Pathways to Management and Leadership

Level 5: Management and Leadership

Unit 5007V1

Organisational Financial Management

Pathways to Management and Leadership

Unit 5007V1: Organisational Financial Management

First edition 2006

Author:	Corinne Leech
Series consultant:	Merritt Associates
Consultants:	Graham Hitchcock Bob Croson
Project manager:	Sid Verber
Editor:	Lyn Ward
Page layout by:	Decent Typesetting

Second edition 2008

Revision author:	Ray Rowlings
Series consultant:	Merritt Associates
Editor:	Suzanne Pattinson
Proof reader:	Rebecca Norman
Page layout by:	Decent Typesetting

Revised July 2013

British Library Cataloguing-in-Publication Data. A CIP catalogue record for this publication is available from the British Library.

ISBN 0-85946-512-8

Organisational Financial Management

Contents

About this workbook

The unit

The main purpose of this workbook is to support you as you study for the Chartered Management Institute Level 5 in Management and Leadership qualifications, so it specifically focuses on the content of the syllabus for Unit 5007V1 *Organisational Financial Management*. It builds on the knowledge and understanding covered in Unit 5004V1 *Practices of Resource Management* and therefore assumes you have already completed that unit.

This workbook provides underpinning knowledge and develops understanding to improve your skills as well as to prepare you for future assessment. If you are studying for the Level 5 in Management and Leadership qualifications, then you will be assessed by your approved centre on 'your knowledge and understanding of' the following learning outcomes.

1. Understand how to control a financial system.
2. Be able to identify and use a range of financial controls.
3. Understand the sources and availability of finance to an organisation.

The aims of this workbook

This workbook aims to help you learn how to:

- review/develop the financial plan of the business
- understand essential business financial controls and their appropriateness in seeking and maintaining profitability
- consider the sources and availability of finance for an organisation and how these may be affected by external factors.

Syllabus coverage

The table below shows which sections of the workbook address each of the assessment criteria of the qualification syllabus.

Unit 5007V1 syllabus coverage	Addressed within section:
Financial Control	
1.1 Assess the relationship(s) between a financial system, /function and other systems/functions in an organisation	1
1.2 Describe the systems of accounts and financial statements used to control a financial system	1
1.3 Analyse financial information contained in a set of accounts or financial statements	1
2.1 Construct a budget for an area of management responsibility	2
2.2 Develop budgetary control systems comparing actuals with planned expenditure	2
2.3 Discuss corrective actions to be taken in response to budgetary variations	2
2.4 Identify conflicts that can occur with management control systems and how these could be resolved or minimised	2
3.1 Define the current and potential sources of finance that support organisational activities	3
3.2 Evaluate the distribution of finance in support of organisational activities	3
3.3 Evaluate the monitoring and control of finance employed in support of organisational activities	3

Getting started

All organisations are financially accountable. For example, public limited companies are, by law, accountable to shareholders as well as to HM Revenue & Customs. Public-sector organisations are accountable to the Audit Commission and charities can be regulated by a range of bodies, including the Charities Commission. They all have to produce financial statements, which are audited.

For many non-financial managers, these financial statements retain an air of mystery. This workbook will explain the simple principles on which accounts are based and attempt to dispel some of the mystification. By the end, you should have the ability to tackle statements such as the balance sheet, profit and loss account and cash flow statement with much more confidence.

This workbook also explores aspects of financial planning and some of the finance-related external factors that affect an organisation's plans. This will enable you to view the financial context of your organisation within a wider context.

How to use the workbooks

The workbooks provide ideas from writers and thinkers in the management and leadership field. They offer opportunities for you to investigate and apply these ideas within your working environment and job-role.

Structure

Each workbook is divided into sections that together cover the knowledge and understanding required for that unit of the Chartered Management Institute Level 5 in Management and Leadership. Each section starts with a clear set of objectives that identify the background knowledge to be covered, and the management skills in the workplace that enable you to demonstrate this knowledge. You do not have to complete the sections in the order they appear in the workbook, but you should try to cover them all to make sure that your work on the unit is complete. There are self-assessment questions at the end of each section that allow you to check your progress. You may want to discuss your answers to these questions with your line manager or a colleague.

Activities

Throughout the workbooks there are activities for you to complete. These activities are designed to help you to develop yourself as a manager. Space is provided within the activities for you to enter your own thoughts or findings. Feedback is then provided to confirm your input or to offer more ideas for you to consider.

To get the best from the workbooks, you should try to complete each activity fully before moving on. However, if the answer is obvious to you because the issue is one you have encountered previously, then you might just note some bullet points that you can then compare quickly against the feedback. You may sometimes find it difficult to write your complete response to an activity in the space provided. Don't worry about this — just keep a separate notebook handy, which you can use and refer to as needed.

Try not to look at the feedback section before completing an activity. You might like to try covering up the feedback with a postcard or piece of paper while you are working through an activity.

Timings

Timings are suggested for each section and activity, although it is important that **you** decide how much time to spend on an activity. Some activities may occupy only a few moments' thought, while others may be of particular interest and so you might decide to spend half an hour or more exploring the issues. This is fine – the purpose of the activities is to help you reflect on what you are doing, and to help you identify ways of enhancing your effectiveness. It is always worth writing something though, even if it's brief – the act of writing will reinforce your learning much more effectively than just referring to the feedback.

Scenarios

There are scenarios and examples throughout each workbook to illustrate key points in real workplace settings. The scenarios cover a wide range of employment sectors. As you work through, you might like to think of similar examples from your own experience.

Planning your work

The reading and reflection, scenarios and activities in each section of the workbooks are designed to take around two hours to complete (although some may take longer). This is a useful indicator of the minimum length of time that you should aim to set aside for a study session. Try to find a quiet place where you will not be interrupted and where you can keep your workbooks, notes and papers reasonably tidy. You may also like to think about the time of day when you work best – are you a 'morning person' who likes to get things done at the start of the day, or do you work better in the evening when there may be fewer disturbances?

Preparing for assessment

Further information on assessment is available in the Student Guide produced as part of the *Pathways to Management and Leadership* series. If you have any further questions about assessment procedures, it is important that you resolve these with your tutor or centre co-ordinator as soon as possible.

Further reading

Suggestions for further reading and links to management information are available via ManagementDirect through the Study Support section of the Institute's website at http://mde.managers.org.uk/members. Alternatively, email ask@managers.org.uk or telephone 01536 207400. You will also find titles for further reading in the Bibliography at the end of this workbook.

Section 1 Understanding financial statements

Time required: about 4 hours

Learning outcomes

By the end of this section you should be able to:

1.1 Assess the relationship(s) between a financial system/function and other systems/functions in an organisation

1.2 Describe the systems of accounts and financial statements used to control a financial system

1.3 Analyse financial information contained in a set of accounts or financial statements.

The Chartered Management Institute has produced two useful checklists on understanding financial statements:

- Checklist (130): Reading a balance sheet
- Checklist (183): Reading a profit and loss statement.

Financial information

Financial information records the circulation of money within an organisation. It can be grouped broadly into three categories:

- financial statements – these report on what has happened (i.e. the past)
- management accounts – these deal with what is happening at the present time and include records of current income and expenditure
- financial plans and budgets – financial plans have to be developed for the long term with budgets forecasting the short term, often for the next financial year.

Producing financial statements, such as a balance sheet, is the responsibility of the company accountants. They then pass their findings to external auditors, who confirm and explain their own view. The statements are required for legislative reasons and external users (shareholders, investors).

However, it's important that managers also understand these key financial statements, for two main reasons.

- Managers need to recognise the impact of day-to-day financial activity on the overall financial position of the organisation.
- Managers need to understand the overall financial health of the organisation so they can use it as a baseline for financial

planning. Financial statements are a mirror image of the operational health of a business in money terms.

In this section, we explain the following three financial statements:

- the balance sheet
- the profit and loss account
- the cash flow statement.

The balance sheet

A balance sheet is a snapshot of an organisation's financial position (i.e. what it's worth) at one specific point in time. It gives a summary of the organisation's assets (everything the organisation owns) and the claims on the organisation. The total assets always equal the total amount of claims on the organisation.

There are two types of claims for public companies. These are as follows.

- **Liabilities**: These are debts to banks, suppliers and other creditors (money owed by the organisation).
- **Equity capital**: This is everything that belongs to the shareholders – what they've invested in the company and profits that belong to the shareholders but are being kept by the company to enable it to operate (retained profit). In the case of public limited companies, there are shareholders. In the not-for-profit sector, organisations have 'reserves' instead of retained profit.

Therefore, the full balance sheet equation is:

Assets = Claims (Liabilities + Equity capital)

The whole structure of business accounting is based on this simple principle. The principles of how a balance sheet is put together are the same for all organisations, so this section will be useful to you even if you don't work in the private sector.

Activity

Activity 1.1 **(about 5 minutes)**

A company buys a building for £100,000. It pays for this with £40,000 profit it has accumulated and makes up the difference with a bank loan of £60,000.

Fill in the figures in the gaps below to show how the balance sheet equation works for this transaction.

Assets	=	Liabilities	+	Equity capital
£	=	£	+	£

Feedback

In this situation, the building is an asset, the bank loan is a liability and the profit forms part of the equity capital.

£100,000 = £60,000 + £40,000

Every time an organisation makes a financial transaction of any kind, an adjustment is made to each side of the balance sheet equation. It's not necessary to draw up a new balance sheet every time, although it would be quite possible to do so. An organisation normally draws up a balance sheet once a year on a date known as the 'Accounting reference date' or more commonly, the 'Year end'.

A good way to understand how a balance sheet works is to see how different kinds of transactions are recorded on it. Here, we will arrange the information in a different way from the format that's normally used for balance sheets in the UK, because this makes it easier to see what is happening.

We begin with an empty chart, for a limited company, which shows the assets on one side of the equation and the liabilities and capital on the other. These two sides must always be equal to each other.

Assets	£	Liabilities and equity capital	£

We will build up a balance sheet for PC Servicing Ltd, a small computer servicing company that has just been set up. The first event that takes place is that the shareholders pay £10,000 into the company. Now the company has an asset of £10,000 cash in its bank account and an equal claim on it from the shareholders.

Assets	£	Liabilities and equity capital	£
Cash	10000	Share capital	10000

The company buys a set of specialist repair manuals, costing £75, by cheque. Now the balance sheet looks like this:

Assets	£	Liabilities and equity capital	£
Fixed assets		Current liabilities	
Manuals	75		
Current assets			
Cash	9925	Share capital	10000

As you can see, the cash in the bank has gone down by £75. The equity capital remains unchanged. We have also divided the assets into two categories. Fixed assets are items that are used by the company on a long-term basis and that it does not trade in. Current assets are cash and items that the company sells or would expect to use up within a year.

Activity

Activity 1.2 **(about 10 minutes)**

Would you classify the following as fixed or current assets? Place a tick in the relevant column in each case..

	Fixed Asset	Current Asset
1. Freehold and leasehold land	☐	☐
2. Investments	☐	☐
3. Buildings	☐	☐
4. Plant and equipment	☐	☐
5. Stocks of raw materials	☐	☐
6. Stocks of finished goods for sale	☐	☐
7. Fixtures and fittings	☐	☐
8. Cash and bank balances	☐	☐
9. Money owed to the company	☐	☐
10. Stocks of stationery	☐	☐
11. Motor vehicles	☐	☐
12. Prepayments made to suppliers	☐	☐

Feedback

Items 1, 3, 4, 7 and 11 are fixed assets. All the rest are current assets.

Liabilities are also classified in a similar way. They are described as long term or current. We will now return to the balance sheet of PC Servicing Ltd.

Activity

Activity 1.3 **(about 5 minutes)**

Next, the company buys specialist tools worth £250, again by cheque. Amend the balance sheet to show the effect of this transaction.

Assets	£	Liabilities and equity capital	£
Fixed assets			
Manuals	75		
Current assets			
Cash	9925	Share capital	10000

Feedback

This is exactly the same kind of transaction as the purchase of the manuals. You should have deducted £250 from the cash figure and added another fixed asset to the list.

Assets	£	Liabilities and equity capital	£
Fixed assets			
Manuals	75		
Tools	250		
Current assets			
Cash	9675	Share capital	10000

The next transaction is slightly more complicated. The company buys 100 electronic circuit boards for £900 on three months' credit. Since the circuit boards have been purchased with a view to selling them in the business, they are therefore stock (a current asset). They have been purchased on credit. A cheque has not been written out and the bank balance is not affected. However, it is necessary to make another entry on the balance sheet so that the two sides still balance. This is done by including a creditor (a current liability) for the sum of £900.

Assets	£	Liabilities and equity capital	£
Fixed assets		Current liabilities	
Manuals	75	Creditors	900
Tools	250		
Current assets			
Stock	900		
Cash	9675	Share capital	10000

Notice that the stock is included on the balance sheet at the price that the company paid for it, even though it's expected to sell at a profit. This is known as the historic cost principle.

Activity

Activity 1.4 **(about 10 minutes)**

Next, the company sells ten of its 100 circuit boards at £15 each. There are three changes to be made to the balance sheet. Two of these are on the assets side. What changes would you make to:

Cash?

Stock?

A new category, 'Retained profit', is created on the liabilities and capital side. What figure should go in here?

Feedback

You should have added £150 to the cash figure. You might have been tempted to subtract this same amount from the stock figure, but remember that stock is valued at the amount that it cost the company. You should have subtracted only £90, one-tenth of £900, from the stock. The asset side of the balance sheet is now £60 higher than it was before the transaction. This £60 is profit that the company has made.

Assets	£	Liabilities and equity capital	£
Fixed assets		Current liabilities	
Manuals	75	Creditors	900
Tools	250		
Current assets			
Stock	810	Retained profit	60
Cash	9825	Share capital	10000

Activity

Activity 1.5 **(about 10 minutes)**

Next, the company services the computer system in a local office and puts in an invoice for £300, to be paid in 30 days. A new category of trade debtors is added to the asset side, with an entry of £300. Fill in the balance sheet below to show how you would balance the equation.

Assets	£	Liabilities and equity capital	£
Fixed assets		Current liabilities	
Manuals	75	Creditors	900
Tools	250		
Current assets			
Stock	810		
		Retained profit	60
Cash	9825	Share capital	10000

Feedback

Nothing has been taken away from the assets of the company by this transaction, so the balancing entry must be made on the other side of the equation. The correct answer here is to add £300 to the retained profit.

Assets	£	Liabilities and equity capital	£
Fixed assets		Current liabilities	
Manuals	75	Creditors	900
Tools	250		
Current assets			
Stock	810		
Trade debtors	300	Retained profit	360
Cash	9825	Share capital	10000

You will notice that the amount of £300 has to go into the accounts at the time at which it was invoiced, and not when the money is actually received. This is because of the principle of accruals. There are four fundamental accounting concepts that you should be aware of.

- *The going concern concept* — this assumes that the company will remain in business. Items are valued on the basis of their original cost to the company (minus depreciation, in some cases) rather than on the basis of what they would be worth if the company was wound up.
- *The accruals concept* — this recognises sales revenue when a product is sold, rather than when the proceeds of the sale are received. It matches the sales revenue with the cost of producing or purchasing what has been sold and attaches business expenses to the period to which they relate, rather than to the period in which they are paid.
- *The consistency concept* — this requires consistent treatment of similar items, both within a given accounting period and from one accounting period to another. If, for some reason, it's necessary to adopt a different approach to a particular item, then this concept requires that this change is disclosed in the financial statements.
- *The prudence concept* — this requires a conservative approach, not anticipating profits before they are realised, and making proper provision for all known losses at the earliest possible time.

Every time a transaction is recorded on the balance sheet, one or more further entries must be made to ensure that the equation still balances.

Activity

Activity 1.6 **(about 10 minutes)**

See if you can decide how the following transactions would be recorded.

1. Buy a second-hand van by cheque for £3000.
2. Pay £200 repair costs on the van in cash.
3. Receive the £300 already invoiced for servicing the computers.

Assets	£	Liabilities and equity capital	£
Fixed assets		Current liabilities	
Manuals	75	Creditors	900
Tools	250		
Current assets			
Stock	810		
Trade debtors	300	Retained profit	360
Cash	9825	Share capital	10000

Feedback

1. *The first transaction is simple. You should have included another fixed asset of £3000 and reduced the cash by the same amount.*
2. *This repair bill comes out of the bank account. You may have considered balancing this item by increasing the value of the van by £200, but this would not have been correct. (Remember the principle of historic cost.) This transaction affects the profits of the company and you should have reduced the retained profit figure by £200.*
3. *The cash figure goes up by £300 and the trade debtors figure is reduced to zero.*

Now the balance sheet looks like this:

Assets	£	Liabilities and equity capital	£
Fixed assets		Current liabilities	
Van	3000	Creditors	900
Manuals	75		
Tools	250		
Current assets			
Stock	810		
Trade debtors	—	Retained profit	160
Cash	6925	Share capital	10000