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EBU5402 Enterprise Management

Lecture 10 - Financial Reporting and
Management Accounting

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Agenda

Yesterday

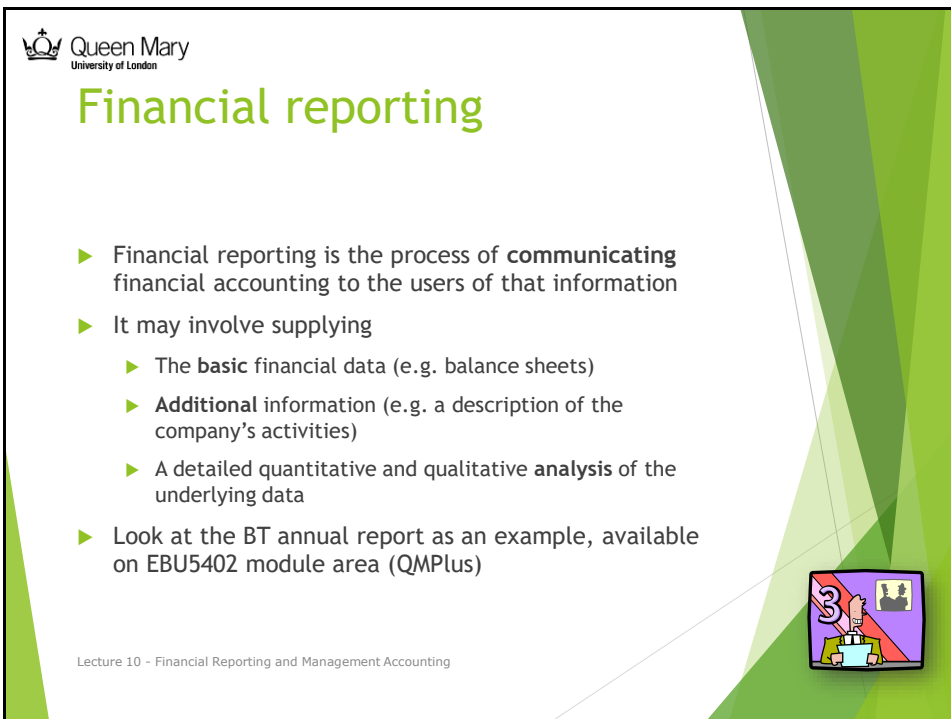
- ▶ What is financial management?
- ▶ What is accounting?
- ▶ Financial Accounting

Today

- ▶ Financial Reporting
- ▶ Management Accounting
- ▶ Some financial ratios

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Financial reporting

- ▶ Financial reporting is the process of **communicating** financial accounting to the users of that information
- ▶ It may involve supplying
 - ▶ The **basic** financial data (e.g. balance sheets)
 - ▶ **Additional** information (e.g. a description of the company's activities)
 - ▶ A detailed quantitative and qualitative **analysis** of the underlying data
- ▶ Look at the BT annual report as an example, available on EBU5402 module area (QMPlus)

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A cartoon character is shown on a screen, holding a large number 3. The screen is part of a larger graphic that includes a green and white background with a stylized '3' and a small inset showing two silhouettes of people.

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Financial reporting

- BT annual report

- **Overview:** contains a summary of the strategy, performance and activities of the group as well as messages from the Chairman and Chief Executive
- **Report of the Directors:** provides detailed information about what the businesses within BT do and their financial performance in the year. It also gives details of BT's commitment to the wider community and how they govern themselves
- **Financial statements:** includes the consolidated financial statements, the notes to the financial statements and other useful summary financial information and operational statistics
- **Additional information:** provides helpful information for shareholders and a glossary and index

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Financial reporting

- BT annual report - overview


- **Introductory material** (BT pg.5)
 - Tells you something about the company and a summary of the year
- **Chairman's message**(BT pg. 12-13)
 - An individual statement from the Chairman - this is **not** a legal requirement, but is often included
- **Chief Executive's message**(BT pg. 14-15)
 - An individual statement from the Chief Executive - this is also **not** a legal requirement, but is often included

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Financial reporting - director's report

- ▶ The directors of a company shall for **each** financial year prepare a report [23]
 - ▶ Containing a **fair review** of the development of the business and its subsidiary undertakings during the financial year and of their position at the end of it, and
 - ▶ Stating the amount (if any) which they recommend should be paid as **dividend** and the amount (if any) which they propose to carry to **reserves** (1985 Companies Act)

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Financial reporting - director's report

- ▶ **Other elements** that should be included are
 - ▶ business review
 - ▶ fixed assets
 - ▶ directors
 - ▶ political and charitable donations
 - ▶ shares
 - ▶ disabled persons
 - ▶ employee involvement and employee's health
 - ▶ safety and welfare

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Financial reporting - operational and financial review

- ▶ “is an exposition of a company’s performance and prospects supported by both narrative and quantitative information” [22]
- ▶ **Operating** (or business)review which contains - review of activities, prospects, expansion, risks and links with stakeholders (BT pg. 72)
- ▶ **Financial** review which contains - capital, taxation, cash, liquidity and performance measures (BT pg. 119)

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Financial reporting - corporate governance

- ▶ “**Corporate governance** is the set of processes, customs, policies, laws and institutions affecting the way a corporation is directed, administered or controlled”
- ▶ Corporate governance also includes the **relationships** among the many **players** involved (the stakeholders) and the **goals** for which the corporation is governed
 - ▶ The **principal** players are the shareholders, management and the board of directors
 - ▶ **Other stakeholders** include our people (employees), customers, communities and society, shareholders, lenders, pensions scheme, suppliers, HM government, regulators, the environment (BT pg.43-54)



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Financial reporting - corporate governance

- ▶ **Remuneration report** (BT pg. 156)
 - ▶ Part of the corporate governance requirements
 - ▶ Remuneration committee is set up to decide what the **directors** should be **paid**
 - ▶ members can only include **non-executive** directors who will not benefit from the decisions


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Financial reporting - annual accounts

- ▶ **Auditors report** (BT pg. 190)
 - ▶ Auditors are expected to check the accounts but will only state that it is 'a true and fair view' of them
- ▶ **Financial statements** (BT pgs 189)
 - ▶ During this **lecture**, we have covered simple P&L, Balance Sheet and cash-flows
 - ▶ In annual reports (which are required for companies), the following are for the **entire organisation** - usually made up of multiple divisions
 - ▶ Group profit and loss account
 - ▶ Group statement and company balance sheet
 - ▶ Group cash flow statement

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Financial reporting - financial statements

- ▶ Group **profit and loss** account
 - ▶ Published version of accounts
 - ▶ Companies Act allows for expenditure to be represented in two ways
 - ▶ **Operational** format
 - ▶ **Type** of expenditure format
 - ▶ Similarities can be seen with the P&L for a small business and a company

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Financial reporting - financial statements

- ▶ Group statement and company **balance sheet**
 - ▶ **Published** version of accounts
 - ▶ **Differences** to internal accounts
 - ▶ Normally prepared for a group of companies
 - ▶ More detailed than sole trader's balance sheets
 - ▶ Include comparative figures
 - ▶ A good many notes accompany them
- ▶ Group **cash flow** statement

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1) Recap of key points

- ▶ Financial reporting is the process of **communicating** financial accounting to the users of that information
- ▶ It may involve supplying
 - ▶ The **basic** financial data (e.g. balance sheets)
 - ▶ **Additional** information (e.g. a description of the company's activities)
 - ▶ A detailed quantitative and qualitative **analysis** of the underlying data

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Management Accounting




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Management Accounting

- ▶ Definition:
 - ▶ “the application of the principles of accounting and financial management to **create**, protect and increase value so as to **deliver** that value to stakeholders of profit and not-for-profit enterprises, both public and private” [24]




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Management Accounting

- ▶ In **contrast** to financial accountancy information, management accounting information is
 - ▶ usually **confidential** and used by management, instead of publicly reported
 - ▶ **forward-looking**, instead of historical
 - ▶ **pragmatically** computed using extensive management information systems and internal controls, instead of complying with accounting standards
- ▶ This is because of the different emphasis: management accounting information is used **within** an organization, typically for decision-making




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Management Accounting (cont.)

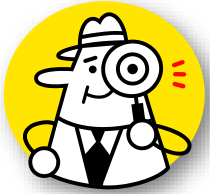
- ▶ One of its most important roles is **planning** (e.g. supporting the creation of a strategic plan)
- ▶ The **main aims** of management accounting are [Wikipedia]
 - ▶ Formulating strategies
 - ▶ Planning and constructing business activities
 - ▶ Helping in making decisions
 - ▶ Making best use of resources
 - ▶ Supporting financial reports preparation
 - ▶ Safeguarding assets

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Financial Ratios to look at...




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Analyzing financial statements - trend analysis

- ▶ Trend analysis is used to compare financial data **from year to year** to see how they have changed
- ▶ You can use trend analysis to uncover **shifts** in the **nature** of the business over time
- ▶ When you comparing one period with another, it's **important** to take into account the effects of **extraordinary** or unusual items such as
 - ▶ the **sale** of major **assets**
 - ▶ the **purchase** of a new line of **products** from another company
 - ▶ **weather**
 - ▶ **economic** conditions that may have affected the company in one period but not the next






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Analyzing financial statements - ratio analysis

- ▶ Ratio analysis compares **two elements** from the **same year's** financial figures
- ▶ They are called ratios because they are computed by **dividing** one element of a financial statement by another
- ▶ The advantage of using ratios is that it puts companies on the **same footing**
- ▶ It makes it possible to **compare companies** in spite of, for example, their differing sizes and changing currency exchange rates




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Analyzing financial statements - two basic rules

- ▶ Before we look at some reviewing specific ratios, there are two basic rules :
 1. Avoid drawing too strong a conclusion from **any one** ratio
 2. Once ratios have presented a **general** indication, refer back to the **specific data** involved to see whether the numbers **confirm** what the ratios suggest


 In other words do a little investigating, because **statistics can be misleading**

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Types of financial ratios



- ▶ **Profitability ratios** help you analyze how well a company is conducting its ongoing operations
 - ▶ They show the state of the company's financial performance or how well it is generating profits




- ▶ **Liquidity ratios** measure the ability of the firm to pay its short-term obligations
 - ▶ lenders and creditors are keenly interested in liquidity measures




- ▶ **Activity ratios** analyze how well a company is managing its assets

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Types of financial ratios (contd.)


- ▶ You can measure a company's ability to pay its long-term debts by calculating its **debt ratios**, or **leverage ratios**
- ▶ **Lenders** look at these ratios to decide whether or not the **potential borrower** has put enough money into the business to serve as a protective cushion for the loan



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Profitability ratios



Three of the most common profitability ratios

Return on Sales (ROS) =

$$\frac{\text{Net Income}}{\text{Net Sales}}$$
<http://www.investopedia.com/terms/r/ros.asp>


Return on Investment (ROI) =

$$\frac{\text{Net Income}}{\text{Total Owner's Equity}}$$
<http://www.investopedia.com/terms/r/returnoninvestment.asp>


Earnings per Share =

$$\frac{\text{Net Income}}{\text{Average Shares Outstanding}}$$
<http://www.investopedia.com/terms/e/eps.asp>

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Liquidity ratios



Working Capital =
$$\text{Current Assets} - \text{Current Liabilities}$$

<http://www.investopedia.com/terms/w/workingcapital.asp>


Current Ratio =
$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

<http://www.investopedia.com/terms/c/currentratio.asp>


Quick Ratio =
$$\frac{\text{Current Assets} - \text{Inventory}}{\text{Current Liabilities}}$$

<http://www.investopedia.com/terms/q/quickratio.asp>

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Activity ratios




Inventory Turnover =
$$\frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

<http://www.investopedia.com/terms/i/inventoryturnover.asp>


Receivables Turnover =
$$\frac{\text{Sales}}{\text{Average Accounts Receivable}}$$

<http://www.investopedia.com/terms/r/receivableturnoverratio.asp>

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Leverage (or debt) ratios



$$\text{Debt to equity} = \frac{\text{Total liabilities}}{\text{Total equity}}$$

<http://www.investopedia.com/terms/d/debtequityratio.asp>

$$\text{Debt to total assets} = \frac{\text{Total liabilities}}{\text{Total assets}}$$

<http://www.investopedia.com/video/play/total-debt-total-assets/>


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2) Recap of key points

- ▶ Management Accounting is the application of the principles of accounting and financial management to **create**, protect and increase value so as to **deliver** that value to stakeholders of profit and not-for-profit enterprises, both public and private
- ▶ Management Accounting information
 - ▶ usually **confidential** and used by management, instead of publicly reported
 - ▶ **forward-looking**, instead of historical
 - ▶ **pragmatically** computed using extensive management information systems and internal controls, instead of complying with accounting standards
- ▶ Carry out trend and ratios analysis

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Summary

- ▶ Accounting is a **complex** field, contrary to common perceptions
- ▶ Financial accounting information facilitates the exchange and management of **resources**
- ▶ To be a sophisticated financial statement **user**, you need to **understand** how the information in financial reports is recorded

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Directed Reading

Course Textbook (Ebert, R. J. and Griffin, R. W., 9th Edition)


- ▶ Chapter 14. The Role of Accountants and Accounting Information (p356 - p378)

Additional Reading

- ▶ Dyson, J. R. (2007), *Accounting for non-accounting Students*, 7th edition, Times/ Prentice Hall; ISBN-10: 0273709224/ISBN-13: 978-0273709220



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2.	.. Pg. 4	13.	.. Pg. 86
3.	.. Pg. 5	14.	.. Pg. 90
4.	.. Pg. 45	15.	.. Pg. 549
5.	Chartered Institute of Management Accountants (CIMA) 2000, take from Dyson pg. 10	16.	.. Pg. 548
6.	.. Pg. 50	17.	.. Pg. 163
7.	.. Pg. 51	18.	.. Pg. 168
8.	.. Pg. 52	19.	.. Pg. 174
9.	.. Pg. 84	20.	.. Pg. 179
10.	.. Pg. 83	21.	.. Pg. 557
11.	.. Pg. 86	22.	.. Pg. 214
		23.	.. Pg. 213
		24.	.. Pg. 13

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