SECOND EDITION

HOW TO KEEP SCORE IN BUSINESS

ACCOUNTING AND FINANCIAL ANALYSIS FOR THE NON-ACCOUNTANT

ROBERT FOLLETT

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Second Edition

Robert Follett

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About the Author

Robert Follett never had a course in accounting or finance. But as he moved into corporate management, he had to learn about these subjects in order to be successful. He learned the hard way.

Keeping score using accounting and financial analysis is an important skill that many who move up from nonmanagement positions don't have. Follett wanted to help others avoid the dumb mistakes he made. That's why *How to Keep Score in Business* came to life.

Before the book was written, Follett undertook much study and then presented seminars, workshops, and short courses for new managers. These helped him hone the book's contents.

Follett began his career as a very junior editor in a publishing company. He rose through both editorial and sales positions to become president. Then he became chairman of a large, multidivision company. His business career spans over 60 years—years in which knowing the basics of accounting and financial analysis has been critical.

Follett is the author of seven other books. He teaches university classes, mainly for young people with no knowledge of accounting or finance who will need this knowledge as their careers develop. He works with various charitable organizations and continues his involvement in business.

1

Introduction

The purpose of this book is to teach you the fundamentals of keeping score in business. You will learn the basic workings of the accounting system. When you are through, you will be able to read, understand, discuss, and use a balance sheet, an income statement, and other statements found in financial reports. You will know something about various tools for analyzing financial reports and investment opportunities. You will have a basic vocabulary of the important terms used in accounting. You will be able to talk with more confidence to accountants, auditors, financial analysts, budget directors, controllers, treasurers, bankers, brokers, and lots of other people who use accounting jargon.

This book will not make you an accountant. But it will help you talk with accountants. This book will not teach you to keep the books for a company. But it will help you understand the financial reports produced by bookkeepers and accountants.

This is a book for non-accountants. It was written by a non-accountant. This book aims to make you successful in business despite your lack of formal accounting education or experience.

To get the most out of this book, you need three things. You need to keep paper and pencil beside you as you read. You need a calculator (or a good head for computation). Any cheap, simple calculator that can add, subtract, multiply, and divide will do. If you don't have one, I strongly recommend that you get one. Finally, you will need some time to get the most out of this book.

This is not a long book. But it will repay close attention. Some of the concepts are confusing. Some of the computations are a bit complex. There is nothing here that a good high school student cannot understand and handle. But it will take time. The time you spend will be repaid with a basic understanding of business accounting.

The title of this book is *How to Keep Score in Business*. 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 the number 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. This book fills in some of the blanks.

Knowing how to keep score in business is essential to moving up in management. That's why seminars on accounting and finance for nonfinancial managers are among the most popular. That's why courses on this topic are offered at hundreds of colleges and continuing-education centers. That's why hundreds of books have been published on this topic.

However, most of the seminars, courses, and books suffer from one major problem.

They are put together by accountants.

Most accountants know too much to explain the business scorekeeping system to the non-accountant.

I am not an accountant. I started my business career in sales. Then I had a lot to do with product development. I was the president of a large company. I became chairman of an even larger company. Along the way I had to learn about financial accounting the hard way. I have worked with accountants, auditors, bankers, treasurers, and controllers. These experts often flimflammed me with accounting lingo I didn't understand. I was made to look like a fool because somebody with an accounting degree exposed my ignorance. I've made almost every dumb mistake that a manager with no financial or accounting background can make.

But over many years in business I finally learned something about the accounting system. Now I can keep score along with the best. I don't know everything. But I know enough to be a good manager who can use financial information.

If you study this book carefully, I'll give you many years of hard knocks and dumb mistakes distilled into a relatively few pages. When you're finished studying this book, you will be well on your way to mastering an indispensable management skill. You will know the basic system for keeping score in business. You will understand the major elements of financial accounting.

Here is how the rest of the book is organized:

In the remainder of this chapter you will learn why this book is about keeping score. You will see that accounting scores are not the same as spendable dollars. This key concept will underlie much of the rest of the book.

Chapter 2 is a glossary of key financial terms. Here you will find definitions of the key words and phrases most often used by accountants. These are practical definitions that will help you develop the essential vocabulary you need for communication. You will want to refer to this glossary often—as you use the rest of the book and later, when you deal with accountants and financial reports.

Chapter 3 introduces you to the balance sheet. This is a statement of a company's financial position at one point in time. It is a basic financial report. In this chapter you will invest in the Acme Widget Company.

Chapter 4 tells more about the balance sheet. It gives you insight into what is shown and what is *not* shown. You will learn some useful methods of analyzing balance sheet information. Some valuable information never appears on any financial report. This will be discussed in this chapter.

Chapter 5 completes the presentation on the balance sheet. When you are finished with this chapter, you will have completed the most difficult part of the book—difficult because it introduces you to many new concepts and ideas. These will make it much easier for you to handle the chapters that follow. Then you will be better able to handle real-life experiences with financial reports.

We turn to the income statement in Chapter 6. This financial report summarizes a company's operations over a period of time. The last line of the income statement is the famous "bottom line." You will learn what income statements show and what they hide. Various ways of analyzing income statements are introduced. A brief section shows the reconciliation between the income statement and the balance sheet—how they connect.

Chapter 7 discusses return on investment. Several methods of computing return on investment are presented. Return on investment is an excellent way to evaluate company performance or analyze possible investments or acquisitions. You will learn how to use this tool.

The statement of changes in financial position is presented and analyzed in Chapter 8. Using this statement will help you see how funds flow into, through, and out of a company. It reveals some of the things that are not too clear on the balance sheet or income statement.

Chapter 9 teaches you one method of making a cash flow budget. This is an especially valuable management tool. With it you can plan ahead and avoid the embarrassment of running out of cash, even when sales are good. (It can happen.)

Chapter 10 introduces a variety of other analysis ratios and tools. Some are valuable to managers, others to lenders, and still others to investors. I will caution you about the limitations of these ratios and tools. No substitute has yet been devised for common sense.

What will you have learned when you finish this book? Chapter 11 is the summary chapter. It briefly recaps all the major ideas presented in the preceding ten chapters.

This book has no pinup pictures. But it does have a lot of figures. You will find many of them in the tables and illustrations and in the Appendixes. Appendix A summarizes the most important details of Acme Widget Company. Appendix B is a table of present values. You will learn how to use this valuable analysis tool in Chapter 7. You will want to use it frequently thereafter. The book ends with an index, where you can quickly look up things as you work with financial reports and accountants.

Have fun! Number crunching and massaging of figures can be an enjoyable pastime, even if you have no formal training. This book should give you enough information so that you can crunch and massage with anyone.

The First Lesson: Scores Are Not Real Dollars

Basically, accounting is simple. Lots of people are accountants who aren't as smart as you are. Of course, the Internal Revenue Service, the Financial Accounting Standards Board, the Securities and Exchange Commission, and other organizations have made a basically simple system more complicated. To be a good manager you need to know only the basics. Let's begin with the most basic of basics—the bottom line.

When people talk about the bottom line, they usually mean the last line of an income statement, which is labeled "Net Profit After Taxes" or "Net Income." This is the amount of money a business has to spend, right?

Wrong! Dead wrong.

The bottom line, net profit after taxes, is just a score. The business may have many more actual dollars to spend than the bottom-line figure shows. Or it may have a lot fewer dollars to spend. The bottom line is a score. Don't confuse the score with real money. For a long time I did. This led to a lot of dumb mistakes.

Learn this lesson, and learn it well. The numbers you see on financial reports are scores in the game of business. They usually do not represent real, spendable dollars. In the remainder of this book you will be shown why this is so. You will also see how to figure out how many real spendable dollars a business has or is likely to have in the future.

Let's carry this further. You get a sales report. It shows the number of dollars of sales. Can the money from these sales be spent? No! In most businesses, sales figures are scores. The actual money will be unavailable until later, when the customers pay their bills.

You get a purchasing report. It shows how many dollars worth of goods have been purchased and put into stock. Does that mean those dollars are spent and gone? No! In most businesses this is a score. The actual dollars are not paid to the suppliers of the goods until sometime later.

And so it goes with most financial reports. These reports show scores. Scores are not the same thing as real, spendable dollars.

The Accrual Method

It is time to turn to a diabolical accounting invention—the accrual method.

Individuals keep track of cash. In fact, the IRS directs individuals to keep track of their cash expenditures and cash revenues for tax purposes. This means you don't have any revenue until you have cash in hand (or could have it). Just because someone owes you the money doesn't mean you have any revenue.

The same thing goes for your personal expenditures. If you want to take a deduction for a medical expense on your tax return, you actually have to pay the bill with a check or currency. Just because you visited the doctor and he sent you a bill is not enough to get you a tax deduction. Cash has to change hands.

None of this is true in business. In business, we use the accrual method of accounting, not the cash method.

If you used the accrual method, you would record your revenue whenever it was first owed to you, not when it was paid. You would record your expenditure when you got the doctor's bill, not when you paid it.

The business world offers similar examples of the accrual method. A sales transaction is recorded when the company makes up an invoice for the sale. The dollars are recorded on the financial reports at that time, even though the customer may actually pay days or weeks or months later—or never.

The same thing happens in reverse when a company buys something. As soon as the company gets the invoice for the goods or services it is buying, the cost is recorded in the company's financial records. The dollars involved in the purchase will show on financial reports, even though the company may not pay those dollars for 30 or 300 days.

These are examples of the workings of the accrual system. Transactions enter the financial records as soon as they take place, not when the cash involved with the transaction changes hands. It is quite possible for a company to report big profits and be broke—unable to come up with enough cash to buy a cup of coffee. Conversely, a company may show a loss on its financial reports even though it put cash in the bank.

The accrual method of business accounting guarantees that financial reports show scores, not real, spendable dollars.

But Scores Are Important

Before we leave this topic, let me offer a word of caution. Don't think that scores are unimportant because they don't represent real dollars. Jobs are lost, promotions are won, raises are given, companies bought and sold on the basis of financial scores. You want to have good scores in business, even if they don't reflect the true cash status. Good scores produce winners in business just as good scores produce winners in sports.

In the rest of this book, you will learn some ways to improve the scores.

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