

## 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