

THE LANGUAGE OF BUSINESS

A PRIMER

OBJECTIVE

This Primer can help you begin to gain a basic financial vocabulary and to understand the subject of business finance. Topics cover only the fundamentals of accounting and financial reporting. The Primer explains the terms and ideas you'll need to understand these topics and succeed in better understanding your executive customer.

Because you are in sales, you will probably never take up permanent residence in the world of finance. However, we want you to be comfortable as an occasional visitor to that world as you begin to focus on your customers and their business issues.

Before you begin, please take out the Annual Report that you have obtained for your Target Account. As you read the primer follow along with your customer's Annual Report. At the end, you will be asked to answer some questions about your customer.

ANNUAL REPORT

An [annual report](#) is exactly what it sounds like - a formal report on a company's performance in the preceding year. A public company produces an annual report for its Shareholders, the people and institutions that own the company.

Other interested parties, such as customers, vendors and potential investors, read this report, too. In fact, the [Securities and Exchange Commission \(SEC\)](#), a U.S. government agency, or internationally, your local stock exchanges, require a public company to keep Shareholders informed on the state of its business.

An annual report is one of the most important documents a company produces and is often the first document someone consults when researching a company. It reports how the company did financially and often explains the scope of its business mission and management philosophy.

For these reasons companies take the development of an annual report seriously. They carefully consider its design and construction and even the paper to print it on. Today, many companies also produce Web and CD-ROM versions of their annual reports but it is best to get the printed copy from the company's corporate office or the local stock exchange in your country. You can link to many resource for ordering annual reports for companies around the world at <http://www.kirbyarnold.com/data.html>.

ELEMENTS OF AN ANNUAL REPORT

- ✓ **Financial highlights.** Probably the most often-read section of any annual report, these highlights give a quick summary of a company's performance. The numbers appear in a short table, usually accompanied by supporting graphs.
- ✓ **Letter to Shareholders.** This letter may be from the chairperson of the board of directors, the chief executive officer, or both. It can provide an analysis and a play-by-play review of the year's events, including any **problems, issues**, and successes the company had. It usually reflects the business philosophy and management style of the company's executives, and often it lays out the company's **direction for the next year**.
- ✓ **Corporate message.** Some analysts, business executives, and Shareholders consider this message an advertisement for the company; others find it useful. However, it almost always reflects how a company sees itself, or how it would like others to see it. The company can explain itself to Shareholders, using photographs, illustrations, and text. This message may cover the company's lines of business, markets, mission, management philosophy, corporate culture, and strategic direction.
- ✓ **Management discussion.** This series of short, detailed reports discusses and analyzes the company's performance. It covers results of operations, and the adequacy of liquid and capital resources to fund operations. Important financial issues are referenced, and often the company's key ratios are given. Frequently, the company's segments are reported and their performance discussed.
- ✓ **Financial statements and notes.** These statements provide the raw numbers for the company's financial performance and recent financial history. The SEC requires three statements – statement of earnings (the income statement), statement of financial position (the balance sheet), and statement of cash flows – all covered in this Primer. (The statement of Shareholders' equity is not addressed here.) These statements include a comprehensive set of related notes that provide explanations, additional detail, and supplementary financial information.
- ✓ **Selected financial data.** This information summarizes a company's financial condition and performance over five years or longer. Data for making comparisons over time may include [revenue](#) or [turnover](#) (sales), [gross profit](#), [net earnings](#) (net income), [earnings per share](#), [dividends](#) per share, financial [ratios](#) such as [return on equity](#), number of shares outstanding, and the market price per share.

- ✓ **Board of directors and management.** This list gives the names and position titles of the company's board of directors and top management team. Sometimes companies include photographs. This information is often in the back of the annual report.
- ✓ **Shareholder information.** This information covers the basics of the company's corporate office headquarters, the exchanges on which the company trades its stock, the location and time of the next annual Shareholder's meeting, and other general Shareholder service information. [Shareholder](#) information is usually in the back of the annual report
- ✓ **[Auditors'](#) report.** This summary of the findings of an independent firm of certified public accountants shows whether the financial statements are complete, reasonable, and prepared consistent with generally accepted accounting principles ([GAAP](#)) at a set time.
- ✓ **Report of management.** This letter, usually from the board chairperson and the chief financial officer, takes responsibility for the validity of the financial information in the annual report, and states that the report complies with SEC and other legal requirements. The discussion attests to the presence of internal accounting control systems that cover effectiveness of operations, reliability of financial reporting, and compliance with federal laws.

THE BALANCE SHEET

The [Balance Sheet](#) is like a snapshot because it shows what the company is worth at that set date that it was compiled. It is a record of the company's financial structure. The statement shows:

- ✓ what the company owns - [ASSETS](#)
- ✓ what the company owes - [LIABILITIES](#)
- ✓ what belongs to the owners - [SHAREHOLDER'S EQUITY](#)

It is called a balance sheet because of the way one part – assets – is in balance with the sum of the other two parts – liabilities and Shareholders' equity.

→
$$\text{Assets} = \text{Liabilities} + \text{Shareholder's Equity}$$

In the UK the balance sheet is set up a little differently. The first part of this balance sheet measures total assets (fixed + current) minus current liabilities. The second part measures total equity and shareholders' equity.

→
$$(\text{Total Assets} - \text{Current Liabilities}) = (\text{Total Equity} + \text{Shareholder's Equity})$$

In an annual report, the balance sheet or statement of financial position includes information for at least the last two years to allow comparison of changes between years.

Assets

Companies own things, called assets. These things might be physical assets such as buildings, trucks, inventories of products, equipment, and [cash](#). Or they may also be ownership rights such as [intangible assets](#), [goodwill](#), trademarks, and patents.

Assets are either current or noncurrent. [Current assets](#) are things a company expects to convert to cash within one year. Examples are [accounts receivable](#) or [inventories](#) of products to sell. Finally, current assets include cash and [securities](#) such as treasury bills and certificates of deposit the company expects to convert to cash within the year.

Noncurrent assets are things a company does not intend to convert to cash or that would take longer than a year to convert. Noncurrent assets include [fixed assets](#), often listed as "Property, plant, and equipment" because that's what they usually are. Companies use fixed assets to manufacture, display, store, and transport products.

The amounts of fixed assets vary by company and industry. For example, manufacturing companies generally have a large investment in fixed assets because making things requires property, plant, and equipment. Service companies usually have fewer fixed assets.

Liabilities

On the balance sheet, debts are called liabilities. All companies have liabilities. Examples of liabilities include:

- ✓ money owed to banks and other lenders ([debt](#))
- ✓ money owed to suppliers of goods and services ([accounts payable](#))
- ✓ taxes owed to government authorities ([income taxes payable](#))

Liabilities are either current (short term) or long term. [Current liabilities](#) are financial liabilities of the business that are due to be paid within one year. In the normal course of business, current liabilities are expected to be paid from the current assets (products) into cash. Cash is then available to pay off a current liability. Long-term liabilities are due in longer than one year.

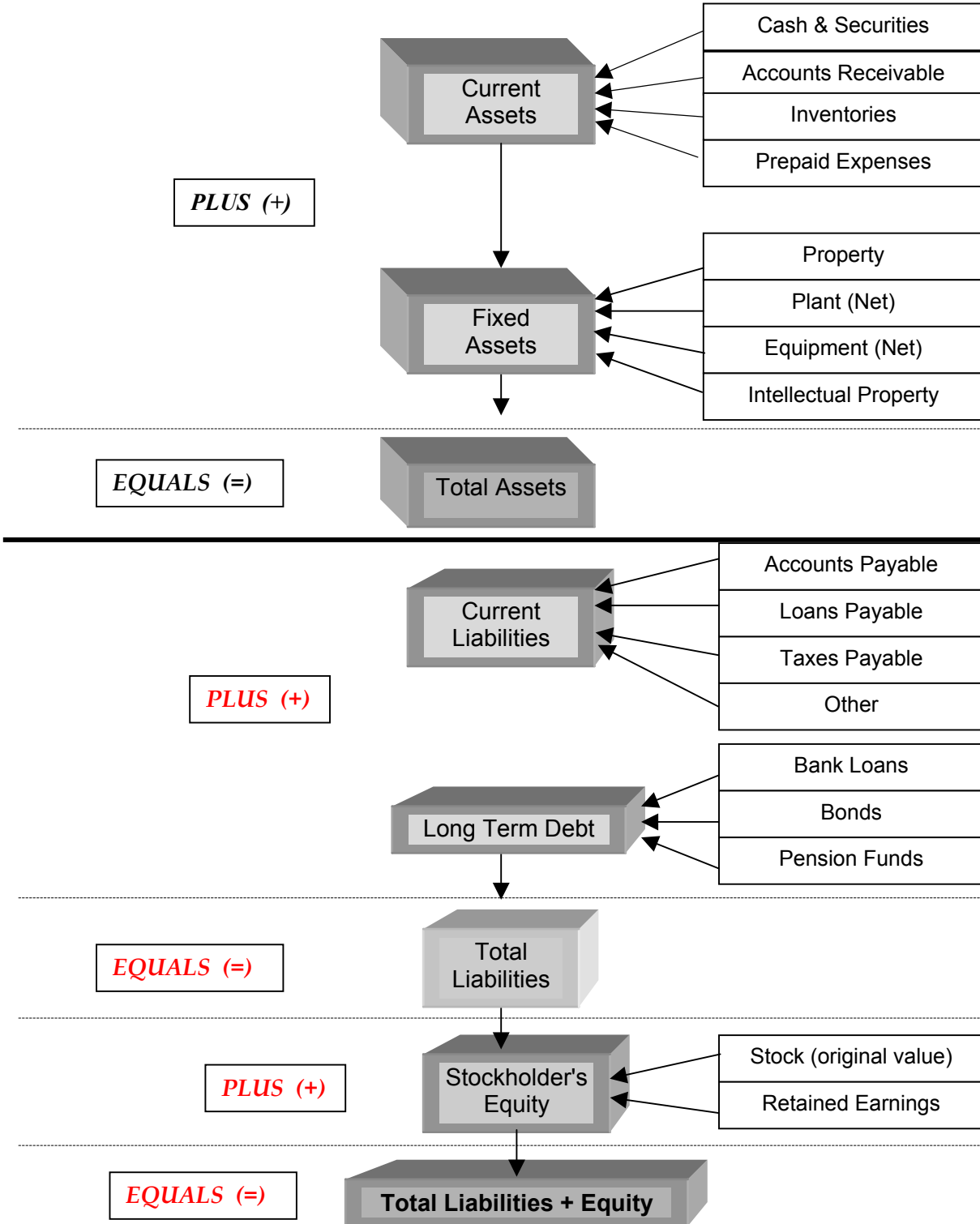
Although liabilities are a necessary part of doing business, companies must manage their liabilities carefully. If a company cannot make interest payments on time and repay the principal when due, the company can be forced to declare bankruptcy and either reorganize or disband.

Shareholders' Equity

Shareholder's equity is the owner's share of the business's assets in excess of claims on those assets by liabilities. On the balance sheet the amount of Shareholders' equity always equals the value of all the assets minus all the liabilities. For example, if a company's assets are valued at \$10,000 and liabilities total \$6,000, the equity is \$4,000. Shareholder's equity is on the liability side of the balance sheet because it is technically a liability of the firm to its owners. The next two pages will give you a graphic representation of an international balance sheet and the balance sheet used by companies in the UK.

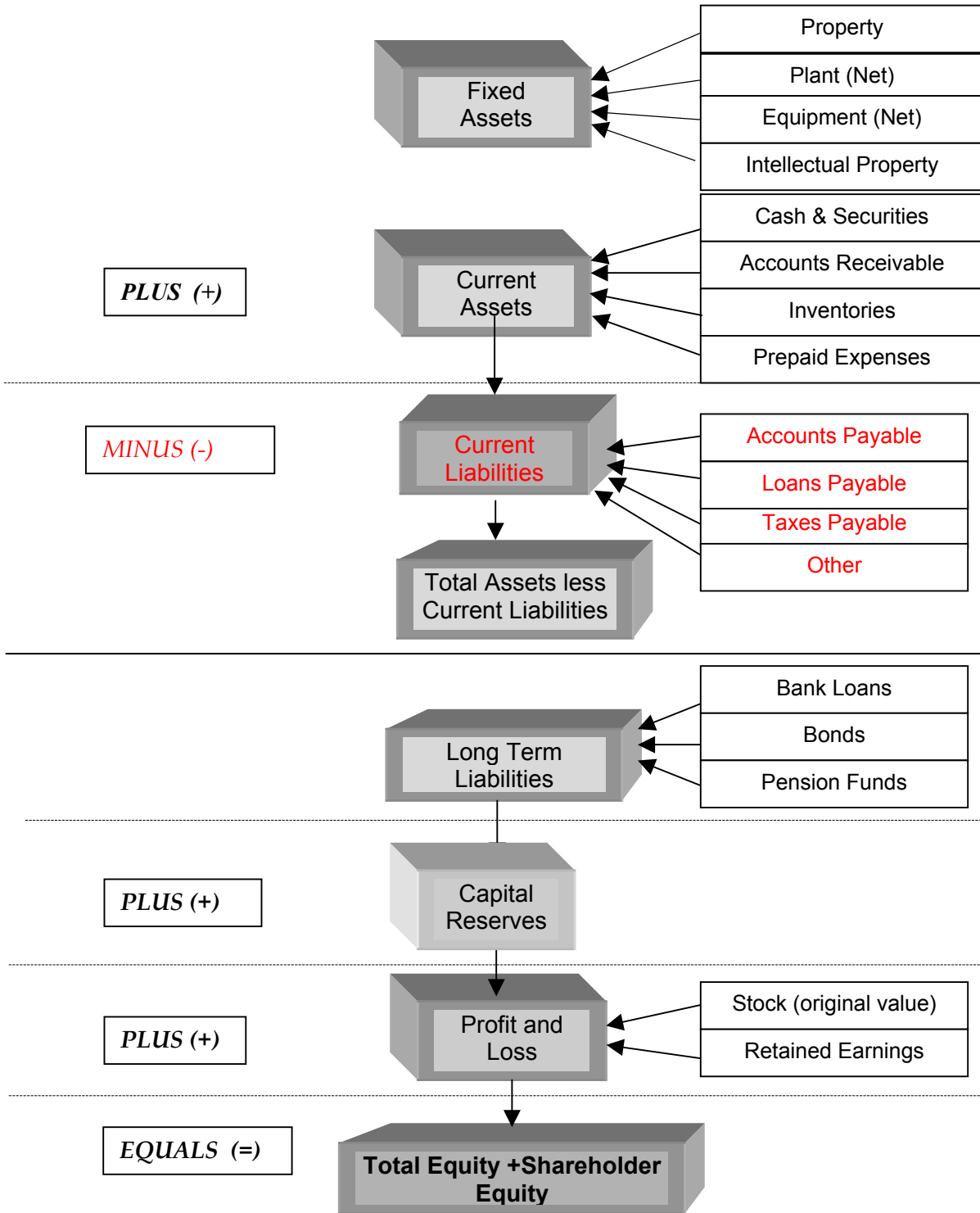
THE BALANCE SHEET

→ **Assets = Liabilities + Shareholder's Equity**



BALANCE SHEET UK

→ (Total Assets – Current Liabilities = (Total Equity + Shareholder’s Equity))



THE INCOME STATEMENT

The [income statement](#) records the income and [expenses](#) of a business over a period of time. It gives us the financial results of business activity - how successful the operation of the business is. If income exceeds expenses during the period measured, there is a [net profit](#). If expenses exceed income, there is a net loss. The operations recorded in the income statement flow through to the balance sheet. Generally, the income statement is an important analytical tool for understanding the operations of the business.

A rule of business is, "It takes money to make money." Typically, producing goods for sale is the greatest cost of generating [revenue](#). For example, a computer manufacturing company must buy wiring and other raw materials to make computers; pay wages to workers and managers; and spend money on overhead – power, facilities, and maintenance. A company deducts these costs (cost of sales, cost of goods sold) from revenue or sales, showing gross profit (or loss).

Revenue or Sales ([turnover](#) – UK)

Companies earn revenue (turnover) in one or more of the following ways:

- ✓ by selling products or services, or both
- ✓ by leasing and renting equipment or property to others
- ✓ by receiving interest from loans to other companies or individuals

Revenue is the total amount of funds generated by the business from product and/or services delivered to customers during the income statement period. Sales are recorded when made, not when the sold product or service is actually paid for.

Some companies have only one source of revenue; others have several. For example, HP reports revenue from its products, such as computer hardware and software. It also reports revenue from its services, which include maintenance, outsourcing, consulting and financing.

Minus

Cost of Goods Sold or Cost of Sales

The cost of goods sold is the amount it costs to produce or procure the products sold during the income statement period. This figure can also include additional items such as downward adjustments of inventory (not sold) at the end of the period to recognize the loss of value of inventory that has become obsolete, was damaged or was stolen. Cost of Goods Sold is subtracted from Revenue or Sales to equal Gross Profit or Gross Income.

Minus

Gross Profit or Gross Income (or loss)

Gross Profit or Gross Income is the income from sales or revenue after deducting the cost of goods sold. As the first measure of income in the income statement, it is important because it tells us what kind of markup (in relation to sales) the business is able to obtain on its cost of goods sold.

Minus

Operating Expenses

Operating expenses are the expenses that are incurred by the business during the income statement period, that are not directly linked to the cost of making a product, but that are a cost of day-to-day operations. Examples are administrative and management salaries (but not labor), rent, utility costs, advertising, insurance, office supplies, commissions to sales, research and development, etc. A business deducts these operating expenses from gross profit, resulting in operating income (or loss).

Equals

Operating Income

Operating income is the income that remains after cost of goods sold and operating expenses are deducted from sales or revenue. It represents a company's [revenue](#) minus all [expenses](#) required to obtain that revenue. Operating income is derived by subtracting operating expenses from gross profit or gross income. It is an important measure of the success of the company because it represents the earnings ability of the business as a result of doing what it was formed to do, instead of making profits through its investments or other non operating activities.

Minus

Interest Expense

Interest expense is the amount charged for the use of borrowed funds during the income statement period. It includes interest on all loans, both short- and long term and any other financial costs related to borrowing such as loan fees.

Minus

Income Tax Expense

Income tax expense is the tax payable to the government on the business's taxable income to include operating income and non-operating income such as income on investments or the sale of property, etc.

Equals

Net Income (loss) or Net Earnings

Net earnings are the magical "bottom line" (often literally the last line on the statement). After a company deducts all costs and expenses from revenue. When revenue exceeds costs and expenses, the bottom line shows a profit. When costs and expenses exceed revenue, the bottom line shows a loss.

The net income can be used for one of three uses:

- ✓ It can be retained by the company (in which case it will flow through to the retained earnings account on the balance sheet).
- ✓ It may be distributed all or in part to shareholders as their share of the firm's profits for the period covered by the income statement (in which case it benefits the shareholders but not the future operations of the company). Those payments are called [dividends](#). It can be used to buy growth in net earnings and that usually signals that a company is doing well.

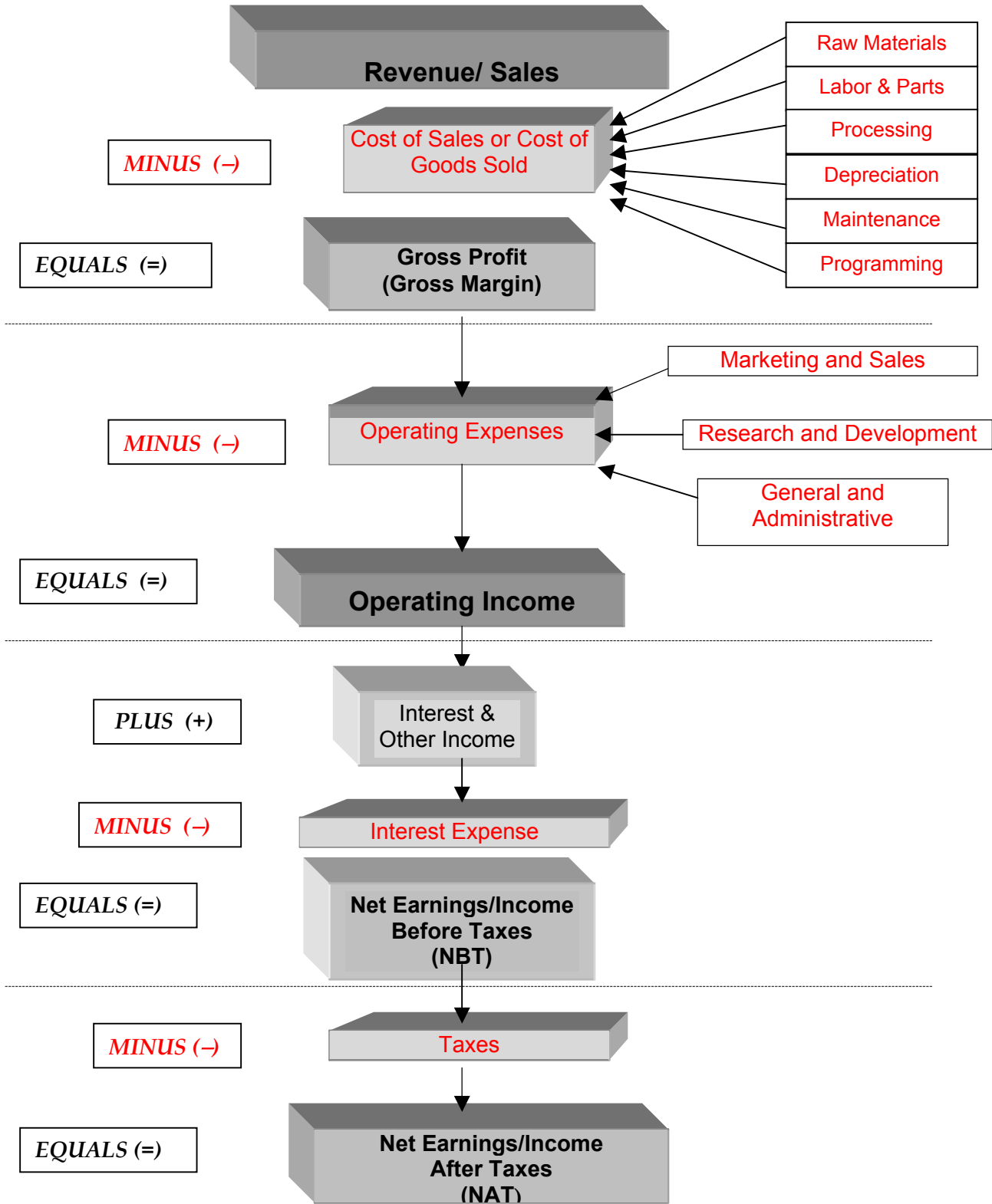
Earnings per share (EPS) shows how much money Shareholders would receive for each share of [stock](#) if the company distributed all net earnings to its Shareholders. Although all net earnings really belong to the Shareholders, a company almost never distributes the full amount to them directly. A company needs money to grow, so it takes part of the net earnings and reinvests that money in itself. The total amount of a company's net earnings since its inception, minus any payments made to Shareholders, is called retained earnings.

Although the term may suggest a large pool of cash, that image is misleading. Retained earnings is actually part of Shareholders' equity and represents the portion of a company's assets that is financed from profitable operations rather than from selling stock to investors or borrowing from external sources. If the company reinvests those earnings profitably, the Shareholders benefit from that reinvestment over the long term.

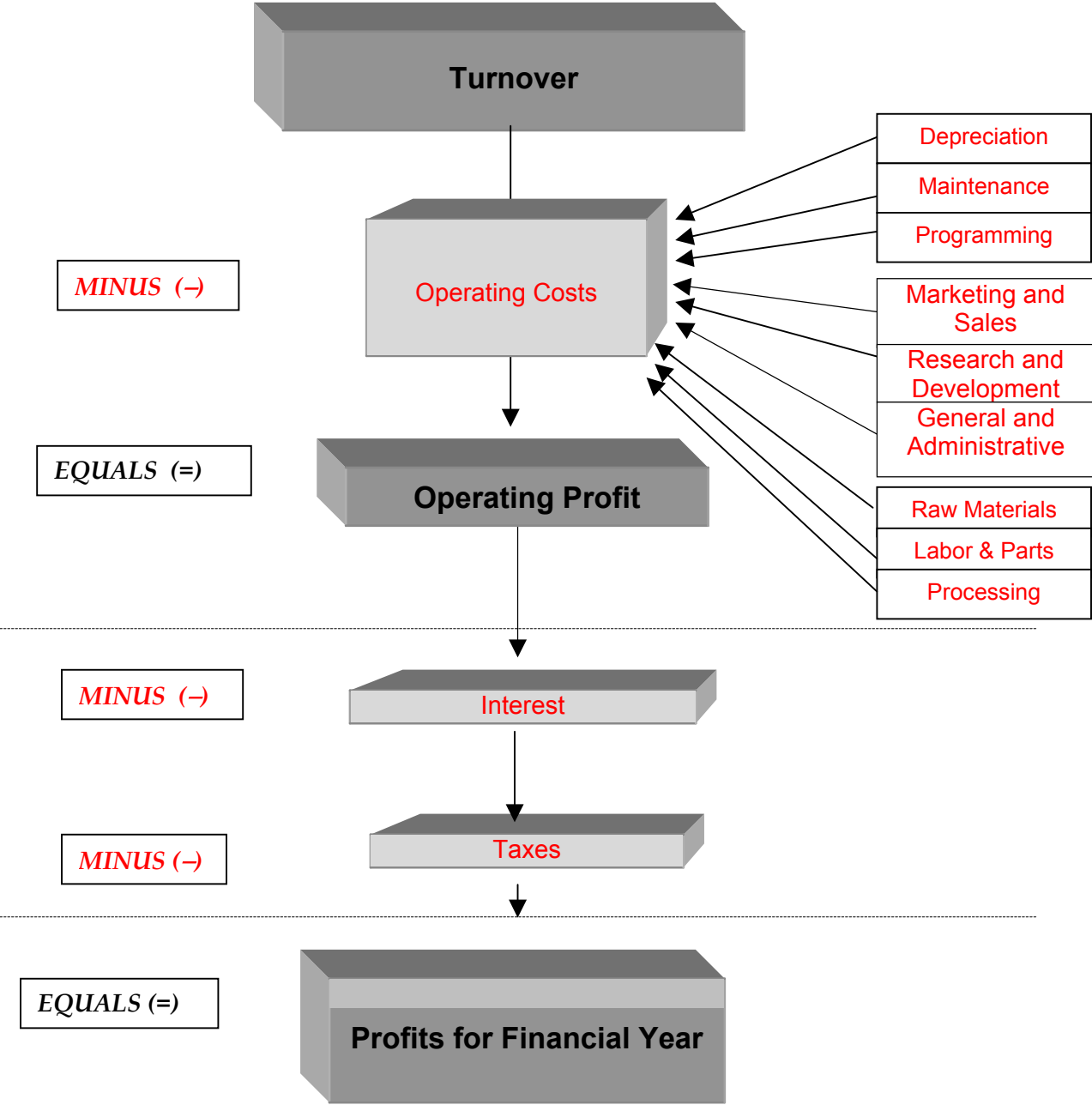
A second way Shareholders benefit from retained earnings is through dividends. A company's board of directors, with the advice of management, decides on the amount of dividends per share to pay. Companies usually pay dividends quarterly; however, many companies don't pay dividends at all, and a few pay dividends irregularly.

The next two pages will give you a graphic representation of an international income statement and the income statement used by companies in the UK.

INCOME STATEMENT



THE INCOME STATEMENT UK



RATIOS

Ratios show the relationships between certain components of the two financial statements we have just reviewed. The ratio can be a powerful tool for you to use to understand the underlying reasons the financial structure, condition and trends of your customer. When you analyse ratios, however, you must relate your customer's ratios historical performance to the ratios of their competitors or their industry. Ratios are always "compared to what" and should never be taken at face value on a stand alone basis.

Typically you will find ratios discussed in the financial highlights, historical summary of financial data and the management discussion and analysis sections. The ratios that we will be looking at to help you to identify trends and potential business issues within your accounts will be:

- ✓ [Market Ratios](#) - the market's anticipation of the stock's performance
- ✓ [Operating Ratios](#) - measuring how profitable the company is based on how well it uses its resources
- ✓ [Efficiency Ratios](#) - measuring the speed/activity with which the company can turn its assets into cash

Market Ratios

[Earnings per Share](#) (EPS) the portion of a company's profit assigned to each share of stock

→
$$\text{EPS} = \text{Net Income} \div \text{Total Outstanding Shares of Stock}$$

Price Earnings (P/E) the relationship between a company's price per share and the earnings per share (EPS)

→
$$\text{P/E} = \text{Market Price of One Share} \div \text{EPS}$$

Price per Sales (P/S) the relationship between a company's price per share and the total sales per share

→
$$\text{P/S} = \text{Market Price of One Share} \div \text{Total Sales per Share}$$

Operating Ratios

[Gross Profit Margin](#) (GPM) the gross income expressed as a percentage of sales

→
$$\text{GPM} = \frac{\text{Revenue (Sales)} - \text{Cost of Goods Sold}}{\text{Revenue (Sales)}}$$

[Operating Profit Margin](#) (OPM) the operating income expressed as a percentage of sales

→
$$\text{OPM} = \frac{\text{Operating Income}}{\text{Revenue (Sales)}}$$

[Return on Sales](#) (ROS) or [Net Profit Margin](#) (NPM) the net income expressed as a percentage of sales

→
$$\text{NPM (ROS)} = \frac{\text{Net Income}}{\text{Revenues (Sales)}}$$

[Return on Equity](#) (ROE) A measurement of return on investment expressed as net income for a specific period as a percentage of equity.

→
$$\text{ROE} = \frac{\text{Net Income}}{\text{Total Shareholder Equity}}$$

[Return on Assets](#) (ROA) A measurement of return on investment expressed a net income for a specific period as a percentage of assets.

→
$$\text{ROA} = \frac{\text{Net Income}}{\text{Total Assets}}$$

Efficiency Ratios

[Inventory Turns](#) the average rate that inventory moves out of the business and is replaced during a specific period.

→
$$\text{Inventory Turns} = \frac{\text{Cost of Goods Sold}}{\text{Total Inventory}}$$

Days Inventory expresses inventory turns in terms of the number of days it takes for inventory to turn

→
$$\text{Days inventory} = \frac{365}{\text{Inventory Turns}}$$

[Days Sales Outstanding](#) (DOS) (aka: Days Receivables) the average time it takes for receivables to be collected (turned into cash) by the company

→
$$\text{DOS} = \frac{\text{Accounts Receivable}}{\text{Total Sales} \div 365}$$

YOUR CUSTOMER

Now is the time for you to apply what you have just learned about your customer by reading the annual report and looking over their income statement and balance sheet. The following are a list of questions that we would like you to answer about your target account.

Who is your customer?

What is their business?

Who are your customer's customers?

What are the business issues that your customer's customers are struggling with?

What is your customer doing about the business issues of their customers?

What is your customer's business (niche or solution)

What is their strategy for future success?

Who are their competitors?

What are your customer's 2 biggest business issues?

Using the financials and FAST:

What were the net revenues in 2000 and 2001?

What was the net profit or loss in 2000 and 2001?

As a percentage of revenue, what was the gross profit in 2000 and 2001?

As a percentage of revenue, what was the investment in R&D in 2000 and 2001?

As a percentage of revenue, what was SG&A in 2000 and 2001?

How much were Accounts Receivable in 2000 and 2001?

How much were inventories in 2000 and 2001?

Please bring the answers to these questions to class with you.