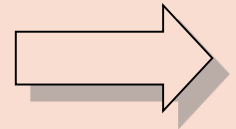


ACCOUNTING AND FINANCE



Use your mouse to move around the software. You can either click anywhere on the screen to get the next animation or click on a button if you see one on the screen.

Always move the mouse before you click it.



ACCOUNTING AND FINANCE

- £ Sources of finance
- £ Budgets and cash flow forecasts
- £ Costs and break even analysis
- £ Final accounts
- £ Ratios and performance

ACCOUNTING AND FINANCE



Sources of finance

In order to set up and run a business, finance is essential.

It is not usually feasible to provide goods or a service without first purchasing ‘the tools of the trade’.

The sources of finance fall broadly into two categories:

INTERNAL

and

EXTERNAL

ACCOUNTING AND FINANCE



Sources of finance

Internal

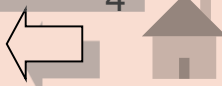
External

Raised from within the business

Supplied by a source outside the business

Remember that the business is a separate entity from the people that run and own it. Even Jim, the self employed window cleaner, is separate from his own business. If Jim sets himself up by buying a van, ladder, bucket and some cloths, out of his savings, he has provided the capital for the business. The business now has:

- The assets – van, ladder, bucket and cloths
- A debt to Jim



ACCOUNTING AND FINANCE



Sources of finance - External

Examples of external sources of finance include:

Savings

Grants

Loans

Overdrafts

Factoring

Finance houses

Shares & debentures



Sources of finance - External

Savings

Grants

Loans

Overdrafts

Factoring

Finance houses

Shares & debentures

Savings could be personal savings or those of a friend or relative.

Advantages:

- **Less formal**
- **More flexible**
- **Fast to arrange**
- **Could use a variety of sources**





Sources of finance - External

Savings

Grants

Loans

Overdrafts

Factoring

Finance houses

Shares & debentures

Savings could be personal savings or those of a friend or relative.

Disadvantages:

- **Lack of formality could lead to disputes**
- **You are less likely to be able to rely on promised finance**
- **Could 'leave you short' in your everyday life**



Sources of finance - External

Savings

Grants

Loans

Overdrafts

Factoring

Finance houses

Shares & debentures

Grants are frequently available to start up and expand businesses.

Advantages:

- **Once agreed, finance is guaranteed**
- **Terms are often inexpensive if the grant is in the form of a loan**
- **You can also use other sources**



Sources of finance - External

Savings

Grants

Loans

Overdrafts

Factoring

Finance houses

Shares & debentures

Grants are frequently available to start up and expand businesses.

Disadvantages:

- **The business will be locked into certain conditions**
- **Type and place of trade may be restrictive**
- **Bureaucracy and paperwork might be onerous**

ACCOUNTING AND FINANCE



Sources of finance - External

Savings

Grants

Loans

Overdrafts

Factoring

Finance houses

Shares & debentures

Grants are frequently available to start up and expand businesses.

Sources include:

- **Local government**
- **Central government**
- **European Union**
- **Charities, welfare organisations etc.**

ACCOUNTING AND FINANCE



Sources of finance - External

Savings

Grants

Loans

Overdrafts

Factoring

Finance houses

Shares & debentures

Grants are frequently available to start up and expand businesses.

Grants are usually available in areas of high unemployment and in threatened skill areas.

IT and manufacturing enterprises frequently attract grants.

ACCOUNTING AND FINANCE



Sources of finance - External

Savings

Grants

Loans

Overdrafts

Factoring

Finance houses

Shares & debentures

Loans are frequently provided by banks, as well as central and local governments in the form of grants.

Loans can be secured or unsecured. A secured loan or mortgage is guaranteed by an asset e.g. a property. If the business defaults on the loan, the lender seizes the asset to regain his investment. These loans are less risky to the lender so cost less.



Sources of finance - External

Savings

Grants

Loans

Overdrafts

Factoring

Finance houses

Shares & debentures

Loans are frequently provided by banks, as well as central and local governments in the form of grants.

Disadvantage of secured loans:

- Secured loans are impossible to get if you have no security**
- Lender has some control over secured asset – you cannot keep the loan and dispose of the asset**





Sources of finance - External

Savings

Grants

Loans

Overdrafts

Factoring

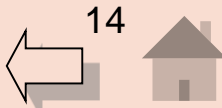
Finance houses

Shares & debentures

Loans are frequently provided by banks, as well as central and local governments in the form of grants.

Advantage of secured loans:

- Secured loans are less expensive**
- They tend to be available for longer periods of time**





Sources of finance - External

Savings

Grants

Loans

Overdrafts

Factoring

Finance houses

Shares & debentures

Loans are frequently provided by banks, as well as central and local governments in the form of grants.

Unsecured loans are more risky to the lender, as it is possible that there will be no assets to seize if the business defaults. As a consequence, unsecured loans tend to be more expensive.





Sources of finance - External

Savings

Grants

Loans

Overdrafts

Factoring

Finance houses

Shares & debentures

Loans are frequently provided by banks, as well as central and local governments in the form of grants.

Advantage of unsecured loans:

- They are available if you have no assets for security

Disadvantage of unsecured loans:

- They are more expensive



ACCOUNTING AND FINANCE



Sources of finance - External

Savings

Grants

Loans

Overdrafts

Factoring

Finance houses

Shares & debentures

Overdrafts can be arranged with a bank and their value can vary on a daily basis.

The previous examples of sources of finance were more suited to long term investment as they were for fixed sums, repayable over longer periods of time. An overdraft would be more appropriate to provide working capital than capital assets.



Sources of finance - External

Savings

Grants

Loans

Overdrafts

Factoring

Finance houses

Shares & debentures

Overdrafts can be arranged with a bank and their value can vary on a daily basis.

Advantages of an overdraft:

- They can be arranged quickly to overcome cash flow problems
- They can be agreed beforehand without a specific purchase being identified





Sources of finance - External

Savings

Grants

Loans

Overdrafts

Factoring

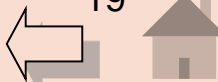
Finance houses

Shares & debentures

Overdrafts can be arranged with a bank and their value can vary on a daily basis.

Disadvantages of an overdraft:

- They can be expensive as they are more risky to the bank
- There is no long term guarantee that the bank will not foreclose on an overdraft – it is difficult to plan ahead in the business



ACCOUNTING AND FINANCE



Sources of finance - External

Savings

Grants

Loans

Overdrafts

Factoring

Finance houses

Shares & debentures

Factoring is the selling on of debts that are owed to the company.

It is common in business to deliver goods to your customer but then not receive the cash for some time. This is frequently 30 days but can be many months. Your customer is effectively using you as a bank overdraft.

ACCOUNTING AND FINANCE



Sources of finance - External

Savings

Grants

Loans

Overdrafts

Factoring

Finance houses

Shares & debentures

Factoring is the selling on of debts that are owed to the company.

Companies exist that will purchase these debts from you. They will pay you a percentage of the outstanding debt but keep all the cash that the debtor finally pays.

Note that some companies never pay and these are called 'bad debtors'.



Sources of finance - External

Savings

Grants

Loans

Overdrafts

Factoring

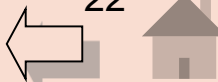
Finance houses

Shares & debentures

Factoring is the selling on of debts that are owed to the company.

Advantages:

- **Cash is liberated quickly to help cash flow**
- **Bad debts can become the responsibility of the factoring company**
- **Saves time chasing debtors**





Sources of finance - External

Savings

Grants

Loans

Overdrafts

Factoring

Finance houses

Shares & debentures

Factoring is the selling on of debts that are owed to the company.

Disadvantages:

- **Factoring companies will often only take on good creditworthy customers who pay on time**
- **It is expensive**



ACCOUNTING AND FINANCE



Sources of finance - External

Savings

Grants

Loans

Overdrafts

Factoring

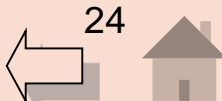
Finance houses

Shares & debentures

Finance Houses

Private companies will provide short, medium and long term loans against the purchase of specific assets.

Additionally, they will lease plant and equipment to businesses.





Sources of finance - External

Savings

Grants

Loans

Overdrafts

Factoring

Finance houses

Shares & debentures

Finance Houses

Advantages:

- Simple to set up
- Flexible
- Leases are available for short periods on short life assets
- Does not require the use of capital to purchase capital assets





Sources of finance - External

Savings

Grants

Loans

Overdrafts

Factoring

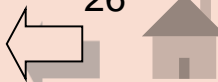
Finance houses

Shares & debentures

Finance Houses

Disadvantages:

- Leases can be difficult to get out of
- The business can be left paying for an obsolete asset





Sources of finance - External

Savings

Grants

Loans

Overdrafts

Factoring

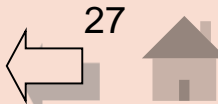
Finance houses

Shares & debentures

Finance Houses

Examples of assets that are frequently financed this way include:

- **Cars on a 2 or 3 year lease**
- **Computers on a 6 to 24 month renewable contract**
- **Photocopiers and other machinery on short term leases**





Sources of finance - External

Savings

Grants

Loans

Overdrafts

Factoring

Finance houses

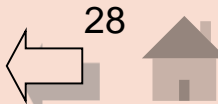
Shares & debentures

Finance Houses

The legal agreements differ.

Under some schemes, the title of the asset eventually passes to the business.

Under others, the asset is returned after the rental period. Full maintenance may well have been included in such an agreement.



ACCOUNTING AND FINANCE



Sources of finance - External

Savings

Grants

Loans

Overdrafts

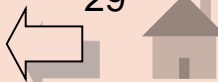
Factoring

Finance houses

Shares & debentures

Finance Houses

Some lease agreements for company cars include full service and repairs and a guaranteed buy back price for the vehicle at the end of the agreement. Penalties would be included for mileage above an agreed annual amount.



ACCOUNTING AND FINANCE



Sources of finance - External

Savings

Grants

Loans

Overdrafts

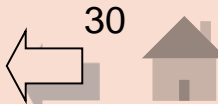
Factoring

Finance houses

Shares & debentures

Finance Houses

Although these sorts of schemes can be expensive, they allow a business to plan its cash flow more accurately which could be much more useful than tying up cash in capital.



ACCOUNTING AND FINANCE



Sources of finance - External

Savings

Grants

Loans

Overdrafts

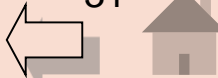
Factoring

Finance houses

Shares & debentures

Finance Houses

You will notice that this method of finance is useful for short life assets with high depreciation.



ACCOUNTING AND FINANCE



Sources of finance - External

Savings

Grants

Loans

Overdrafts

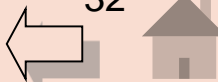
Factoring

Finance houses

Shares & debentures

The types of finance mentioned so far are available to any type of business so long as it is able to persuade the lender to make the investment.

There are other types of finance that are only available to companies that are limited by guarantee. These include private and public limited companies.



ACCOUNTING AND FINANCE



Sources of finance - External

Savings

Grants

Loans

Overdrafts

Factoring

Finance houses

Shares & debentures

We shall look at shares and debentures in more detail. They are made available to private and public limited companies, as the companies have to be run under much stricter control than other enterprises.

Depending on their size, they must make detailed accounts available to holders of shares and debentures.



ACCOUNTING AND FINANCE



Sources of finance - External

Savings

Grants

Loans

Overdrafts

Factoring

Finance houses

Shares & Debentures

Shares - they are exactly what they sound like. If you buy shares in a company, you are buying part of the company. You automatically have rights regarding the running of the company and a right to a share in the assets when the company is wound up.

You can also sell your shares on to another person.



ACCOUNTING AND FINANCE



Sources of finance - External

Savings

Grants

Loans

Overdrafts

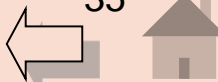
Factoring

Finance houses

Shares & Debentures

Ordinary Shares - Allow you to have voting rights and a share of the profits (dividend) but it is at a variable rate and the company does not have to pay a dividend every year.

Ordinary share holders' dividends are the last to be paid out of profit. They are also the last to be paid when a company is wound up.





Sources of finance - External

Savings

Grants

Loans

Overdrafts

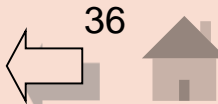
Factoring

Finance houses

Shares & Debentures

Preference Shares - do not usually allow you to have voting rights but do give you a fixed share of the profit (preference dividend). It is paid before the ordinary shares' dividend at a fixed rate so you are more likely to get it.

Preference shares are sometimes cumulative so if the dividend is not paid one year, it is made up when dividends can be afforded.



ACCOUNTING AND FINANCE



Sources of finance - External

Savings

Grants

Loans

Overdrafts

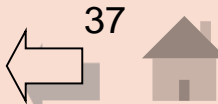
Factoring

Finance houses

Shares & Debentures

Dividends are not paid if profits are low and the company cannot afford to pay them. It may also be that cash is short - perhaps cash is required to fund a new investment. Shareholders could be happy about this as future profits might be higher.

The shareholders can raise cash themselves by selling their shares.



ACCOUNTING AND FINANCE



Sources of finance - External

Savings

Grants

Loans

Overdrafts

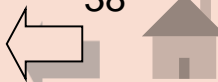
Factoring

Finance houses

Shares & Debentures

If a business is wound up, preference shareholders will collect their share of the proceeds before ordinary shareholders.

You will notice that there is a greater risk attached to ordinary shares, but as their dividend is not fixed, there is the potential for greater rewards when profits are high.



ACCOUNTING AND FINANCE



Sources of finance - External

Savings

Grants

Loans

Overdrafts

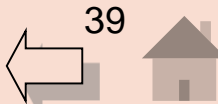
Factoring

Finance houses

Shares & Debentures

The advantages of raising finance by a share issue include:

- **It can be simple**
- **Dividends don't have to be paid if profits are low**
- **The workforce and directors themselves may invest in their own company, improving their motivation**





Sources of finance - External

Savings

Grants

Loans

Overdrafts

Factoring

Finance houses

Shares & Debentures

The disadvantages of raising finance by a share issue include:

- **It can be complex and time consuming and expensive to set up initially**
- **Existing shareholders' interests in the company can be diluted**



Sources of finance - External

Savings

Grants

Loans

Overseas

Factoring

Finance houses

Shares & Debentures

A creditor is a person who owes money to the company.

Debentures are sometimes called loan stock. Holders of debentures are not members of the company and so have no voting rights.

Debentures are secured on the assets of the company. If the company fails to pay the interest due on the debentures, the creditor can seize the assets and dispose of them to regain his money.

ACCOUNTING AND FINANCE



Sources of finance - External

Savings

Grants

Loans

Overdrafts

Factoring

Finance houses

Shares & Debentures

Debentures are sometimes called loan stock. Holders of debentures are not members of the company and so have no voting rights.

Debentures are secured on the assets of the company. If the company fails to pay the interest due on the debentures, the creditor can seize the assets and dispose of them to regain his money.

ACCOUNTING AND FINANCE



Sources of finance - External

Savings

Grants

Loans

Overdrafts

Factoring

Finance houses

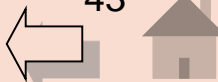
Shares & Debentures

Advantages include:

Good for long term planning

Disadvantages include:

Large creditors of the company have little interest in the running and performance of the company beyond payment of their interest.



ACCOUNTING AND FINANCE



Sources of finance - Internal

Examples of
internal sources
of finance
include:

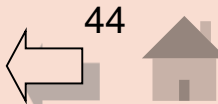
Investing surplus cash

Reducing stocks

Retained profits

Selling assets

Trade credit





Sources of finance - Internal

Investing surplus cash

Reducing stocks

Retained profits

Selling assets

Trade credit

If surplus cash is invested, it should gain interest. This interest, along with the possible proceeds of the sale of the original investment, is available as a source of finance for the company.





Sources of finance - Internal

Investing surplus cash

Reducing stocks

Retained profits

Selling assets

Trade credit

Advantages: this is a simple and reliable method of looking after surplus cash.





Sources of finance - Internal

Investing surplus cash

Reducing stocks

Retained profits

Selling assets

Trade credit

Disadvantages: assuming the company is not an investment company, perhaps the cash could be better employed within the company, earning profits. A strong company would generate wealth faster by employing cash within its own business rather than investing it outside.





Sources of finance - Internal

Investing surplus cash

Reducing stocks

Retained profits

Selling assets

Trade credit

Carrying stock from month to month absorbs cash. If stock levels fall, creditors will be paid less, releasing cash within the business.

It might be possible to achieve this by not reordering as much new stock or returning unused stock to suppliers.





Sources of finance - Internal

Investing surplus cash

Reducing stocks

Retained profits

Selling assets

Trade credit

Some suppliers will provide stock on a sale or return basis. In rare cases, some suppliers will allow you to keep their stock in your warehouse ready for you to use, but not invoice you until you tell them that you have used it - this is very rare.





Sources of finance - Internal

Investing surplus cash

Reducing stocks

Retained profits

Selling assets

Trade credit

Advantages:

- a very simple process
- associated costs might well fall too, such as storage costs
- inexpensive
- no administrative burden
- no increase in external control from creditors





Sources of finance - Internal

Investing surplus cash

Reducing stocks

Retained profits

Selling assets

Trade credit

Disadvantages:

- unreliable for long term
- possible to cause delays in delivery of your own products
- less able to take advantage of bulk purchasing power
- more frequent, more expensive smaller deliveries





Sources of finance - Internal

Investing surplus cash

Reducing stocks

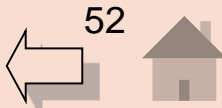
Retained profits

Selling assets

Trade credit

Slowing down the renewal cycle of assets has a similar effect to reducing stock but takes place over a much longer period of time.

For example, if vehicles are replaced every four years instead of every three, a saving might be made.



ACCOUNTING AND FINANCE



Sources of finance - Internal

Investing surplus cash

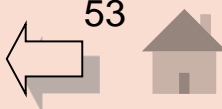
Reducing stocks

Retained profits

Selling assets

Trade credit

Profits that are made within the business can be retained rather than being distributed to shareholders as dividends.





Sources of finance - Internal

Investing surplus cash

Reducing stocks

Retained profits

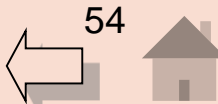
Selling assets

Trade credit

Advantages:

- **inexpensive**
- **not subject to external control**

This is a good method of financing both long and short term acquisitions, mainly due to its low cost and retention of company structure.





Sources of finance - Internal

Investing surplus cash

Reducing stocks

Retained profits

Selling assets

Trade credit

Disadvantages:

- can leave the company cash poor
- shareholders might wish to see the profit distributed as dividends

Note that a company that returns a profit might still not have sufficient cash to make a capital investment.



ACCOUNTING AND FINANCE



Sources of finance - Internal

Investing surplus cash

Reducing stocks

Retained profits

Selling assets

Trade credit

Disposal of company assets can be used to raise finance.

Examples include selling off old, redundant plant and machinery or relocating premises to cheaper accommodation.



ACCOUNTING AND FINANCE



Sources of finance - Internal

Investing surplus cash

Reducing stocks

Retained profits

Selling assets

Trade credit

**Disposal of company assets
can be used to raise finance.**

Advantages:

- **inexpensive**
- **can be very fast**





Sources of finance - Internal

Investing surplus cash

Reducing stocks

Retained profits

Selling assets

Trade credit

Disposal of company assets can be used to raise finance.

Disadvantages:

- **you have to have surplus assets to dispose of if you are not to damage the company**
- **second-hand and scrap values can be very low**





Sources of finance - Internal

Investing surplus cash

Reducing stocks

Retained profits

Selling assets

Trade credit

Taking longer to pay your creditors can be used to raise finance. Cash that would have otherwise been used to pay creditors can be diverted elsewhere.

Advantages:

- inexpensive and fast





Sources of finance - Internal

Investing surplus cash

Reducing stocks

Retained profits

Selling assets

Trade credit

Taking longer to pay your creditors can be used to raise finance. Cash that would have otherwise been used to pay creditors can be diverted elsewhere.

Disadvantages:

- can create problems restocking if creditors are unhappy with repayment terms



ACCOUNTING AND FINANCE



Sources of finance - Internal

Investing surplus cash

Reducing stocks

Retained profits

Selling assets

Trade credit

When companies are in trouble financially, they will often take credit from any creditors that they can. These include, the Inland Revenue (late payment of tax and national insurance), Customs and Excise (VAT) and even their workforce.

The price of such behaviour is extremely high.





Sources of finance

Whatever form of finance is chosen, it should match the nature of the expenditure that is going to be incurred.

Generally speaking, the purchase of fixed assets that will serve the company for many years should be financed through long term finance that matches the life of the asset. Similarly, short term finance should only be used to fund short term projects. This allows careful, accurate cash flows to be projected and will help to ensure the financial stability of the company.

Clearly, paying your creditors for last month's purchases from the sale of a £2m printing press that is important to the business is a bad move!



Budgets and cash flow forecasts

The main function of any business enterprise is to make a profit. Clearly, it is sensible to think about this before moving forward with the enterprise.

The construction of a budget will allow managers to plan for the future.

It should be noted that when constructing a budget, it is important to match expenditure to income. A company might order its raw materials in May, use them in June and pay for them in July, finally selling them in August. In a budget, the cost should be recognised when the income is recognised i.e. when the sales are invoiced.

ACCOUNTING AND FINANCE



Budgets and cash flow forecasts

An effective budgeting system is complex but would follow this outline:

Sales Budget - the number of sales to be made, the revenue from each sale and total sales figure

Production Budget - the number of items that will need to be made and the cost of making them

Fixed Asset Budget - the cost of purchasing any additional fixed assets including plant, machinery and premises and the timing of these purchases

Departmental Budgets - the costs associated to departments that are not directly involved in manufacture, such as administration and advertising

The time periods for such budgets vary from firm to firm but monthly is not uncommon and annually is essential to anticipate the financial statements.



Budgets and cash flow forecasts

The budgets can then be used to:

- Introduce an element of **control** by comparing the budget to actual figures and reconciling (explaining) the differences
- **Plan for the future** - looking back at a comparison between budgeted figures and actual figures can help managers identify changes that will improve performance in the future
- Take speedy **corrective or preventative action** by carefully watching actual performance against the budget
- **Set performance targets** - these can be related to bonuses and performance related pay in order to increase the workforce's commitment to the company



Budgets and cash flow forecasts

For budgets to be effective, they should be **integrated** and **flexible**. A budget will be **flexed** so that managers can see what the consequences would be if sales figures fell, or the costs of raw materials were to rise.

A **fully integrated budget** contains all the elements of the budgets of the departments in the enterprise.

However, the budget will be useless if the company cannot pay its bills so it is essential to consider the possible cash flows as a consequence of the budget.



Budgets and **cash flow forecasts**

Future flows of working capital are called **cash flow forecasts** or just cash forecasts.

Cash flow forecasts are essential as otherwise:

- creditors might not be paid
- wages might not be paid
- early settlement discounts might be missed
- cash surpluses might not be fully utilised



Budgets and **cash flow forecasts**

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- cash surpluses might not be fully utilised



This could result in:

- Creditors refusing to supply additional purchases
- Creditors offering less favourable terms



Budgets and cash flow forecasts

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- wages might not be paid
- early settlement discounts might be missed
- cash surpluses might not be fully utilised

This could result in:

- Key staff not working and output decreasing

- The permanent

loss of staff including key staff



ACCOUNTING AND FINANCE



Budgets and cash flow forecasts

Future flows of working capital are called **cash flow forecasts** or just cash forecasts.

Cash flow forecasts are essential as otherwise:

- creditors might not be paid
- wages might not be paid
- early settlement discounts might be missed
- cash surpluses might not be fully utilised

This could result in:

- Purchases being more expensive
- Staff becoming de-motivated as they do not feel that their efforts to support the firm are being supported by

the finance
department





Budgets and **cash flow forecasts**

Future flows of working capital are called **cash flow forecasts** or just cash forecasts.

Cash flow forecasts are essential as otherwise:

- creditors might not be paid
- wages might not be paid
- early settlement discounts might be missed
- cash surpluses might not be fully utilised

This could result in:

- Investment opportunities being missed



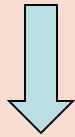
ACCOUNTING AND FINANCE



Budgets and cash flow forecasts

Cash flow forecasts preparation requires that:

Cash **receipts** are
identified



These are
inflows of cash



Cash **payments** are
identified



These are
outflows of cash



It will be necessary to determine

- when the flow occurs
- how much the cash flow is for

ACCOUNTING AND FINANCE



Budgets and cash flow forecasts

		Mar	Apr	May
		£000	£000	£000
Inflows	Sales	500	400	450
	Other	10	20	5
Total Inflows		510	420	455
Outflows	Materials	200	300	250
	Wages	25	30	30
	Rent	10	10	10
	Heat and Lighting	15	0	15
	Fixed Assets	0	45	0
	Tax and VAT	10	47	12
	Other Expenses	23	22	15
	Total Outflows		283	454
Net Surplus (deficit)		227	-34	123
	B/Fwd	-125	102	68
	C/Fwd	102	68	191

ACCOUNTING AND FINANCE



Budgets and cash flow forecasts

		Mar	Apr	May
		£000	£000	£000
Inflows	Sales	500	400	450
	Other	10	20	5
Total Inflows		510	420	455
Outflows	Materials	15	20	20
	Wages	25	30	30
	Rent	10	10	10
	Marketing	10	10	15
	Fixed Assets	0	45	0
	Tax and VAT	10	47	12
	Other Expenses	23	22	15
	Total Outflows	283	454	332
Net Surplus (deficit)		227	-34	123
	B/Fwd	-125	102	68
	C/Fwd	102	68	191

All cash flows should be inclusive of VAT

ACCOUNTING AND FINANCE



Budgets and cash flow forecasts

		Mar	Apr	
		£000	£000	
Inflows	Sales	500	400	
	Other	10	20	
Total Inflows		510	420	
Outflows	Materials	200	300	
	Wages	25	30	
	Rent	10	10	10
	Heat and Lighting	15	0	15
	Fixed Assets	0	45	0
	Tax and VAT	10	47	12
	Other Expenses	23	22	15
	Total Outflows		283	454
Net Surplus (deficit)		227	-34	123
	B/Fwd	-125	102	68
	C/Fwd	102	68	191

Other inflows of cash might include:

- Proceeds from the sale of fixed assets or investment
- Tax refunds
- Grants
- Investment income

ACCOUNTING AND FINANCE



Budgets and cash flow forecasts

		Mar	Apr	May
		£000	£000	£000
Inflows	Sales	500	400	450
	Other	10	20	5
Total Inflows		510	420	455
Outflows	Materials	200	300	250
	Wages	25	30	30
	Rent	10	10	10
	Heat and Lighting	15	0	
	Fixed Assets	0	45	
	Tax and VAT	10	47	
	Other Expenses	23	22	
	Total Outflows		283	454
Net Surplus (deficit)		227	-34	
	B/Fwd	-125	102	68
	C/Fwd	102	68	191

A deficit is not necessarily a bad thing.

It could be to finance the purchases for a large sale in the future or even the purchase of an essential fixed asset.

ACCOUNTING AND FINANCE



Budgets and cash flow forecasts

		Mar	Apr	May
		£000	£000	£000
Inflows	Sales	500	400	450
	Other	10	20	5
Total Inflows		510	420	455
Outflows	Materials	200	300	250
	Wages	25	30	30
	Rent	10	10	
	Heat and Lighting	15	0	
	Fixed Assets	0	45	
	Tax and VAT	10	47	
	Other Expenses	23	22	
Total Outflows		283	454	
Net Surplus (deficit)		227	-34	
	B/Fwd	-125	102	
	C/Fwd	102	68	191

You will often see a deficit and negative figures written like this:

(34)

The brackets indicate that it is negative (a deduction).



ACCOUNTING AND FINANCE

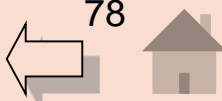
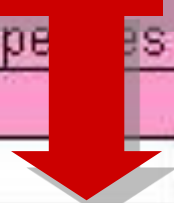


Budgets and cash flow forecasts

		Mar	Apr	May
		£000	£000	£000
Inflows	Sales	500	400	450
	Other	10	20	5
Total Inflows		510	420	455
Outflows		200	300	250
		25	30	30
		10	10	10
		15	0	15
		0	45	0
		10	47	12
	Other Expenses	23	22	15
Total Outflows		283	454	332
Net Surplus (deficit)		227	-34	123
	B/Fwd	-125	102	68
	C/Fwd	102	68	191

B/Fwd stands for 'brought forward'.

It is the final balance from the previous period (a month in this case).



ACCOUNTING AND FINANCE



Budgets and cash flow forecasts

		Mar	Apr	May
		£000	£000	£000
Inflows	Sales	500	400	450
	Other	10	20	5
Total Inflows		510	420	455
Outflows	Wages	200	300	250
	Materials	25	30	30
	Utilities	10	10	10
	Depreciation	15	0	15
	Interest	0	45	0
	Dividends	10	47	12
Other Expenses	23	22	15	
Total Outflows		283	454	332
Net Surplus (deficit)		227	-34	123
	Balance b/d	-125	102	68
	C/Fwd	102	68	191

C/Fwd stands for 'carried forward'.

It is the final balance to be used as the opening balance in the next period.



ACCOUNTING AND FINANCE

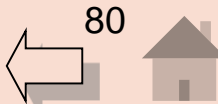


Budgets and cash flow forecasts

		Mar	Apr	May
		£000	£000	£000
Inflows	Sales	500	400	450
	Other	20	20	20
Total Inflows		520	420	470
Outflows	Materials	200	250	250
	Wages	25	30	30
	Rent	10	10	10
	Heat and Lighting	15	0	0
	Fixed Assets	0	45	45
	Tax and VAT	10	47	12
	Other Expenses	23	22	15
Total Outflows		283	454	332
Net Surplus (deficit)		227	-34	123
	B/Fwd	-125	102	68
	C/Fwd	102	68	191

The sales figure for March is actually £500,000 (1/2 a million pounds).

The three zeros after the pound sign indicate that the figures are in thousands of pounds.



ACCOUNTING AND FINANCE



Costs and break even analysis

The costs that a company has to suffer can be considered as the bills that it has to pay but there are some subtle differences in the kinds of costs that a business experiences. Consider the following costs:

Wages for production staff

Salaries for office staff

Rent for office space

Purchases of raw materials

Buying stationery

Advertising

Buying a car for the sales

Electricity for the workshop

Petrol for the salesman's car

Corporation tax

Oil for the machinery in the workshop

VAT

Insurance

Buying a machine for the workshop

These fall into four categories as follows:



ACCOUNTING AND FINANCE



Costs and break even analysis

Costs fall into four categories as follows:

Wages for production staff

Salaries for office staff

Rent for office space

Purchases of raw materials

Buying stationery

Advertising

Buying a car for the sales staff

Electricity for the workshop

Petrol for the salesman's car

Corporation tax

Oil for the machinery in the workshop

VAT

Insurance

Buying a new machine for the workshop

ACCOUNTING AND FINANCE



Costs and break even analysis

Insurance

Electricity for the workshop

Petrol for the salesman's car

Purchases of raw materials

Salaries for office staff

Wages for production staff

Rent for office space

Oil for the machinery in the workshop

Buying stationery

Corporation tax

Advertising

VAT

Buying a car for the sale staff

We shall consider each type of cost in turn.

Buying a new machine for the workshop

ACCOUNTING AND FINANCE



Costs and break even analysis

Electricity for the workshop

Purchases of raw materials

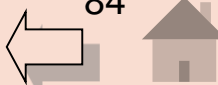
Wages for production staff

Oil for the machinery in the workshop

These costs also **VARY** with the amount of goods produced. The more the firm produces, the greater the costs.

These costs are connected **DIRECTLY** to production. The more the firm produces, the greater the costs.

Costs that are directly connected to the cost of production or vary with the amount produced are called **DIRECT COSTS** or **VARIABLE COSTS**.



ACCOUNTING AND FINANCE



Costs and break even analysis

Insurance

Petrol for the salesman's car

Salaries for office staff

Rent for office space

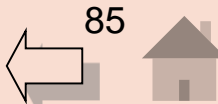
Buying stationery

Advertising

Even if the business ceased manufacture for a few weeks, they would still incur these fixed costs.

These costs are not connected directly to production. They are costs associated with the running of the business.

Costs that are not directly associated with production are called **FIXED COSTS** or **OVERHEADS**.





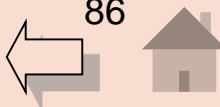
Costs and break even analysis

When a company is making a decision regarding taking on a contract, it will be necessary to consider the impact that the decision will have.

Will the additional costs related to the company impact on **VARIABLE COSTS**?

This is highly likely as additional raw materials and labour will be required. It would be important to consider how these can be funded. Increasing output could imply using staff that are paid overtime, making the product too expensive to be worthwhile producing.

Variable costs will always feature in changes in production.





Costs and break even analysis

When a company is making a decision regarding taking on a contract, it will be necessary to consider the impact that the decision will have.

Will the additional costs related to the company impact on **OVERHEADS?**

This is less likely. The firm should however consider the following: will more admin staff be required? Do we need more floor space? Will we need more salesmen? Will increased sales mean higher insurance costs? Etc.

A decrease in production might mean that overheads can be saved too – e.g. sublet floor space that is no longer needed.

ACCOUNTING AND FINANCE



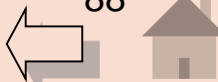
Costs and break even analysis

Break even analysis is the method that is used to see when a firm will reach a point at which their revenue (sales income) is equal to their total costs (fixed and variable).

It is easiest to understand by considering an example:

Mike sells burgers from a caravan in a lay-by on the A249. He rents the caravan and equipment from his sister for £20 a week, uses £5 of gas a week and buys his rolls and fillings for 10p and 40p respectively. He is very fortunate that he can buy these one at a time from a supermarket just behind his caravan! He sells his burgers for £1 each.

Let us start by putting the information into a more manageable form.



ACCOUNTING AND FINANCE



Costs and break even analysis

Mike's total overheads are £25 per week.

Mike sells burgers from a caravan in a lay-by on the A249. He rents the caravan and equipment from his sister for £20 a week, uses £5 of gas a week and buys his rolls and fillings for 10p and 40p respectively. He is very fortunate that he can buy these one at a time from a supermarket just behind his caravan! He sells his burgers for £1 each.

No matter how many burgers he sells, he will have to pay £20 for rent and £5 for gas. These costs are

OVERHEADS

ACCOUNTING AND FINANCE



Costs and break even analysis

Mike's total overheads are £25 per week.

Mike's total variable costs are 50p per sale.

Mike sells burgers from a caravan in a lay-by on the A249. He rents the caravan and equipment from his sister for £20 a week, uses £5 of gas a week and buys his rolls and fillings for 10p and 40p respectively. He is very fortunate that he can buy these one at a time from a supermarket just behind his caravan! He sells his burgers for £1 each.

He will have to buy a filling at 40p and a roll at 10p for every burger he sells. These are

VARIABLE COSTS

ACCOUNTING AND FINANCE



Costs and break even analysis

Mike's total overheads are £25 per week.

Mike's sales revenue is £1 per burger.

Mike's total variable costs are 50p per sale.

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Mike will take £1 every time he sells a burger.

ACCOUNTING AND FINANCE



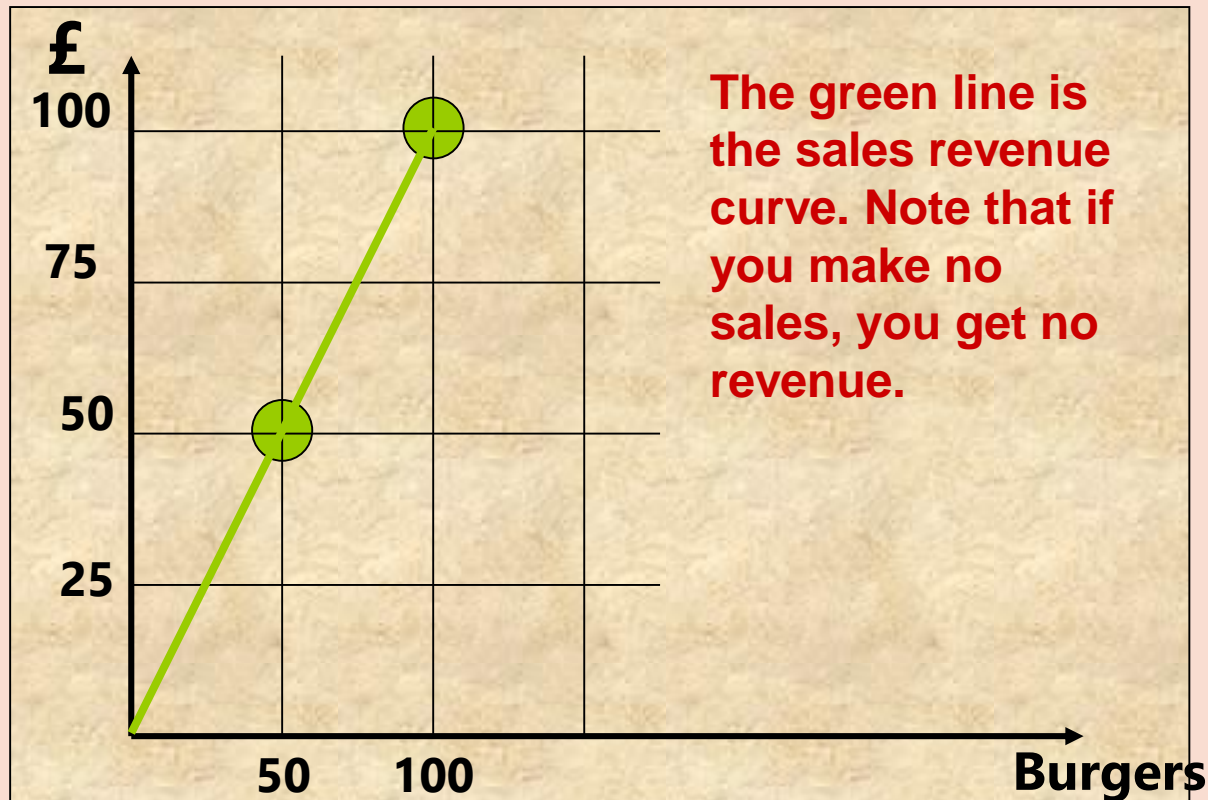
Costs and **break even analysis**

Mike's total overheads are £25 per week.

Mike's sales revenue is £1 per burger.

Mike's total variable costs are 50p per sale.

Let's see what happens if he sells 50 or even 100 burgers:



50 burgers:

Sales £50.00

Variable costs £25.00

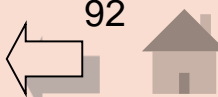
Fixed costs £25.00

100 burgers:

Sales £100.00

Variable costs £50.00

Fixed costs £25.00



ACCOUNTING AND FINANCE



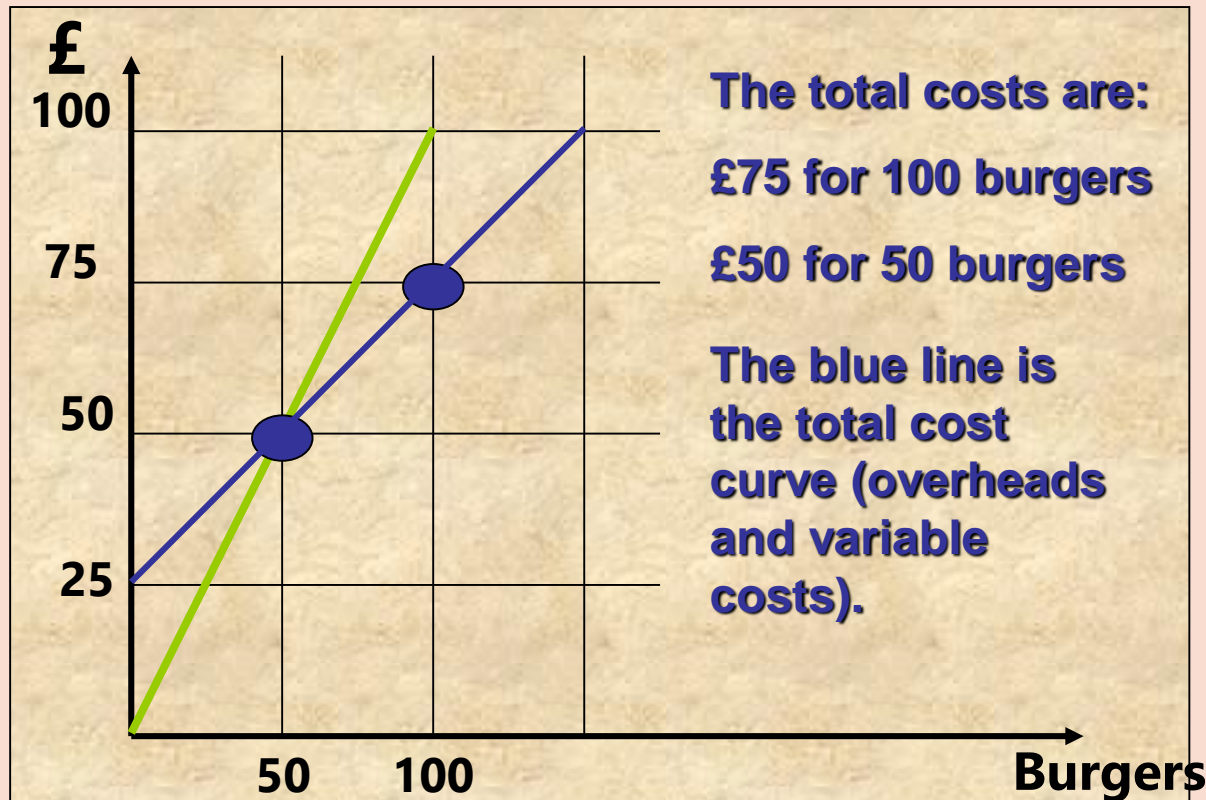
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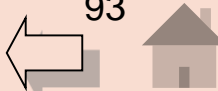
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Variable costs £50.00

Fixed costs £25.00



ACCOUNTING AND FINANCE



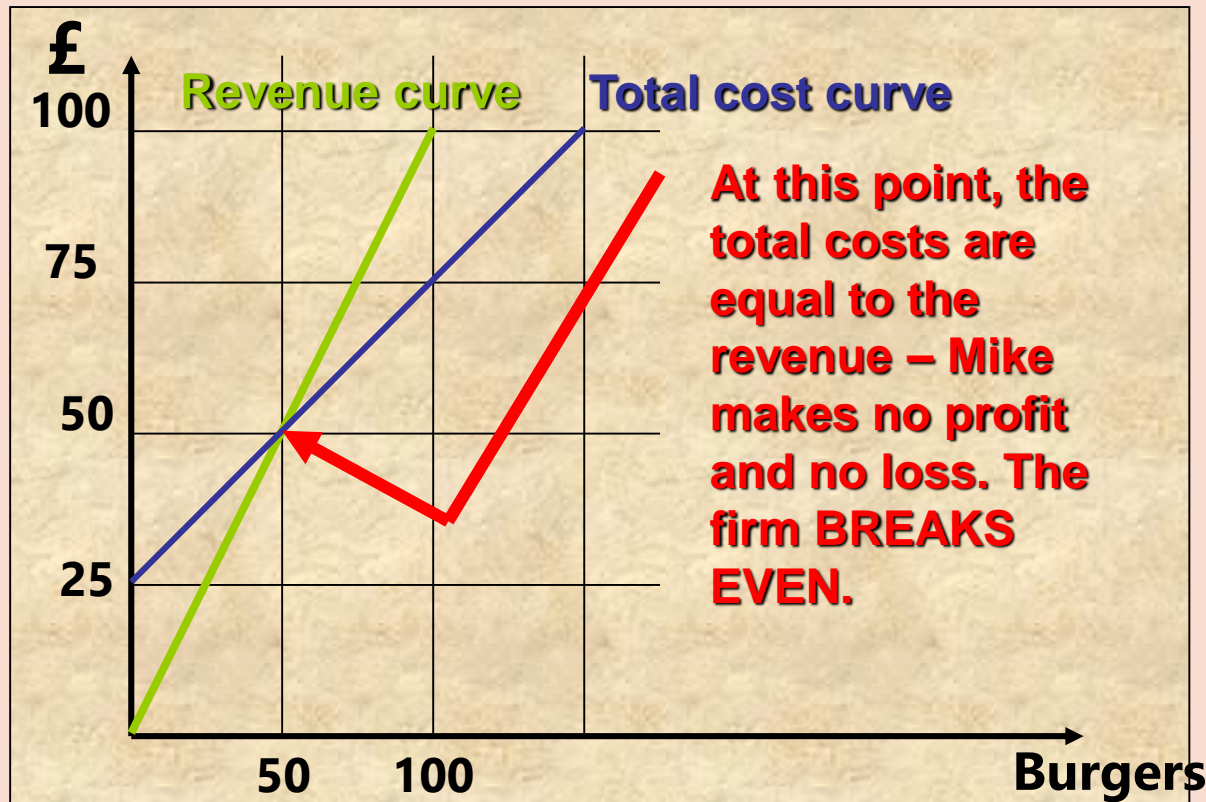
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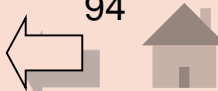
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Variable costs £50.00

Fixed costs £25.00



ACCOUNTING AND FINANCE



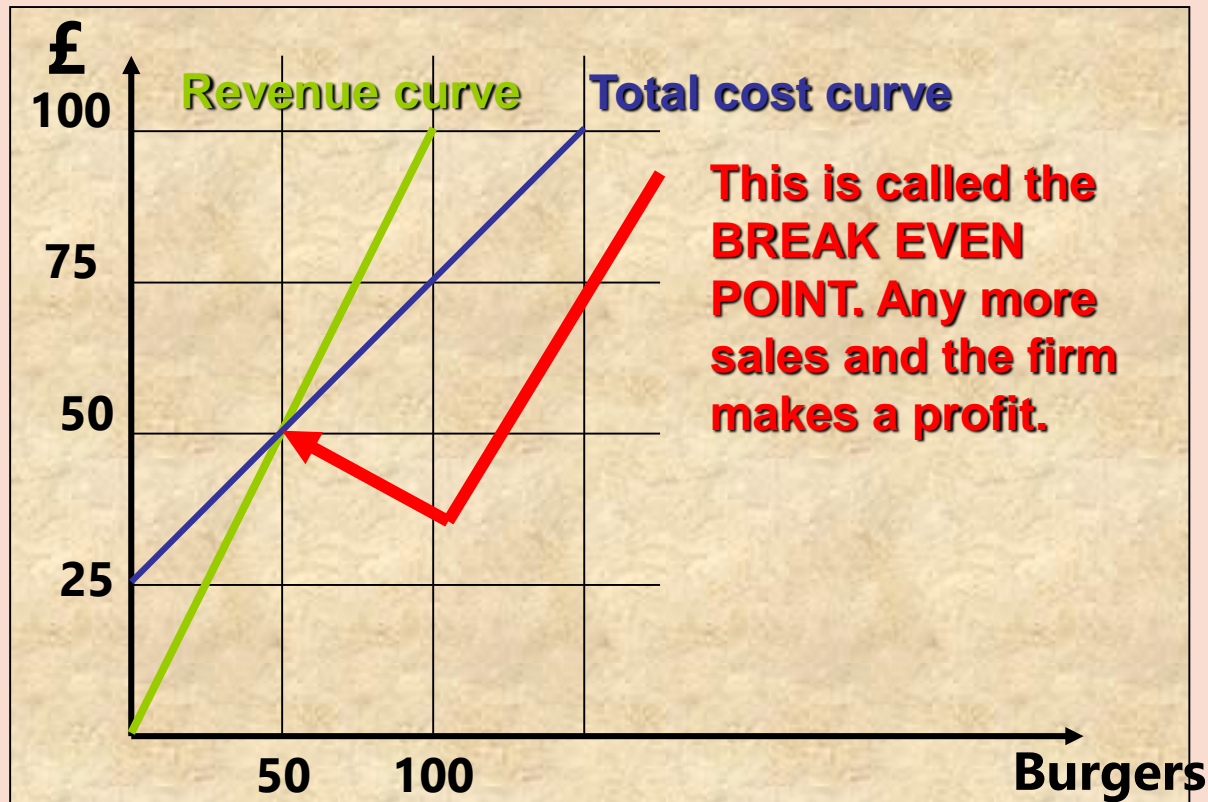
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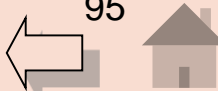
Fixed costs £25.00

100 burgers:

Sales £100.00

Variable costs £50.00

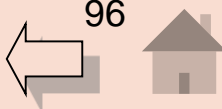
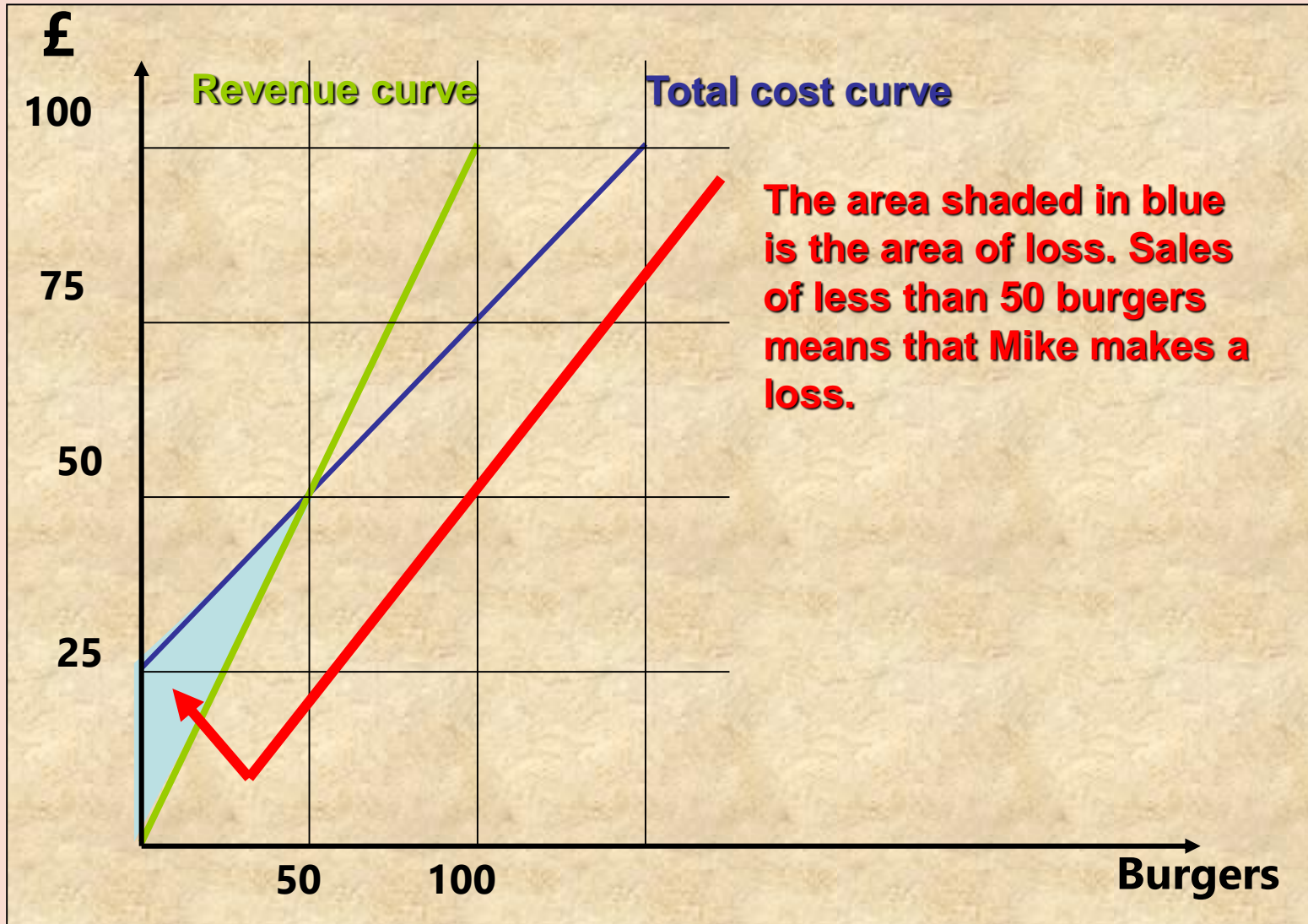
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ACCOUNTING AND FINANCE



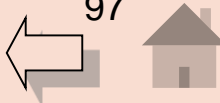
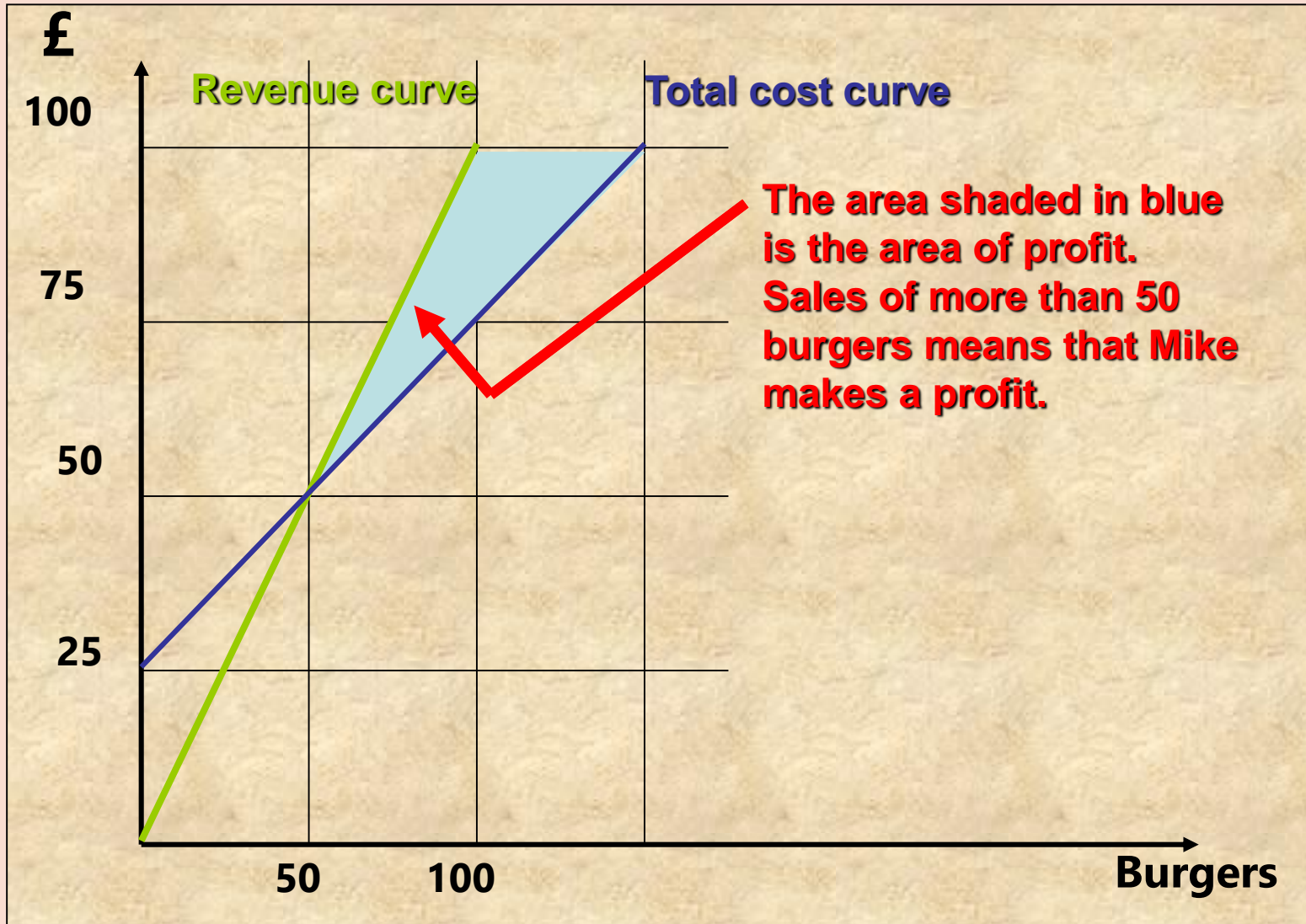
Costs and **break even analysis**



ACCOUNTING AND FINANCE



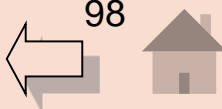
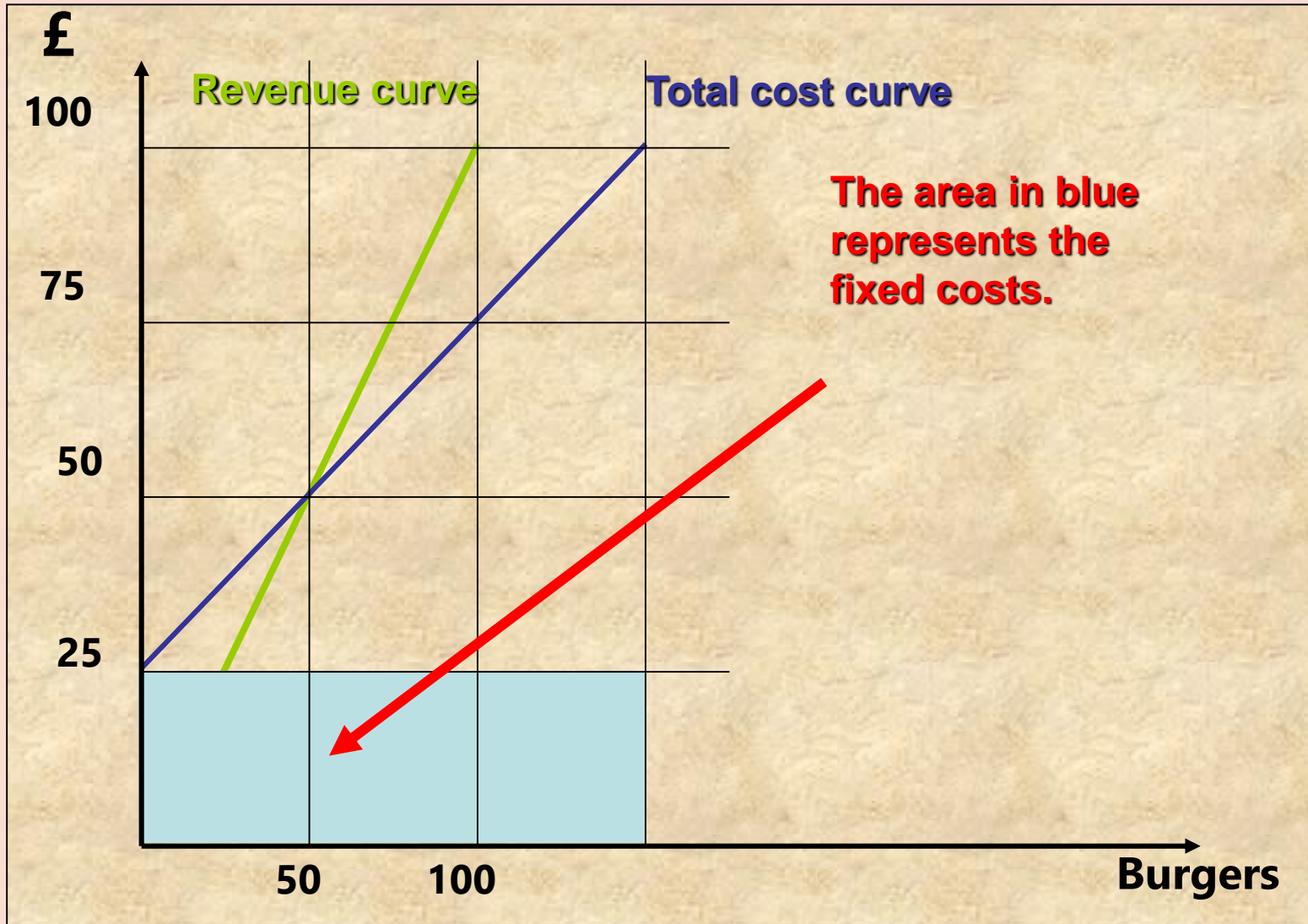
Costs and **break even analysis**



ACCOUNTING AND FINANCE



Costs and **break even analysis**

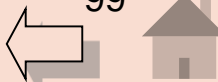
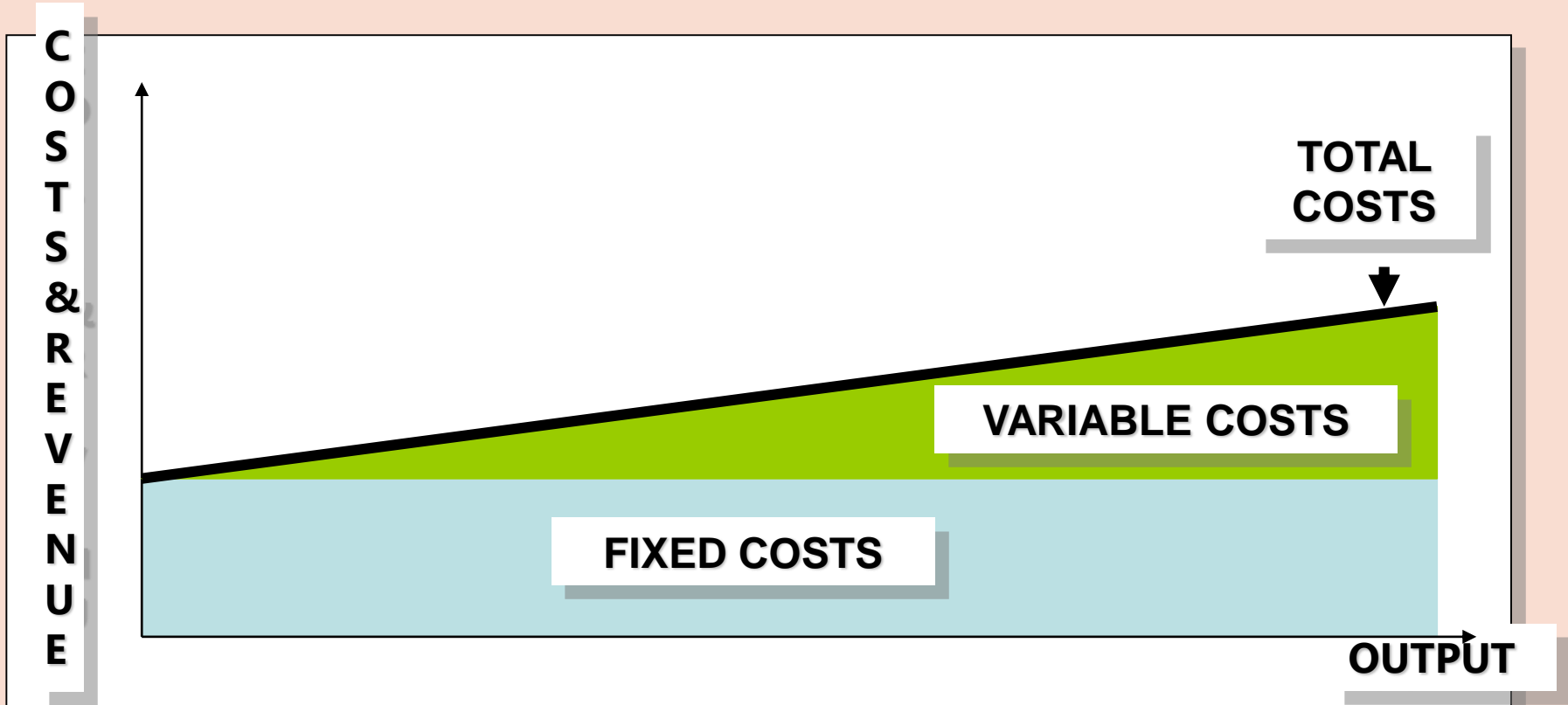


ACCOUNTING AND FINANCE



Costs and break even analysis

BREAK EVEN CHART SUMMARY

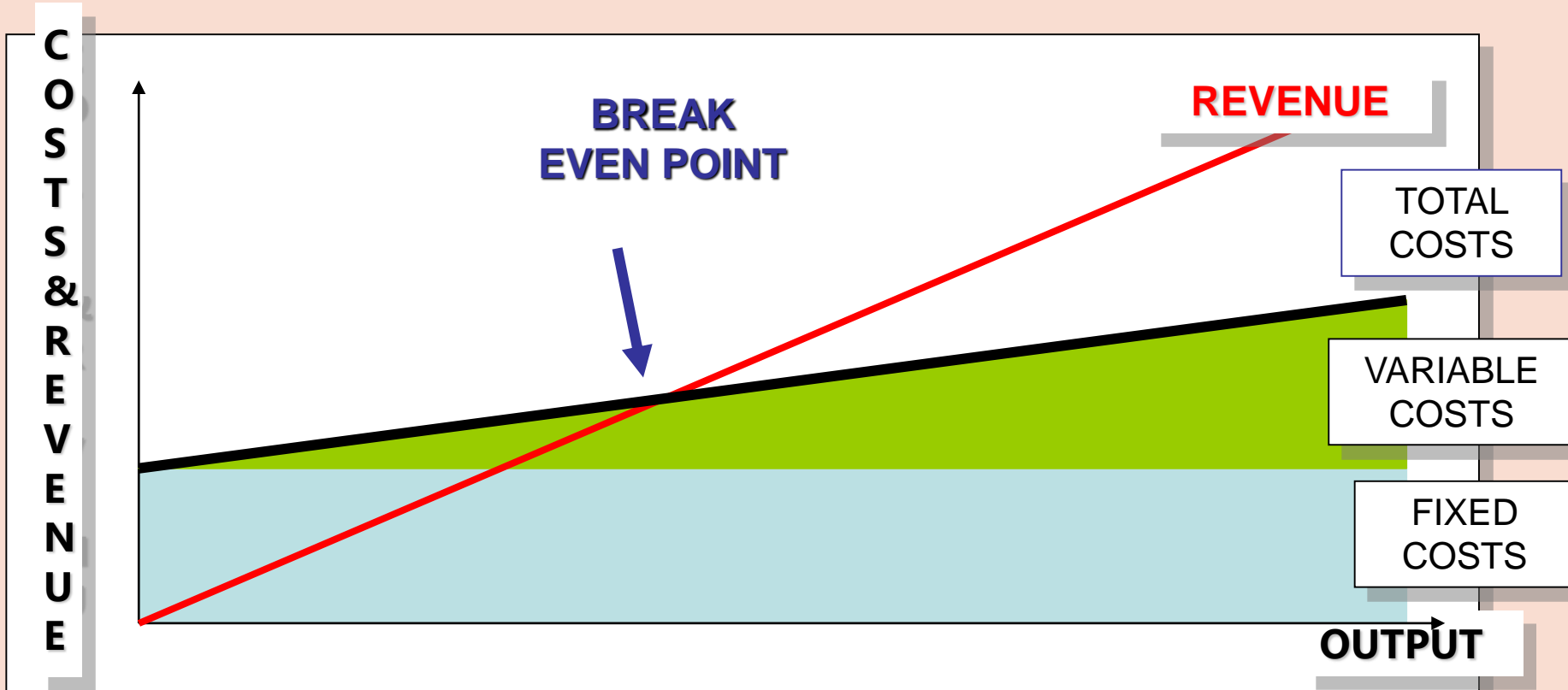


ACCOUNTING AND FINANCE



Costs and **break even analysis**

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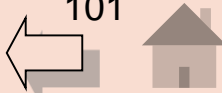
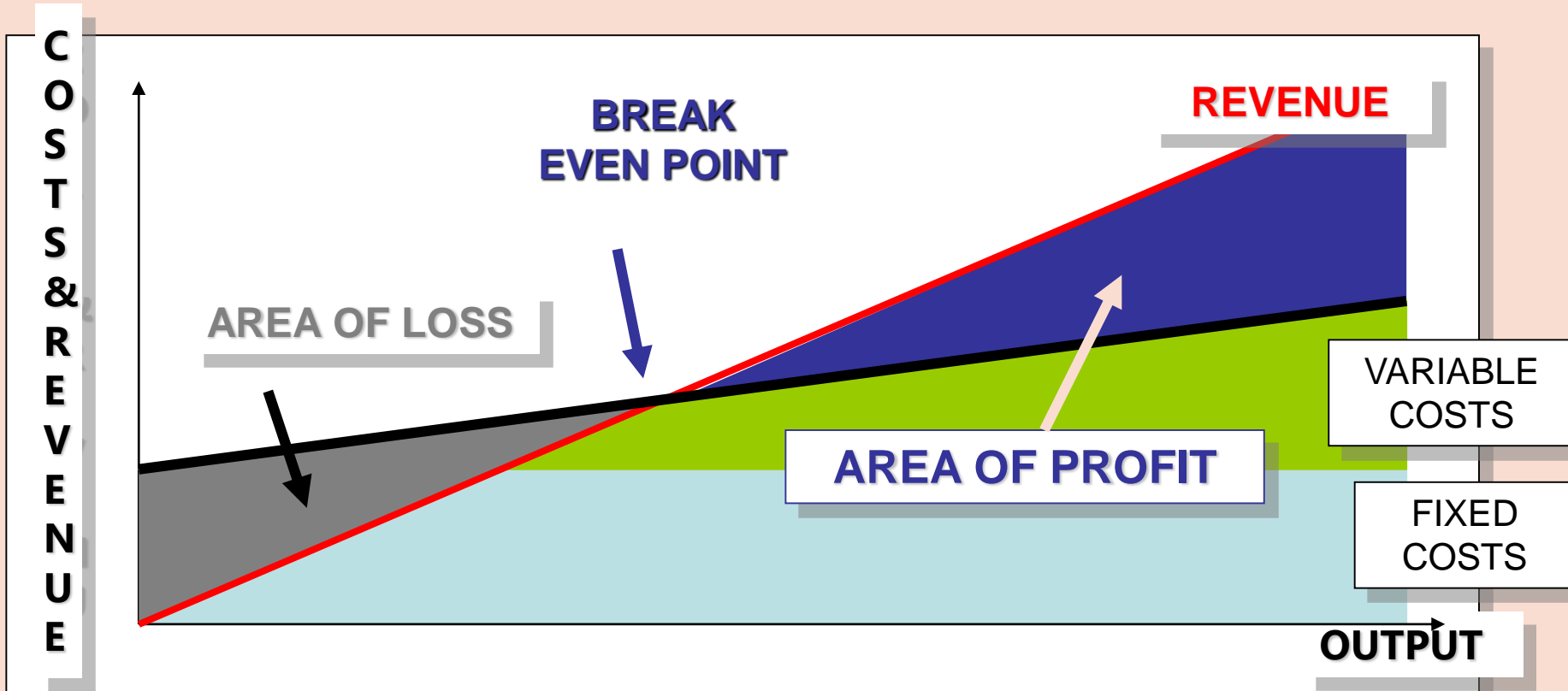


ACCOUNTING AND FINANCE



Costs and **break even analysis**

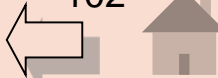
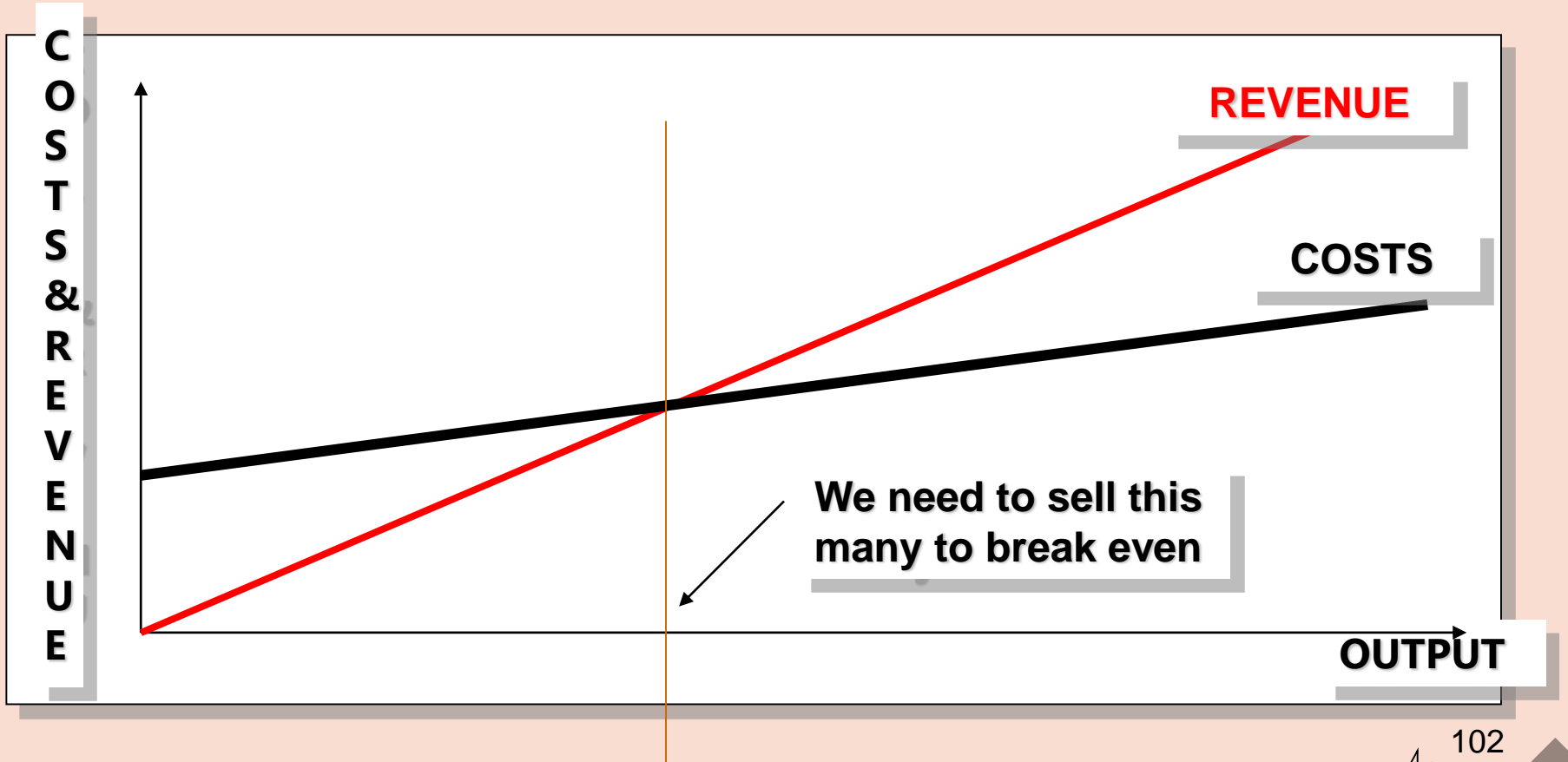
BREAK EVEN CHART SUMMARY





Costs and **break even analysis**

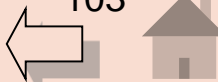
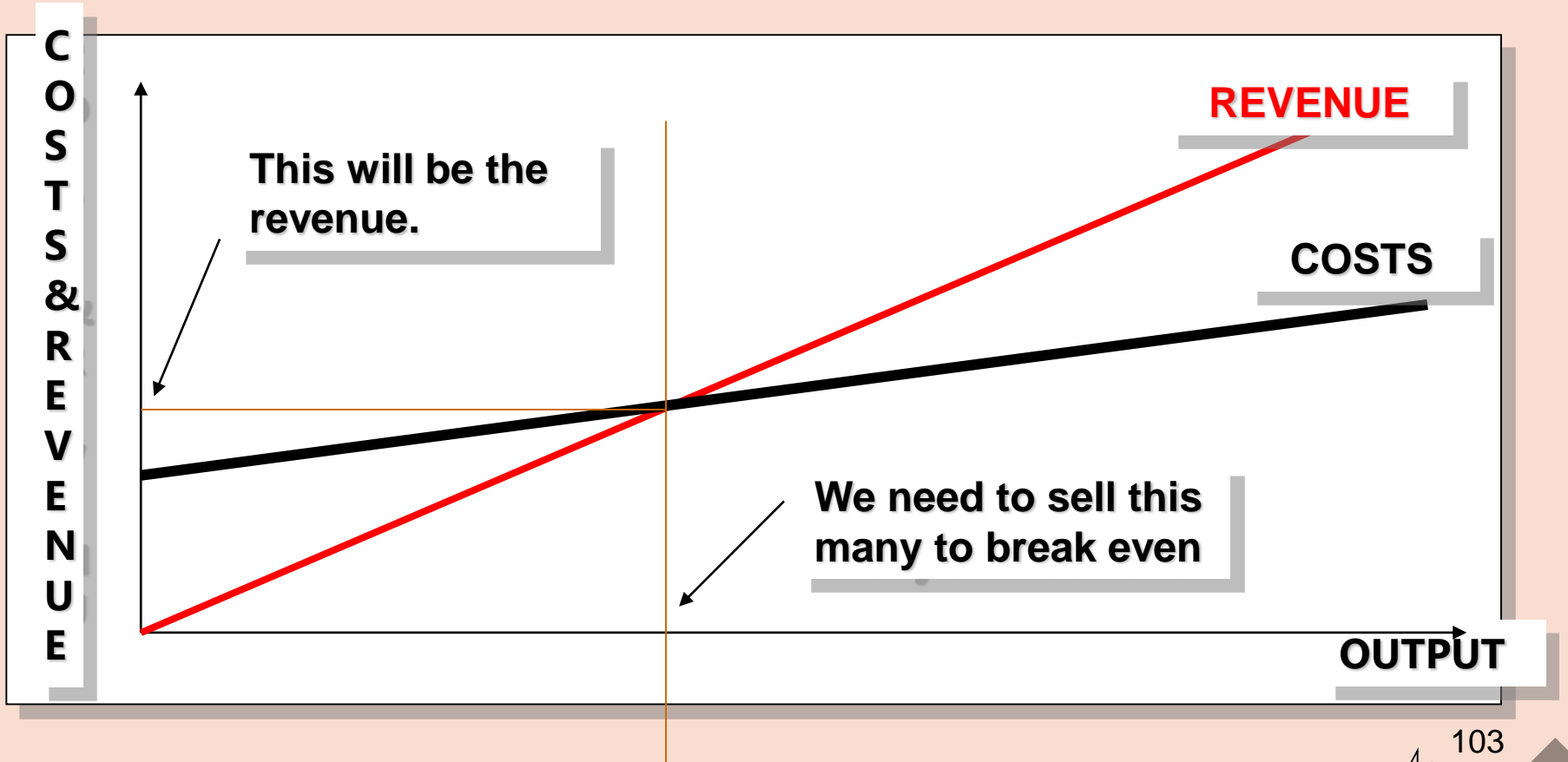
BREAK EVEN CHART SUMMARY





Costs and **break even analysis**

BREAK EVEN CHART SUMMARY





Costs and break even analysis

Sales Price – Variable Costs = Contribution

This is the contribution towards covering the fixed costs.

When the break even point has been reached, the fixed costs will have been covered.

Financially, it is always worth selling another item if it makes a contribution to fixed costs, even if overall, the firm is still making a loss – it will make a smaller loss!

We can rearrange the formula to get:

Contribution = Sales Price – Variable Costs

What is the contribution of Mike's 11th burger?

ACCOUNTING AND FINANCE



Costs and break even analysis

Contribution = Sales Price – Variable costs

What is the contribution of Mike's 11th burger?

Mike's total overheads are £25 per week.

Mike's sales revenue is £1 per burger.

Mike's total variable costs are 50p per sale.

Contribution = £1.00 – 50p = 50p

In fact, every burger Mike sells up to his break even point, contributes 50p to fixed costs.



Final accounts

Every year, most trades will produce (or have produced for them), a set of “final accounts”.

These reflect the way that the firm has traded during the year and the state of the firm on the last day of that year.

Users of final accounts include:

- Potential investors
- Current investors
- Current and potential trading partners
- Current and potential customers
- Current and potential suppliers
- The Inland Revenue
- Customs and Excise



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To confirm the firm's performance, investors could include the bank providing an overdraft facility or loan.





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- Current and potential suppliers
- The Inland Revenue
- Customs and Excise



To confirm the firm's performance, investors could include the bank providing an overdraft facility or loan.

Is it time to consider changing the investment?





Final accounts

Every year, most trades will produce (or have produced for them), a set of “final accounts”.

These reflect the way that the firm has traded during the year and the state of the firm on the last day of that year.

Users of final accounts include:

- Potential investors
- Current investors
- Current and potential trading partners
- Current and potential customers
- Current and potential suppliers
- The Inland Revenue
- Customs and Excise

Shareholders will be interested in a company's accounts .





Final accounts

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Users of final accounts include:

- Potential investors
- Current investors
- Current and potential trading partners ←
- Current and potential customers
- Current and potential suppliers
- The Inland Revenue
- Customs and Excise

If your trade relies on the trade of others, you will want to be abreast of their financial position.

Competitors will also be interested in each others' accounts.





Final accounts

Every year, most trades will produce (or have produced for them), a set of “final accounts”.

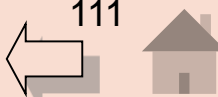
These reflect the way that the firm has traded during the year and the state of the firm on the last day of that year.

Users of final accounts include:

- Potential investors
- Current investors
- Current and potential trading partners
- Current and potential customers ←
- Current and potential suppliers ←
- The Inland Revenue
- Customs and Excise

If a firm trades with another firm, it will be concerned with its long term financial viability.

Final accounts can be an indicator of this.





Final accounts

Every year, most trades will produce (or have produced for them), a set of “final accounts”.

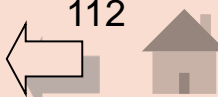
These reflect the way that the firm has traded during the year and the state of the firm on the last day of that year.

Users of final accounts include:

- Potential investors
- Current investors
- Current and potential trading partners
- Current and potential customers
- Current and potential suppliers
- The Inland Revenue ←
- Customs and Excise

Tax liabilities of companies, partnerships and sole traders are calculated on the adjusted profits of final accounts.

All traders will submit some form of accounts to the “Revenue”.





Final accounts

Every year, most trades will produce (or have produced for them), a set of “final accounts”.

These reflect the way that the firm has traded during the year and the state of the firm on the last day of that year.

Users of final accounts include:

- Potential investors
- Current investors
- Current and potential trading partners
- Current and potential customers
- Current and potential suppliers
- The Inland Revenue
- Customs and Excise

VAT inspectors will frequently try to reconcile a firm's sales figures with those supplied on their VAT returns. They will also compare the figures in the accounts to similar trades to look for fraud.





Final accounts

The trading account sets out the performance of the company over the past year in its basic trade.

The trading account is concerned only with the revenues and costs associated with the principle business of the firm.

It will contain details of the direct / variable costs but not the overheads. It will include revenue from the sale of goods but not from the disposal of assets.

Typically:

Turnover

Cost of sales

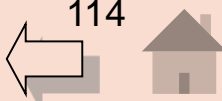
Gross profit



This is the total revenue (income) from sales.

If the firm charges VAT, turnover is quoted excluding VAT.

It should only include sales made within the year.





Final accounts

The trading account sets out the performance of the company over the past year in its basic trade.

The trading account is concerned only with the revenues and costs associated with the principle business of the firm.

It will contain details of the direct / variable costs but not the overheads. It will include revenue from the sale of goods but not from the disposal of assets.

Typically:

Turnover

Cost of sales

Gross profit



This is the total of the variable costs of production associated with those sales. It can be broken down further as we shall see later.





Final accounts

The trading account sets out the performance of the company over the past year in its basic trade.

The trading account is concerned only with the revenues and costs associated with the principle business of the firm.

It will contain details of the direct / variable costs but not the overheads. It will include revenue from the sale of goods but not from the disposal of assets.

Typically:

Turnover

Cost of sales

Gross profit



**This is the profit that
been made purely by
the sale of the
products sold but
excluding the cost of
any overheads.**



ACCOUNTING AND FINANCE



Final accounts

A full trading account would look more like this:

The value of stock that the firm had at the start of the year.



Turnover	£	120
Opening Stock	10	
Purchases	55	
Less Closing Stock	<u>(15)</u>	
Cost of Sales		<u>(50)</u>
Gross Profit		70

Note that in many financial statements, negative numbers (numbers to be subtracted) are written in brackets as the closing stock and cost of sales are here.

ACCOUNTING AND FINANCE



Final accounts

A full trading account would look more like this:

The value of stock that the firm purchased during the year.



	£	£
Turnover		120
Opening Stock	10	
Purchases	55	
Less Closing Stock	<u>(15)</u>	
Cost of Sales		<u>(50)</u>
Gross Profit		70

ACCOUNTING AND FINANCE



Final accounts

A full trading account would look more like this:

The value of stock that the firm had left at the end of the year.

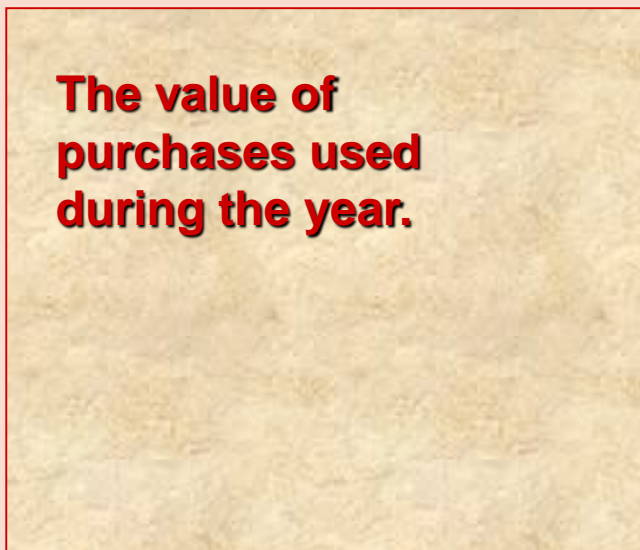
Turnover	£	120
Opening Stock	10	
Purchases	55	
Less Closing Stock	<u>(15)</u>	
Cost of Sales		<u>(50)</u>
Gross Profit		70

ACCOUNTING AND FINANCE



Final accounts

A full trading account would look more like this:



	£	£
Turnover		120
Opening Stock	10	
Purchases	55	
Less Closing Stock	<u>(15)</u>	
Cost of Sales		<u>(50)</u>
Gross Profit		70

ACCOUNTING AND FINANCE



Final accounts

A full **trading account** would look more like this:

	£	£
Turnover		120
Opening Stock	10	
Purchases	55	
Less Closing Stock	<u>(15)</u>	
Cost of Sales		<u>(50)</u>
Gross Profit		70

Clearly, we also need to include the overheads of the firm if we are to reflect their whole trade over the year. This is achieved using a **profit and loss account**,

ACCOUNTING AND FINANCE



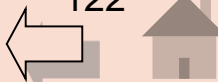
Final accounts

A **Profit and Loss account** might look like this:

These three lines are the trading account that we have already seen.

Here, the figures in red are subtracted.

	£	£
	000's	000's
Turnover		1,250
Cost of sales		230
Gross profit		1,020
Overheads		
Employee costs	50	
Premises costs	70	
Admin costs	110	
Motor expenses	25	
Travelling & subsistence	10	
Advertising	90	
Legal fees	5	
Bad debts	1	
Interest	27	
Other finance charges	36	
Depreciation and loss/profit on disposal	10	
Other expenses	5	
		419
Net Profit		1,439



ACCOUNTING AND FINANCE



Final accounts

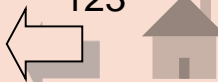
A **Profit and Loss account** might look like this:

All the overheads are then listed in various categories. Not every set of accounts has the same categories.

These expenses exclude VAT for a VAT trader who has reclaimed the VAT.

The total figure for all the overheads appears at the bottom of the list.

	£	£
	000's	000's
Turnover		1,250
Cost of sales		230
Gross profit		1,020
Overheads		
Employee costs	50	
Premises costs	70	
Admin costs	110	
Motor expenses	25	
Travelling & subsistence	10	
Advertising	90	
Legal fees	5	
Bad debts	1	
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ACCOUNTING AND FINANCE



Final accounts

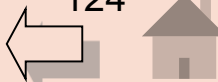
A **Profit and Loss account** might look like this:

The term 'Bad debts' is either

- a provision for a debtor that you do not expect to pay you
- a write off of debtors who you know will never pay you
- or a mixture of the two.



	£	£
	000's	000's
Turnover		1,250
Cost of sales		230
Gross profit		1,020
Overheads		
Employee costs	50	
Premises costs	70	
Admin costs	110	
Motor expenses	25	
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ACCOUNTING AND FINANCE

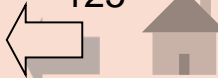


Final accounts

A **Profit and Loss account** might look like this:

Depreciation is a charge that is made to the profit and loss account to account for the use of fixed assets that have been bought by the firm. E.g. if the firm buys a £2,000,000 machine with an expected life of 20 years, they might charge the profit and loss account £100,000 every year.

	£ 000's	£ 000's
Turnover		1,250
Cost of sales		230
Gross profit		1,020
Overheads		
Employee costs	50	
Premises costs	70	
Admin costs	110	
Motor expenses	25	
Travelling & subsistence	10	
Advertising	90	
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ACCOUNTING AND FINANCE

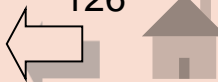


Final accounts

A **Profit and Loss account** might look like this:

Loss on disposal is the loss that could be made when disposing of a fixed asset. Suppose the machine is sold after 1 year for £500,000. Its value in the accounts is £900,000, as £100,000 depreciation was charged last year. So the loss on disposal would be £400,000.

	£	£
	000's	000's
Turnover		1,250
Cost of sales		230
Gross profit		1,020
Overheads		
Employee costs	50	
Premises costs	70	
Admin costs	110	
Motor expenses	25	
Travelling & subsistence	10	
Advertising	90	
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ACCOUNTING AND FINANCE

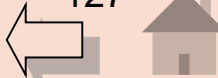


Final accounts

A **Profit and Loss account** might look like this:

Profit on disposal is the profit that could be made when disposing of a fixed asset. Suppose the machine is sold after 1 year for £1,200,000. Its value in the accounts is £900,000, as £100,000 depreciation was charged last year. So the profit on disposal would be £300,000.

	£	£
	000's	000's
Turnover		1,250
Cost of sales		230
Gross profit		1,020
Overheads		
Employee costs	50	
Premises costs	70	
Admin costs	110	
Motor expenses	25	
Travelling & subsistence	10	
Advertising	90	
Legal fees	5	
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ACCOUNTING AND FINANCE



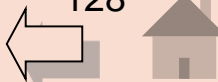
Final accounts

A **Profit and Loss account** might look like this:

Note that the list of overheads is a list of expenses to the firm – that is why they are subtracted from the gross profit.

If the firm makes a profit on disposal, this will be like an income so will be negative in the list of expenses.

	£ 000's	£ 000's
Turnover		1,250
Cost of sales		230
Gross profit		1,020
Overheads		
Employee costs	50	
Premises costs	70	
Admin costs	110	
Motor expenses	25	
Travelling & subsistence	10	
Advertising	90	
Legal fees	5	
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ACCOUNTING AND FINANCE

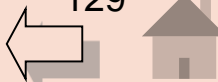


Final accounts

A **Profit and Loss account** might look like this:

The net profit is what is left after the expenses of trading. Further deductions that might be made from company accounts, after the net profit, include dividends paid to share holders and taxation.

	£	£
	000's	000's
Turnover		1,250
Cost of sales		230
Gross profit		1,020
Overheads		
Employee costs	50	
Premises costs	70	
Admin costs	110	
Motor expenses	25	
Travelling & subsistence	10	
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ACCOUNTING AND FINANCE



Final accounts

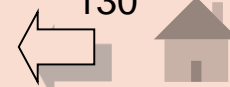
A **Profit and Loss account** might look like this:

The profit and loss account gives a picture of the firm's performance over the year.

Note that final accounts can be prepared for periods of longer or shorter than a year.

The profit and loss account will relate to the 'period' of the accounts.

	£ 000's	£ 000's
Turnover		1,250
Cost of sales		230
Gross profit		1,020
Overheads		
Employee costs	50	
Premises costs	70	
Admin costs	110	
Motor expenses	25	
Travelling & subsistence	10	
Advertising	90	
Legal fees	5	
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ACCOUNTING AND FINANCE



Final accounts

A **Profit and Loss account** might look like this:

There are various other names that you will hear in the media such as:

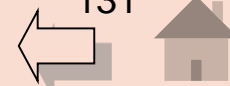
The revenue line

&

The bottom line

These are not accepted terms.

	£ 000's	£ 000's
Turnover		1,250
Cost of sales		230
Gross profit		1,020
Overheads		
Employee costs	50	
Premises costs	70	
Admin costs	110	
Motor expenses	25	
Travelling & subsistence	10	
Advertising	90	
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ACCOUNTING AND FINANCE



Final accounts

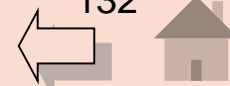
A **Profit and Loss account** might look like this:

It is almost standard practice to put last year's figures alongside this year's figures.

Last year's figures are called **comparatives**.

They are included to enable readers to draw their own conclusions about how the firm is progressing.

	£ 000's	£ 000's
Turnover		1,250
Cost of sales		230
Gross profit		1,020
Overheads		
Employee costs	50	
Premises costs	70	
Admin costs	110	
Motor expenses	25	
Travelling & subsistence	10	
Advertising	90	
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ACCOUNTING AND FINANCE



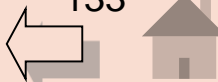
Final accounts

A **Profit and Loss account** might look like this:

Companies with share capital are taxed in their own right. A charge for taxation would be made after the net profit.

Sole traders are taxed individually as a person rather than the business so a charge for tax will not occur in the accounts.

	£ 000's	£ 000's
Turnover		1,250
Cost of sales		230
Gross profit		1,020
Overheads		
Employee costs	50	
Premises costs	70	
Admin costs	110	
Motor expenses	25	
Travelling & subsistence	10	
Advertising	90	
Legal fees	5	
Bad debts	1	
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ACCOUNTING AND FINANCE

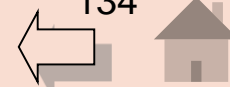


Final accounts

A **Profit and Loss account** might look like this:

Partnerships are also taxed. Sometimes a charge to tax will occur in the accounts but sometimes it is excluded from the accounts on the grounds that it is the partners who are taxed and not the partnership itself.

	£	£
	000's	000's
Turnover		1,250
Cost of sales		230
Gross profit		1,020
Overheads		
Employee costs	50	
Premises costs	70	
Admin costs	110	
Motor expenses	25	
Travelling & subsistence	10	
Advertising	90	
Legal fees	5	
Bad debts	1	
Interest	27	
Other finance charges	36	
Depreciation and loss/profit on disposal	10	
Other expenses	5	
		419
Net Profit		1,439



ACCOUNTING AND FINANCE



Final accounts

A **BALANCE SHEET** reflects the company's financial position on the last day of the period for which the accounts are prepared.

The balance sheet reflects what the assets of the company are worth, what its liabilities are and how the firm is funded.

Due to the variety of ways that firms can be funded, there are a variety of formats that the balance sheet can take. However, general practice could be summarised as follows:

Note that the sum of the balances on the top of the balance sheet are equal to the sum of the balances on the lower part.

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	(200)
	<u>1,300</u>
Profit brought forward	1,100
Profit for the year	100
Share capital	100
	<u>1,300</u>



ACCOUNTING AND FINANCE



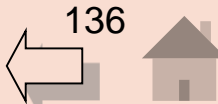
Final accounts

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The balance sheet reflects what the assets of the company are worth, what its liabilities are and how the firm is funded.

The top section of the balance sheet contains the net effect of what the firm owns – its excess of assets over liabilities.

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u>1,300</u>
Profit brought forward	1,100
Profit for the year	100
Share capital	<u>100</u>
	<u>1,300</u>



ACCOUNTING AND FINANCE



Final accounts

A **BALANCE SHEET** reflects the company's financial position on the last day of the period for which the accounts are prepared.

The balance sheet reflects what the assets of the company are worth, what its liabilities are and how the firm is funded.

The top section of the balance sheet contains the net effect of what the firm owns – its excess of assets over liabilities.

The bottom section reflects the ownership of the firm.

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u>1,300</u>
Profit brought forward	1,100
Profit for the year	100
Share capital	<u>100</u>
	<u>1,300</u>



ACCOUNTING AND FINANCE



Final accounts

A **BALANCE SHEET** reflects the company's financial position on the last day of the period for which the accounts are prepared.

The balance sheet reflects what the assets of the company are worth, what its liabilities are and how the firm is funded.

The fixed assets represent the value of items purchased for use in the business which are anticipated to last for more than the usual accounting period.

A charge for the use of these assets is made to the profit and loss account every year. This represents the use of the asset, matched to the income that it produced. This charge decreases the value of the asset in the balance sheet.

This charge is called **depreciation**.

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	(200)
	<hr/>
	1,300
	<hr/>
Profit brought forward	1,100
Profit for the year	100
Share capital	100
	<hr/>
	1,300
	<hr/>



ACCOUNTING AND FINANCE

Final accounts

A **BALANCE SHEET** reflects the company's financial position on the last day of the period for which the accounts are prepared.

The balance sheet reflects what the assets of the company are worth, what its liabilities are and how the firm is funded.

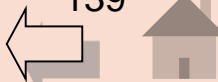
WIP stands for work-in-progress. Stock and work-in-progress includes:

- Raw materials
- Partly made goods
- Finished products yet unsold

All of these items must have a foreseeable use within the firm, otherwise they are written off to purchases in the trading account.

Stock is valued at the lower of cost and net realisable value – how much the firm could 'get for it'.

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u>1,300</u>
Profit brought forward	1,100
Profit for the year	100
Share capital	<u>100</u>
	<u>1,300</u>



ACCOUNTING AND FINANCE



Final accounts

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The balance sheet reflects what the assets of the company are worth, what its liabilities are and how the firm is funded.

The 'Debtors' figure represents all money that is owed to the firm. This will usually be collectable within less than the accounting period.

Typical debtors include:

Trade debtors – customers that owe money to the firm

Customs & Excise – VAT that is being reclaimed by the company (this is a net figure where, unusually, liabilities are set off against assets).

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	(200)
	<hr/>
	1,300
Profit brought forward	1,100
Profit for the year	100
Share capital	100
	<hr/>
	1,300



ACCOUNTING AND FINANCE



Final accounts

A **BALANCE SHEET** reflects the company's financial position on the last day of the period for which the accounts are prepared.

The balance sheet reflects what the assets of the company are worth, what its liabilities are and how the firm is funded.

All cash and bank or building society balances are included here.

Cash would include petty cash – the money that is kept handy to pay the window cleaner etc.

Bank balances do not include overdrafts, which would be included under liabilities.

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u>1,300</u>
Profit brought forward	1,100
Profit for the year	100
Share capital	<u>100</u>
	<u>1,300</u>



ACCOUNTING AND FINANCE



Final accounts

A **BALANCE SHEET** reflects the company's financial position on the last day of the period for which the accounts are prepared.

The balance sheet reflects what the assets of the company are worth, what its liabilities are and how the firm is funded.

Liabilities are often split between those falling in less than and more than one year. They are amounts owed by the firm.

This can include bank overdrafts, bank loans, hire purchase agreements, VAT and tax liabilities, debentures, proposed and as yet unpaid dividends.

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	(200)
	<hr/>
	1,300
Profit brought forward	1,100
Profit for the year	100
Share capital	100
	<hr/>
	1,300

ACCOUNTING AND FINANCE



Final accounts

A **BALANCE SHEET** reflects the company's financial position on the last day of the period for which the accounts are prepared.

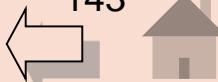
The balance sheet reflects what the assets of the company are worth, what its liabilities are and how the firm is funded.

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u>1,300</u>
Profit brought forward	1,100
Profit for the year	100
Share capital	<u>100</u>
	<u>1,300</u>

This is the cumulative profit from previous years.



It excludes previous distributions of profit such as dividends to shareholders.



ACCOUNTING AND FINANCE



Final accounts

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	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u>1,300</u>
Profit brought forward	1,100
Profit for the year	100
Share capital	<u>100</u>
	<u>1,300</u>

This is the undistributed profit transferred from the profit and loss account.



Undistributed means after any dividends paid to shareholders.



ACCOUNTING AND FINANCE



Final accounts

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	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u>1,300</u>
Profit brought forward	1,100
Profit for the year	100
Share capital	<u>100</u>
	<u>1,300</u>

This is the capital invested by shareholders.



ACCOUNTING AND FINANCE



Final accounts

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The balance sheet reflects what the assets of the company are worth, what its liabilities are and how the firm is funded.

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	(200)
	<hr/>
	1,300
	<hr/>
Profit brought forward	1,100
Profit for the year	100
Retained profit	100
	<hr/>
	1,300
	<hr/>

A sole trader's balance sheet could look like this:



ACCOUNTING AND FINANCE



Final accounts

A BALANCE SHEET

The balance sheet reflects what the assets of the company are worth, what its liabilities are and how the firm is funded.

Partnership accounts could look like this:

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u>1,300</u>
Partners' capital and current accounts brought forward	1,100
Profit for the year	100
Partners' capital and current accounts carried forward	<u>100</u>
	<u>1,300</u>



ACCOUNTING AND FINANCE



Final accounts

A **BALANCE SHEET** reflects the company's financial position on the last day of the period for which the accounts are prepared.

The balance sheet reflects what the assets of the company are worth, what its liabilities are and how the firm is funded.

This figure is sometimes called the balance sheet total.

It is sometimes thought of as the net worth of the company.

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	(200)
	<hr/>
	1,300
	<hr/> <hr/>
Profit brought forward	1,100
Profit for the year	100
Retained profit	100
	<hr/>
	1,300
	<hr/> <hr/>



ACCOUNTING AND FINANCE



Final accounts

A **BALANCE SHEET** reflects the company's financial position on the last day of the period for which the accounts are prepared.

The balance sheet reflects what the assets of the company are worth, what its liabilities are and how the firm is funded.

The balance sheet is designed to give a snap shot picture of the financial state of affairs of a company on a particular day.

The information included within it and the profit and loss account is subject to certain codes of practice and for incorporated firms, by statute too.

Like the profit and loss account, comparatives are nearly always provided too.

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u>1,300</u>
Profit brought forward	1,100
Profit for the year	100
Retained profit	<u>100</u>
	<u>1,300</u>



ACCOUNTING AND FINANCE



Final accounts

A **BALANCE SHEET** reflects the company's financial position on the last day of the period for which the accounts are prepared.

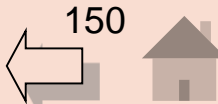
The balance sheet reflects what the assets of the company are worth, what its liabilities are and how the firm is funded.

There are many other balances that we have not considered but common sense will often help you to decide how to include them.

Where would you include the long term investments (shares) held in other companies?

Close to fixed assets would seem a reasonable place as they will be held for a long time.

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u>1,300</u>
Profit brought forward	1,100
Profit for the year	100
Retained profit	<u>100</u>
	<u>1,300</u>



ACCOUNTING AND FINANCE



Final accounts

A **BALANCE SHEET** reflects the company's financial position on the last day of the period for which the accounts are prepared.

The balance sheet reflects what the assets of the company are worth, what its liabilities are and how the firm is funded.

How might you account for a shop that was purchased 30 years ago for £1,000 and is now worth £1,000,000?

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u>1,300</u>
Profit brought forward	1,100
Profit for the year	100
Retained profit	<u>100</u>
	<u>1,300</u>



ACCOUNTING AND FINANCE



Final accounts

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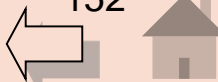
The balance sheet reflects what the assets of the company are worth, what its liabilities are and how the firm is funded.

How might you account for a shop that was purchased 30 years ago for £1,000 and is now worth £1,001,000?

Increase its value in fixed assets by £1,000,000.

But now the balance sheet will not balance.

	£ 000's
Fixed Assets	2,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u>2,300</u>
Profit brought forward	1,100
Profit for the year	100
Retained profit	<u>100</u>
	<u>1,300</u>



ACCOUNTING AND FINANCE



Final accounts

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How might you account for a shop that was purchased 30 years ago for £1,000 and is now worth £1,001,000?

Increase its value in fixed assets by £1,000,000.

But now the balance sheet will not balance.

So we add a new line in the bottom of the balance sheet – the revaluation reserve.

	£ 000's
Fixed Assets	2,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	(200)
	<hr/>
	2,300
	<hr/>
Profit brought forward	1,100
Profit for the year	100
Retained profit	1,000
	100
	<hr/>
	2,300
	<hr/>



ACCOUNTING AND FINANCE



Final accounts

A **BALANCE SHEET** reflects the company's financial position on the last day of the period for which the accounts are prepared.

The balance sheet reflects what the assets of the company are worth, what its liabilities are and how the firm is funded.

This illustrates the fundamental link between the profit and loss account and the balance sheet.

Only trading profit should pass through the profit and loss account. This produces distributable reserves that can be transferred to the balance sheet.

Revaluations etc should not pass through the profit and loss account but be transferred directly to a revaluation reserve.

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u>1,300</u>
Profit brought forward	1,100
Profit for the year	100
Retained profit	<u>100</u>
	<u>1,300</u>



ACCOUNTING AND FINANCE



Final accounts

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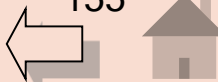
The balance sheet reflects what the assets of the company are worth, what its liabilities are and how the firm is funded.

So, what do we mean by assets?

Fixed assets are the items bought by the firm to use over a long period of time.

They include premises, machinery, vehicles, furniture, computers etc.

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u>1,300</u>
Profit brought forward	1,100
Profit for the year	100
Retained profit	<u>100</u>
	<u>1,300</u>



ACCOUNTING AND FINANCE



Final accounts

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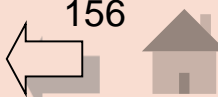
The balance sheet reflects what the assets of the company are worth, what its liabilities are and how the firm is funded.

So, what do we mean by assets?

Current assets are items that the firm owns with 'near cash' value.

These include cash, bank balances, stock, WIP and finished goods, along with short-term investments.

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u>1,300</u>
Profit brought forward	1,100
Profit for the year	100
Retained profit	<u>100</u>
	<u>1,300</u>



ACCOUNTING AND FINANCE



Final accounts

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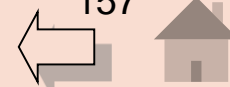
The balance sheet reflects what the assets of the company are worth, what its liabilities are and how the firm is funded.

So, what do we mean by liability?

Current liabilities are debts that the firm owes and fall due within one year.

These include bank overdrafts, an element of hire purchase agreements, debts to suppliers, VAT, tax and PAYE liabilities, along

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	(200)
	<hr/>
	1,300
	<hr/>
Profit brought forward	1,100
Profit for the year	100
Retained profit	100
	<hr/>
	1,300
	<hr/>



ACCOUNTING AND FINANCE



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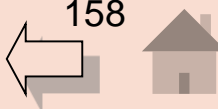
So, what do we mean by capital?

This is the funding of the business.

Share capital is the money that investors 'put up' in order to fund the running of the company.

Partners invest their own capital which is shown in the

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u>1,300</u>
Profit brought forward	1,100
Profit for the year	100
Retained profit	<u>100</u>
	<u>1,300</u>



ACCOUNTING AND FINANCE



Final accounts

A **BALANCE SHEET** reflects the company's financial position on the last day of the period for which the accounts are prepared.

The balance sheet reflects what the assets of the company are worth, what its liabilities are and how the firm is funded.

So, how can we use a balance sheet?

There are many ways, Here are some at a glance:

How have the balances changed since last year? Are they getting short of cash because debtors are building up?

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u>1,300</u>
Profit brought forward	1,100
Profit for the year	100
Retained profit	<u>100</u>
	<u>1,300</u>



ACCOUNTING AND FINANCE



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So, how can we use a balance sheet?

There are many ways, Here are some at a glance:

How have the balances changed since last year? Do they have sufficient long term funding or are they totally reliant on overdrafts?

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u>1,300</u>
Profit brought forward	1,100
Profit for the year	100
Retained profit	<u>100</u>
	<u>1,300</u>



ACCOUNTING AND FINANCE



Final accounts

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The balance sheet reflects what the assets of the company are worth, what its liabilities are and how the firm is funded.

So, how can we use a balance sheet?

There are many ways, Here are some at a glance:

How have the balances changed since last year? Are they running out of cash?

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u>1,300</u>
Profit brought forward	1,100
Profit for the year	100
Retained profit	<u>100</u>
	<u>1,300</u>



ACCOUNTING AND FINANCE



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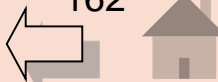
The balance sheet reflects what the assets of the company are worth, what its liabilities are and how the firm is funded.

So, how can we use a balance sheet?

There are many ways, Here are some at a glance:

How have the balances changed since last year? Do they have a strong asset base giving the firm a higher share value?

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u>1,300</u>
Profit brought forward	1,100
Profit for the year	100
Retained profit	<u>100</u>
	<u>1,300</u>



ACCOUNTING AND FINANCE



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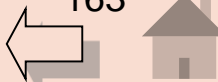
The balance sheet reflects what the assets of the company are worth, what its liabilities are and how the firm is funded.

So, how can we use a balance sheet?

There are many ways, Here are some at a glance:

How have the balances changed since last year? Are debtors building up and causing cash flow problems?

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u>1,300</u>
Profit brought forward	1,100
Profit for the year	100
Retained profit	<u>100</u>
	<u>1,300</u>



ACCOUNTING AND FINANCE



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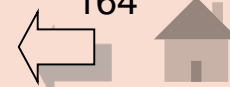
The balance sheet reflects what the assets of the company are worth, what its liabilities are and how the firm is funded.

So, how can we use a balance sheet?

There are many ways, Here are some at a glance:

Are they making sustained profits?

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	(200)
	<hr/>
	1,300
	<hr/>
Profit brought forward	1,100
Profit for the year	100
Retained profit	100
	<hr/>
	1,300
	<hr/>



ACCOUNTING AND FINANCE



Final accounts

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The balance sheet reflects what the assets of the company are worth, what its liabilities are and how the firm is funded.

So, how can we use a balance sheet?

There are many ways, Here are some at a glance:

Are they wasting money by spending a great deal on short term finance even while they have cash in the bank?

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u>1,300</u>
Profit brought forward	1,100
Profit for the year	100
Retained profit	<u>100</u>
	<u>1,300</u>



ACCOUNTING AND FINANCE



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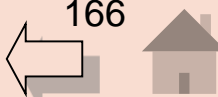
So how can we use a balance sheet?

There are many ways, Here are some at a glance:

Does the firm have net assets or net liabilities?

Simple numerical calculations can yield a great deal from final accounts as

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u>1,300</u>
Profit brought forward	1,100
Profit for the year	100
Retained profit	<u>100</u>
	<u>1,300</u>



ACCOUNTING AND FINANCE



Ratios and performance

 **Gross Profit**

 **Net Profit**

 **ROCE**

 **Current Ratio**

 **Acid Test**

Profitability ratios

Liquidity ratios



Use of asset ratios



Main Menu



ACCOUNTING AND FINANCE



Ratios and performance

Gross Profit

= turnover - purchases

Gross profit margin or percentage

Gross profit margin or percentage

=

$\frac{\text{Gross Profit}}{\text{Turnover}} \times 100\%$

2002: GP% = $((1,500)-(750)) / (1,500) \times 100\% = \underline{50\%}$

2003: GP% = $((2,200)-(900)) / (2,200) \times 100\% = \underline{59\%}$

E.g. for Digico plc:

Year ended 31.3.02

Turnover = £1,500

Purchases = £750

Year ended 31.12.03

Turnover = £2,200

Purchases £900

Comments:

- The gross profit margin has increased
- This is usually a good thing

The firm might be:

- Making its goods more efficiently
- Buying raw materials more cheaply
- Selling its goods at a higher price
- Using cheaper labour



ACCOUNTING AND FINANCE



Ratios and performance

Gross Profit

= turnover - purchases

Gross profit margin or percentage

Gross profit margin or percentage

=

$\frac{\text{Gross Profit}}{\text{Turnover}} \times 100\%$

2002: GP% = $((1,500)-(750)) / (1,500) \times 100\% = \underline{50\%}$

2003: GP% = $((2,200)-(900)) / (2,200) \times 100\% = \underline{59\%}$

E.g. for Digico plc:

Year ended 31.3.02

Turnover = £1,500

Purchases = £750

Year ended 31.12.03

Turnover = £2,200

Purchases £900

Comments:

- The gross profit margin has increased
- This is usually a good thing
- But this could be a bad thing

The firm might be:

- Making its goods from inferior materials
- Exploiting its workforce
- Selling its goods at higher prices that it cannot sustain



ACCOUNTING AND FINANCE



Ratios and performance

Gross Profit

= turnover - purchases

Gross profit margin or percentage

Gross profit margin or percentage

=

$\frac{\text{Gross Profit}}{\text{Turnover}} \times 100\%$

2002: GP% = $((1,500)-(750)) / (1,500) \times 100\% = \underline{50\%}$

2003: GP% = $((2,200)-(900)) / (2,200) \times 100\% = \underline{59\%}$

E.g. for Digico plc:

Year ended 31.3.02

Turnover = £1,500

Purchases = £750

Year ended 31.12.03

Turnover = £2,200

Purchases £900

Comments:

It would be best to look at the gross margins in other firms which carry on the same trade to see what is happening. Suppose the industry average was 55%.

We might conclude that the firm had realised that it was underperforming and consequently made changes to improve its efficiency radically.



ACCOUNTING AND FINANCE



Ratios and performance

Gross Profit

= turnover - purchases

Gross profit margin or percentage

Gross profit margin or percentage

=

$\frac{\text{Gross Profit}}{\text{Turnover}} \times 100\%$

2002: GP% = $((1,500)-(750)) / (1,500) \times 100\% = \underline{50\%}$

2003: GP% = $((2,200)-(900)) / (2,200) \times 100\% = \underline{59\%}$

E.g. for Digico plc:

Year ended 31.3.02

Turnover = £1,500

Purchases = £750

Year ended 31.12.03

Turnover = £2,200

Purchases £900

Comments:

It would be best to look at the gross margins in other firms which carry on the same trade to see what is happening. Suppose the industry average was 65%.

We might conclude that the firm had realised that it was underperforming and consequently made changes to start to improve its efficiency.





Ratios and performance

Gross Profit

= turnover - purchases

Gross profit margin or percentage

Gross profit margin or percentage

=

$$\frac{\text{Gross Profit}}{\text{Turnover}} \times 100 \%$$

Comments:

Spice Industries Ltd has seen its gross profit margin percentage fall steadily from 25% to 20% whilst the industry average for its line of business has remained steady at 24%.

Spice Industries are becoming less competitive:

Solutions could be to:

- Increase their selling price
- Purchase cheaper raw materials
- Reduce labour costs (cut overtime etc.)
- Use more efficient techniques to cut down on use and waste of raw materials



ACCOUNTING AND FINANCE



Ratios and performance

Gross Profit

= turnover - purchases

Gross profit margin or percentage

Gross profit margin or percentage

=

$\frac{\text{Gross Profit}}{\text{Turnover}} \times 100 \%$

Comments:

Spice Industries Ltd has seen its gross profit margin percentage fall steadily from 25% to 20% whilst the industry average for its line of business has remained steady at 24%.

If the firm is still making a profit and the cost of investment into the firm is low, this might be a good investment for a shareholder who has expertise in this sector of industry.

The firm is underperforming so shares are cheap. Buy them, turn the business around and improve the share price.

Now sell the shares at a profit.



ACCOUNTING AND FINANCE



Ratios and performance

Net Profit

= turnover – purchases - overheads

Net profit margin or
percentage

Net profit margin or
percentage

=

$\frac{\text{Net Profit}}{\text{Turnover}} \times 100\%$

E.g. for Softco plc:

Year ended 31.3.02

Turnover = £1,500

Net profit = £150

Year ended 31.12.03

Turnover = £2,200

Net profit £180

2002: NP% = $150 / 1,500 \times 100\% = \underline{10\%}$

2003: NP% = $180 / 2,200 \times 100\% = \underline{8\%}$

Comments:

- The net profit margin has decreased
- This is usually a bad thing

Firstly we need to consider if the problem is due to a change in gross profit.

Let us assume that it isn't.



ACCOUNTING AND FINANCE



Ratios and performance

Net Profit

= turnover – purchases - overheads

Net profit margin or percentage

Net profit margin or percentage

=

$\frac{\text{Net Profit}}{\text{Turnover}} \times 100\%$

2002: NP% = $150 / 1,500 \times 100\% = \underline{10\%}$

2003: NP% = $180 / 2,200 \times 100\% = \underline{8\%}$

E.g. for Softco plc:

Year ended 31.3.02

Turnover = £1,500

Net profit = £150

Year ended 31.12.03

Turnover = £2,200

Net profit £180

Comments:

- The net profit margin has decreased
- This is usually a bad thing

It could be due to a fall in turnover no longer providing such high cover of fixed costs.

We could check this in the comparatives of the profit and loss account.



ACCOUNTING AND FINANCE



Ratios and performance

Net Profit

= turnover – purchases - overheads

Net profit margin or percentage

Net profit margin or percentage

=

$\frac{\text{Net Profit}}{\text{Turnover}} \times 100\%$

2002: NP% = $150 / 1,500 \times 100\% = \underline{10\%}$

2003: NP% = $180 / 2,200 \times 100\% = \underline{8\%}$

E.g. for Softco plc:

Year ended 31.3.02

Turnover = £1,500

Net profit = £150

Year ended 31.12.03

Turnover = £2,200

Net profit £180

Comments:

- The net profit margin has decreased
- This is usually a bad thing

It could be due to a particular cost increase that has hit the industry. Insurance after 9.11 might be an example.

We could check this in the comparatives of the profit and loss account.



ACCOUNTING AND FINANCE



Ratios and performance

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Turnover = £1,500

Net profit = £150

Year ended 31.12.03

Turnover = £2,200

Net profit £180

Comments:

- The net profit margin has decreased
- This is usually a bad thing

It could be that overheads are getting out of control either generally or in one particular area.

We could check this in the comparatives of the profit and loss account.



ACCOUNTING AND FINANCE



Ratios and performance

Net Profit

= turnover – purchases - overheads

Net profit margin or
percentage

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Turnover = £1,500

Net profit = £150

Year ended 31.12.03

Turnover = £2,200

Net profit £180

Comments:

- The net profit margin has decreased
- This is usually a bad thing

It could be that the firm has been hit by a large loss on the disposal of a particular asset.

We could check this in the comparatives of the profit and loss account.



ACCOUNTING AND FINANCE



Ratios and performance

Net Profit

= turnover – purchases - overheads

Net profit margin or percentage

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Net profit £180

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2003: NP% = $180 / 2,200 \times 100\% = \underline{8\%}$

Comments:

- The net profit margin has decreased
- This is usually a bad thing

Generally, a look at the comparatives will at least locate the source of the problem.

In an 'analytical review', an analyst might jot down the percentage increases in each category in the profit and loss account.



ACCOUNTING AND FINANCE



Ratios and performance

Net Profit

= turnover – purchases - overheads

Net profit margin or
percentage

Net profit margin or
percentage

=

Net Profit

X 100 %

Turnover

Comments:

Ourco plc has seen its net profit fall from 17% to 15%.

The industry average has fallen from 17% to 12% so actually we are pleased with Ourco's performance – but we might wish to move our investment out of the sector altogether if the trend looks like it will continue.



ACCOUNTING AND FINANCE



Ratios and performance

Net Profit

= turnover – purchases - overheads

Net profit margin or
percentage

Net profit margin or
percentage

=

$$\frac{\text{Net Profit}}{\text{Turnover}} \times 100 \%$$

Comments:

Yourco plc has seen its net profit rise from 17% to 27%.

The industry average has fallen from 17% to 12% so we are very pleased with Yourco's performance – but we might wish to look closely at the profit and loss account to see how this was achieved. Have they sold off all their assets?



ACCOUNTING AND FINANCE



Ratios and performance

ROCE return on capital employed

ROCE

=

Net Profit

X 100 %

Capital employed

It is pronounced as one word 'roce'.

The capital employed can be taken from the balance sheet.

In some cases, you might see long term loans in this section of the balance sheet. They should be removed as they do not reflect ownership even if there is some control.

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	(200)
	<hr/>
	1,300
	<hr/>
Profit brought forward	1,100
Profit for the year	100
Retained profit	100
	<hr/>
	1,300
	<hr/>



ACCOUNTING AND FINANCE



Ratios and performance

ROCE return on capital employed

ROCE

=

$$\frac{\text{Net Profit}}{\text{Capital employed}} \times 100 \%$$

$$\text{ROCE} = (100 / 1,300) \times 100 \% = \underline{8 \%}$$

Note that it is the profit for the year that is used.

This figure shows how effectively the owners' capital is being used.

If the building society was paying 10%, you might switch your investment!

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	(200)
	<hr/>
	1,300
	<hr/>
Profit brought forward	1,100
Profit for the year	100
Retained profit	100
	<hr/>
	1,300
	<hr/>



ACCOUNTING AND FINANCE



Ratios and performance

ROCE return on capital employed

ROCE

=

$$\frac{\text{Net Profit}}{\text{Capital employed}} \times 100 \%$$

$$\text{ROCE} = (100 / 1,300) \times 100 \% = \underline{\underline{8 \%}}$$

If the ROCE is not what you had expected, you need to refer to the gross profit margin percentage and the net profit margin percentage to find out why.

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	(200)
	<u>1,300</u>
Profit brought forward	1,100
Profit for the year	100
Retained profit	100
	<u>1,300</u>



ACCOUNTING AND FINANCE



Ratios and performance

ROCE return on capital employed

$$\text{ROCE} = \frac{\text{Net Profit}}{\text{Capital employed}} \times 100 \%$$

$$\text{ROCE} = (100 / 1,300) \times 100 \% = \underline{\underline{8 \%}}$$

Again the ROCE should be comparable between industries in the same sector.

The ROCE will be different between sectors reflecting the possible degree of risk to an investor within the sector.

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	(200)
	<u>1,300</u>
Profit brought forward	1,100
Profit for the year	100
Retained profit	100
	<u>1,300</u>

ACCOUNTING AND FINANCE



Ratios and performance

Current ratio

$$\text{Current ratio} = \frac{\text{current assets}}{\text{current liabilities}}$$

$$\text{CR} = (10 + 440 + 50) / 200 = \underline{2.5}$$

Note that you must be sure that you are only using current liabilities.

Current assets would include stock, WIP, debtors, bank balances, cash in hand and current investment.

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u>1,300</u>
Profit brought forward	1,100
Profit for the year	100
Retained profit	<u>100</u>
	<u>1,300</u>



ACCOUNTING AND FINANCE



Ratios and performance

Current ratio

$$\text{Current ratio} = \frac{\text{current assets}}{\text{current liabilities}}$$

$$\text{CR} = (10 + 440 + 50) / 200 = \underline{\underline{2.5}}$$

This is used to check that the firm is able to pay its short term debts.

This firm could do it 2.5 times from its current assets which is quite healthy.

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u><u>1,300</u></u>
Profit brought forward	1,100
Profit for the year	100
Retained profit	<u>100</u>
	<u><u>1,300</u></u>



ACCOUNTING AND FINANCE



Ratios and performance

Current ratio

$$\text{Current ratio} = \frac{\text{current assets}}{\text{current liabilities}}$$

$$\text{CR} = (10 + 440 + 50) / 200 = \underline{\underline{2.5}}$$

We could say that the firm has £2.50 of near cash to pay every £1.00 of short term debt.

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u><u>1,300</u></u>
Profit brought forward	1,100
Profit for the year	100
Retained profit	<u>100</u>
	<u><u>1,300</u></u>



ACCOUNTING AND FINANCE



Ratios and performance

Current ratio

$$\text{Current ratio} = \frac{\text{current assets}}{\text{current liabilities}}$$

$$\text{CR} = (10 + 440 + 50) / 200 = \underline{\underline{2.5}}$$

The current ratio should be similar between similar businesses.

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u><u>1,300</u></u>
Profit brought forward	1,100
Profit for the year	100
Retained profit	<u>100</u>
	<u><u>1,300</u></u>



ACCOUNTING AND FINANCE



Ratios and performance

Current ratio

$$\text{Current ratio} = \frac{\text{current assets}}{\text{current liabilities}}$$

$$\text{CR} = (10 + 440 + 50) / 200 = \underline{\underline{2.5}}$$

Too high a current ratio could indicate that a company is not reinvesting its cash in the business; too low and it might not be able to pay its short term debts.

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u><u>1,300</u></u>
Profit brought forward	1,100
Profit for the year	100
Retained profit	<u>100</u>
	<u><u>1,300</u></u>



ACCOUNTING AND FINANCE



Ratios and performance

Acid test ratio

$$\begin{aligned} \text{Acid test ratio} \\ = \\ \frac{\text{current assets} - \text{stock}}{\text{current liabilities}} \end{aligned}$$

$$\text{CR} = (10 + 440) / 200 = \underline{2.25}$$

This tells us if the firm can pay its short term debts without selling its stock, raw materials or WIP.

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u>1,300</u>
Profit brought forward	1,100
Profit for the year	100
Retained profit	<u>100</u>
	<u>1,300</u>



ACCOUNTING AND FINANCE



Ratios and performance

Acid test ratio

Acid test ratio

=

$$\frac{\text{current assets} - \text{stock}}{\text{current liabilities}}$$

$$\text{CR} = (10 + 440) / 200 = \underline{2.25}$$

In this case the firm could pay it two and a quarter times.

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u>1,300</u>
Profit brought forward	1,100
Profit for the year	100
Retained profit	<u>100</u>
	<u>1,300</u>



ACCOUNTING AND FINANCE



Ratios and performance

Acid test ratio

$$\begin{aligned} &\text{Acid test ratio} \\ &= \\ &\frac{\text{current assets} - \text{stock}}{\text{current liabilities}} \end{aligned}$$

$$\text{CR} = (10 + 440) / 200 = \underline{2.25}$$

This is also known as the liquid capital ratio. It is important as stock is less easy to turn into cash than a bank balance. A company with a good CR might have a lot of stock and still not be able to pay its bills.

	£ 000's
Fixed Assets	1,000
Stock & WIP	50
Debtors	440
Bank and cash	10
Liabilities	<u>(200)</u>
	<u>1,300</u>
Profit brought forward	1,100
Profit for the year	100
Retained profit	<u>100</u>
	<u>1,300</u>



ACCOUNTING AND FINANCE



Ratios and performance

Rate of stock turnover ('stockturn')

Rate of stock turnover

=

Cost of sales / average stock

This tells us how many times the stock is replenished (turned over) in the accounting period.

This is sometimes given in terms of stock days. E.g. Yourco plc has a cost of sales of £2m in one year and averages stock levels of £250,000.

Rate of stock turnover

$$= 2,000,000 / 250,000 = 8$$

i.e. it turns over its stock 8 times every year.

This is equivalent to keeping stock for $1/8^{\text{th}}$ of a year i.e. 46 days.

Rate of stock turnover should be comparable within a sector and consistent within a firm unless there are mitigating circumstances.



ACCOUNTING AND FINANCE



Ratios and performance

Debtors' collection period (debtors' days)

Debtors' collection period

=

$\text{debtors} / \text{turnover} \times 365$

This tells us how long it takes for the firm to collect its debts.

E.G. Yourco plc has sales of £5m in one year and averages debtors' levels of £400,000

Debtors' days

$= 400,000 / 5,000,000 \times 365 = 29 \text{ days}$

i.e. it takes 29 days to collect a debt.

Debtors' days should be comparable within a sector and consistent within a firm unless there are mitigating circumstances. Increasing debtors' days show that the firm's customers are using the firm as their banker. They will do this in order to avoid paying interest on overdrafts. The firm's problem will then be to pay its creditors.



ACCOUNTING AND FINANCE



Ratios and performance

Creditors' collection period (creditors' days)

Creditors' collection period

=

creditors / cost of sales x 365

This tells us how long it takes the firm to pay its debts.

E.G. Yourco plc has a cost of sales of £4m in one year and averages debtors' levels of £300,000

Creditors' days

= $300,000 / 4,000,000 \times 365 = 27$ days

i.e. it takes 27 days to collect a debt.

Creditors' days should be comparable within a sector and consistent within a firm, unless there are mitigating circumstances. Increasing creditors' days show that the firm is using its customers as its banker. The firm will do this in order to avoid paying interest on overdrafts. The firm's problem will be that creditors will be reluctant to make further supplies and might not let the firm have preferential terms.



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