



Finance for Non-Financial Managers Training Course

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Dublin (Head Office) 01-8610700

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Website: PDLcourses.ie

Email: info@PDLcourses.ie

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1 - Finance

The ability to purchase things by ensuring that funds are:

- Available at the right price
- Available for the right time period
- Obtained at the lowest cost

Management Objectives

- Maximisation of profit relative to investment.
- Other objectives are:
 - Growth
 - Risk reduction
 - Personal aspirations
 - Social objectives



2 - Financial Statements

"Financial Statements are like fine perfume to be sniffed but not swallowed."

Financial Statements provide information to enable decisions to be made.

- Profit & Loss Account
- Balance Sheet
- Funds Flow Statement

Users of Financial Statements

Internal

- Directors
- Employees
- Shareholders

External

- Potential Shareholders
- Stock Market Analysts
- Investment Advisers
- Competitors
- Suppliers/Customers
- Long-Term Lenders
- Short-Term Lenders
- Government
- Other Interested Parties



3 - Accounting Concept & Conventions

The science of Accounting is constantly being examined by its practitioners in their quest for better ways and systems of presenting and interpreting accounting data. The word system can apply to many things, e.g. the court system, the school system, the police system etc., however, by an accounting system we mean the collection, inputting, processing and outputting of relevant information. Its basic goal is to provide information for decision-making.

The Accountant's function is to analyse the information provided and communicate it to the decision makers. The information is used by a wide variety of people and consequently has to be tailored to meet their varying needs.

Information Users:

- Management
- Share holders & Investors
- Creditors
- Employees
- Government

There are other groups who will be interested in the information but the above are the main users.

Over the years Accountants have established various concepts and conventions which in the main are:

Money Measurement Concept

Accounting systems are only concerned with those facts and transactions that can be expressed in monetary terms. Thus financial statements can never give a complete picture of a firm's position; e.g. they do not touch upon employee/employer relationship; competitor's activity; government decisions.

Going Concern

Accountancy assumes that the business will continue indefinitely. If this assumption does not hold, the value of all assets within the business will be affected.



Cost Concept

Assets are usually recorded in the books at cost price which, over time, may bear no relationship to the saleable value of the assets, e.g. the replacement cost of plant and machinery may far exceed the original purchase price of the initial asset. This anomaly may be better understood by comparing two shops side by side in the same street, one bought by the owners in 1970 and the other one bought in 1989. To all intents and purposes actually the same asset, but, the cost in the company's books will be different.

Business entity Concept

This concept sees the business as being distinct from the owner or owners irrespective of the legal position, e.g. a sole trader who invests €10,000 in a business is shown as a creditor for capital in the business' books.

Accrual Concept

Assumes that profit or loss on a transaction is earned at the time of the sale to the customers and not when the payment is received. Revenue receipts and expenditure that apply to a period should be accounted for within that period irrespective of the date of the payment or receipt, e.g. rent paid in advance, goods received not invoiced etc.

The Realisation Concept

Closely related to the cost concept, realisation allows that any change in the value of an asset can only be realised when the asset is sold. In other words, you can't count your chickens before they're hatched.

Prudence

When faced with a choice between two figures the Accountant will normally choose the figure that underestimates rather than overestimates the profit. The rule is to anticipate possible losses but not ever anticipate possible profits.

Consistency

The usefulness of financial information is largely determined by the extent to which it can be used for comparison with previous years or with information from other companies. Therefore, it is desirable that financial information is prepared on a consistent basis. This consistency is enforced on a company basis but not between companies as yet.



Accounting Equation

Resources in the Business = Resources supplied by the owners

Assets = Capital + Liabilities

Assets

- Are the property & possessions of a business.
- Are classified according to their nature:
 - Fixed
 - Tangible
 - Intangible
 - Current
 - Liquid

Liabilities

A liability is an amount which a business is legally bound to pay. It is a claim by an outsider on the assets of the firm.

They are classified as:

- Creditors due within one year (current).
- Creditors due over one year.



4 - Capital & Revenue Expenditure

- **Capital Expenditure**
Relates to fixed assets, that is costs which are not used within 1 year
- **Revenue Expenditure**
Relates to the day to day running costs of the business
- The treatment of expenditure will have an effect on the profit and loss account as well as the balance sheet.

Type of Statements (1)

Balance Sheet

- State of the business at one point in time.
- List the Assets - amounts owned by the business.
- Capital and Liabilities - amounts owed by the business.



Balance Sheet

Fixed Assets

Intangibles

Investments

Current Assets

Stock

Debtors

Cash

(Creditors < 12 months)

(Creditors)

(Overdraft)

Working Capital/Net Current
Assets

=====

(Creditors > 12 months)

Long Term Loans

Net Assets

=====

Share Capital

Profit & Loss

Reserves

Shareholders Funds

=====



The Balance sheet expresses the value of a business's Assets and Liabilities as at a point in time, e.g. 12 midnight on 31 Dec 2006.

	Cost	Cum. Deprec.	N.B.V.	
Fixed Assets				
Motor Vehicles	10,000	1,800	8,200	
Furniture & Fittings	2,500	225	2,275	
	<u>12,500</u>	<u>2,025</u>	<u>10,475</u>	10,475
	=====	=====	=====	=====
Current Assets				
Stocks at cost			3,000	
Debtors		17,820		
Less: Prov. for doubtful debts		178		
		<u>17,642</u>		
Prepayments			50	
Bank Balance			<u>6,000</u>	
			<u>26,692</u>	

Current Liabilities				
Creditors		3,500		
Accruals		<u>1,500</u>		
			<u>5,000</u>	
Net Working Capital				21,692

Total Assets				32,167
				=====
Financed by				
Term Loan			5,000	
Capital Account			20,000	
Net Profit for the year			<u>7,167</u>	
			<u>32,167</u>	
			=====	



Types of Statements (2)

Trading Account

Sales/Turnover

less Opening Stock

+ Purchases

- Closing Stock

= Gross Profit

Profit and Loss Account

Gross Profit minus Total Expenses equals Net Profit

Turnover _____

Cost of Goods Sold ()

Gross Profit _____

Selling, General & Admin. ()

Operating Profit _____

Interest ()

Profit before Tax _____

Tax ()

Profit after Tax/Net Profit _____

Dividend ()

Retained Profit _____



Trading and Profit & Loss Accounts

The Trading Account is used to calculate the Gross Profit or Gross Margin of a Business. The Profit and Loss Account is used to calculate the net profit of the business. The following is an example:

Trading and Profit & Loss Account

Sales			€	70,000
	Purchases	31,000		
	Less: Closing Stock	3,000		
		—————		
Cost of Sales				28,000
Gross Profit				————— 42,000
Selling & Distribution Costs				
	Salesmen's Salaries	12,000		
	Motor Expenses	2,000		
	Depreciation - Motor Vehicle	1,800		
		—————		
				15,800
Administrative expenses				
	Rent	6,000		
	Office Supplies	10,800		
	Insurance	350		
	Light & Heat	1,000		
	Bank charges	100		
	General expenses	200		
	Depreciation - furniture & fittings	225		
		—————		
				18,675
Financial Expenses				
	Lease Interest	180		
	Bank Interest	178		
		—————		
				358
Total overhead expenses				34,833
Net Profit				————— 7,167 =====



Trial Balance

A trial balance is a listing of account balances outstanding on the ledger. If all postings have been entered correctly then the debit total of the Trial Balance will equal the credit total.

	Debits	Credits
Motor vehicles	10,000	
Furniture & Fittings	2,500	
Debtors	17,820	
Bank	6,000	
Stocks	3,000	
Creditors		3,500
Prepayments	50	
Accruals		1,500
Prov. for doubtful debts		178
Cumulative depreciation - Motors		1,800
Cumulative depreciation - F & F		225
Sales		70,000
Purchases	31,000	
Sales salaries	12,000	
Motor Expenses	2,000	
Rent	6,000	
Closing Stock		3,000
Office Salaries	10,800	
Insurance	350	
Lease interest	180	
Light & heat	1,000	
Depreciation Motors	1,800	
Depreciation Furn & Fitt.	225	
General expenses	200	
Bank charges	100	
Bank interest	178	
Capital account		20,00
Term Loan		5,000
	<hr/> 102,203 =====	<hr/> 102,203 =====



Funds Flow Statement

Companies are required to prepare FRS1 (with exception of small companies) as part of their financial statements.

- Sets out standard basis
- Cash generation and absorption for the period
- Assists users in their assessment of:
 - Liquidity
 - Viability
 - Financial adaptability

Funds Flow Statement (FRS1)

Sources of Funds

Operating Profit (before Interest and Tax)	_____
+ Depreciation	_____
= Gross Operating Cash Flow	_____
Decrease in Stock	_____
Decrease in Debtors	_____
Increase in Creditors	_____
= Net Operating Cash Flow	=====

Application of Funds

Dividends Paid	_____
+ Interest Paid	_____
+ Tax Paid	_____
+ Increase in Fixed Assets	_____
= Free Funds before Financing	=====

Funds from other sources

Increase in:	
Issued shares	_____
Loans	_____

Movement in Net Liquid Funds

Increase in:	
Cash	_____
Short Term investments	_____



5 Financial Statement Analysis

General

- Date of Publication? How long after year end? For seasonal businesses check High vs. Low point.
- Do the figures add up? Do they balance?
- Are they signed? By whom?
- Consolidated v/s Company.

Chairman's and Director's Reports

- Description of Business. Any Change?
- Explanation of past performance and indication of future performance.
- Compare against last year's forecast.
- Any change in Shareholders, Directors, Bankers or Auditors?
- Are shareholders and Directors known to us?

Auditors Statement

- Date to match financials.
- Auditor status.
- Qualified, unqualified and semi-qualified statement.

Income Statement

- Sales
- Examine make up of sales
- By customer, product, region, division, industry, country etc.
- Avoid over dependence to one or few customers/industry
- Identify largest customer
- % Cash v/s Credit sales
- Increase acceptable? Compared to competitors
- Future increases sustainable?
- Analyse increases: Price v/s volume

Cost of Goods Sold

- Is margin acceptable for the industry?
- Has it been consistent for the period?
- How has it been calculated?
- What is stock valuation policy?



Gross Profit

- Acceptable for industry?
- Growth levels
- Comparisons against major competitors
- Analyse per product, division etc. and compare against sales performance.

Expenses

- Scrutinise all disclosed items.
- Any capitalised items (See notes to the accounts)
- Identify any sudden increase
- Identify fixed v/s variable
- Identify any strong sole item of expenditure which could represent a high percentage of total costs.
- Analyse tax rate, compute tax paid and dividends paid.
- Anything missing? Does it look right?

Extraordinaries and Exceptionals

- Likely to recur again?
- Above or below the line?
- Tax treatment, e.g.. Reconstruction costs, profit/loss on sale of subsidiary, restructuring costs.

Net Profit

- Acceptable percentage?
- Growth
- Performance versus competitors.

(NB: all notes to the income statement to be read fully!)



Balance Sheet - Liabilities

Share Capital

- Authorised v/s Issued.
- Identify different classes and types of shares.
- Voting rights, important for passing of ordinary and special resolutions.
- Identify shareholders.

Revenue Reserves

- Past Profits
- Not Cash!
- Also called Distributable Reserves
- Can be paid as dividends.

Capital Reserves

- Also called Non-Distributable Reserves
- Cannot be paid as dividends
- Would arise for example upon a property revaluation

Shareholder's Equity

- Total of Share Capital, Revenue and Capital Reserves.
- Also called shareholder's funds, net worth, book value.
- Represents owner's capital
- Assets less liabilities

Director's Loans

- Check terms and conditions
- Could be withdrawn at a moment's notice
- Bank has no control.

Hybrids

- Examine financing structure fully.
- Analyse rights debt holders.



Long Term Liabilities

- Mostly long term loans
- Over 12 months
- Check asset encumbrance
- Check repayment provisions.
- Portion repayable within the next 12 months to be included under current liabilities.

Deferred Tax

- A reserve arising out of timing of tax provisions
- Identify true nature of provision

Balance Sheet - Assets

Fixed Assets

- For production purposes and not for resale.

Land and Building

- Compare book value v/s/ market value.
- Watch out for sudden revaluation and basis of revaluation
- Could building be sold easily?
- Freehold or leasehold
- Security value should cover (1) Discount of forced sale.
(2) Extra costs of Maintenance and realisation.
(3) Roll up interest.

Plant and Equipment

- Is depreciation adequate?
- Efficiency of utilisation.
- Provision for replacement.
- Level of skills required for the workforce.
- Production losses.
- Safety records.
- Saleability.



Fixtures, Fittings and Motor Vehicles

- Is depreciation adequate?
- Check fleet management.
- Replacement provisions and policy.
- Saleability.

Investments

- In either quoted or unquoted companies subsidiary or associated company.
- Determine market value, liquidity, ease of repayment and reason for such investment.
- Sold since balance sheet date?
- Subject to be charged as security?

Goodwill

- Arises on acquisition.
- To be written off against reserves or profits over time.
- Value at nil or use DCF techniques.

Brand

- Transferable? Saleable?
- Value at nil or use DCF.

Current Assets

Stock

- Determine nature of stock
- Look for obsolescence, seasonability and perish ability.
- Examine stock turnover
- Separate raw materials, work in progress and finished goods (each has its own degree of risk).
- Identify method of stock valuation.
- Be wary of customised products.
- Are they subject to Reservation of Title.
- Valued at the lower of cost or net realisable value.



Debtors

- Analyse spread, age and overdue schedule.
- Past bad debt record?
- Average payment period.
- Identify large customers.
- Inter company deals.
- Already factored?
- What is company's credit control like?

Cash

- Cash generator or cash absorber?
- Cash figure in balance sheet, by itself, a meaningless figure really.

Current Liabilities (under 12 months)

Creditors

- Analyse spread, age and average payment period.
- Any over dependence to any one or few suppliers.

Bank

- Term and conditions of existing short term facility.
- What is overdraft limit?

Notes to the Balance Sheet

- Look out for any change in accounting policy.
- Examine contingent liabilities and capital commitments.
- Examine off balance sheet financing, particularly leasing obligations.
- Any significant event since balance sheet date.

Cash Flow Statement

- Where did funds come from?
- What was done with them?
- Ensure right mix of finance was used.
- Analyse full liquidity position.



6 - Management Accounting

Five main areas of interest

- Growth
- Profitability
- Efficiency
- Solvency
- Liquidity

Measurement of Growth

Use Sales, Net Income or Earning per Share

- Simple year on year growth rate
- Average growth rate over a number of years
- Compound growth rate

These rates are frequently compared with the rate of inflation to see if the company is showing "true" growth.

Measurement of Profitability

$$\text{Gross Margin} = \frac{\text{Gross Profit}}{\text{Sales}} \times 100$$

$$\text{Net Margin} = \frac{\text{Net Profit}}{\text{Sales}} \times 100$$

$$\text{Return on Capital Employed (ROCE)} = \frac{\text{Net Profit before Interest and Tax}}{\text{Average Capital Invested}}$$



Measurement of Efficiency

Asset Turns	$\frac{\text{Sales}}{\text{Total Assets}}$
Equity Turns	$\frac{\text{Sales}}{\text{Shareholders' Equity}}$
Capital Intensity	$\frac{\text{Sales}}{\text{Fixed Assets}}$
Days' Cash	$\frac{\text{Cash}}{\text{Cash Costs}} \times 365$
Debtor Days	$\frac{\text{Debtors}}{\text{Sales}} \times 365$
Days' Inventory	$\frac{\text{Average Stock}}{\text{Cost of Sales}} \times 365$
Inventory Turnover	$\frac{\text{Cost of Sales}}{\text{Average Stock}}$
Working Capital Turnover	$\frac{\text{Sales}}{\text{Working Capital}}$



Measurement of Solvency

Short Term

Current Ratio $\frac{\text{Current Assets}}{\text{Current Liabilities}}$

Acid Test Ratio $\frac{\text{Current Assets} - \text{Stock}}{\text{Current Liabilities}}$

Long Term

Equity Ratio $\frac{\text{Shareholders' Equity}}{\text{Total Assets}}$

Interest Coverage $\frac{\text{Profit before interest \& Tax}}{\text{Interest Charges}}$

Debt/Equity Ratio $\frac{\text{Total Liabilities}}{\text{Shareholders' Equity}}$

Measurement of Liquidity

From the Funds Flow Statement

Measurements of Financial Performance

Earnings per Share $\frac{\text{Net Income}}{\text{No. Shares Outstanding}}$

Dividend Yield $\frac{\text{Dividend per Share}}{\text{Market price per share}}$

Dividend Payout $\frac{\text{Dividend per Share}}{\text{Net Income per share}}$



Business Structure

Sole Trader	-	Full liability
Partnership	-	Each has full liability
Limited Company	-	Limited liability
Public Limited Company (plc)	-	Traded shares

Capital

Shares

- Ownership of the Business
- Control of the Business
- Entitled to residual on liquidation

Types of shares

- **Ordinary**
Entitled to dividends only from profits and after allowing for tax, capital, working capital, etc.
- **Preferences**
Have preference over ordinary shares for dividends and possibly, also on liquidation. May be:
 - Redeemable
 - Cumulative
 - Fixed dividend.

Classes of Shares

- Different voting rights
- Effect on control.



Loan Capital

Debentures

- Guaranteed interest and capital.
 - Fixed against specified assets.
 - Floating

Unsecured loan notes

Shares, debentures and unsecured loan notes may all be quoted on the Stock Exchange and transacted between buyers and sellers.

Capital Structure

Ratio of loan capital to share capital = Gearing.

Implications:

- Control of the business
- Cost of Capital
- Fluctuations

Cost of Capital

- Cost of Debt
- Cost of Equity



Valuing Assets

- (1) Historical cost
- (2) Present value of future earnings
- (3) Inflation adjusted
- (4) Replacement cost
- (5) Net realizable value

Fixed Assets

Land
Buildings
Plant & Machinery
Cars
Fixtures and Fittings
Intangibles
Depreciation - Straight Line
 - Decreasing Balance

Current Assets

Cash
Stock
Debtors - Bad debts
 - Doubtful debts

Financial Assets

Shares
Loans



Long Range Business Planning

- 3 - 5 year Time scale
- Updated regularly
- Reviewed at least annually.

Mission Statement



Objectives



Goals

- Specific
- Measurable
- Achievable
- Realistic
- Time framed

SWOT Analysis

Business Plan

- Assumptions



Assumptions

- Inflation
- Interest Rates
- Market
 - Growth
 - Share
 - Competition
 - Margins
- Prices
- Labour
 - Cost
 - Availability
- Materials
 - Cost
 - Availability
- Technology
- Political
 - Stability
 - Regulation
 - Tax

Sensitivity Analysis

The assumptions made are usually on the optimistic side. Sensitivity analysis involves altering these assumptions and calculating their effect on key indicators e.g. profit. Thus, a 1% decrease in the assumed price might have a 5% effect on net profit.

All the key assumptions should be replaced with realistic but pessimistic values and the key results calculated. This gives us a range of expected outcomes between the optimistic and pessimistic assumptions. The actual outcome will almost certainly fall between these two extremes.



Short Term Business Planning

- 12 month time scale
- Planning and control system

Budgets

- Based on projected activity levels
- Agreed with those responsible
- Measured with sufficient accuracy
- Monitored
- Used as a problem solving tool to explain variances
- Should not be used "politically".

Common Problems

- Budgets are untruthful due to padding and fudging.
- Budgets are cut unilaterally regardless of activity levels.
- Spending is not recorded accurately.
- Variances are used to blame, not explain.

Budgetary Process

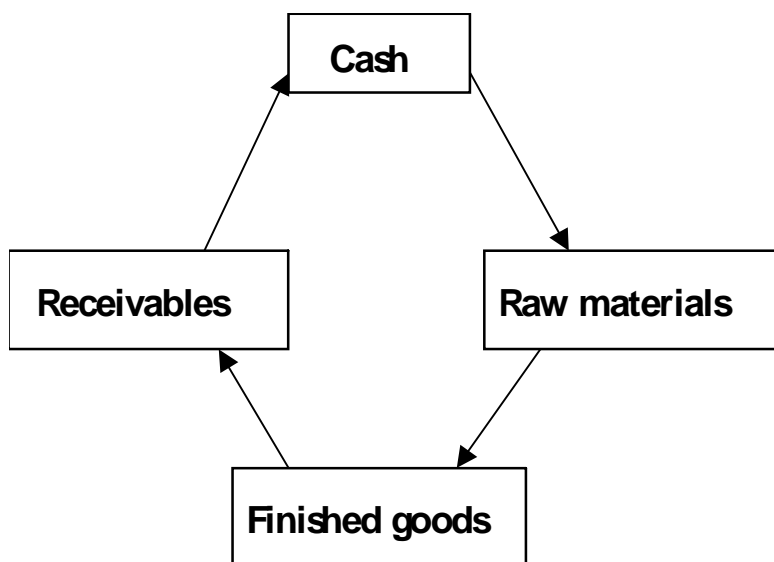
- Sales Forecast
- Cost Forecasts
- Stock holding forecasts and Policy
- Cash Flow forecasts.

Steps in the Budgetary Process

1. Sales Budget.
2. Production Budget.
3. Direct Materials Usage Budget
4. Materials Purchases Budget.
5. Direct Labour Costs Budget.
6. Overhead Costs Budget.
7. Closing Stock Budget
8. Selling & Administrative Costs Budget.
9. Capital Expenditure & Research & Development Budgets
10. Cost of Goods Sold Budgets
11. Cash Budget
12. Budgeted Profit and Loss Account
13. Budgeted Balance Sheet.



The Operating Cycle

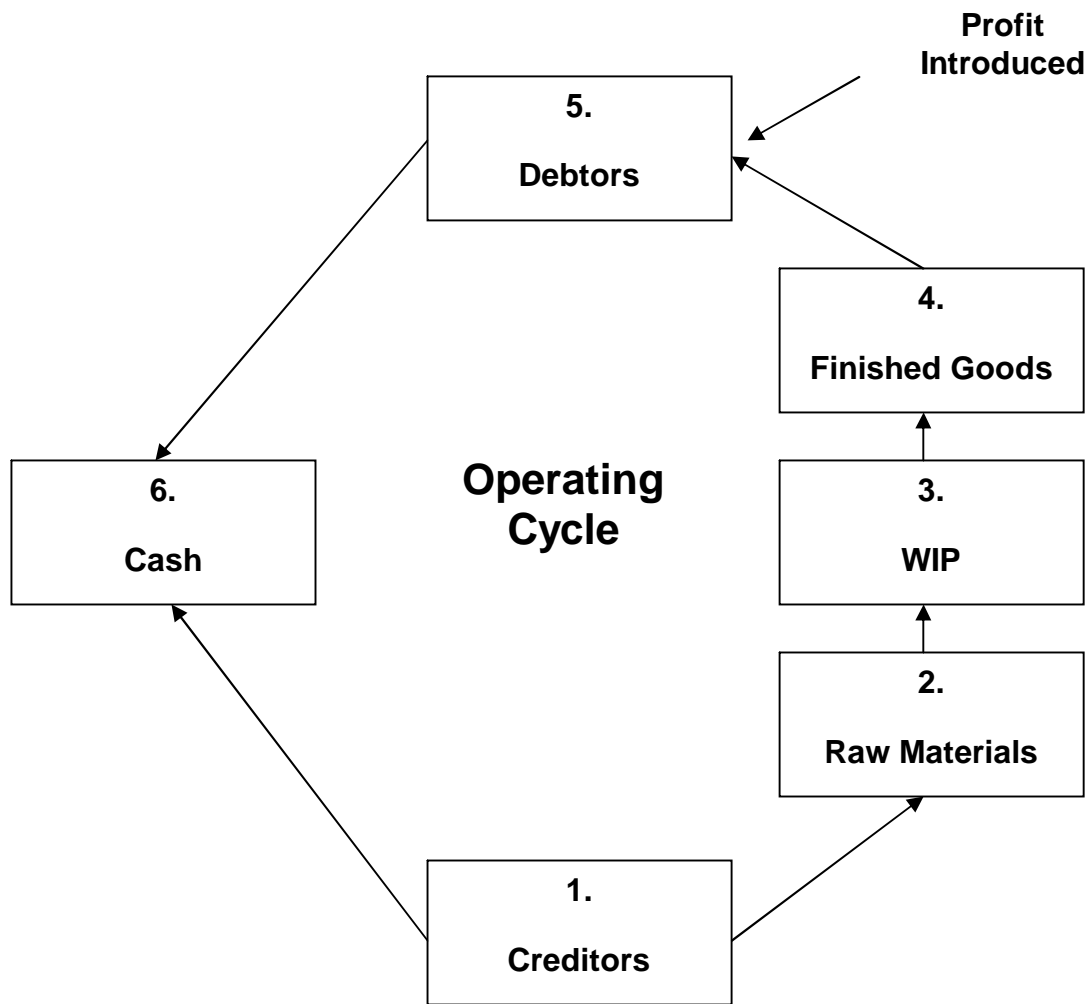


Net Operating Cycle (Days)

Operating Cycle		(Days)
Raw material turnover	$\frac{\text{Average Value of RM Stock}}{\text{Daily RM Purchases}}$	96
Production Cycle	$\frac{\text{Average Value of WIP}}{\text{Daily Average Cost of Goods Sold}}$	42
Production Goods Turnover	$\frac{\text{Average Value of FG}}{\text{Daily average cost of goods sold}}$	41
Customer Credit Period	$\frac{\text{Average Value of Debtors}}{\text{Daily Average Sales}}$	77
Financing Cycle		
Suppliers Credit Period	$\frac{\text{Average Value of Creditors}}{\text{Daily RM Purchases}}$	60
Net Operating Cycle		196



The Operating Cycle and Liquidity



7 - Working Capital

- Working capital cycle
- Investment in working capital
- The components of working capital
 - Stock
 - Debtors
 - Creditors

Working Capital Cycle

