FT PUBLISHING

THE FINANCE BOOK

Second Edition

Understand the numbers even if you're not a finance professional

STUART WARNER & SI HUSSAIN

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Stuart is the author of four finance books. His goal is to help businesses increase productivity and profits through innovative, engaging and experiential finance training programmes. He delivers training and consultancy internationally across multiple sectors. Over his career, Stuart has trained thousands of people. He has taught accounting trainees for professional qualifications and has delivered CPD courses for qualified accountants and interactive courses for non-finance professionals from graduate to board level. Stuart studied management sciences at UMIST and became a Chartered Accountant whilst working at PwC.

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Saieem (Si) trained with KPMG qualifying as a Chartered Accountant in 1991. During his 30+ year career, Si has delivered financial training programmes to countless professionals and has held senior roles in companies, including Chief Executive of BPP Professional Education. He continues to teach finance to a full spectrum of professionals including managers and directors, non-finance professionals as well as those starting out on their careers.

Si is an experienced facilitator and training consultant providing services to a wide range of organisations.

Praise for *The Finance Book*

'This book is a rich and satisfying guide for non-finance professionals who wish to make informed financial decisions. The book tackles the complexities and challenges of finance with impeccable clarity, backed up with recent examples. A road map to enlightenment in finance!'

Yahya Alamari, Talent and Cultural Change Consultant;
former HR Regional Director, KPMG MESA

'I wish I had read this book earlier in my career! A very inviting and must-read book covering the financial concepts that all senior managers should know and told in a way that resonates with those who did not grow up in finance.'

Rupert Brown, People Director – Digital, Virgin Media O2

'As a developing clinical leader, the language of finance can sometimes be a barrier. The authors provide a succinct, easy-to-understand introduction to accounting concepts and terminology. This book will support aspiring leaders to access wider involvement and understanding in their business or organisation.'

Dr Jason I. Broch, Clinical Chair, NHS Leeds CCG;
Health & Social Care Lead, Yorkshire & Humber Health and
Care Record; Partner, Oakwood Lane Medical Practice

'This book is different. It is neither traditional finance nor traditional accounting. It does not attempt to provide a theoretical foundation for the subject but offers nuggets of practical wisdom in a way that distils the authors' decades of experience in the field. The book is clear, immediate, exhaustive and (dare I say it) fun to read – unburdened by theory, down to earth, succinct and practical. Middle or senior management will find it useful, if not essential, in their day-to-day activities.'

Emeritus Professor Robert Cressy, University of Birmingham, UK

'I have adopted The Finance Book *for students studying my MBA financial management module and have no hesitation in recommending this text to all those who need to understand the core financial aspects of business operations.'*

Dr David Fairclough, Borlace Management Ltd

18. Trade and other payables

	Group		Parent Company	
	2020 £m	2019 £m	2020 £m	2019 £m
Trade payables	**48.8**	66.7	**48.8**	66.7
Amounts owed to subsidiary undertakings	**–**	–	**7.7**	7.7
Other taxes and social security	**6.8**	8.9	**6.8**	8.9
Other payables	**17.4**	31.9	**17.4**	31.9
Accruals	**15.1**	32.0	**15.1**	32.0
Advance payments from customers	**2.5**	2.3	**2.5**	2.3
Deferred government grants	**0.5**	0.5	**0.5**	0.5
	91.1	142.3	**98.8**	150.0

In 2019 accruals and other payables included accruals of £27.0 million for performance-related remuneration. There are no similar accruals in 2020.

(Appendix pp. 471, 472)

Consolidate and apply

To see how the concepts covered in this chapter have been applied within Greggs plc, review Chapter 36, p. 395.

Watch out for in practice

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- Liabilities/expenses for goods or services received close to the year end will need to be accounted for and due to their timing will often have to be accrued. Requesting prompt invoices or estimates from suppliers will aid the accruals process.
- An analysis of supplier invoices received early in the financial year can help identify goods or services received in the previous financial year, which should have been accrued.
- Unexpected differences in the year-on-year trend for prepayments and accruals.

14 Provisions and contingencies

'There is nothing more imprudent than excessive prudence.'

Charles Caleb Colton,
British clergyman and author

In a nutshell

Provisions and contingencies are liabilities arising from past activities, which a company may have to pay in the future.

To present a realistic and prudent picture of financial performance, company accounts may include provisions for liabilities, even where the extent and timing of these liabilities cannot be precisely determined.

Need to know

Provisions

A *provision* is a known yet imprecise liability, i.e. we know it exists but we may not know exactly when it will have to be paid or how much will be paid.

A provision has to be made when each of the following occurs:

- There is a present obligation (i.e. a duty to make a future payment) resulting from a past event – see the **Nice to know** section below for more detail.
- It is probable that there will be a future cost (or outflow of resources).
- The amount of the obligation can be reliably estimated.

Contingent liabilities

In contrast, a 'contingent' liability arises when there is uncertainty over one or more of the above (hence the use of the term 'contingent'). Typically, the uncertainties are around:

- the likelihood of the obligation (where it is possible but not probable) and
- the reliability.

Contingent liabilities become actual liabilities only if one or more uncertain events actually happen. It is prudent to make shareholders aware of the possible liabilities that may crystallise rather than ignore them.

In these situations, the company should disclose the presence of a 'contingent' liability, however, unlike a provision, the financial impact of the liability should not be recognised in the financial statements.

Why is this important? ?

Provisions are recognised as a cost to a business. They reduce both profit and net assets and adversely impact key performance measures (see **Chapter 23 Profitability performance measures** and **Chapter 26 Long-term solvency performance measures**) including:

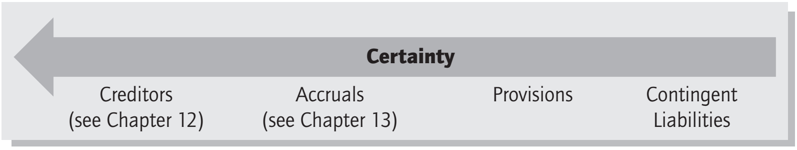
- net profit margin
- return on capital employment
- gearing.

Provisions are challenging, as firstly they must be identified and secondly, they require judgement to assess their value. This emphasises the important point that financial statements contain estimates based on management judgement and should be interpreted in this context (see **Chapter 20 External financial audit**).

In contrast, other liabilities are usually easier to identify and assess. For example, creditors are certain, as they relate to supplier invoices (see **Chapter 12 Debtors and creditors**) and accruals should be traceable to a specific transaction (see **Chapter 13 Prepayments and accruals**).

Liabilities: the big picture

It can be helpful to visualise provisions and contingent liabilities along a continuum of liabilities.



When is this important?

At the end of each reporting period a company should consider if any provisions need to be made and existing provisions should be reviewed to see if they should be increased, reduced or removed.

Time	Impact on expenses	Impact on profit
On creation:	▲	▼
If increasing:	▲	▼
If reducing:	▼	▲
On removal:	▼	▲

In practice

Some examples of infamous provisions are:

- **Hyundai's engine recall**. In the financial year ending 31 December 2020, Hyundai made a provision of Won 5 trillion (~£3 billion) to reflect potential warranty claims in relation to the recall of its Theta II and other engines.
- **Volkswagen's diesel emissions scandal**. In 2020, Volkswagen disclosed cumulative fines and settlements to date of €31 billion.[1] Since the scandal broke in 2015, Volkswagen has made provisions for these costs as soon as they were foreseen. A provision for further costs remains at the time of publication.
- **BP's Deepwater Horizon disaster**. In 2020, the New Orleans Advocate reported that BP and its partners have spent $71

1 reuters.com/article/us-volkswagen-results-diesel-idUSKBN2141JB

billion to date on the disaster.[2] Since the 2010 oil well incident in the Gulf of Mexico, BP has made provisions for these costs as soon as they were foreseen. A provision for further costs as well as contingent liabilities still remained in BP's 2020 annual accounts.

Other examples of provisions are:

- **Dilapidations**
  - If a business rents property, it may face dilapidations (exit costs) at the end of its lease. Typically, this involves putting a property back into its original, pre-let state.
  - Accounting rules allow companies to make a provision at the start of a lease, for the dilapidations cost which will arise at the end of a lease.
- **Onerous contracts**
  - If a company which rents property must relocate before the end of the lease term, it will still be committed to the lease. If it is unable to re-let the property, it may become an onerous lease.
  - In this case the company could make a provision for future lease rentals and exit costs for properties which are no longer occupied but have remaining lease terms. See the **Where to spot in company accounts** section below to Greggs plc's provision for onerous contracts.
- **Restructuring**
  - If, prior to the year end, a company has decided to close part of its business, relocate or fundamentally reorganise its operations it may be necessary to make a provision.
  - Companies should only make restructuring provisions where a formal plan has been publicly communicated to stakeholders.

2 nola.com/news/business/article_ca773cc0-80f4-11ea-8fbe-ffa77e5297bd.html

- **Legal obligations**
  - Legal obligations will often result in provisions. For example, if a company has issued a service warranty with the sale of a product. The company has a legal obligation to fulfill the warranty and should provide for the warranty costs at the time of the sale.
- **Constructive obligations**
  - A well-known and established refund policy (for example those offered by retailers such as Marks & Spencer and John Lewis) is an example of a constructive obligation. A breach of this policy, even where there is no legal or contractual obligation, may cause damage to the company's reputation and have a commercial impact. Therefore, a provision should be made for estimated refunds.

Nice to know

Contingent liabilities

Typical examples of contingent liabilities are provisions which are either improbable or cannot be reliably estimated. These will often include legal claims and product warranties which are unlikely to be exercised. There may be a degree of subjectivity and judgement whether a potential liability is:

- improbable and disclosed as contingent, or
- probable and becomes a provision with a quantitative impact on the financial accounts.

An example of a contingency liability can be found in the 2019 Financial Statements (filed in February 2021) of Uber London Ltd, part of the Uber Group. The note to the accounts explains that Uber is 'involved in a dialog with HMRC, which is seeking to classify the Uber group as a transportation provider in the UK. Being classified as a transportation provider would result in a VAT (20%) on gross bookings or on the service fee that the company charges drivers both retroactively and prospectively. The Uber group believes that the position of the HMRC and the regulators in similar disputes and audits is without merit and is defending itself vigorously'.