2 Financial Statements for Decision Making

2.1 Introduction and objectives

This chapter introduces the various types of financial statements used for internal and external financial reporting. There has been much change in the international external reporting regulations in recent times and this has caused some changes to terminology and internal reporting changes. Traditionally the terminology used within the UK and the USA has been very different, but a number of terms are becoming more internationally utilised industry-wide. This chapter explores the basics of reports and financial information reporting in the context of their use in management accounting. This textbook focuses on management accounting, so the annual financial accounting reports are considered from a management use perspective only, the further reading section gives further guidance for those needing information concerning detailed financial accounting concepts and approaches.

After studying this chapter you should:

- Have a better knowledge and understanding of a variety of accounting statements
- Be able to critically evaluate the usefulness of such information to managers, and other statement users
- Have a better knowledge of alternative accounting terminology used within financial reports
- Have a working knowledge of the concepts of profit and cash in the business context.

2.2 Alternative accounting statements

Companies' year-end accounts are a legal requirement for external reporting purposes and are regulated by rules and statement formats that need to be followed. However, management accounting is not a legal requirement for organisations; it is an internal tool to aid managers in performing their roles and responsibilities. Given this, a variety of different reporting structures and accounting statements exist, the key being they need to be 'fit for purpose' for the style, orientation and size of the organisation using them.

It is also important to understand that in management accounting it is not a case of ignoring annual financial reports and only focusing on management accounting reports. Externally focused financial statements can aid managers by giving an overview of competitors and be useful as a benchmark (comparison) for evaluating your own organisation's performance, particularly at the higher, more strategic level in the organisation.

Throughout this textbook a variety of management accounting reports and formats are used for specific purposes and with specific management accounting technique. Every organisation will do things slightly differently and over time, formats and terminology change within financial statements reported externally. The fact that there are many financial statement formats and frequent change can lead to frustration with those studying management accounting; one report talks about 'stock' and the next 'inventories'; the terms 'fixed assets' and 'non-current assets' have the same meaning; and a 'profit and loss statement' is the equivalent of an 'income statement'. This chapter gives a broad overview of some key financial statements and the alternative terminology used.

2.3 The difference between profit and cash

The difference between profit and cash is an important basic accounting concept that often causes much confusion – they are not the same and both are important in an organisation.

Profit = the surplus of value between sales revenue and associated costs for the same period

Sales revenue – Costs = Profit

In commercial operations income statements use an accounting system known as 'accrual accounting', which 'matches' sales generated and costs incurred over a specific period of time. Accrual accounting requires sales to be 'recognised' when the sale takes place, not when cash changes hands. If someone stays in a hotel tonight, but their company is to pay on account in 1 month's time accrual accounting would state this is a sale today, not when the cash changes hands. Likewise, gas used to heat the hotel room today, for today's sale means the hotel is committed to pay that cost in the future. In accrual accounting the expense of gas would be costed when it occurred, not when it is paid.

There are also 'non-cash' expenses, such as depreciation, a cost that is an internal accounting transaction, but not a cash item. An example would be buying equipment that has a life of 5 years. In cash terms this could be £10,000 going out of the business on the day of purchase, then having it to use for 5 years. For profit purposes the cost is effectively 'shared' over its operational life of 5 years by charging depreciation to the income statement. In this example, using the 'straight line method of depreciation', £10,000/5 years = £2,000 per year would be charged as a depreciation cost under accrual accounting.

2.3.1 Example: difference between cash and profit

Cultural Events is a small local events company, its operating information for one month, April is:

- Sales for the period are £40,000, which includes £10,000 invoiced and yet to be paid by the customer.
- Cost of sales, £12,000, which includes £6,000 still to be paid to the supplier.
- Expenses for the month are £20,000, but this includes £4,000 paid previously and £6,000 not to be paid until the next month.
- At the start of the month the bank balance (cash) was £5,000.
- A cash payment of £15,000 is paid in April related to last month's expenses.

Table 2.1: Differences between profits and costs

Cultural Events	Profit		Cash
		Opening cash	£5,000
Sales revenue	£40,000	+ cash from sales	£30,000
– Cost of sales	£12,000		£35,000
= Gross profit	£28,000	– Expenses for March	£15,000
– Expenses	£20,000	– Expenses for April	£10,000
Profit	£8,000	Closing cash	£10,000

Table 2.1 is a very simplified example of the concept, but highlights the differences between profit and cash positions.

Profit tells a manager 'if' all sales revenue came in and 'if' all costs and expenses related to April (the same time period) were paid, a profit (surplus on sales after all costs) would equal £8,000. That £8,000 profit is just a paper financial value, it is a statement of 'value', but not a statement of how much physical cash is available at the end of April. This is the matching concept of accrual accounting.

Cash is the physical amount of money, in this case £10,000 in the bank of Cultural Events. This is money that is available as a resource to the company. Over time, theoretically cash and profit should always match, but in an ongoing