

A Useful Guide to Managing Money



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1. Introduction

Who should use this Useful Guide?

Anybody who lives and/or works in any kind of organised society and hopes to improve it. I think managing money should be on the national curriculum!

This useful guide assumes no previous knowledge of the subject.

Whether we are managing the local tennis club, a soup kitchen or a large part of a multi million pound business, we have many things in common, or should have. Some of the things I think we should all have in common are debatable, but one, in my opinion, is not. We all need to provide good, long term value for the money entrusted to us. The idea of good value for money has been around forever, but it seems clear to me that some of our 'leaders' over the last 20 years have forgotten about the 'long term' part. Some of our senior politicians and captains of industry now seem to me to be only concerned with what happens 'on their watch'. Short term thinking usually only provides short term results and makes it very much harder for the future. Anyone can have a good year when they 'sell the family silver'.

This useful guide is intended for anybody wanting to get the best financial outcomes for their organisation. It is intended to help you to make your organisation's money work more effectively for that organisation.

This is not a comprehensive work. There are many other topics which could be added, but I have tried to make it a 'starter for ten' for people with no previous knowledge of this subject.

Benefits of using this Useful Guide

This useful guide will help you to understand:

- Some (enough) of the jargon, including that mentioned below!
- Cash flow and its importance.
- The need to manage financial performance / 'live within our means' (described by Profit and Loss Accounts or Income and Expenditure Statements).
- The importance of good 'asset management' (described by Balance Sheets).
- The need to control 'working capital'.
- Using financial performance indicators/ratios.

This useful guide will not baffle you with science. It assumes that you know nothing at all about the subject, although I bet you will discover that you already know lots more about it than you thought you did. This is probably because of the jargon that surrounds it.

Exercises

Sometimes things we learn sound completely clear until we try to put them into practice, and then they seem more difficult. This useful guide provides some exercises that you can use, **if you wish**, to check your understanding of the points made. Please may I stress the '**if you wish**' part. Some people like to work out the numbers and others do not. If you are happier just reading the narrative please carry on – have a peek at the answer pages if you like. For those doing the exercises, I have tried to make them as 'user friendly' as I can. Each exercise contains in part:

1. The data to get you started.
2. A pro forma which you can use, or not as you wish (the pro forma makes the task easier – up to you!). If you would rather not do the maths, that's fine – just miss that stage and look at the answer. Try to see where the numbers came from.
3. My answer.
4. Pro forma for the next step.
5. And so on.

Tip: If you have a friend or colleague who shares your need to get to grips with this subject, work as a pair and help each other.

Again, if you don't like working with numbers (and many people don't) forget the calculations and just try to look at the problem in words. For example, you need not work out how much the remaining stock is worth – all you need to understand is that we bought a lot and have some left (or not). At work you will probably have someone to do the maths for you who really enjoys doing it! The principles are more important than the maths (unless you are the accountant!).

Points for Action

This useful guide provides suggested points for action. I strongly recommend that you take the suggested actions – unless of course you already have!

Putting the subject into perspective - running a business and running a home

Everyone needs to know a little about financial management and almost everyone does. Unfortunately, once we start to receive financial information at

work, many of us are baffled by the jargon. Some people think that this is a deliberate attempt by the accountants to stop us asking difficult questions and maybe in a very few cases I think this is true! However, if we reflect for a moment on the language we all use at work, it seems to me that every trade and profession has its own special terminology and language and furthermore that it is helpful – as long as we are communicating with people in the same job. The problem is that whilst plumbers, electricians, brain surgeons and so on tend to communicate at work mostly within their own circles and those closely related to them, accountants have to communicate with all of us. You may take some comfort from the fact that they don't understand all of our jargon either.

Joking aside, it is an enormous help at work if we can understand the wealth of useful information that we can obtain from accounts and this useful guide will help you to do just that, and equally importantly that it is OK to ask! Nearly all accountants you meet at work will be delighted that you show interest and they will go out of their way to help you understand.

Relax; it's not rocket science, at least at the level we need to understand.

If you really want to get into the jargon, may I recommend that you purchase 'The Oxford Dictionary of Accounting'. It is an excellent work of only 360 pages and since getting a copy about 25 years ago, I have never met anyone who understands all the terms it contains. The important thing is to understand the very small number of terms we need and not be afraid to ask about others.

Before you go any further with this useful guide, forget about work and give a minute's thought to where your cash comes from and goes to at home. Get some paper, draw a vertical line down the middle and head one column 'IN' and the other 'OUT', like this:

NB please use your pc if you prefer.

IN	OUT

For Read Our Loud Readers: The table has finished

Then write in the main headings. Don't go into too much detail or you will be at it for hours and probably get quite depressed! Now repeat the exercise but this time with work in mind. You don't need to know exactly where the money comes from and goes to, where you think it does will do.

Now compare the two lists and ask yourself what is the difference? I am fairly sure that the two lists have much in common. For example, they both probably refer to income or costs related to:

- Income from work done/goods sold/grants/donations/investments.
- Costs related to premises, owned or rented.
- Day to day 'consumables'.
- Banking costs.
- Interest received (not much of this lately) or paid.
- Investment in major items (things that will be useful for a long time).
- Sales of major items. e.g. the old car when you get a new one.
- Her Majesty's Revenue and Customs.

I am hoping that you will see that running your life and running your part of an organisation have a lot in common. In fact they are almost identical except for two very important things.

1. The scale. At home we talk about tens or hundreds of pounds and only occasionally venture into thousands. At work you are likely to work with much larger amounts.
2. Accountability. At home, if you are fortunate enough to have some spare cash, 'the world is your oyster!' At work you need to account for it all.

Points for Action

- Complete this useful guide. It will get you started.
- Decide that you will further improve your understanding of the financial information you need at work, find yourself a friend in the accounts department, buy them a cup of tea and ask for their help.

Summary

There are three basic financial principles we all need to understand:

- Cash Flow. Cash is what can be used to pay bills today. It is not the same as profit/surplus.
- Living within our means, described by Profit and Loss Accounts/Income and Expenditure Statements. This is about measuring performance over a stated period of history. It is not the same as measuring cash.
- Asset Management, described by Balance sheets. These show the assets (things we own) and liabilities (things we owe) of the organisation at a specific point in time.

2. Cash Flow

For the purpose of this discussion cash means money you can use to pay bills today. It may be in your pocket or at the bank. It might ultimately belong (be due) to someone else, but right now, you can say what happens to it.

Cash is very definitely not the same as profit/surplus because, for example:

- You might very well have a lot of cash in the bank at this moment, but it is not profit if you will have to pay out twice as much in bills.
- You may have just completed a highly profitable project/job, but have a massive overdraft because you haven't been paid yet.

Whatever sort of organisation you work in, you need to be aware of the importance of cash and cash flow management. Cash flow management is partly about timing. It is similar at work and at home, that is to ensure that you have enough cash available to pay bills when they are due. You don't even have to own the cash (although generally I think it's a good thing if you do). For instance, it could come from the bank in the form of an overdraft. A word of caution; sorry to state the obvious but if using borrowed cash to pay bills, we must then not only plan how to pay back the sum borrowed, but the interest on it as well. We all probably know a person or organisation struggling to pay overdraft or credit card interest. My 92 year old Mother says "Only rich people can afford to borrow money" and she has a very good point.

A major reason for the failure of new businesses is not, as many people believe, that the owners didn't know what they were doing. Most were experts in their field but some didn't understand the importance of cash flow management. No matter how important your business, or worthy your cause, if you don't pay your electricity bill you will very soon be trying to work in the dark without your tools.

To the best of my knowledge, the only person in the UK that does not (allegedly) need to carry cash is Her Majesty the Queen. I am not sure if this is true but I am very sure that the rest of us need to manage our cash flow with great care.

For most of my lifetime, interest rates on cash on deposit have kept ahead of inflation, so a healthy bank balance has been good news. When, as now, inflation is ahead of interest on cash on deposit (thanks to the people we trust to manage such things) we have to think differently in some ways but not others:

1. It may be better to spend money we have in the bank on valuable projects now, even before they are absolutely essential simply because cash in the bank is losing real value whilst the cost of our project might be increasing and will (hopefully) make/save you money when complete.
2. On the other hand, we need to retain enough cash to pay our bills or risk penalty or interest payments/blackouts and so on. Whilst we don't get much interest on money we invest (in 2012), we still have to pay large amounts of interest on money we borrow. At the time of writing, the difference between interest rates for lending and borrowing is very high. It's bad news for everyone except bankers.

To illustrate this I recall:

Example 1:

A dear friend of mine was trained (apprenticed) as an electrician. At 22 years old and after working for a well known builder for about a year, he decided to 'cut out the middle man'. Being well known for the quality of his work and work ethic, he had no problem getting some fairly impressive contacts. He bought a van and some materials and set to work. He was much respected, admired, and envied, by his contemporaries and quite rightly so!

After a few months however, he was struggling. He had estimated and quoted well. He had worked within his budget and done a good job. So what could be wrong? Many of you will be familiar with the situation. The clients hadn't paid on time so he was crippled with overdraft interest payments and could not get cash to purchase materials for the next job. There was no problem with the work done, just an endless list of reasons/very poor excuses why the money hadn't been paid as agreed. Some people say that the most common lie in the world is 'the cheque is in the post'.

The irony was that when he gave up his business and got a job, he became quite well off for a while. This was because his debtors eventually did pay.

Example 2:

I used to do a lot of work for a well known FTSE 100 company. Before they pay, they require that, having delivered the service to the standard agreed (fair enough), you should also:

- Comply with a variety of quite difficult contractual obligations aimed at multi-million pound international organisations.
- Quote their multi-digit alpha-numeric contract number (which they were often 'unable' to provide)
- Quote their multi-digit alpha-numeric order number (which, surprisingly, they were often 'unable' to provide).
- Jump through all sorts of other ever-changing administrative hoops.
- Etc.

Getting paid could take weeks. If you are really charitable, you might think that all the problems they have with paying a small supplier are due to the size and complexity of their organisation. Believe me, this is rubbish. They could put someone on Mars if they wanted to. What they are trying to do, even if the people you deal with are really nice and unaware of it, is to run their business on your cash. If you are not careful, you will spend half your earnings on overdraft interest charges and half your life 'jumping through administrative hoops'.

I would have to be close to starvation before I would work for them again.

Doing a cash flow forecast at work may sound complicated, but we all (hopefully!) do it all the time at home. For example, let's say that you plan a holiday for two in Europe this time next year (say July). The cost might look something like this:

For Read Out loud Readers: The following table has 2 columns and 7 rows.

	£
Rent of apartment	500
Flights	500
Car hire	140
Airport car park	60
Holiday 'extras' (essential!)	600
Total	1,800

For Read Out loud Readers: The table has finished.

Assuming we don't have £1800 'in the holiday jar', we must start saving. At a glance, it looks as if saving £150 per month for twelve months would do the trick but life isn't always that simple, is it?

We always spend a lot more than usual over Christmas so saving in November and December is out of the question. Then there are some special birthdays, the month when the car needs insurance, service, road tax and MOT test and so on. Although these all delay the holiday saving, they all happen on known dates so can be built into a forecast. It just might mean that the holiday saving has to happen over eight months not twelve.

Having started to think about when we can save the cash, we need to think about when we need to pay out. When you book the apartment, the owner will almost certainly ask for a deposit of approx 25% immediately. Having paid this, you may wish to book your flights. It is likely that the airline will need to be paid in full at the time of booking. You can usually get airport parking at about half price if you book and pay well in advance. And so on. Your holiday cash flow forecast might look like this:

For Read Out your Readers: The following table has 14 columns and 4 rows.

	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
Save	225	225	225	0	0	225	225	225	225	0	0	225	0
Pay	0	0	625*	0	0	60*	0	0	0	0	515*	500*	100*
In jar	225	450	50	50	50	215	440	665	890	890	375	100	0

For Read Out your Readers: The table has 2 columns.

- October * £625 (£125 deposit on apartment plus £500 flights)
- January * £60 Airport car park
- June * £515 (£375 balance of apartment plus £140 car hire)
- July * £500 for Euros
- August * £100 credit card

I know this is a bit simplistic and that the washing machine and TV will breakdown the same day in June that you were planning to pay the balance of the apartment and hire the car! Although these things do not have a 'self destruct date' printed on them, we know they won't last forever and we should therefore build a contingency fund into the cash flow forecast. Please note that doing a good cash flow forecast helps you make best use of your cash but does not generate any extra cash. Doing a cash flow forecast might only serve to demonstrate that there is no way we should be planning a holiday this year!

A word of caution

When you look at real accounts, you will **sometimes** see figures in brackets (). This often denotes that the figure is negative/to be deducted. However, this is not always the case. It can also mean that the figure is 'different' from those that surround it or out of place.

For example, a supplier's account may have a long list of all the amounts you owe them which in due course will be deducted from your cash account. Although deductions, they will not be in brackets. If the supplier gives you a retrospective discount, they may well put the figure in brackets to make the single figure that they will pay you stand out from all the figures that you will pay them. This probably sounds confusing but as long as you don't always assume that bracketed figures are negative, you will be OK.

Generally you can tell whether a figure is + or - by the words beside it. An asset is something you own = positive and a liability is something you owe = negative.

Points for Action

1. Do a cash flow forecast. Work out not only how much cash you will need or receive but also when it will arrive or need to be paid out. Plan ahead to be sure that your cash will arrive in good time to pay your bills.
2. If you think you may need an overdraft facility (internal or external), negotiate it before you need it.
3. Unless you are desperate for work, don't work for people that do not behave ethically. Even if you 'earn a crust', your rate of pay may be quite low when you take into account the time you have to spend chasing your payments.

I hope this has been useful and interesting but many of you will want to see or produce an example. If you don't, that's fine. Exercise 1 part 1 is the first of several. The first part is meant to be straightforward. There is another cash exercise later which includes doing a cash flow forecast.

Exercise 1 Part 1

Starting data:

A high street shop was established using £4,000 of the owners' money (share capital).

- The owners negotiated an overdraft facility of £6,000.
- Fixtures and fittings cost £4,800 and will last 4 years.
- The rent was £400 per month.
- Wages were £1,000 per month.

During the first month they:

- Spent £1,000 on stock.
- Spent £50 on packaging.
- Took £2,500 in cash sales

At the end of the month they:

- Owe £400 for rent (they haven't paid yet).
- Have £200 worth of stock left, of which £50 worth is ruined.
- Have £20 worth of packaging left in perfect condition.

Your task:

Using the same kind of 'IN / OUT' table as before, note all the CASH transactions (where actual cash changed hands) and work out what, if any, cash is left at the end of the month.

Exercise 1 Part 2: Pro-forma

For Read Out loud Readers: The following table has 4 columns and 8 rows.

Cash received	£	Cash paid	£
Share capital		Fixtures and fittings	
Takings from sales		Stock	
		Packaging	
		Rent	
		Wages	
Total		Total	

For Read Out loud Readers: The table has finished.

Cash balance at the end of the month £.....

Exercise 1 part 3: My answer

For Read Out loud Readers: The following table has 4 columns and 8 rows.

Cash received	£	Cash paid	£
Share capital	4,000	Fixtures and fittings	4,800
Takings from sales	2,500	Stock	1,000
		Packaging	50
		Rent	0
		Wages	1,000
Total	6,500	Total	6,850

For Read Out loud Readers: The table has finished.

Cash balance at the end of the month (£350) – minus £350

Before moving on, please reflect on how the new enterprise is performing before considering my comments on the next page.

They have:

- Spent £350 more than they received but have an agreed overdraft limit of £6,000 – sufficient to pay the rent arrears, next month's wages and purchase more stock and packaging.
- A well-equipped shop with all fixtures and fittings already paid for.
- Some saleable stock and packaging.

How are they performing? A bit early to say, but they certainly live to fight another day!

The next part of this exercise will be to work out whether they made a profit/surplus, which we will look at within the next section.

3. Measuring Performance

As we know, the amount of cash that we have need not indicate how well we are running the organisation. To see how we have performed, we use Profit and Loss Accounts (P & L) or Income and Expenditure Statements. These measure and state performance in financial terms. They look at what money has been generated (on paper) and what money was due for payment, even if not actually paid, during a specified period of history and what, if anything, was left.

We can't use our cash figures to measure performance because, for example, we may have just spent a 'fortune' on equipment which will last for years and it would be unfair to book the total cost against one year's income. Also, the 'Postie', human or electronic, may be about to deliver a huge pile of cheques – or bills! Actual cash figures may need to be 'adjusted' to reflect and measure performance.

Commercial organisations use the term 'Profit and Loss' whilst not-for-profit organisations use the term 'Income and Expenditure' and some people think they are very different. I believe that the principles of both kinds of organisation are, or should be, very much the same:

- To get the best value for money.
- To operate cost-effectively.
- To secure the future.
- To continue to improve.

Where confusion exists, it is often because of the jargon/terminology used and our perceptions of what the words 'profit' or 'surplus' mean. Please try to forget for a moment about the headline-grabbing sums made by large organisations.

There is really no such thing as a 'non-profit making organisation', or not for long! To not make a profit, or to 'break-even,' means that the income from a project/transaction exactly equals the cost of doing it. If you are running an amateur football club, for example, this might sound acceptable. Your income from membership and match fees is exactly equal to the cost of cutting the grass, painting the white lines and maintaining the goal posts.

(Football clubs; please forgive the over-simplification).

Anyone who has run a football club will (hopefully) be thinking that's only the day-to-day activities. What about purchasing or saving up for:

- A new lawn mower/ line painting machine.
- Providing/improving showers.
- Replacing the roofing felt on the changing rooms.
- Improving the drainage of the pitch.
- etc.

In order to do these things, the club must make a surplus, i.e. an excess of day-to-day income over day-to-day expenditure. It's the same as a profit in a commercial organisation but it is called a surplus in a not-for-profit organisation. There is nothing wrong with providing for the future; we should all do it. Profit/surplus is needed to secure the future. They both provide the means to:

- Replace or modernise equipment/premises.
- Improve and develop.
- Provide for 'a rainy day'.

In addition to these things, a commercial organisation has to give something back to the owners of the business in the form of a dividend.

It may help to think of a non-profit '*making*' organisation as a non-profit '*distributing*' organisation, i.e. any surplus remains within the organisation.

I will use 'P & L' from now on to mean both Profit & Loss and Income & Expenditure reports.

We will look at a simple P & L shortly, but it will help to describe some of the terms, features and 'adjustments' first.

Please remember that we are describing performance – not measuring cash!

1. Income/Turnover: money due in exchange for an activity or to fund the activity over a specified period of history. It may or may not have all been received at the end of the period covered by the P & L.

2. Costs: there are two main kinds:-
 - a. Fixed costs: these are costs that are incurred regardless of activity level. For example, the rent for a shop. You pay the same amount whether you have any customers or not. These are charged to the P & L for the time covered by them, regardless of whether they have been paid. Some of these types of costs are called overheads. One such cost is called depreciation. This is the amount charged, on paper, to reflect the use of something which will last several years. For example, if you have purchased a new truck which will last 3 years, you would charge one third of the cost for each of the next 3 years (remember we are measuring performance – not cash). No money changes hands; it's just a way of making the end result realistic. Some people say depreciation is like an internal hire purchase scheme; the finance department provides the truck and the transport department pays them back over its useful life, but remember no cash changes hands between the departments!
 - b. Variable costs/costs of sales: these do vary with activity. For example, the more fruit and veg that a greengrocer sells, the more they have to purchase. The amount of fruit and veg charged to the P & L as a cost must be the same amount as that sold to produce the income. If you book income from the sale of 100kg of fruit and veg, you must book the cost of 100kg of fruit and veg. This principle is called matching.
3. Bank interest: this is the amount paid or received to or from the bank during the time covered by the P & L. For example the interest on the loan you took out to purchase the new truck.
4. Tax: the amount due on the profit, if any, made by a commercial organisation during the period covered by the P & L adjusted by Her Majesty's Revenue and Customs (HMRC) to reflect previous over/under payments and current rules.
5. Dividends: money paid to shareholders in commercial organisations in return for investing their money for the period covered by the P & L.

6. Retained profit or loss/surplus or deficit; the amount, positive or negative, that will remain when all transactions relating to the period covered by the P & L have been completed. This is sometimes known as 'reserves', which some people find very confusing as it might imply great stores of cash. In reality, any retained profit may have already been spent on something that will help the organisation's future – another new truck perhaps. The figure is a measurement of growth/performance – not cash.

N.B. The word 'prudence' has been used a lot by politicians on TV during the last decade. Accountants use this term to describe a principle of preparing P & Ls. A P & L should not provide an over-optimistic picture of events. It should not anticipate future profits prematurely but should show future losses as soon as they are known. For example, a P & L would not normally show income from a job not invoiced during the time covered by the P & L. On the other hand, if a customer that had already paid was demanding a refund (with good cause), you could book an amount to the P & L to cover this, even if the 'discussion' was unlikely to be completed during the current year. This would be called 'making a provision'. The concept of prudence is very sensible. It stops you booking this year's losses to next year's income; in effect hiding them, which would of course not be a very good way of measuring this year's performance.

I hope this is beginning to make sense. It really is very logical once you get the hang of it – promise! If it's still a bit woolly, please carry on anyway. When you eventually understand all this, your current labours will seem well justified.

When you are ready, and if you feel like it, please return to exercise 1 (part 4)

Exercise 1 part 4: Profit and Loss Account (P & L) for month 1:- Pro-forma

Note the income from sales and deduct the costs that relate to them (match them) as previously described and see what, if any, profit has been made. In other words, construct a profit and loss account (P & L)!

Please remember that the objective is to measure performance, not cash. We already know the cash situation, £350 overdraft.

The next page is the pro-forma with some extra clues; use it or not, as you wish. If you prefer not to do the maths, that's fine.

The page after that is my answer which, if you take out the 'clue' and 'ref.' columns, is a simple P & L.

Exercise 1 part 4: Pro-forma

For Read Out Loud Readers: The following table has 4 columns and 12 rows.

	Clue	Ref.	£
Turnover/Sales income	Invoiced value – paid or not	a	
<i>Less cost of sales:</i>			
Stock	At cost price, matched to sales	b	
Stock wastage	At cost price, matched to sales	c	
Packaging	At cost price, matched to sales	d	
Gross profit	a-b-c-d	e	
<i>Less overheads:</i>			
Depreciation	For 1 month i.e. total for 4 yrs divided by 48	f	
Rent	For the month, paid or not	g	
Wages	For the month, paid or not	h	
Operating / trading profit	e-f-g-h		

For Read Out Loud Readers: The table has finished.

Exercise 1 part 5: Profit and Loss Account (P & L) for month 1 – My answer

	Clue	ref	£
Turnover/sales income	Invoiced value – paid or not	a	2,500
<i>Less cost of sales:</i>			
Stock	At cost price, matched to sales	b	800
Stock wastage	At cost price, matched to sales	c	50
Packaging	At cost price, matched to sales	d	30
Gross profit	a-b-c-d	e	1,620
<i>Less overheads:</i>			
Depreciation	For 1 month i.e. total for 4 yrs divided by 48	f	100
Rent	For the month, paid or not	g	400
Wages	For the month, paid or not	h	1,000
Operating / trading profit	e-f-g-h		120

For Read Our Book Readers: The table has finished.

Some of you may be thinking things such as:

- Q: We spent £1000 on stock, so why only book £800 + £50 wastage to the P & L?
- A: Because the remaining £150 worth did not contribute to (match) this month's P & L; it will contribute to and appear next month.
- Q: We spent £50 on packaging, so why only charge £30 to the P & L?
- A: Same logic as above for stock.
- Q: We paid £4800 for fixtures and fittings, yet we only booked £100 – why?
- A: This P & L is showing one month's performance; it would be unfair to charge for things that will continue to give service for the next 4 years.
- Q: Why book £1000 for rent – they haven't paid it?
- A: One month's income should pay one month's rent, in order to reflect that month's performance.

We already knew (from Exercise 1 Part 3) that they have:

- Spent £350 more than they received, but have an agreed overdraft limit of £6000 – sufficient to pay the rent arrears, next month's wages and purchase more stock and packaging.
- A well-equipped shop with all fixtures and fittings already paid for.
- Some saleable stock and packaging.

We know also know that they made some profit. To round off our knowledge of this organisation, we must also look at the amount invested to make the profit. To do this, we must create a 'Balance Sheet', which is quite easy when you get the hang of it, but there is something very important we must look at before that.

Really useful tip!

I think in some ways this is the most important part of this useful guide.

I have heard hundreds of hard-working, clever people say things that indicate that they underestimate the importance of ordinary, everyday actions they take at work. If you ask people at work, including many in authority, who they think controls the money in their organisation, many say the accountants, directors, senior managers and so on. This of course is true but what about all the others. I believe there is no-one at work, employed or volunteer that does not influence the money - the end result. If they don't, why are they there? If you accept that we all influence the figures, I would like to illustrate just how much.

First a light moment! They say that if you ask an engineer, a lawyer and an accountant 'what is 2+2', you will get three different answers:

- The engineer says 4 – they deal in precision!
- The lawyer says 'I will have to get back to you' – after careful checking!
- The accountant says 'it all depends' – and it does.

We all know that financial success depends, among other things, on how much money we receive (income), how much we spend (expenditure), and what we spend it on. Let us look at these in a little more detail and constantly ask ourselves if, and how much, we influence these things.

Income

This is the money we receive in exchange for the work we do and things we sell. The amount depends on how much we do or sell and how much we charge. The question is how do we, no matter how junior, influence these things? Would your customers (term used loosely) come to you even if they knew they could buy more cheaply just down the road? The answer is - it all depends. The deciding factor is their perception of the quality of goods or services you provide.

For example:

1. I often visit our local shops although there is a huge supermarket, presumably cheaper and with free parking, in the next town. The reason is the people who work in the shops. They are friendly, polite and nothing is too much trouble for them. In the huge supermarket you are lucky if you can find anyone to ask if they sell what you are looking for, and as for them getting something in just for you.....! The people that influence where I shop are probably among the lowest paid in their business.
2. When I managed a large business, there were always people trying to sell something to us and promising to undercut our existing suppliers. Always trying to maximise our return to shareholders, we naturally shopped around. You will know that often several suppliers sell exactly the same things, so the choice is just about price – or is it? Suppose that supplier 'A' is the most expensive but always delivers exactly what you order exactly when they promise; supplier 'B' is cheaper but sometimes sends red ones instead of green and was a day late delivering last month. The difference in performance between 'A' and 'B' is determined probably not by their respective Managing or Financial Directors but by more junior people 'at the sharp end' and those who lead and hopefully motivate them. The choice is yours and you will know whether price or reliability is the most important factor to you at the time. You might well use both suppliers, depending on conditions at the time. Remember the accountant's answer: 'it all depends'!

Expenditure

This is how much we spend to gain the income already mentioned. Two of the things that control expenditure are efficiency and timing. A good example of efficiency is wastage. This might be waste of materials or time. I am often amazed at the things thrown away by all kinds of organisations.

The people doing the throwing sometimes say things like 'we are a multi-million pound organisation so it's not worth our time to salvage this stuff'. Sometimes they are correct, but not always. Remember 'it all depends'.

Another commodity wasted is time. Imagine the quantity and quality of work done by a motivated person compared with that of someone who hates the job and their colleagues. I am sure that it will be several times greater. Words like good leadership and teamwork do not appear on a P & L, but the money they produce certainly does!

People 'at the sharp end' make hundreds of decisions every day that affect both these kinds of wastage.

Timing

We all know from home that although we may well be able to afford a particular item, we may not have sufficient cash available at this moment. This means that we will either have to borrow the money or draw it from some longer-term investment (if we have any). Either way, interest will need to be paid or lost. How many of us have asked our boss for a new P.C. or other item of equipment because there is now an enhanced version available? The important question is "is the old one doing its job reliably?" If the answer is yes, be patient. There may be an even better version being launched in the near future.

You may be wondering why I am devoting so much space to relatively insignificant things. Please bear with me and have a look at the following extremely simplified P & L:

Income	100
Expenditure	90
Profit /Surplus	10
Profit margin (profit divided by income as a %age)	10%

For Read Out loud Readers: The table has finished.

Bearing in mind all the things we know that can affect income and expenditure and that many of these things are in the hands of the most junior and lowest paid people:

1. Do you think it may be possible with more attention to detail and better motivation that we could achieve 2% more income and 2% less expenditure? N.B. contrary to popular opinion these things are not necessarily mutually exclusive!
2. If the 2% beneficial changes were achieved, would it result in flying champagne corks and great celebration?

Let's redo the P & L with the beneficial changes.

Income	102
Expenditure	98
Profit/Surplus	14
Profit margin	13.7%

Obvious you may say, simple maths! However, the profit/surplus margin, a figure many measure themselves by, has gone from 10% to 13.7% which is an increase of 37% I have seen many champagne corks fly to celebrate much more modest improvements.

In this example, a 2% increase in income plus a 2% decrease in expenditure resulted in the profit margin increasing by 37%!

Or $2\% + 2\% = 37\%$

And that's not all! This example shows an increase of 37% profit margin which is remarkable. Many people value a measurement called Return on Investment (ROI). The profit is the 'return'. The next section on balance sheets looks at the investment. What about trying not only to improve the return but also doing it on a smaller investment? More of this to follow.

Cautionary notes

1. Running a successful organisation is an art – not a science. You can easily calculate the saving that would be generated by charging your workers for their morning tea which has been free since your organisation began. What cannot be so easily worked out is the cost of the lost productivity and morale when your people spend half the day discussing what a skinflint you are!
2. The reverse of the 2+2 case is also true. A 2% loss of income plus a 2% increase in expenditure will produce a significant decrease in profit/surplus.

Points for Action

1. When you have looked at and controlled the 'headline grabbing' numbers, ask everyone if they know of ways to improve service/cut costs even in a small way. Do the sums to see if the ideas are good, then adopt the good ones with all the credit going to the inventor. Explain to the unsuccessful contributors why you are unable to adopt their suggestions at this time and how much you look forward to their next ideas.
2. Make sure all your team recognise the importance of their work and how much you appreciate good work.
3. Replace equipment at the most cost effective time

Useful tip

Remembering that fixed costs do not vary with activity but variable costs do, we can look at 'economies of scale'. i.e. the more activities you can perform without increasing in size, the less each one costs.

For example: Our local barber has to pay the same rent for his shop, no matter how many or how few haircuts he does. If he did one haircut then took the rest of the week off, that haircut would have cost him 15 minutes of his time plus a whole week's rent. If he does one hundred haircuts a week, then each one costs him 15 minutes of his time plus one hundredth of the weekly rent. He obviously understands this well. He works by appointment only and last time I asked for a morning appointment he said "7.30 OK?"

It is tempting to imagine that if he could do five hundred haircuts a week, he would retire very young. The problem is that he would have to employ more barbers and get a much bigger shop. His fixed costs (rent and salaries) would then be much larger and it may not be worthwhile.

4. Asset Management

Mr Micawber told us: "Annual income twenty pounds, annual expenditure nineteen pounds nineteen shillings and six pence, result happiness; annual income twenty pounds, annual expenditure twenty pounds and six pence, result misery. This may be true as far as it goes but it is over-simplistic. Six pence (2.5p) profit must be viewed against the size of the organisation that produced it. The financial size of an organisation is described by a Balance Sheet.

Many people use the term balance sheet as a generic name for a piece of paper with numbers on it. It is in fact something specific. It is a list of all the things the organisation owns (assets) and owes (liabilities) at a stated point in time. It is very useful because it describes not only how much money is invested but exactly where it is and where it came from. It helps to put everything we have discussed so far into perspective.

For example: If someone told you their business had £1 million in the bank and made £½ million profit last year, should you be impressed? You guessed – it all depends! If they are running your local corner shop you would probably be more impressed that if their business was called Tesco! The balance sheet will level the playing field for us. It will tell us the financial size of the organisation so we can compare the return (from the P & L) to the investment (amount of money employed to run it).

It measures money tied up in:

1. Fixed assets. These are things that we need to keep long term to run the organisation, eg tools, buildings, vehicles, long term investments. They will be recorded on an asset register which auditors may inspect. In order to keep the register manageable, there is usually a minimum value stipulated, eg £1,000, otherwise we may be recording hundreds of small value items such as pocket calculators.

These assets will appear on the balance sheet at their value at that time. i.e. the original cost less depreciation to date. Generally buildings appreciate rather than depreciate. In this case their value will be stated at today's price. If an organisation has many similar items, eg service engineers equipment that fall below the value set for the asset register but are none the less worth recording, it may have a 'small asset register' as well.

2. Current assets. These are items which hopefully move quickly through an organisation, eg cash, stock, debtors:
 - a. Cash means that which is immediately available, not in a long-term investment. Although you may maintain a permanent bank balance, there will be a stream of movements in and out. If you have an overdraft, this will be shown later as a creditor – not negative cash.
 - b. Stock is anything you intend to sell as a normal activity. It may be a finished product or the component parts thereof. If it is part completed, it is known as 'work-in-progress', often called W.I.P. This need not be a tangible thing. Stock, in all its forms, is shown on the balance sheet at what it cost – not what you hope to sell it for.
 - c. Debtors are people that owe us money payable in the short term. Having lots of debtors may sound bad news but it's fine as long as they pay within the agreed period and that you have access to sufficient cash (yours or the bank's) to run the organisation until they do.
3. Current liabilities. These are items which you will have to pay in the short term. eg overdrafts, trade creditors:
 - a. Overdrafts: although you may keep using your overdraft allowance for years, the bank will want it back if you don't meet their conditions.
 - b. Trade creditors are people to whom you owe money for goods or services they have supplied.
4. Long term liabilities: this is money you will have to pay in the longer term, eg mortgage or long term loan.

All the above describe what the organisation is made up of in financial terms but that is only half the story. The other half describes where the money came from.

Both halves are always equal because whatever money is put in must show somewhere. To make this point, I will insert the words **financed by** to separate the two halves. They do not usually appear on a published balance sheet.

5. Share capital: this is money invested by the owners.

6. Retained profit: all the profit made to date. This is often called reserves which is a very misleading term. To most people it implies a stock of ready cash but this is highly unlikely to be the case. Reserves can be represented by any of items 1 or 2 in this list, only one of which is cash.

Useful note. Current assets less current liabilities is called net current assets (liabilities) or working capital. More about this later.

Hopefully this has given an insight into what balance sheets are for and a little about what they look like. Exercise 1 part 6 provides an opportunity to prepare one if you wish or just to look at part 7 for the answer. Again, if you remove the 'clues' and 'ref.' column, you have a simple balance sheet.

Exercise 1 part 6

Using information from your previous work on exercise 1, please prepare a balance sheet for the high street shop. As usual, start with a blank page for more of a challenge or use the pro-forma on the next page if you prefer.

Exercise 1 part 6: Pro-forma

	Clue	ref	£
Fixed assets:	Items we need to keep		
Fixtures and fittings	Purchase price less depreciation	a	
Current assets:	Items we use or sell		
Stock	At cost price	b	
packaging	At cost price	c	
Total current assets	b + c	d	
Current liabilities:	Amounts falling due within a year		
Overdraft	Worked out in parts 2/3	e	
Trade creditor	Unpaid rent	f	
Total current liabilities	e + f	g	
Net current assets (liabilities)/working capital	d - g	h	
Total assets less net current liabilities	a + h	i	
Financed by			
Share capital	The owner's investment	j	
Retained profit	Cumulative, also known as Reserves	k	
Total assets/capital account	j+ k (must be equal to i)		

For Read Out loud Readers: The table has finished.

Exercise 1 part 7: My answer

For Read Our Best Readers: The following table has 4 columns and 17 rows.

	clue	ref	£
Fixed assets:	Items we need to keep		
Fixtures and fittings	Purchase price less depreciation to date	a	4,700
Current assets:	Items we use or sell		
stock	At cost price	b	150
packaging	At cost price	c	20
Total current assets	b + c	d	170
Current liabilities:	Amounts falling due within a year		
Overdraft	Worked out in parts 2/3	e	350
Trade creditor	Unpaid rent	f	400
Total current liabilities	e + f	g	750
Net current assets (liabilities)/working capital	d - g	h	(580)
Total assets less net current liabilities	a + h	i	4,120
Financed by			
Share capital	The owner's investment	j	4,000
Retained profit	Cumulative, also known as Reserves	k	120
Total assets/capital account	j + k (must be equal to i)		4,120

For Read Our Best Readers: The table has finished.

Point for Action

- Remember that anything you add to your balance sheet increases the capital you have employed/invested in the organisation. It should therefore increase your profit/surplus, otherwise why do it? It would be like putting more money into a savings account but not getting more interest. However, there are reasons why you may have to increase your investment without hope of increasing your profit/surplus. e.g. to comply with new legislation.

5. Working capital/net current assets (liabilities)

You will remember from the balance sheet that this includes items such as stock, cash and debtors minus items such as overdrafts and trade creditors. It is everything that moves quickly through the organisation for day-to-day running.

Working capital is in some ways more difficult to control than longer term investments such as buildings and major equipment. Everywhere I have ever worked, there has been a strict process to be followed in order to purchase major equipment. A strong case has to be made, usually to a Director or committee formed to decide such things. Your case will have to meet preset criteria even to get a hearing. The final decision will be made by a select and senior few. Although this is potentially frustrating, it is very sensible because you are making a long-term and substantial investment.

On the other hand, everybody in the organisation has some control over working capital. This is because it includes a vast multitude of things. It includes the contents of the stationery cupboard, any stock of material, work in progress, finished goods and energy used to name a very small sample. A warehouse manager I met told me about his ballpoint pen experience. He was aware that there were always pens lying about the warehouse, so he decided to pick them up for re-use. He collected over 200, many of which did not work for some reason. It is tempting to think that a manager should not waste time on such trivia, and I'm sure that the pens could have been better managed. The point is that pens are only one of hundreds of sundry items which, although individually small, often add up to a considerable amount. All the money tied up in such items will either reduce your cash balance or increase your overdraft.

Remember the 2+2 exercise!

The trick is to have as little money as possible tied up this way and still run effectively. Working capital moves in a cycle.

1. It starts with some cash which you use to produce your goods/services. This may be a quick and simple thing like buying some newspapers at lunchtime and selling them all on the street during the afternoon; or it may be more complex and involve many purchases of items or people's time before you have anything to sell.
2. When you have sold something, you will send the client a bill and they become a debtor. If it takes a long time to collect from your debtors, you will have to put in more cash to continue to operate.

3. The debtor pays and you have some cash to start again and hopefully some left over, which is your profit/surplus.

You will see that the faster the cycle goes, the quicker the cash returns and the less will be tied up in it. The longer it takes to complete the cycle, the more cash you will need. Needing loads of cash means that you will either have to use your own or borrow from someone else. Either way it will cost you.

The thing to remember is that all money tied up in your organisation must be used effectively to do whatever you do. It is most likely that money used to fund some clever innovation will be more beneficial than owning ten years' supply of office stationery. So does this mean that we should always keep the absolute minimum stock of everything? Well as you know, it all depends. **IF** you use a lot of pencils and **IF** you know the price of pencils is about to double and **IF** you have loads of space to store pencils and **IF** you are certain that you will always need lots of pencils and **IF** you have cash to spare and **IF** and **IF** and **IF**..... then go and buy a truck load of pencils.

Points for Action

- Be aware that any increase in investment should normally produce a proportional increase in profit.
- Look at timing when purchasing new assets.

6. Performance indicators / Ratios

I enjoy studying financial accounts and hope that you will see them in a new light after reading this useful guide! However, there are probably a few key indicators/ratios that you need to watch constantly while the others, although important, need less frequent attention. Clever management accountants will keep you aware of these key indicators without you having to wade through reams of figures. My car can provide me with more information than I can possibly take in at one time but right in front of me at all times is how fast I am going and how much fuel I have left.

I once worked with a small and very successful family business where he was the engineer and she was the accountant. She produced the most amazing and comprehensive management accounts I have ever seen. I noticed that on all his old sets I saw that the same two figures (out of several pages) were always marked with a highlighter. When I asked why, he said that one was the amount of platinum used in the products and the other was the wastage of platinum. He explained that the cost of platinum in the product was such a huge percentage of the total product cost, so if he got that right, success was more or less assured.

There are hundreds of popular performance indicators and some will be important to you, others not. If none of the common ones appeal to you, invent your own! The important thing is that they tell you at a glance how you are doing.

Although text books can provide definitions of indicators/ratios, please do check exactly what your organisation includes in any that are relevant to you as there might be a bit of 'poetic licence' used. It's an art, not a science.

Some popular and very useful indicators start with 'Return on', for example:

- Return on investment (ROI)
- Return on capital employed (ROCE)
- Return on stock investment (ROSI)

These all express the return (profit) as a % of an investment. If you invest your money in a savings account you will get a return in the form of interest. If you can get 5% interest from your local high street bank, you would expect to get much more from running a business – otherwise why take the risk?

Other ratios measure time/turnover, for example:

- Stock turn: Value of stock right now divided by the amount of stock used in a year x 365; this will tell you how many days on average items remain on your shelves.
- Debtor days: Amount owed to you right now divided by your annual turnover x 365; this tells you how many days on average you are waiting for payment.

Some measure profit margins, for example:

- Profit before tax (PBT): Profit before tax as % of turnover

As I said, there are hundreds and you need never worry about asking your accounts colleagues what they mean. Some are very simple. When I was a full time trainer/adviser, my main concern was the number of chargeable days' work I did in a year. Not very sophisticated but unless I got the charge out rate badly wrong, I knew that once I had enough days in the diary the mortgage would be paid. This one is much loved by all kinds of self-employed people.

Point for Action

- Pick the two or three most critical factors under your control and make sure you have instant access to indicators that measure them.

Well that's more or less it from me. Thank you for getting this far! I have included below a detailed exercise which will help you to confirm your understanding.

Good luck!

Exercise 2 part 1

Starting data

F. Green was formed using £4,000 of the owner's money.

They purchased equipment for £2,500

Information for the first six months:

Sales - amount invoiced	60,000
Sales - amount received	48,000
Materials purchased and received	26,000
Materials paid for	20,000
Wages paid	18,000
Overheads paid	13,800
Depreciation	200

For Read Out loud Readers: The table has finished.

At the end of six months they:

Owe £6,000 for materials

Have £2,000 worth of material left

Are owed £12,000 by their customers

Task. Work out how much cash there is at the end of the six month period.

Just use totals. Ignore the monthly breakdown for now.

Monthly breakdown of actual (cash) sales receipts and material payments

Month	Receipts (sales)	Payments (materials)
April	4,000	6,000
May	5,000	6,000
June	5,000	2,000
July	7,000	2,000
August	12,000	2,000
September	15,000	2,000
Totals	48,000	20,000

Exercise 2 part 2: Pro-forma

Cash

Received	£	Paid	£
Share capital		Materials	
Sales		Wages	
		Overheads	
		Equipment	
Total		total	

Cash balance at 30th September	£
--	----------

Exercise 2 part 3: My answer

Cash

Received	£	Paid	£
Share capital	4,000	Materials	20,000
Sales	48,000	Wages	18,000
		Overheads	13,800
		Equipment	2,500
Total	52,000		54,300

Cash balance at 30th September	(2,300)
--	----------------

We now know that we will have an overdraft of £2300 at the end of six months. I always think it's much easier to get an overdraft facility (internal or external) before, rather than when you need it. If you were the lender, who would you rather finance:

- a. Someone who has planned ahead;
- b. Someone who is already in a muddle.

Even if you get your overdraft when you are already in a muddle, you will probably pay very dearly for it. With this in mind please start to consider the overdraft allowance you think you will need. Of course, before you do this you must do a cash flow forecast. In real life no one will provide all the figures and you will have to work them out or even use your intuition. This is not a guess; it is your professional opinion. As this is an exercise, please use the figures you have.

Next task. Prepare a month-by-month cash flow forecast.

Exercise 2 part 4: Pro-forma

Cash flow summary

	April	May	June	July	Aug	Sept
Receipts						
Sales						
Share capital						
Total receipts						
Payments						
Materials						
Wages						
Overheads						
Equipment						
Total payments						
Cash flow this month						
Balance carried forward						

For Read Out loud Readers: The table has finished.

Exercise 2 part 5: My answer

For Read Out Loud Readers: The following table has 7 columns and 13 rows.

	April	May	June	July	Aug	Sept
Receipts						
Sales	4,000	5,000	5,000	7,000	12,000	15,000
Share capital	4,000					
Total receipts	8,000	5,000	5,000	7,000	12,000	15,000
Payments						
Materials	6,000	6,000	2,000	2,000	2,000	2,000
Wages	3,000	3,000	3,000	3,000	3,000	3,000
Overheads	2,300	2,300	2,300	2,300	2,300	2,300
Equipment	2,500					
Total payments	13,800	11,300	7,300	7,300	7,300	7,300
Cash flow this month	(5,800)	(6,300)	(2,300)	(300)	4,700	7,700
Balance carried fwd.	(5,800)	(12,100)	(14,400)	(14,700)	(10,000)	(2,300)

For Read Out Loud Readers: The table has finished.

How accurate was your first idea of the overdraft requirement? The moral of the story is that we must look at cash flow at least monthly. We might very well be OK in six months time if we survive, but will we?

Next task. Prepare a P & L for the six month period.

Exercise 2 part 6: Pro-forma

Profit and loss account for 6 months ended 30th September

For Read Out (aud Readers): The following table has 3 columns and 10 rows.

		£
Turnover	<i>amount invoiced during stated period</i>	a
Cost of sales		
Materials	<i>at cost price, matched to sales</i>	b
Labour	<i>at cost price, matched to sales</i>	c
Gross profit	<i>a-b-c</i>	d
Overheads		
Depreciation	<i>for the period stated</i>	e
Other overheads	<i>for the period stated</i>	f
Operating/trading profit	<i>d-e-f</i>	

For Read Out (aud Readers): The table has finished.

Exercise 2 part 7: My answer

Profit and loss account for 6 months ended 30th September

For Read Out (aud Readers): The following table has 3 columns and 10 rows.

		£
Turnover	<i>amount invoiced during stated period</i>	60,000
Cost of sales		
Materials	<i>at cost price, matched to sales</i>	24,000
Labour	<i>at cost price, matched to sales</i>	18,000
Gross profit	<i>a-b-c</i>	18,000
Overheads		
Depreciation	<i>for the period stated</i>	200
Other overheads	<i>for the period stated</i>	13,800
Operating/trading profit	<i>d-e-f</i>	4,000

For Read Out (aud Readers): The table has finished.

Next task. Prepare a balance sheet for the six month period.

Exercise 2 part 8: Pro-forma

Balance sheet as at 30th September

For Read Out (aud Readers): The following table has 3 columns and 22 rows.

Fixed Assets	<i>Things we mean to keep</i>		£
Equipment	<i>purchase price less depreciation</i>	a	
Current Assets:			
Materials	<i>at cost price</i>	b	
Debtors	<i>at face value</i>	c	
Total current assets	<i>b+c</i>	d	
Current liabilities – amounts falling due within one year			
Overdraft		e	
Trade creditor	<i>materials</i>	f	
Total current liabilities	<i>e+f</i>	g	
Net current assets (liabilities) or working capital	<i>d-g</i>	h	
Total assets less current liabilities	<i>a+h</i>	i	
Financed by			
Share capital	<i>the owner's money</i>	j	
Retained profit	<i>cumulative, also called reserves</i>	k	
Total assets/capital account	<i>J+k, must be equal to i</i>		

For Read Out (aud Readers): The table has finished.

Exercise 2 part 8: My answer

Balance sheet as at 30th September

For Read Out loud Readers: The following table has 3 columns and 22 rows.

Fixed Assets	<i>Things we mean to keep</i>		£
Equipment	<i>purchase price less depreciation</i>	a	2,300
Current Assets:			
Materials	<i>at cost price</i>	b	2,000
Debtors	<i>at face value</i>	c	12,000
Total current assets	<i>b+c</i>	d	14,000
Current liabilities – amounts falling due within one year			
Overdraft		e	2,300
Trade creditor	<i>materials</i>	f	6,000
Total current liabilities	<i>e+f</i>	g	8,300
Net current assets (liabilities) or working capital	<i>d-g</i>	h	5,700
Total assets less current liabilities	<i>a+h</i>	i	8,000
Financed by			
Share capital	<i>the owner's money</i>	j	4,000
Retained profit	<i>cumulative, also called reserves</i>	k	4,000
Total assets/capital account	<i>J+k, must be equal to i</i>		8,000

For Read Out loud Readers: The table has finished.

7. Conclusion

I hope this useful guide has been useful! I have tried to say that you do not have to become an accountant to make good use of financial information and make good financial decisions.

I hope you have thought 'this is just common sense, what's all the fuss about'.

If there are some aspects that you need to clarify for your specific organisation please put the kettle on and invite your accounts colleagues for tea.

8. Feedback

We are always trying to improve our Useful Guides and would appreciate any feedback you can give us on A Useful Guide to Managing Money. Please click on the link below to access our online feedback form ...

<http://www.pansophix.com/useful-guide-feedback.html>

If we use your feedback to improve **A Useful Guide to Managing Money** we will email you a copy of the updated version.

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