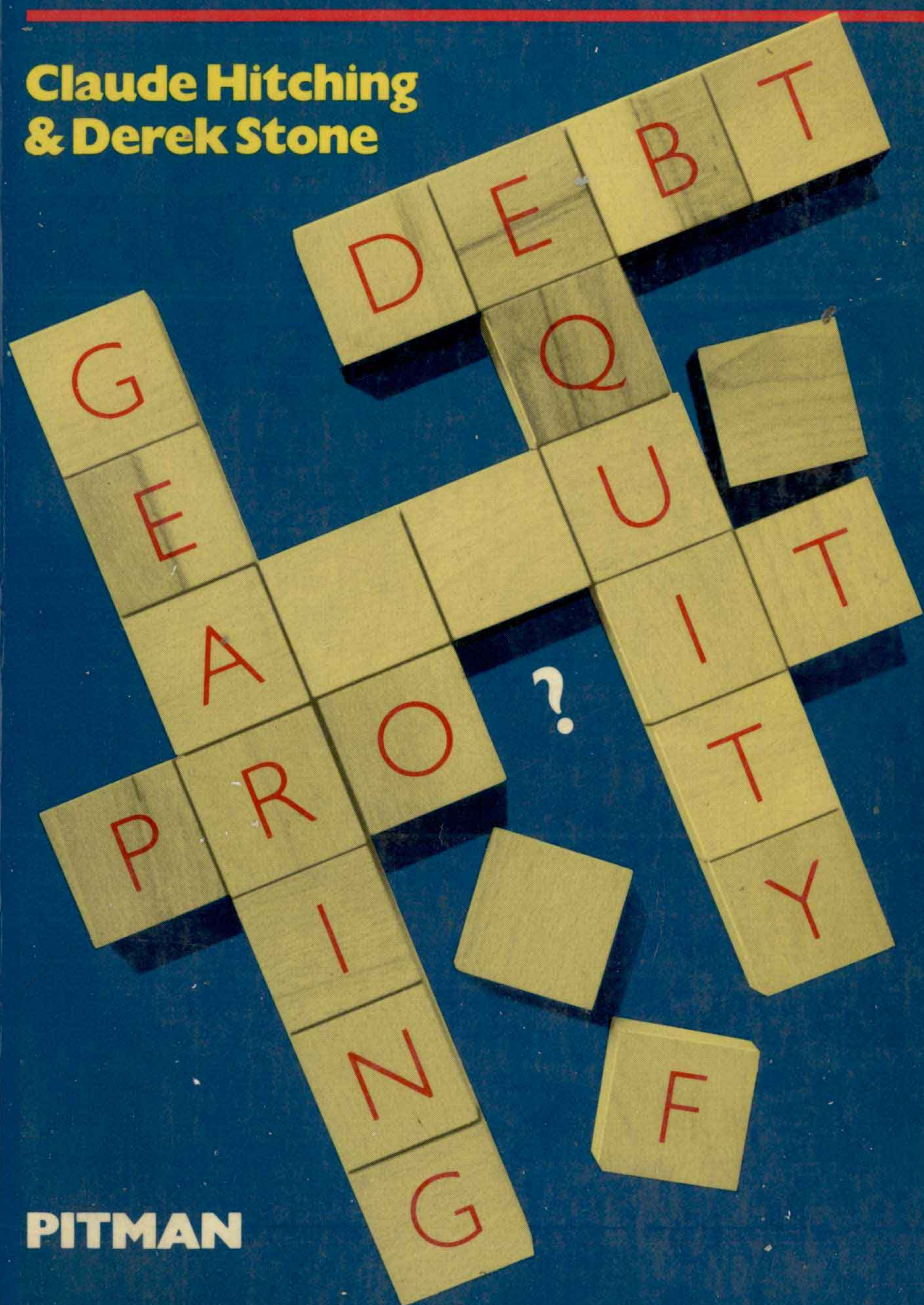


Understand Accounting!

**Claude Hitching
& Derek Stone**



PITMAN

Understand Accounting!

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Preface and acknowledgements

Background

Some time ago, we each had the good fortune to become involved in the development and presentation of a series of in-house training courses for Roche Products Ltd, one as the internal accountant responsible for internal organization and liaison, and the other as the external course consultant and lecturer.

One of the things which helped to make these courses so successful and enjoyable was the degree of commitment that they received from the top. Bill Gerard, Managing Director of Roche, gave every sort of support imaginable to the company's Management Development Programme, of which these courses formed a part. As well as the valuable lecture presentations contributed by senior finance managers from both the UK and the Swiss parent company, Bill and his fellow directors were always ready and available to take part in one of our role-playing case studies. In fact, it even got to the point where we had to make up a rota for the allocation of roles—and we couldn't have asked for a greater commitment than that!

One of the main objectives of the courses was to try to stimulate a general interest in the subject of business finance and commercial awareness among people who really ought to be concerned with it, but probably felt that the subject was either too dull, too specialized, or too complicated for them. So we decided at the outset that a light, palatable form of presentation was needed, and that we should avoid, at all costs, the use of the words 'accountancy' or 'finance' in the title of the course!

And yet a basic knowledge of the elements of finance is an essential part of any manager's mental equipment, because finance

is the common denominator through which managers from all functional backgrounds can *communicate* with each other. The ability to communicate with his colleagues is absolutely essential to any manager in business who wishes to *stay* in business. This is a point which is inevitably going to be emphasized several times throughout the book.

So we have a very important message to try to get across. It is important, not only to the accountant, but also to his colleagues from all walks of corporate life—or to the director of a small business who tries to fulfil most of the functional roles himself. It is also important to the managers of the future—the young people who are perhaps in need of a general background knowledge of accountancy and business finance against which to develop their own specialized training, whether this be in the accountancy profession itself, or in some other field where ‘accounting’ may be a secondary subject.

The path ahead

This is not intended to be a syllabus text aimed at coaching a student through to a specified professional examination level. It is intended to provide a broad background of understanding against which more detailed study can be undertaken as required. We have consequently tried to incorporate a practical approach within a light-weight frame, and we have decided to start at the very beginning! We have assumed that the reader will be starting off with absolutely no knowledge at all of finance or accounting, and we shall limber up in the first chapter with a brief discussion on the problems of communication that need to be recognized and overcome within any business organization. We shall then move on to a topic that is near and dear to all our hearts, and to the very heart of all our business lives—the functions of *money*!—into which we shall introduce some basic terminology through the use of a simple example. A few pages on cost behaviour are also included here in order to provide a familiar base to which some people will be able to relate, and from which, hopefully, they will be able to proceed with confidence to our discussion of the basic financial structure of a business, and the need for a formal presentation of financial information.

This leads us to a study of the conventions which lie behind the

presentation of the balance sheet and the profit and loss statement, and to a few words about the need for profit in business, and the function of taxation in our economy. We are then ready to tackle the methods by which the financial transactions of a company are recorded in its books of account, and this will lead us on to the source and application of funds statement and the cash flow forecast.

By this time, our thoughts will have gradually moved from the recording and interpretation of historically-based data to the formulation of financially evaluated plans and budgets for the future. A manager can only hope to lead his company forward if he is looking in the direction in which he is hoping to go, but he will need to have access to reliable and relevant information from the past in order to be able to assess which is likely to be the most potentially successful strategy out of a number of possible alternatives.

One way of looking at management information is via the use of ratios. We shall be studying some of the more common of these in some detail and examine the ways in which they can be used as reliable bases for decision making. This is the part that is likely to be of most practical interest to a manager, although it would be impossible to appreciate fully the points at issue here without first understanding the basic principles behind the figures. Conversely, to read a book confined solely to basics would be like walking down a cul-de-sac, or learning the rules of a game without ever getting a chance to play it—and this is why finance is also called ‘The Rules of the Business Game’.

We have followed the same reasoning in delaying our brief discussion of the legal obligations of companies to display financial information until the very end of the book, after we have delved into the basic principles of Added Value and Inflation Accounting. Although the balance sheet and profit and loss examples that we shall be using throughout the book have all been built around the formats prescribed in the Companies Act of 1981, it seemed pointless to divert into the statutory aspects of these statements too soon. By the time you get through to Chapter 16, however, these formats should be familiar enough for you to follow the reasoning behind the requirements of the Act quite easily.

The book is rounded off with a comprehensive glossary of all the terms encountered throughout the course of the book. However, it should perhaps be pointed out here that some of the definitions used at the ends of the earlier chapters will not be quite so comprehensive as the ones used in the Glossary. This is because we want to avoid

jumping in too quickly at the deep end, and there will be some cases where a definition will be gradually expanded as we go along.

We have also included definitions or cross references for about fifty or so additional or 'alternative' terms that the reader may encounter in practice, and we are indebted to Kenneth Harry of the Kingston Regional Management Centre for his suggestions and assistance in the compilation of this list. Some of these terms are the American 'equivalents' of the UK terminology used throughout the text, and there are also some definitions of terms which we decided not to bring into our general discussions because of the risk of introducing unnecessary clutter and confusion. It should, however, be readily possible to appreciate the implications of these additional topics once you have read the main text, and they may well prove to be useful as a future point of reference.

In order to provide an easy-reference round-up of all the case study material, we have also included an appendix in which this has been assembled into two complete sets of financial statements—primarily in order to provide you with a convenient point of reference *after* you've read the book, as distinct from a convenient point of reference as you are trying to work out the figures for yourself!

Acknowledgements

Our acknowledgements and thanks are due to a number of people and organizations without whose help and encouragement the completion of this project would have been a very daunting task. As we have already explained, this book was born out of a series of in-house management training courses with which we had the pleasure to be associated. A number of training packages were sampled during our initial period of research and preparation, and many of these contained some very sound ideas, but did not completely comply with our own particular requirements.

The outcome was almost inevitable. Various basic ideas were 'borrowed' from these sources, and remoulded into the programme that was considered to be most appropriate to our needs. One such package was a video learning programme entitled 'Minding Our Own Business', produced by ICI Plastics Division, and now marketed by Vision, Communications in AV/TV, in conjunction with Training Films International Ltd. The finance and economics

consultant for this package was Mr H. S. Corlett, of Resource Planning Ltd. The first three modules of this package set out to explain the use of money, and how it is made to work and grow in both domestic and commercial situations.

A theme was developed which illustrated a person winning some money, and then using the money to buy a car with which to start his own taxi business. This seemed a particularly good way in which to build the foundations for the rest of our course—especially since it also slotted in very nicely with another source of training material in which we were interested.

Video Arts Ltd had produced two excellent films which we decided to use as the 'main frame' around which the course presentations and case studies would be built. These were 'The Balance Sheet Barrier' and 'The Control of Working Capital', both of which featured John Cleese and Ronnie Corbett. Both films, and their supporting booklets, were written by Ernest Jones and Antony Jay, and produced by Video Arts. They are based on the structure of the course 'Finance for the Non-Financial Manager', devised by Ernest Jones of Mobile Training and Exhibitions Ltd. These sources provided inspiration for a basic approach to cash movement and the financial statements, the close analogies that can be drawn between the human and the corporate body, and the development of a balance sheet from a financial model. They also used horse-racing as an illustrative parallel: this provided the link to the ICI 'M.O.O.B.' package referred to above and the idea of Andrew Coe, one of our central characters, came from this.

Having built up, and progressively modified, all the ideas and data that we needed to cover the ground of our course, we found that we nearly had sufficient material available from which to compile a useful book on the subject of the preparation and interpretation of company accounts. This seemed to be a sensible idea, although the problems were immediately obvious, because we had never started out with the intention of writing anything completely original from start to finish—even if such a thing had been possible in the first place. Natural modesty does not forbid us to admit that at least some of the ideas and case study development is completely original, although we are nevertheless greatly indebted to all the people and organizations mentioned above for the inspiration provided by their work, and for their permission for the adaptations that have been made from their copyright material.

This applies also to Thomson McLintock & Co., whose excellent

booklet on the understanding and application of the 1981 Companies Act proved to be a most valuable reference for our own chapter on this subject. Our special acknowledgement is also due to the invaluable advice and infinitely patient co-operation of Michael McFee, a tax partner with Thomson McLintock & Co, for his guidance through the complexities of taxation topics. Brian Earle, Computer Manager of Inter Company Comparisons Ltd, has also been a tremendous help to us in the provision of data from his Company's files—only a fraction of which we have been able to use in this book. Reference has also been made to a number of tax changes prescribed in the 1984 budget and, to the best of our knowledge and belief, the book is—for all practical purposes—‘up to date’ at the time of writing. We must, however, add the inevitable disclaimer that none of the people referred to above are responsible for any of the views expressed which are our own.

We are extremely grateful to the directors of Roche for their agreement to our adaptation and development of their course material in this way, and for the many facilities that they have very generously put at our disposal throughout the preparation and reproduction of the completed typescript. Our sincere thanks are also due to Nick Bond, Fraser Goodall, Lynda Howell, Alban Kissane, Veronica Wootliff and Jack Wright for their patience and diligence in checking through the proofs of the typescript and the numbers in the case studies, and for their valuable initial feed-back.

And finally . . .

. . . our thanks are due to Andrew Coe and Matthew Grimble, without whose involvement this book would never have taken shape. They are both fictional characters who bear nothing but a purely coincidental resemblance to any person, alive or dead, although we have to admit that we have grown to know them both pretty well by now.

We used to meet Andrew occasionally at our local hostelry, where the conversation would sometimes turn to matters of a financial nature. He started off by working for someone else, and then he had a stroke of luck, won some money, and started up his own Andycab taxi business. This did quite well, and, after a while, he decided to launch his own manufacturing company under the name of Andco Ltd.

Matthew Grimble had a slightly easier start to life than Andrew, and, by the time we meet him, his business had already been established for about five years. He had invented a fantastic little product which had completely taken over the old widget market, and it was quite natural that these 'midget miracles' should very quickly become affectionately named after their creator. The 'grimble' revolution had arrived!

This is not intended to be as gimmicky as it may sound, because every company makes grimbles—even your company makes grimbles. They are just another name for whichever product it is that your company is in business to sell—whether it be chemicals, textiles, jam, garden furniture or combine harvesters. If you can accept this definition, you should find it much easier to translate our examples into your own environment than if we had used a title like 'The Walter Wall Carpet Co. Ltd'. If we had done that, there would inevitably have been a carpet specialist out there somewhere who would have got hold of our examples, and immediately disputed all the figures.

Anyway, that brings us up to date with the origins and background of the book. We can now set out on our journey of discovery together, and we look forward to the pleasure of your company along the way, in the hope that you will receive as much enjoyment out of reading our book as we have obtained from writing it.

Let's get down to business by trying to learn something about the 'Language of Business' . . .

Summer 1984

Claude Hitching
and
Derek Stone

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The language of business

Introduction

Never ask of money spent
Where the spender thinks it went.
Nobody was ever meant
To remember or invent
What he did with every cent.

So said Robert Frost, the American poet who manages to convey the impression in these few short lines that he was a little out of touch with the world of finance. Perhaps he was someone who preferred to leave the control of money to those who were trained and paid to do it for him—the accountants.

A lot of people would agree with him, largely because they don't really understand the weird mumbo-jumbo that they have heard accountants use. They probably couldn't care less whether or not fixed assets are always the things that are nailed down, or whether or not an unpaid electricity bill should be classified as a current liability.

But think what the accountant has to put up with! He has to listen to builders going on about their bending moments, flashing, and relieving arches, and to engineers trying to explain the difference between a grub screw and an endless belt. Or he might have to discuss inter-grade differentials with the personnel manager, or try and appreciate the shipping manager's concern over deviation claims, lay days, CIF, and Section 7 Relief. And then, while all this is going on, the data processing manager is rushing around making sure that nobody has got their bits mixed up with their bytes, or their ROMs confused with their RAMs, and that they have all remembered to 'boot' their disks before settling down with their micros!

In fact, while we are on the subject of data processing jargon, how about this sample extract from a set of instructions recently issued with a 'software package'?

The options in the file are processed as though they replace the **OPTIONS** option. Consequently, the **OPTIONS** option in one option file can refer to another option file. Options files can be chained together in this manner. Alternatively, the **OPTIONS** option in the **SCRIPT** command line might refer to a file that contains a list of **OPTIONS** options, each of which points to a different options file . . .

Faced with all that, the only thing the accountant wants to do is to escape back to his own office and browse quietly among his debits and credits. He does not really want to be a nuisance to anybody . . .

The need for communication

All managers and specialists have their own particular jargon which they use as a means of communication. This is fine when they are communicating with someone who understands the same sort of language, but it is not so good when they are trying to get a message across to someone who doesn't.

Two things can sometimes happen. The specialist may assume that his audience understands every word he says, whereas they don't, but don't like to admit it. And also, it is not unknown for specialists to deliberately try to get out of tricky situations by blinding their audiences with science, and hoping that they won't be honest enough to admit that they didn't get the point—often only to find that one of them did!

Either way, things could very quickly degenerate into a situation where a state of mutual embarrassment and mistrust brings on the withdrawal symptoms that push people further and further back into their own functional and departmental corners, cutting the lines of communication as they go.

This must be wrong. It is counter-productive, and a sure recipe for disaster. A successful business depends on a cohesive management team—and teamwork depends on *Communication*. The ability to communicate depends entirely upon the availability and the universal understanding of a common language—and this is where the accountant has the golden opportunity to come into his own, because finance really can be claimed to be the 'language of