Book The Definitive Guide to Business Finance

What Smart Managers Do with the Numbers

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Recommendation

You'd expect a book on business finance to be dry, dull and soporific – that is, a great cure for insomnia. Well, wake up, because Richard Stutely's manual on numbers for nonfinancial managers blows a bracing gust of fresh air into a stale subject. The business expert's witty asides, funny anecdotes and tongue-in-cheek approach make for a relatively painless introduction to the basics of number crunching. More important, he focuses on making sense of figures and data and on applying the knowledge they provide. *BooksInShort* suggests this instructive guide to new managers who seek a primer on business finance; business students who need a comprehensible revision aid; seasoned nonfinancial executives, who will refer to it again and again; and novice business owners, who'll find that its easy-to-use layout really helps make the material accessible.

Take-Aways

- No matter your position or level, you are responsible for your business's profitability.
- Understanding your firm's financial information and knowing how to use the numbers will affect your career.
- Start by getting to know the basic software for spreadsheets, charts and graphs.
- Ask "hard questions" about how your firm accounts for sales, expenses and cash flow.
- Learn how accountants and finance directors approach their work.
- Use numbers to analyze trends and spot patterns in your revenue and costs.
- Gather information to forecast sales, which is the pivotal factor that determines the rest of your estimates.
- Be aware of the ins and outs of reporting and question the underlying suppositions that go into preparing financial statements.
- Know the components of and relationships among your balance sheet, cash flow statement and income statement (called "profit and loss accounts" in the UK).
- Beware of manipulative accounting tricks – like "the big bath," which uses a general restructuring to hide losses, or "merger magic," where costs disappear into an M&A.

Summary

"It Is All About the Money – Mainly"

No matter which department you serve in your company – sales, marketing, IT, human resources – and regardless of your seniority, you are responsible for your firm's profitability. That's true whether you own a one-person business or work in a multinational corporation. Understanding the numbers is a prerequisite for making money. Your comprehension of figures and financial statements – and, most important, your knowledge of how to use them – will make a huge difference in your current job and throughout your career. You need a good grasp of the numbers if you are creating and defending budgets, forecasting sales, developing strategic plans, deciding on projects, and dealing with auditors or accountants, among other activities. You don't need an accounting degree or experience as a financial analyst; anyone can learn to master the numbers.

The Care and Feeding of Accountants

To learn about the financials, analyze where your accountants and financial directors come from – historically, culturally and educationally. Accountants long ago earned the nicknames "bean counters" and "dough kneaders" for their exactness and their data-massaging skills. The oldest recorded human writing – 5,500 years old – most likely described bookkeeping and taxes.

> "Success in business finance comes from more than just looking after the cents, pence or whatever."

Accountants undertake rigorous training and certifications; they are "indoctrinated with the need for meticulous precision and attention to detail." Different types of accountants perform various duties: Financial accountants deal with reporting, cost accountants with budget and expense analysis, and management accountants with "trying to make sense of it all." The chief financial officer directs a firm's financial operations with the help of a treasurer, who is responsible for cash management. Accounts receivable and payable teams collect money and pay bills; bookkeepers produce financial accounts; information specialists work on computer applications; and auditors check everyone else.

> "It's about how you manage the numbers. All of them."

When you take on a managerial role with financial responsibility, ask the accountants for a manual specifying your job's financial aspects. Add a disclaimer for any changes that you do not receive in writing. Also request an internal audit of your unit as a benchmark. Be aware that accountants follow certain core beliefs: "Everything can be measured," "the value of something is what you paid for it," "always play it safe" and accounting "policies are set in stone."

Getting Started

Get to know the basic software for spreadsheets, charts and other graphic ways of displaying data. Heed some simple tips when presenting figures, such as "the 4/5 rule," which says to round down numbers ending in four and round up those ending in five. Straightforward, right? Knowing when to round up or down matters, since you could end up with errors like 2 x 2 = 6. How? For instance, 2.4 x 2.4 = 5.76, but if you round 2.4 down to 2 and 5.76 up to 6, in this case, 2 x 2 = 6. When you look at figures and charts others have prepared, question the correctness of the numbers: Did the preparer round the figures accurately and at the right point? Do the graphics reflect the data properly? Did the preparer map calculations correctly in the spreadsheet?

> "With a reasonable command of the figures, you will be able to manage more effectively and efficiently, make better decisions, produce stunning reports, be a better communicator and at least hold your own in difficult meetings."

Learn the underlying concepts of the net present value and future value of money and calculate them with your software. Such computations are critical to making decisions about investments, projects and rates of return. Similarly, understand the fundamentals of bookkeeping: Create a "chart of accounts" that lists your firm's assets, liabilities, equity, sales and their cost, operating expenses, and other income and expenses. These categories all come into play in your balance sheet, which is a snapshot of your assets, liabilities and equity; your income statement, which measures your income and expenses over a set time period; and your statement of retained earnings, which is the result of your net profit or loss added to the firm's capital base.

> "As an entrepreneur or manager, your job is to contribute to the bottom line, to ensure that income exceeds expenditure and happiness ensues."

Analyze your business's practices by asking some "hard questions":

- Does your company mandate a two-person system for preparing and paying bills?
- Do two signatories endorse every check or funds-transfer instruction?
- Are your outgoing and incoming payments marked and acknowledged in the correct accounting categories?
- Are checks typewritten and free of changes or "paint" – that is, hand corrections that could lead to errors?
- When a payment exceeds $25, do you send a check or disburse it from petty cash?
- Do you have written rules on expense control?
- Does the staff reconcile bank statements regularly?
- Does your firm actively monitor past-due accounts?

Use the Numbers to Forecast Sales

Now that you understand the basics, gather several years of data and use that information to make some judgments about your business and its future track. Use basic spreadsheet software to plot the sales, expenses, cash flow and other important statistics. Seek trends that will help you see relationships and patterns. For instance, in considering your sales history, watch for "one-off influences" that can distort your figures; an "underlying trend" that signals your firm's actual progress; "any cyclical factors" that correlate to the general economy; "seasonality" that can add to or detract from sales; and "residual noise," hard-to-explain, outlier facts that might require deeper digging to find their meaning. Seek relationships amid the numbers, like "a 10% increase in advertising...leads to a 2% increase in sales," or "a 5% cut in prices boosts sales by 10%."

> "You have to turn chaos into order, data into information. You will analyze, interpret, review and criticize (this last one is fun)."

Next, use what you've learned about your company's past to attempt to predict its future. Start with a sales forecast, because all other guesses about any other aspect of your business – including predictions of expenses, net income and cash position – pivot on the sales projection. Know the difference between forecasting and estimating: Forecasting requires using a more sophisticated method than you need for estimating. Forecasting calls for analyzing all the components that could affect future sales growth. Using the sales projection lets you logically deduce and estimate other aspects of your business. Forecast sales with one of these methods:

- **"From the ground up"** – Talk to your field salespeople and review your order history.
- **"The numbers game"** – Take a mathematical look at how many sales calls result in orders, and base your forecast on how many salespeople you have and how many client meetings they can have.
- **"Try harder"** – Increase your sales goal by a percentage of last year's numbers.
- **"Whatever you can manage"** – Target some percentage of the total market.

> "Cooking up a forecast...nearly always boils down to forecasting sales volumes...Once you have this central number, everything else will be estimated, not forecast."

Look within your business, in your industry and outside to external experts – trade associations, consultants, academia and government – to learn about factors that could have an influence on future revenues. Create alternative forecasts, including best- and worst-case scenarios.

Use the Numbers to Estimate Costs

Capital spending on fixed assets – property, plant and equipment, as well as intangibles such as goodwill – represents the largest chunk of most companies' expenses. Because these assets have years of useful life (although they don't immediately add value to the bottom line), businesses use special accounting methods to determine the depreciation of real assets, the amortization of intangible assets and the depletion of natural resources.

> "Accountants and financiers are essential to the functioning of every business...Love them or hate them, you just can't live without them."

When reviewing your firm's treatment of fixed assets, inquire whether the values ascribed to them on the books indicate their true current market value. Find out if fixed asset tallies omit any intangible assets, such as the brands of your machinery, the location of your premises or your intellectual property. Determine whether installation and maintenance costs, useful-life estimates, and depreciation policies are correct. Always ask if it makes more sense to lease than to buy.

> "When given figures, question them ruthlessly. Do not assume that because they are in a complex spreadsheet they must be right."

Besides capital spending, other expenses are the cost of sales, operating expenses and overhead, ongoing expenses on fixed assets, and taxes and loan interest. Different companies group these categories in different ways: by product, geography or functional group, like sales or research. Employee expenses can be a significant portion of total costs, but are also among the easiest to segregate and analyze; these include salaries and wages, benefits, payroll taxes, and training and legal costs. Operating costs cover marketing, communications, rentals, property maintenance, technology, travel and office expenses.

> "Today, common office software has matured to the extent that a nonfinancial manager can do tricks with numbers that were previously undreamed of even by mathematical specialists."

You can choose among several methods for projecting monthly future costs. Besides just extrapolating from the past, consider "fixed relationships"; for example, how much computer paper you need may be a function of head count. Account for expected increases, like inflation and seasonality. In reviewing others' projections, look for ways "managers massage costs": adjusting inventory values, changing depreciation and amortization amounts, tinkering with provisions and reserves, and "inflating or skimping on maintenance and repairs."

Financial Reporting

The balance sheet, the income statement and the cash flow statement are the holy trinity of financial reporting. The income statement and the cash flow statement cover a period of time, such as a quarter, six months or a year. The balance sheet, on the other hand, is a view of assets, liabilities and owners' equity on a given day. Take note, too, of "off balance sheet" items such as contingent liabilities and assets, contracts and negotiations, influential "related parties," and any issues that arose after the balance sheet's closing date. These have the potential to add to or detract from the balance sheet's noted values.

> "If numbers can talk, charts positively sing."

While the income statement covers revenues and their associated costs, the cash flow statement tracks the in-and-out movement of funds. It measures a company's liquidity over a period of time, accounting for transfers of cash or near-cash equivalents (like short-term – less than three months – investments). Positive cash flow should grow over time, ensuring a firm's ability to continue operating. Note any "large or unusual items" that distort it, and query the suppositions preparers made to see if those assumptions are reasonable. Cast a critical eye when reviewing such reports from your accountants or other analysts: "Always ask yourself, could they have recorded this differently?"

"What They Don't Want You to Know"

Be alert to the following types of financial smoke and mirrors:

- **"Cookie-jar accounting"** – "Overestimating liabilities (sales returns, loan losses) in good years" can build a stash of assets to dip into when times get tough.
- **"The big bath"** – A general "financial restructuring" can hide all sorts of losses.
- **"Merger magic"** – Mergers and acquisitions offer a chance to write off costs.
- **"Disappearing details"** – Transactions that are carried out through subsidiaries have a habit of vanishing.
- **"Transfer tricks"** – Deals among related entities sometimes are not at market prices.
- **"(Im)materiality"** – In some instances, businesses can use their judgment on what they want to report.
- **"Unrealistic revenue recognition"** – Recording sales before they're final and other techniques exaggerate revenues.
- **"Profiting from pensions"** – Manipulating pension-fund allocations and surpluses can tamper with reported results.
- **"Obscuring with options"** – Paying with equity bypasses profit and loss lists.
- **"Derived values"** – Derivatives are tough to price and value.
- **"Playing footsie"** – Look for important items buried in fiscal statement footnotes.
- **"Fraud"** – "Not all dishonest accounting is legal."

> "Go out and do what smart managers do with the numbers – stay on top of them."

Assessing any enterprise's financial health can be a daunting challenge – but with fundamental knowledge, you can ask the right questions at the right time to gauge what's really happening.

About the Author

Richard Stutely is an author, educator and Microsoft-certified professional with extensive experience in corporate finance.