Finance is fun!

Decoding financial management

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FINANCE IS FUN! Decoding financieel management
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Before we start…

For the last 20 years I've been fascinated by explaining finance in everyday terms. Balance sheets and profit and loss statements are exciting documents. That is, if you know how to read them. That's what this book is about. I want to help you discover the building blocks of the financial world. We are going to explain the basics of every financial document in simple, no nonsense terms and with lots of examples.

There is an ancient logic to every financial calculation and report. The Italian Luca Pacioli was already writing about the Venetian accounting method in the fifteenth century. This system is still being used all over the world.

If you want to take your first steps in finance, you will need to understand this way of thinking. The good news is that this logic hasn't changed. The less good news is that the world of finance loves to come up with new terms. Often these new words are not new at all, it's a case of more of the same. For example, large companies often use the term capex. Small companies hardly ever use this word. They talk about investments. So there are two terms for the same idea. This happens a lot. Sometimes there are five or more terms for one idea. This means that a financial conversation isn't simple.

Something else you need to know is that one word can mean a number of things. Whenever someone talks about cash flow for example, it's a good idea to ask exactly what they mean, because cash flow has a lot of meanings.

In this book you'll find out which terms are common in the financial world. If a word has a number of meanings, they will be explained.

And then there's another thing. A lot of financial words seem simple… but they are anything but. Words like profit, capital, reserves and sales, for example, seem like well known terms. We think we know what these words mean.

Usually we assume that they have something to do with cash:
- A company with a lot of capital has a lot of cash.
- A company with large reserves has a large amount of savings.
- Making a lot of profit means having a lot of money.
- A large volume of sales means that you are bringing in a lot of money.

None of these statements is absolutely true. An example: a company that makes a profit can own a nice sum of money. However there are also a good number of profitable companies with cash problems.

We are going to examine what these 'simple' words mean in more detail. What do they say, and what is often more important, what don't they say.

But first, let's go back to the good news. The financial logic has been the same for centuries and is applied throughout the world. I particularly want to explain how this logic, which isn't actually that difficult, works. I will let you think about the basics critically, using lots of examples. Really, all financial figures and calculations are based on the logic which we will be discussing here.

To keep you alert – and to make it more fun – a quiz has been included in the book. You will find 50 statements which are true or…. false. You'll find the answers to these questions while reading the book. Too curious to wait? You'll find all of these statements in one list at the back of the book.

I hope that once you have read this book that you will be convinced that financial figures are exciting and important. Because if you want to know if a company is healthy, financial reports are an essential source of information. You can read them like a novel…or a thriller.

Finance is fun! Let the show begin…

2 THE BALANCE SHEET

This chapter explains how the balance sheet works. Wherever you are in the world, there is a certain logic behind every balance sheet. It is essential to keep returning to this fundamental logic in order to understand this important financial document properly.

On the next page, you'll find an overview of the balance sheet. Each entry will be explained in the text.

True or false?

Some warming up before starting the chapter? In the text you'll find statements which are true… or not true. You'll find the answers while reading the text. This chapter contains statements 5 to 15.

BALANCE SHEET PRINCIPLES

A company views the balance sheet in two ways:

- **Liabilities: Investors**
  The liabilities tell you how a company is financed. You can see it as a list of investors. Which investor gave which sum of money? Is it mainly shareholders providing money? Or did the company take a lot of bank loans? If this is what you want to know, you should check the liabilities side of the balance sheet.

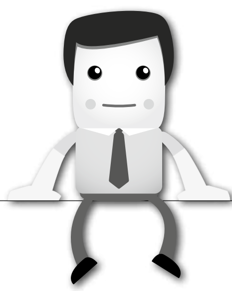
- **Assets: Investments**
  The assets tell you about what happened to the money coming from the investors. You can see it as a list of investments. What was invested in? In buildings? In machines? In inventory? All this information is on the assets side of the balance sheet.

To put it in simple terms:

- Liabilities: where did the money come from?
- Assets: where did the money go to?

BALANCE SHEET

ASSETS	LIABILITIES
Fixed assets • Intangible • Tangible • Financial	**Equity** External equity: • Shareholders' capital • Share premiums • Revaluation surpluses Internal equity: • Reserves • Retained earnings (or loss)
Current assets • Inventory • Accounts receivable • Cash	**Provisions**
	Debt Long term: • Financial debt • Accounts payable Short term: • Financial debt • Accounts payable



Obviously a company cannot do anything without first attracting money from somewhere. This means that the following is always true:

Liabilities = Assets

This explains why the document putting the liabilities and assets together is called the balance sheet. This means that statement 9 (a balance sheet is always in balance) is true. In the many examples which follow, you'll see again and again that this balance is always respected.

LIABILITIES

Liabilities give us information about where the money came from. Earlier we've read that money can be invested in the company in the form of equity or debts. In addition there is another inbetween form which we can find in the liabilites: provisions. We'll look at all three in more detail.

Equity

Equity is made up of two parts:
1. External equity
2. Internal equity

External equity

a) Capital

This is the money which the company receives from the shareholders. In return for their money they receive a certificate of ownership or share. They are the owners of the company. The total amount of money which the shareholders have brought in, is the shareholders' capital.

Even though the term capital seems straighforward, there is still quite some confusion about this word. Often capital gets confused with cash. When a company has a lot of capital, many people think the company has a lot of money. But this doesn't need to be the case at all.

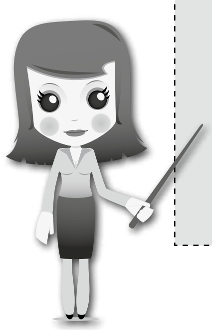
An example:

ASSETS		LIABILITIES	
Building	100,000	Capital	100,000
TOTAL:	**100,000**	**TOTAL:**	**100,000**

How to read this simple balance sheet:

- Assets: where the money is going to:
- This company has invested all of its money in a building.
- Liabilities: where the money comes from:
- The building was financed by capital. This means that the company didn't take a loan. The building was financed by the shareholders.
- There is a capital of 100,000 euros, but no cash. All of the money brought in by the shareholders, has been invested in the building. Statement 8 (a company with a lot of capital has a lot of money) is therefore false. The capital on the liabilities only tells you how much money has ever been invested by the shareholders. It doesn't tell you anything about the amount of cash which a company does or doesn't have.

Statement 5



If you'd like to analyse the health of a company, then look at the internal equity first.

True   False

b) Share premiums

Share premiums are also amounts of money coming from the shareholders. The system works as follows: if a company issues new shares (= equity), it is possible that the shareholders who sign up will need to pay more for the same shares than the shareholders who already invested in the company. The extra amount is the share premium. The reason for this is as follows: the earlier shareholders have taken a greater risk than the new shareholders. The new shareholders are investing in an established company. Determining the share premium is an important point of discussion between the 'old' and 'new' shareholders.

Statement 6

There are some loans which you don't need to pay interest on.

O True O False

c) Revaluation surplus

We don't come across this entry very often on a balance sheet. Revaluation surplus has to do with assets which gain in value. Let's use an example to explain this: imagine that a company owns a building in an exclusive area. The market value of the building has increased a lot over the last couple of years. The company can list in the assets that the building now has a higher value: the assets increase. Because there always needs to be a balance between assets and liabilities, the liabilities increase as well. The shareholders are then entitled to the increased value of the building. This is why this amount is included in the equity, as the entry revaluation surplus.

Internal equity

If a business is profitable, the shareholders decide what happens to the profit. We have already seen that they can decide not to pay out any profit, but to keep it in the company, to finance further growth. This means that the company can be financed by its own profits. This is the internal equity. To find internal equity on the balance sheet you have to look for the items called ‘reserves’ and ‘retained earnings’.

What’s the difference between reserves and retained earnings? The law differs from country to country, but it usually means the following. When shareholders decide to book profits as reserves, they indicate that they are not planning to pay out this profit in the future. If they book the profit as part of the retained earnings, then the profit stays in the company for the time being, but may be paid out at some time in the future.

We already know that shareholders have an annual general meeting to decide on the profit. They don’t just decide about the profit from the previous year. The retained earnings from past years are also on the agenda.

Statement 7

A company with a lot of cash, won’t have many cash problems.

O True O False

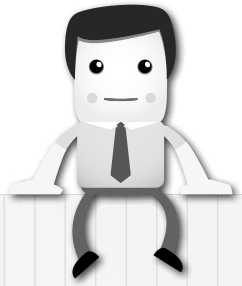
What happens if there is a loss? Then the annual general meeting doesn’t take long, because you can’t pay out any dividend if there is a loss (unless this loss is compensated for by retained earnings from previous years). The loss will reduce the internal equity on the balance sheet.

Let us take a moment to look at the reserves. The financial layman probably associates the word reserves with cash. It's easy to think that a company with a lot of reserves has some nice savings. But the truth can be very different. The term reserves doesn't say anything about the amount of disposable cash which a company has. If a company has 10 million euros in reserves, this means that the company is being financed by its own profits for a sum of 10 million euros. These profits are already in use. They are stuck somewhere in the assets. So statement 12 (a company with a lot of reserves has a lot of money) is not true. Reserves tell us nothing about the presence of cash.

Here's another simple balance sheet to make this clear:

ASSETS		LIABILITIES	
Building	100,000	Capital	20,000
		Reserves	80,000
TOTAL:	**100,000**	**TOTAL:**	**100,000**

- Assets: where the money goes to:
- This company has invested all of its money in a building.
- Liabilities: where the money comes from:
- The building has been financed by:
  - Capital 20,000 euros. This means that 20,000 euros has been funded by the shareholders.
  - Reserves: 80,000 euros. This building is being financed by profits made in the past for an amount of 80,000 euros.
- So this means there is a capital of 20,000 euros and reserves of 80,000 euros, but there is still no cash. All of the money is tied up in the building.



External or internal equity? The balance sheet doesn't tell us

The terms external and internal equity are used in financial analysis, because they show that equity can have two sources. However, you won't find these words literally on the balance sheet. Fortunately, it isn't difficult to find the external and internal equity. You just need to know which words to look for.

Equity is money which came from the shareholders. This can happen in two ways:

- Capital:
  The shareholder provides the money to finance the company. We call this external equity.

- Reserves, retained earnings:
  These terms refer to the profits which shareholders have left in the company. In principle this is also the shareholders' money, as the profit belongs to the shareholders. But this is something different from capital, because these are resources which the company has generated itself by establishing a profitable activity. That's why we call this internal equity.

Finance is fun!

Vera Smets has been saying it for over 25 years: Finance is fun! With this book Vera wants to bridge the gap between financials and non-financials. Do you attend meetings where financial reports crop up? Do they make you want to scream and run away as fast as you can? If so, this book is for you.

Vera starts from scratch and explains, step by step, how a balance sheet and income statement are compiled. The concept of cash flow is also discussed in detail. After all, making a profit doesn't mean that you have cash.

Finance is fun ... that's why the book includes a quiz of 50 questions. Also, Vera is not a great fan of difficult words. Her language is no-nonsense and simple, with a touch of humour. Her primary indicator is plain old common sense!

Finance is fun is not only available as a book. On **www.financeisfun.com** you will find lots of help to test your financial knowledge.

About Vera

Vera Smets (1964) is an internationally renowned trainer/consultant. In 1995, she launched Fincover BV (= FINancial COnsulting VERa). Using her no-nonsense approach Vera is able to break down complex financial figures into clear and workable concepts. Vera usually works in-company. Companies such as BASF, Telenet, Worldline, Lampiris, VOKA, Duvel and Umicore work with Vera to introduce non-financial employees to their world of finance. To be completely on top of things, Vera prepares every training course together with the finance department. This means every in-company training is tailor-made. Old school in Vera's method is that it incorporates plenty of practice for participants. New school is the mix of classroom, webinar and e-learning. Nevertheless, the basic values are the same: simplicity, customisation and fun!

Finance is fun!

by Fincover

This book in Dutch or French?

Finance is Fun! is available in Dutch, English and French. Please find details on www.financeisfun.com.