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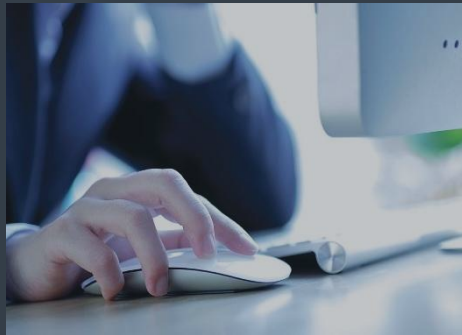
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Accounting Principles and Procedures



15 January 2020

Accounting Principles and Procedures



Accounting Principles & Procedures

This programme aims to provide a broad appreciation of the core elements of accounting principles and procedures with regard to managerial & company accounts, balance sheets, profit & loss statements. and their application.

Contents

1. Company accounts & The Company's Act 2006
2. Management accounts vs Financial accounts
3. Profit and Loss statements vs Balance sheet
4. Exercise: 20 minutes
5. Cash flow statements
6. Budgets and Financial Forecasting
7. S Curves in Construction Contracts
8. Budgets & Financial Forecasts
9. Ratio Analysis
10. Budgeting
11. Typical APC questions
12. Tips & Advice
13. Exercise: 30 minutes

Accounting Principles & Procedures

By the end of the programme the learners will be able to:

1. Understand the APC Requirements
2. Explain the difference between a balance sheet and a profit and loss statement.
3. Understand Cash Flows
4. List at least three of the most common accounting ratios
5. Understand the importance of budgets and forecasting as managerial tools.

Accounting Principles & Procedures

Accounting Principles & Procedures is a mandatory competency that learners are required to demonstrate understanding to Level 1.

Level 1

The RICS defines it as:

‘Demonstrate knowledge and understanding of accounting concepts and the format and preparation of management and company accounts, including profit and loss statements, cash flow statements and balance sheets’

Simply put the RICS requires its candidates, to have a broad appreciation of the core elements of accounting – profit and loss, cash flow and balance sheet statements etc.

Accounting Principles & Procedures

Question: Why, as chartered surveyors, do we need to know about accounting principles and procedures, after all isn't that why we have accountants?

Answer: Having passed the APC some of you may wish to set-up your own consultancy or some may join the company's management team: basic knowledge of accounting principles will be an advantage:

1. for monitoring your own business;
2. assessing competition;
3. assessing the financial standing of contractors and subcontractors;
4. assessing the financial standing of landlords or tenants, and
5. for profit-method evaluation.

Accounting Principles & Procedures

The RICS definition provides the first clues to your study list:

- Company accounts & The Company's Act 2006;
- Management accounts vs Financial accounts;
- Profit and Loss statements vs Balance sheet;
- Cash flow statements;
- Budgets and Financial Forecasting.

Less obvious topics:

- Taxation;
- Capital allowance;
- Ratio analysis;
- Profitability / insolvency;
- Auditing.

Accounting Principles & Procedures

Company Accounts & The Company's Act 2006:

This Act had the distinction of being the longest Act in British Parliamentary history: with 1,300 sections and covering nearly 700 pages, and containing 16 schedules (contents list is 59 pages), but now surpassed, by the Corporation Tax Act 2009.

Part 15, chapters 1 to 12, require the preparation of company accounts and reports on a yearly basis.

Accounting Principles & Procedures

Management Accounts vs. Financial Accounts:

Management accounting provides information to people within an organization and is not required by law.

Financial accounting is mainly for those outside the organisation, such as shareholders, and is required by law.

Accounting Principles & Procedures

Profit & Loss Statement vs Balance Sheet:

The primary difference between the profit and loss statement and the balance sheet involves their respective **treatments of time**.

- The balance sheet summarizes the financial position of a company for one specific point in time.
- A balance sheet does not involve time periods.
- Instead, it reports the value of all assets, liabilities and equity as at a given date.

Typical layout of a balance sheet

	£'000		£'000
Shareholders' Funds		Fixed Assets	
Share Capital	30,000	Land and Buildings	20,000
Reserves	20,000	Machinery	10,000
		Vehicles	15,000
External Funds		Current Assets	
Long term loans	10,000	Stock	15,000
Creditors	20,000	Debtors	15,000
		Cash	5,000
TOTAL LIABILITIES	£80,000	TOTAL ASSETS	£80,000

Accounting Principles & Procedures

Profit and Loss Statement vs Balance Sheet (cont'd):

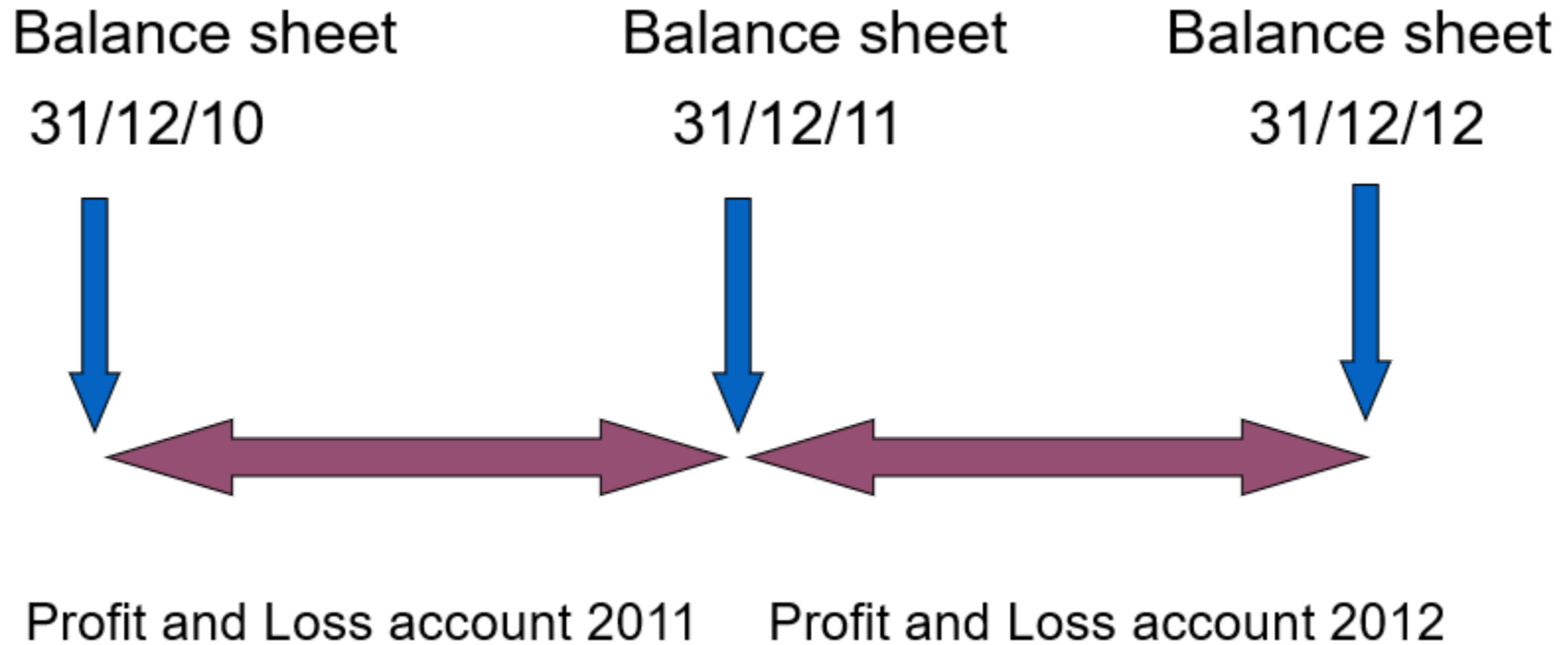
The Profit & Loss statement shows revenues and expenses during a set period of time.

The income statement summarizes the total revenue, expenses and profit or loss incurred during a set period.

Accounting Principles & Procedures

Typical Profit & Loss Statement

	£'000
Sales	20,000
Less Cost of Sales	15,000
PROFIT	5,000



- **Balance Sheet – specific to a given date.**
- **Profit & Loss – over a set period.**

Accounting Principles & Procedures

Exercise – 20 minutes

Produce a simple Balance Sheet from:

- Current Assets

- Cash £11.50
- Accounts Rec £ 0.00
- Books £28.00
- Coffee £5.50
- Fixed Assets
- Coffee maker £24.00
- Deprecation 20%.

- Liabilities

- Bank loan £25.20
- Accounts payable £0.00

- Owner's equity

- Equity £15.00
- Earnings (profit) £24.00

Presenter see Word Document for answer

Accounting Principles & Procedures

Exercise (Cont'd)

Produce a simple Profit and Loss Account from:

Income

Service rendered	£94,600
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Expenses

Salaries	£25,000
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Telephone & internet	£6,500
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Water & Electricity	£16,000
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Property tax	£3,500
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PI insurance	£7,300
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General Insurance	£3,500
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Accounting Principles & Procedures

Cash Flow Statements (CFS):

A cash flow statement is a financial statement that shows how changes in balance sheet accounts and income affect cash.

The CFS compliments the balance sheet and income statement, and records the amount of cash and cash equivalents entering and leaving a company.

The CFS allows investors to understand how a company's operations are running, where its money is coming from, and how it is being spent.

Accounting Principles & Procedures

There are two main types of **Cash Flow** forecast:

➤ **Organisational cash flow**

The cash flow forecast of a company (i.e. a contractor or consultant) – otherwise known as an **organisational cash flow**.

The cash flow forecast of a company will review and analyse the predicted incoming and outgoing cash for a set period of time (usually a year) and is often used for business and resource planning and for analysing the financial health of companies.

➤ **Project cash flow**

The cash flow forecast of a particular construction contract or project – otherwise known as **project cash flow**.

The cash flow forecast of a construction contract or project deals specifically with the payments due under a particular construction contract.

Cash Flow Statement

	£'000
Cash Sales	20,000
Less Cash Costs	15,000
CASH INCREASE	5,000

Accounting Principles & Procedures

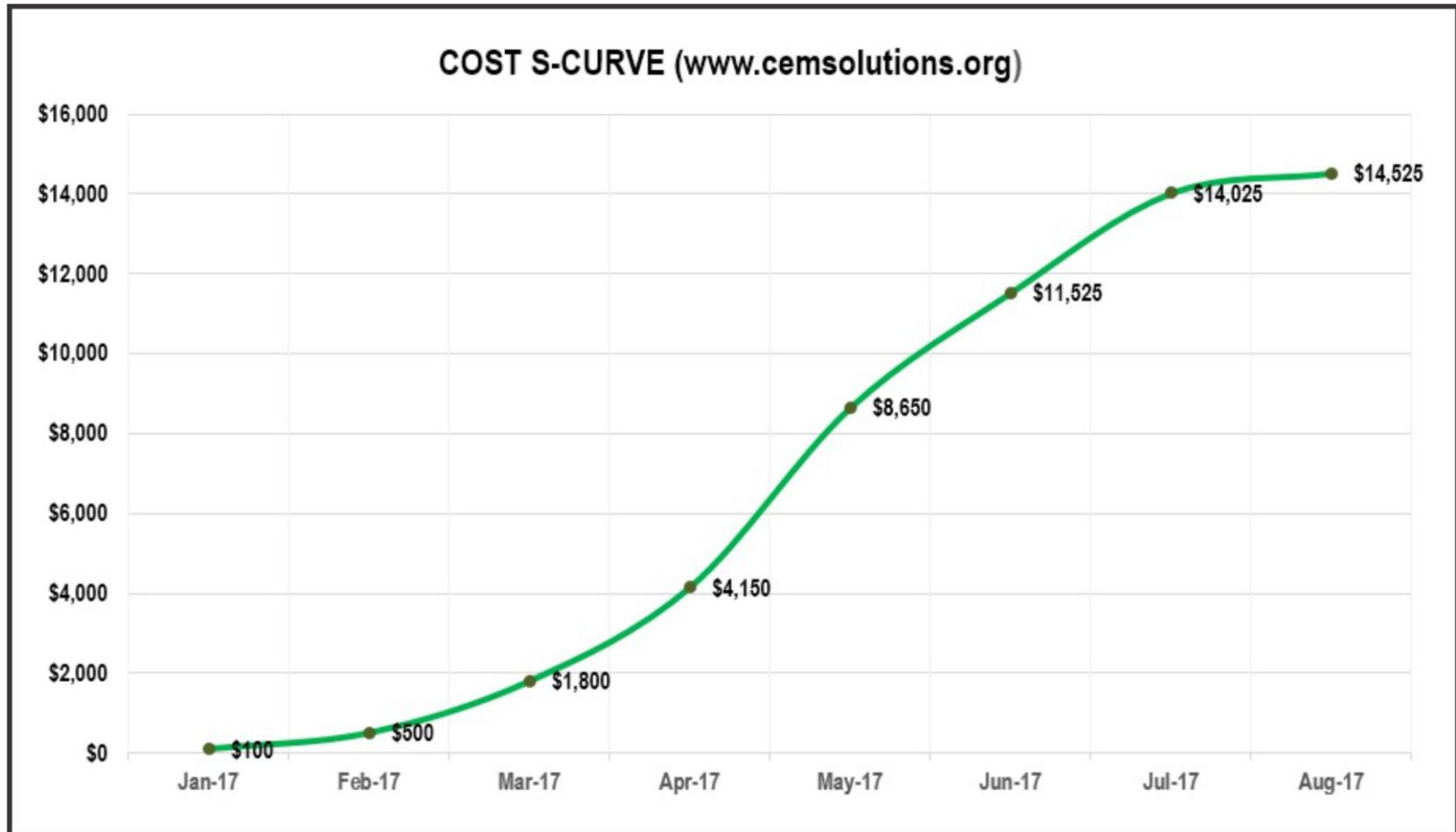
S Curves in Construction Contracts

The S-curve stands for '**standard**' curve but it also takes the shape of the letter 'S' when shown on a graph (see next slide).

This represents the lower level of periodic expenditure at the beginning of a contract (due to site set up and relatively inexpensive enabling works) and the lower level of expenditure at the end of a contract (due to the vast majority of materials being on site, reduced number of trades on site and reduction of contractor's staff overhead).

These S-curves are ascertained by formula, which uses data from previously similar construction projects.

Accounting Principles & Procedures



Accounting Principles & Procedures

What can a **Company Cash Flow** tell you?

- Is the business viable?
- What size of overdraft/borrowings are needed.
- Early warning of turn down in business.
- Incentive to “get money in” asap.
- Do you have excess cash available that might be better used?
- Are your customers taking too long to pay?
- Are you paying your bills too quickly?

Accounting Principles & Procedures

What can a **Construction Contract Cash Flow** tell you?

- Is the project behind programme?
- Are the subcontractors behind programme?
- Is the Contractor having difficulty paying their bills resulting in subcontractors not committing materials or labour?
- Is the contractor recouping the financial effects of change?
- Has the tender been “front loaded”?
- Is the programme wrong?

Accounting Principles & Procedures

Budgets & Financial Forecasts:

A budget estimates the amount of revenues and expenses a company may incur over a future period.

- Budgeting represents a business' financial position, cash flows and goals.
- A financial forecast is a **fiscal management tool** that presents estimated information based on past, current, and projected financial conditions. This will help identify future revenue and expenditure trends that may have an immediate or long-term influence on government policies, strategic goals, or community services.

Accounting Principles & Procedures

Ratio Analysis:

Is a form of fundamental analysis that links together the three financial statements commonly produced.

Ratios provide useful figures that are comparable across industries and sectors.

Investors can develop a feel for a company's attractiveness based on its competitive position, financial strength and profitability.

- **Liquidity:**

The most common liquidity ratio is the current ratio, which is the ratio of **current assets** to **current liabilities**. This ratio indicates a company's ability to pay its short-term bills. Current assets / current liabilities. The ideal ration is 2:1, if it's 1:1 could imply a firm is not able to meet's debts quickly.

Accounting Principles & Procedures

Ratio Analysis (cont'd):

- **Solvency:**

Solvency ratios indicate financial stability because they measure a **company's debt** relative to its **assets and equity**. A company with too much debt may not have the flexibility to manage its cash flow if interest rates rise or if business conditions deteriorate.

- **Debt to assets** = Total interest-bearing debt / Total assets.
- **Debt to capital** = Total interest-bearing debt / Total interest-bearing debt + Total equity.
- **Debt to equity** = Total interest-bearing debt / Total equity.
- **Financial leverage ratio** = Average total assets / Average total equity.

Accounting Principles & Procedures

Ratio Analysis (cont'd):

- **Profitability:**

Profitability ratios indicate management's ability to convert sales into profits and cash flow. $\text{Gross profit} / \text{net sales} \times 100$.

- **Efficiency:**

Two common efficiency ratios are inventory turnover and receivables turnover. Inventory turnover is the ratio of cost of goods sold to inventory. A high inventory turnover ratio means that the company is successful in converting its inventory into sales. $\text{Cost of goods} / \text{Average stock} (\text{opening stock} + \text{closing stock} / 2)$

Accounting Principles & Procedures

Ratio Analysis (cont'd):

- **Acid Test Ratio:**

Is a severe test of a firm's capabilities to meet its debts.

The formula is the same as the Current Ratio but with the added problem of writing off all stock. This is because it assumes that stock may be perishable, it may go out of date, or it may go out of fashion or become obsolete.

In other words, the firm may be left with stock it cannot sell. An ideal value of 1:1 is generally accepted. Current assets – stock / current liabilities.

Accounting Principles & Procedures

Budgets – What is a Budget?

A budget is a financial plan for a defined period, often one year.

It may also include planned sales volumes and revenues, resource quantities, costs and expenses, assets, liabilities and cash flows. Companies, governments, families and other organizations use it to express strategic plans of activities or events in measurable terms.

Accounting Principles & Procedures

Budgets

- Budgets provide:
 - financial focus;
 - co-ordination of activities;
 - facilities control
 - measure performance.
- **Budgets are not written in blood nor chiselled in stone** – they provide guidance and a bench mark from which to gauge performance.

Accounting Principles & Procedures

Budgeting (cont'd):

- Essential features of budgets:
 - they provide policies to be pursued to meet overall objectives;
 - they contain both quantitative & financial data;
 - the data is documented;
 - they cover a defined period or event.

Accounting Principles & Procedures

Budgeting (cont'd):

- Budgets provide:
 - definition concerning managerial responsibility;
 - an action plan for specific areas of responsibility;
 - an incentive to adhere to allocation;
- Under or over spending and the resulting review improves decision making in the future.
- Budgets should be used for guidance and must NOT considered as 'controlling' documents.
- Decisions must be made on whether the product or service is required not whether there is money allocated, or not, in the budget.

Accounting Principles & Procedures

The following sections contains typical questions and answers that may be raised during your APC interview.

Accounting Principles & Procedures

1. What is revenue?

Revenue is income from business activities usually from the sales of goods and services.

2. What is capital expenditure?

Capital expenditure is money spent by a business to acquire fixed assets such as land, buildings or equipment.

Accounting Principles & Procedures

3. What are the basics of cash flow management?

The basic principles are to ensure that sufficient cash is held to meet a firm's payment obligations. It involves an analysis of money coming in versus money going out over a given period or timeline to calculate liquidity.

4. How can cash flow be used?

The purpose of a cash flow forecast is to ensure that the employer has an accurate assessment of payments, and at what periods. In the construction industry the most common use of a cash flow forecast is to monitor the progress of the works. Monitoring progress against a cash flow forecast should only be considered as indicative.

Accounting Principles & Procedures

5. What is the difference between a profit and loss statement and a balance sheet?

A balance sheet is a statement of the assets, liabilities, and capital of a business at a particular point in time, detailing the balance of income and expenditure over the preceding period. (Assets = Liabilities + Equity).

The profit and loss statement summarizes the revenues and expenses generated by the company over the entire reporting period. It is also referred to as the income statement and/or statement of earnings. (Profit = Revenue – Expenses).

Accounting Principles & Procedures

6. What are examples of company overheads?

Overhead expenses are all costs on the income statement except for direct labour, direct materials, and direct expenses.

They include accounting fees, advertising, insurance, interest, legal fees, labour burden, rent, repairs, supplies, taxes, telephone bills, travel expenditures, and utilities etc.

Accounting Principles & Procedures

7. What's the difference between budgeting and financial forecasting?

Budgeting and financial forecasting are financial planning techniques that help business personnel in the decision-making process.

Budgeting uses estimation to quantify the expectation of revenues a business wants to achieve for a future period. Essentially they detail where a business wants to go.

Financial forecasting is used to estimate the amount of revenues that will be achieved, the forecasting indicates where the business is actually headed.

Accounting Principles & Procedures

Tips & Advice:

- It is important to remember that you are only expected to achieve this competency to Level 1.
- While you should be aware of the main accounting ratios, you are NOT qualified accountants. Thus do not claim that you analyse accounts (unless of course you do). (Do not fall foul of the RICS Rules of Ethics).
- If you are comfortable with regard to specific accounting details, mention that in your Experience Record. If it appears in your report the APC panel may ask you questions – be conscious of what you know (or don't know)

Accounting Principles & Procedures

Exercise:

1. What is a Balance Sheet?
2. What is a Profit and Loss Account?
3. What is a Cash Flow?
4. In respect of a Company Cash Flow what could be the cause of outgoings exceeding income?
5. In respect of a Construction Contract Cash Flow what could be the cause of the cash flow lagging behind that forecast?
6. List at least three of the most common accounting ratios
7. What are the APC Requirements in respect of this Competency?

(30 mins – Tutor to read these out individually and ask for student verbal answers)

Accounting Principles & Procedures

Exercise:

1. What is a Balance Sheet?

The balance sheet summarizes the financial position of a company for one specific point in time. A balance sheet does not involve time periods. Instead, it reports the value of all assets, liabilities and equity as at a given date.

2. What is a Profit and Loss Account?

The Profit & Loss statement shows revenues and expenses during a set period of time. The income statement summarizes the total revenue, expenses and profit or loss incurred during a set period.

3. What is a Cash Flow?

The CFS records the amount of cash and cash equivalents entering and leaving a company.

Accounting Principles & Procedures

Exercise:

4. In respect of a Company Cash Flow what could be the cause of outgoings exceeding income?
- Is the business viable?
 - What size of overdraft/borrowings are needed.
 - Early warning of turn down in business.
 - Incentive to “get money in” asap.
 - Do you have excess cash available that might be better used?
 - Are your customers taking too long to pay?
 - Are you paying your bills too quickly?

Accounting Principles & Procedures

Exercise:

5. In respect of a Construction Contract Cash Flow what could be the cause of the cash flow lagging behind that forecast?
- Is the project behind programme?
 - Are the subcontractors behind programme?
 - Is the Contractor having difficulty paying their bills resulting in subcontractors not committing materials or labour?
 - Is the contractor recouping the financial effects of change?
 - Has the tender been “front loaded”?
 - Is the programme wrong?

Accounting Principles & Procedures

Exercise:

6. List at least three of the most common accounting ratios

- Profitability (Profit divided by nett sales x 100)
- Liquidity (Current assets / current liabilities)
- Solvency: Debt to assets = Total interest-bearing debt / Total assets.
- Solvency: Debt to capital = Total interest-bearing debt / Total interest-bearing debt+ Total equity.
- Solvency: Debt to equity = Total interest-bearing debt / Total equity.
- Solvency: Financial leverage ratio = Average total assets / Average total equity.

Accounting Principles & Procedures

Exercise:

7. What are the APC Requirements in respect of this Competency?

Demonstrate knowledge and understanding of accounting concepts and the format and preparation of management and company accounts, including profit and loss statements, cash flow statements and balance sheets'

Accounting Principles & Procedures

We only had limited time to skim the surface of this very important and expansive subject. The following links provide further reading and research opportunities:

- Companies Act 2006 – Overview - Eversheds Sutherland:
www.eversheds-sutherland.com/documents/companies-act-overview.pdf.
- Accounting Principles and Procedures for RICS APC:
www.slqsoman.org/wp-content/uploads/2017/08/General-Presentation.pdf.
- Ratio analysis:
http://www.bbc.co.uk/bitesize/higher/business_management/finance/ratio_analysis/revision/1/.

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Further reading and research opportunities (cont'd):

- Accounting principles:
<https://www.accountingcoach.com/accounting-principles/explanation>
- Guide to Construction Accounting: <http://www.jhs.com/wp-content/uploads/2014/12/Guide-to-Construction-Accounting.pdf>

Accounting Principles & Procedures



Write down two (2) things you have learnt today.