PERSONNEL NOTEBOOK

For Your Most Important Resource — The Human Resource

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The Skills of Top Managers

Part VIII

In Parts I through VII of this subject, we reviewed the first 13 of what *Harvard Business Review* (HBR) identifies as the 13 skills that set top managers apart from others. Those 13 skills were**:**

1. **Setting Goals That Inspire Others**
2. **Hiring the Best**
3. **Keeping the Best**
4. **Delegating With Confidence**
5. **Managing Your Time**
6. **Managing Teams**
7. **Appraising and Coaching**
8. **Handling Problem Employees**
9. **Dealing With Crisis**
10. **Developing Your Career**
11. **Becoming a Leader**
12. **Strategy**
13. **Mastering Financial Tools**

We began number 13, Mastering Financial Tools, with the budgeting process and continued into preparing the Master Budget.

In this, part VIII, we will continue with Financial Tools and Understanding Financial Statements.

Understanding Financial Statements

If you are a manager in your firm, you might be thinking "I don't need to know this stuff. That's for that bunch at the top, not for me." Think again. The ability to read, understand and interpret financial statements has become more and more necessary as accountability and decision making authorities are pushed further down to lower levels. When the conversation turns to "current liabilities", "profit margin", financial leverage" and "working capital", you will need to know what they mean if you intend to move up in management. The language of modern business draws heavily on financial terminology.

Is your company in good shape? Is it heading in the right direction? More specifically:

- What does your company own and what does it owe to others?
- What are its sources of revenue and how has it spent its money?
- How much profit has it made?
- What is the state of your company's financial health?

Financial statements are the essential documents of business. Mangers use them for decision making. Shareholders Use them to keep tabs on how well their capital is being managed. Outside investors use them to identify

opportunities. Banks, lenders and suppliers routinely examine them to determine the creditworthiness of companies with which they deal.

Further, publically traded companies are required by the Securities and Exchange Commission (SEC) to produce financial statements and make them available. Though companies not publically traded are under no such requirement, their owners and bankers will require them.

The Financial Statement
The financial statement consists of the:

A. Balance Sheet
B. Income Statement
C. Cash Flow Statement

A. The Balance Sheet
Just like getting an annual physical, the balance sheet is a snapshot of the company's financial health at that specific time. But balance sheets are typically produced at the end of each month, quarter or fiscal year.

The balance sheet describes the assets controlled by the business and how those assets are acquired (financed), by borrowing the money from creditors or with the funds of the owners or both. The balance sheet can be expressed as an equation:
Assets - Liabilities = Owner's Equity.

Assets: Your balance sheet usually begins by listing the assets most easily converted to cash; cash on hand, marketable **securities, receivables and inventory.** These are usually called your "*Current Assets*". Generally your current assets are those you can convert to cash within one year.

Next are listed the "*Fixed Assets*" which are tougher to convert to cash, such as buildings, land and equipment. Most fixed assets (except land) will depreciate in value over time.

Some companies list "good will" among their assets. In such cases they may have paid a higher than market value for the asset in order to acquire the well established reputation and expected business from that reputation. Patents owned are also considered an asset.

The total sum of all these assets are listed on the bottom line of your balance sheet as "Total Assets".

Liabilities: Now we know what our assets are. So let's consider the claims (or debts) against those assets. We start by creating a group called "*Current Liabilities*". Current liabilities are those claims that must be paid within one year. This includes short-term IOUs, accrued salaries, accrued income taxes and accounts payable. If you have any long-term loans, you will only list the amount of those loans that must be paid within one year.

Once you have totaled all current liabilities, you will subtract that number from your previously totaled "Current Assets". What you have left is called your "Net Working Capital". This is the amount of money the company has tied up in its current operating costs. The amount you are using to operate your business.

"Long Term Liabilities" are considered to be bonds and mortgages, debts that the company is obliged to repay over the long run. The total of all these is called our "Total Liabilities".
Remember our formula:

Assets - Liabilities = Owners Equity.
We have identified our assets and our liabilities. When we subtract our total liabilities from our total assets, what we have left is the:
Owner's Equity: That tells the owners how much the company is worth to them right now, or what their share of the company is.

If you recall the information about 'Fixed Assets" on page two, there was a statement about how "most fixed assets (except land) depreciate in value over time". Note that; seldom will the fixed assets value shown on the balance sheet accurately reflect the true value of those assets, because of an item called "historical values". This means that accountants must record most items at their acquired (or historical) cost because otherwise, the current value would have to be constantly re-appraised. Professional appraisals are expensive and easily manipulated. So accountants choose the lesser of two evils and accept historical (original) value as the standard accounting practice.

Although the balance sheet is prepared by accountants, it represents a number of important issues for managers who want to lead. Most specifically:

- Working Capital
- Financial Leverage
- Financial Structure of Your Company

Working Capital:
Working capital gives you the money to operate your business. Don't just think of working capital as money to keep things going or to survive, but if your company is profitable doing what you do, then working capital gives you the opportunity to do more of it and thereby make more profit.

One of the major issues for many managers is inventory. Having enough working capital gives you the ability to maintain adequate inventories to meet sales and production needs. Although with today's "Just In Time" management demands, inventories are kept very low in most companies as they depend on quick, on-time deliveries to meet their sales and production needs. Not enough inventory can cause you to fall behind in operations, delay incoming cash and lose business. But having too much inventory can be very expensive, warehouse space, insurance, loss, theft, deterioration, risk of damage etc. can all make too much inventory an expensive business decision.

But a more significant consideration is that too much inventory ties up working capital, capital that you may be paying interest on. That capital may otherwise be more profitably used even if only earning interest.

Financial Leverage
Financial leverage refers to the use of borrowed money in acquiring an asset.

When you hear someone say "this is a highly leveraged situation". Do you know what they mean by "leveraged"? It means that money was borrowed to acquire that item (asset). When we say that a company is highly leveraged, we mean that the amount of debt against the company is getting close to the amount of money invested by the owners.

For managers, leverage can be a good thing if the value of the asset acquired remains high or gains in value. You have acquired something that should earn you more than you paid for it. In addition, interest paid on such loans can be a

valuable tax deduction. But leverage can cut both ways. If the value of the asset drops (or fails to produce the expected level of revenue) then you end up paying a lot of money or something that is worth less than you paid for it and it isn't bringing in the profits you expected.

Financial Structure of Your Company

Your financial structure is mostly an appraisal of the debt you carry balanced with the owners equity you show (debt-to-equity ratio).

When banks and creditors look at your company's debt-to-equity ratio, the more debt they see the more risk they see. Money is loaned at a rate that is tied to the amount of risk the lender sees in getting the money back. So the more debt/risk, the higher the interest rate will likely be.

When investors look at your company's balance sheet they also look closely at your debt-to-equity ratio. They want to see a realistic balance between your debt and your equity. The leverage we discussed earlier can be very good as long as the profitability of those acquired assets continues. Because investors see that the higher interest rates and higher payments for highly leveraged companies warn them that those payments must continue even if times get tough and the assets can't produce profitable revenues for a while.

Although the financial statement of assets and liabilities being used to determine equity is still the standard for American as well as most of the world's accounting systems, there has been over the last few years a new criticism of this standard. Some have even called today's financial statement irrelevant! Former Federal Reserve Board Chairman Alan Greenspan complained in 2000, that most companies are grossly undervalued because they have not taken into consideration the value of the human asset. As more companies become knowledge based firms using information, creativity and producing intellectual properties created by workforce know-how, we are beginning to see that the value of today's companies is highly based on talent, brainpower and skill. The implication is that investors are beginning to look beyond the brick and mortar, equipment and cash to find the true value of today's companies that is highly dependent on the value of the people making it all happen.

In part IX of our series on the Skills of Top Managers we will continue with Mastering Financial Tools and look at the Income Statement.

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