Pro Active Resolutions

FINANCIAL AWARENESS

Notes

Pro Active Resolutions

WELCOME

Welcome and many thanks for choosing our introductory guide to Financial Awareness, published by Pro Active Resolutions. Pro Active Resolutions was formed in February 1995 as business friend to help businesses be sustainable, grow and prosper. We do this by providing value for money accounting, business, educational and training services.

Financial systems are needed to keep a track of where the money is going and where it is coming from. The benefits of having a good system can be compared to the control panel on an aircraft, the pilot relies upon their instruments to measure and control the performance of the aircraft, show them how the aircraft is doing, what outside conditions are like, the flight path to be taken and so on. The instrument panel is not flying the aircraft; it is helping the pilot to do their job properly. Typical questions that a business may ask, and that need an answer includes

- What is profit, and how is it calculated?
- Which is more important, cash or profit?
- What does it cost to deliver a service and/or producing a product?
- How do we know how we are doing financially?

The purpose of this short guide is to provide an initial framework of understanding and we have used the lens of an arts organisation to illustrate this. This guide is based on articles previously published in Arts Professional.

The principles and comments within the guide apply equally to all other types of business, commercial or otherwise.

Our website proactiveresolutions.com has a free library of resources and will also tell you more about what we do and how we can help you. We have additional business learning resources hosted by our sister company knowledgegrab.com, their mission being to 'teach the world to learn and apply accounting and enterprise in business, work and study'.

We hope you enjoy the guide and would love to hear your feedback and thoughts.

Best wishes and happy reading

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INTRODUCTION

Financial statements present useful information that helps in the efficient running of an organisation, indicate how successful its management is performing and provide users with information about its resources and activities.

Accounting has developed over a number of centuries and with it has evolved a framework with accepted guidance and 'rules' as to how accounts should be prepared. The accounting framework allows for flexibility of interpretation and judgement, this allows accountants to be 'creative', albeit not in an artistic sense.

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MAIN FINANCIAL STATEMENTS

Two of the main financial statements produced by Arts organisations are a balance sheet and a profit statement (or income statement). The balance sheet lists all assets owned or controlled by an organisation and all of its debts (liabilities) at that same point in time; the profit statement shows income generated and the costs incurred in generating that income.

Examples of assets would include office furniture, computer equipment, stage props, money owed by customers, scenery, cash, grant monies not yet received; examples of liabilities include bank overdrafts, PAYE, money owed to suppliers for goods and services purchased but not yet paid for.

Accounting statements are presented in monetary terms therefore they only include items that can be measured with certainty and reliably, for example a monetary value can be placed on the purchase of computer. However skilled and loyal members of staff cannot be valued reliably and therefore would not appear in a set of financial accounts.

Assets are items of value that can be sub-divided into those that have been acquired for long term use by an organisation (fixed assets) to help it earns its income and carry out its work; current assets are another category, this includes cash or items that an organisation intends to turn into cash within one year. For example a theatre company will have stage scenery, lighting rigs and costumes that it may use for a number of productions; these will all be examples of fixed assets. If that same theatre company runs a café then all its food and drink stock will be classified as current assets

CAPITAL AND REVENUE EXPENDITURE

Another important classification and distinction to be aware of is that between capital and revenue costs, if an item is classified as capital then it will appear in the balance sheet, if it is classified as revenue costs it appears in the profit statement and is used to calculate profit.

Capital costs are those that results in acquiring fixed assets or in improving them; revenue costs are those incurred in:

- Obtaining assets for turning into cash
- The day to day running costs of an organisation, for example wages, rent
- Maintaining fixed assets

Capital costs usually have associated revenue costs, for example a van used by a theatre company for touring would be classified as a fixed asset (balance sheet), the associated revenue costs would be the fuel, repairs, insurance and road tax (profit statement); the building owned by the above theatre company would be classified as a fixed asset (balance sheet), if the building were to be painted or broken window replaced then this would normally be classified as revenue (profit statement), if the building were to have an extension then this would be classified as capital (balance sheet).

A profitable organisation does not necessarily mean it is cash rich; it is not that unusual for an organisation to be profitable for a period of time and have a shortage of cash.

PROFIT MEASUREMENT

We have looked at the profit and loss statement, the balance sheet and the cash flow statement. It is important to remember that these statements attempt to reflect the financial impact of Arts organisations activities. In financial and accounting terms transactions are either revenue or capital, if they are if they are of a revenue nature then they appear in the profit statement, if they were of a capital nature they would appear in the balance sheet.

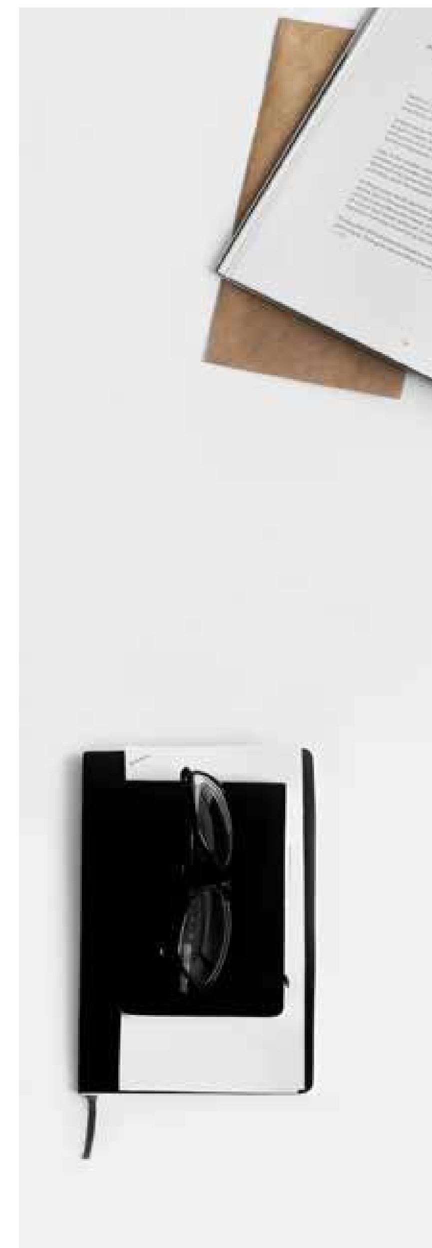
The calculation of profit involves the application of one of the key accounting rules known as 'matching'. This states that income and expenses should be included in the period in which they were earned or incurred rather than when the money was paid or received.

DEBTORS AND CREDITORS

Imagine a theatre company that prepares its financial statements to 31st March 2017, in the last week of its financial year it does a workshop for which it charges £100 and allows 30 days for payment.

The £100 will be included as income in the profit statement for the year to 31st March 2017; the amount owing is called a debtor (receivable) and will be recorded in the theatre company's balance sheet.

If the same theatre company had to hire stage props and the cost was (say) £30, with the supplier allowing 30 days for payment the £30 would be included as an expense in the profit statement for the year to 31st March 2017; the amount owing is called a creditor (payable) and will be recorded in the theatre company's balance sheet.



DEPRECIATION

When an organisation purchases a fixed asset it does so with the intention of long term use to help it earn its income and carry out its work, examples being buildings, furniture, stage scenery, motor vehicles, computer equipment etc. The matching concept requires that the cost of these assets be spread over how long these assets will be useful to the organisation. The application of this matching concept is commonly referred to as 'depreciation'; an example should illustrate how it is applied in practice.

Imagine an organisation that spends £6,000 on buying stage scenery, this scenery is estimated to last (say) three years. Over the next three years the organisation will include in its profit statements an amount for depreciation totalling £6,000, how much it includes in each of those years is a matter of personal choice. It could include £2,000 per annum, or it could include (say) £3,000 in the first year, £2,000 in the second year and £1,000 in the final year. These two methods of calculating depreciation are called straight line (equal amount charged each year) and reducing balance.

A common misconception is that depreciation should not be applied when it comes to buildings, on the grounds that buildings rise in value and thus depreciation should not be included in the profit statements.

However, depreciation reflects the costs to an organisation of using the asset over its lifetime, most assets have a finite life and thus depreciation will be calculated. Land is an asset that has an infinite life and therefore would not usually be depreciated.

ACCOUNTING JUDGEMENTS

There are a number of areas in preparing financial statements that require the exercise of judgment and use of estimates. Referring to the examples above, if the theatre company thought that it would not collect the £100 from its workshops then £100 would be included in the profit statement (for 31-Mar-17), this would be called a provision for bad debts – profit would go down and the figure for debtors would reduce. If the stage scenery were thought to last (say) 2 years then depreciation (using straight-line) would be £3,000 for each year (cost of asset £6,000/2 years), profit would go down and the figure for assets would reduce.

We can see that the actual receipt and payment of cash is irrelevant for the calculation of profit, organisations can (and do) make profits but be in debt. Profit is very much a subjective figure; cash to a large extent is factual and represents the lifeblood for any organisation.

CASH AND ACCOUNTS INTERPRETATION

As discussed before a profitable organisation does not necessarily mean it is cash rich; it is not that unusual for an organisation to be profitable and also to be in debt. Cash is required to pay suppliers, employees, banks, investments in projects etc., it is considered to be the lifeblood of any organisation, Insufficient or inadequate control of cash is one of the primary reasons for organisational failure.

A cash flow statement links the profit and loss statement and balance sheet together and shows the impact of organisation activities in cash terms. It will show the sources of cash, for example from operating activities, grants received, sale of assets, it will also show where the cash has gone, for example capital purchases, loan repayments etc. The overall effect of these cash receipts and payments is reflected by the increase or decrease in the bank balances during the year. This statement also helps management assess the liquidity, solvency and financial adaptability of the organisation.

The published cash flow statement is an historical statement, due to the criticality attached to cash management it is recommended that all organisations prepare a forecast cash statement on a rolling twelve-month basis (at minimum), this will prove to be an invaluable management tool.

The financial statements can provide a valuable insight into the performance of an organisation, a number of performance indicators can be used to measure its efficiency and effectiveness. Financial statements are those that tend to be published for groups outside of the organisation, management accounts are for internal use and contain more detailed information and are more use as a management tool.

APPENDIX: GLOSSARY OF TERMS

Term	Definition
Asset	Something of value owned by a business, and is available for use by the business
Fixed Asset	Assets bought as part of infrastructure and capacity
Current Asset	Assets that are to turn into cash e.g. stock, debtors, cash
Long-Term Liability	Funds provided for the business on a medium to long-term basis by an individual or organisation, e.g. a bank
Current Liability	Amounts owed (debt) by the business within one year, e.g. PAYE
Net Assets	Total assets less total liabilities
Net Current Assets	Also called working capital and is the difference between the current assets and the current liabilities. These are the available funds of the business for day-to-day transactions, e.g. paying bills.
Depreciation	A non-cash expense which spreads the cost of the asset over its useful life.
Debtors	This is part of current assets and is also known as receivables. This is the sum of money owed to business by its customers.
Trade Creditors	This is also known as payables and is money owed to suppliers.
Capital Cost	Cost incurred on the acquisition of fixed assets for use in the business and not for resale.
Revenue Cost	Cost incurred in the manufacture, selling and distribution of goods and the day-to-day administration of the business.
Gross Profit	Disclosed in the trading account and is the difference between sales income and the cost of those sales (cost of purchases).
Net Profit	Gross profit less the expenses for the period
Fixed costs	Costs that remain constant over a period of time or activity level.
Variable costs	Cost that vary with a level of activity, e.g. number of miles travelled
Direct costs	Costs that can be easily identified with an individual product or service, and are economic to quantify, e.g. materials used for manufacture.
Indirect costs	Also called overheads, these are support costs

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