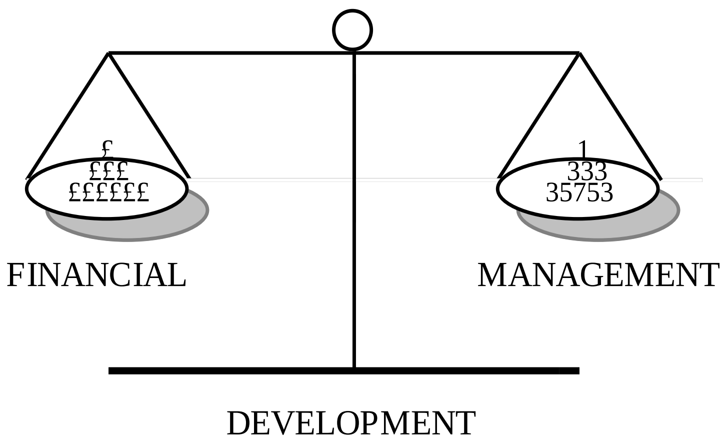
FINANCIAL MANAGEMENT DEVELOPMENT

Test your knowledge

NO 512

DIAGNOSTIC ANSWERS



ONE OF A SERIES OF GUIDES FOR

FINANCIAL MANAGEMENT DEVELOPMENT

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ANSWERS TO DIAGNOSTIC QUESTIONS

These are the answers to the questions in 511

1. A sale is recognised in the profit and loss account when (c) the goods or services are delivered. This is an application of the accruals or matching principle that seeks to identify profit as the difference between sales and the associated costs. An order has no accounting significance (a feature which is often overlooked in management information systems). Making goods is great but it is different from selling them. Any delay in raising invoices should be accounted for by accruing for income. Waiting for cash payment to signify the sale could be excessively prudent - or in the case of advance payment imprudent - and would not necessarily give a useful indication of profitability. Careful consideration has to be given to the application of this concept where delivery spans a period of time or is conditional e.g. long term fixed price contracts, warranty provisions etc.

2. Advertising is a (c) cost. If it has not yet been paid for it will also be a (b) liability. Although it may constitute an investment for the future it will not normally appear as an asset. Some companies (particularly those who spend a large percentage of sales on advertising) have recognised that this application of the prudence concept is too harsh and they now "capitalise" advertising by recognising the value of the brand in the balance sheet. However, it is the brand value which is shown, not the advertising cost.

3. Spending on equipment (assuming these are too large to be written off as stationery items) would result in (a) an asset on the balance sheet. If not paid for they could also show up as (b) a liability. They are an investment for the future and will be written off over their useful life by being depreciated. Thus the costs will match the using up of the original investment during the life of the equipment.

4. When a client pays in advance it is always (c) a good thing. It avoids any potential bad debt and improves cashflow. Whilst the cash itself is an asset there is now (b) a liability i.e. the value owed to the client of the work yet to be done or the goods to be delivered. No sale has taken place. The sale will only occur when the goods are delivered or the services are performed. The grant of a warranty period may give rise to the need to set up a provision.

5. Putting a bill in the drawer will help reported profit.....for one month! Then it will come back to haunt you
   The electricity bill should be shown as (a) an expense in the Profit and Loss Account and as (b) a liability in the Balance Sheet. Hiding expenses is not a good idea nor does it particularly help cashflow. The electricity company will chase the bill if it is not paid.

6. (a) A Profit and Loss Account is a statement of sales less costs for a given period. This may be completely different from the cash received and paid.
   (b) A cashflow statement shows cash movements. It is a vital reporting document.
   (c) See (d.)
   (d) A Balance Sheet is a list of items owned (assets) and items owed (liabilities) The net of the two is the amount due to shareholders. It is not a statement of value of the business as it excludes all the elements of goodwill - people, customers, suppliers and brands and it may contain items at cost rather than market value (land etc). It does prove that the bookkeeping system has worked (if it balances!).

7. (c) Capital Expenditure is a term used to describe spending on items of property or equipment, including all related costs, to bring into existence an asset which will benefit the business over its life, normally longer than one accounting period. Such assets are normally called Fixed Assets. Revenue expenditure is a term frequently used to cover costs written off immediately in the same accounting period in which they were incurred. Whilst Capital Expenditure is normally large, some revenue expenditure e.g. salaries may be larger.

8. Depreciation is not cash. It is (d) a charge to match the use of an asset and the spreading of the its cost. It is not necessarily the reduction in value (on a potential sale) but would be the reduction in the value in the books. It is frequently calculated as being the cost of an asset divided by its expected useful life (if there is no residual value). In the UK Depreciation is not the same as the tax allowance.

9. (a) No company shows the value of its employees, although some football clubs show the transfer fees they have paid for players as fixed assets.
   (b) Few companies mention their order book in their annual accounts. None try to include it as that would be imprudent. The profit has yet to be earned.
   (c) Work completed but not yet invoiced should be included as accrued sales income in the Profit and Loss Account (if someone tells the Accounts Department) and will be in the Balance Sheet as "Work in Progress" or amounts recoverable under contract or even debtors.
   (d) The value of the organisation will not be shown in a set of accounts. The value of the assets less liabilities only gives the Net Worth. The Employees, Brand Names and relationships with Customers and Suppliers, which together are called Goodwill also have a value. Quoted Companies can calculate their Goodwill by taking the Value of Net Worth shown in the Balance Sheet away from the value of their shares on the stock market.

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David is an experienced financial professional who has devoted his skills to management training in practical understanding and utilisation of financial information. A Graduate, Chartered Accountant, and Associate of the Institute of Taxation, he is also a Member of the Chartered Institute of Personnel and Development and has been an Ordained as a Deacon in the Catholic Church.

He has worked as a Financial Controller and Company Secretary in the Finance industry and as a Director of Finance and Administration in the Computer Services industry. Since 1990 he has conducted management development programmes for over forty major organisations including Arla Foods, Blue Circle, BP, CSC Computer Sciences, Conoco, Ernst & Young, Lloyds Bowmaker, Royal Mail, Unilever and Zeneca. He also runs programmes for the Leadership Foundation and the management teams at a number of Universities. International training experience includes work in Belgium and Holland for CSC, in Denmark, Kenya and the Czech Republic for Unilever, in Holland and the US for Zeneca, in Dubai for Al Atheer, in Bahrain and Saudi Arabia for Cable & Wireless.

He specialises in programmes in financial management for both tactical and strategic decision making. In addition he has run courses in acquisition evaluation (The Economist, Eversheds, Blue Circle and Hays Chemicals) and in post-acquisition management (Unilever). All training is specifically tailored to the needs of the organisation with the emphasis on practical applications to enhance profitability and cashflow. He has developed material for delivery by in-house personnel (Royal Mail, Lloyds Bowmaker and Conoco), computer based training packages (The Post Office, Unilever and BP), and post course reinforcement self-study workbooks (CSC and Zeneca). He has also produced a training video on Cashflow Management.

He is a prolific writer of case studies, role plays and course material. He has also published articles on the financial justification of training, financial evaluation of IT investment proposals, the use of Activity Based Costing and Customer Profitability statements, commercial considerations for consultants, the need for taxation awareness training for general managers, evangelisation and Christian business ethics.

Many of his generic documents are freely available on his website:
FinancialManagementDevelopment.com including papers on Charity Management.

In addition to his Diaconal work in the Church, he has held a number of voluntary positions including University, College and School Governor, Hospice Treasurer and Trustee of various charitable institutions. He continues to provide ad hoc commercial advice to several other charitable organisations. He has been married for over 35 years and has one daughter and three granddaughters.

This series of papers is designed to help managers by providing a basic understanding of key financial concepts to assist them in their work. It is provided at no cost since this knowledge is a Gift from God and thus to be shared (Matthew 10:8).

