THE BALANCE SHEET POCKETBOOK

By Anne Hawkins and Clive Turner

Drawings by Phil Hailstone

“A uniquely accessible guide - if you only read one book on finance, read this!”
Peter Colley, Director of Finance and Membership Services,
RAC Motoring Services Ltd

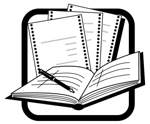
“The authors’ wealth of practical experience and understanding of the line manager’s perspective is fully reflected in this clear and readable book.”
Ray Jennings, Human Resources Director, Dowty Aerospace

CONTENTS

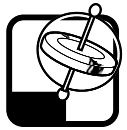
INTRODUCTION 1

THE BUSINESS FINANCIAL MODEL 5
Sources of Funds, Uses of Funds, making profit, summary

CLASSIFICATION OF EXPENDITURE 35
Why classify? Capital or Revenue? control



FINANCIAL REPORTS 41
Introduction

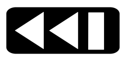


THE BALANCE SHEET 45
Use of Funds (Fixed Assets, Working Capital), Source of Funds, the balancing act, published format

PROFIT AND LOSS ACCOUNT 69
Profit is not cash, operating profit, financing costs, published format

APPENDIX ONE 93
Jargon explained

APPENDIX TWO 101
Calculating depreciation



This symbol refers the reader back to a previous section where the item or term has already been explained

INTRODUCTION

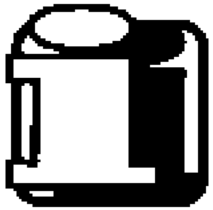
INTRODUCTION

CONFUSED?

Many people are discouraged in their attempts to understand financial statements by the jargon accountants use ... and a fear of numbers!

INTRODUCTION

DON'T BE PUT OFF!



Use the Structured process:

Step One: Develop a 'common sense' model of business finance

Step Two: Understand the impact of capital and revenue expenditure on this Business Financial Model

Step Three: Extract from this Model the
- Balance Sheet
- Profit and Loss Account

COMMON MISCONCEPTIONS

Listed below are some of the more common misconceptions we, the authors, encounter in our training sessions. See if any of them seem familiar ...

- *'The Balance Sheet tells me the value of the business'*
- *'At the year-end the retained profit must be somewhere; in the bank, or the accountant's drawer'*
- *'If the company's share price rises it has more money'*
- *'If I compare the results of two businesses, the one which has made more profit has done better'*
- *'The accountant balances the Balance Sheet by entering a balancing figure somewhere ... probably profit'*

These misconceptions will be dealt with at appropriate points in the book.

THE BUSINESS FINANCIAL MODEL

	Page
Introduction	6
Source of Funds	9
Uses of Funds	18
Making Profit	28
Summary	31

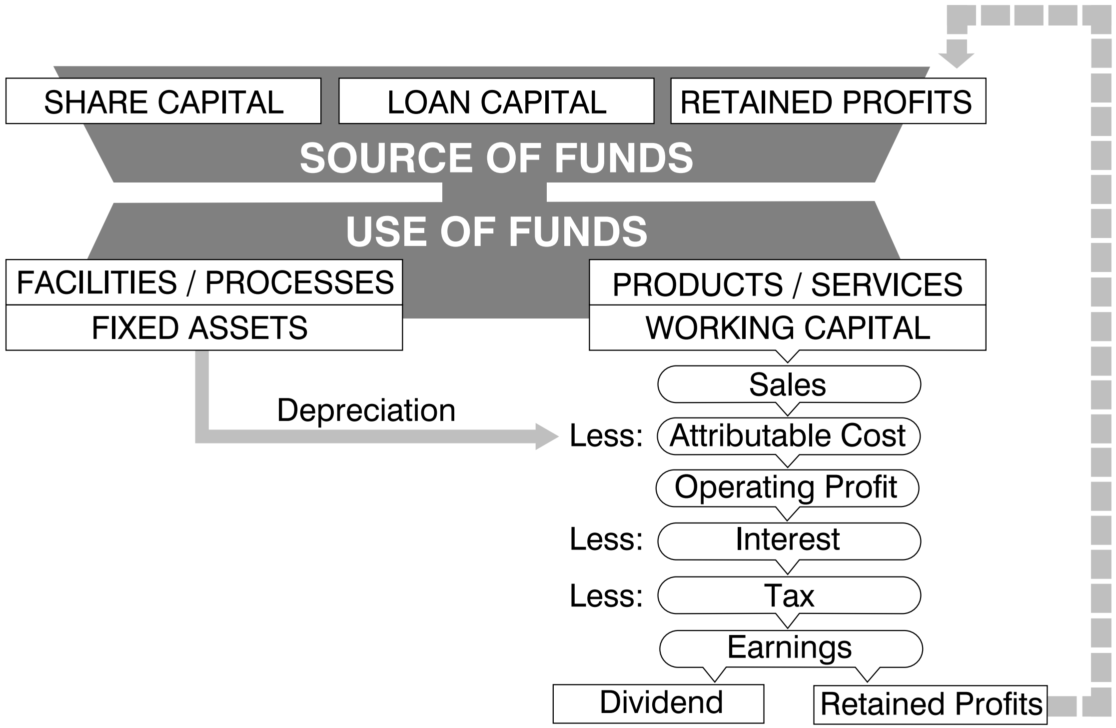
THE BUSINESS FINANCIAL MODEL

INTRODUCTION

In this section a Business Model is developed which explains in straightforward terms how money works within the business.

THE BUSINESS FINANCIAL MODEL

THE MODEL



THE BUSINESS FINANCIAL MODEL

APPLYING THE MODEL

Use the model to understand **your** business

- How is **your** business funded?
- What have **you** used this money for?
- How much profit do **you** make?
- **IS IT WORTH THE EFFORT?**

Make the Business Model and Financial Reports work for you!

Let’s start at the beginning →

SOURCE OF FUNDS

Most businesses need **long-term finance**, ie: money that is being invested in the business on a long-term basis, to allow it to achieve its aims.

There are three categories of long-term finance:

- Share capital
- Loan capital
- Retained profits

Each of these has different investor expectations and implications for the way the business is run.

Most companies will choose to have a mix of the three types.

SOURCE OF FUNDS

SHARE CAPITAL

Definition:

Individuals or financial institutions provide capital by buying shares in the business. They do this in anticipation of a return comprising:

- dividends
- growth

Dividends:

- Generally paid twice a year - an interim dividend based on the half-year accounts - a final dividend dependent on the full year's result
- No legal obligation for the company to pay a dividend

Growth:

- The investment increases in value, creating the opportunity to sell at a profit

SOURCE OF FUNDS

IMPLICATIONS OF SHARE CAPITAL

- The shareholders own the business, **not** the Chief Executive and Board of Directors
- Shareholder expectations, therefore, have to be treated with respect
- If the performance of the business does not meet shareholder expectations:
  - some or all of the Board may be dismissed
  - investors may sell their shares, leading to a fall in share prices, thus
  - making the business vulnerable to being `taken over’

Note To acquire the business a predator has to buy the **shares**, not the land, buildings, stock, etc. If the share price falls, the business becomes cheaper to buy.

COMMON MISCONCEPTIONS

‘If the company’s share price rises it has more money. If it falls, it has less.’

Apart from when the company wishes to raise new share capital or is warding off a takeover bid, the share price has no immediate impact on the business.

Example: Alex invests £1,000 in the shares of a new business.
The company receives £1,000 which it uses to buy stock and machinery. Alex receives a piece of paper ... a Share Certificate.

When the company prospers, Bill offers to buy the shares for £1,200. Alex hands over the piece of paper; Bill hands over the £1,200.

Alex has made a gain of £200. The company has no involvement in the transaction and its finances are therefore unaffected. Similarly, if the share value falls and Bill decides to sell, he will lose out but there will be no effect on the company accounts.

THE BUSINESS FINANCIAL MODEL

SOURCE OF FUNDS

LOAN CAPITAL

Definition:

Money on loan to the business which will have to be repaid

- The first thing any potential lender will want to see is the Business Plan
- Having satisfied himself that the proposed venture is viable, the lender will require
  - interest on the loan
  - eventual repayment of the loan itself
- The terms of the loan will be defined by a contractual agreement

SOURCE OF FUNDS

IMPLICATIONS OF LOAN CAPITAL

Borrowing money, ie: loan capital, entails financial risk

- The terms of the loan are defined by contractual agreement
- The business has to keep making the payments of Interest and Capital, whether or not it is trading profitably
- The lender will require **security** or collateral (so that the loan can be recovered if the borrower defaults)

SOURCE OF FUNDS

LOAN CAPITAL - EXAMPLE

Taking out a mortgage is a similar process to a business loan:

1 The lender considers the **'business plan'**

- The real value of the property
- How much you wish to borrow
- Your income and existing outgoings

2 The **mortgage agreement** defines the terms of the loan

3 As **security,** the lender retains the title deeds in case you default on your payments

THE BUSINESS FINANCIAL MODEL

SOURCE OF FUNDS

RETAINED PROFITS

Definition:

When a business makes ‘profits’ it has the opportunity to plough back some of the money it has made to self-finance its future growth.

- Retained profit is money the business has made itself
- It is therefore the cheapest source of long-term finance avoiding:
  - dividend payments
  - interest payments

Hence the company financing a larger proportion of its business with Retained Profits has a

C O M P E T I T I V E   A D V A N T A G E

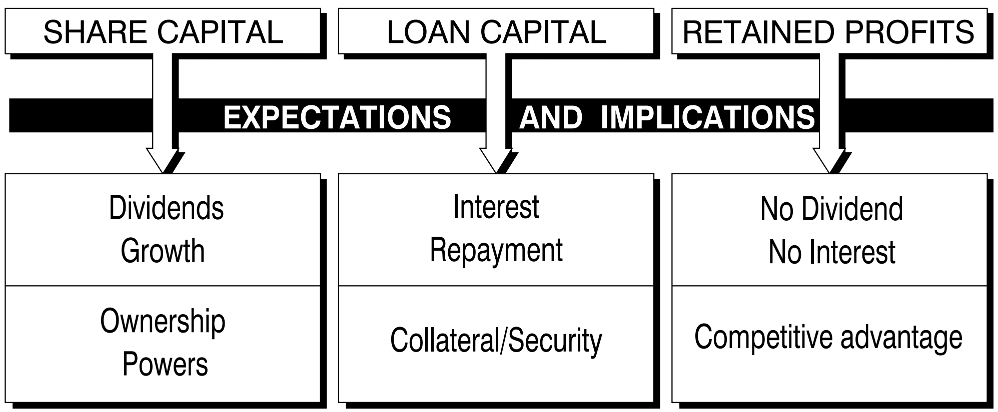
THE BUSINESS FINANCIAL MODEL

SOURCE OF FUNDS

SUMMARY

Summary of the categories of Long-term Finance:

SOURCE OF FUNDS



THE BUSINESS FINANCIAL MODEL

USE OF FUNDS

A business raises Long-term Funds in order **to spend it** on things required to run the business:

USE OF FUNDS

Items on the shopping list are grouped to reflect the nature and significance of the expenditure:

	Facilities/Processes Tools to do the job **... to be used!**	Products/Services Materials and added value **... to be sold!**
	eg: Premises Machines Vehicles Computers	eg: Materials Labour Utilities Insurance Maintenance
TIMESCALE:	Retain for many years	Continually changing
SCALE:	High Value Items	Low Value Items
DECISION LEVEL:	Strategic	Operational
ACCOUNTANT'S JARGON:	Fixed Assets	Working Capital

THE BUSINESS FINANCIAL MODEL

USE OF FUNDS

FACILITIES/PROCESSES - FIXED ASSETS

Facilities and processes ....tools to do the job, to be used

How much investment do you need? This will depend on:

- Nature and scale of business
- Type of industry
- Service provided to customer

Business Position		Process Investment
Retailing		High Street outlets or out-of-town stores? What about warehousing and transport?
Distribution		Transport What about warehousing?
Manufacturer		Plant and machinery What about warehousing and transport?

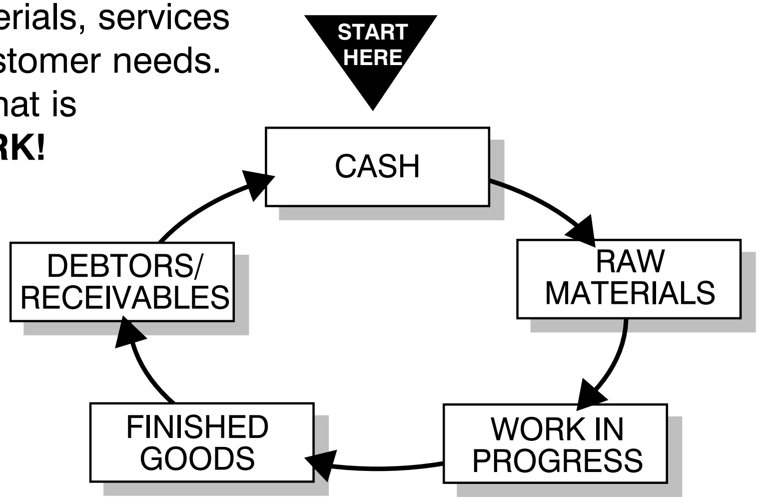
THE BUSINESS FINANCIAL MODEL

USE OF FUNDS

PRODUCTS/SERVICES - WORKING CAPITAL

Products and services ... for sale to the customer

Funds are required to provide the flow of materials, services and credit to achieve the sales and satisfy customer needs. Accountants call this **working capital**... and that is exactly what the investment has to do ... **WORK!**



- Cash is used to buy
- Raw Materials, which are converted into
- Work in Progress, and through to
- Finished Goods, which are then
- Sold to customers,
- Who, after the agreed credit period, pay for the goods they have received

This process is referred to as the CURRENT ASSET CYCLE

Note: Stock = Raw Materials + Work in Progress + Finished Goods

USE OF FUNDS

WORKING CAPITAL: CREDIT

- Most businesses do not receive cash on delivery from their customers or pay cash on delivery to their suppliers
- Credit is allowed to customers and taken from suppliers

Debtors
- the amount owed by customers for goods they have received
- customers are ‘indebted’ to the business
- also referred to as ‘Receivables’
- part of **Current Assets** p21

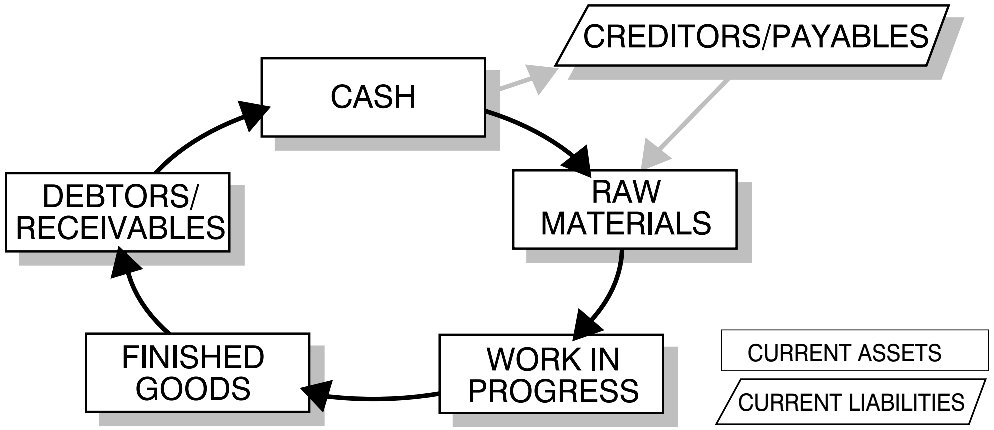
Creditors
- the amount owed to suppliers for goods/services received but not yet paid for
- also referred to as ‘Payables’
- part of **Current Liabilities** (ie: short-term owings)

THE BUSINESS FINANCIAL MODEL

USE OF FUNDS

WORKING CAPITAL CYCLE

The Working Capital cycle can then be shown as:



How much has the business invested in Working Capital?

- Not all the stock will have been paid for. Therefore Working Capital is the value of Current Assets less the amount owed to suppliers:

  WORKING CAPITAL = CURRENT ASSETS *less* CURRENT LIABILITIES
  = (STOCK *plus* DEBTORS *plus* CASH) *less* CREDITORS

USE OF FUNDS

WORKING CAPITAL CYCLE

Note

1 The amount of working capital required is a function of:

- The size of the business
- Credit given and taken
- Lead time through the manufacturing process
- Range of products/services offered

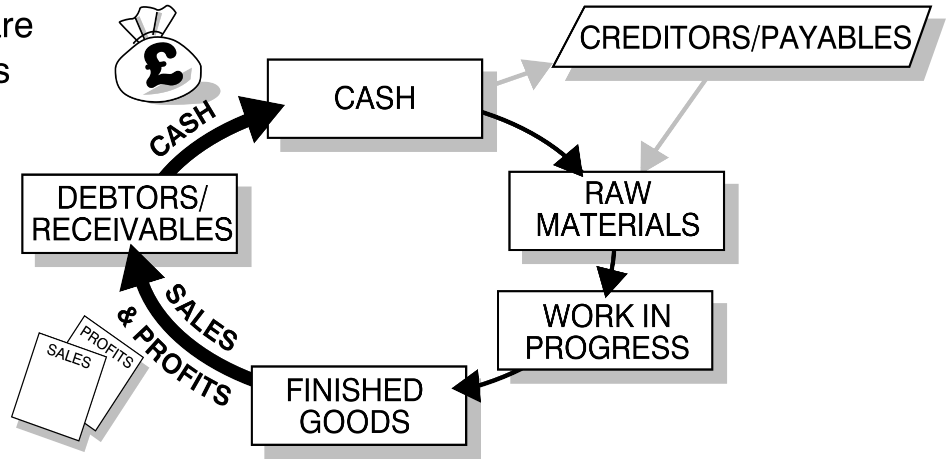
2 Moving from cash to other parts of the cycle **entails risk** and must therefore offer the prospect of a **sufficient return** to compensate for such risk

USE OF FUNDS

WORKING CAPITAL CYCLE

3 If the goods are being produced at a profit, the business generates profit and cash every time the cycle is completed. Note however that Profit and Cash are measured at different points in the cycle.

- **Sales** (and hence Profit) are measured when the goods are despatched to the customer
- **Cash** is only received when the customer pays
- This timing difference is one of the factors contributing to the outcome that PROFIT ≠ CASH

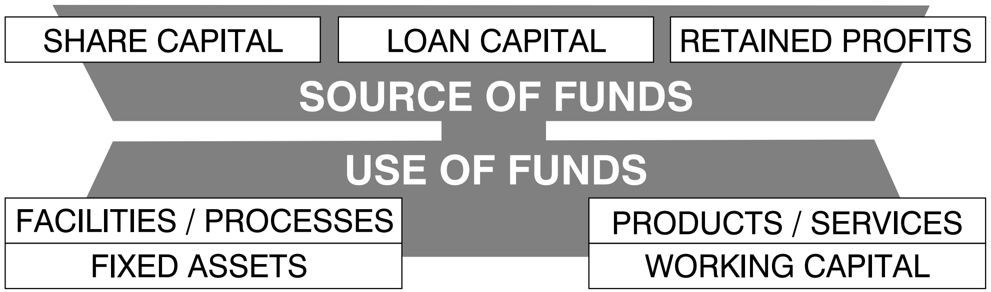


These ideas are developed in *The Managing Cashflow Pocketbook*

THE BUSINESS FINANCIAL MODEL

SUMMARY

The model so far:



THE BUSINESS FINANCIAL MODEL

DON'T WASTE MONEY

Grasp the significance of this simple model!

Money is raised ...

SOURCE OF FUNDS

... to be used in the business...

USE OF FUNDS

Every £1 of investment has to be
- **Raised**
- **Financed** (interest and/or dividends paid)

So it is essential to:

- Control Expenditure
- Justify New Processes
- Plan and Control Products

MAKING PROFIT

PRODUCTS / SERVICES
WORKING CAPITAL

Sales
Less: Attributable Cost
Operating Profit

- The reason for setting up a business is to generate a profit
- Profit results from sales
- Profit is assessed when the Finished Goods are sold to the customer
- Operating Profit is achieved when the selling price exceeds the attributable costs, ie: the operational costs incurred in sourcing/manufacturing, selling and distributing the goods sold

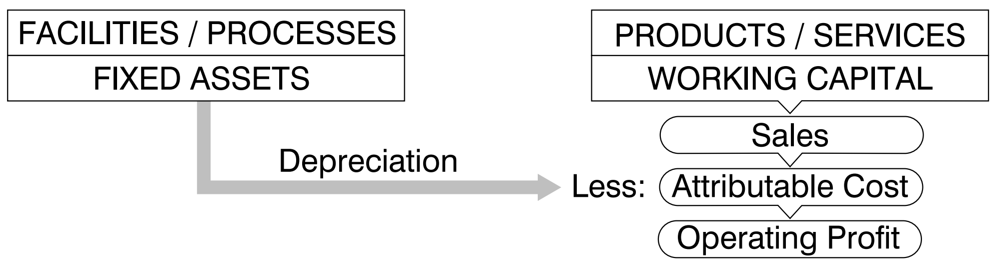
MAKING PROFIT

DEPRECIATION

However, there is something missing.

Companies invest in Fixed Assets in order to provide a facility within which products can be made.

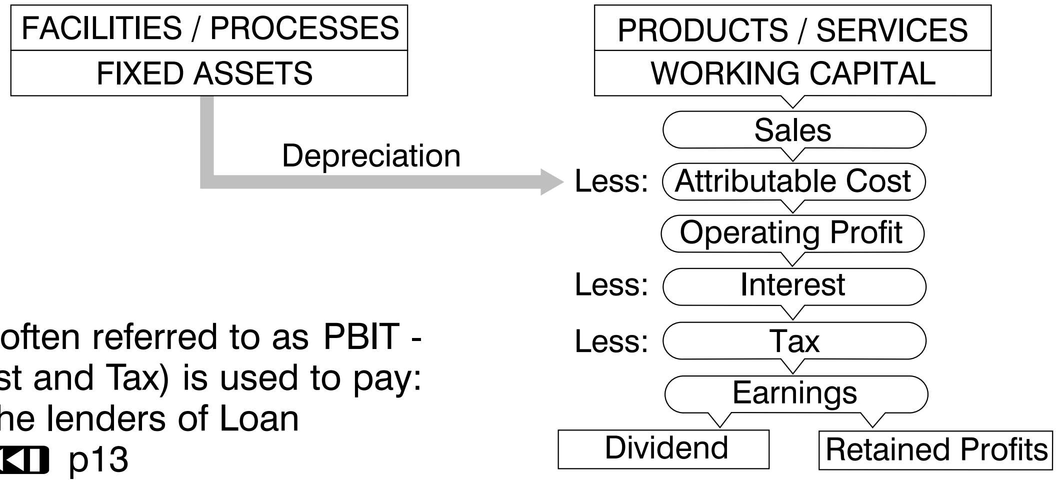
Therefore, part of the cost of the product is a charge for the use of these processes and facilities. This charge is called **DEPRECIATION.**



Note *For the calculation of Depreciation refer to pages 101-106*

MAKING PROFIT

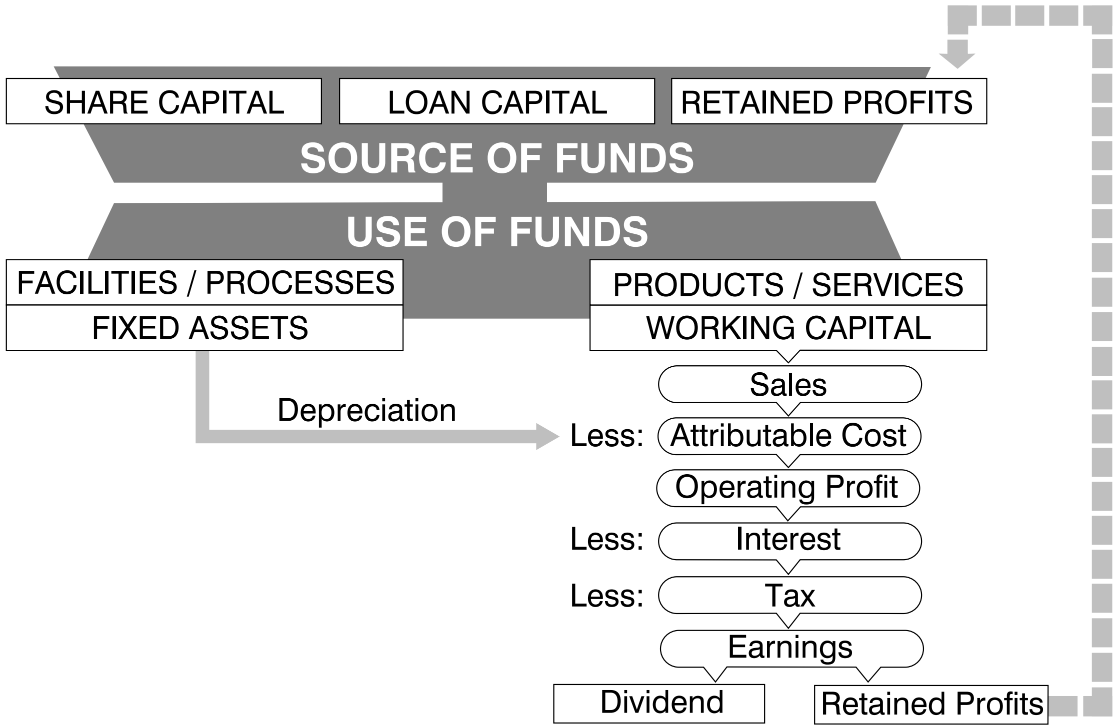
OTHER CHARGES TO BE MET



- **Operating Profit:** (often referred to as PBIT - Profit Before Interest and Tax) is used to pay:
  - **interest** to the lenders of Loan Capital p13
  - **tax** to the Government
- **Earnings:** whatever remains after all these costs have been met belongs to the shareholders and will either be:
  - paid out as a **Dividend**, or
  - ploughed back as **Retained Profit** p16

THE BUSINESS FINANCIAL MODEL

THE COMPLETE PICTURE



THE BUSINESS FINANCIAL MODEL

OVERVIEW

SOURCE OF FUNDS

- Funds are raised to finance the long-term business requirements

USE OF FUNDS

- Managers choose how to invest the money to:
  - provide the tools to do the job
  - finance the day-to-day running of the business products and services

OPERATING PROFIT

- Products are sold at a profit (or loss)

EARNINGS

- Earnings are distributed as dividends and/or ploughed back as Retained Profit

RETAINED PROFIT

- Retained Profit can be used to finance the purchase of even better facilities and/or an increased product range which would:
  - ➔ increase operating profits
  - ➔ increase Earnings
  - ➔ increase Dividends
  - ➔ retain additional profit... and so the process continues

THE BUSINESS FINANCIAL MODEL

COMMON MISCONCEPTIONS

‘At the year-end the Retained Profit must be somewhere; in the bank, or the accountant’s drawer.’

Yes. The Retained Profit ***is*** *somewhere - it has been re-invested back within the business. If the company merely ‘collected’ Retained Profit and held it until the year-end before tipping it back into the top of the model, it would be extremely inefficient. This re-cycling is, therefore, happening continuously, ie: there is no tank at the bottom of the model, simply a meter and a pump. Every year the meter is set to zero and the profits are measured as they are re-cycled.*

NOTES

CLASSIFICATION OF EXPENDITURE

CAPITAL or REVENUE?

	Page
Why Classify?	36
Classification of Expenditure	37
Control of Expenditure	39

CLASSIFICATION OF EXPENDITURE

WHY CLASSIFY?

Whenever the business spends money it has an impact on the model.

Expenditure must therefore be:

- Classified - in order for it to be reported correctly within the structure of the model
- Controlled - to ensure it is effective in working the model to achieve the business financial objectives

CLASSIFICATION OF EXPENDITURE

CAPITAL OR REVENUE?

Capital Expenditure - the purchase/improvement of Fixed Assets p20

Revenue Expenditure - expenditure to source, make, sell and deliver the products/services required by the customer

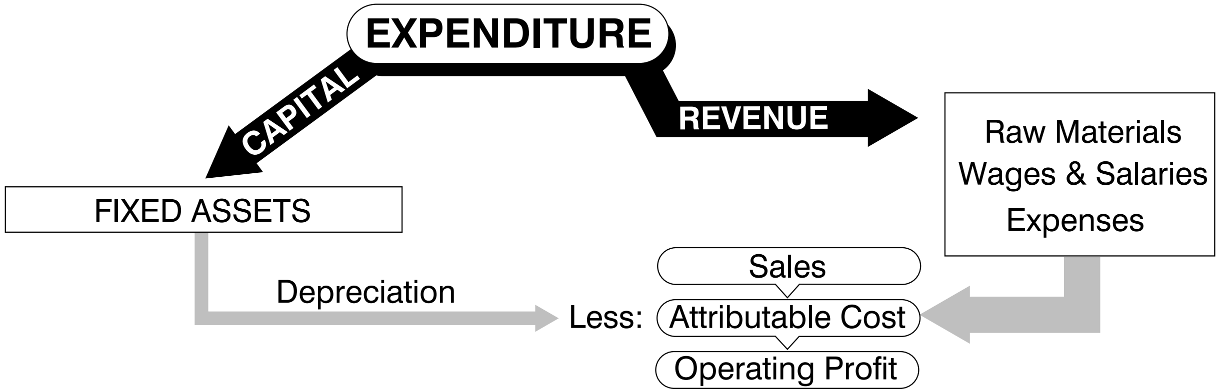
Think of a garage owner with bills to pay for:

- A new recovery vehicle
- An extension to his workshop
- His mechanic's wages
- Some new cars to sell

The first two items are capital expenditure, the second two are revenue.

CLASSIFICATION OF EXPENDITURE

WHAT WILL IT DO TO MY PROFIT?



- The impact of Capital Expenditure on Profit is spread over the asset life via the depreciation charge (see page 49)
- Revenue Expenditure is included in Attributable Cost - and hence reduces profit - as soon as the product/service for which it was purchased is sold

CLASSIFICATION OF EXPENDITURE

CONTROL

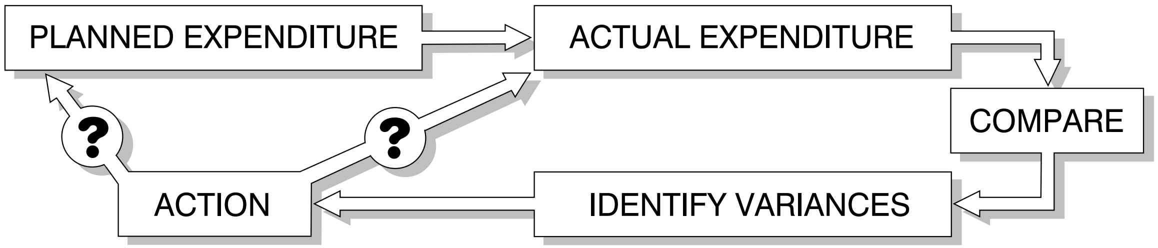
CAPITAL EXPENDITURE

- Commits Long-Term Finance into processes and facilities to be used over a long period of time
- If your business buys the wrong 'tools'
  - can you get your money back?
  - what if the competition buys better 'tools' - how can you compete?
- Therefore capital expenditure must be supported by a justification - a business plan which examines risk, investment and return

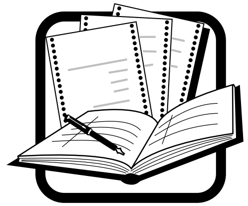
CONTROL

REVENUE EXPENDITURE

- Businesses have limited resources
- Plans have to be made and resources allocated to the activities and expenditures required to meet the business aims
- Actual expenditure is compared with planned expenditure to identify any differences (variances)
- Action must then be taken either to:
  i) bring expenditure back in line with budget, or ii) amend the budget

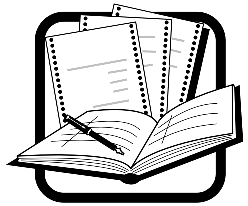


See further *The Managing Budgets Pocketbook*



FINANCIAL REPORTS

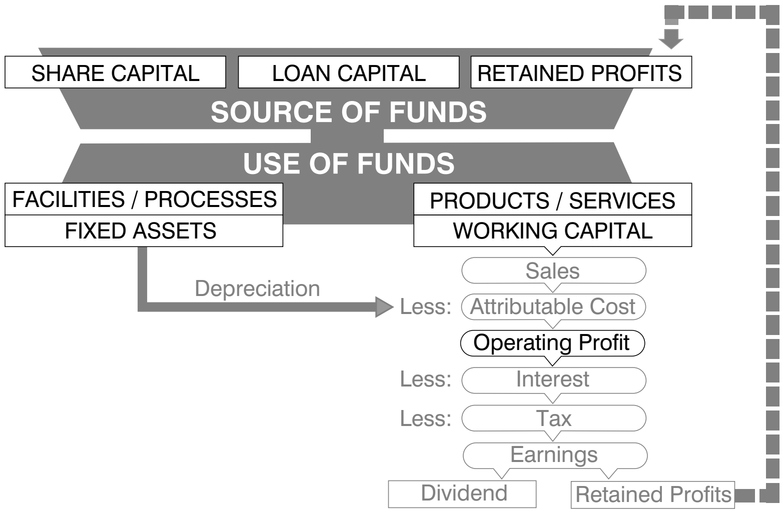
	page
Introduction	42
Section 1: The Balance Sheet	45
Section 2: The Profit and Loss Account	69



INTRODUCTION

Here is the Business Financial Model as developed in the first section of the pocketbook. p31

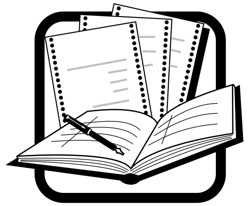
BUSINESS FINANCIAL MODEL



- **Funds are raised** to finance the planned investment
- **Funds are used** in support of the Business Plan
- **Assessment of Profit Performance** - a measure of the effectiveness with which this investment has been used in order to generate profits

FINANCIAL REPORTS

INTRODUCTION



The business must provide information in the form of financial reports to the owners - the shareholders.

These reports include:

i) a summary of the business investment

... **a Balance Sheet**

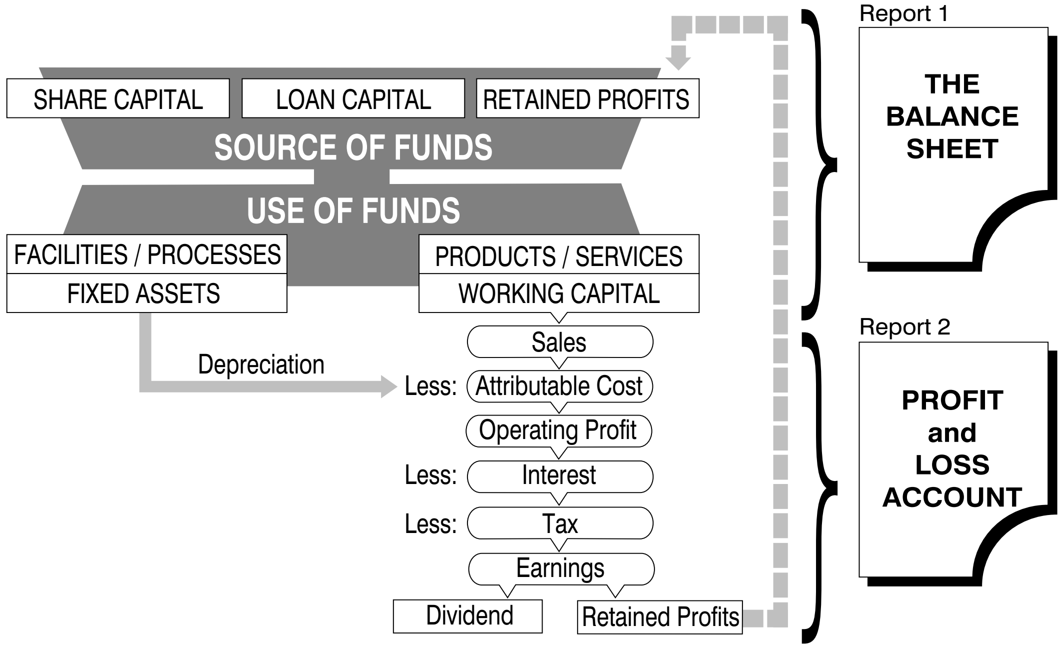
ii) a summary of the operating performance

... **the Profit and Loss Account**

INTRODUCTION

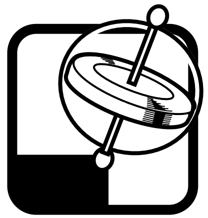
The Balance Sheet and Profit and Loss Account are reports of the Business Financial Model:

THE LINK TO THE BUSINESS FINANCIAL MODEL



A summary of investment in the business at a specific point in time

A summary of Profit Performance covering a stated Trading Period



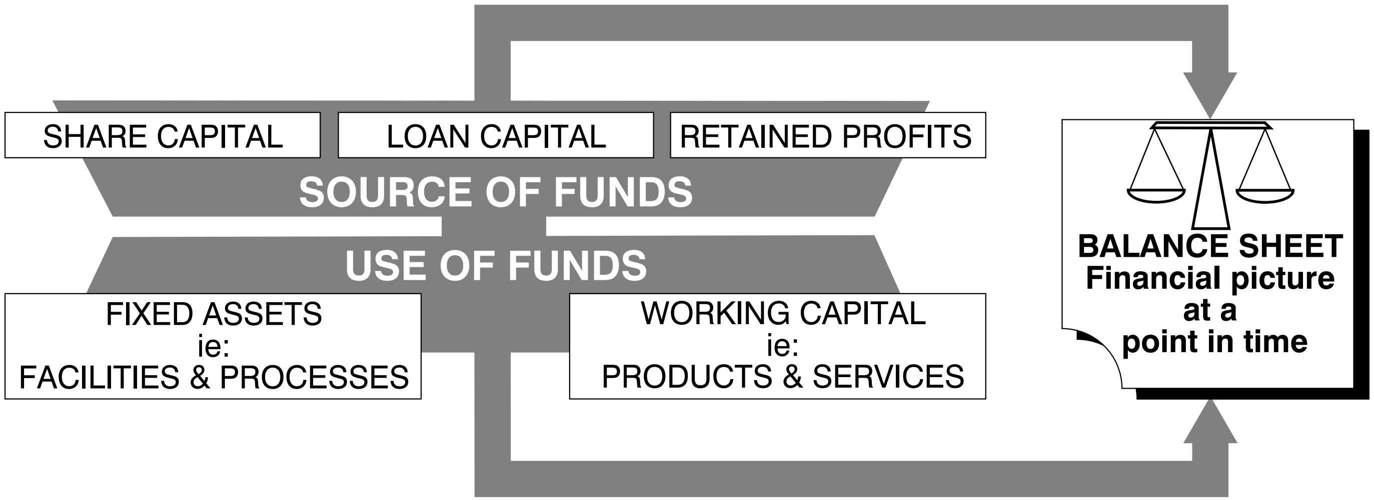
SECTION 1
THE BALANCE SHEET

Page

Introduction	46
Use of Funds:	
Fixed Assets (including Depreciation)	48
Working Capital	51
Source of Funds	53
The Balancing Act	56
Summary	59
Published Format	65

THE BALANCE SHEET

INTRODUCTION



The Balance Sheet is:

- A financial statement of the business investment as at a specific point in time; and
- Reports at the specific point in time
  - where the money invested in the business came from SOURCE OF FUNDS
  - and how it is currently invested USE OF FUNDS

FORMAT

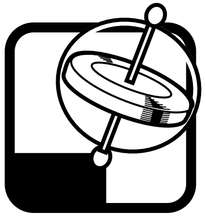
The Balance Sheet format swops the two halves of the model over:

- Use of Funds appears at the top of the statement
- Source of Funds appears at the bottom of the statement

Hence ...

Balance Sheet: ARC plc as at 31st December 200-

	£
Use of Funds	
Fixed Assets	
Working Capital	
Source of Funds	
Share Capital	
Retained Profits	
Loan Capital	



FIXED ASSETS

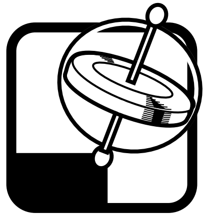
VALUATION OF FIXED ASSETS

Fixed Assets are:

Facilities and Processes acquired for use in the business as a result of Capital Expenditure p20

Fixed Assets are valued on the Balance Sheet at

	£
Cost, to include:	
purchase costs	
legal costs	
installation costs	
Less:	
Depreciation	______
ie:	
Net Book Value	
(or Written Down Value)	______



FIXED ASSETS

DEPRECIATION OF FIXED ASSETS

By definition:

- Fixed Assets are used in the business for a period in excess of one year
- The cost of the Fixed Asset is considered significant given the scale of the business operation

Charging capital expenditure against profits in the year of purchase would **unfairly penalise that year's result** and subsequent years, when the facility continued to be used, would not bear any of the cost.

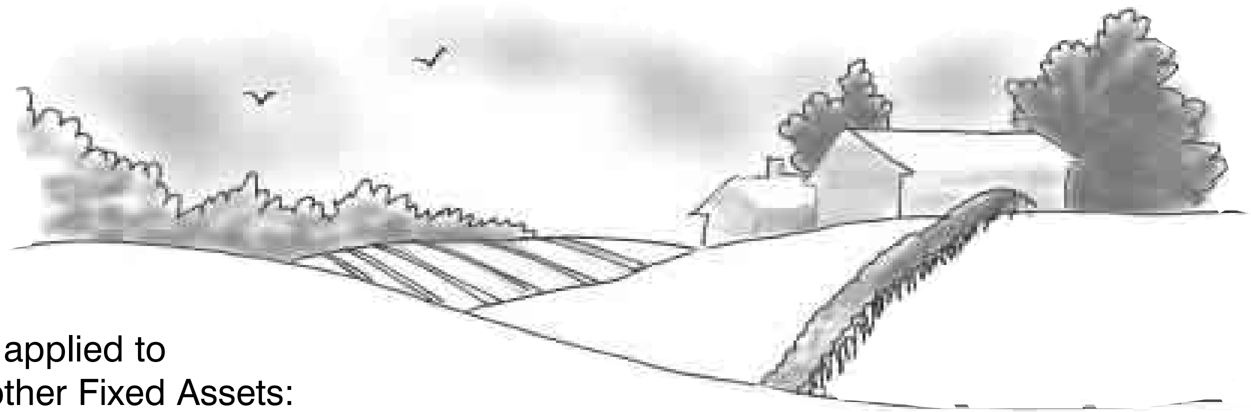
Therefore there needs to be a basis for apportioning the cost of the investment over the years which will benefit from its use.

The resultant charge is called:

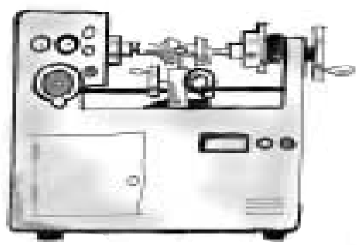
D E P R E C I A T I O N

DEPRECIATION OF FIXED ASSETS

Depreciation is not applied to land (with the exception of quarries and mines).



It is applied to
all other Fixed Assets:



WORKING CAPITAL

DEFINITION

The Funds used to provide the flow of materials, services and credit required to achieve the sales and satisfy customer needs. p23

- Stock (Raw materials, Work in Progress and Finished Goods)
- Debtors/Receivables (Amounts owed by customers)
- Cash

CURRENT ASSETS

Less:

- Creditors/Payables (Amounts owed to suppliers)

CURRENT LIABILITIES

Equals Working Capital

THE BALANCE SHEET

VALUATION OF WORKING CAPITAL

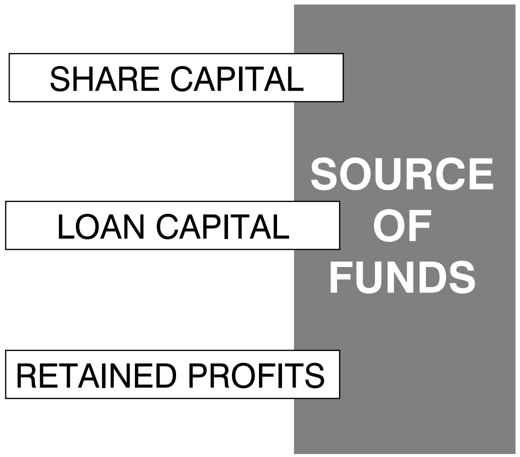
The values shown in the Balance Sheet are as follows:

Stock	At the **lower** of cost and net realisable (ie: saleable) value - Allowances are made for slow-moving and redundant stock, etc
Debtors	At the sum expected to be collected - Bad debts are written off - Allowances are made for possible bad debts
Cash	At face value
Creditors	At the sum expected to be paid

SOURCE OF FUNDS

VALUATION

We now reach the bottom half of the Balance Sheet, which shows where the funds (used in the top half) came from.



- SHARE CAPITAL
  the number of shares issued valued at a standard or 'nominal' value (see page 54)

- LOAN CAPITAL
  long-term borrowings from Banks (or similar institutions)

- RETAINED PROFITS
  the accumulation of profits re-invested into the business, reported on the Balance Sheet under the collective term 'Reserves' (see page 54)

RESERVES

‘Reserves’ is a collective term used on the Balance Sheet and forms part of the shareholders’ investment in the business.

The principal reserves are:

Retained Profits:
This represents the cumulative profits made by the business which have been ‘ploughed back’. p16

Share Premium Account:
Share Capital is shown on the Balance Sheet at its ‘Nominal Value’, eg: £1 per share. If shares are issued above nominal value the premiums are put into the Share Premium Account.

Example: Company X has shares with a nominal value of £1. The company issues 100,000 new shares at the current market price of £1.30.

Share Capital increases by £100,000
Share Premium Account increases by £30,000
balanced by the increase in Cash of £130,000.

RESERVES

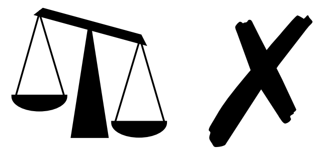
Revaluation Reserve:

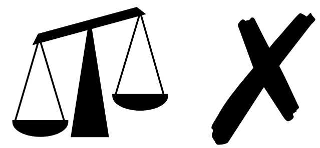
Companies are required periodically to revalue their Land and Buildings and adjust their Balance Sheet values accordingly.

- The business belongs to the shareholders
- Therefore any change in the value of assets held by the business falls to those shareholders
- Hence any increases or decreases in asset values caused by revaluation will be matched by an increase or decrease in the Revaluation Reserve

Note: Depreciation of Buildings will be based on the revalued amount.

THE BALANCING ACT

- **You can’t do something with money you never had** 

- **Neither can money you have had just disappear!** 

THE BALANCE SHEET

COMMON MISCONCEPTIONS

‘The accountant balances the Balance Sheet by entering a balancing figure somewhere ... probably profit.’

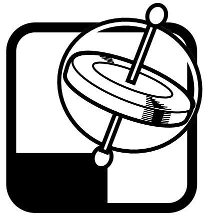
The Balance Sheet balances automatically because for every transaction in the books of account there are always two entries - double-entry book-keeping!

The two entries will either increase or decrease both halves of the Balance Sheet by the same amount, or there will be equal plus and minus entries within the same half.

See the following examples.

THE BALANCE SHEET

COMMON MISCONCEPTIONS



EXAMPLES

	Source of Funds	***Use of Funds***
Issue £1m shares (at nominal value) for cash	*+ £1m Share Capital*	*+ £1m Cash*
Repay £0.5m Loan Capital	*- £0.5m Loan Capital*	*- £0.5m Cash*
Purchase new machine for £50k cash	*+ £50k Fixed Asset*	*- £50k Cash*

Remember: *the Balance Sheet **must** balance because the two halves are explaining:*

Source of Funds - where the money came from

Use of Funds - where it is now

ARC plc

THE BALANCE SHEET

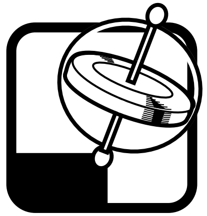
THE BALANCE SHEET

SUMMARY

This is a summarised Balance Sheet for ARC plc:

Balance Sheet as at 31st December 200-

	Note	£`000	£`000
USE OF FUNDS			
Fixed Assets			470
Current Assets		520	
Less:			
Current Liabilities		290	
Working Capital	2		230
Net Assets Employed	1		700
SOURCE OF FUNDS			
Issued Share Capital		300	
Reserves	3	200	
Shareholders' Funds	4		500
Loan Capital			
Net Capital Employed	1		200
			700



SUMMARY

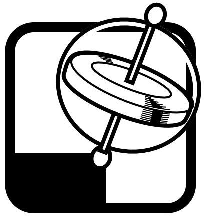
Notes:

1 **Net Assets Employed** is the accountant's term for the total Use of Funds
Net Capital Employed is the accountant's term for the total Source of Funds
Hence:
Net Assets Employed = Net Capital Employed p56

2 **Working Capital = Current Assets - Current Liabilities** p51

3 **Reserves** is a collective term which includes
Retained Profits accumulated over the life of the business p54

4 **Shareholders Funds** (or Net Worth) is the total amount of long-term funding invested by the shareholders either directly (by buying shares) or indirectly (by allowing some of their earnings to be re-invested as Retained Profits)



SUMMARY

Here is the same Balance Sheet expanded to itemise the Fixed Assets and the constituent parts of Working Capital:

Balance Sheet as at 31st December 200-

	£'000	£'000	£'000
Fixed Assets			
Land & Buildings		230	
Plant & Equipment		170	
Vehicles		70	470
Current Assets			
Stock	320		
Debtors	190		
Cash	10		
Less:			
Current Liabilities		520	
Creditors	290		
		290	
Working Capital			230
Net Assets Employed			700
Source of Funds			
Issued Share Capital			
300,000 £1 Ordinary Shares		300	
Reserves			
Retained Profits		200	
Shareholders Funds			500
Loan Capital			200
Net Capital Employed			700

THE BALANCE SHEET

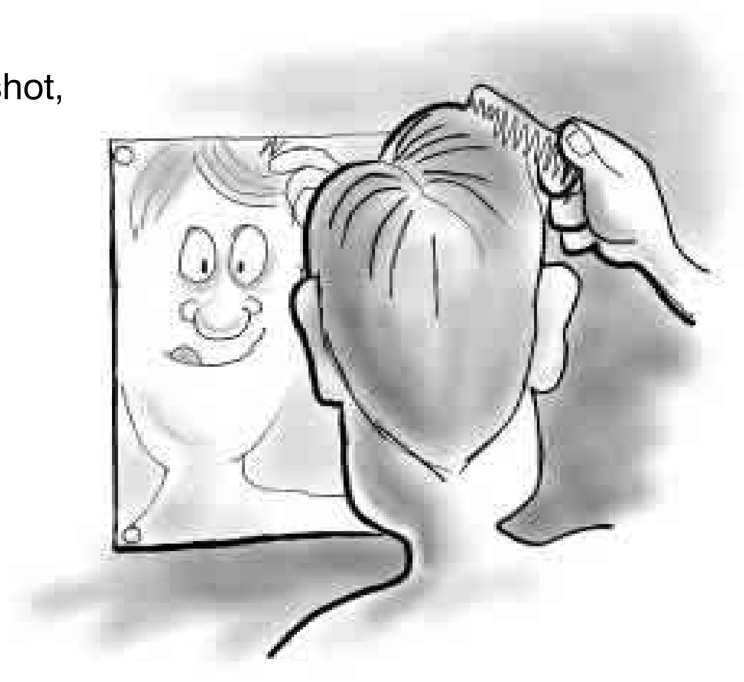
SUMMARY

Be careful! This statement has its limitations!

Remember that the Balance Sheet is a snapshot, at a point in time, of where the money came from and how it is currently invested.

What do people do before having their photographs taken? They make themselves look as presentable as possible.

Companies do the same thing!



The camera may not lie ... but just what does that business look like for the other 364 days of the year?

Chaotic? - perhaps!

THE BALANCE SHEET

COMMON MISCONCEPTIONS

'The Balance Sheet tells me the value of the business.'

No. Remember the shareholders own the business and therefore the value of the business is the cost of acquiring those shares, ie:

Number of shares x Share Price

There are many reasons why this is not the same as the Balance Sheet value of Shareholders' Funds. For instance, some of the business's value does not appear on the Balance Sheet, eg:

- *Employee skills*
- *Market Opportunities*
- *Order Book*
- *Market value of Fixed Assets or Stocks*

INTERNAL FORMAT

- The format examined to this point has addressed an **internal** report to the Management Team
- The focus has been to consider the Management decisions in respect of the:

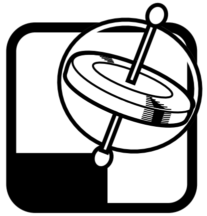
  Use of Funds (Net Assets Employed)

  made available to the business from a number of external sources:

  Source of Funds (Net Capital Employed)

- Management must account for and make a return on the Net Capital Employed
- **The Report provides essential management information**

PUBLISHED FORMAT



The Balance Sheet

... published format

A Report to the Owners of the Business

... the Shareholders

- The published format is structured to feature the different needs of the Shareholders - the owners of the business
- The Shareholder is seeking to trace that part of the business funded by the Shareholders either through Share Capital or Reserves
- **This change of end user requires a change of format only.** The accounting terms used to this point are retained with the same definitions

REPORTS TO THE SHAREHOLDERS

Internal Format

		£'000
Fixed Assets		470
Current Assets	520	
Less:		
Current Liabilities	290	
Working Capital		230
Net Assets Employed		700
Financed by:		
Share Capital		300
Reserves		200
Shareholders' Funds		500
Loan Capital		200
Net Capital Employed		700

Published Format

		£'000
Fixed Assets		470
Current Assets	520	
Less:		
Current Liabilities	290	
Net Current Assets		230
(Working Capital)		
Total Assets less		
Current Liabilities		700
Less:		
Creditors/Loans		
(greater than 1 year)		200
Total Net Assets		500
Capital and Reserves		
Share Capital		300
Reserves		200
Shareholders' Funds		500

PUBLISHED FORMAT

- In most companies the Balance Sheet is subject to external audit (Note: different rules now apply for small companies)
- Current Liabilities includes all items due for payment within the next financial year
- Creditors and Loans (greater than one year) includes items of indebtedness required to be paid in the future but not in the next 12 months
- The format provides summary information only - the report is supported with detailed notes cross referenced to the Balance Sheet
- The format is required to show the comparative figures for the preceding year

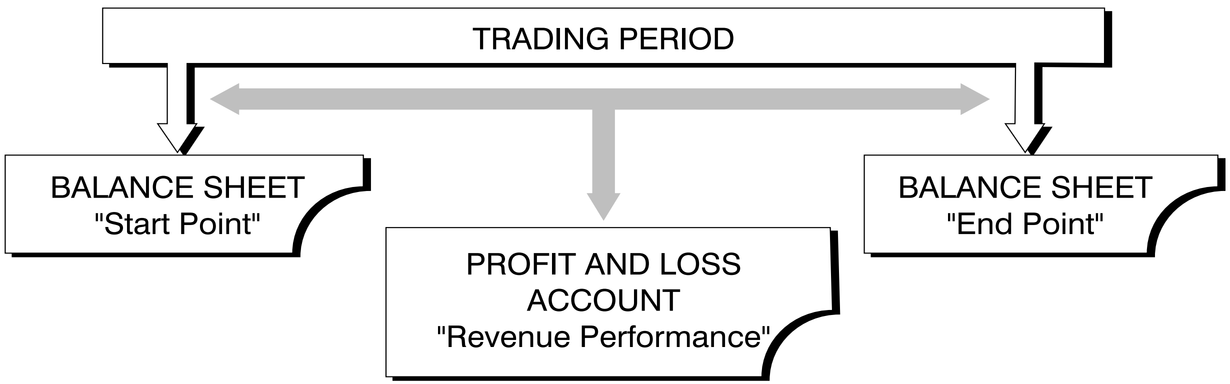
SECTION 2
THE PROFIT AND LOSS ACCOUNT

	Page
Introduction	70
Profit not Cash	73
Operating Profit	78
Financing Costs	82
Example	85
Published Format	90

PROFIT AND LOSS ACCOUNT

LINK BETWEEN FINANCIAL REPORTS

- Revenue performance is assessed in respect of a defined trading period
- The Balance Sheet provides a picture of the business investment **at a specific point in time,** eg:
    - at the start of the trading period
    - and at the end of the trading period
- The Profit and Loss Account reports what happened, in terms of Revenue Performance, between those Balance Sheet dates

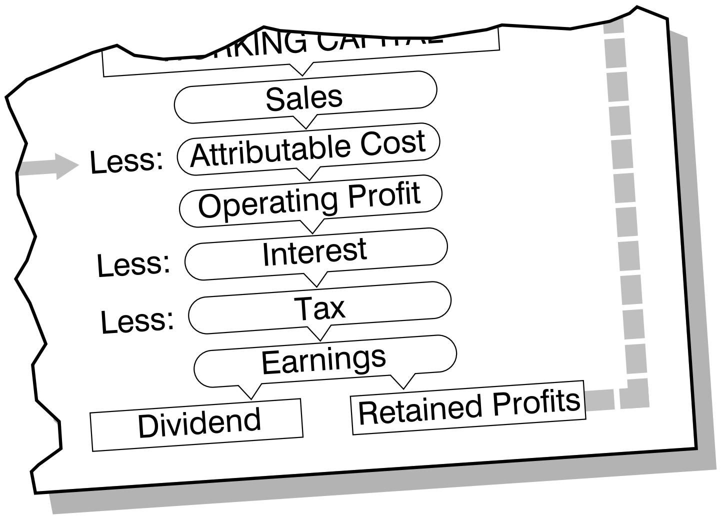


DIFFERENT APPROACHES

Companies use many different formats and styles to report their revenue or profit performance internally, eg:

- Trading Account
- Operating Statement
- Revenue Account, etc

Whatever the name, the statement will be reporting on some or all of this part of the business model.



p44

PROFIT AND LOSS ACCOUNT

REVENUE PERFORMANCE

Hence the Profit and Loss Account is a statement of revenue performance over a given period of time showing:

- The value of products or services sold - **Sales**
- The costs the business has incurred in meeting those sales

PROFIT NOT CASH

The Profit and Loss Account measures the profit or loss made on the goods sold during the period.

- It does **not** measure the cashflows into and out of the business
- This is an essential difference
- Cashflow is a vital part of the financial management of the business and is dealt with separately in the Cashflow Statement
  (see further The Managing Cashflow Pocketbook)
- To manage a business both **Profit** and **Cash** must be considered

PROFIT NOT CASH

SALES

This is the value of product or services sold during the period (excluding Value Added Tax)

NOT

the amount of cash collected

(Any sales not yet paid for by the customer will appear on the Balance Sheet as Debtors/Receivables.)

PROFIT AND LOSS ACCOUNT

PROFIT NOT CASH

ATTRIBUTABLE COSTS

For `Profit' to be a meaningful measure, 'like' has to be compared with `like'.

DON'T SELL APPLES AND COST PEARS!

Hence Attributable Costs are the operating costs associated with producing and delivering the items sold during the period

NOT
the amount of cash spent

PROFIT NOT CASH

- Goods received, and not yet used for the products that have been sold will appear as **Stock** on the Balance Sheet
- Goods received, but not yet paid for will appear under **Creditors**/**Payables** on the Balance Sheet

Example

£100 worth of stock is delivered to your premises

● When it is received:	Stock increases by £100 Creditors increase by £100	Does not affect profit and loss
● When it is paid for:	Creditors decrease by £100 Cash decreases by £100	Does not affect profit and loss
● When it is despatched to the customer:	Stock decreases by £100 Attributable cost increases by £100	Affects profit and loss NOW

PROFIT IS NOT CASH

It is evident, therefore, that whenever a business:

- Holds stock, or
- Gives credit, or
- Takes credit

then profit and cash will not be the same thing.

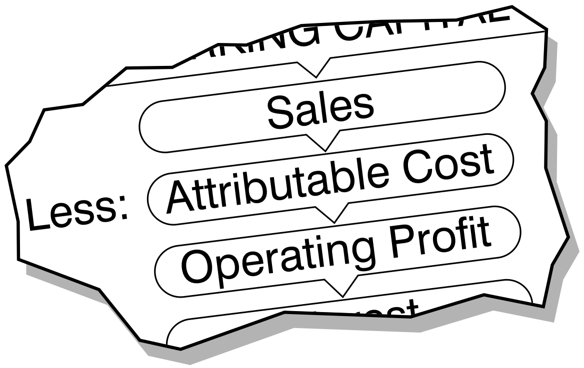
This debate is examined in more detail in *The Managing Cashflow Pocketbook.*

OPERATING PROFIT

Profit is measured at various levels down the Statement as additional aspects of business cost are taken into account.

First consider **Operating Profit** - the measurement of local operating performance.

This was shown within the model as being:



OPERATING PROFIT

ATTRIBUTABLE COSTS

The operating (or attributable) costs of the business result from two types of Revenue Expenditure:

Product-related: Those forming part of the product cost and ultimately the **cost of goods sold**

Expenses: Those which relate to the provision of support services, eg:

- selling
- distribution
- R & D
- personnel
- administration, etc

OPERATING PROFIT

ATTRIBUTABLE COSTS

Whilst each company will have its own unique costing system, typically the division would be:

- **Product-related:** Material, parts purchased for re-sale, shopfloor labour, manufacturing expenses (ie: Production Overheads)

- **Expenses:** All non-manufacturing departmental running costs

The two categories are shown separately on the statement as:

- Cost of goods sold (Product-Related)
- Expenses (sometimes referred to as Support Services)

Product Costing systems are explained in *The Managing Budgets Pocketbook.*

OPERATING PROFIT

Hence a more detailed statement of Operating Profit would show:

	£
Sales	1600
Less:	
Cost of goods sold	1000
Gross Profit	600
Less:	
Expenses	400
Operating Profit	200

Note:

1 Gross Profit is the difference between the selling price and the cost of manufacturing the goods sold in the period.

2 Operating Profit is the lowest level in the Profit and Loss Account over which operational management has control. (This is often referred to as PBIT ... Profit Before Interest and Tax or the 'Bottom Line').

FINANCING COSTS

After accounting for the operating costs of the business there are other costs still to be met.

- **Interest:** Loan interest to be paid in accordance with the contractual agreement. p14
  Note - Interest must be paid whether the company has had a good year or not, so the greater the loan capital within the business, the greater the financial risk.

- **Tax:** Whilst businesses aim to minimise their tax bills by legitimate means (tax avoidance) the key determinant in the amount paid will be government fiscal policy.

The profits left over after allowing for Interest and Tax are called **Earnings.**

EARNINGS

Earnings are what is left after all the business costs have been met.
Earnings, therefore, belong to the shareholders.

Some of the Earnings will be paid out to the shareholder to give them income on their investment. This is the **Dividend.**

The rest will be re-invested back within the business enabling the business to grow. This is the **Retained Profit** and will be included on the Balance Sheet as Reserves. p54

PROFIT AND LOSS ACCOUNT

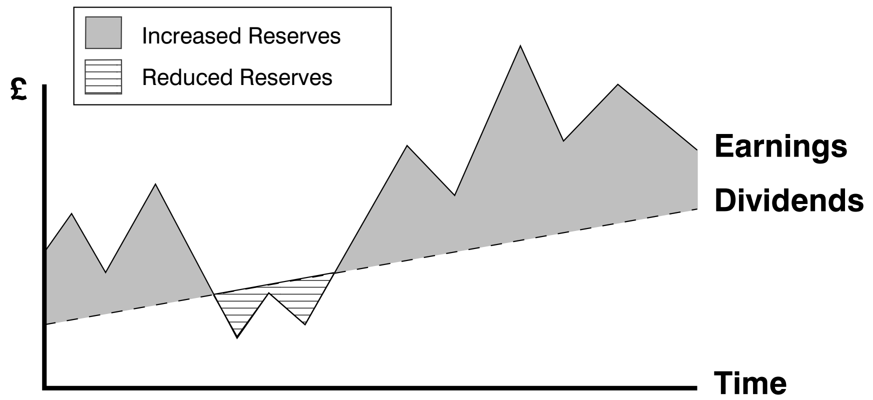
DIVIDEND PAYMENT

HOW MUCH DIVIDEND TO PAY

- Retained Profit is the cheapest form of Long-Term Finance, so most companies will wish to retain as much as possible
- But shareholders expect income as well as growth
- Failure to keep the shareholders happy can result in the removal of the Board of Directors and/or leave the company vulnerable to takeover bids p11

So the way Earnings are divided has to be a political decision.

Substantial shareholders, eg, financial institutions, will prefer a steady flow of dividend. Therefore, if Earnings fluctuate from year-to-year, so will Retained Profit.



Note that under certain conditions Dividends can even exceed Earnings - resulting in a reduction in Reserves.

PROFIT AND LOSS ACCOUNT

EXAMPLE - ARC PLC

Profit and Loss Account for the 12 months ending 31st December 200- [1]

		£'000	£'000
	Sales		1,600
Less:	Cost of Goods Sold [2]		
	Direct Materials	500	
	Direct Labour	150	
	Production Overheads	350	
			1,000
	Gross Profit		600
Less:	**Expenses**		
	Administration	200	
	Selling	60	
	Distribution	80	
	Marketing	60	
	Total Expenses		400
	Net Operating Profit		200
Less:	**Interest**		33
	Net Profit Before Tax		167
Less:	**Tax**		57
	Earnings		110
Less:	**Dividend**		30
	Retained Profits		80

Note

1 The statement relates to the defined period of time for which the profits or losses are being measured.

2 Cost of Goods Sold is sometimes analysed into the different elements of product cost.

PROFIT AND LOSS ACCOUNT

COST OF GOODS SOLD

An alternative presentation of the Cost of Goods Sold is:

	£'000
Opening stock of Finished Goods	260
Add:	
Finished Goods completed during the period	920
	1,180
Less:	
Closing Stock of Finished Goods	180
Cost of Goods Sold	1,000

COST OF GOODS SOLD

- Assume the company has a Finished Goods stock at the start of the period of £260k
- During the period £920k of completed products are transferred from production
- At the end of the period, if nothing had been sold, there would be £1,180k stock of Finished Goods
- However, when the closing stock is valued there is found to be only £180k in stock
- Hence, **by difference**, the value of stock shipped from Finished Goods, ie: the Cost of Goods Sold - must be £1,000k

COMMON MISCONCEPTIONS

'If I compare the results of two businesses, the one which has made more profit has done better.'

Not necessarily. What matters is not profit but profitability, ie: how much profit has been made on every £1 invested in the business. After all, if evaluating the opportunity to invest in a project offering a profit of £1,000 the first question would be: `How much has to be invested in order to make the £1,000 profit?' Company performance is measured on this basis using the ***Return on Capital Employed (ROCE)***

$$ROCE = \frac{\textbf{Operating Profit}}{\textbf{Net Capital Employed}} \times 100$$

Note

- *Operating Profit is used as being the lowest level in the Profit and Loss Account over which operational management has control* p81
- *Net Capital Employed = Source of Funds* p61

COMMON MISCONCEPTIONS

EXAMPLE

Compare the performance of companies X and Y:

	Operating Profit	*Net Capital Employed*	*ROCE*
	£m	*£m*	*%*
X	*10*	*25*	*40*
Y	*100*	*400*	*25*

Hence, although Y makes 10 times more operating profit than X, X is the better investment as it generates 40p per £1 long-term finance compared with Y's 25p.

PROFIT AND LOSS ACCOUNT

PUBLISHED FORMAT

The Profit and Loss Account

..... Published Format

A Report to the Business Owners

..... the Shareholders

PROFIT AND LOSS ACCOUNT

PUBLISHED FORMAT

- This report to the Shareholders is published and consequently is available to the competitors

  Consider the dilemma:
  - provide information to inform the Owners
  - competitors use published information

- Therefore the practice tends to be to provide the legal minimum in terms of specific numbers and to provide business statements and pictures to support the numbers shown (eg: the Directors' Report)

- Key items of Revenue Expenditure are given in the Notes to the Accounts, eg:
  - Payroll Costs; Payroll Expenses; Social Security Costs; Depreciation; Charitable Donations; Political Contributions, etc

PROFIT AND LOSS ACCOUNT

PUBLISHED FORMAT

- At first glance the format may not look dissimilar to the internal management format
- Preceding years' figures are required to be shown
- Figures shown are totals only - some analysis will be available in the Notes to the Accounts
- In large companies/groups it will be difficult, if not impossible, to break down the figures - by product, customer or business units
- The Published Statement is subject to audit

(Note: Special rules apply for small companies)

Profit and Loss Account for the 12 months ended...

		£'000
	Turnover	1600
Less:	Operating Costs	1400
	Profit before Interest and Tax	200
Less:	Interest	33
	Profit before Tax	167
Less:	Tax	57
	Earnings	110
Less:	Dividend	30
	Retained Profits	80

APPENDIX ONE

JARGON EXPLAINED

APPENDIX ONE

JARGON EXPLAINED

		Page
Amortisation:	See **Depreciation**	
Attributable Cost:	The Revenue Expenditure associated with producing and delivering the products sold during the period	27
Balance Sheet:	A financial statement showing, at a point in time, where the money came from **(Net Capital Employed)** and how it is currently invested **(Net Assets Employed)**	46
Bottom Line:	See **Operating Profit**	81
Capital Expenditure:	All expenditure related to the purchase or improvement of Facilities/Processes **(Fixed Assets)**	37
Cost of Goods Sold:	The **Product Cost** of those goods sold during the period (also known as Cost of Sales)	80
Current Assets:	Cash or other assets which are converted into cash in the normal course of trading, eg: **Stock, Debtors**	21

APPENDIX ONE

JARGON EXPLAINED

		Page
Current Liabilities:	Amounts due to other parties (eg: suppliers, banks) within the short-term (usually 12 months)	22
Creditors:	The amount of money the company owes its suppliers (also referred to as **Payables**)	22
Debtors:	The sum owed to the business by its customers (also referred to as **Receivables**)	22
Depreciation:	A method of charging out the cost of **Fixed Assets** to those periods benefiting from the assets' use	29
Dividend:	The part of **Earnings** paid out to the Shareholders in order to give them an income on their investment	30
Earnings:	The profits left for the Shareholders once all the business costs (including **Interest** and **Tax**) have been met. Some will be paid out as **Dividend**, the rest reinvested within the business - **Retained Profit**	30

APPENDIX ONE

JARGON EXPLAINED

		Page
Fixed Asset:	Facilities or Processes providing the infrastructure of the business. These are purchased for use within the business rather than for purposes of re-sale	19
Gross Profit:	**Sales** less **Cost of Goods Sold**	80
Interest:	Lenders will expect a return on their investment in the form of interest	30
Inventory:	See **Stock**	
Loan Capital:	Long Term investment in the business in the form of a loan	13
Net Assets Employed:	The accountant's expression for **`Use of Funds',** ie: **Fixed Assets** and **Working Capital**	61
Net Book Value:	Fixed Assets are valued at Net Book Value in the Balance Sheet, being Cost less Depreciation	46

APPENDIX ONE

JARGON EXPLAINED

		Page
Net Capital Employed:	The accountant's expression for **`Source of Funds',** ie: **Net Worth** and **Loan Capital**	61
Net Profit:	See **Operating Profit**	
Net Worth:	See **Shareholders' Funds**	
Operating Profit:	A measure of local operating performance. This is the profit after all operating costs (product-related and expenses) have been considered, but before financing costs, eg: **Interest, Tax** and **Dividend**	78
Operating Statement:	See **Profit and Loss Account**	
Payables:	See **Creditors**	
Product Cost:	This will depend on the company's costing system but will typically include the cost of material, shopfloor labour and associated manufacturing expenses	80

APPENDIX ONE

JARGON EXPLAINED

		Page
Profit and Loss Account:	A financial statement measuring profit performance for a stated trading period	69
Receivables:	See **Debtors**	
Reserves:	A collective term for undistributed profits which form part of **Shareholders' Funds**. The principal reserves are: **Retained Profits, Share Premium Account and Revaluation Reserve**	54
Retained Profits:	Profits which are reinvested within the business	16
Revaluation Reserve:	On revaluing **Fixed Assets** any increase or decrease in value is matched by an increase or decrease in the Revaluation Reserve	55
Revenue Account:	See **Profit and Loss Account**	

APPENDIX ONE

JARGON EXPLAINED

		Page
Revenue Expenditure:	All expenditure which does not result in an increase in the value of Fixed Assets	36
ROCE:	Return on **Capital Employed**. Measures the effective use of **Net Capital Employed** to generate **Operating Profit** $= \dfrac{\textbf{Operating Profit}}{\textbf{Net Capital Employed}} \times 100$	88
Sales:	The invoice value of goods sold (excluding VAT)	74
Share Capital:	Long-term funding by Shareholders who buy a share of the business ownership	10
Share Premium Account:	When shares are issued at a price above nominal value, the premiums are accumulated to form this **Reserve**	54

APPENDIX ONE

JARGON EXPLAINED

		Page
Shareholders' Funds:	The total shareholder investment in the business, ie: **Share Capital** and **Reserves**	60
Stock:	The total value of raw materials, work in progress and finished goods	21
Tax:	Part of company profits have to be used to finance the tax bill paid to the Government	81
Trading Account:	See **Profit and Loss Account**	
Turnover:	See **Sales**	
Working Capital:	Funds used to provide the flow of materials, services and credit. **(Current Assets - Current Liabilities)**	22
Written Down Value:	See **Net Book Value**	

APPENDIX TWO

CALCULATING DEPRECIATION

APPENDIX TWO

CALCULATING DEPRECIATION

How do accountants decide how much depreciation to charge?

Depreciation is .....

Assessed on an annual basis by apportioning the ‘depreciable amount’ over the ‘effective useful life’.

APPENDIX TWO

CALCULATING DEPRECIATION

- What is the depreciable amount?

  That part of the Capital Expenditure which is ‘consumed’ by the business

  ie: Cost less residual/scrap value at the end of the asset’s useful life to the business

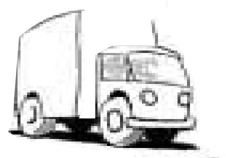
APPENDIX TWO

CALCULATING DEPRECIATION

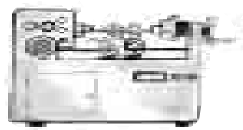
- What is the effective useful life?

  The period over which the business intends to use the Fixed Assets.

40-50 years?



3-5 years?



4-25 years?

2-5 years?

- How many years will it benefit the business?
  - how long will the asset last?
  - what is the likelihood of a breakthrough in technology?
  - and when would this happen?
  - what is the market life of the products requiring this facility?

  The accountant may need some help deciding this!

APPENDIX TWO

CALCULATING DEPRECIATION

STRAIGHT-LINE METHOD

The most simple basis for apportioning the depreciable amount over the effective useful life is the `straight-line' method.

$$\frac{\textbf{Depreciable amount}}{\textbf{Useful life}}$$

$$= \textbf{£ .... p.a.}$$

Example:

A company purchases a new machine which costs £500,000 to make a product which has an expected life of 5 years. It is estimated that at the end of the 5 years the machine will have a resale value of £50,000.

$$\text{Depreciation charge p.a.} = \frac{\textbf{£500,000 - £50,000}}{\text{5 years}}$$

$$= \underline{\textbf{£90,000 p.a.}}$$

APPENDIX TWO

CALCULATING DEPRECIATION

OTHER METHODS

There are other methods of calculating depreciation, eg:

- **Reducing balance** - where the depreciation charge is a fixed % per annum of the reduced balance (ie: cost less cumulative depreciation)
- **Production Unit method** - where the depreciation charge depends on the number of units of output produced

Companies must select the method which is most appropriate to the asset in question and its application within the business.

The choice of method and the parameters used **MATTER.**

It affects
- Profit
- Product Cost
- Fixed Asset Values

Don’t let the accountant take sole responsibility!

About the Authors

Anne Hawkins, BA, CIMA is a Management Accountant with a first class honours degree in Business Studies. Anne has progressed from this strong knowledge base to gain senior management accounting experience within consumer and industrial product industries. As a Training Consultant she develops and presents finance programmes to Directors and Managers from all sections of industry.

Clive Turner, ACMA, MBCS is Managing Director of Structured Learning Programmes Ltd, established in 1981 to provide management consultancy and training services. Clive works with management to develop strategic business options. He participates in the evaluation process: designs the appropriate organisation structure and provides management development to support the implementation process. Clive continues to have extensive experience in delivering financial modules within Masters Programmes in the UK and overseas.

Contact

For details of support materials available to help trainers and managers run finance courses in-company, contact the authors at:
Tall Trees, Barkers Lane, Wythall, West Midlands B47 6BS.

© Anne Hawkins and Clive Turner 1995

This edition published in 1995 by Management Pocketbooks Ltd.
14 East Street, Alresford, Hants. SO24 9EE, UK   Reprinted 1997, 1999, 2000

Printed in England   ISBN 1 870471 326

TRAINERS, HRD MANAGERS and TEAM LEADERS!

BUILD KEY MANAGEMENT SKILLS with Games Exercises, Tests & Quizzes that will ABSORB ENTERTAIN & ENLIGHTEN

MANAGEMENT POCKETBOOKS

THE MANAGEMENT POCKETBOOK SERIES

Pocketbooks

Appraisals Pocketbook
Assertiveness Pocketbook
Balance Sheet Pocketbook
Business Planning Pocketbook
Business Presenter's Pocketbook
Business Writing Pocketbook
Challengers Pocketbook
Coaching Pocketbook
Communicator's Pocketbook
Creative Manager's Pocketbook
Cross-cultural Business Pocketbook
Cultural Gaffes Pocketbook
Customer Service Pocketbook
Decision-making Pocketbook
Empowerment Pocketbook
Export Pocketbook
Facilitator's Pocketbook
Improving Efficiency Pocketbook
Improving Profitability Pocketbook
Influencing Pocketbook
Interviewer's Pocketbook
Key Account Manager's Pocketbook
Learner's Pocketbook
Managing Budgets Pocketbook
Managing Cashflow Pocketbook
Managing Change Pocketbook
Managing Your Appraisal Pocketbook
Manager's Pocketbook
Manager's Training Pocketbook
Marketing Pocketbook
Meetings Pocketbook
Mentoring Pocketbook
Motivation Pocketbook
Negotiator's Pocketbook
Networking Pocketbook
People Manager's Pocketbook
Performance Management Pocketbook
Personal Success Pocketbook
Project Management Pocketbook
Problem Behaviour Pocketbook
Quality Pocketbook
Sales Excellence Pocketbook
Salesperson's Pocketbook
Self-managed Development Pocketbook
Stress Pocketbook
Teamworking Pocketbook
Telephone Skills Pocketbook
Telesales Pocketbook
Thinker's Pocketbook
Time Management Pocketbook
Trainer Standards Pocketbook
Trainer's Pocketbook

Pocketfiles/Other

Leadership: Sharing The Passion
The Great Presentation Scandal
Hook Your Audience
Trainer's Blue Pocketfile of Ready-to-use Exercises
Trainer's Green Pocketfile of Ready-to-use Exercises
Trainer's Red Pocketfile of Ready-to-use Exercises

Audio Cassettes

Tips for Presenters
Tips for Trainers

ORDER FORM

Your details

Name ______________________

Position ______________________

Company ______________________

Address ______________________

____

____

Telephone ______________________

Facsimile ______________________

E-mail ______________________

VAT No. (EC companies) ______________________

Your Order Ref ______________________

Please send me:

	No. copies
The Balance Sheet Pocketbook	
The ______________ Pocketbook	
The ______________ Pocketbook	
The ______________ Pocketbook	
The ______________ Pocketbook	

Order by Post

MANAGEMENT POCKETBOOKS LTD

14 EAST STREET ALRESFORD HAMPSHIRE SO24 9EE UK

Order by Phone, Fax or Internet

Telephone: +44 (0)1962 735573
Facsimile: +44 (0)1962 733637
E-mail: pocketbks@aol.com
Web: www.pocketbook.co.uk

Customers in USA should contact:
Stylus Publishing, LLC, 22883 Quicksilver Drive, Sterling, VA 20166-2012
Telephone: 703 661 1581 or 800 232 0223
Facsimile: 703 661 1501 E-mail: styluspub@aol.com