Southern New Hampshire University



Takeaways From Module One

Evaluating an organization's financial performance and health requires studying not only financial reports, but also the organization's strengths and weaknesses, its industry, and its economic environment.

1. The key financial statements produced by most businesses and other organizations are the income statement, cash flow statement, and balance sheet. Publicly traded corporations must publicly disclose these statements for previous quarters and years, along with explanatory notes and commentary. But within most businesses and other organizations, these and many other financial reports, including much more detail, are used extensively to analyze the past and try to forecast and plan the future.
2. Privately owned businesses are not required to publish financial information, but most produce that information anyway, following proper accounting rules. Why? They do it for their own internal management, but also because banks, potential equity investors, potential partners, and even major suppliers and customers may want to see them.
3. Although there are important differences in accounting rules among different countries, there are far more similarities than differences, and these have existed for many decades. Accountants and financial managers in North America, Europe, Africa, and Asia can and do work well together.
4. Financial evaluation involves, among other things, examining various ratios and trends to help managers and investors make better decisions. Probably the most common financial ratio is simply year-over-year percentage change. In many cases, data is adjusted to separate the effects of non-operating and one-time items, such as currency rate changes, from underlying performance. One can examine ratios and trends of historical results, future projections, or both.
5. It is tempting to focus too much on the numbers when you are evaluating an organization's financial performance and health. But think of it this way: Those numbers don't really tell us the answers; instead, they tell us what questions to ask.

Financial Statements, Cash Flow, and Taxes

An **income statement** (sometimes called a P&L, or profit-and-loss, statement) shows an organization's revenue, expenses, and income for one or several specific time periods, such as "full year 2015." Revenue is sometimes shown by product type, operating division, or geographic market. Expenses are often shown by components, such as "cost of goods sold" or depreciation or income taxes. Income or earnings are often shown in total and per share (EPS).

A **cash flow statement** shows an organization's cash inflows and outflows (sometimes called cash sources and uses), generally grouped into three main buckets: operating, investing, and financing. Realistically, most publicly disclosed cash flow statements are difficult to analyze, because they obscure as much as they reveal, for various reasons. Another type of cash flow statement, often used internally, groups cash flows into receipts and disbursements. Although in some ways this format is more illuminating, it is difficult to relate to the income statement.

A **balance sheet** is a snapshot of the organization's assets, liabilities, and equity at a specific point in time, such as December 31, 2015. It is harder to intuitively understand than the income statement, but it has been said that the balance sheet never lies. Financial problems are more likely to be revealed by careful scrutiny of balance sheets than of other financial statements.

A publicly traded corporation will disclose not only these statements but also extensive notes and commentary. Many financial experts suggest reading the commentary (usually called the management discussion and analysis, or MD&A) and the notes to financial statements before scrutinizing the statements themselves.

Financial analysts will often duplicate these reports and add columns and rows for year-over-year percentage growth rates, variances between actual results and a budget, and all sorts of other financial ratios.

Organizations use many more financial reports internally to provide greater detail, different ways of "slicing and dicing" the information, and additional subtotals and calculations. For example:

- Sales pipeline reports help forecast revenue by showing the status of various sales leads and sales negotiations.
- Backlog reports also help forecast revenue, by showing customer orders that have not yet been fulfilled.

- Various staffing reports show employees, contract worker levels, and compensation costs in different divisions, functions, and locations.
- Various project reports show status and costs for various projects to develop new products and services and for internal projects such as updating a computer system.

Analysis of Financial Statements

- Although cash flows are more important, businesses and investors focus more on accounting measurements such as revenue, operating income, operating margin, earnings per share, and the price/earnings ratio, as they are more readily available. They are also easier for most nonfinance people to understand. Additionally, they focus not just on the absolute numbers but on the year-over-year growth rates. A growth rate is a type of ratio, such as this year's revenue divided by last year's revenue.
- Businesses and investors frequently look at adjusted measurements and ratios. *Adjusted* means removing the effects of non-operating and one-time items such as foreign currency movements and effects of acquisitions and divestitures. Removing such unusual or one-off effects provides what is sometimes called underlying or organic performance.
- An organization's past and projected financial performance is important not only to investors but also to bankers and other lenders, suppliers (also called vendors), distributors, major customers, potential partners, and employees. For example, if SNHU were considering utilizing a cloud-computing service, they would want to know if the provider is going to be around for the next few years.

Other Essential Information

If a professional soccer fan really wanted to understand the financial performance and health of her favorite team, would she look only at financial reports? Obviously not. She would also study her team's players and management, its win/loss and other game statistics, attendance and viewership, its "farm" system for recruiting, and its visibility and reputation. And she would study its economic environment: other teams in the league, the demographics of the customer marketplace, and perhaps even the competition from other sports and recreation alternatives. She would read reputable, authoritative trade journals and insightful commentary by knowledgeable sports journalists. She would speak personally with current and former employees, fans, and other informed individuals. She would ask a lot of questions.

The same process should apply when you are evaluating the financial performance and health of any business, not-for-profit organization, or governmental organization. Start by studying the numbers. Ask a lot of questions. Read a lot of authoritative material. And converse with knowledgeable people. That's why there's no smartphone app that can do this work.

In Module Two, we will use an understanding of an organization's past performance and current health as a foundation for predicting its future.