Financial and Management Accounting Concepts

Editorial

This month's newsletter focuses on the way in which you can interpret fully the information you present in the form of financial statements to either your clients or your employers.

The interpretation covers concepts and performance indicators as: profitability, liquidity and utilisation but also a cash forecast and cash flow statement perspective. It is often the case that a client may observe that a profit has been made but the bank balance has fallen ---- why?

I hope that this will be useful in your working environment.

Dr Philip E Dunn

Editor

To download this article in printable format click here

The purpose of this Case Study is to illustrate within a single case scenario a number of financial and management accounting concepts.

Musgrave Joinery and Maintenance Services (Small Business Case Study)

The business was established in the early 1980's by Simon James and Pauline Musgrave. In the past three years, the business has expanded rapidly. You are employed as an Accounting Assistant by a firm of Practicing Certified Book-keepers who have recently been doing some work for the partnership.

The expansion has been partly due to the addition of maintenance contracts with a large Private School in the area. This has involved employing a further three skilled persons. Much of this incremental work has been labour intensive.

During this period the business has introduced a more strict control of materials by opening a new material stores and staffing it with a part-time experienced stores personnel. This has led to more accurate information being readily available for job and contract costing.

The business has altered its buying policy for materials and has secured a contract with a national supplier, who will allow better quantity discounts than were previously available.

The expansion has also involved extra investment in motor vehicles and equipment.

The following is the Case File. It contains the following documents and information:

1. Extracts from Trading Statements 2005 and 2006
2. Extracts from Balance Sheets 2005 and 2006
3. Cash Flow Forecast Data January – June 2007

Extract from Trading Statements

	2005	2006
Work Done	160,500	255,600
Cost of materials	88,950	111,500
Contribution	71,550	144,100

Overheads and other costs

Wages	20,100	60,200
Motor Vehicle Running Costs	6,900	7,800
Insurances	1,600	2,400
Consumables	510	620
Depreciation	4,200	9,400
Rent of Workshop	500	750
Bank Charges	1,400	2,200
Administration	1,250	2,100
Loan Interest	650	2,150
Professional Fees	250	300
	37,360	87,920
Net profit for year:	£34,190	£56,180

Extracts from Balance Sheets

		2005	2006
Fixed Assets			
Motor Vehicles and Equipment		13,700	27,000
Current Assets			
Stocks		4,500	9,500
Debtors		25,500	65,000
		30,000	74,500
Less Current Liabilities			
Creditors		11,000	24,000
Bank Overdraft		1,800	18,500
		12,800	42,500
Working Capital		17,200	32,000
		£30,900	£59,000
Financed by:			
Partners:	Capital Accounts	12,000	12,000
	Current Accounts	9,700	26,000
		21,700	38,000
Long Term Liabilities			
Loans		9,200	21,000
		£30,900	£59,000

Notes to Balance Sheet

Stocks and Debtors end 2004: £4,000; £21,000

Drawings 2006: £39,880

Loans repaid 2006: £3,200

Loans negotiated 2006: £15,000

Cash Flow

Forecasts January - June 2007

Information

1. Existing debtors will pay their accounts:
   £30,000 January; £20,000 February; £15,000 March
2. Existing creditors will be paid:
   £14,000 January; £10,000 February (includes VAT creditor)
3. Work done projected January - June £24,000; £25,000; £23,000; £25,000; £24,000; £23,500 (exclusive of VAT); but subject to VAT

   Debtors to be allowed one month only.**
4. Materials £9,650; £10,250; £10,100; £10,900; £10,400; £10,700 (exlusive of VAT); but subject to VAT

   Creditors to allow one month's credit.
5. Wages £5,150 per month
6. Other overheads £1,650 per month (plus VAT of *£175 per month)
7. Income Tax January £4,500; Drawings £3,250 per month (in total); Loans £600 per month

N.B: Depreciation charges half year £4,700, Stock Valuation £9,500

* Not all items are subject to VAT

** In the past, invoices had not been issued on a timely basis, this was to be addressed

On a recent visit to Musgrave Joinery and Maintenance Services you are assigned the following tasks:

1. Simon asks you to prepare a comparison of 2005 and 2006 accounts, and you decide to use the following performance indicators:

   a) Net profit % of work done.

   b) Contribution % of work done.

   c) Overheads (ex wages) % of work done.

   d) Wages % of work done.

   e) Current Ratio (current assets : current liabilities)

   f) Acid Test (current assets – stocks : current liabilities)

   g) Debtors payment period (average debtors/turnover *365)

   h) Stock turnover (cost of materials/average stock)

   i) Asset turnover (turnover/total assets – current liabilities)

   Tabulate your answer and comment briefly on your findings.

2. Simon asks you to explain why it is that, having made a profit for 2006, the bank overdraft has risen.

   You decide to produce a Cash Flow Statement as a basis, to help you with this task.

3. Simon informs you that he has arranged a meeting with his Bank Manager and that the bank has asked for a cash forecast for 6 months ended June 2007. Your case file contains information for this period.

   Prepare the forecast for the partnership for January to June 2007; together with Profit Statement and Balance Sheet.

Basis of the report

Musgrave Joiner and Maintenance Services

Ration Analysis 2005 and 2006 Comparisons

Ratio			**Comments**
1. Net Profit % of Work Done	21.3	21.9	Marginal increase in profitability
2. Contribution % of Work Done	44.6	56.4	Reflects purchasing policy and tighter controls on materials
3. Overheads (ex Wages) % Work Done	10.7	10.8	Cost of overheads held in line with activity
4. Wages % Work Done	12.5	23.6	Reflects additional staff and new work
5. Current Ratio	2.3:1	1.8:1	Sound Liquidity in both periods
6. Acid Test	2.0:1	1.5:1	---------
7. Debtors Collection Period	53 Days	65 Days	Controls need to be tighter on collection of funds from Debtors
8. Stock Turnover	20.9	15.9	Holding just less than one month's supply of materials
9. Assest Turnover	5.21	4.3	Less asset utilisation in Year 2 as the investment in vehicles and equipment has not resulted in a direct proportional increase in turnover

Cash Flow Statement for year Ended 2006

		£
Net Cash Flow from Operating Activities: **(see Note 1 below)**		34080
Investing Activites:		
	Payments to Acquire Fixed Assets*	
Financing:	Drawings	(22700)
	Loans Negotiated	(39880)
	Repayment of Loans	(3200)
	Increase/(Decrease) in Cash or Cash Equivalents	£(16700)
Note 1:	**Reconciliation of Operating Profit to Net Cash Flow from Operating Activities:**	
	Operating Profit	56180
	Depreciation	9400
	Increase in Stocks	(5000)
	Increase in Debtors	(39500)

	Increase in Creditors	13000
		£34080
	Cash During Year:	
	Balance 1 January	(1800)
	Net Cash Flow	(16700)
	Balance 31 December	(18500)

*Fixed assets (05)	£13700
Less Depreciation	9400
	4300
Fixed assets (06)	27000
Additions	£22700

Although a profit of £56180 was achieved during the year (after allowing for depreciation); the extra investment in working capital, additional stocks and debtors and the change in creditors resulted in cash flow from operating activities of £34080.

Although additional loans were negotiated to partly finance the new equipment and vehicles, this investment of £22700 together with partner drawings of £39880 result in a weakening of the cash position of £16700.

The Cash Forecast

Management of cash resources is an integral part of the management of working capital in any organisation.

Preparing the cash budget: this covers a number of objectives, including:

- Providing periodic budgeted cash balances for the budgeted balance sheet
- Integrating and profiling the effect of functional budgets on an organisation's cash resources
- Anticipating cash surpluses or shortages in such a way that time is made available to deal with them
- Providing a means of comparison with actual performance so that control can be implemented

It is essential for the control of day-to-day cash balances to ensure that there is sufficient cash to:

- Meet day-to-day cash flow needs
- Pay wages and salaries when they fall due
- Pay creditors to ensure continued supply of goods and services
- Pay government taxation, VAT and other taxes
- Pay providers of capital dividends and interest
- Invest in further fixed assets for the longer term

Cash budgets may be prepared for the long term in line with a corporate plan of, say, three to five years, or the short term relating to the current budget cycle and period. It is often the case that a separate cash budget is formulated for a specific project or contract.

There are several factors to take into account when preparing a cash budget. You may have to:

- Forecast sales volume and level of activity
- Forecast the time it will take to convert debtors to cash and link this to the timing of cash inflows
- Determine material usages and inventory levels and hence purchases
- Forecast the time taken for creditors to pay for purchases
- Forecast payments of wages, salaries, overhead
- Consider other cash payments for capital expenditure, tax, dividends and loan repayments
- Incorporate other cash receipts such as loans and issues of capital (shares, debentures)

Format of the cash budget: a tabular layout is normally used. The rows detail the cash inflows and outflows and the columns the period base. The format can be easily converted to a spreadsheet, as you will see in the layout below.

Cash Forecast January - June 2007

	Jan	Feb	Mar	Apr	May	June
Inflows:						
Existing Debtors	30000	20000	15000			
Work Done	-	28200	29375	27025	29963	28200
	30000	48200	44375	27025	29963	28200
Outflows:						
VAT				6825		
Existing Creditors	14000	10000				
Materials		11339	12044	11868	12808	12220
Wages	5150	5150	5150	5150	5150	5150
Overheads	1825	1825	1825	1825	1825	1825
Taxation	4500					
Drawings	3250	3250	3250	3250	3250	3250
Loan Repayments	600	600	600	600	600	600
	29325	32164	22869	29518	23633	23045
Net Inflow (Out) for month	675	16036	21506	(2493)	6330	5155
Brought Forward	(18500)	(17825)	(1789)	19717	17224	23554
Carried Forward						
In Hand / (Overdrawn)	(17825)	(1789)	19717	17224	23554	28709

This forecast relies heavily on the timely issuing of the invoices and the tighter control of debtors that leads to a stronger cash position. If however the debtors collection period is allowed to continue, then the cash position would still be negative.

Forecasted Profit Statement January - June 2007

		£
Income:		
	Work Done	145000
Less:		
	Cost of Materials Used	62000
	Gross Margin	83000
Other Costs:		
	Wages	30900
	Other Overheads	9900
	Depreciation	4700
		45500
	Net Profit for Period	£37500

Forecasted Balance Sheet as at 30 June 2007

	£	£
Fixed Assets:		
Motor Vehicles and Equipment		22300
Current Assets:		
Stock	9500	
Debtors	27613	

Cash at Bank	28709	
	65822	
Less Current Liabilities:		
Creditors	12572	
VAT	6650	
	19222	
Net Current Assets		46600
		£68900
Financed By:		
Partners Capital		12000
Current Accounts*		395000
		51500
Long Term Liabilities:		
Loans		17400
		£68900

*This will equal balance December 2006 + Profit - Drawings

ie: £26000 + £37500 - (19500 + 4500) = £39500