



## Unit 1

# The Fundamentals of Finance

### Learning Outcomes

**By the end of this unit the learner will be able to:**

- ✓ Define basic financial terminology
- ✓ Prepare a budget of any type or size

## Unit 1

### The Fundamentals of Finance

#### Basic Concepts

##### Recording Financial Transactions

A useful budget is prepared under the same umbrella of guidelines as the company's actual financial statements. There must be consistency in the way the numbers are prepared. As such, it is necessary to understand some key terms.

**Bookkeeping** is the exercise of recording all the transactions that take place in a business. Transactions take place between the business and:

- Customers, who buy products and services sold by the business
- Employees, who are paid wages and provided benefits
- Vendors, who sell services, equipment, and supplies to the business
- Government agencies, who collect taxes from the business
- Sources of equity capital (investors or owners who put money in and take it out of the business)
- Sources of debt capital (banks and lending institutions)

**Accounting**, on the other hand, is the methodology used to accomplish this goal and to prepare related statements and reports. Accounting guidelines govern how businesses record transactions. They also dictate the design of the recordkeeping system that a business uses and how reports are prepared, based on the information gathered and put into the system.

This brings us to another question. Often, we hear the terms “financial statements” and “financial reports” used interchangeably. Is there a difference?

For the purpose of our courses, yes, there is a major difference. A **financial report** is a document prepared for internal company use. It can come in many forms and be used for many purposes. A **financial statement** is a formal document prepared in a specific format as outlined by your region's Generally Accepted Accounting Principles (which we will discuss in a moment) or another governing organization (such as your tax legislation).

## Types of Costs

There are two parts to a budget: sources of cash and uses of cash. When we think about uses of cash we can break them down as follows.

### Sunk Costs

A sunk cost has already been incurred; it just needs to be paid. It is the result of a past irrevocable decision and is sunk in the sense that it cannot be avoided. As a result, sunk costs may not impact future decisions.

### Recurring Costs

Quite simply, recurring costs recur and require a periodic outlay of funds. Material costs, supplies, heat, and lights are prime examples.

### Generally Accepted Accounting Principles

Accounting forces people to measure things in a relatively consistent manner. A good budget is prepared based on consistent rules as well. Accountants refer to the rules in their rule book as **generally accepted accounting principles** (GAAP). The objective of GAAP is to ensure comparability among different companies and overall reliability of information.

While there can be slight differences between regions, GAAP typically includes the following principles:

- The **matching principle**: Earnings and expenses must be booked in the relevant accounting or budget period when one benefits the other. This is necessary to properly evaluate results.
- The **cost principle**: Assets and service, and the resulting liability, are taken into the accounting records at cost.
- The **consistency principle**: A company's accounting procedures need to remain consistent over time. If they are changed, the reasons for the change and the financial impact of the change must be documented in detail.
- The **objectivity principle**: Whenever possible, the amounts used in recording transactions are based upon objective evidence rather than on subjective judgments.
- The **realization principle**: This principle defines revenue as an inflow of assets (not necessarily cash) in exchange for goods or services. It requires the revenue to be recognized at the time, but not before it is earned.

### Budgeting Terms

A **budget** is an operating plan that outlines projected revenue and expenses for a particular period of time.

A **projection** is a prediction for the future, based on past data, *extrapolation*, and summarizing key factors.

**Forecasting** is the process of putting together several *projections* to create a *projection* for the future. (Think of a weather forecast.)

**Extrapolation** is the process of applying past data to the future to arrive at a reasonable *projection*.

### Your Role in Company Finances

#### What's My Role?

Understanding the cycle of finance will help you figure out where you fit into your company's financial structure. No matter what your role is, you can help save your company money. Small savings add up!

What if

- You work in the company's payroll department and you could save \$2.50 per employee check, per payday? How much could you save your company over one pay period?
- You supervise a team that produces widgets and you find a way for them to produce two extra widgets a day without any extra cost? If they sell for \$49.99 each, how much income would the extra two items bring in per year?
- You find a new advertising method that has the same reach but saves \$30,000 a month. What else could you do with that money?

**What can you do to improve your organization's finances?**

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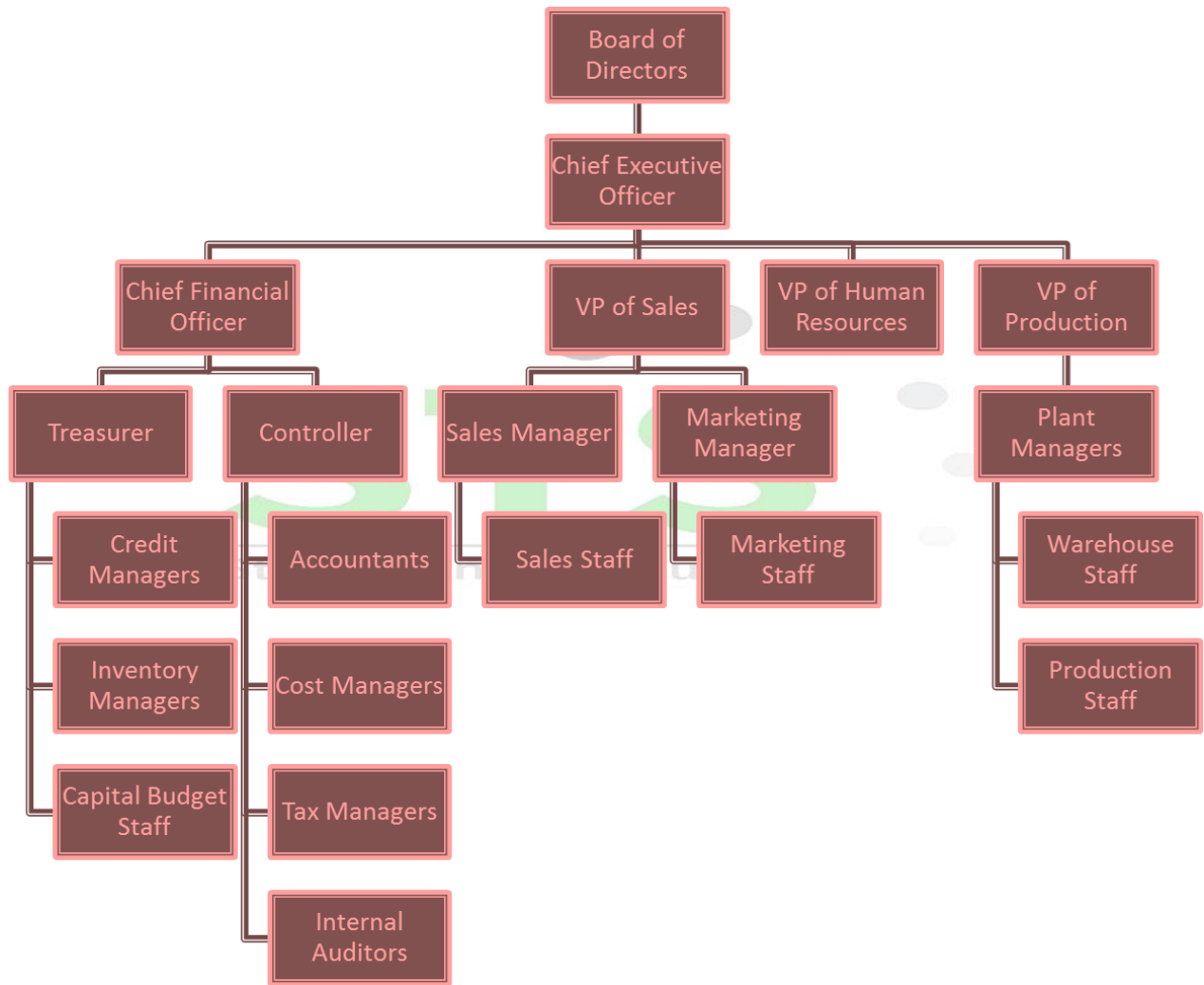
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### The Big Picture

Once you’ve thought about your role, think about your organization and look at what financial-based roles exist. Understanding their responsibilities will help you get a better picture of what your role is, and it will help you identify who to go to when you need help.

Here is how many mid-sized organizations are structured, although not all organizations will have all roles:



The board of directors usually leads the company’s financial direction. Their vision is usually carried out by the Chief Executive Officer (CEO).The CFO, or Chief Financial Officer of a company, is just behind the CEO.

## Identifying the Key Players in Your Organization

Look at the top three to five levels of the organizational chart that you brought with you. List each person's finance-related activities next to their entry.

## The Basics of Budgeting

### Defining a Budget

A business shouldn't open its doors without having some idea of what to expect, and it shouldn't close its doors without knowing what happened. A business should also plan and prepare for its future. One way to do this is to budget, to plan ahead for future income and expenses.

Budgets provide the baseline against which to measure actual performance. The actual performance of an organization is documented by the accounting system and the reports it generates. Supervisors should compare expected performance against actual performance. With this information, supervisors with budget responsibilities act as physicians to assess the current financial health of their organization. They should look for areas where they have done well and areas that need attention.

If the latest report from the accounting office says sales are too low compared to budget, the sales manager has to figure out why. If overtime costs are running too high, the production manager has to figure out why. And if there are too many rejects on the shop floor, it may be up to the quality control officer to figure out why.

Why should we bother with budgets in this age of change? Sometimes, you go through all that work and then senior managers make changes that knock your whole budget for a loop. However, even though planning is difficult, we must plan in order to maintain focus and prevent wasting resources. A budget is an educated guess that reflects your long-term plans. Planning is the key characteristic of budgeting.

### The Budget Committee

- Should one department be responsible for the budget?
- Should the budget be handed down from the executives?
- Should the budget for one department interact with another (e.g. sales and production)?

### The Budget Period

- How small should a budget period be?
- Should it coincide with the fiscal period?
- Should a long range budget be in place? How accurate are they?

## Types of Budgets

As companies grow, their budgeting process understandably becomes more complex. No matter how big it gets, however, you can prepare a budget for almost any singular aspect of the operation.

### Sales Budget

Your sales budget incorporates the estimated number of products or services that you will sell in an upcoming period. Total revenues are estimated by simply calculated by multiplying the number of units by the price per unit.

The sales budget is normally the starting position for the budgeting season. The sales budget normally grows from a reconciliation of business forecasts, capacity estimates, proposed selling expenses (advertising, sales salaries, etc.) and the quantity of sales estimated for the period.

The sales budget drives a very important part of the expense budget: the Merchandise Purchases Budget. This budget would be used in a company that manufactures, builds, or further processes materials for future sale. This will also spill over into inventory level budgets, which assists in warehouse capacity planning, plant usage, and labor.

### Expense Budget

Expense budgets include things like office equipment, stationary, travel, and refreshments for meetings.

Sales expense budgets should be derived almost directly from the sales budget. Overhead and general costs associated with the sales process can normally be estimated as a derivative of the sales volume in a variable budget.

General and administrative expenses usually are the responsibility of the office manager(s) who should base a budget on past history, with a forecast component that takes into account staff levels, inflation, new technology that may reduce or increase expenses, and other management policies (such as bonuses and raises).

### Production Budget

The production budget is prepared after the sales budget, since this process takes the sales budget and estimated quantities to be sold and then calculates the cost of staffing, construction or manufacturing materials, and other expenses required to create the products. Often, production budgets are based solely on a per unit cost basis. So if production was to be 10,000 units and the budget was estimated at \$1,000,000 in expenses, there would be a unit cost budget of \$100/unit.

## **Manufacturing Budget**

A manufacturing budget should include the cost of raw materials, direct labor, and manufacturing overheads. Many manufacturing firms prepare three sub-budgets that account for the three items mentioned: raw materials, direct labor, and manufacturing overhead.

## **Labor Budget**

The labor budget includes the names and numbers of all positions within the company, and includes the salary, benefits, replacement, vacation, and pension contributions budgeted for each position. Some of the company's labor costs may not be captured here, such as direct sales or direct manufacturing costs.

Overall this is a large budget component because for most companies, labor is a large part of the overall expenses.

## **Capital Budget**

This is the manager's plan to acquire fixed assets such as furniture, computers, and office space, to support the operations of a business. The capital expenditure budget lists equipment that will be scrapped within the budget period as well as replacement costs and acquisition prospects.

Plant capacity planning will play a role here. If the existing facilities are insufficient to handle forecasted capacity then new equipment and/or a plant may need to be acquired.

## **Cash Budget**

Another budget that is normally performed once all of the other budgets are gathered and assembled is the cash budget. This is very important to highlight the flow of cash throughout the year to pinpoint when cash requirements may exceed existing cash resources.

If you find that you will be short on cash at a particular time, work can be performed now to plan for it. Excess cash forecasts can also be a problem: no one wants excess cash sitting unused if it could be invested and yield a greater return.

## Understanding Where Your Budget Fits In

Your budget should flow down from your company's plan, like this:



## Parts of a Budget

Any plan should have four key parts:

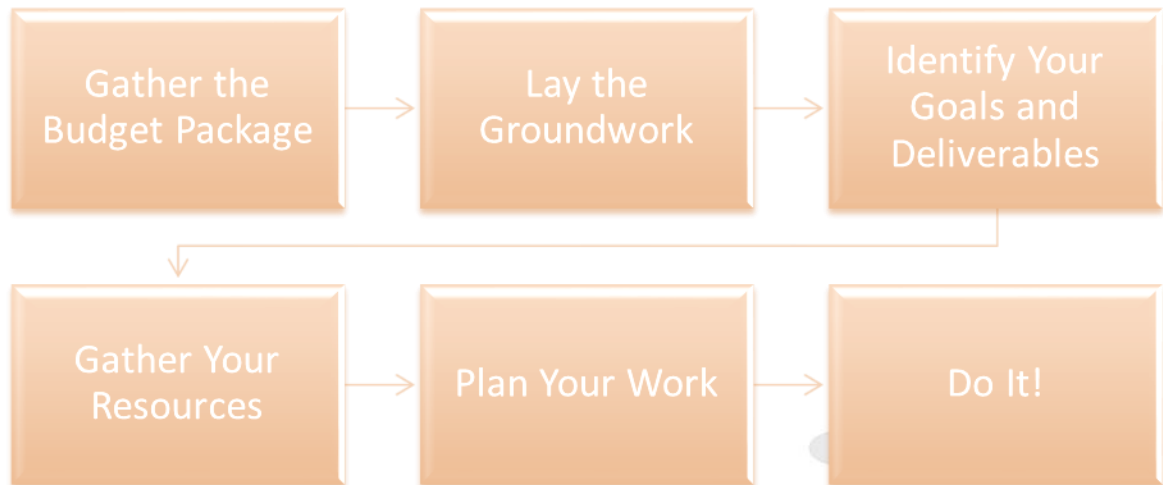


Identify these parts in the budget that you brought for a pre-assignment.

## The Budgeting Process

### Overview

The budgeting process typically has six steps.



### Step One: Gather the Budget Package

If you are in charge of preparing a budget, your organization will usually give you a budget package. Typically this contains:

- Company-wide budget and goals
- Description of your department and its goals as laid out in the strategic plan
- Business or performance indicators
- Past financial statements and budgets
- List of accounts and profit and cost centers involved
- Proposed budget, if there is one
- Allocated budget amount, if there is one (sometimes you are given a pot of money to budget; at other times you need to determine what you need and then fight for it!)
- Templates for completing the budget

If you aren't given this information, then go out and find it!

## Step Two: Lay the Groundwork

If you dive into the budget package right now, you won't be able to find your way out! Before you get into things, outline a few key pieces of information.

### Standard of Precision

Find out how precise your budget should be.

- How detailed do you need to be with your numbers – down to the penny or rounded to thousands of dollars?
- What period of time should you budget for – the month, quarter, year, or beyond?
- What accounts do you need to budget for?
- Are there any special rules or formulas (such as depreciation) that are simplified for budgeting?

### Line of Control

You will need to know what parts of the budget will be monitored and who will control them. This is a very important part of the plan and hard to get right. VP's certainly don't want to be counting every pencil, but line managers will probably need to report on more than the year's final figures.

### Preparing for Monitoring

Make sure that you know:

- How will the budget be monitored?
- Will a review and adjustment take place at any point in the year?
- Is there an allocated budget amount given to you, or will you need to make a case to receive funds?
- What kind of evidence will you need to back up your budget?

## Case Study (Part One)

### Background Information

The Christmas Party at ABC Company always was the event of the year. People were still talking about the generosity of management well into the following summer. The company always rented the Windsor Lodge, a private and secluded property equipped with guest rooms, party rooms, exquisite food, and excellent entertainment for the party. Employees were provided with guest rooms, babysitting services, transportation, and an all-expense paid party. In addition, there were Christmas bonuses for everyone

handed out by Santa (who looked suspiciously like the old man himself). About \$50,000 was allotted for the party each year.

Unfortunately, this year the profits of the company have taken a serious drop and the budget for the party and bonuses has been drastically reduced to \$17,500. As a member of the management entertainment committee it is your job to allocate the available funds and develop a budget to provide the best party you can with the limited resources. Be creative!

### Budget Template

Expense	Last Year's Expenses	Your Budget
Accommodations	\$6,000	
Evening Meals	\$4,000	
Beverages	\$10,000	
Entertainment	\$2,000	
Breakfast Meals	\$4,000	
Transportation Costs	\$3,600	
<b>Sub-Total</b>	<b>\$29,600</b>	
Bonuses of \$100 x 100 workers	\$10,000	
Bonuses of \$500 x 10 managers	\$5,000	
<b>Grand Total</b>	<b>\$44,600</b>	

### Step Three: Identify Your Goals

You should also write down what high-level goals your budget must have. Some basic examples might be: increase sales by 20%, hire two new staff, or increase production by 5%. For best results, goals should have SPIRIT!

#### Specific

Be specific about what you want or don't want to achieve. The result should be tangible and measurable. "Increase production" is pretty ambiguous; "increase production by 5%" is specific.

## Prizes

Reward yourself at different points in the goal, particularly if it's long-term. If your goal is to increase production by 5%, for example, you might order pizza for the team when you meet the halfway point, and again at the 5% mark.

## Individual

The goal must be something that you want to do. If your boss wants you to increase production, and you aren't interested, you're not going to want to work towards the goal. Find something about it that you can link to and motivate yourself.

## Review

Review your progress periodically. Does the goal make sense? Are you stuck? Do you need to adjust certain parts of it?

## Inspiring

Frame the goal positively. Make it fun to accomplish. You could make a poster of the end result, frame it, and post it on the wall.

## Time-Bound

Give yourself a deadline for achieving the goal. Even better, split the goal into small parts and give yourself a deadline for each item.

## Case Study (Part Two)

### Background Information

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**Set a SPIRIT goal for this special budget.**

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**Step Four: Gathering Your Resources**

Next, make sure you have all the information you will need. Make a list of additional sources of information and people who can help you out if you get stuck. We have included a basic checklist below. Feel free to customize it and use it for your next budget!

	Item	Typical Department
	Direct compensation policy, including pay grades, salary ranges, salary caps, and merit increases	Human Resources
	Indirect compensation policy, including benefits, bonuses, profit sharing, etc.	
	Promotion policy	
	Any policies on mandated raises, such as cost-of-living increases or union agreements	
	Legislation on mandated government payments (tax, insurance, etc.)	
	Organizational chart with head count for your departments	

	Item	Typical Department
	All relevant financial information (historical for three to five years plus current year)	Accounting
	Chart of accounts	
	Accounting policies	
	Capital asset registers	
	Templates or tools that they use	
	Organizational chart of cost and profit centers with your responsibilities clearly marked	

✓	Item	Typical Department
	All relevant sales information (historical for three to five years plus current year)	Marketing and Sales
	Projected sales for the following year	
	Information on expected trends, planned promotions, and other factors that could affect your budget	
	Economic forecast for the following year	Budget Management Team
	Strategic plan for the following year	
	Information on expected trends, planned events, and other factors that could affect your budget	
	Fiscal calendar with important events marked	
	Complete budget package	
	Policy on budget completion, reviews, monitoring, reporting, and management	
	Additional resources and tips	

✓	Item	Typical Department
	Goals for your team	Your Supervisor
	Their expectations of you	
	Their goals	Your Team
	Knowledge, ideas, or experience that will help you	
	Any relevant financial information	

**Steps Five and Six: Planning and Doing**

**Step Five: Planning Your Work**

Now you can create a detailed plan of what needs to be done, when it is due, and how you're going to do it. Make sure you leave enough time to let the budget sit for a few days and then to do a thorough review.

Here is a template that you can use.

Task	Resources Required	Target Date	Due Date	Complete

## **Step Six: Do It!**

Now that the groundwork is in place, you can start working through the budget package. (If you don't have a budget package, you should still have enough information about what is expected of you to complete the required documents.) Delegate tasks where appropriate, but make sure you maintain final control over decisions. And, always double-check the numbers (even your own!).

### **Where can you get your numbers from?**

Where at all possible, gather historical data and extrapolate it. This means analyzing the data, identifying patterns if they exist, and then applying those lessons to next year's budget.

For example, let's say your office supplies expenses have increased by \$500 each year for the past three years. To arrive at a reasonable budget number, take last year's expenses and add \$500. Or, let's say that your marketing budget is always 25% of your sales revenue. Take the estimated sales revenue and calculate the percentage.

The next best choice is to take relevant historical data and use it in place of actual historical data. For example, let's say that you need to budget for a computer upgrade next year. Your department has never done one, but a department of similar size did upgrade last year. You can use their information to get a good idea of what your expenses will look like.

If no exact or relevant historical data exists, your next best choice is an expert's estimate. For the computer example, perhaps your IT department or the computer company can let you know approximately how much the upgrade will cost. Or, find information from industry averages or even competing companies.

You should always be able to find data and information from one or all of these sources. You should never put in a number just for the sake of putting something in that line. That's a recipe for disaster!

## **Case Study (Part Three)**

### **Background Information**

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## Budgeting Tips and Tricks

### Top Ten Excuses for Being over Budget

1. Those reports are probably wrong.
2. I sent a revised budget; didn't you get it?
3. I didn't plan for a hurricane (or you can insert some other calamity)!
4. It's only a little over budget; 10% of a million dollars is just a drop in the bucket!
5. We can make it up next year.
6. My intern created that budget and obviously messed it up.
7. It's like buying a house – an investment in our future.
8. I was supposed to get a lot of help (or resources) from such and such a department, and they didn't come through.
9. Last year was worse, so I thought this would be okay!
10. I made budget the last two years, and two years out of three isn't bad!

### Up-Front Budget Maneuvers

- Involve key people in your budget planning
- Do some selective padding in case of emergencies
- Tie your budget requests to your organization's values
- Create more requests than you need and give them up freely
- Shift the time frame
- Be prepared

### Not-So-Nice Budget Maneuvers

- Threaten and blackmail your budget competition
- Be a dictator instead of a democrat
- Request things you don't need just so others don't get the money
- Inflate last year's expenses
- Trust no one!

### Further Reading:

- ✓ *Brookson, Stephen. Essential Managers: Managing Budgets. DK Publishing, 2001.*
- ✓ *Chatton, Moira, and James Gill. Understanding Financial Statements (3rd Edition). Axzo Press (Crisp Series), 2009.*