

REVISED
EDITION

HARVARD BUSINESS REVIEW PRESS

Financial *Intelligence*

*A Manager's Guide to Knowing
What the Numbers Really Mean*

KAREN BERMAN + JOE KNIGHT *With* JOHN CASE



Financial *Intelligence*

*A Manager's Guide to Knowing
What the Numbers Really Mean*

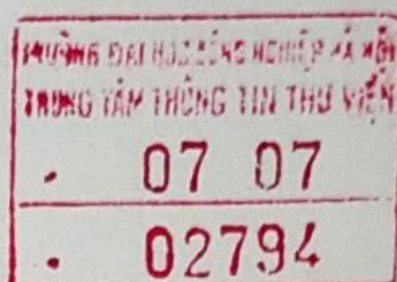
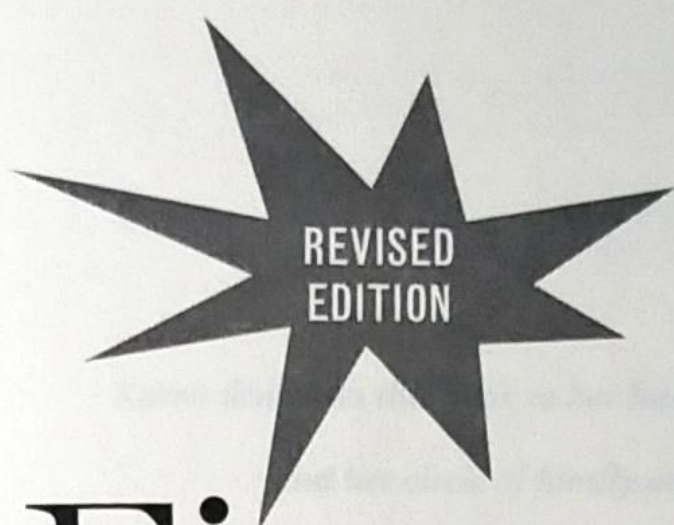
KAREN BERMAN

JOE KNIGHT



GIFT OF THE ASIA FOUNDATION
NOT FOR RE-SALE

QUÀ TẶNG CỦA QUỸ CHÂU Á
KHÔNG ĐƯỢC BÁN LẠI



Financial *Intelligence*

*A Manager's Guide to Knowing
What the Numbers Really Mean*

KAREN BERMAN

JOE KNIGHT

with JOHN CASE

HARVARD BUSINESS REVIEW PRESS
BOSTON, MASSACHUSETTS

Copyright 2013 Business Literacy Institute, Inc.

All rights reserved

Printed in the United States of America

10 9

The web addresses referenced in this book were live and correct at the time of the book's publication but may be subject to change.

No part of this publication may be reproduced, stored in or introduced into a retrieval system, or transmitted, in any form, or by any means (electronic, mechanical, photocopying, recording, or otherwise), without the prior permission of the publisher. Requests for permission should be directed to permissions@hbsp.harvard.edu, or mailed to Permissions, Harvard Business School Publishing, 60 Harvard Way, Boston, Massachusetts 02163.

Library of Congress Cataloging-in-Publication Data

Berman, Karen, 1962—

Financial intelligence : a manager's guide to knowing what the numbers really mean / Karen Berman and Joe Knight ; with John Case. — 2nd ed., rev. and expanded.

p. cm.

ISBN 978-1-4221-4411-4 (alk. paper)

1. Financial statements. 2. Cash management. 3. Corporations—Finance.

I. Knight, Joe, 1963— II. Case, John, 1944— III. Title.

HG4028.B2B422 2013

658.15'11—dc23

2012039043

The paper used in this publication meets the minimum requirements of the American National Standard for Information Sciences—Permanence of Paper for Printed Library Materials, ANSI Z39.48-1992.

*Karen dedicates this book to her husband, her daughter,
and her circle of family and friends.*

*Joe dedicates this book to his wife, Donielle, and to the
seven Js—Jacob, Jordan, Jewel, Jessica,
James, Jonah, and Joseph Christian (JC).*

CONTENTS

Preface: What Is Financial Intelligence?

xi

PART ONE

THE ART OF FINANCE (AND WHY IT MATTERS)

- | | |
|---|-----------|
| 1. You Can't Always Trust the Numbers | 3 |
| 2. Spotting Assumptions, Estimates, and Biases | 10 |
| 3. Why Increase Your Financial Intelligence? | 17 |
| 4. The Rules Accountants Follow—and
Why You Don't Always Have To | 26 |
| Part One Toolbox: | 36 |
| Getting What You Want; The Players and What
They Do; Reporting Obligations of Public Companies | |

PART TWO

THE (MANY) PECULIARITIES OF THE INCOME STATEMENT

- | | |
|---|----|
| 5. Profit Is an Estimate | 43 |
| 6. Cracking the Code of the Income Statement | 48 |
| 7. Revenue: The Issue Is Recognition | 56 |
| 8. Costs and Expenses: No Hard-and-Fast Rules | 63 |

9. The Many Forms of Profit	75
-----------------------------	----

Part Two Toolbox:	83
-------------------	----

Understanding Variance; Profit at Nonprofits;

A Quick Review: "Percent of" and "Percent Change"

PART THREE

THE BALANCE SHEET REVEALS THE MOST

10. Understanding Balance Sheet Basics	89
--	----

11. Assets: More Estimates and Assumptions (Except for Cash)	95
--	----

12. On the Other Side: Liabilities and Equity	106
---	-----

13. Why the Balance Sheet Balances	111
------------------------------------	-----

14. The Income Statement Affects the Balance Sheet	114
--	-----

Part Three Toolbox:	119
---------------------	-----

Expense? Or Capital Expenditure?;

The Impact of Mark-to-Market Accounting

PART FOUR

CASH IS KING

15. Cash Is a Reality Check	125
-----------------------------	-----

16. Profit \neq Cash (and You Need Both)	129
--	-----

17. The Language of Cash Flow	135
-------------------------------	-----

18. How Cash Connects with Everything Else	139
--	-----

19. Why Cash Matters	148
----------------------	-----

Part Four Toolbox:	152
--------------------	-----

Free Cash Flow; Even the Big Guys Can Run Out of Cash

PART FIVE

RATIOS: LEARNING WHAT THE NUMBERS ARE REALLY TELLING YOU

20. The Power of Ratios	157
21. Profitability Ratios: The Higher the Better (Mostly)	164
22. Leverage Ratios: The Balancing Act	172
23. Liquidity Ratios: Can We Pay Our Bills?	176
24. Efficiency Ratios: Making the Most of Your Assets	179
25. The Investor's Perspective: The "Big Five" Numbers and Shareholder Value	185
Part Five Toolbox:	191
Which Ratios Are Most Important to <i>Your</i> Business?;	
The Power of Percent of Sales; Ratio Relationships;	
Different Companies, Different Calculations	

PART SIX

HOW TO CALCULATE (AND REALLY UNDERSTAND) RETURN ON INVESTMENT

26. The Building Blocks of ROI	197
27. Figuring ROI: The Nitty-Gritty	203
Part Six Toolbox:	216
A Step-by-Step Guide to Analyzing Capital Expenditures;	
Calculating the Cost of Capital; Economic Value Added	
and Economic Profit—Putting It All Together	

PART SEVEN

APPLIED FINANCIAL INTELLIGENCE: WORKING CAPITAL MANAGEMENT

28. The Magic of Managing the Balance Sheet	225
29. Your Balance Sheet Levers	229

30. Homing In on Cash Conversion	234
Part Seven Toolbox:	239
Accounts Receivable Aging	
 PART EIGHT	
CREATING A FINANCIALLY INTELLIGENT COMPANY	
31. Financial Literacy and Corporate Performance	243
32. Financial Literacy Strategies	249
33. Financial Transparency: Our Ultimate Goal	257
Part Eight Toolbox:	259
Understanding Sarbanes-Oxley	
 <i>Appendix: Sample Financials</i>	261
<i>Notes</i>	265
<i>Acknowledgments</i>	267
<i>Index</i>	271
<i>About the Authors</i>	285