Contents

1 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

business'. Almost every business situation is capable of financial evaluation, and most situations should therefore be capable of being related through this common denominator.

It is consequently extremely important that all managers should have a full and confident knowledge and understanding of the financial and commercial implications and consequences of the actions and decisions with which they may be involved, or for which they may be responsible. This sense of commercial awareness is an essential quality for all managers who hope to be able to make an effective contribution to the work of their management team, or to the future success of their company. The secret is to ensure that their accountant provides them with all the information they need to enable them to make the best and safest judgements possible in the circumstances that prevail.

One of the main objectives of this book is to help non-financial managers—and others—to learn the 'language of finance', and to help them identify and interpret the sort of information they will need in order to perform their management function more effectively.

The person who prepares this information for them is the accountant, who, according to the *Oxford Dictionary* definition, is the 'professional keeper and inspector of accounts'. This is not the only definition that we could quote, and you may well care to suggest a number of others, some of which may not be quite so complimentary as the Oxford Dictionary! In any event, and however we may choose to define his responsibilities, it must be accepted that the accountant has a key role to play as a member of the management team. Part of his time will also be taken up with the preparation of the company accounts to send to the company's shareholders, and looking after the company's financial relationship with the outside world—a role which involves making sure its customers pay their accounts on time, and that there is enough cash in the bank with which to pay the company's suppliers and its employees' wages, and so on.

But we don't need to dwell on this side of the accountant's duties too much here. We are more concerned with his (or her) 'management accounting' responsibilities, which can be very briefly summarized as follows:

1 To assist colleagues in the planning and co-ordination of company budgets and forecasts, and to ensure that these are both reasonable and acceptable.

2 To prepare timely, relevant and accurate management reports and accounts.
3 To hold regular performance reviews with management colleagues, and to help them interpret past results and update future forecasts and strategies.
4 To play a consultative role by advising colleagues on the possible financial implications of actions and decisions for which they may be responsible.

Summary

Throughout this book, we shall be concentrating mainly on building up an understanding of the accountant's jargon: the way in which he prepares his reports, what his financial statements mean, and how his work integrates with that of his colleagues in the company's management team.

His role can be compared to that of a GP advising on his company's health and well-being; a referee keeping a record of the score in the 'game of business'; or an interpreter translating opinions, judgements, actions or decisions into the common language of commercial finance. Part of this latter function must also be to ensure that his colleagues are able to recognize, understand and appreciate the signs and messages of this common language. So, if you ever see an advertisement for an accountant who is required to be qualified in medicine, hold a referee's certificate, and speak several foreign languages, then you'll know that at least one other person has read this book apart from yourself!

2 Who needs money?

What is money?

Many people have defined money in their own particular way. Oscar Wilde once said, 'When I was young, I used to think that money was the most important thing in the world. Now that I am old, I know it is!', while 200 years ago Benjamin Franklin said: 'The use of money is all the advantage there is of having it. If you would like to know the value of money, go and try to borrow some'. James Baldwin, on the other hand, thought that money was rather like sex 'You thought of nothing else if you didn't have it, and of other things if you did', which makes you wonder what they used to think about before money was invented . . ..

In those days, people could only exchange, or barter, their own goods or labour for the goods or labour of others. The shopping list of the average working man might have read:

1 Cow = 3 Sheep
= 10 Days' work
etc., etc.

This meant that traders had to carry wagonloads of goods around with them, or herd their animals around until they found somebody with whom they could arrange some mutually satisfactory barter. They eventually decided to make things easier by using less bulky, but more rare and valuable things, like measures of gold and silver, which were of an agreed and recognizable value, and which they could exchange for other goods of equivalent value.

Then, about 700 years BC, the Lydians of Asia Minor began to make coins of fixed values which they could use as tokens of exchange. The idea caught on very well, because coins of gold, silver

and copper were used for over 2,500 years before the Americans started using paper money in large quantities, and then, in 1914, the Europeans started to do the same.

Paper money and coinage have no great value in themselves. Their value depends on what they can be exchanged for; so a country could not get rich simply by printing lots of paper money. If there were not enough goods being produced to be exchanged for the money, the money itself would be worthless.

What do we need to know about money?

Nowadays, we all tend to take money for granted—unless we haven't got any. But we are going to concentrate for the moment on what money means to us, as individuals.

There are basically two things that we need to know about money. Where it comes from, and where it goes to—or how we can get our hands on it, and what we can do with it once we've got it. These two things need to be thought about together, because you can't very well spend money before you are reasonably certain that you are going to have some to spend, and, conversely, money isn't very much good to you unless you use it. It's nice to know you've got some, but if you just stash it away in a safe, it will gradually lose its purchasing power as inflation pushes up the cost of goods and services, so you need to keep it moving if it's really going to be of any 'value' to you. In other words, it has to *flow* in order to maintain or increase its value.

Where does money come from?

As individuals, we can obtain money in several ways. We earn wages and salaries from our jobs, receive interest or dividends from investments made in the past, obtain revenue from the sales that we make in our shop—or maybe we have just been lucky enough to inherit a fortune.

Where does money go to?

Once we've got some, we can then decide what we are going to do with it, and consider what it is useful for.

We immediately find that we have achieved a degree of flexibility

that barter could never provide. We are able to make a choice about the way we use our money. For example, we can spend it or save it. We can store—or invest—the results of our labours at one time or period, and obtain the benefits from them at some other time in the future. Conversely, money also enables us to obtain goods or services on credit, and to pay for them out of our future income.

There are also a number of different areas in which we can decide to allocate our money. These include:

(a) Essentials, such as housing, clothing and food.
(b) Consumer durables/luxuries, such as a car, a television, or a washing machine.
(c) Consumables, such as food, drink, tobacco and leisure pursuits, on which expenditure is mainly a matter of choice.

Money as a measure

As well as thinking about money from the viewpoint of its function as a useful means of exchange, we must also consider its use as a measure. For instance, money can help us to form opinions or judgements, and to take decisions, such as:

(a) The relative cost, and value for money, of one lawnmower compared with another.
(b) Which building society offers the best rate of interest on the money we deposit with them.
(c) Which assurance company offers the best value in life policies.
(d) Whether or not we can afford to buy and run a car.

In exactly the same sort of way, managers in business can use money measures to help them decide:

(a) Whether or not they should invest money in a new factory or piece of machiney, or in the promotion of a new product.
(b) Whether one project is 'better' or 'worse' than another.
(c) Whether or not they are trading profitably or wisely.

Savings and investment

Having thought about some of the ways in which we can obtain money, and about some of the things we can spend it on once we've

got it—or, in some cases, even before we've got it—let us now suppose that we have been lucky enough to earn or obtain more money than we actually need to spend on the things that we happen to want at the moment. We have a surplus—so what do we propose to do with it?

We can either save it or invest it. We can store it in a piggy-bank, stuff it under the mattress or under the clock on the mantel-piece, or we can put it into a bank, post-office or building society account, where we hope and trust that it will attract more money to itself in the form of interest—and so increase in value over time.

This is quite commonly all lumped together under the general heading of 'Saving', but we ought really to be a bit more specific in our definitions. We shall therefore define 'saving' as merely holding on to our money for use at some future date without adding any value in the form of accrued interest—in other words, the 'mattress' or the 'piggy-bank' approach. The storage of money in any place where it can attract, or *earn*, interest—such as a bank deposit or a building society account—must be defined as an *investment* in just the same way that money can be invested in property, shares, coins, stamps, pictures, or any other article that the investor considers will increase in value over time.

What is investment?

Investment is therefore a way of making money work, and can be simply defined as

An outlay of cash or its equivalent, in the anticipation of obtaining a net profit at some time in the future.

If, for instance, we were lucky enough to inherit £30,000, we could 'save' it under the mattress so that it would always be available for a rainy day. But not many people would do this for the simple reason that, while it is under the mattress, it is not *doing* anything. It is not working, or earning any interest.

We are much more likely to put it on deposit in a bank, or into the Proverbial Building Society, where we are confident that it will be safe, and where it is almost guaranteed to earn a known rate of interest. This interest would be our 'return on investment' or 'return on capital employed'—terms that we shall encounter quite a lot later on.

There are not many places 'safer' than a building society in which

we could invest our money because there is hardly any risk that we shall lose it, or fail to accumulate interest on it as the years go by. The rate of return that we would expect will not therefore be particularly exciting—perhaps 10 per cent after tax—but will be the sort of return that we would expect from a 'low-risk' investment. The £30,000 invested in a building society at this rate would therefore be worth about £48,300 after five years.

The important thing to consider is our freedom of choice. No one is going to *make* us put our money into the building society, because it is *our* money, and it is entirely up to us to do what we like with it, and, if we are anything like the other 99 people out of a hundred in a similar situation, the investment that we shall look for is the one that we feel is likely to attract the highest rate of return commensurate with the degree of risk involved.

Risk and judgement

The next question we have to ask is who is going to quantify the degree of risk for us? Well, this is something that must depend on our judgement, and our judgement alone. There are all sorts of 'experts' about who will be only too happy to advise us on any aspect of investment and risk that we care to think of, but they can never make us do anything against our 'better judgement'. Therefore we are always ultimately responsible for the 'management' of our own money.

Perhaps we may feel that we would like to invest our £30,000 in stamps, or in property. We might regard either of these as just about as 'safe' as the building society, so what sort of 'return' would they be likely to yield? A philatelic expert may advise us that a £30,000 collection of stamps could very well be worth about £50,000 in five years' time, and an estate agent or surveyor may estimate that a house costing £30,000 now could easily be worth £52,000 by then. Both of these amounts are more than we expect from the building society, so, assuming that we have just about equal faith in each of these expert assessments, we are likely to go for property, because our sources of information tell us that this is the way in which we shall obtain the greatest 'growth' from our money over the next five years.

Of course, there is always the chance that our information could have been wrong. There is no way of knowing, until the five years are up, just how accurate the forecasts were. Perhaps, after all, we

have not made the right choice. That will be our own hard luck! Nobody made us make the wrong decision—in the end, it was the result of our own *mis*judgement, which may have been absolutely sound and valid at the time, but eventually turned against us. This could very likely have arisen out of a change of circumstances over time—probably circumstances over which we had no control at all, so that, in reality, our investment was nothing more nor less than speculation.

A risky business

Suppose you have been longing to start up your own business. That £30,000 that has just come your way may be just what you have been waiting for, because not many businesses can be launched without any capital being available. Or maybe you have a friend who wants to start a business, and he has heard about this £30,000, and asked you to invest your new-found wealth in that. You have the money that he needs, and he is prepared to pay you for the use of it.

If you considered that this might be a risk worth taking, and agreed to lend him your money for a certain number of years, he might guarantee to pay you 20 per cent per annum for it—twice as much as you would expect to get from the building society—or he might perhaps offer you a 'share' in the business, where the return you get would depend entirely upon the degree of success or failure that he achieved. This may consequently be more or less than the 20 per cent he promised you in return for the loan of your money, but the choice is yours. It would be up to you to assess the degree of risk that would be involved, and whether or not you are prepared to take that risk in order to earn a possibly higher rate of return from your money than you would expect to get from the many other 'safer' options that are likely to be available at lower rates of return. The final decision will depend upon your own final judgement.

However, whatever you decide, your friend will still need to find money from somewhere if he is going to get his business started. He will need it because investment is fundamental to business, and this is another concept of investment that we need to keep very firmly in our minds. The other—as we have already explained—is that investment is essentially speculative by nature, because it is based on the principle that money is being spent or committed today in the hope of yielding a 'return', or profit, at some time in the uncertain future.

Information

So how uncertain is the future? Is there any way in which we can predict what is likely to happen tomorrow, next week, or over the next few years with any reasonable degree of accuracy?

Some people might consult the stars and their horoscopes, but others would tend to shrug this off as being far too unrealistic to be used as a practical base for forecasting purposes, even though the astrological charts and tables have been built up painstakingly over centuries of observation and measurement. Most people, however, accept the view that what happens today is in some way an extension or progression of what happened yesterday, and that, consequently, what happens tomorrow will be a sort of extrapolation of the same chain of events.

Everything would be nice and simple if we could take one thing at a time and consider it in complete isolation from everything else, but reality is never as simple as that. While food-shopping, for example, we are unlikely to look at the price of potatoes in the supermarket and think to ourselves that, if a given quantity costs 70p today, and the same quantity cost 80p last month, then it is likely that they will cost 60p next month—and nothing in seven months' time! What we might do is to relate this month's price to the price of potatoes exactly a year ago, and then to forecast next month's price by applying the same relationship to the price that ruled twelve months prior to that—assuming, of course, that we could remember what it was.

In other words, in order to make our forecast, we would be mentally acknowledging the existence of seasonal variations in the price of potatoes, and be superimposing this on to the general underlying trend or pattern of price movements over a given period of time in the past. In order to quantify the future, however, we have to be in a position of being able to quantify the past—we already know how much potatoes cost today, but, in order to estimate how much they are likely to cost next month, we now want to know how much they cost twelve months ago, and how much they cost eleven months ago. We need historical *information.*

In this respect, an investor is no different from the food-shopper. He also needs to have information about what has happened in the past in order to enable him to assess the sort of risk that might be involved, and the amount of return that he might reasonably expect

to receive in the future as a result of the outlay of a certain sum of money at the present time. If he is thinking of spending his money on physical things of value, such as stamps or antiques, he will want to know how prices for these things have moved over the past few years, and, if he is considering putting his money into an established company, the sort of information that he needs will be found in the balance sheets and profit and loss statements of that company for the last few years.

We shall be devoting quite a lot of time to these and other financial records of a company in later chapters, but let us just say for now that the balance sheet will help him assess the degree of *risk* that is likely to be associated with his investment, and that the profit and loss statement will help him assess the sort of *return* that he might expect to receive from the use of his money.

This would be an appropriate point at which to pause and to summarize the points that we have covered so far.

Summary

The value of money lies only in what it can be exchanged for, and it has to move—or *flow*—in order to maintain or increase its value, or purchasing power. It provides flexibility of choice about the way in which it is used, and it can also be used as a relative measure.

Investment is a speculative outlay of cash or its equivalent, in the hope of obtaining a net inflow of cash or its equivalent—or a net profit—at some time in the future.

The choice of investment will depend upon the investor's own assessment of the relative risks from the range of choices available, commensurate with his assessment of the possible rates of return that he might expect from the use of his money. Normally, the higher the degree of risk involved, the higher the rate of return that will be required by the investor.

In order to assess the level of risk involved, and the possible rate of return that might be expected, the investor will need to have access to specialized information. This information will be based on records of historical events and performances, and he will then need to judge how these past performances might be expected to extrapolate into the future. 'Now' is only one single moment in time during the course of a continuing stream of events, and the important things to know are: