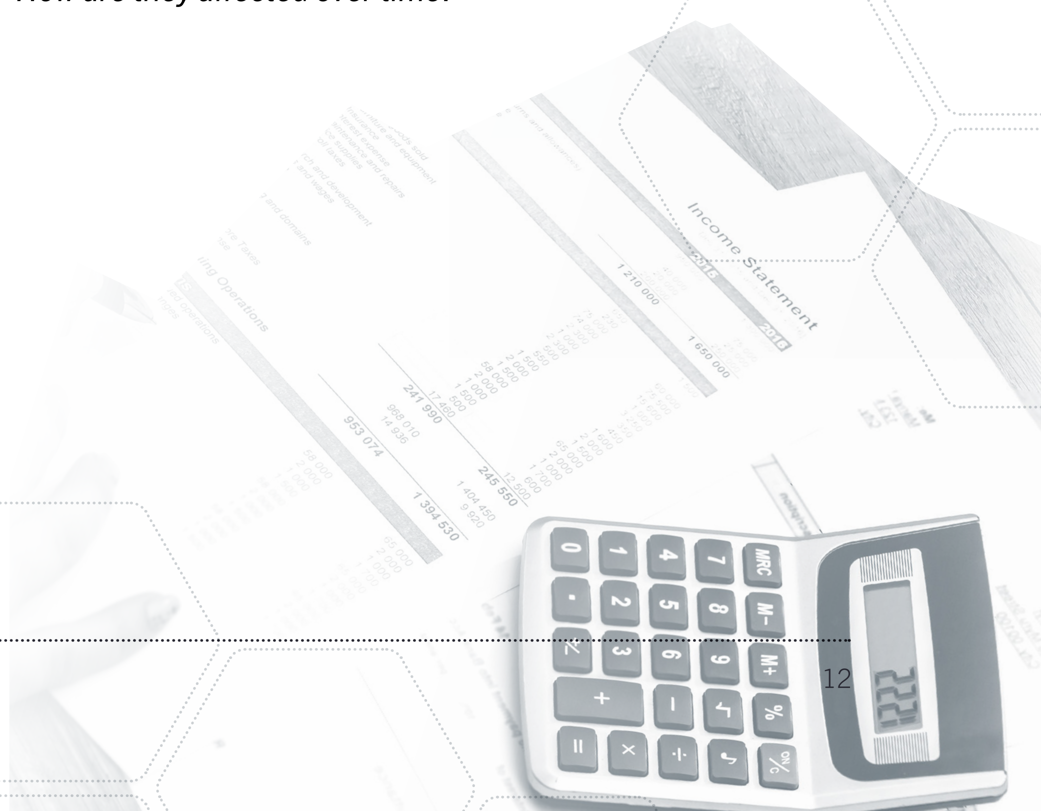
Vertical Analysis

Vertical analysis refers to the method of financial analysis where each line item is listed as a percentage of a base figure within the statement. This means line items on income statements are stated in percentages of gross sales instead of in exact amounts of money, such as dollars.

In short, it's the process of reading down a single column of data in a financial statement and determining how individual line items relate to each other (e.g., showing the relative size of different expenses, as line items may be listed as a percentage of operating expenses).

This type of analysis makes it simple to compare financial statements across periods and industries, and between companies, because you can see relative proportions. It also helps you analyze whether performance metrics are improving.

Vertical analysis isn't always as immediately useful as horizontal analysis, but it can help you determine what questions should be asked, such as: *Where did costs rise or fall? What line items are contributing most to profit margins? How are they affected over time?*



Horizontal Analysis

Whereas vertical analysis focuses on each line item as a percentage of a base figure within a current period, **horizontal analysis** compares changes in the dollar amounts in a company's financial statements over multiple reporting periods. It's frequently used in absolute comparisons but can be used as percentages, too.

Horizontal analysis makes financial data and reporting consistent per **generally accepted accounting principles (GAAP)**. It improves the review of a company's consistency over time, as well as its growth compared to competitors.

Because of this, horizontal analysis is important to investors and analysts. By conducting a horizontal analysis, you can tell what's been driving an organization's financial performance over the years and spot trends and growth patterns, line item by line item. Ultimately, horizontal analysis is used to identify trends over time—comparisons from Q1 to Q2, for example—instead of revealing how individual line items relate to others.

BUSINESS INSIGHT:

Accounting Standards: GAAP vs. IFRS

Accounting standards are critical to ensuring a company's financial information and statements are accurate and comparable to data reported by other organizations.

The two main sets of accounting standards followed by businesses are GAAP and IFRS.

- **GAAP**, also referred to as **US GAAP**, is an acronym for Generally Accepted Accounting Principles. This set of guidelines is set by the Financial Accounting Standards Board (FASB) and adhered to by most US companies.
- **IFRS** stands for **International Financial Reporting Standards**. These principles are dictated by the International Accounting Standards Board (IASB) and followed in many countries outside the US.

Deciding which set of standards to use depends on whether your company operates in the US or internationally. Work is being done to converge GAAP and IFRS, but the process has been slow going.

The Case for Both

The question isn't whether you should leverage vertical or horizontal analysis when evaluating income statements but rather: How can you best leverage both forms of analysis to make better decisions? Utilizing both techniques can provide you with more insights than relying solely on one.

BUSINESS INSIGHT:

An Income Statement Example

Here's an example of an income statement for the year that ended on September 28, 2019.

This income statement tells you:

1. The company brought in a total of $4.36 billion through sales, and it cost approximately $2.74 billion to achieve those sales, for a gross profit of $1.62 billion.
2. A total of $560.43 million in selling and operating expenses and $293.73 million in general and administrative expenses, were subtracted from that profit, leaving an operating income of $765.23 million.
3. Additional gains were added to the operating income and losses were subtracted, including $257.64 million in income tax.
4. By the end of the year, the company saw a net income of $483.23 million.

Company B
Income Statement
For Year Ended September 28, 2019 (In Thousands)

NET SALES	$	4,358,100	
COST OF SALES		2,738,714	
GROSS PROFIT		**1,619,386**	1
SELLING AND OPERATING EXPENSES	$	560,430	
GENERAL AND ADMINISTRATIVE EXPENSES		293,729	
TOTAL OPERATING EXPENSES		**854,159**	
OPERATING INCOME		**765,227**	2
OTHER INCOME	$	960	
GAIN (LOSS) ON FINANCIAL INSTRUMENTS		5,513	
(LOSS) GAIN ON FOREIGN CURRENCY		(12,649)	
INTEREST EXPENSE		(18,177)	
INCOME BEFORE TAXES		**740,874**	
INCOME TAX EXPENSE		257,642	3
NET INCOME	$	**483,232**	4

The Cash Flow Statement

A **cash flow statement** provides a detailed picture of what happened to a business's cash during a specified duration of time, known as an **accounting period.** It demonstrates an organization's ability to operate in the short and long term, based on how much cash is flowing into and out of it.

The Purpose of a Cash Flow Statement

By reading a cash flow statement, you can see how much cash different types of activities generate, then make business decisions based on that analysis.

It's important to note that cash flow is different from profit, which is why a cash flow statement is often interpreted with other financial documents.

BUSINESS INSIGHT:

Cash Flow vs. Profit

The key difference between cash flow and profit is that, while **profit** indicates the amount of money left over after all expenses have been paid, **cash flow** indicates the net flow of cash into and out of a business.

Profit and cash flow are important in their own ways. As a manager, you need to understand both metrics and how they interact if you want to evaluate the financial health of a business.

For example, it's possible for a company to be profitable and have a negative cash flow hindering its ability to pay its expenses, expand, and grow. Similarly, a company with positive cash flow and increasing sales can fail to make a profit, as is the case with many startups and scaling businesses.

The Contents of a Cash Flow Statement

Cash flow statements are broken into three sections: cash flow from operating activities, cash flow from investing activities, and cash flow from financing activities.

- **Operating activities** detail cash flow that's generated once the company delivers its regular goods or services and includes both revenue and expenses.
- **Investing activities** comprise of cash flow from purchasing or selling assets using free cash, not debt; this is usually in the form of physical property, such as real estate or vehicles, and non-physical property, like patents
- **Financing activities** detail cash flow from both debt and equity financing

Ideally, cash from operating income should routinely exceed net income. A positive cash flow speaks to a company's financial stability and ability to grow its operations.

How Cash Flow Is Calculated

Now that you understand what comprises a cash flow statement and why it's important for financial analysis, here are two common methods used to calculate and prepare the operating activities section of cash flow statements.

Direct Method

The first method used to calculate the operation section is called the **direct method**, which is based on the transactional information that impacted cash during the period.

To calculate the operation section using the direct method, take all cash collections from operating activities and subtract all of the cash disbursements from the operating activities.

Indirect Method

The second way to prepare the operating section is the **indirect method**. This method depends on the accrual accounting method in which the accountant records revenues and expenses at times other than when cash was paid or received—meaning that these accrual entries and adjustments cause the cash flow from operating activities to differ from net income.

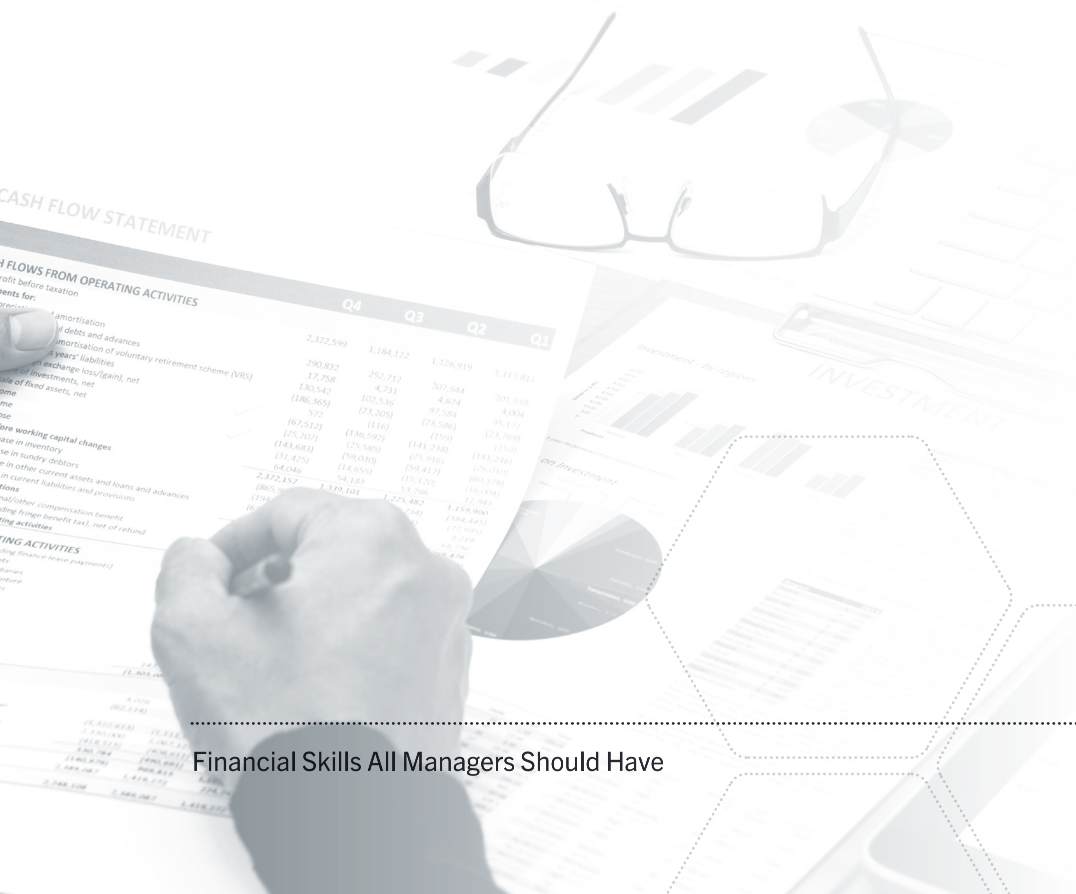
Instead of organizing transactional data, like the direct method, the accountant starts with the net income number found in the income statement and makes adjustments to undo the impact of the accruals made during the period.

Essentially, the accountant will convert net income to actual cash flow by de-accruing it through a process of identifying any non-cash expenses for the period from the income statement. The most common and consistent of these are **depreciation**, the reduction in the value of an asset over time, and **amortization**, the spreading of payments over multiple periods.

How to Interpret a Cash Flow Statement

Cash flow statements can reveal what phase a business is in: whether it's a rapidly growing startup or a mature and profitable company. It can also reveal whether a company is going through transition or in a state of decline.

As a manager, you might look at a cash flow statement to understand how your particular department is contributing to your company's health and wellbeing, and use that insight to adjust your team's activities. Cash flow might also impact internal decisions, such as budgeting or whether to hire (or fire) employees.



Types of Cash Flow

Cash flow is typically depicted as being positive or negative. Here's what those designations mean.

Positive Cash Flow

Positive cash flow indicates that a company has more money flowing into the business than out of it over a specified period. This is an ideal situation because having an excess of cash allows the company to reinvest in itself and its shareholders, settle debt payments, and find new ways to grow the business.

Positive cash flow does not necessarily translate to profit. Your business can be profitable without being cash flow-positive, and you can have positive cash flow without actually making a profit.

Negative Cash Flow

Having **negative cash flow** means your cash outflow is higher than your cash inflow during a period, but it doesn't necessarily mean profit is lost. Negative cash flow may instead be caused by expenditure and income mismatch, which should be addressed as soon as possible.

Negative cash flow may also be caused by your company's decision to expand and invest in future growth, so it's important to analyze changes in cash flow from one period to another, which can indicate how the business is performing overall.

BUSINESS INSIGHT

A Cash Flow Statement Example

Here's an example of a cash flow statement for the year that ended on March 30, 2020.

This cash flow statement tells you:

1. The company started the year with approximately $10.75 billion in cash and equivalents.
2. It brought in $53.66 billion through its regular operating activities.
3. It spent approximately $33.77 billion in investment activities.
4. In addition to investment activities, it spent a further $16.38 billion in financing activities, making for a total cash outflow of $50.15 billion.
5. The company ended the year with a positive cash flow of $3.51 billion, and total cash of $14.26 billion.

COMPANY C
STATEMENT OF CASH FLOWS

Year ended March 30, 2020 (In Millions)

	AMOUNT	
CASH AND CASH EQUIVALENTS, BEGINNING OF THE YEAR	$ 10,764	1
OPERATING ACTIVITIES:	**AMOUNT**	
NET INCOME	37,037	
ADJUSTMENTS TO RECONCILE NET INCOME TO CASH GENERATED BY OPERATING ACTIVITIES:		
DEPRECIATION AND AMORTIZATION	6,757	
DEFERRED INCOME TAX EXPENSE	1,141	
OTHER	2,253	
CHANGES IN OPERATING ASSETS AND LIABILITIES:		
ACCOUNTS RECEIVABLE, NET	(2,172)	
INVENTORIES	(973)	
VENTOR NON-TRADE RECEIVABLES	223	
OTHER CURRENT AND NON-CURRENT ASSETS	1,080	
ACCOUNTS PAYABLE	2,340	
DEFERRED REVENUE	1,459	
OTHER CURRENT AND NON-CURRENT LIABILITIES	4,521	
CASH GENERATED BY OPERATING ACTIVITIES	53,666	2
INVESTING ACTIVITIES:	**AMOUNT**	
PURCHASES OF MARKETABLE SECURITIES	(148,489)	
PROCEEDS FROM MATURITIES OF MARKETABLE SECURITIES	20,317	
PROCEEDS FROM SALES OF MARKETABLE SECURITIES	104,130	
PAYMENTS MADE IN CONNECTION WITH BUSINESS ACQUISITIONS, NET OF CASH ACQUIRED	(496)	
PAYMENTS MADE FOR ACQUISITION OF PROPERTY, PLANT, AND EQUIPMENT	(8,195)	
PAYMENTS FOR ACQUISITION OF INTANGIBLE ASSETS	(911)	
OTHER	(160)	
CASH USED IN INVESTING ACTIVITIES	(33,774)	3
FINANCING ACTIVITIES:	**AMOUNT**	
DIVIDENDS AND DIVIDEND EQUIVALENT RIGHTS PAID	(10,564)	
REPURCHASE OF COMMON STOCK	(22,860)	
PROCEEDS FROM ISSUANCE OF LONG-TERM DEBT, NET	16,896	
OTHER	149	
CASH USED IN FINANCING ACTIVITIES	(16,379)	4
	AMOUNT	
INCREASE/(DECREASE) IN CASH AND CASH EQUIVALENTS	3,513	
CASH AND CASH EQUIVALENTS, END OF YEAR	**$ 14,259**	5

The Annual Report

An **annual report** is a publication that public corporations are required to publish every year by law. It describes a company's operations and financial conditions so that current and potential shareholders can make informed investment decisions.

Unlike other financial data, annual reports include editorial and storytelling, and they're typically professionally designed and used as marketing collateral. Annual reports are sent to a company's shareholders before its annual shareholder meeting and the election of its board of directors, and they're often accessible to the public via the company's website.

The Purpose of an Annual Report

An annual report can help you learn more about what type of company you work for and how it operates, including:

- Whether it's able to pay debts as they come due
- Its profits and/or losses year over year
- If and how it's grown over time
- What it requires to maintain or expand its business
- Operational expenses compared to generated revenues

All of these insights can help you be privy to conversations surrounding your company's future.

The Contents of an Annual Report

An annual report is often split into two halves. The first section typically includes a narrative of the company's performance over the previous year, along with forward-looking statements. The second section strips the story out and includes financial documents and statements. Here's a more detailed list of the items an annual report contains:

- **Letters to shareholders:** These letters typically include one from the CEO or president and other key figures, such as the CFO.
- **Management's discussion and analysis (MD&A):** This is a detailed analysis of the company's performance, as conducted by its executives.
- **Audited financial statements:** These are financial documents that detail the company's financial performance, such as balance sheets, cash flow statements, income statements, and equity statements.
- **A summary of financial data:** This refers to any notes or discussions pertinent to the financial statements listed above.
- **Auditor's report:** This report describes whether the company has complied with GAAP in preparing its financial statements.
- **Accounting policies**: This is an overview of the policies the company's leadership team adhered to when preparing the annual report and financial statements.

BUSINESS INSIGHT:

Annual Report vs. 10-K Report

Annual reports aren't the only documents public companies are required to publish yearly. The US Securities and Exchange Commission (SEC) requires public firms to produce a **10-K report**, which informs investors of a business's financial status before they buy or sell shares.

While there's similar data in both reports, they are separate.

10-K reports are organized per SEC guidelines and include full descriptions of a company's fiscal activity, corporate agreements, risks, opportunities, current operations, executive compensation, and market activity. You can also find detailed discussions of operations for the year and a full analysis of the industry and marketplace.

Because of this, 10-K reports are longer and denser than annual reports and have strict requirements—they must be filed with the SEC between 60 to 90 days after the end of a company's fiscal year.

If you need to review a 10-K report, you can find it on the SEC website.

Reviewing and understanding these financial documents can provide you with valuable insights about your organization, such as:

- *Its debts and ability to repay them*
- *Profits and losses for a given quarter or year*
- *Whether profit has increased or decreased compared to similar past accounting periods*
- *The level of investment required to maintain or grow the business*
- *Operational expenses, especially compared to the revenue generated from those expenses*

The value of these documents lies in the story they tell when reviewed together.

SKILL 2: FINANCIAL FLUENCY

If you're in a non-finance role, the thought of talking data, forecasts, and valuations may seem daunting. Having that financial fluency, however, can help you clearly communicate the monetary implications of decisions to stakeholders and make a greater impact on your company.

Here are eight terms and definitions you should know.

1. **Asset Allocation:** Asset allocation refers to how you choose to spread money across different investment types, also known as **asset classes**. These include:

- **Bonds:** Bonds represent a form of borrowing. When you buy a bond, typically from the government or a corporation, you're essentially lending them money. You receive periodic interest payments and get back the loaned amount at the time of the bond's **maturity**—or the defined term at which the bond can be redeemed.
- **Stocks:** A stock is a share of ownership in a public or private company. When you buy stock, you become a shareholder and can receive **dividends**—the company's profits—if and when they're distributed.
- **Cash and Cash Equivalents:** This refers to any asset that's in the form of cash or can easily be converted into cash

2. **Capital Gain:** A capital gain is an increase in the value of an asset or investment above the price you initially paid for it. If you sell an asset for less than its original purchase price, it would be considered a **capital loss**.

3. **Compound Interest:** This refers to "interest on interest." When you're investing or saving, compound interest is earned on the amount you deposited, plus any interest you've accumulated. While it can grow your savings, it can also increase your debt; compound interest is charged on the initial amount you were loaned, as well as the expenses added to your outstanding balance over time.

4. **Forecasting:** Forecasting is the process of using available data and assumptions to develop a set of future incomes and expenses. You can use forecasting to predict a project's future cash flows, then discount those cash flows to determine its present value.

5. **Liquidity:** Liquidity describes how quickly your assets can be converted into cash. Because of that, cash is the most liquid asset. The least liquid assets are items like real estate or land, which can take weeks or months to sell.

6. **Net Worth:** Net worth indicates the overall state of your financial health. You can calculate net worth by subtracting what you own (your assets) from what you owe (your liabilities).

7. **Time Value of Money:** The time value of money is the concept that a unit of currency received today is worth more than the same unit of currency received at a future point. The further into the future, the less the unit of currency is worth. This is because of three factors: the opportunity cost of not having currency to invest, the impact of inflation, and the risk of not receiving the unit of currency in the future.

8. **Valuation:** Valuation is the process of determining the current worth of an asset, company, or liability. Regularly repeating the process can help ensure you're prepared if faced with an opportunity to merge or sell your company, and when seeking funding from outside investors.

By mastering these basic finance terms, you can gain a more holistic view of your business, understand the value of your work, and improve how you communicate financial goals and performance.

"Gaining a core competency in financial analysis is really important in helping me create an environment where the correct and best decisions get made as we work cross-functionally with Finance and Development."

Lisa Arpey
Leading with Finance
Participant

SKILL 3: ROI CALCULATION

***Return on investment (ROI)** is a metric used to denote how much profit has been generated from an investment that's been made.*

Knowing how to calculate ROI can benefit you in several ways, including helping you make the case for a project, providing greater insight into your team's performance, and making it easier to identify which efforts should be greenlit.

Anticipated vs. Actual ROI

Return on investment comes in two primary forms, depending on when it's calculated: anticipated ROI and actual ROI.

Anticipated ROI, or **expected ROI**, is calculated before a project kicks off and often used to determine if that project makes sense to pursue. Anticipated ROI uses estimated costs, revenues, and other assumptions to determine how much profit a project is likely to generate.

This figure will often be run through several different scenarios to determine the range of possible outcomes. These numbers are then used to understand risk and, ultimately, decide whether an initiative should move forward.

Actual ROI is the true return on investment generated from a project. This number is typically calculated after a project has concluded and uses final costs and revenues to determine how much profit was made compared to what was estimated.

Positive vs. Negative ROI

When a project yields a **positive return on investment**, it can be considered profitable because it produced more in revenue than it cost to pursue. If it yields a **negative return on investment**, it means the project cost more to pursue than it generated in revenue. If the project breaks even, it means the total revenue matched the project's expenses.

The ROI Formula

Return on investment is typically calculated by taking the actual or estimated income from a project and subtracting the actual or estimated costs. That number is the total profit a project has generated, or is expected to generate, divided by the costs.

The formula for ROI is typically written as:

ROI = (NET PROFIT / COST OF INVESTMENT) X 100

In project management, the formula is written similarly but with slightly different terms:

ROI = [(FINANCIAL VALUE - PROJECT COST) / PROJECT COST] X 100

Calculating the ROI of a Project: An Example

Imagine you have the opportunity to purchase 1,000 chocolate bars for $2 apiece. You would then sell the chocolate to a grocery store for $3 per piece. In addition to purchasing the chocolate, you need to pay $100 in transportation costs.

To decide whether this would be profitable, you would tally your total expenses and your total expected revenues.

EXPECTED REVENUES = 1,000 X $3 = $3,000

TOTAL EXPENSES = (1,000 X $2) + $100 = $2,100

You would then subtract the expenses from your expected revenue to determine the net profit.

NET PROFIT = $3,000 - $2,100 = $900

To calculate the expected return on investment, you would divide the net profit by the cost of the investment, and multiply that number by 100.

ROI = ($900 / $2,100) X 100 = 42.9%

By running this calculation, you can see the project will yield a nearly 43 percent positive return on investment, so long as factors remain as predicted. Therefore, it's a sound financial decision. If the endeavor yielded a negative ROI, or an ROI that was so low it didn't justify the amount of work involved, you would know to avoid it.

TEST YOUR KNOWLEDGE

Question

Refer to the chocolate bar example in this section. What would the anticipated ROI be if you had the opportunity to buy 1,500 chocolate bars for $3 apiece and decided to sell them for $5 each? Be sure to factor in the $100 in transportation costs.

Once you've done your calculations, proceed to the next page for the answer.

It's important to note that this example calculates an anticipated ROI for your project. If any of the factors affecting expenses or revenue were to change during implementation, your actual ROI could be different.

For example, imagine that you've already purchased your chocolate bars for the agreed-upon $2 apiece and paid $100 to transport them. If the most that the store will pay you is $2.25 per chocolate bar, then your actual revenues drop substantially compared to your projected revenues. The result is a reduced net profit and a reduced actual ROI.

ACTUAL REVENUES = 1,000 X $2.25 = $2,250

TOTAL EXPENSES = (1,000 X $2) + $100 = $2,100

NET PROFIT = $2,250 - $2,100 = $150

ROI = ($150 / $2,100) X 100 = 7.1%

Circumstances are rarely as straightforward as this example. There are typically additional costs that should be accounted for, such as overhead and taxes. In addition, there's always the possibility that an anticipated ROI will not be met due to unforeseen circumstances, but the same general principles hold true.

TEST YOUR KNOWLEDGE

Answer

The anticipated ROI would be 63 percent. Here's a breakdown of the calculations:

Expected Revenues =
1,500 x $5 = **$7,500**

Total Expenses =
(1,500 x $3) + $100 = **$4,600**

Net Profit =
$7,500 - $4,600 = **$2,900**

ROI =
($2,900 / $4,600) x 100 = **63%**

By learning how to calculate ROI for projects you're interested in pursuing, you can self-evaluate them before they're shared with other decision-makers within your organization and ensure you're making the best possible use of available resources. Similarly, by understanding how to calculate ROI after a project is done, you can speak to the contributions that you and your team have made toward shared company goals.

SKILL 4: BUDGETING

*One of the most important finance skills for managers to master is **budgeting**, or the process of preparing and overseeing a financial plan that estimates income and expenses over a defined period.*

At its most basic level, a budget ensures a team or department has the resources needed to achieve its goals. For managers, the budget serves as a vital tool for:

- *Communicating expectations and goals to stakeholders*
- *Mobilizing teams and departments around organizational objectives*
- *Assessing group and individual performance*
- *Gaining insight into an organization's financial health*
- *Allocating resources strategically and appropriately*

If you want to reap the benefits of these techniques, here are five budgeting tips you can employ to become a better manager.

1. Know Your Organization's Budgeting Timeline and Procedures

Familiarize yourself with your organization's budgeting deadlines and procedures at the outset of the process. Your numbers may be reliant on financial targets set by your supervisor and other department heads. Knowing when specific deliverables are due will help ensure you effectively manage your time and connect with stakeholders who can inform your allocation decisions.

2. Leverage Financial Data

In addition to connecting with stakeholders, leverage existing financial data in your decision-making process. By analyzing financial statements, you can gain insight into your organization's financial health and determine how to suitably apportion resources.

"Business conditions change rapidly, and basing your current budget on historical information can adversely impact budgets within other areas of an organization," writes John Wong, HBS Online's senior associate director of Financial Planning and Analysis, in an article for the Business Insights blog.

3. Work Toward Goals

Understanding your organization's goals is vital to successful budgeting. This knowledge can help you develop a clear picture of how your team's work fits into the company's key objectives and advances its overarching mission.

For example, your firm may be planning an important organizational change initiative, such as a redesign of its website. As part of this process, your team will be responsible for writing web copy, creating videos, and designing graphics.

With these requirements in mind, you can break your team's work down into specific deliverables and line items within your budget, accounting for all the resources your employees will need to produce the desired results and push the project through to completion.

4. Evaluate Performance

By preparing your budget with your organization's mission in mind and a detailed set of deliverables, you can develop a roadmap for evaluating performance. Keep track of expenses so you can compare your spending against projected costs, and stay in close contact with other stakeholders to ensure your team's timeline for completing work is in sync with company-wide project plans.

The deliverables in your budget can serve as key milestones that inform how you manage your employees' time and deliver feedback. If a particular task is at risk of not being completed or incurring additional costs, be prepared to modify line item amounts and delivery dates.

Maintain this kind of flexibility throughout the budget management process and be ready to reallocate resources, when needed, to ensure your organization is well-positioned to achieve its goals.

5. Communicate Progress and Results

Clear and consistent communication is crucial when overseeing a budget. Establish a regular cadence for meeting with key stakeholders to report your employees' contributions and results. Use data visualization techniques to illustrate your team's progress, and make it a point to highlight any accomplishments or shortcomings that could have implications that extend beyond your direct reports.

Carve out time to update your employees as well. Keeping them apprised of the impact of their work can help them feel more engaged and motivated.

"I use what I learned on a daily basis. Even though I'm not in a finance role, operating in a general management position, I need to make decisions utilizing the principles we learned daily. The course empowered me to do that."

Paul Accornero
Leading with Finance Participant

Budgeting is an essential management skill that can drive organizational success. With a clear understanding of your firm's processes and goals, a well-developed plan for evaluating performance, and a knowledge of financial principles, you can make more informed decisions and ensure your team meets its targets.

SKILL 5: FINANCIAL PERFORMANCE MEASUREMENT

***Financial key performance indicators (KPIs)** are metrics used to track, measure, and analyze the financial health of a company. They fall under a variety of categories, including profitability, liquidity, solvency, efficiency, and valuation.*

By learning financial KPIs, you can understand how your organization is performing financially. You can then use this knowledge to adjust your department or team's goals and contribute to strategic objectives.

Here are 12 financial KPIs managers should understand.

1. Gross Profit Margin

Gross profit margin is a profitability ratio that measures the percentage of revenue left after subtracting the cost of goods sold. The cost of goods sold refers to the direct cost of production and does not include operating expenses, interest, or taxes. In other words, gross profit margin is a measure of profitability, specifically for a product or item line, without accounting for overheads.

GROSS PROFIT MARGIN =
(REVENUE - COST OF SALES) / REVENUE * 100

2. Net Profit Margin

Net profit margin is a profitability ratio that measures the percentage of revenue and other income left after subtracting all costs for the business, including costs of goods sold, operating expenses, interest, and taxes. Net profit margin differs from gross profit margin as a measure of profitability for the business in general, taking into account not only the cost of goods sold but all other related expenses.

NET PROFIT MARGIN = NET PROFIT / REVENUE * 100

3. Working Capital

Working capital is a measure of the business's available operating liquidity, which can be used to fund day-to-day operations.

WORKING CAPITAL =
CURRENT ASSETS - CURRENT LIABILITIES

4. Current Ratio

Current ratio is a liquidity ratio that helps you understand whether the business can pay its short-term obligations—that is, obligations due within one year—with its current assets and liabilities.

CURRENT RATIO = CURRENT ASSETS / CURRENT LIABILITIES

5. Quick Ratio

The quick ratio, also known as an **acid test ratio**, is another type of liquidity ratio that measures a business's ability to handle short-term obligations. The quick ratio uses only highly liquid current assets in its numerator, such as cash, marketable securities, and accounts receivables. The assumption is that certain current assets, like inventory, are not necessarily easy to turn into cash.

QUICK RATIO =
(CURRENT ASSETS - INVENTORY) / CURRENT LIABILITIES

6. Leverage

Financial leverage, also known as the **equity multiplier**, refers to the use of debt to buy assets. If all the assets are financed by equity, the multiplier is one. As debt increases, the multiplier increases from one, demonstrating the leverage impact of the debt and, ultimately, increasing the business risk.

LEVERAGE = TOTAL ASSETS / TOTAL EQUITY

7. Debt-to-Equity Ratio

The debt-to-equity ratio is a solvency ratio that measures how much a company finances itself using equity versus debt. This ratio provides insight into the solvency of the business by reflecting the ability of shareholder equity to cover all debt in the event of a business downturn.

DEBT-TO-EQUITY RATIO = TOTAL DEBT / TOTAL EQUITY

8. Inventory Turnover

Inventory turnover is an efficiency ratio that measures how many times per accounting period the company sold its entire inventory. It gives insight into whether a company has excessive inventory relative to its sales levels.

INVENTORY TURNOVER = COST OF GOODS SOLD / (BEGINNING INVENTORY + ENDING INVENTORY / 2)

9. Total Asset Turnover

Total asset turnover is a ratio that measures how efficiently a company uses its assets to generate revenue. The higher the turnover ratio, the better the company's performance.

TOTAL ASSET TURNOVER = REVENUE / (BEGINNING TOTAL ASSETS + ENDING TOTAL ASSETS / 2)

10. Return on Equity

Return on equity, more commonly displayed as ROE, is a profitability ratio measured by dividing net profit over shareholders' equity. It indicates how well the business can utilize equity investments to earn profit for investors.

ROE = NET PROFIT / (BEGINNING EQUITY + ENDING EQUITY) / 2

11. Return on Assets

Return on assets, or ROA, is another profitability ratio similar to ROE. It's measured by dividing net profit by the company's average assets. It's an indicator of how well the company is managing its available resources and assets to net higher profits.

ROA = NET PROFIT / (BEGINNING TOTAL ASSETS + ENDING TOTAL ASSETS) / 2

12. Seasonality

Seasonality is a measure of how the period of the year is affecting your company's financial numbers and outcomes. If you're in an industry affected by high and low seasons, this measure will help you sort out confounding variables and see the numbers for what they truly are.

It's important to note there's no absolute good or bad when it comes to financial KPIs. Metrics need to be compared to prior years or industry competitors to see whether your company's financial performance is improving or declining, and how it's performing relative to others.

Now that you know the financial skills you need to succeed as a manager, the question becomes: How do you acquire and develop those skills?

In the next section, you'll learn how taking an online course could help you achieve your educational and professional goals.

Taking the Next Step in Your Financial Education

If you want to develop or further your financial skills, you might be interested in Harvard Business School Online's Financial Accounting and Leading with Finance courses. Curious about which certificate program is the right fit for you? Here's a closer look at what the courses offer.

Course Information	Financial Accounting	Leading with Finance
Faculty	V.G. Narayanan	Mihir Desai
Course Length	8 Weeks	6 Weeks
What You'll Learn	• How to prepare a balance sheet, income statement, and cash flow statement • Processes for reading and analyzing financial statements to determine your company's business performance and potential • Forecasting and valuation methods	• A toolkit for making smart financial decisions and the confidence to communicate those decisions to key stakeholders • Financial analysis techniques and how capital markets work • Ways to create and assess value to evaluate and pitch projects
Who Will Benefit	• Current or aspiring managers who want to understand how their decisions impact their company's bottom line and improve its profitability • Recent graduates interested in learning the language of business • Those considering an MBA who want to prepare for the classroom with a course HBS offers to incoming students	• Early- and mid-career professionals who want to understand the financial landscape of their business and industry to advance their career—particularly if they're in a non-finance role • Aspiring finance professionals who want to learn fundamental financial terms, concepts, and principles • New leaders who want to equip themselves with the skills to create a budget, calculate ROI, and articulate the financial implications of their decisions
How to Learn More	Visit the Financial Accounting course page	Visit the Leading with Finance course page

Both courses can equip you with skills that will prove invaluable in your role as a manager and throughout your career.

Developing financial literacy will enable you to make better business decisions, understand the financial implications of your actions, and more effectively communicate and collaborate with others throughout your organization.

To learn more about what HBS Online can do for you, visit online.hbs.edu.

Harvard Business School Online