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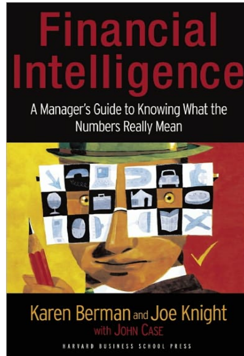

Financial Intelligence

A Manager's Guide to Knowing What the Numbers Really Mean

by Karen Berman, Joe Knight and John Case
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Take-Aways

- Managers with "financial intelligence" are more engaged in their work. They help increase corporate profitability and can make more effective decisions.
- All managers should attempt to master the language and "art of finance."
- Your firm's financial estimates are good guesses based on previous history and judgments on revenue recognition, expense allocation, and the like.
- Income statements represent a company's profitability over a certain time period.
- Accounting's "matching principle" requires companies to record revenue in line with the expenses incurred in realizing that revenue.
- Balance sheets show equity or assets minus liabilities – that is, the difference between what companies own and what they owe at a specific point in time.
- Profit and cash are not the same. Profit is the gain you have left after you use your cash to pay your expenses.
- Use ratios to understand how different numbers relate to each other.
- Faster bill collection and smaller inventories lead to more cash and more profitability.
- Make basic fiscal literacy part of your corporate culture and teach it to your employees.

Rating (10 is best)

Overall	Applicability	Innovation	Style
8	**9**	**6**	**8**

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Relevance

What You Will Learn

In this summary, you will learn: 1) What basic financial terms and formulas mean and 2) Why "financial intelligence" matters.

Recommendation

Many managers do not understand their companies' numbers, warn financial consultants Karen Berman and Joe Knight and business journalist John Case, and that can be personally and professionally detrimental. The authors' primer on fiscal know-how addresses managers who don't really understand how to read an income statement even though they may have to track their departments' expenses. Accountants' vocabulary and formulas may be intimidating, but this book can help you build your "financial intelligence," so you can understand the basic principles of the "art of finance," and analyze business reports individually and as part of a bigger picture. The prose can be a bit dry in spots, but this useful guide clearly explains financial concepts to the uninitiated. *getAbstract* recommends it to managers and employees who struggle with business numbers.

Summary

Why "Financial Intelligence" Matters

"The one thing every organization has in common is numbers and how those numbers are tabulated, analyzed and reported."

You can learn to boost your financial intelligence, and the math isn't even so complicated. Companies perform better when their managers speak the language of business – the numbers. Financially intelligent executives know how to question the number crunchers when the figures don't look right. And, understanding finance also helps managers make better decisions inside their departments and outside of them, as well.

Recent financial scandals demonstrate why businesspeople must be financially literate. Even without breaking any laws, companies can inflate their numbers so they appear more profitable than they are. Accountants must make their best predictions about what the next month, quarter and year will bring based on previous history and market forces. To rely on those numbers, you must understand that they are estimates – well-informed estimates, but estimates nonetheless.

"Financial intelligence means understanding where the numbers are 'hard' – well supported and relatively uncontroversial – and where they are 'soft' – that is, highly dependent on judgment calls."

Financially intelligent managers are familiar with basic business accounting terminology. They can read an income statement, balance sheet and cash flow statement. They know the difference between profit and cash. They can use ratios and return on investment analysis to help in their understanding of the business and the decisions they make.

"The Art of Finance"

Despite what most people think, some of the numbers on financial reports depict good guesses. Ideally, accountants try to match their estimates with reality, but that's not easy. For example, when is a sale a sale? Does that happen when your client signs a contract, when you ship the product or when you receive payment for it? Allocating costs requires making some assumptions: If you work on a new product in June and introduce it to your clients in July, your accountant must justify how much of your pay to charge to the cost of research and development or to the cost of the product, and how much to accrue in June versus July.

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Depreciation – the reduction of the value of physical goods such as buildings and equipment over time – is another number you can record different ways. Usually, accountants spread depreciation costs out over the predicted lifespan of an asset rather than subtracting its total cost at the time of purchase. But how fast and how much you depreciate an asset has an impact on your financial statement. For example, when airplanes remained in service beyond their expected useful life span, industry accountants extended their depreciation periods, deducting less in depreciation costs from revenue each month, and thereby boosting airline profitability.

"Much of the art [of finance] lies in choosing the valuation method. Different methods produce different results – which, of course, injects a bias into the numbers."

The Income Statement

The income statement shows a firm's profitability over a set time period. These reports – also known as profit and loss (P&L), operating or earnings statements – measure profit or lack of profit for the whole company or for individual units. Income statements may be "actual," showing real sales and costs, or "pro forma," projecting what accountants believe will happen, for example, in a start-up.

The P&L statement adheres to a basic accounting imperative: "the matching principle." It says you must record your revenue in line with the expenses you have incurred in realizing that revenue. The P&L statement shows sales as they occur when you deliver a product or service to a client, not necessarily when you receive payment; it does not record cash coming into the business. Yet each company records sales differently. For example, consulting work may take several months to unfold and, thus, accountants must spread that revenue out over time. Similarly, the expenses associated with that revenue must match the timing of the sale. Recognizing revenue, sales and costs can be a gray area; in fact, this is where most financial fraud cases occur.

"When someone asks, 'What's the bottom line?' he or she is almost always referring to net profit."

A P&L statement shows expenses in two major categories. The first is "cost of goods sold" (COGS) or the "cost of services" (COS). Both categories include all the expenditures of delivering a product or service, including labor and supplies. The second category is operating expenses, the day-to-day costs, such as utilities, salaries, and the like. Determining how to categorize each cost sometimes requires judgment and interpretation.

Profit equals revenue minus expenses, and it comes in three types: Subtract COGS or COS from revenue to compute your gross profit. Operating profit, which is gross profit minus operating expenses, is also called "earnings before interest, taxes, depreciation and amortization" (EBITDA). Net profit is what remains after you subtract all these costs and also subtract interest and taxes. Companies can increase net profit three ways without cooking the books: increase profitable sales, lower costs or reduce the workforce. The first two options are expensive and time-consuming. The last option provides a short-term solution to a long-term problem, as CEO "Chainsaw Al" Dunlap found at Sunbeam. The company's profits rose after he instituted waves of layoffs, but the company's underlying problems eventually caught up with the accounting. Then the firm fired Dunlap.

"Just because a company is making a profit in any given time period doesn't mean it will have the cash to pay its bills. Profit is always an estimate – and you can't spend estimates."

The Balance Sheet

A balance sheet reflects what a company owns, owes and is worth, or assets, liabilities and owners' equity. Balance sheets pinpoint a company's financial health at a certain point in time, such as at the end of the year.

Assets include anything a firm owns, such as cash, securities and real estate. Accounts receivable (A/R) represent what your customers owe you; on the balance sheet, money due to you is an asset. The balance sheet also lists your inventory, property and equipment.

"Revenue recognition is a common arena for financial fraud."

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"So what is the balance sheet? It's no more, and no less, than a statement of what a business owns and what it owes at a particular point in time."

With acquisitions, companies may receive both tangible assets, such as inventories, buildings or machinery, as well as intangible assets, such as brand recognition, patents, proprietary knowledge and a trained labor force. Accountants used to write down the value of goodwill – the intangible assets in an acquisition – over time like other assets, but new accounting rules treat goodwill more like land, which doesn't depreciate and may gain value over time.

The other side of the balance sheet demonstrates how a business got its assets: either through what it owes (called liabilities), such as long- and short-term debt or accounts payable (A/P), or what it used of its own resources (called owners' equity). Short-term liabilities include what a firm owes its vendors; although vendors and suppliers may deliver goods daily, companies often wait 30 or more days to pay for those items. Long-term liabilities include outstanding long-range loans and other obligations, such as pensions and deferred compensation. Equity can take several forms, including shares issued, "additional paid-in capital" (the excess investors pay over shares' par value) and retained earnings (profits the firm reinvests in its business).

"Since you can't get something for nothing, the 'owns' side and the 'how we obtained it' side will always be in balance. They have to be."

Balance sheets, aptly enough, must always balance. One side has to equal the other, because each transaction affects both assets and liabilities and/or equity. The income statement also affects the balance sheet: Each sale appears on the income statement as either cash or A/R, while some expenses show up in A/P. The balance sheet answers these important questions:

- **"Is the company solvent?"** – More assets than liabilities means equity is positive.
- **"Can the company pay its bills?"** – Short-term assets should always cover short-term liabilities.
- **"Has owners' equity been growing over time?"** – Comparing several years' worth of balance sheets will indicate a firm's progress.

The Cash Flow Statement

Warren Buffett and many other leading investors made their fortunes by paying close attention to the importance of cash in a business. You can manipulate income statements and balance sheets, but not cash flow statements. Cash is a firm's "reality check."

"Cash is different. Look at a company's cash flow statement, and you are indirectly peering into its bank account."

Profit and cash are not the same thing. You earn profit when you make a sale, but you could wait 30 or more days for the cash from the sale. Ideally, cash flow will eventually match net profit, but not always. For example, take a fictional start-up, a bakery, which sells to retailers. In January, it operated at a loss of $2,000, but it rebounded in February and March, making $2,000 and $8,000 in profits, respectively. Sounds great, right? But the bakery pays its vendors and suppliers in 30 days, while the bakery's customers have 60 days to pay their bills. So the business can never catch up; eventually, it will run out of cash unless it finds additional sources of revenue.

"One reason why so many small companies fail in their first year [is that they] simply run out of cash."

Because cash represents real money, cash flow statements are straightforward: "Cash coming in is a positive number, cash going out is a negative one, and net cash is simply the sum of the two." Financially healthy companies turn profits to cash in a timely way. "Free cash flow" is what remains after you subtract what you need to run the business; it's an important indicator of a firm's financial well-being. The Wall Street frenzy around dot-coms in the 1990s ignored this key marker; these start-ups weren't generating any cash except from avid investors. The subsequent dot-com crash shouldn't have surprised anyone who could read a cash flow report.

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Ratios

Ratios show you how numbers relate to each other. They flesh out a story that statistics alone can't tell. Compare ratios from year to year to see if your projections were accurate and if your company performed well against its competition. Managers typically look at four groups of ratios:

1. **"Profitability"** – Calculate gross, operating and net profit margins as percentages of total revenue to give you an idea of how well a business generates profits. Dividing net profits by total assets or total equity gives you the return on assets or equity (ROA or ROE), which help show how well a firm is using its resources.
2. **"Leverage"** – Another word for debt, leverage allows companies to grow. "Operating leverage" refers to the relationship between a firm's variable and fixed costs. "Financial leverage" indicates how much debt finances a company's assets. A debt-to-equity ratio – divide total liabilities by shareholder's equity – reveals the amount of financing for each dollar of equity. Debt-to-equity ratios can vary based on corporate size and industry, but most companies have more debt than equity.
3. **"Liquidity"** – These ratios tell you how well firms can meet their obligations, including payroll, vendor payments, taxes, and the like. The current ratio compares short-term assets to liabilities due within a year. A ratio that is too low (at 1 or less) means a firm risks running out of money to pay its bills; a ratio that is too high means a "company is sitting on its cash."
4. **"Efficiency"** – Asset productivity is a critical measure of a company's financial health. The quicker a firm turns over its inventory and the faster it collects on its sales, the better. Days Sales Outstanding (DSO) measures the average time it takes to receive payment; a high DSO indicates a problem in your collections. Reducing DSO adds cash to coffers.

"It's pretty tough for anyone to cook the books when they're open for everyone to see."

"Better balance sheet management makes a business more efficient at converting inputs to outputs and ultimately to cash."

"The ultimate lesson here is that companies need both profit and cash. They are different, and a healthy business requires both."

Financial Intelligence at Work

Even if you're a nonfinancial professional, you play a role in ensuring your business's financial strength. Your work can directly affect your company's financial statements.

Understand the concept of working capital (current assets minus current liabilities): A working capital cycle begins with cash, which the firm uses to buy raw materials; it converts these materials in products in various stages of development, or inventory; then, once it makes a sale, it creates a receivable from a client, which eventually becomes cash. If you keep your DSO figures low, you'll need less working capital. Carefully manage your inventory: Overstock leads to greater cost, and lack of stock leads to upset customers.

Train your managers in financial literacy: Hold 30- to 60-minute training sessions, each on a basic financial topic. Help them see how their work contributes to the organization's fiscal success.

"Have no fear: The math is easy. And calculators are cheap. You don't need to be a rocket scientist to be financially intelligent."

About the Authors

Karen Berman and **Joe Knight** own the Business Literacy Institute, a consultancy specializing in financial intelligence programs. Co-author **John Case** has written several business books.

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