Financial Intelligence

The Ten Accounting Instruments Every Professional Should Know

PREVIEW

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Course Objectives

After you've completed this course, you'll be able to:

- Identify the advantages of analyzing financial information.
- Understand the purpose and benefits of budgets.
- Differentiate among various financial instruments.
- Conduct horizontal and vertical analyses using your organization's financial information.
- Recognize which ratios are most important to your organization.

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Introduction

In today's economy, organizations are doing more with less. They're demanding more productivity from every employee and looking for every possible measure to improve the bottom line. And they're expecting their employees to monitor and drive this process themselves.

Most business professionals offer special skills to their employers, and most of these skills are NOT related to accounting and finance. However, a basic working knowledge of financial statements and calculations is necessary to make sound decisions about all aspects of a business.

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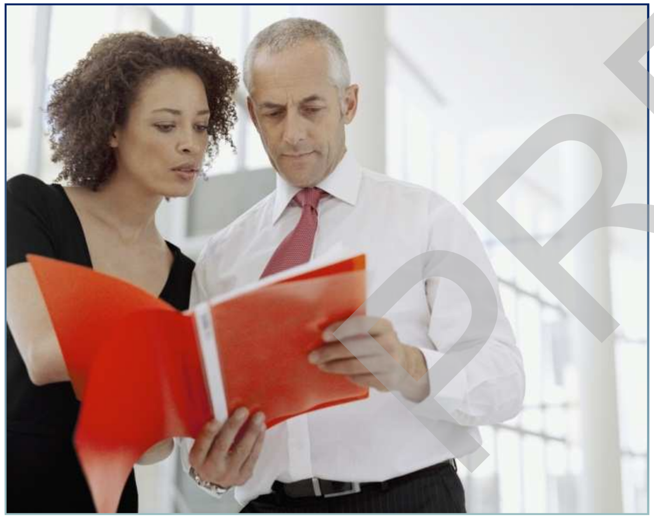
Introduction (cont.)

Financial statements and instruments reveal important information about your organization's financial health by highlighting areas where your organization performs well and areas where there are opportunities for improvement. By learning how to read and interpret a few basic financial instruments, you can recognize opportunities to increase revenue and shave expenses, thus increasing your value to the organization.



By improving your financial know-how, you'll empower yourself in many ways. You'll know how to justify requests and translate performance into financial terms. You'll be able to quantify your department's contribution to the organization—and your own. You'll communicate more effectively with your boss, upper management, shareholders, and other stakeholders about the financial results you have achieved and those you plan to deliver.

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Ten Financial Instruments

We'll look at ten financial instruments that will help you make decisions and influence the success of your organization.

Instrument	Module
1. Budget	1
2. Balance sheet 3. Income statement 4. Statement of cash flows 5. EBITDA 6. Break-even analysis	2
7. Liquidity ratios 8. Profitability ratios 9. Leverage ratios 10. Efficiency ratios	3

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Module 1: Budgeting

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The Budgeting Process

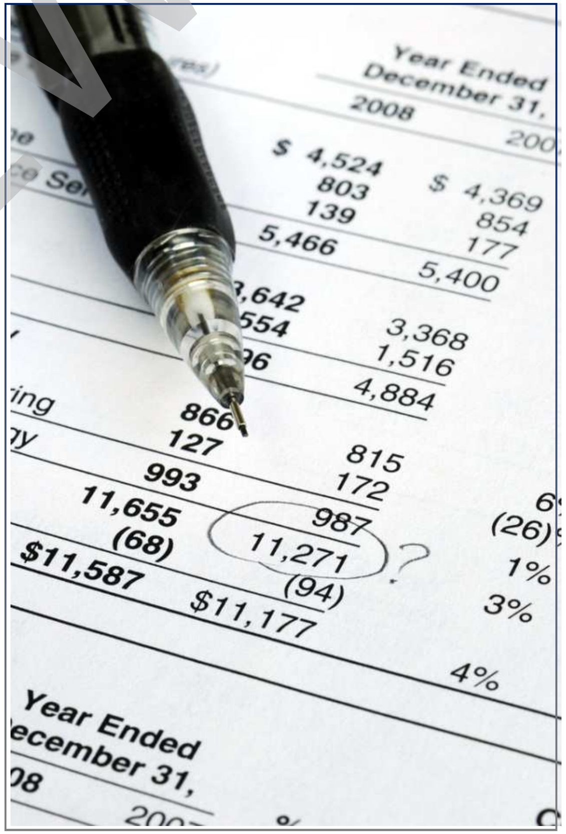
Budgeting can be as simple or as complicated as you want to make it. Use this three-part process and simplify or elaborate on it based on the needs of your department and your organization.

1. Create your budget.

2. Track and report.

3. Analyze and make course corrections.

We'll look at each part of the process in more detail over the next several slides.



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1. Create Your Budget

The easiest way to create a new budget is to start with a previous budget. Then take your annual strategic plan (if you have one) and a list of the specific activities under your jurisdiction required to achieve the strategic plan and your organization's goals. With that information:

- Establish your monthly profit goals.
- Establish revenue targets.
- Forecast variable costs. (These change as revenue changes.)
- Forecast fixed expenses. (These are usually easier to forecast.)
- Forecast net profit.

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What Makes a Budget Effective?

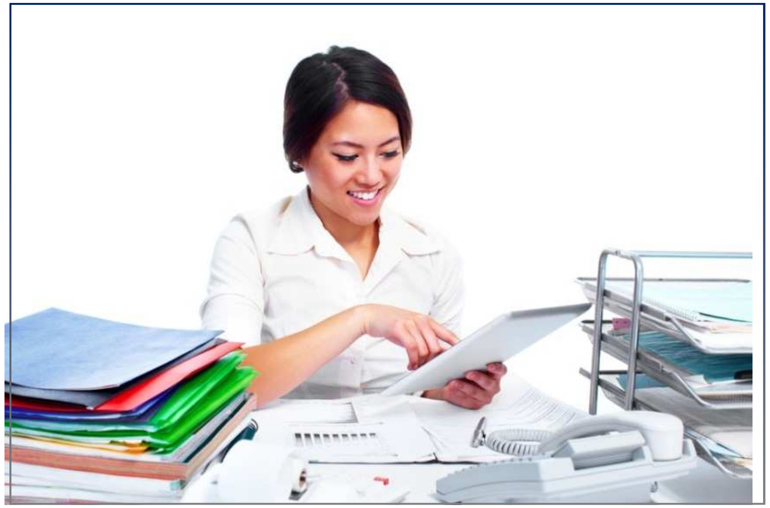
The following attributes help ensure the effectiveness of any budget.

Validity of assumptions: Is your budget realistic and quantifiable? Are your assumptions in line with historical data?

Ownership and control: Are the items in your budget under your control? Can you influence the results or outcome?

Purpose: Does the budget help you meet profit targets and avoid costly surprises?

Flexibility: Does your budget allow you to make adjustments based on actual results or changing conditions?



You want to answer "yes" to all these questions.

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Test Your Knowledge

Read the question, then click on the answer.

Which of the following is NOT an attribute of an effective budget?

a. Locks your estimates firmly in place so others can see whether or not you have met your targets.
b. Is based on valid assumptions and historical data.
c. Contains items that are under your control and that you can influence.
d. Is flexible so you can make adjustments if actual results or changing conditions warrant it.

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QUIZ

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Income Statement

Purpose: The income statement provides a summary of revenues and expenses over a certain period of time, usually a quarter or a year.

Think of an income statement as a set of stairs. Start at the top with the total amount of sales made during the accounting period. Then go down one step at a time. At each step, deduct certain costs or operating expenses. At the bottom of the stairs, after you've deducted all the expenses, you reach the **net earnings**—how much the company earned or lost. This is the proverbial "bottom line."

The bottom line is calculated using this equation:

Net earnings = Revenues – Expenses

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Break-Even Analysis

Definition: Calculating the point at which a company neither makes nor loses money when it sells a product or service.

It is important to know the **break-even point** when setting prices and sales targets for goods or services.

Two ways to calculate

Break-even (in revenue) = Fixed costs + Variable costs

Break-even (in units) = Fixed costs ÷ Gross margin per unit

- **Fixed costs** (also known as Operating expenses): expenses that do not change in relation to the volume of sales
- **Variable costs:** expenses that vary depending on the volume of sales
- **Gross margin per unit** = Selling price – Cost of goods sold (COGS) per unit

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Break-Even Analysis Practice

Using the information provided, calculate the following items for Brenda's Beach Towels.

Brenda sold 30 beach towels at $12 each. She paid $5 for each towel and $1 per towel for materials to monogram them. She pays $30 per month to lease a monogramming machine and spends $50 per month on advertising and publicity.

Cost of goods sold (per unit) =

Total COGS =

Gross margin per unit =

Fixed costs (operating expenses) per month =

Break-even (in revenue) =

Break-even (in units) =

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Profitability Ratios

Profitability ratios measure how well a company performs by determining the amount of income it receives from each dollar of sales. There are many different profitability ratios. Here are some of the most common:

ROI (return on investment) = Net income ÷ Average stockholders' equity

ROA (return on assets) = Net income available to common stockholders ÷ Total assets

Gross margin = (Sales revenue — COGS) ÷ Sales

Net profit margin = Net income ÷ Sales revenue

Return on stockholders' equity = Net income available to common stockholders ÷ Stockholders' equity

Price-earnings ratio = Market price per share ÷ Earnings per share

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Final Analysis

Consider these questions as you look at the big picture of your organization's financial health:

- Did sales grow? Sales growth is usually the key to sustained profit growth.
- Were there any unusual gains for losses? For example, sale of a large asset, retiring a large debt, large legal settlement, etc.

- Was the organization profitable? If so, did the profit generate an increase in cash flow? Sometimes organizations have to build up accounts receivable and inventory.
- Are there any signs of financial distress? Consider liquidity ratios and the credibility of the management team. A credible team is able to convince investors and creditors to extend credit when necessary.

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Case Study

Read the case study and answer the questions that follow in order to put your critical thinking skills into practice.

Organization: A medical supply company

People: Cheryl, the manager of a large division of the company; Cheryl's boss, the Executive Vice President

Situation: Sales in Cheryl's division have been erratic, but in the past couple months they appear to have become stronger. She wants to take advantage of the potential for increasing sales by hiring more people.

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Questions to Consider

1. How can Cheryl get a better handle on the erratic sales pattern? What financial instrument would best help her do that?
2. Cheryl wants to hire more people. What financial instrument(s) would help her most in making that decision?
3. The organization recently acquired another company, but borrowed heavily to accomplish that. What financial instrument would best indicate the state of the organization's financial health as a result of that purchase?

Review the ideas and suggestions provided on the following slides.

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