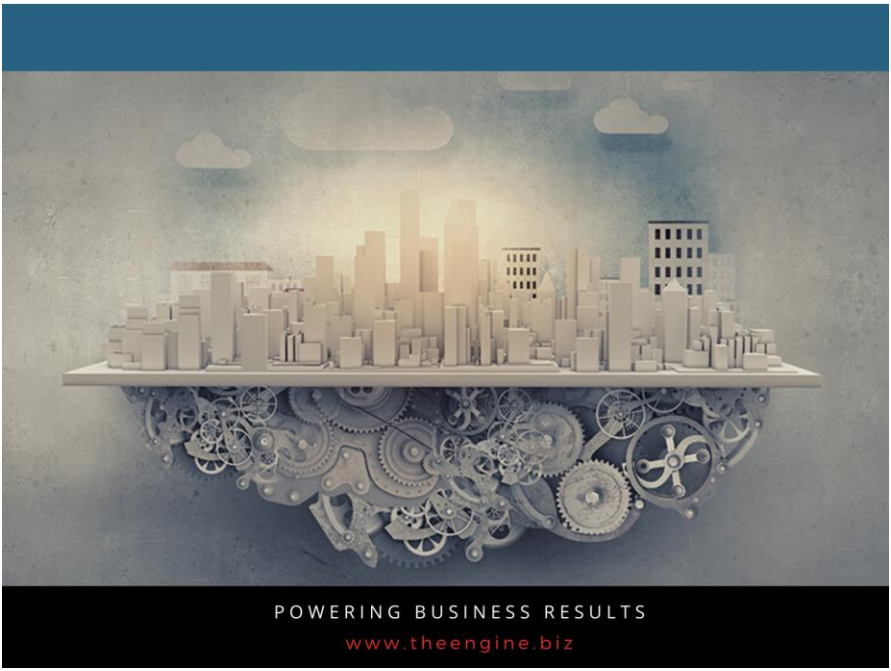
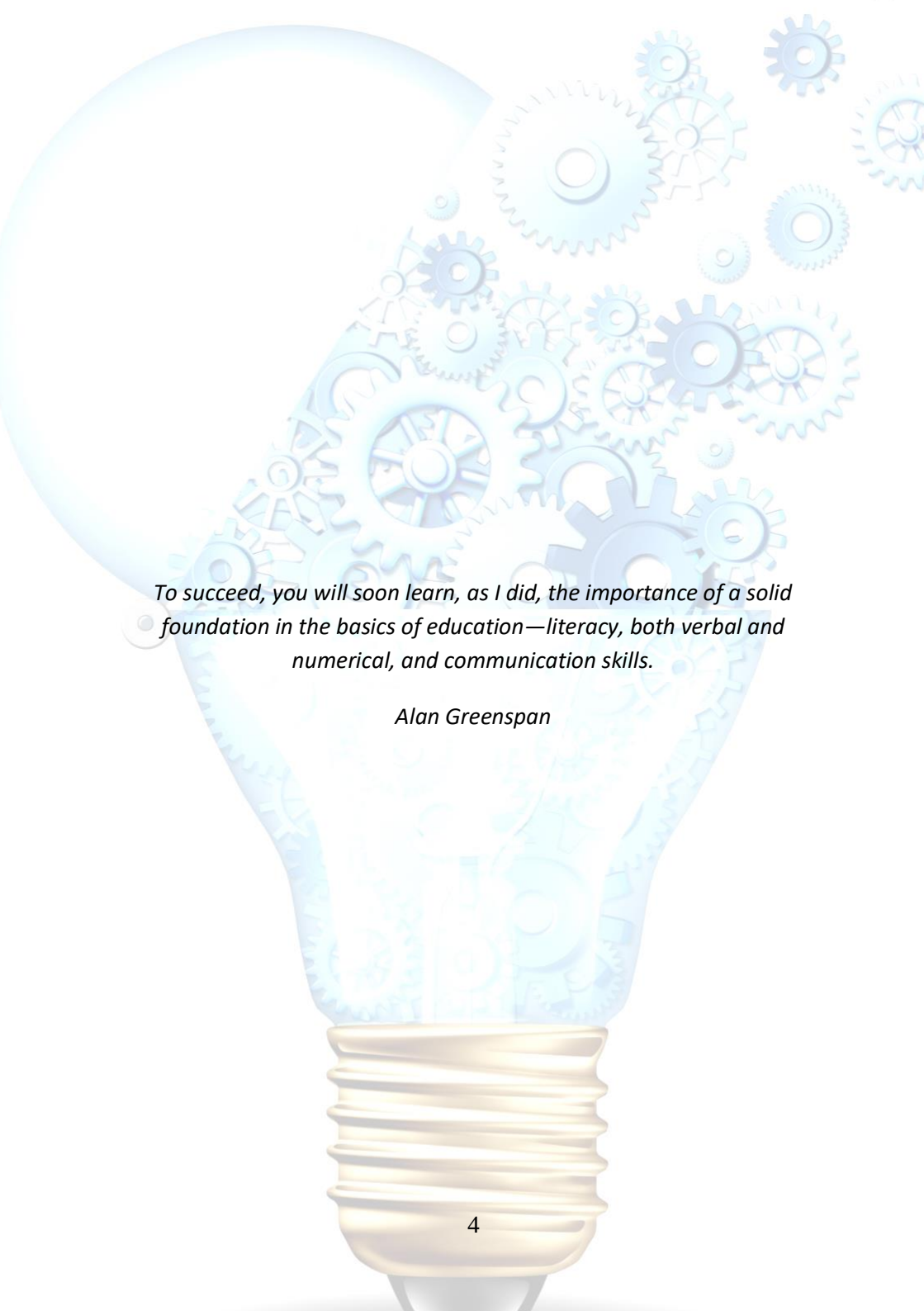
THE ENGINE™
POWERING BUSINESS RESULTS

Budgets and Financial Reports



Copyright Notice

CONTENTS



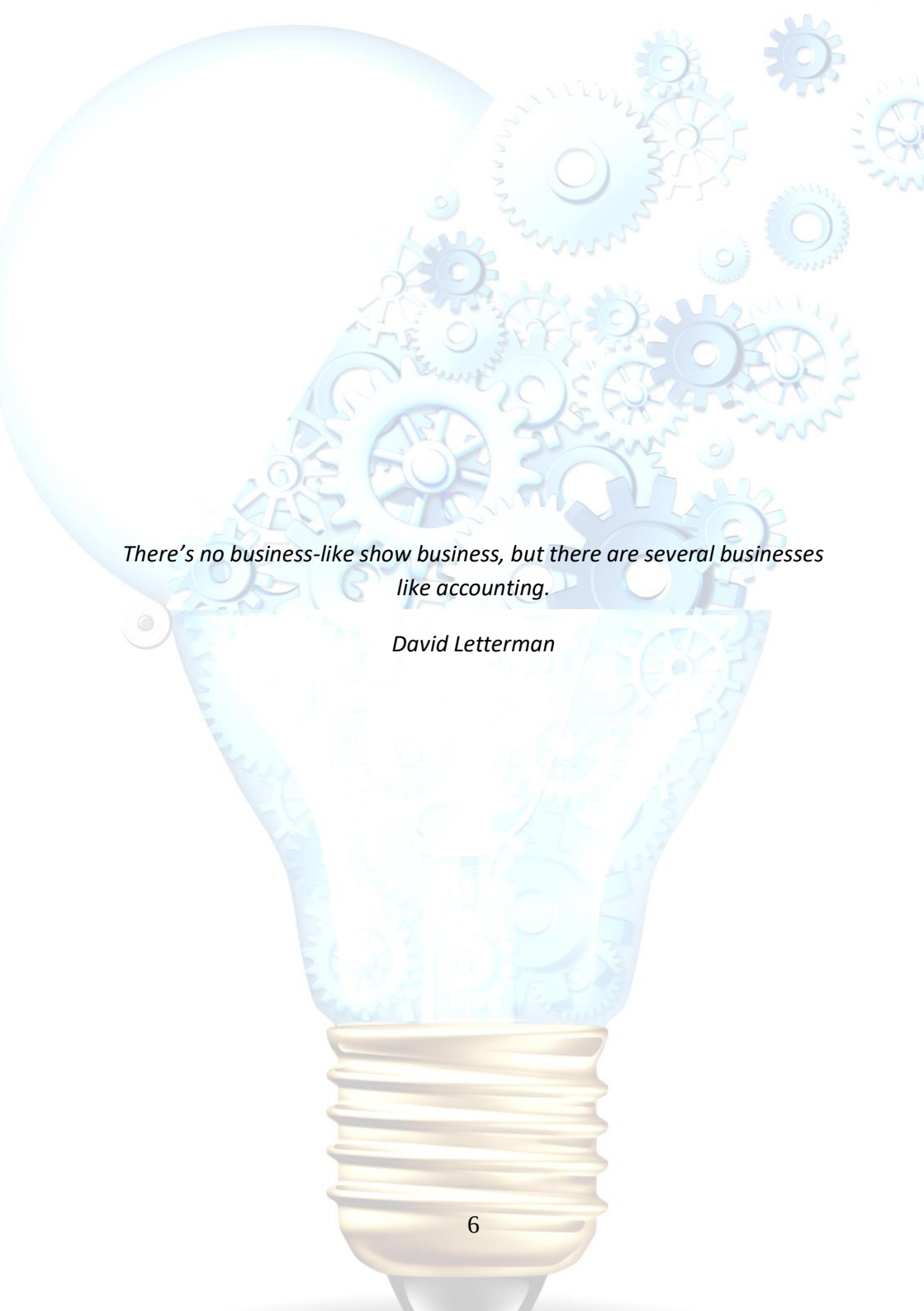
To succeed, you will soon learn, as I did, the importance of a solid foundation in the basics of education—literacy, both verbal and numerical, and communication skills.

Alan Greenspan

Preface

Everyday businesses deal with budgets and financial reports in some form or fashion. At minimum, business managers review budget numbers and run financial reports for decision-making and reporting to shareholders and Federal regulators once a month. Many companies devote the last few months of the calendar year to creating budgets for the next calendar year. In addition, organizations create and disseminate year-end financial reports to investors.

The goal of this book is to give you a basic understanding of budgets and financial reports so they can hold relevant discussions and render decisions based on financial data. This book will define key terms like ROI, EBIT, GAAP, and extrapolation. Furthermore, this will discuss commonly used financial terms, financial statements, budgets, forecasting, purchasing decisions, and laws that regulate the handling of financial information.



There's no business-like show business, but there are several businesses like accounting.

David Letterman

Chapter One: Glossary

In order to understand the concepts of budgets and financial reports, it is best to get to know essential terminology. Understanding basic financial terms and concepts will serve as the foundation for the rest of this book. In addition, having a foundation of financial terminology will help you understand discussions and other financial communication at both the individual and organizational level.

In this chapter, you will learn key financial terminology and concepts that will help you build your financial vocabulary and knowledge. You will learn the following terms and concepts:

- What is finance
- Commonly used terms
- Key players
- Important finance organizations
- Generally Accepted Accounting Principles (GAAP)

What is Finance?

The term finance has broad meaning. According to the online Encarta® World Dictionary, finance could mean the money required to do something, the money at the disposal of an organization, country, or person. Finally, another meaning for finance is the business or art of managing the monetary resources of an organization, country, or person.

Many of us are here to today to learn how to deal with the finances of their company or organization. This aspect of finance is the focus of this book.

Everyday companies capture financial data and store it for later use to compare values with predetermined budgets. In addition, organizations create monthly reports they must deliver to the board of directors and make public to both the shareholders and the government.

Your involvement in finances may be because you have been promoted to a position that requires you to create and manage a budget. You may also be required to create reports about the finances in your area.

Understanding budgets and financial reports are crucial skills in determining how well a company is doing. Many times, the raw financial data does not give enough information on how the financial position of the company is doing.

Analysing budgets and financial reports help you take action to correct trends that are taking the company off course in terms of budget and financial performance.

As you learn about budgets and financial reports, you will begin seeing this data as a useful tool for managing the everyday business functions. Before we get deeper into the topic, let us get a basic understanding of common financial terminology.

Commonly Used Terms

Finance has a vast vocabulary. Having a grasp of all the terminology in not essential in order to have a working knowledge of finances at work. Here is a list of commonly used terms in finance that will help you begin your learning journey in this discipline:

• Accounting	• Depreciation
• Assets	• Equity
• Balance sheet	• Expenses
• Budget	• Financial ratio
• Capital	• Income
• Cash flow	• Income statement
• Credit	• Liability
• Debit	• Net income

This list of terms is going to help you. This list is not an all-inclusive list and as we navigate through this book, you may encounter other terms. When you do, please write them down. This will help build your vocabulary and knowledge in finances.

Key Players

Many people utilize the financial data of an organization. The purpose will vary, but the fact remains that accurate budget and financial reports are necessary to meet each of those key player's needs.

Here is a list of those key players and their role:

Player	Role
CEO	They use financial data to steer the organization to the strategic vision, mission, and goals of the organization.
CFO	They ensure that the financial data is accurate and create reports. In addition, they analyse the information and help the CEO make decisions.
Senior Leadership	They use financial data to control budgets of several departments and business units.
Accounting	They collect financial data and record them daily in computer systems for compiling at the end of the month.
Department Managers	They use financial data to manage their areas or business units.

Board of Directors	They use financial data to determine how well the organization is doing and hold leaders accountable for meeting budgets and other obligations.
Government Regulators	They use financial data to determine if the company is being managed according to rules.
Stockholders	They use financial data to determine if the company if profitable and being managed well.
Investors	They use financial data to determine if they want to purchase stocks in hopes of a financial return.
Creditors	They use financial data to determine if the company is capable of paying back a new or current loan.

Important Financial Organizations

Several financial organizations help shape the way financial data is structured and reported. Some organizations are private institutions and others are government run. Here is a list of the most important financial organizations.

- **United States Securities and Exchange Commission (SEC):** The SEC works with private organizations like the AICPA and FASB to help set standards for accounting principles.

- **American Institute of Certified Public Accountants (AICPA):** This organization publishes audit and accounting guidelines, provide guidance on financial reporting topics until standards are set by the FASB or GASB. Publish practice bulletins, which focus on reporting issues not handled by the FASB or GASB

- **Financial Accounting Standards Board (FASB):** This organization publishes the statements of financial accounting standards, statements of financial accounting concepts, interpretations, and technical bulletins related to accounting standards.

  This organization also has an Emerging Issues Task Force (EITF), which handles new and unusual financial issues that may have the potential to be a larger problem in the industry.

- **Governmental Accounting Standards Board (GASB):** This organization deals with government financial reporting issues. It resembles the FASB, but deals exclusively with government agencies.

Understanding GAAP

The Generally Accepted Accounting Principles were developed to give a consistent framework for companies to use in structuring their financial statements. Organizations are required to follow GAAP standards and most accountants and auditors are familiar with this concept and use it every day.

If you are not an accountant or auditor, that is okay. Understanding GAAP will help you realize the importance of keeping excellent records of your revenue and expenditures in your area.

Furthermore, understanding GAAP will increase your financial vocabulary and knowledge of why financial reports must conform to a particular set of standards.

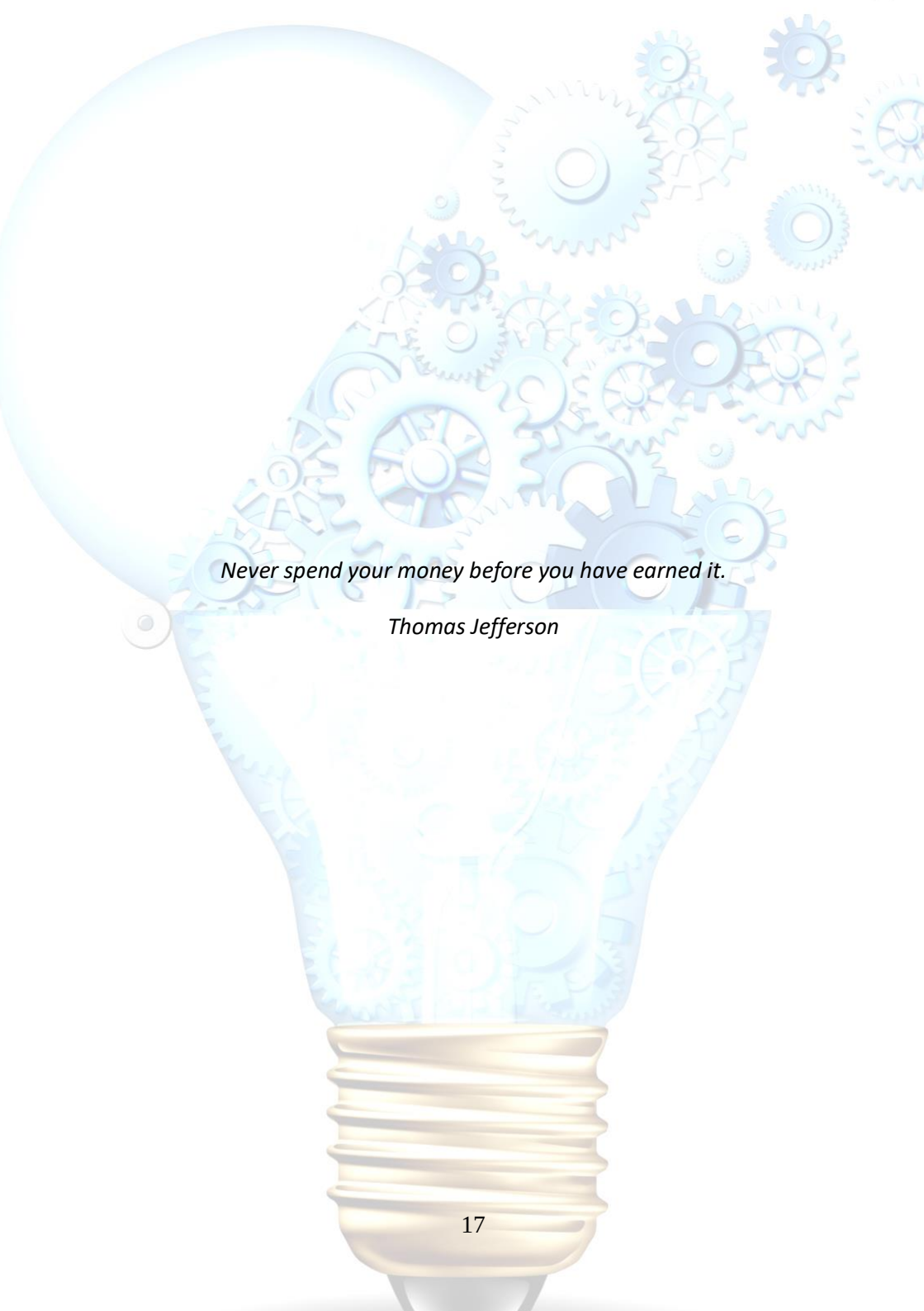
In general, GAAP deals with the following reporting standards:

- When is revenue recognized as actual revenue that can be counted? This prevents overstatement of revenues by determining when revenue can be claimed or recognized.
- Balance sheet item classification standardizes the items found on the balance sheet to avoid confusion.
- Outstanding share measurements

You may not have to deal with these principles on a daily basis, but understanding their importance in the area of budgets and financial reports will help your credibility because this is a very common and basic concept in this area.

Practical Illustration

Sara had recently been promoted, and with that promotion, she became a key player in respect to the company's finances. With the position came the responsibility of creating a monthly financial report. Sara learned that these reports were much more than just numerical data. Instead, they also included an overview of the financial situations. These helped give context to the data and a clearer image of the company's financial standing.



Never spend your money before you have earned it.

Thomas Jefferson

Chapter Two: Understanding Financial Statements

Financial statements are the communication tools for the organization. There are many aspects of a business's financial dealings reported in financial statements. Revenues coming in and expenses going out are key data that require reporting. Tangible items like equipment, property, and cash reserves are also reported in financial statements. Understanding these financial statements opens the door to analysing finance data for budgeting, controlling, and making decisions.

This chapter will discuss the following topics:

- Balance sheets
- Income statements
- Statement of retained earnings
- Statement of cash flows
- Annual reports

The two most widely known statements are the balance sheet and income statement.

Balance Sheets

The balance sheet is a report on the financial condition of an organization and is required by GAAP. In the balance sheet, assets are expressed in terms of liabilities and capital, which must equal each other.

Assets are the cash on hand, properties owned, and monies owed to the organization and can be liquidated and pay the organization's debt.

Liabilities are the debts the organization owes to their creditors and this goes against assets. In addition, the organization's assets belong to the owners, this is called capital, and this goes against the assets.

The balance sheet can reveal a lot about a company. The level of debt the companies owes against what it owns in cash and properties could reveal a liquidity problem.

Furthermore, if a company has no debts and huge level of assets, this may be a sign that the company is not running efficiently and is allowing the assets to remain idle instead of using it for a return.

Balance sheets are usually set up as columns always comparing the assets versus the liabilities and capital. Many times balance sheets will show the previous month or year's data for comparison.

Later in this book, you will get a chance to use the figures from the balance sheet to determine specific financial ratios that will help you understand the organization's financial condition.

Income Statements (AKA Profit & Loss Statements)

The income statement is a summary of the income and expenses of an

organization in a given period and is required by GAAP. Usually companies create monthly and yearly income statements.

Income statements list all the areas where income is generated. Sometimes, the income is categorized certain categories:

- Income from sales
- Income from interest
- Income from investments

The income statement also contains the expenses and this can be categorized too:

- Dividend expense
- Operating expense
- Cost of goods sold
- Taxes

The net income or loss is calculated by subtracting the expenses from the income. This number represents the income or loss after all expenses are applied. This number is usually incorporated into the statement of retained earnings discussed later in this chapter.

The income statement gives you the ability to determine how well the company is bringing in income. If the expenses are greater than the income then the net income will become the net loss, which subtracts from the owner's equity in the statement of retain earnings.

The income statement is also called the Profit and Loss Statement because it indicates by the calculations mention earlier.

The format of the income statement is usually in column format and it can be presented along with the previous month or year's information for quick comparisons. In addition, you may see the changes expressed in percentages.

Statement of Retained Earnings

The statement of retained earnings can appear on a balance sheet, income statement or a separate financial report. This report is required by GAAP and it reports the change in owner's equity from one period to another.

The basic components of the statement of retained earnings include the following:

- Beginning balance
- Net Income/loss
- Dividends paid
- Ending balance

The resulting calculation is then applied to the owner's equity under the capital heading on the balance sheet.

Statement of Cash Flows

The statement of cash flows helps to determine how cash flowed in and out of the company. This is considered a mandatory financial report. The statement of cash flows does not factor in cash flows from credit transactions or accounting manoeuvres like depreciation expense. The statement of cash flows can be a complicated report to produce, but understanding it is not so difficult.

There are three main components of the statement of cash flows. They are the following:

- Cash flow from operations
- Cash flow from investing
- Cash flow from financing

When the cash flow reveals that the majority of the cash flowing in is from operations, this is a good sign for regulators, stockholders, and investors.

A negative cash flow does not necessarily mean the company is doing poorly. There could have been a large investment in equipment or inventory. Negative cash flow situations require more analysing to determine why it is negative.

However, a negative cash flow resulting from poor operations could be a sign of a company going bankrupt. Understanding the cash flow will help you understand how the company is obtaining the cash and how they are using the cash.

Annual Reports

The annual report is an annual document that provides a comprehensive report on the financial activities of the past year of an organization. Along with the financial reports are reports from key people in and out of the organization.

Here are the basic components of an annual report:

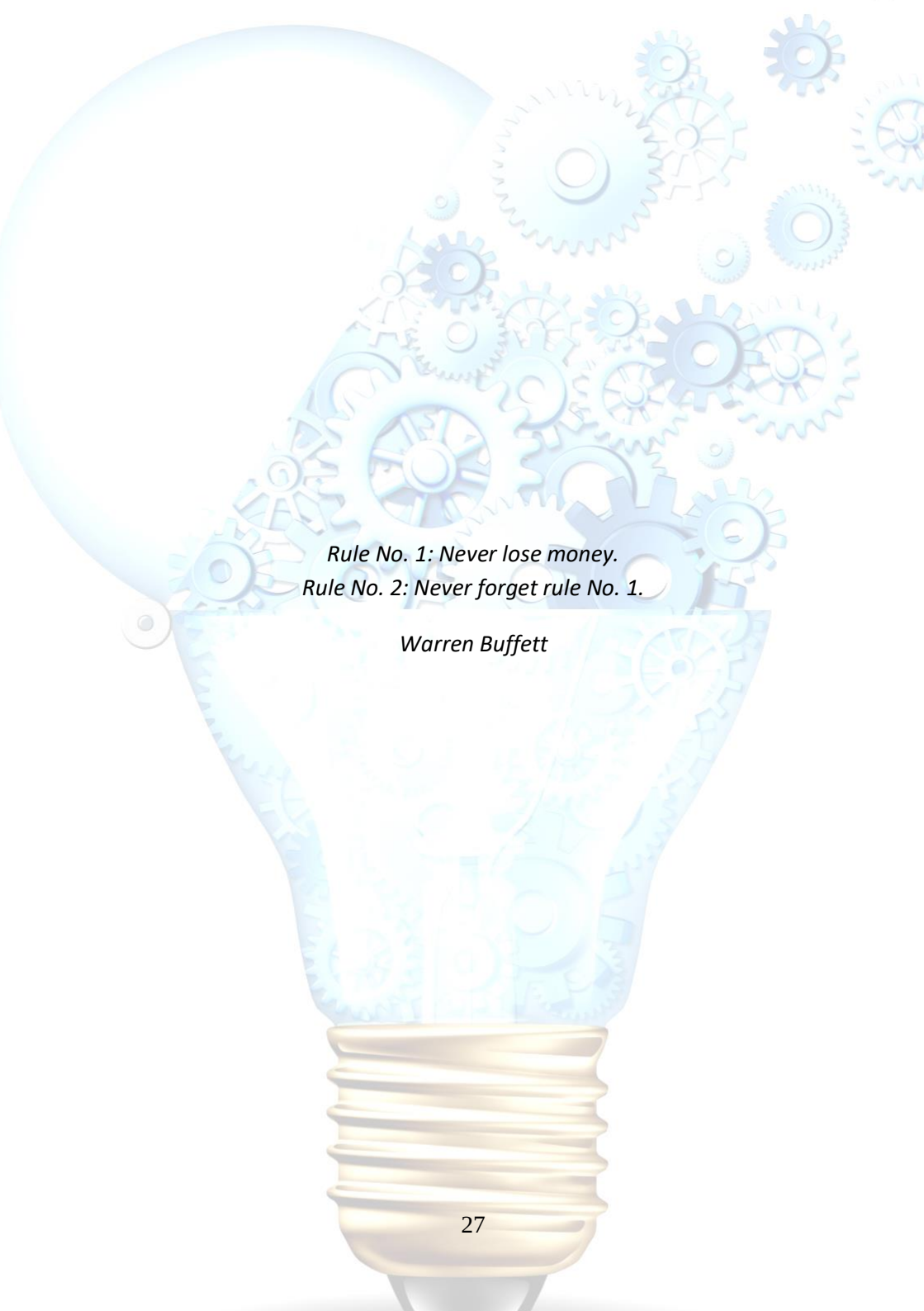
- Chairman's report
- CEO's report
- Auditor's report
- Mission statement
- Corporate governance statement
- Statement of director's responsibilities
- Balance sheet
- Statement of retained earnings
- Income statement
- Cash flow statement
- Notes to the financial statements
- Accounting policies

Investors and stockholders use the annual report and the government reviews these reports for compliance to regulations. Understanding that all company activities eventually is incorporated into the annual report.

As a manager, you may not see the relevance of the annual report for your daily job, but realizing how you run your department may reflect on this annual report makes it worthwhile to know what reports go into the annual report.

Practical Illustration

James needed to create financial statement for the previous quarter. He started with a balance sheet, which showed the balance of liabilities and assets within the company. Next, he created an income statement. This showed the profits and losses of the company. Finally, he created a cash flow statement, which showed the money coming in and money going out. While the company had been seeing a negative cash flow, James knew it was because of investments within the company, and that the cash flow would return to normal. At the end of the year, all of the data collected from the reports was combined into the annual report that went out to the company's key players and shareholders.



Rule No. 1: Never lose money.
Rule No. 2: Never forget rule No. 1.

Warren Buffett

Chapter Three: Analyzing Financial Statements (I)

While financial statements report the financial status of the business, it does not automatically give the condition or financial health of the business. Ratios are calculations that help to simplify the many numbers on the various financial statements into a number that is easier to understand. Understanding the various ratios that can be calculated will help you examine and analyse financial statements, giving a clear picture of the financial health of the business.

This chapter discusses five basic ratios that will help you analyse the financial statements of your organization. The following are the topics discussed in this chapter:

- Income ratios
- Profitability ratios
- Liquidity ratios
- Working capital ratios
- Bankruptcy ratios

Income Ratios

Income ratios help to determine the level of income to various factors like wages, assets, etc.

Here are some income ratio calculations and their uses:

Ratio Calculation	Formula	Result
Net Income Increases to Pay Increases	Net Income Increases to Pay Increases = change in net income / change in salaries, wages and benefits	Shows when net income is increasing faster than wages (in dollar terms).
Net Income per Employee	Profits per Employee (Net Income per Employee) = net income / number of employees	Shows the average profit generated per person employed in the company.
Net Income to Assets	Net Income to Assets = net profit before taxes / total assets.	This ratio provides a way for evaluating the efficiently of financial management of the average dollar invested in the firm's assets, and determines if the dollar came from investors or creditors.

Non-Operating Income to Net Income	Non-operating Income to Net Income = non-operating income / net income	Increasing ratios may mean that the business is moving away from its core business.
Operating Income to Wages and Salaries	Operating Income to Wages and Salaries = operating income / (salaries + wages + benefits)	This ratio shows the relationship between operating income and amount of wages and salaries paid.

Profitability Ratios

Profitability ratios help to determine how well the company is doing in terms of the profits generated by the company. There are many ratios. Here is a list of common profitability ratios.

Ratio Calculation	Formula	Result
Cash Debt Coverage Ratio	Cash Debt Coverage = (cash flow from operations - dividends) / total debt.	This ratio shows the percent of debt that current cash flow can retire.
Cash Return on Assets	Cash Return on Assets (excluding interest) = (cash flows from operations before interest and taxes) / total assets.	A higher cash return on assets ratio indicates a greater cash return.
Cash Return to Shareholders	Cash Return to Shareholders = cash flow from operations / shareholders equity	The cash return to shareholders ratio indicates a return earned by shareholders.
Contribution Margin Ratio	Contribution Margin Ratio = (sales - variable costs)/sales	The contribution margin ratio indicates the percent of sales available to cover fixed costs and profits.

Gross Profit Margin	Gross Profit Margin Ratio = gross profit / sales	This ratio provides clues to company pricing, cost structure and production efficiency
Operating Margin	Operating Margin = net profits from operations / sales	This ratio determines whether the fixed costs are too high for the production volume.
Profit Margin Ratio	Pre-tax Margin Ratio = net profit before taxes / sales	This ratio shows how much profit the company makes for every dollar of sales.

Liquidity Ratios

Liquidity ratios determine the ability of an organization to meet its short-term financial debt in a timely manner. Here are some liquidity ratios you may find useful:

Ratio Calculation	Formula	Result
Acid Test Ratio (Quick Ratio)	Acid Test Ratio = (cash + marketable securities) / current liabilities	The acid test ratio measures the immediate amount of cash immediately available to satisfy short term debt
Accounts Payable Turnover Ratio	Accounts Payable Turnover Ratio = total supplier purchases / average accounts payable	The accounts payable turnover ratio shows the number of times that accounts payable are paid throughout the year.

Cash Debt Coverage	Cash Debt Coverage = (cash flow from operations - dividends) / total debt	The cash debt coverage ratio shows the percent of debt that current cash flow can retire
Debt Income Ratio	Debt Income Ratio = total debt / net income	The debt income ratio shows the amount of total debt in proportion to net income
Quick Assets	Quick Assets = cash + marketable securities + accounts receivable	Quick assets are the amount of assets that can be quickly converted to cash

Working Capital Ratios

Working capital is the organizations ability to use capital after their debt has been satisfied. Here are the formulas for calculating working capital.

Ratio Calculation	Formula	Result
Working Capital	Working Capital = current assets - current liabilities	This calculation shows the liquid reserve available to satisfy contingencies and uncertainties
Working Capital ratio	Working Capital Ratio = current assets / current liabilities	This ratio evaluates the liquidity, or ability to meet short term debts
Working Capital Provided by Net Income	Working Capital from Operations to Total Liabilities = working capital provided from operations / current liabilities	This ratio measures the degree internally generated working capital is available to satisfy obligations
Working Capital From Operations to Total Liabilities	Working Capital Provided by Net Income = net income - depreciation	A high ratio indicates that a company's liquidity position is improved because net profits result in liquid funds

Bankruptcy Ratios

Bankruptcy ratios help to determine if the company is not generating enough income to cover its debts. These calculations could help to determine a course of action to avoid bankruptcy or to seek bankruptcy protection if the situation warrants it.

Here are some calculations that help to determine if a company is heading toward bankruptcy.

Ratio Calculation	Formula	Result
Working Capital to Total Assets	$\frac{\text{Net Working Capital}}{\text{Total Assets}}$ = Working Capital to Total Assets Ratio	This ratio records net liquid assets relative to total capitalization. This is the most valuable indicator of a bankruptcy.
Retained Earnings to Total Assets	$\frac{\text{Retained Earnings}}{\text{Total Assets}}$ = Retained Earnings to Total Assets Ratio	A negative ratio indicates potential financial problems.
EBIT to Total Assets	$\frac{\text{EBIT}}{\text{Total Assets}}$ = EBIT to Total Assets Ratio	This ratio shows the productivity of the assets.
Equity to Debt	$\frac{\text{Market Value of Common + Preferred Stock}}{\text{Total Current + Long-Term Debt}}$ = Equity to Debt Ratio	This ratio shows you by how much assets can decline in value before it becomes insolvent.
Cash Flow to Debt	$\frac{\text{Cash Flow}}{\text{Total Debt}}$ = Cash Flow to Debt Ratio	This ratio shows potential insolvency issues.

Practical Illustration

Henry was reviewing a financial statement that was sent to him, and saw some numbers that puzzled him. He decided to ask a colleague to explain some of the meanings behind the figures in the report. Henry learned that the income ratios were simply representations of the income to things like wages. Next he looked at the profitability ratios. They represented the gain or loss in profits of the company. Liquidity ratios represented the company's ability to pay off its short-term debt. The working capital ratios showed the company's use of capital after paying off its debts, and the bankruptcy ratios helped demonstrate whether or not the company was creating enough income to pay off its debts. After understanding the figures, Henry could better visualize the state of the company.

Life is a game. Money is how we keep score.

Ted Turner

Chapter Four: Analyzing Financial Statements (II)

In this chapter, we are going to learn more ratios and calculations for analysing financial statements. Here are the topics for this chapter:

- Long-term analysis ratios
- Coverage ratios
- Leverage ratios
- Calculating return on investment (ROI)

Long-Term Analysis Ratios

Long-term analysis is helpful in determining how well the company is going to perform over time as it relates to the organization's financial obligations. These are the formulas in calculating long-term performance.

Ratio Calculation	Formula	Result
Current Assets to Total Debt	$\frac{\text{Current Assets}}{\text{Current + Long-Term Debt}}$ = Current Assets to Total Debt Ratio	This ratio determines the degree of protection linked to short- and long-term debt. More net working capital protects short-term creditors.
Stockholders' Equity Ratio	$\frac{\text{Stockholders' Equity}}{\text{Total Assets}}$ = Stockholders' Equity Ratio	This ratio determines the relative financial strength and long-run liquidity.
Total Debt to Net Worth	$\frac{\text{Current + Deferred Debt}}{\text{Tangible Net Worth}}$ = Total Debt to Net Worth Ratio	This ratio measures the organization's total liabilities against its tangible net worth.

Coverage Ratios

Coverage ratios show how many times a company's earnings can cover the fixed-interest payments on its long-term debt. The Times Interest Earned Ratio calculates this and the formula is the following:

$$\frac{\text{EBIT}}{\text{I}} = \text{Times Interest Earned Ratio}$$

EBIT is earnings before interest and taxes

I is the interest amount payable on the debt

Leverage Ratios

Leverage ratios calculate the proportion of the owner's contribution and the contribution from creditors. Three formulas help you calculate ratios:

Ratio Calculation	Formula	Result
Equity Ratio	$\frac{\text{Common Shareholders' Equity}}{\text{Total Capital Employed}}$ = Equity Ratio	This ratio shows how much of the total capitalization actually comes from the owners.
Debt to Equity Ratio	$\frac{\text{Debt + Preferred Long-Term}}{\text{Common Stockholders' Equity}}$ = Debt to Equity Ratio	With this ratio, a high ratio means less protection for creditors. A low ratio means more protection for the creditors.
Debt Ratio	$\frac{\text{Current + Long-Term Debt}}{\text{Total Assets}}$ = Debt Ratio	This ratio determines how much of the assets are financed.

Calculating Return on Investment (ROI)

Calculating the return on investment (ROI) is a very useful tool in determining if an investment is worth the effort. This calculation takes the project return the investment promises and subtracts the cost of the investment, leaving either a gain or a loss. That figure is then divided by the cost of the investment.

If the calculation produces a large percent or whole number then the investment would be a good one to make. Of course, this would have to be approved by an authorized agent within your company. If the calculation produces a small percentage then it would not be a good investment to make.

A zero means the investment would break-even. Here is the formula:

- ROI = (Gain from investment – cost of investment) / cost of investment

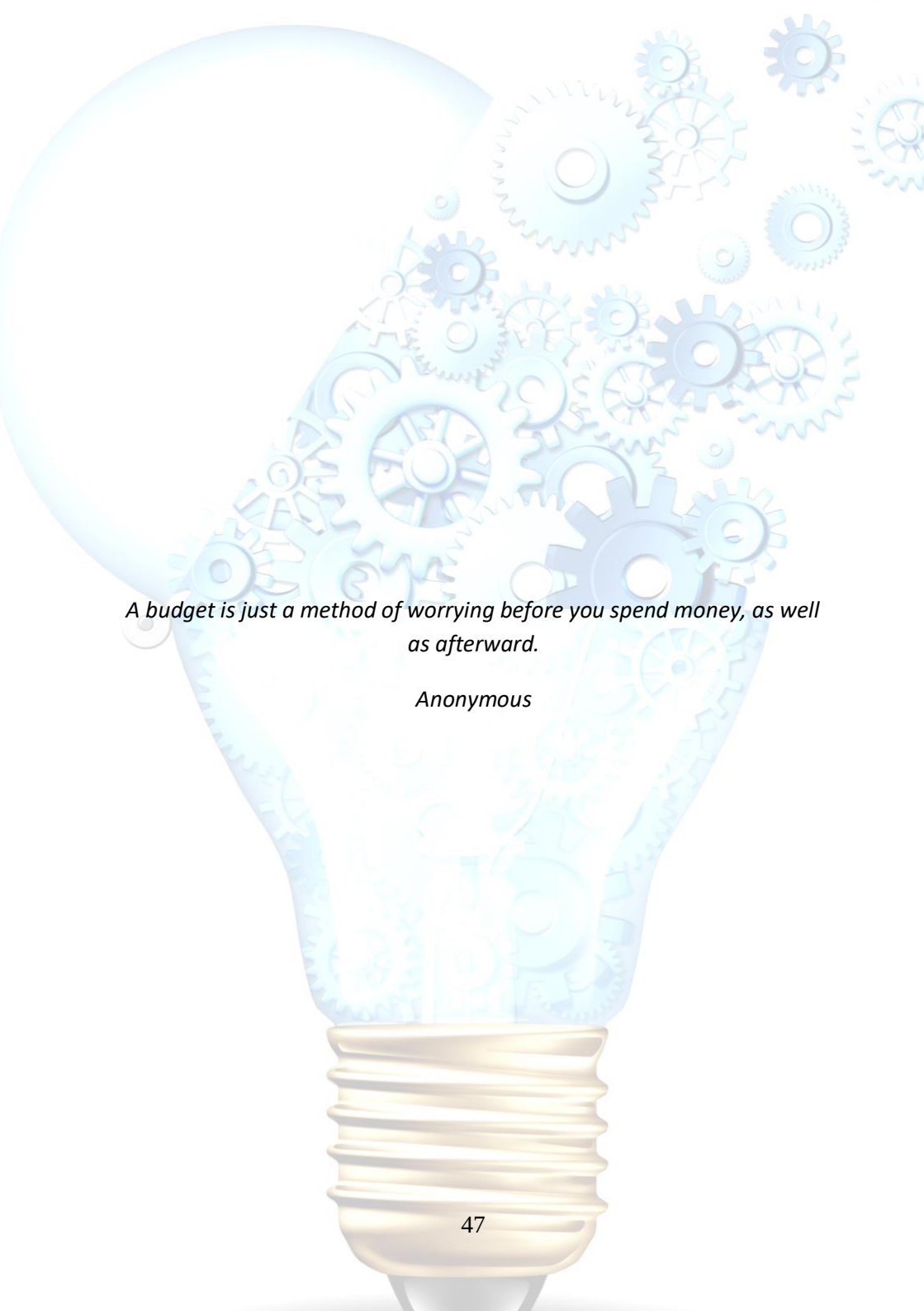
Whenever you need to make a purchasing decision, it is always a good practice to determine the return on investment. Presenting this ahead of the purchase to your manager and it would make you look very wise. In addition, taking the time to calculate the ROI demonstrates that you care about the organization.

There are other return calculations you can use. Here are a few:

- Return on assets (ROA)
- Return on capital employed (ROCE)
- Return on equity (ROE)
- Return on gross invested capital (ROGIC)
- Return on investment capital (ROIC)

Practical Illustration

Jenny was working on her company's financial reports and needed include key financial ratios. The first was the long-term analysis ratio. This ratio shows how well the company will perform over an extended period of time given its financial obligations. Next she needed to include the coverage ratios. These demonstrate how many times the company can pay the interest on its debt with its current earnings. Next, Jenny made sure to put in the leverage ratios. These calculated the proportion of the owner's contribution and the contribution from creditors to the company. Together, these ratios helped describe the financial situation of the company and the impact of its debt.



A budget is just a method of worrying before you spend money, as well as afterward.

Anonymous

Chapter Five: Understanding Budgets

Budgets are critical for businesses. Many stakeholders within the organization require that budgets be submitted for review every year. The budget sets spending limits and usually is broken down to the individual departments or business units. Typically, budget numbers are reviewed every month to determine how well the company is keeping within the budget.

Understanding budgets will help you create and manage one for your areas or departments. Furthermore, knowing how a budget is formed will give you working knowledge that will increase your value to the organization.

In this chapter, you will learn the following on budgets:

- Common types of budgets
- What information do I need?
- Who should be involved?
- What should a budget look like?

Common Types of Budgets

There are six commonly used budget types for businesses. Here they are:

Sales budget: This budget estimates future sales. This is usually broken down into units and dollars. This budget is used to create company sales goals.

Production budget: This budget estimates the number of units that must be manufactured to meet sales goals. The production budget also estimates the various costs involved with manufacturing those units, which includes labour and materials.

Cash Flow/Cash budget: This budget predicts future cash receipts and expenditures for a particular time. It is usually for the short-term future. The cash flow budget helps businesses determine when income will be sufficient to cover expenses and when the company will need to get a loan to cover expenses during this time.

Marketing budget: This budget is an estimate of the funds needed for promotion, advertising, and public relations in order for the organization to market their product or service.

Project budget: This budget is a prediction of the costs associated with a particular project. These costs include labour, materials, and other related expenses. The project budget is often broken down into specific tasks called activities, with budgets assigned to each.

Expenditure budget: This budget estimates what expenses the organization will have for a time. This could include supplies for sale, office supplies, and bills.

What Information do I Need?

In order to begin a budget, you will need the following three pieces of information:

- **Goal:** Identifying a goal is the first step to creating a budget. Think about what you need to accomplish. This could be a sales goal, an efficiency goal or quality goal. No matter what the goal is, it is important to think carefully about the feasibility of the goal. Use the SMART technique for goal setting, which is making the goal **S**pecific, **M**easurable, **A**ttainable, **R**ealistic, and **T**ime driven.

- **Money:** How much money do you have? In the corporate environment, you may need to review the financial reports to determine how well the company is doing. When things are financially tight, the monies allocated to the budgets may be limited. Knowing how much is available will help you determine what you should request in terms of the business environment.

- **Costs:** You will need to determine how much are the costs related to your goals. This may require you to breakdown your goals in to smaller components so you can put a price on each of them. Knowing how much things will cost will help weed out unnecessary expenses in your budget.

These three items will point you in the right direction when you are ready to begin your budget.

Who Should Be Involved?

Creating a budget is a challenging task especially when it is for the entire organization. The budget process will require input from many areas and departments. It will require strategic thinkers and people with the ability to determine what cost-effective methods of doing things are.

In addition, people who know how to generate funds should be a part of the process. This will help to determine how much money the organization will need to make in order to meet budget goals.

When creating a budget for the organization, a team of people from various areas should be assembled. The team should include following areas:

- Accounting
- Operations
- Sales
- Top administration officials

Furthermore, these specific people should attend from each area mentioned:

- CEO
- CFO
- Finance manager
- Department leaders or directors
- Project managers
- A member of the Board of Directors

Once the members of the team are established, they each should submit budgets from the areas they manager and direct.

The refining process usually involves the input from the CEO or CFO. Once the budget is set, the team can monitor the budget on a monthly basis to ensure each area is being held accountable to their budget for their area or department.

What Should a Budget Look Like?

A budget for an organization almost looks like an income statement, but with a few extra columns. A budget may be presented many ways. Some budgets present previous information from the past several years. Others only focus on the most current information.

Here is a basic outline of the categories of a budget:

- **Categories:** This column is on the left usually and it lists all the inflows, expenses, and net income categories. This can be general or very specific.

- **Actual:** This column is usually to the right of the categories column and contains the actual numbers that have been reported.

- **Budget:** This column is usually to the right of the Actual column. This column contains the budgeted numbers.

- **Difference:** This column is the last column on the right of the page. This column shows the difference from the budget.

This format can be expressed as a monthly report with year-to-date totals or it can be used as an end-of-year report. Other variations could be differences expressed in percentages.

Practical Illustration

Grant needed to create a budget for the department he oversaw. First he identified the goal of the budget, which was to increase the efficiency in the department. Next he reviewed the amount of money he had available to cover the costs associated with his goals. In order to increase efficiency, he needed to receive value for all money spent. To help him put together meaningful numbers, he consulted people who worked in accounting, operations, sales, and administration. He formatted the budget within pre-set parameters, then sent it to management for review. Grant had successfully drafted an efficient budget, which would help the company reach its goals.

About the time we can make ends meet,
somebody moves the ends.

Herbert Hoover

Chapter Six: Budgeting Made Easy

Budgeting does not have to be a difficult task. Knowing what information you should use and how to put it all together ahead of time will make budget making a painless process. Having a systematic approach to making a budget will reduce the time you need to spend on creating a budget.

In this chapter, you will learn the following techniques that will make budgeting easier:

- Factoring in historical data
- Gathering related information
- Adjusting for special circumstances
- Putting it all together
- Computer based methods

Factoring in Historical Data

When budgeting, using historical data could make the process easier. Using previous financial information could reveal trends that could help you determine certain budget numbers. For example, if sales have steadily increased by 10% over the last three years, this can be used to assume that it will happen again.

Historical data could come from other businesses. Reading up on journals and reviewing reports could help to give you more information on what could affect your budget numbers in the year to come.

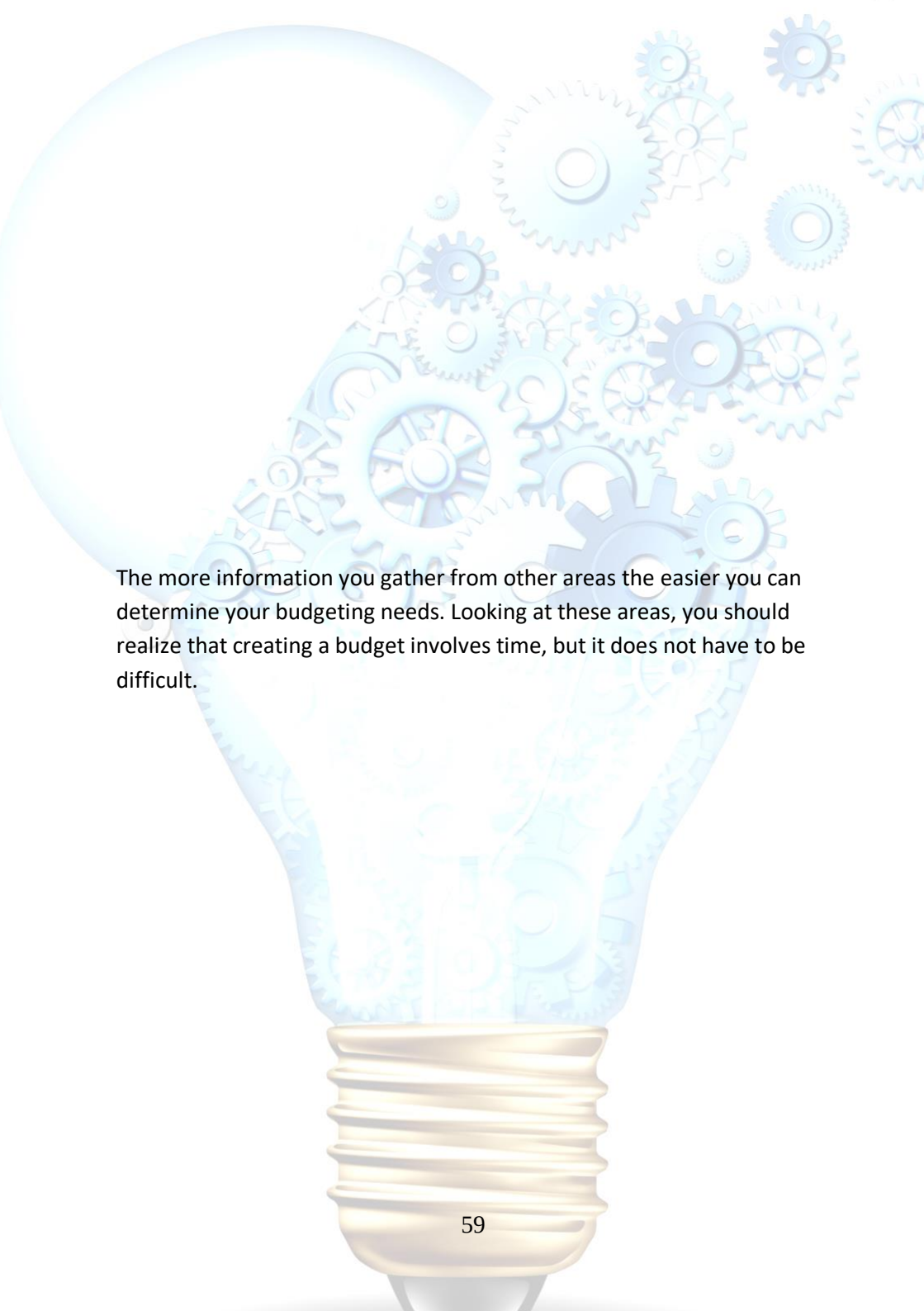
When using historical data, make sure it is reliable and from a good source. You would not want to base your budget on false information. The results could be disastrous.

Finally, historical data could be incorporated right into your budget report. This is a good way to justify your budget. It also helps to keep that historical information handy when doing your monthly review to make sure you are trending in the right direction.

Gathering Related Information

Here are four areas that may be helpful for your budget.

- Analyse the external environment
    - Market trends
    - Economic condition
    - Regulatory issues
    - Competition
- Analyse the internal environment
    - New product developments may increase expenses
    - Strength and weaknesses which is determined by review the financial statements of the organization
- Analyse the staff requirements
    - Can the staff handle the new strategic goals or do you need to hire more people?
- Review existing policies
    - Compare the effects of existing policies on the budget. Could there be issues that could alter the budget later.



The more information you gather from other areas the easier you can determine your budgeting needs. Looking at these areas, you should realize that creating a budget involves time, but it does not have to be difficult.

Adjusting for Special Circumstances

Many times, a special circumstance may arise which may affect the budget. Budgets are meant to be guides and should be regarded as flexible. Of course, the budget should not be changed randomly or whenever something happens.

In order to address unforeseen circumstances, it is best to build in a cushion for risk. This technique is used commonly in project management budgeting. Project managers know that special circumstances or risks could happen any time.

Here are some steps you can take to determine if you need to budget for additional special circumstances:

1. **List** all potential issues that could affect the budget throughout the budget period.

2. **Order** the issues from the least likely to occur to the most likely.

3. **Assess** the cost of each issue if this circumstance were to manifest as reality.

4. **Determine** if this cost should be factored into a contingent reserve category on your budget.

The **LOAD** techniques helps organize potential situations and categorize them so you can make the decision if these costs should be factored into a reserve category on your budget. You should always seek approval before using the contingent funds. Furthermore, if the contingent funds are not used by the end of the budget period, it should be returned to the organization.

Putting It All Together

There are many approaches to putting a budget together. Here are five steps you can take to putting the budget together. We even gave it an acronym so you can remember it later. It is called RADAR.

1. **Research** both the internal and external environments to determine the factors that may affect your budget throughout the budget period. Adjust your numbers according to these factors.

2. **Acquire** the goals of the organization and every department, determine, and work with the leaders to determine what it will take financially to realize these goals.

3. **Develop** a working budget. This is used by the budget team and is used for the review process, making revisions as necessary. At minimum, the working budget should contain the following columns:

    a. Categories

        i. Assets, liabilities and capital (balance sheet budget)

        ii. Income and expenses (income statement budget)

    b. Actual (current or last year's numbers)

    c. Projected (budgeted)

4. **Adopt** a final budget for final review, gain the approval by the Board of Directors, and implement. The final budget can look

similar to the working budget but with an extra column for variances.

5. **Report** results and revise the budget as necessary, showing all variances in the appropriate column.

Computer Based Methods

It is no doubt that computers make things easier. When it comes to creating a budget, computer programs can make this an efficient process. Computer programs offer these benefits when creating a budget:

- Allow collaboration across the organization
- Centralize the budget document and avoid duplication
- Reduced calculation errors
- Quick analysis
- Reporting features
- Graphs and visuals

Programs like Microsoft Excel and SharePoint make creating budgets more efficient and offer features that make sharing information easy.

Practical Illustration

Zach had been tasked with creating a new budget for his department. The first thing he did was review past budgets and compare the projected outcomes with the actual outcomes. This helped give him an idea of the effectiveness of past budgets, and where changes would need to be made to reach current goals. Next, he systemically developed the budget. He researched internal and external environments such as market trends and the company's strengths and weaknesses in adapting to changes in the market. He consulted the managers who worked under him to get an idea of what goals needed to be met. Finally he submitted the budget to be reviewed and approved by the board of directors.

If you have to forecast, forecast often.

Edgar R. Fiedler

Chapter Seven: Advanced Forecasting Techniques

Forecasting is essential to assessing how much the budget should be. Various techniques and tools can be used to help forecast costs. While no technique is a guarantee, using a standard tool will help you be more consistent in forecasting.

In this chapter, the following forecasting techniques will be discussed:

- Using the average
- Regression analysis
- Extrapolation
- Forma financial models

Using the Average

Taking the average of actual yearly numbers can help to forecast what the next budget could be. Of course, you may need to factor in economic data like inflation or increases in taxes. Averaging the numbers is an easy process when using a spreadsheet program.

You can use information from the past five years and average them. You can also average the percent change between the years to determine how much to increase the new budget for the new term.

Regression Analysis

Regression analysis is a statistical tool used to find the relationships between variables. This tool is used to predict future values. Using this tool as a method of forecasting requires knowledge in statistics. You may not use this tool yourself, but understanding that this is a forecasting tool could help you find resources and experts when need to make forecasts.

Extrapolation

Extrapolation is a mathematical tool using historical data to determine what will happen in the future. Using this tool as a method of forecasting requires knowledge in advance mathematics. You may not use this tool yourself, but understanding that this is a forecasting tool could help you find resources and experts when need to make forecasts.

Formal Financial Models

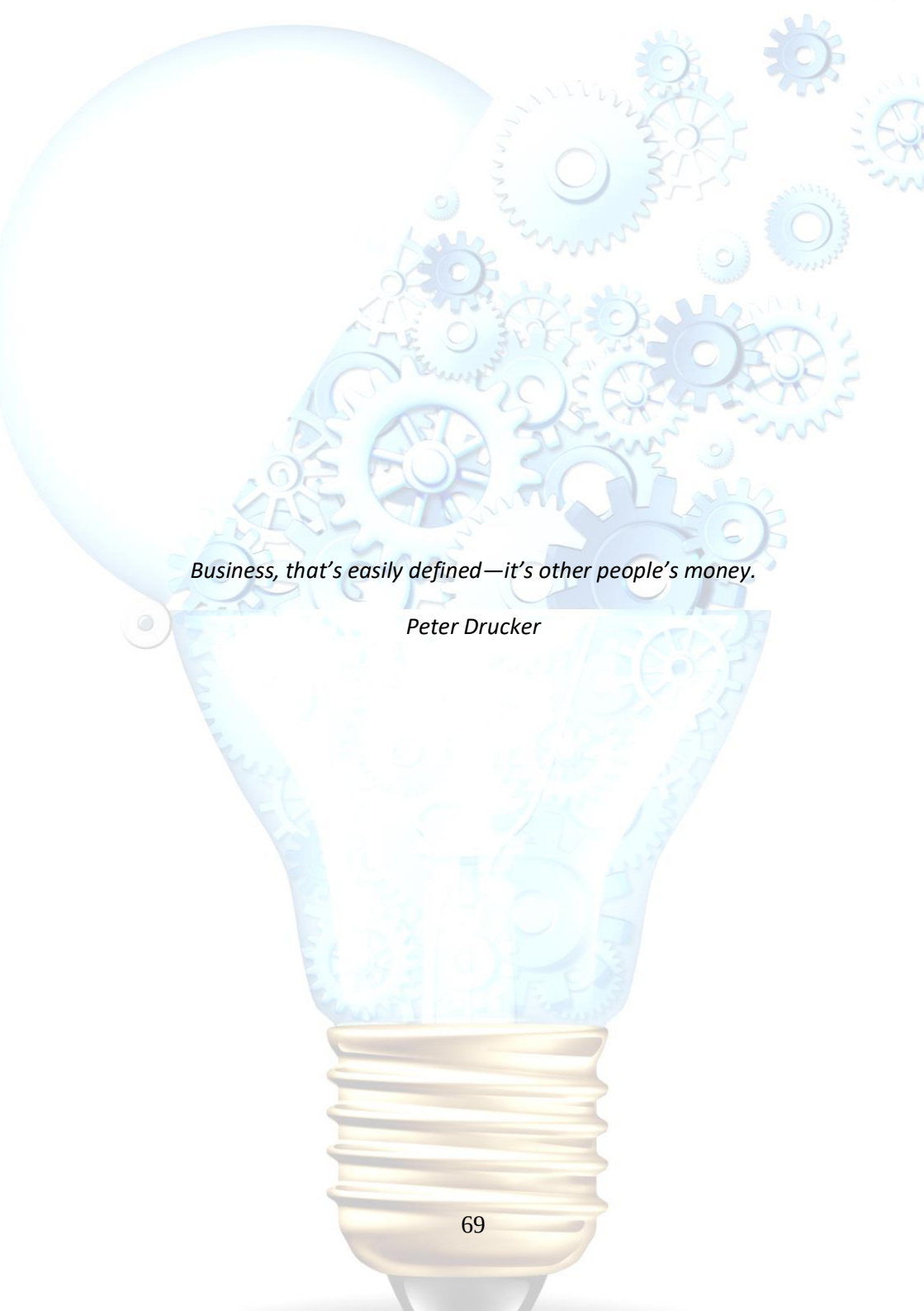
When determining capital budgets, there are formal financial models used by accounting to determine certain numbers. Having a basic understanding of what is calculated and how they are determined, will give you the ability to hold meaningful discussions with employees and managers that deal with this on a regular basis.

The following are some formal models:

- Accounting rate of return
- Net present value
- Profitability index
- Internal rate of return
- Modified internal rate of return
- Equivalent annuity

Practical Illustration

Karen had gathered the data and information needed to create a budget, but when it came to forecasting how much the budget should be, she needed some assistance. She asked a colleague explain what methods could be used to create a budget. The first method was to use an average. This was simply taking past budgets and averaging out the figures to create the new budget. Karen knew that wouldn't work very well, as the old budgets were ineffective. The next method was regression analysis. Again, this method relied on previous values, so Karen decided not to use it. The same problem applied to extrapolation. In the end, Karen decided that the best method for her needs would be to gather the budget team and create Formal Financial models. This process would create a dialogue that could be used to determine relevant values based on actual needs. Karen used this method and created an effective budget.



Business, that's easily defined—it's other people's money.

Peter Drucker

Chapter Eight: Managing the Budget

Once the budget is determined, it is essential to manage it to ensure that the organization or department is adhering to the allotted costs. Sometimes things may happen that could cause necessary changes to the budget. In any case, knowing how to monitor the budget and make approved changes is essential in managing the budget.

This chapter will discuss the following:

- How to tell if you're on track
- Should your budget be updated?
- Keeping a diary of lessons learned
- When to panic

How to Tell If You're on Track

There are specific steps you should take to determine if your budget is on track. Here are a couple of tips to making sure your budget is set up for success:

- Give other individuals responsibility over certain areas of the budget (ex. By department, business unit, project, etc)
- Schedule regular budget review meetings

Next, here are a few quick steps to help you tell if your budget is on track:

- Collect figures as they become available
- Compare actual number with budgeted amounts
- Cite reasons for positive or negative variances
- Classify reason as a trend or unique incident

Here are some signs you are on track:

- Your variances are minor
- The reasons for any variances are already known and predicted
- Reason for a negative variance is due to a unique incident and not a trend.

Should Your Budget be Updated

Updating the budget requires a collaborative effort. You should seek the right people and discuss options and solutions if the budget is beginning to get off track. The TAKE process helps you approach changes to the budget systematically. Here are the steps for TAKE:

- **Tell** the right people about the budget problems. Go to the right people for information on how to handle the situation. They may be able to give you some advice on how to handle the situation or provide a solution. Nonetheless, telling others about your budget problem will begin dialogue that will provide more opportunities for ideas that you can act on. Here are some people you can contact for help:
    - Your direct supervisor or manager
    - Your accounting department
    - Your budgeting team
- **Act** and make a decision. Depending on the circumstances, you can take the following actions:
    - Do nothing when you determine that the variance will correct itself because there is not strong trend or persistent situation.
    - Create a forecast or update your current one and analyse it against the budget.
    - Create a proposal for a change in the budget
- **Keep** monitoring the budget during this time of decision-making. An approval for a revised budget may take some time.

Keep monitoring the budget. This way if any positive changes occur, you can hold off on any change request or corrective actions.

- **Exchange** information with all budget stakeholders. This is very important if you are proposing a change or revision to the budget.

When managing a budget, you will encounter issues and problems that may be useful for future budget planning.

Keeping a Diary of Lessons Learned

Lessons learned are situation that caused changes or challenges to your budget, forcing a change to take place. Keeping track of lessons you learned from your experiences provides a valuable resource when encountering a problem. A lesson learned diary or journal helps to keeping pertinent information for future use in an existing or new budget, avoiding repeat mistakes.

Here are four **R**s to taking steps when addressing an issue:

- **Review** your lessons learned diary or journal. Try to locate similar situations in the past to determine what was done to resolve the issue and the outcome from that solution.

- **React** to the issue, using a past solution if the problem is similar to one in your lessons learned diary or journal.

- **Record** problems you have never experienced before or are unique. Create a new entry into your diary or journal. Log the date the problem was realized. If the problem is unique, then seek out solutions by talking with your budget team, peer, manager, or expert on the subject if available. Once the problem is resolved, log the solutions used and the outcome along with the date it was implemented.

- **Repository**: It is a good practice to store your lessons learned electronically in a document's repository. This way other managers can access them and use them when they encounter problems. This practice could save your organization money.

When to Panic

You can avoid a panic situation by always keeping on top of your budget

and communicating often with the budget stakeholders. However, situations can arise that can affect your budget drastically. These situations are cause for strong corrective action.

Knowing when to take strong corrective action is the trick. Here are some situations that should cause you to take strong corrective action immediately.

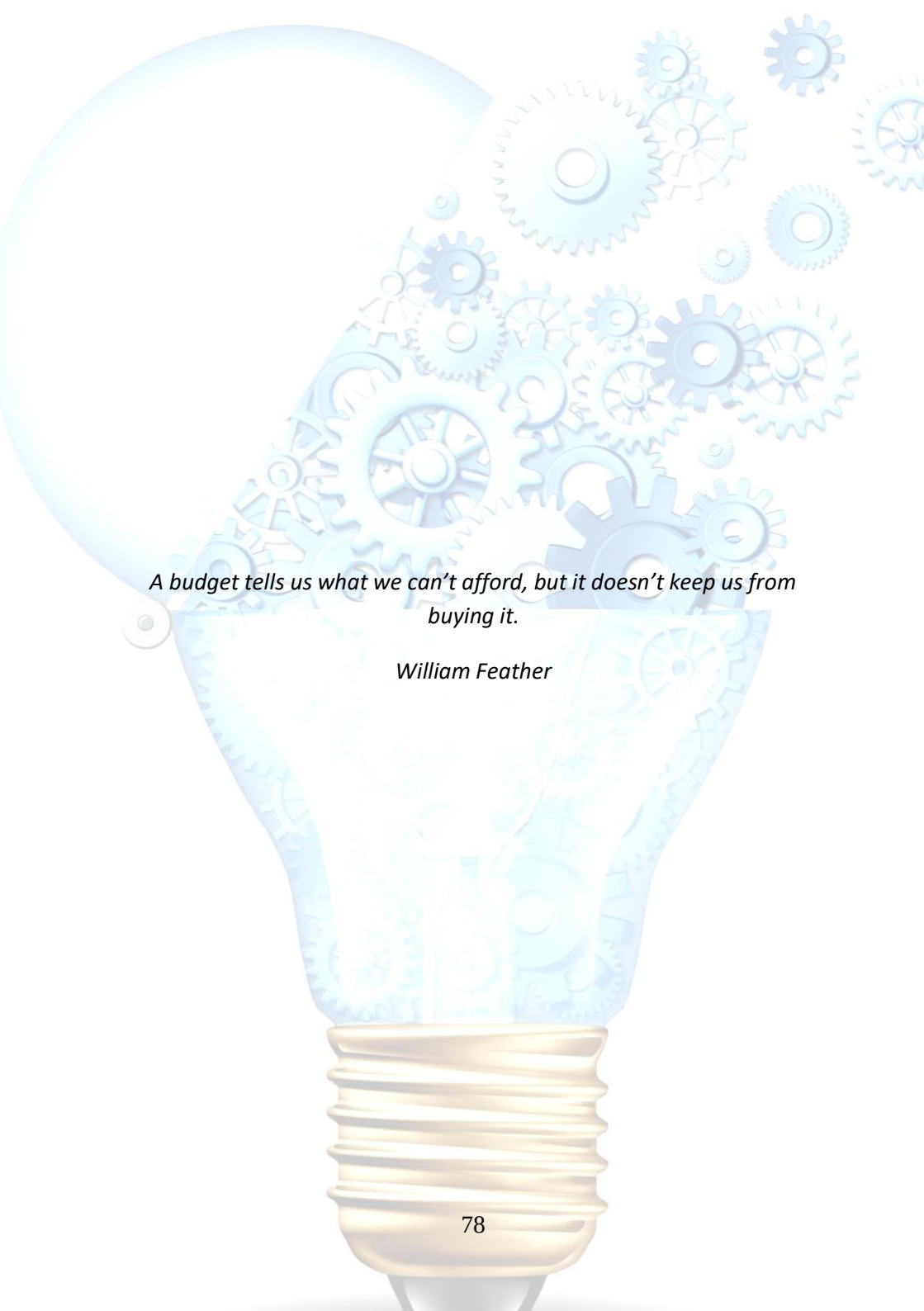
- **S**erious situation arises within the organization. Sometimes unforeseen situations could happen that can affect the company's income or ability to operate. Here are some situations to monitor:
    - Natural disaster
    - Strike
    - Property loss
    - Inventory shrinkage
- **A**ccounting error made. This could be a miscalculated forecast on revenue or cost of goods needed for sales.

- **V**ariance on the budget report shows a huge gap without any visible reasons. A timely investigation is necessary.
- **E**xternal economic or regulatory situation occurs
    - Recession
    - Changes in fuel prices
    - New laws
    - Shortages

You can use the acronym SAVE from these four general categories to help remind you when to panic.

Practical Illustration

Dale had successfully created a budget that was effective, but not very flexible. In order to ensure that it was adhered to by the department, Dale gave responsibilities over certain parts of the budget to certain individuals, and scheduled regular budget meetings. To be sure it stayed on track he made sure that all figures were collected as soon as possible. This allowed him to compare the budgeted amounts with the actual amounts. He could then see the reasons behind the negative or positive variances from the original budget, and determine if it was a trend or a special occurrence.



A budget tells us what we can't afford, but it doesn't keep us from buying it.

William Feather

Chapter Nine: Making Smart Purchasing Decisions

Sometimes, you may be asked to purchase something on behalf of the organization. When purchasing, it is always a good practice to determine if the expense is worth the investment. There are factors that you should determine before making the purchasing decision. Being able to make purchasing proposals by showing the cost and benefit to the organization will help you save money for your company and make you more valuable to the management staff.

This chapter will discuss four tools in making smart purchasing decisions. Here are the topics for discussion:

- 10 questions you must ask
- Determining the payback period
- Deciding whether to lease or buy
- Thinking outside the box

10 Questions You Must Ask

Here are 10 questions you should ask before you make a purchasing decision:

- Is this purchase budgeted?
- Lease or buy it?
- Make or buy it?
- What is the justification or business need for the purchase?
- Does this need to be approved by upper management?
- Can you do without the item?
- Can we restore the old item you are replacing?
- What is the return on the investment?
- What are additional costs related with the purchase?
    - Peripheral equipment
    - Labour
    - Transportation
- What is the benefit to buying this item?

These questions serve as a guide to making an informed decision. You should consult the budget team and subject matter experts to help you build a case for buying the proposed item.

Determining the Payback Period

The time it takes to recover the cost of a purchase is called the Payback Period. The payback period is determined by dividing the cost of the purchase by the annual cash inflows the purchase is projected to return.

Payback Period = Cost of Purchase/Annual Cash Inflows

For example, if you bought a new production device worth $15,000 and the project annual cash inflows for this device is $5,000. The payback period would be three years.

The payback period is a simple calculation. It does not calculate profitability nor does it factor the time value of money. There are other calculations like net present value or internal rate of return that would calculate this for you.

The payback period is meant to help you make a quick determination about the purchase you are considering.

Deciding Whether to Lease or Buy

Leasing equipment has several advantages. First, if owning the equipment is not an essential requirement, leasing allows you the ability to obtain the equipment with little money or no money invested in it.

Leasing is just as beneficial as buying. In some cases, it is better. For example, with leasing you do not have to expense depreciation. In fact, when the item breaks down or requires updating the leasing company typically takes care of the equipment or replaces it.

Another advantage to leasing is the conserving of cash. The organization can use the cash for other business activities. Furthermore, some types of leases can bring a tax advantage. Since the lease is not actually capital for a business, instead it is an expense, having the equipment leased may potentially reduce the tax burden on the business.

A drawback to leasing is the requirement of good credit. If a company if just starting, it may find it difficult to lease equipment because of the short credit history of the organization.

Leasing may be at a disadvantage when it comes to buildings and property. Since lease terms renew every so often, the cost may rise over time. In this case, buying the building or property will provide a more stable cost even if the purchase is accomplished through a loan.

Buying property also brings tax advantages. Leasing, on the other hand, does not. When determining whether to lease or buy, here are some things to consider:

- Do you have the cash to buy the item?
- What tax break would you get if you leased the item?
- Is it necessary to own the item?
- Is having a fixed cost essential?

Thinking Outside the Box

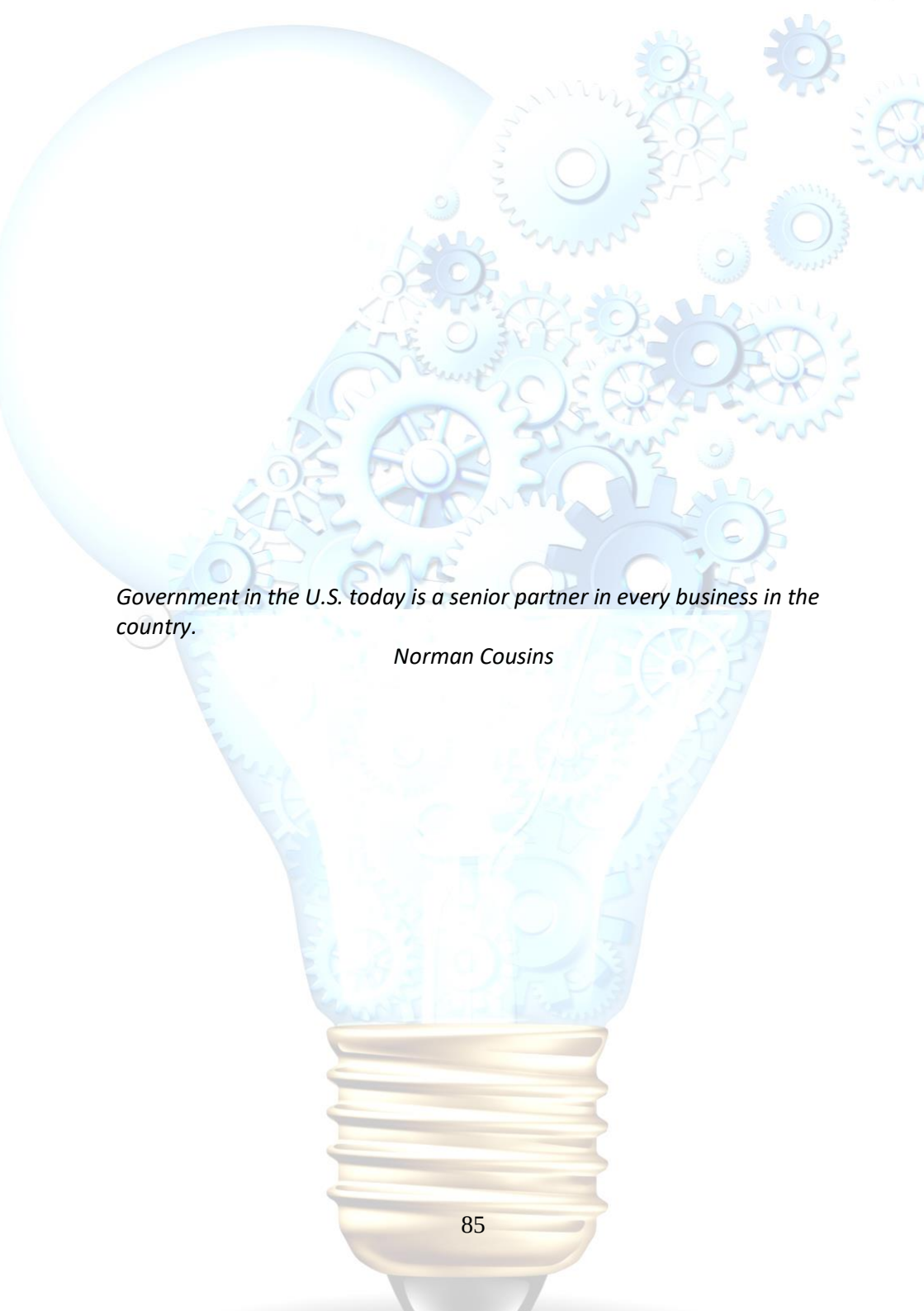
There are many ways to buy things if you think outside the box. Here are some unorthodox resources for buying items for your company.

- Internet markets (ex. Craig's List or eBay)
- Auctions
- Company closures

Thinking outside the box when making purchases may require some additional research time, the payoff may be worth it.

Practical Illustration

Lillian had to decide if her company should buy or lease an office building. There were several factors she needed to take into consideration. If she bought the office space, then would she lease or buy the equipment for the office? If she leased the office, would it be worth it in the long term? What were the tax implications? In order to answer these questions and determine the best course of action, Lillian consulted the budget team. Together, they systematically weighed the cost effectiveness of each option. Some choices began to emerge that were better suited to the company's current budget and goals. In the end, Lillian made the choice and was glad that she weighed her options before making the choice.



Government in the U.S. today is a senior partner in every business in the country.

Norman Cousins

Chapter Ten: A Glimpse into the Legal World

When dealing with corporate finances, there are strict regulations that shape the way financial information is gathered, stored, and reported. As a manager, you must understand why the laws exist, what they require, and how you factor into the situation. There are severe consequences when these laws are not followed. There may be controls already in place at your company, but if you intend on being involved with the financial activities in your company it is best to be familiar with some of the legal requirements business must follow.

In this Chapter, you will learn the following topics:

- A brief history
- The Sarbanes-Oxley Act
- CEO/CFO certification
- 8th Company Law Directive

Let us look at a brief history of the government's involvement in the financial dealings of corporations in the United States.

A Brief History

Abuses in the stock market in the 1900s forced the government to intervene and regulate how companies sold securities. The origins of financial regulations began back in 1933 with the enactment of the Securities Act of 1933. Here is as brief list of subsequent acts throughout history:

- **Securities Act of 1933** regulated the offer and sales of securities.
- **Securities Exchange Act of 1934** governed the secondary trading of securities like stocks, and bonds.
- **Trust Indentured Act of 1939** requires the appointment of an independent trustee to serve for the benefit of the holders of securities.
- **Investment Company Act of 1940** helped reduce or eliminate conditions, which affects the public interest and the interest of the investors.
- **Investment Advisers Act of 1940** regulates the actions of the investment advisers.
- **Sarbanes-Oxley Act of 2002** sets standards for all public company board, management and accounting firms in the United States.
- **Credit Rating Agency Reform Act of 2006** improved ratings quality of companies, protecting investors.

The U.S. Securities and Exchange Commission is the agency that enforces federal securities laws.

The Sarbanes-Oxley Act

The Sarbanes-Oxley Act of 2002 became law on July 30, 2002. This law is also known as the following:

- Public Company Accounting Reform And Investor Protection Act
- Corporate And Auditing Accountability and Responsibility Act
- Sarbanes-Oxley
- Sarbox
- SOX

The law was named after its sponsors U.S. Senator Paul Sarbanes and U.S. Representative Michael G. Oxley. The bill was created after companies like Enron, Tyco International, Adelphia, Peregrine Systems and WorldCom committed major financial scandals.

The law regulates the standards for all U.S. public company board of directors, management, and public accounting firms. The Securities and Exchange Commission (SEC) oversees the enforcement of this law.

The law establishes the following:

- Public Company Accounting Oversight Board, which performs the following
    - Oversee audits of public companies
    - Set audit reporting standards
    - Ensures compliance of public accounting firms
    - Requires accounting firms to register with them
    - Instructs company board of directors to establish auditing, quality and ethical standards
    - Provide rules for auditing standards
- Auditor Independence
- Corporate Responsibility
- Enhanced Financial Disclosures
- Analysis of Conflicts of interest
- Security and Exchange authority

CEO/CFO Certification

Section 302 of the Sarbanes-Oxley Act of 2002 requires that the CEO and CFO certify the annual or quarterly report. The Corporate Responsibility for Financial Reports area of the law outlines the following requirements for the CEO and CFO:

- The signing officer has reviewed the report
- Based on the officer's knowledge, the report does not contain any untrue statement
- Based on such officer's knowledge the report fairly present in all material respects the financial condition
- The signing officers are responsible for establishing and maintaining internal controls
- The signing officers have disclosed to the issuer's auditors and the audit committee of the board of directors all significant deficiencies in the design or operation of internal controls
- The signing officers have indicated in the report whether or not there were significant changes in internal controls

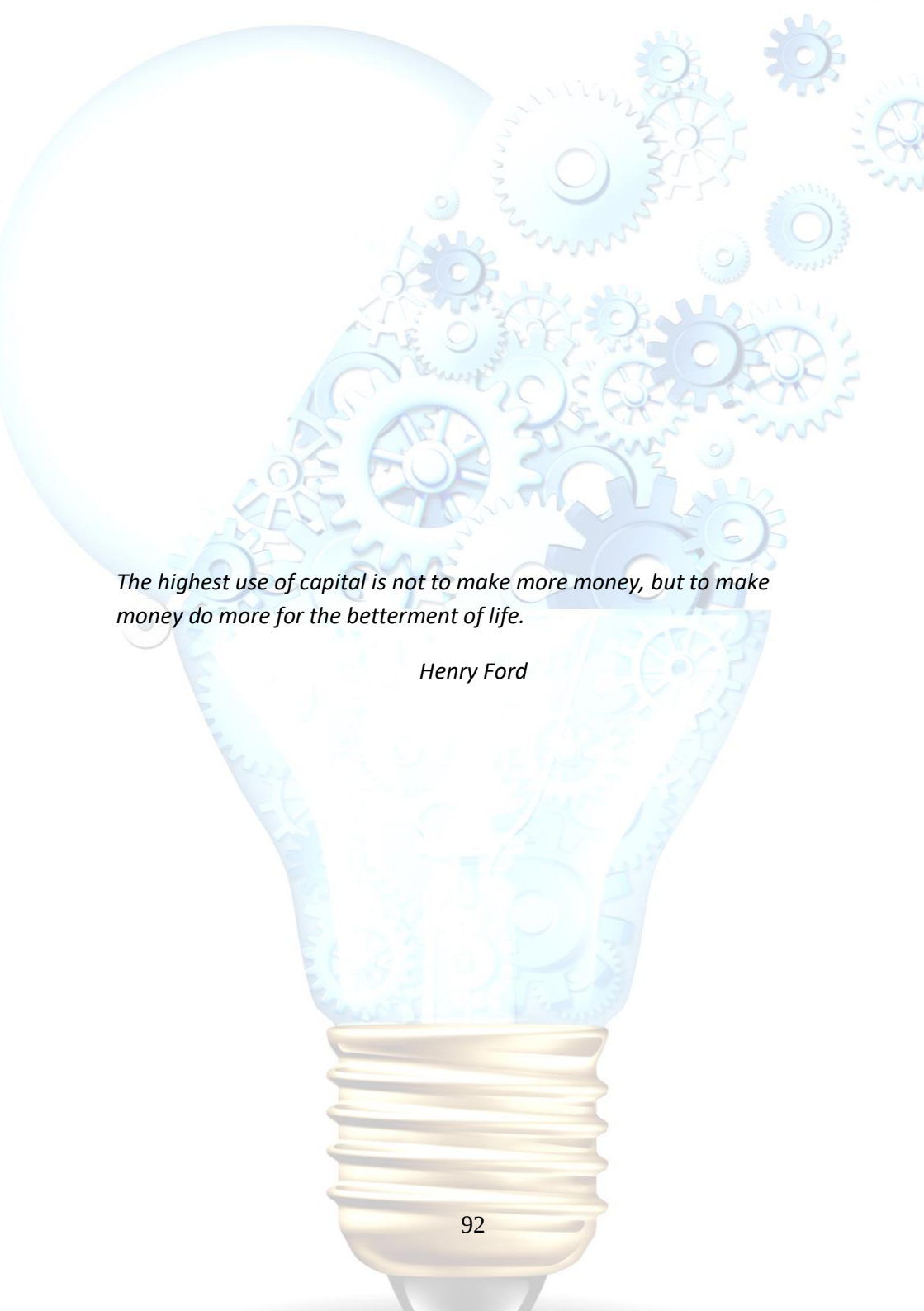
8th Company Law Directive

The 8th Company Law Directive is the European version of the Sarbanes-Oxley Act of 2002. This law was enacted in 2006. Most of you may not have to worry too much about this law unless your organization is based in Europe.

Knowing about this law helps, will allow you to become more globally aware of how corporate finances are regulated.

Practical Illustration

Anna was the CEO of a small accounting firm. She was approached by an employee of the Public Company Accounting Oversight Board. He explained that they require all accounting firms to register with them. Anna explained that her company was registered, and it was expecting an audit soon. After being audited by an independent auditor, Anna's company was found to be on track. Anna knew this would be the case, because as CEO, she had to sign off on the annual report. The report included the results of the audit.



The highest use of capital is not to make more money, but to make money do more for the betterment of life.

Henry Ford

Closing Thoughts

- **William Arthur Ward**: Wise are those who learn that the bottom line doesn't always have to be their top priority.
- **W. Clement Stone**: Try, try, try, and keep on trying is the rule that must be followed to become an expert in anything.
- **Colin Powell**: There are no secrets to success. It is the result of preparation, hard work, and learning from failure.