2. Money and Tools for it's management

- Introduction to accounting
  - Profit and Loss
  - Cash flow
  - Balance Sheet
  - Budgets
- Sources of finance
- Stocks, Shares, Futures and Options
Introduction to accounting

- Why have accounts?
  - Instruments on the dashboard of the company
  - To control, you must first measure
  - Statutory duty

- DO THE BUDGET
- COMPARE WITH REALITY
Legal requirements;

- Keep proper books of account
- Annual audit
- Solvency
Double entry

- TERMS “Debits and Credits”
  - Debit: to receive. Income Owed to the company
  - Credit: to give. Outgoings. Owed by the company
- Ledgers and balances
- Accountancy programs e.g. Sage, Xero

<table>
<thead>
<tr>
<th>Date</th>
<th>Description</th>
<th>Amount</th>
<th>Date</th>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>DEBIT SIDE</td>
<td></td>
<td></td>
<td>CREDIT SIDE</td>
<td></td>
</tr>
</tbody>
</table>
Vertical Format

Income
  Sales
  Interest
  TOTAL Income

Expenditure
  Cost of goods
  Salaries
  Overheads
  Marketing
  TOTAL Expenditure
  Profit
if you form a limited company
the business is not you and you are not the business
so your money is not the business’s
and the business’s money is not yours
Accounts

Profit & Loss Account

Debit
Cost of Goods Sold (all goods for resale minus any stock left at the time)
Expenses (all the costs including wages)
Profit (always a balancing figure)

Credit
Sales (invoices raised etc)

Balance Sheet

Debit
Fixed Assets (eg Computer, Car)
Debtors (people who owe you money)
Stock (goods for resale)
Bank (assuming a positive balance)

Credit
Creditors (people you owe money)
Loans (banks you owe money)
Capital (the money you put in)
Retained Profit (the profit made so far)
Interlinking of Accounts

- Trade and other Debtors
- Sales and other income
- Capital
- Drawings
- Cash and Bank Balances
- Stock and assets
- Trade and other creditors
- Purchases
Account Example 1

Open a bank account with £1,000 to start your business
  • Debit: Bank £1,000
  • Credit: Capital £1,000

Go to market and write a £600 cheque for some Mushrooms
  • Debit: Stock £600
  • Credit: Bank £600 [We could say Debit: Bank -£600 but instead we copy what real Accountants do with minus numbers and change Debit to Credit]

Quick check on the bank
  • We put in £1,000 in and spend £600 leaves £400
    In accounting speak Debit £1,000 then Credit £600 leaves Debit £400
Account Example 2

Door to door we sell half the Mushrooms for £700 which we pay into the bank

- Debit: Cost of Goods Sold £300 (half of £600)
- Credit: Stock £300 (reducing stock for what we sold)
- Debit: Bank £700
- Credit: Sales £700

We can do some accounts

Profit and Loss Account

<table>
<thead>
<tr>
<th></th>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of Goods Sold</td>
<td>300</td>
</tr>
<tr>
<td>Profit (balance)</td>
<td>400</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>700</strong></td>
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</table>

Balance Sheet

<table>
<thead>
<tr>
<th></th>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock</td>
<td>300</td>
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<tr>
<td>Bank</td>
<td>1100</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>1400</strong></td>
</tr>
<tr>
<td>Capital</td>
<td>1000</td>
</tr>
<tr>
<td>Retained Profit</td>
<td>400</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1400</strong></td>
</tr>
</tbody>
</table>
Account Example 2

The mushrooms are looking old - We sell the remainder to a caterer for £350

- Debit: Cost of Goods Sold £300 (the remainder of the stock)
- Credit: Stock £300
- Debit: Bank £350
- Credit: Sales £350

We can do some accounts

<table>
<thead>
<tr>
<th></th>
<th>Profit and Loss Account</th>
<th></th>
<th>Balance Sheet</th>
</tr>
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<tbody>
<tr>
<td>Cost of Goods Sold</td>
<td>£ 600</td>
<td>Sales</td>
<td>£ 1050</td>
</tr>
<tr>
<td>Profit (=balance)</td>
<td>£ 450</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>£ 1050</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Stock</td>
<td>£ 0</td>
<td>Capital</td>
<td>£ 1000</td>
</tr>
<tr>
<td>Bank</td>
<td>£ 1450</td>
<td>Retained Profit</td>
<td>£ 450</td>
</tr>
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<td></td>
<td>£ 1450</td>
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<td>£ 1450</td>
</tr>
</tbody>
</table>
Principles of Accounting 1

• Boundaries
  – Entity
  – Periodicity
  – Going concern
  – Quantative

• Ethics
  – Prudence - if in doubt, understate profits, overstate losses
  – Consistent - use the same rules throughout
  – Objective - avoid personal preference
  – Relevance “True and fair”
Principles 2

- Measurement
  - Money
  - Consistent cost basis
  - Realisation
  - Consistent time basis
  - Double entry
  - Materiality
# Example P&L Budget

<table>
<thead>
<tr>
<th>Month</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>12</th>
<th>Total</th>
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<tr>
<td><strong>Expenditure</strong></td>
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<tr>
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<tr>
<td><strong>Total Costs</strong></td>
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<td>-10,000</td>
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<td>10,000</td>
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## Example Cashflow

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<tr>
<td>Overheads</td>
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<tr>
<td><strong>Total Costs</strong></td>
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<tr>
<td><strong>Profit in the month</strong></td>
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<td>-10,000</td>
<td>20,000</td>
<td>-10,000</td>
<td>-10,000</td>
<td>20,000</td>
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<tr>
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<td>-5,000</td>
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<td>-15,000</td>
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## Revised Cashflow

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<th>5</th>
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<td><strong>Income</strong></td>
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</tr>
<tr>
<td>Programmers</td>
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<td>5,000</td>
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<tr>
<td>Overheads</td>
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<td>5,000</td>
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<td>5,000</td>
<td>5,000</td>
<td>40,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Costs</strong></td>
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<td>-10,000</td>
<td>20,000</td>
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<td>-10,000</td>
<td>-10,000</td>
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<td>-5,000</td>
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</tr>
<tr>
<td><strong>Profit to date</strong></td>
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</tbody>
</table>
## Example Balance Sheet as at the beginning of Month 9

<table>
<thead>
<tr>
<th>Fixed Assets</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Computers</td>
<td>10,000</td>
<td></td>
</tr>
<tr>
<td>Furniture</td>
<td>3,000</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Current Assets</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Work-in-Progress</td>
<td>10,000</td>
<td>retainer, not yet invoiced</td>
</tr>
<tr>
<td>Trade Debtors</td>
<td>30,000</td>
<td>Amount invoiced, but not yet paid</td>
</tr>
<tr>
<td>Cash</td>
<td>0</td>
<td>Normally there would be some petty cash</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Less: Current Liabilities</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade Creditors</td>
<td>5,000</td>
<td></td>
</tr>
<tr>
<td>Bank Overdraft</td>
<td>15,000</td>
<td></td>
</tr>
</tbody>
</table>

| Net current assets       | 33,000|       |
| Representing             |       |       |
| Proprietors Capital      | 13,000| The proprietor paid for the computers etc.|
| Plus: Accumulated Profit | 20,000|       |
Tests

Liquidity Ratios
- Current Assets
- Acid tests

Profitability Ratios
- Return On Investment
- Gross Profit
- Net Profit
- Mark up

Investment Ratios
- P/E ratio
- Gearing
- Earnings per share

Efficiency Ratios
- Stock turnover
- Asset turnover
- Debtor collection period
- Creditor payment period
Ratios

- Current ratio
  - Current Assets / Current Liabilities
    - Measures liquidity
    - < 1 indicates potential cash flow problems

- Acid test (Quick Health check)
  - (Current Assets-Stocks) / Current liabilities
    - Stocks may not be able to be sold quickly
    - Similar to Current Ratio, but shorter term

- Gearing
  - Net Borrowings / Shareholders’ Funds
    - Reliance on borrowings
    - Vulnerability to interest rate rises

- Return on Investment
  - Profit before Tax / Shareholders Funds
    - Efficiency - 40% for sustainable high growth
Budgeting

• Assumptions
  – “Pessimistic realism”
  – Tell the truth - know the worst

• Sensitivity analysis

• Comparison with actual

• Update!!
Product stages

Cash Revenue

Sales

Development Marketing Maintenance

(Dog) Rising Star Cash Cow Dying

Cumulative

Occurrence of Cash Flow

Time >
Debt and Equity

• Debt
  – Loan
    • Credit card, Overdraft, Mortgage, Student Loan, Debenture, Bond etc
    • Interest rates, term, conditions, collateral
    • Repay the same amount regardless performance

• Equity
  – Share of the company
  – Return depends on the performance of the company
    • Can be expensive money
    • Can be valueless if the company folds
    • Only valuable on an exit (sale, IPO etc)
      – Preference shares may have other conditions such as liquidation ratios attached

• Convertible Debentures
• Redeemable Preference Shares
How much will I need?

• **DO THE BUDGET**

• **Working assumption no income for 1\textsuperscript{st} year**
  - One man band, working from home \text{£100,000}
  - 5 people, office etc \text{£1M}
  - 20 people, small factory \text{£5M}

  - Game, software package \$5M
  - New complex chip \$100M
Hard Times
Michael Beckwith, Sequoia Capital

OUR TAKE

MANAGE WHAT YOU CAN CONTROL
SPENDING
GROWTH ASSUMPTIONS
EARNINGS ASSUMPTIONS

FOCUS ON QUALITY

LOWER RISK

REDUCE DEBT

Early revenue
Low hanging fruit, Quick wins
Cash flow positive first, expansion later
Lightweight Companies

• Many computer companies need little capital to start
  – Virtual office
  – Spare time or labour for shares
  – Advanced payment from customers
    • Development clubs, Government/EU grants
    • Crowd funding

• Fail early, Fail often
  – Find the market
Sources of finance

- Family and friends £50K
  - Banks
    - Security
- Angels £500K
- Venture Capitalists £5M
  - VCA
  - VCB
  - Mezzanine
- Stock Market floatation $250M
  - Acquisition
  - Exit

FAIRY GODMOTHERS ARE NOW EXTINCT!
Why stages?

- Risk/Reward profile differ
- Successive dilution
- Typically 30% dilution each stage
  - Investment = pre-money valuation/2
  - “Squeeze the Angels”

<table>
<thead>
<tr>
<th>Round</th>
<th>Investment</th>
<th>Pre-money</th>
<th>Post-money</th>
<th>Founders and staff options</th>
<th>FFF</th>
<th>Angel</th>
<th>VCA</th>
<th>VCB</th>
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<tbody>
<tr>
<td>FFF</td>
<td>50</td>
<td>100</td>
<td>150</td>
<td>67%</td>
<td>33%</td>
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<tr>
<td>Angels</td>
<td>500</td>
<td>1000</td>
<td>1500</td>
<td>44%</td>
<td>22%</td>
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<td>VCA</td>
<td>5000</td>
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<td>15000</td>
<td>30%</td>
<td>15%</td>
<td>22%</td>
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UK Company types

- Sole Trader
- Partnership
- Private company
- Limited Private Company (Ltd)
- Public limited company (plc)
- Listed company
- Special cases (e.g. Trusts, Societies)
Stocks and Shares

• Shares
  – Ordinary and preference
  – Voting and dividend rights
  – Critical amounts (for normal Table A companies)
    • 25+% Blocks “Substantive” resolutions
    • 50+% Day-to-day control
    • 75+% Total control
    • Other trigger points for public companies
  – Other rights and Coupons
  – Directors accountable to shareholders
Buying and Selling Shares

• Illegal to advertise unless a member of an SRO (e.g. Broker),
• Private company usually requires Board approval
  – Stamp Duty 0.5%
• Public company:
  – Primary market: Floatation
  – Shares traded on a public exchange
    • Listing: admitted to the Official List (UK: LSE)
  – Secondary market
    • Settlement
      • Illegal to use or divulge inside knowledge
  – Bull market: upward trend
  – Bear market: downward trend
• Capital Gains Tax
Options and Futures

• Contracts to buy or sell at a fixed price at some future date
  – Typically 10%
  – Futures: Must complete as specified
  – Options: Completion optional
    • Option and future contracts can be traded

• Gambling - leave it to the professionals
  – Spread-betting [www.igindex.com](http://www.igindex.com)

• Markets are largely stochastic - no system
  – Frauds:
    • Ponzi
    • Boiler room
Fraud?

Cambs firm slated over share hike

BAD PRESS has hit Cambridgeshire varicose veins firm DioMed. The company, which is listed on the U.S. Nasdaq exchange, has become a target for the New York Post. The paper claims the company, originally a spin-out from Generics Group at Harston, is enjoying an unwarranted hike in its share price following the efforts of a stock promoter who has a large holding stashed away in the Cayman Islands.

"DioMed is exactly the sort of stock that should send any normal person fleeing the room at the mere mention of its name: suspect auditor (Andersen in the U.S.), offshore accounts, weird product, teeny-weeny revenues, board members with back stories -- this stock's got it all, the complete package," the New York Post says. DioMed's share price has risen more than 200 per cent to $7 this year, the greatest gain of any listed stock on Wall Street in this period.

CEN 27th Mar 2002
Hewlett-Packard agrees deal to buy Autonomy for £7.1bn

Hewlett-Packard is to buy UK software firm Autonomy for £7.1bn ($11.7bn).

The offer, which has been accepted by Autonomy’s board, is 64% above the firm’s market value.

It came as the US company announced a massive strategic shake-up, involving stopping making hardware in order to refocus on software.

Shares in HP spiked as rumours of the various news - now confirmed by HP - broke, but the firm eventually ended the day down 7.6%.

That came on top of a 3.9% fall on Tuesday that was prompted by a warning from rival Dell that it expected demand in the US market to weaken in the coming months.

‘Positive for UK’

Autonomy was set up by researchers at Cambridge University and specialises in pattern-recognition technologies.

Founder Mike Lynch, whose 8.2% stake could be worth several hundred million dollars, has pledged to vote for the deal, told the BBC: “HP understands the special culture we have. This is about building Autonomy. It will be a positive thing for Cambridge and the UK.”

HP will pay 2,550 pence per share, compared with a closing price in London on Wednesday of 1,558p.

The implied valuation of the company is equivalent to 47 times the pre-tax profits earned by Autonomy in the 12 months to June this year.
Hewlett-Packard unveils details of $5bn Autonomy fraud case

US firm claims Mike Lynch inflated revenues by $700m, but Autonomy founder says HP has failed to produce 'smoking gun'

Hewlett-Packard has unveiled full details of its $5bn (£3.3bn) fraud case against the founder of the UK software company Autonomy, claiming that Mike Lynch inflated the revenues of his business by about $700m over a two-and-a-half-year period.

HP, which bought Autonomy in 2011 for $11bn, has filed a claim against Lynch and his finance director Sukhinder Ruggin, in the high court in London, alleging

https://www.theguardian.com/business/2015/may/05/hewlett-packard-unveils-details-of-5bn-autonomy-case
Autonomy founder Mike Lynch sues HP for $160m over fraud claims

HP has accused Mike Lynch and Autonomy's chief financial officer of accounting fraud that forced it to write down the value of the deal by $8.8bn.

By Christopher Williams, in San Francisco
9:17PM BST 01 Oct 2015

Mike Lynch, the founder of Autonomy, has sued Hewlett-Packard for more than $160m over the allegations of massive fraud it has levelled against him.

He challenged Meg Whitman, the Silicon Valley giant's chief executive, to a High Court showdown over the disastrous takeover of the FTSE 100 software company.

In his counterpunch to HP's own $5.1bn damages claim, Dr Lynch accused
Crowd Funding

• Preselling
  – Street Performer
  – Need a prototype or good mockup

• Kickstarter, Indiegogo
  – https://www.kickstarter.com/
  – https://www.indiegogo.com/

• Up to £1m
How much is it worth?

- **Market value**
  - What someone will pay
  - Comparisons

- **Utility value**
  - Customers, lock in, staff, technology
  - Cost to reproduce

- **Asset Value**
  - Often small for startups
    - Not what it cost
  - IPR

- **NPV**
  - Net present value of future profit
  - EBITDA

- **DCF**
  - Discounted cash flow – maybe easier to estimate

- **Statistical models**
  - Black – Scholes