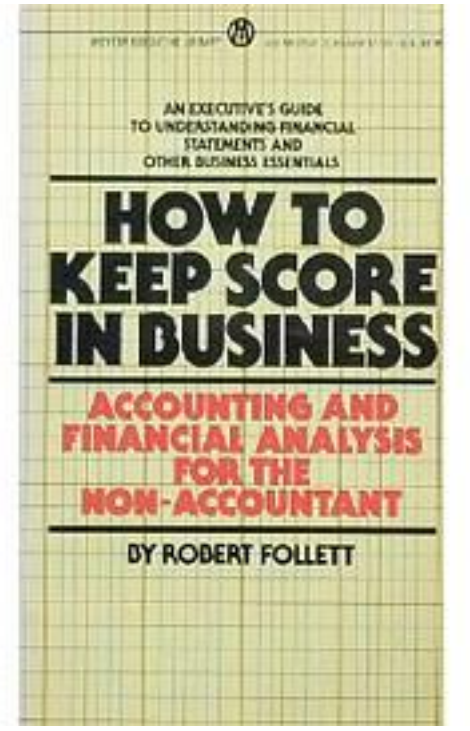
How to Keep Score in Business



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著者:Robert Follett

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The purpose of HOW TO KEEP SCORE IN BUSINESS is to teach you the fundamentals of keeping score in business, so that you can be successful in business despite your lack of formal accounting education. The book will help you read, understand, discuss, and use a balance sheet, an income statement, and other financial reports.

In business, the score is kept in dollars. The system of accounting provides the rules for keeping score. Some people don't understand keeping score in football. They get mixed up about touchdowns, safeties, field goals, and points after. And when there is talk of sacks, percentage completions, and yards per carry, they go blank.

A lot of people don't understand keeping score in business. They get mixed up about profits, assets, cash flow, and return on investment. Discounted cash flow, current ratio, and book value per share leave them blank.

What follows is a brief summary of the key concepts presented in the book. This summary won't make you an accountant but it will help you to begin understanding what you need to know about accounting and financial analysis to succeed in business.

Accounting is a method of keeping score in business. It uses dollars as the basic score. Certain basic financial reports are used to present the score -- the balance sheet, income statement, statement of retained earnings, and statement of changes in financial position. A variety of ratios, percentages, and other tools are used to analyze the scores.

It is very important to understand that the scores on financial reports do not represent real spendable dollars available. A major reason is that businesses use the accrual method of accounting instead of keeping track of cash receipts and payments.

Businesses keep track of transactions that create assets or liabilities on the books of the business. The transactions do not necessarily represent the transfer of cash money at the time the transactions occur. (A sale can be made for which payment will be due in 30 days. The sales transaction is entered on the books as an addition to the assets of the company, even though the company has not received any cash.)

Financial reports not only do not show the actual flow of cash, they are also not exact. Many items in financial reports are estimates. The estimates can differ, depending upon the perspectives and judgments of those who make the estimates.

There is no such thing as the one and only, completely accurate financial report. If you know who prepared the report, and for what purpose it was prepared, you will have a much better idea of the real score.

THE BALANCE SHEET: The balance sheet shows the financial position of a company frozen at one specific point in time. The balance sheet balances. On the left side (or the top) are listed assets (things of value owned by the company). On the right side (or lower portion) are listed liabilities (debts the company owes). Below liabilities is show capital (the amount belonging to the owners after liabilities are subtracted from assets).

Assets = Liabilities + Capital (Or Capital = Assets - Liabilities)

Every entry into or out of the balance sheet must be balanced by a corresponding entry in another part of the balance sheet so that the balance reflected in the formula above is maintained.

Principal Balance Sheet Assets: Cash, Marketable Securities, Accounts Receivable (amounts owed to the company by its customers), Reserves for Doubtful Accounts or Allowances for Bad Debts (a reduction in accounts receivable to provide for accounts that may not be paid), Inventory (goods to be sold to customers), Reserve for Obsolescence (a reduction in the value of the inventory to allow for possible unsalable goods), Prepaid Expenses (amounts paid for goods or services that will come the company in the future, such as rent paid in advance, or payment for a magazine subscription to be delivered over the coming months), Fixed Assets (machinery, land,

buildings, improvements to rented property, and other non-consumable assets used to create inventory or generate sales), Depreciation (a reduction in the value of fixed assets to account for the use of the asset and to turn the expenditure of funds for the asset into an expense), Other Assets (copyrights, patents, franchises, licenses, and other intangible items of value to the business).

Principal Balance Sheet Liabilities: Notes Payable (amounts due to banks or other lenders within a year or less), Accounts Payable (amounts owed to suppliers of goods or services to the company), Accruals (salaries and fringe benefits owed to employees, but not yet paid, also taxes owed but not paid -- although sometimes taxes owed are a separate entry), Long-Term Liabilities (bonds, long-term loans, mortgages, other debts not due for more than one year).

Principal Items of Capital: Capital Stock (preferred and common stock issued and sold to investors who become owners), Retained Earnings (the accumulated after-tax profits of the company, less any dividends paid. Retained Earnings do represent available cash!).

On the balance sheet, assets are listed in the order which they can be converted to cash. Cash itself comes first. Fixed Assets and Other Assets, usually difficult to sell to convert to cash, come last. Liabilities are listed in the order in which they become due for payment. Current assets are those likely to become cash within one year. Current liabilities are those debts due within one year.

Working capital equals current assets minus current liabilities. Working capital represents the funds available in a business which circulate to produce profits. As the business operates, the funds in working capital flow from inventory to accounts receivable to cash to accounts payable to inventory. A decline in working capital is a warning of potential trouble.

All items are entered into the balance sheet at their original cost. Adjustments may be made to reduce value, but increases in value (perhaps from inflation) are not recognized in financial reports. The reductions in value -- Reserves for Doubtful Accounts (Allowance for Bad Debts), Inventory Obsolescence, and Depreciation or Amortization -- are all estimates. When looking at a balance sheet it is important to decide if any assets are valued at more than their true worth (or perhaps, at less than their true worth).

Many valuable assets are not shown on balance sheets -- specially developed software, special production processes, market position, brand awareness, and most especially, the knowledge, experience, and capability of the employees who make the company go. Many times, these unreported assets are far more valuable than those that are reported on the balance sheet.

The net worth or book value of a company equals assets minus liabilities (as shown on the balance sheet). But this number seldom represents what the owners would sell the company for or what a buyer would pay to acquire the company.

The balance sheet and other financial reports are based on certain assumptions: (1- the company is a going concern that will continue in business for the foreseeable future; (2- the estimates used in the report are essentially correct; (3- the perspective of the report reader is the same the perspective of the report preparer; and (4- All entries are entered at original cost.

If any of these assumptions is not justified, the report can be very misleading.

A cautionary note. A company can have lots of assets and a high net worth but be unable to pay its bills, even when sales are terrific and profits look great. If customers pay slowly, if too much money is tied up in inventory that doesn't sell quickly, or if too much money has been invested in fixed assets, a company can be flat broke when its managers believe it is doing well, and the financial reports seem to confirm that belief.

THE INCOME STATEMENT: The income statement (sometimes called the Profit and Loss Statement) summarizes the results of a company's operations over a period of time. The income statement usually follows this format:

Sales minus

Cost of Sales equals

Gross Profit minus

Operating Expenses equals

Operating Profit plus

Non-Operating Income minus

Non-Operating Expenses equals

Net Profit Before Taxes minus

Incomes Taxes equals

Net Profit After Taxes (The "Bottom Line")

Sales represent the delivery of goods or services to customers who agree to pay for them. The customers may or may not actually pay. They often will not pay during the period covered by the income statement.

Cost of sales (sometimes, cost of goods sold) includes all the directly identifiable costs of the goods sold to the customers. Goods produced or acquired, but not sold during the period, do not result in a cost of sales. Until they are sold, they sit in inventory. Cost of sales, purchases, and inventory are related.

Beginning Inventory + Purchases - Ending Inventory = Cost of Sales

Operating Expenses are expenses incurred to generate sales (advertising, promotion, selling, etc.), fulfill orders, collect from customers, keep the accounts, pay the rent and phone bills, and so forth. Some of these expenses are cash expenditures during the period. Some expenses involve the expenditure of cash that have already occurred or will occur in other periods.

Non-operating income is income that arises from sources that are not part of the regular operations of the business. Non-operating expenses are most often interest paid on borrowed money.

Net profit after taxes is the result of all the additions and subtractions on the income

statement. It is not spendable cash. Actual cash generated by operations may be much more or much less.

The statement of retained earnings shows beginning retained earnings plus net profit after taxes minus dividends paid equals ending retained earnings. Remember, retained earnings aren't spendable cash, either.

The statement of changes in financial position shows how funds flowed into, through, and out of the company during the period. It is useful in seeing how working capital changed during the period, and why, as well as showing the change in cash position during the period.

The balance sheet as of a specific date or the income statement for a specific period is only somewhat helpful. To make them much more useful it is necessary to compare the current financial report with other financial reports. Comparison can be made with the similar date or period in the previous month or year. Comparison can be made with the planned or budgeted figures. Comparison can sometimes be made with comparable companies or with industry-wide averages. Using percentages often adds to the value of the financial report. For example, it helps to see that sales increased by 12% while operating profit increased by 18%.

The average collection period is the number of days required, on average, to collect the amounts owed to the company by its customers. A lengthening of the average collection period may signal problems that will lead to serious cash shortages. The formula for computing average collection period is Average Accounts Receivable for the period divided by Sales for the period times 365.

Inventory turnover tells how often the company's inventory is replenished during the year. The formula for computing inventory turnover is Cost of Sales divided by Average Inventory. Low or declining inventory turnover can signal problems of inventory obsolescence or sales effort. Higher inventory turnover means less investment is required to operate the business. (However, high inventory turnover does not mean all items in inventory are selling well. A few items may be selling very rapidly while others just lie there.

The 80-20 rule says that it is likely that 20% of the items in inventory generate 80% of the sales. (The 80-20 rule also says that it is likely that 20% of the customers generate 80% of the sales revenues, 20% of the customers generate 80% of the complaints and problems, and so forth. Many business activities seem to fall within the 80-20 rule, even though there is no scientific foundation for the rule.)

Return on investment (ROI) is the best general method for analyzing a company's (or a division's) financial performance. Return on investment indicates how well the business is using its resources to produce profits. There are several methods of computing ROI. Return on equity = Net Profit After Taxes/Owner's Equity or Capital. Return on Invested Capital = Net profit After Taxes + Interest on Long-Term Debt/Capital + Long-term Debt. This is useful in analyzing companies that have a lot of long-term debt. Return on Assets Used = Operating Profit/Assets Used to Generate Operating Profit. This is often used to analyze divisions or departments of companies.

All ROI formulas produce percentages. These percentages need to be compared with percentages from previous periods, percentages planned or budgeted, percentages produced by competitors or from industry-averages, or percentages of return that could be expected from alternate investments.

In business, investments are always being made today to produce returns in the future. But a dollar in hand today is worth more than a dollar that becomes available sometime in the future. A method called discounted cash flow or net present value is used to analyze investments and their future returns. Popular computer spreadsheet programs and tables found in many publications make it possible to calculate the discounted cash flow or net present value of the returns to be realized from an investment. Of course, these calculations depend upon three assumptions: (1- the amount of the investment and the expected returns, which can usually only be estimated; (2- the length of time over which the analysis is made; and (3- the rate of interest used to compute the present value which ought to be the interest rate or rate of return the company could earn with alternate investments.

Breakeven point is the amount of sales that will just cover all costs. More sales will produce a profit; less sales, a loss. Breakeven is often stated in terms of the number of units that must be sold. If the number of units for breakeven is very high, it may be impossible to make a profit unless costs are cut drastically. This is a valuable management planning tool.

This is a brief summary of some of the important financial reports and financial analysis tools used in business. If you want to know more about how to keep score in business, the complete book is available, and libraries and bookstores are packed with other books that go into often-exhaustive detail about accounting and financial analysis.

Two last thoughts. Remember that financial reports are not exact and the numbers are not real cash. Financial reports are scorecards. Don't be fooled into believing they tell the whole truth about a business.

Remember that financial reports are not the only or even most important measure of what is valuable. The worth of human beings is not shown in financial reports. Love and truth and beauty and adventure and justice and many, many more of life's most important things cannot be pinned down by the numbers on financial reports. Use financial reports as tools -- to help you achieve important and worthwhile goals. But don't let your life be dominated by the numbers on financial reports. They are totally unsuitable tools for many of life's most important goals.

Keep your mind on those things that you will want to look back on with pride as your life draws to a close. I don't think that good financial reports or accounting results will be among those things.

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