

Index

- accountants, roles, 4–5
- accounting
 - applications, 11–12
 - approaches, 8–9
 - building blocks, 64
 - coverage, 9
 - divisiveness of, 3
 - foundations of, 11, 65–83
 - importance of, 1–3
 - incompleteness, 7
 - knowledge of, 1–2
 - logical basis for, 27
 - as measurement system, 6–7, 27–8
 - mechanisms, 11
 - as model, 47–8
 - motivations for, 1
 - overview, 1–9
 - perceptions, as difficult subject, 3–8
 - skills for understanding, 3–4
 - subjectiveness, 2–3, 7
 - terminology, 3
 - use of term, 27
- accounting information
 - in decision making, 128–9
 - in financial analysis, 128–9
 - presentation, 11
 - reliability, 2
 - subjectiveness, 2–3
- accounting model, 47–8
 - double entry, 6, 8
 - features, 65–6
 - universality, 47–8
- accounts
 - commenting on, 28–9
 - context, 5
 - functions, 27
 - and growth determination, 85, 87–98
 - as high-level summaries, 7–8
 - preparation vs. usage, 4–5
 - presentation, 28
 - reading, 4
 - worked examples, 66–7
- accounts payable, 22
 - increase, 94
- accounts receivable, 21
 - increase, 94, 95, 133
 - reduction, 71, 105–6
- accounts receivable turnover,
 - determination, 105–6
- accruals, 37, 53
 - applications, 36
 - concept of, 36
 - principles, 35–9
- accrued expenses, 37
- advertising, expenditure, 69
- annual profit stream, 140–1
- asset utilisation, 104
- assets, 20, 34–5
 - acquisition, 101
 - current, 20–3
 - definition, 20
 - depreciation, 93–4
 - disposal, 91
 - generation, 87
 - growth, 87, 91
 - increase, 77, 92, 133–4
 - investment in, 99–100
 - measurement, 7
 - issues, 7
 - non-cash, 34, 36–7, 53
 - purchase, 68
 - reduction, 37
 - sale of, 89, 90–1
 - and unpaid work, 35–6

- assets (*cont.*)
 - value of, 34
 - see *also* fixed assets; inventory; net assets
- balance sheets, 2, 11, 13, 21, 39–42
 - categories, 20–3
 - changes to, 50, 51, 52
 - types of, 55
 - commenting on, 23
 - components, 49
 - and double entry, 49–56
 - forecasts, 129–32
 - functions, 27, 49–50
 - and growth determination, 85, 91–5, 96
 - impacts on, 48
 - opening, 20, 40
 - preparation, 20
 - presentation, 22–3
 - principles, 20–3
 - structure, 20, 39–40
 - summaries, 45
 - transactions and events, 49
 - see *also* closing balance sheets
- bank loans, 87
 - interest on, 75
 - repayment, 78, 89
- bank statements, 30
 - and cash flow statements compared, 32–3
 - commenting on, 29
 - and economic activity, 29–31
 - limitations
 - fundamental, 29–31, 34–5
 - presentational, 29–31
- banks
 - borrowing from, 68, 87
- branding, 97
- breakeven
 - analysis, 115
 - determination, 115
- budgets, 11–12, 129
- business
 - language of, 3
 - risk assessment, 111, 127
 - valuation, 134–5, 141
 - see *also* companies
- capital
 - cost of, 106–7, 110, 138, 139
 - investment of, 99–100
 - measurement, 110
 - return on bank's, 122–3
 - return on shareholder's, 122–3
 - share, 101–3
 - see *also* return on capital; return on capital employed (ROCE); return on invested capital (ROIC)
- capital employed
 - components, 122
 - and growth, 101
 - and profits, 100, 101
- capital expenditure, 92
 - vs. depreciation, 93, 97
- capital structure, 121
- cash flow statements, 11, 13, 14, 31–4, 68
 - and bank statements compared, 32–3
 - categories in, 15, 33
 - double entry, 91
 - forecasts, 132–5
 - functions, 14
 - and growth determination, 85, 88–91, 96
 - and income statements compared, 41–2
 - limitations, 34–5
 - principles, 13–15
 - structure, 14, 31
 - summaries, 45, 88
- cash flows
 - and depreciation, 93–4
 - determination, 134
 - discounted, models, 136–7
 - discounting, 141
 - expected future value, 135–41
 - forecasts, 141
 - future, 139
 - net, zero, 89, 91
 - types of, 31
 - valuation, 136
 - and wealth, 31, 34
 - see *also* financing cash flows; free cash flow; investing cash flows; operating cash flows
- cash generation, for shareholders, 134–5
- closing balance sheets, 20
 - determination, 40–1

- companies
 - accounting contexts, 5
 - cyclical, 116
- competitors, lawsuits by, 73, 79, 80
- compounding, 137
- contribution
 - definition, 115
 - negative, 116–17
- corporate valuation, 11–12, 140
 - models, 86, 128–41
- cost of capital, 106–7, 110, 138, 139
- cost categories, 118
- cost of goods sold, principles, 17
- cost of sales, principles, 17
- costs
 - fixed–variable split, 117
 - and output, 114–15
 - see *also* direct costs; fixed costs; indirect costs; variable costs
- CR see credits
- credits, 56–62
 - aggregation, 56–7
 - use of term, 57
- current assets, 20–3
- cyclical companies, 116

- data, connections between, 6–7
- DCF (discounted cash flow) models, 136–7
- debits, 56–62, 133
 - aggregation, 56–7
 - use of term, 57
- debt financing, 141
- debtors see accounts receivable
- decision making
 - accounting information in, 128–9
 - financial, 2
 - and operating leverage, 116
 - investment, 138
- depreciation, 18, 37, 83, 96
 - assets, 93–4
 - on balance sheets, 95
 - and cash flows, 93–4
 - fixed assets, 93
 - vs. capital expenditure, 93, 97
- direct costs, 117
 - definition, 118
 - and indirect costs compared, 118–19
- discount rates, 137, 139
- discounted cash flow (DCF) models, 136–7
- discounting, 137
 - cash flows, 141
 - functions, 137
- dividend payments, 89, 101, 134
- Donne, John, 5
- double entry, 6, 8, 47, 64
 - and balance sheets, 49–56
 - cash flow statements, 91
 - effects on financial statements, 51–2
 - impacts, 50–1
 - journal entries, 56–7
 - types of, 54–6
- DR see debits

- economic activity
 - bank statements and, 29–31
 - keeping track of, 11, 47–64
- economic decision making, operating
 - leverage and, 116
- economic profit, 85, 108
 - concept of, 107
 - determination, 107
 - and growth, 107
 - and return on capital, 109
 - and value creation, 106–9
 - variation, 108
 - worked examples, 107–9
- economies of scale, 130
- efficiency, increase, 85
- employees, payment of, 69
- equity, 39–40, 91
 - change in, 122–3
 - definition, 20
 - and financial leverage, 126–7
 - increase, 93
 - and operating leverage, 126–7
 - value of, 132
 - see *also* return on equity (ROE)
- equity balance, factors affecting, 93
- events, 49
 - accounting treatment, 67–75, 77–83
 - recording, 65–6
- expenditure
 - advertising, 69
 - see *also* capital expenditure

- expenses, 16–17, 133
 - accrued, 37
 - summaries, 7–8
 - tax, 36
 - see *also* interest expenses; operating expenses
- financial accounting see accounting
- financial activities, 42
- financial analysis, accounting information
 - in, 128–9
- financial decision making, 2
- financial forecasts, 11–12, 129
- financial information, need for, 11, 27–46
- financial leverage, 85–6, 120
 - definition, 119
 - effects of, 120, 125
 - and equity, 126–7
 - and house buying, 123, 124–6
 - negative, 124
 - and operating leverage compared, 119–20
 - positive, 124
 - and risk, 119–26
- financial performance see performance
- financial position, 2, 47–8
- financial reports, 2
- financial securities, investment in, 87
- financial statements
 - applications, 85
 - building, 11
 - case studies, 13
 - commenting on, 25, 45–6
 - construction, 28
 - coverage, 9, 128
 - double entry effects on, 51–2
 - forecasts, 86
 - functions, 11
 - and growth determination, 85, 87–8, 96
 - guided tour of, 11, 13–26
 - interpretation, 23–5
 - item measurement, 28
 - items to include, 27–8
 - limitations, 96–8
 - linkages among, 42–5
 - overview, 13
 - presentation, 26
 - reading, 4
 - structure, 42–5
 - summaries, 44, 76, 82
 - worked examples, 23–5, 62, 67
- financial transactions see transactions
- financing cash flows, 15, 33, 68, 90
 - and liabilities, 92–3
 - non-shareholder, 54
 - outflows, 133–4
 - principles, 33
 - shareholder, 52–3
 - as wealth-neutral, 34
- fixed assets, 20–3
 - book value, 97
 - depreciation, 93
 - increase, 92
 - investment in, 97
 - reduction, 72
- fixed costs, 111, 119–20
 - definition, 112
 - low, 114
 - and variable costs, 113
- forecasts
 - balance sheets, 129–32
 - cash flow statements, 132–5
 - cash flows, 141
 - financial, 11–12, 129
 - financial statements, 86
 - income statements, 129–32
 - variables, 130–1
 - iterative processes, 129
 - for sales, 129–30
- free cash flow, 139–40
 - determination, 135
- funding
 - sources of, 91
 - external, 87, 90
- gearing see leverage
- general ledgers, 56–62
 - use of term, 59–62
- goods sold, cost of, 17
- gross margin, 112–13
 - factors affecting, 104
 - percentage, 18
- gross profit, 16–17, 112–13
 - principles, 18
- growth
 - assets, 87

- and capital employed, 101
- determination, from accounts, 85, 87–98
- and economic profit, 107
- indicators, 93, 95–6
- operating capacity, 15
- and profits, 101, 102, 103
- property, plant and equipment, 131
- sales, 130–1
- and value creation, 99–103
- house buying, and financial leverage, 123, 124–6
- income statements, 2, 8–9, 11, 13, 17, 21
 - and cash flow statements compared, 41–2
 - commenting on, 19, 34–5
 - forecasts, 129–32
 - variables, 130–1
 - functions, 16, 27
 - and growth determination, 95–6
 - principles, 16–19
 - structure, 16–17
 - summaries, 45
- indirect costs, 117
 - definition, 118
 - and direct costs compared, 118–19
- interest
 - on bank loans, 75
 - payments, 78
 - see *also* rate of interest
- interest expenses, 141
 - principles, 19
- internal rate of return (IRR), 137
 - definition, 135–6
 - on investment, 138–9
 - and return on capital employed compared, 136
 - and return on equity compared, 136
- inventory, 5, 20, 53
 - acquisition, 87
 - increase, 70, 77
 - purchase, 53–4, 68
 - reduction, 77
 - and return on invested capital, 105
 - sale of, 70–1, 87
 - supply of, 54–6
 - see *also* assets
- inventory turnover, definition, 105
- investing cash flows, 14–15, 33, 54
 - assets, 91
 - increase, 93–4
 - negative, 88
 - outflows, 133
 - positive, 88, 89
 - principles, 33, 88
 - as wealth-neutral, 34
- investment
 - in assets, 99–100
 - of capital, 99–100
 - decision making, 138
 - effectiveness, 99–100
 - in financial securities, 87
 - in fixed assets, 97
 - internal rate of return on, 138–9
 - opportunities, 106, 109
 - performance, 100
 - in research and development, 79
 - and value creation, 99–103, 136–7
- IRR see internal rate of return (IRR)
- journal entries, 56–62
 - double entry, 56–7
 - principles, 57–9
 - summaries, 67, 74, 81
- key variables, 9
- lawsuits, by competitors, 73, 79, 80
- leverage
 - concept of, 85–6
 - and return on equity, 121–2, 123, 126–7
 - see *also* financial leverage; operating leverage
- liabilities, 20, 22, 34–5, 39–40
 - definition, 20
 - increase, 92–3
- liquidation, 73–5
- liquidity
 - concept of, 22
 - importance of, 22
 - presentation, 22–3
- losses, 2–3

- management, effectiveness, 123–4
- negative investing cash flows, 88
- negative operating cash flows, 90–1
- net assets, 20
 - offsetting changes within, 53–4
 - and profits, 95–6
 - value of, 132
- net cash flows
 - inflows, 133–4
 - zero, 89, 91
- net income see profit after tax
- net present value (NPV), 136–7
 - negative, 139
 - positive, 139
 - zero, 139
- non-shareholder financing cash flows, 54
- NPV see net present value (NPV)
- opening balance sheets, 20, 40
- operating capacity, growth, 15
- operating cash flows, 14, 15, 33, 36, 37, 52, 68, 69
 - inflows, 133
 - negative, 90–1
 - principles, 33, 88
 - and profits, 133
 - reinvestment, 89, 93–4
 - retained profits, 91
 - and wealth, 34
- operating expenses
 - assumptions, 130–1
 - principles, 18
- operating leverage, 85–6, 112
 - definition, 113
 - effects of, 114
 - and equity, 126–7
 - and financial decision making, 116
 - and financial leverage compared, 119–20
 - high, 113, 114, 116–17
 - implications, 116
 - implications, 116–17
 - importance of, 113, 119
 - issues, 117–19
 - low, 113, 114, 116–17
 - and risk, 111–15
- operating performance, 122
- operating profit, 16–17, 122
 - principles, 18–19
- opportunity cost, 138–9
 - definition, 106
 - shareholders, 106–7
- output
 - and costs, 114–15
 - and revenue, 114–15
- overheads, variable, 130
- percentage rate of return, 100–1
- performance, 11–12, 16, 47–8, 85
 - future trends, 128–9
 - investment, 100
 - measurement, 2–3, 53, 85
 - operating, 122
 - and return on invested capital, 106
- positive investing cash flows, 88, 89
- PPE see property, plant and equipment (PPE)
- price discrimination, 116–17
- profit after tax, 133–4
 - principles, 19
- profit before tax, 16–17
 - principles, 19
- profit and loss accounts see income statements
- profit margins
 - factors affecting, 104
 - increase, 85
 - and return on invested capital, 103
- profit stream, annual, 140–1
- profitability, 123–4
- profits, 2–3, 37
 - calculating, 38–9
 - and capital employed, 100, 101
 - concept of, 16, 35
 - generation, 87
 - and growth, 101, 102, 103
 - as growth measure, 95–6
 - measurement, 38, 110
 - and net assets, 95–6
 - and operating cash flows, 133
 - principles, 35–9
 - retained, 91, 132
 - see also economic profit; gross profit; operating profit

- property, plant and equipment (PPE), 49–50
 - acquisition, 53–4, 133
 - disposal, 54
 - growth, 131
 - increase, 133
 - purchase, 54
 - and sales, 131–2
- R&D *see* research and development (R&D)
- rate of interest, 122
 - and return on capital employed, 123, 124
- rate of return, percentage, 100–1
- raw materials, 21
- rents, 18
 - payment of, 72, 78
- reporting entity, 39–40
- reporting period, 16
- research and development (R&D), 97
 - investment in, 79
 - unsuccessful, 79
- retail space, sales and, 104
- retained profit, 91, 132
- return
 - percentage rate of, 100–1
 - risk and, 124
 - see also* internal rate of return (IRR)
- return on bank's capital, and return on shareholders' capital compared, 122–3
- return on capital, 85, 122
 - and economic profit, 109
 - evaluation, 103–6
 - and value creation, 99–103
- return on capital employed (ROCE), 122, 123–4
 - definition, 100–1, 122
 - determination, 122
 - and house buying, 124–6
 - and internal rate of return compared, 136
 - and rate of interest, 123, 124
- return on debt, 122
- return on equity (ROE), 122
 - components, 123–4
 - definition, 100–1, 120
 - factors affecting, 124
 - and internal rate of return compared, 136
 - and leverage, 121–2, 123, 126–7
- return on invested capital (ROIC), 101, 123
 - and accounts receivable turnover, 105–6
 - control, maximisation, 104
 - definition, 100–1
 - determination, 103
 - importance of, 103
 - and inventory reduction, 105
 - and performance, 106
 - zero, 101–3
- return on shareholders' capital, and return on bank's capital compared, 122–3
- return to shareholders, 122
- revenue, 16–17, 133
 - aggregates, 7–8
 - generation, 85
 - and output, 114–15
 - principles, 17
 - see also* sales
- risk
 - exposure to, 111
 - financial effects of, 111
 - and financial leverage, 119–26
 - and operating leverage, 111–15
 - and return, 124
 - sources of, 85–6
 - understanding, 85–6, 111–27
- risk assessment, business, 111, 127
- ROCE *see* return on capital employed (ROCE)
- ROE *see* return on equity (ROE)
- ROIC *see* return on invested capital (ROIC)
- salaries, 80
- sales
 - cost of, 17
 - forecasts, 129–30
 - growth, 130–1
 - and property, plant and equipment, 131–2
 - and retail space, 104
 - see also* revenue

- sales per square metre, 104
- share capital, raising, 101–3
- shareholder financing cash flows, 52–3
- shareholder value creation, 107
- shareholders
 - cash generation for, 134–5
 - dividends, 134
 - funding from, 87
 - investment opportunities, 109
 - opportunity cost, 106–7
 - return to, 122
- shares
 - purchase, 134
 - repurchase of, 89
- summaries, high-level, 7–8
- suppliers, payments to, 71, 80
- ‘T’ accounts, 59
- tax, 16–17
 - principles, 19
 - unpaid, 38–9
 - see also profit after tax; profit before tax
- tax expenses, 36
- tax payable, 22
- terminal value, 139
 - definition, 139–40
 - determination, 140–1
- trade debtors see accounts receivable
- transactions, 49
 - accounting treatment, 67–75, 77–83
 - recording, 11, 65–6
 - summaries, 7–8
 - see also wealth-neutral transactions
- turnover see revenue
- unpaid tax, 38–9
- unpaid work, assets and, 35–6
- valuation
 - business, 134–5, 141
 - cash flows, 136
 - issues, 38
 - processes, 135, 141
 - see also corporate valuation
- value creation
 - economic profit and, 106–9
 - factors affecting, 109–10
 - growth and, 99–103
 - investment and, 99–103, 136–7
 - measurement, 85, 99–110
 - return on capital and, 99–103
 - shareholder, 107
- variable costs, 111
 - definition, 112
 - and fixed costs, 113
- variable overheads, 130
- variables
 - income statements, 130–1
 - key, 9
- wages, 80
- wealth
 - accounting systems for, 2
 - cash flows and, 31, 34
 - change of, 35
 - operating cash flows and, 34
 - reduction, 36–7
- wealth-neutral transactions
 - financing cash flows and, 34
 - investing cash flows and, 34