

Understanding money

Accounting and finance for the uninitiated

In all walks of life there are few things that people find more confusing than dealing with money. The numbers, the jargon, the rules and regulations – it's all too much. And yet,,

And yet, everyone knows in their heart of hearts that they should pay more attention to it. It doesn't matter whether you're running a business, organising a charity or just trying to keep your own personal life afloat, we all need - somehow – to get a handle on it. The ostrich approach just can't work for very long.

So, here we're going to take you through some of the basic ideas of managing money. The basic ideas are actually quite straightforward, so always keep them in mind. Only as we move into the detail do they have the tendency to become technically complex.

The meaning of "Wealth" and its creation

In the UK, the society in which we live has developed over many centuries, much of it by trial and error. In terms of its approach, its processes and its institutions, there is much which is admired by other countries around the world.

Generally, to be wealthy a nation must create wealth on an ongoing basis and incentivise its people to do so. Thereafter, most of the debate surrounds just how much freedom there should be to create that wealth and what safeguards are necessary and, then, how that wealth should be distributed across the population. Provided that people are not exploited or cheated then most would agree that the creation of wealth is good. Much of the political debate and how we decide to vote then surrounds the distribution of wealth. Should it go to providers of capital, to workers, in taxes for the good of the nation for schools, hospitals etc?

What is wealth? In the world of finance wealth is the ability to buy things, in other words purchasing power. In essence it translates into "money". But here we must think a little further. Receiving a salary is fairly obvious. We work, we are rewarded and it arrives in the form of cash or money in the

bank. But what about the profit from running a business? Profit is an amount calculated from taking our expenses away from our income and should be reflected in an increase in our wealth. However, unless we manage our business properly that wealth may be tied up in assets, in stocks or in our customers owing us money for bills they should have settled.

Likewise, we may achieve an increase in wealth because the price of our house increases. However, telling the cashier at Tesco that you live in a big house does not usually cut much ice. They prefer cash or a credit card. So the pure creation of wealth is not the only important aspect. Cash flow and the ability to meet our financial obligations matter as much.

How much wealth?

Having thought about what wealth is we might now ask ourselves how much do we want? As much as possible I hear you say. It is not as easy as that. Commercial organisations may wish to earn large profits and that is certainly the fundamental assumption behind business and behind the operation of the stock exchange.

However, even that must be tempered somewhat. First, there are all kinds of ethical and moral considerations such as monopoly power, the exploitation of labour, health and safety, pollution. The list goes on. Second, for many the ambition may not be purely financial - involving maximising profits and returns. It may include factors such as continued employment, self-fulfilment, self-esteem, independence and the satisfaction that comes from being your own boss.

For other organisations, such as charities, not-for-profit enterprises or the recently introduced community interest companies, profit will not be the prime motive. Nevertheless, they will be subject to rules and regulations and will also need to manage themselves sensibly from a financial point of view.

Then there is the question of personal lifestyle. Without becoming too Dickensian, how much we

need to earn depends on how much we want to spend. If we have a lavish lifestyle we need to earn lots. If we live modestly then we don't need to generate so much income. This is an important consideration in deciding, for example, how much pension we need to save for, how hard we need to work, and whether or not we can survive through the early years of starting a business when it may not be making much money.

The transfer of wealth across time

In a financially sophisticated country like ours there exist many financial institutions, the stock exchange, banks, pension companies and insurance companies, to name a few. These allow a number of activities to take place. First, in a market economy they allow money to flow freely towards new, profitable ideas and away from older, worn out ideas. Second, they allow people and institutions to transfer wealth across time.

During our lives sometimes we produce more wealth than we consume while at other times we consume more wealth than we are producing. So we need some form of storing mechanism. For example, when we first buy a house with the help of a mortgage we are consuming more wealth than we are producing at that time and so we borrow that extra wealth, the cost of which is the interest we pay, and we pay it back over time.

Conversely, when we're working we choose to delay some consumption by investing in a pension to prepare ourselves for the day when we retire and are no longer producing but are still consuming. So we invest, directly or indirectly, in shares or deposit accounts and the price of us letting others use our money is the return we get.

Risk and Return

All investment is inherently risky, the safest for us probably being investing with the UK government (though not all governments). Thereafter, risk increases depending on the type of investment we undertake.

Investing involves confidence and is a great act of faith. We are entrusting money that we have now, for uncertain future gains probably dealing with people we do not know. We are, therefore, assuming that they are honest and competent and that their ideas are financially sound. That being so, it is a fundamental rule of investing that the more risk we are prepared to take the greater will be the reward that we should expect.

Likewise, the longer we are prepared to tie up our money the more reward we can expect for making that sacrifice. For example, a notice account at a building society would normally expect to earn more interest than an instant access account.

Choosing our investments

Where does that get us in thinking about how to organise our investments? That means shares, bank accounts, house, insurance policies, paintings, stamp collections - in fact anything like that. Even our own knowledge and skills that we've worked to acquire is an investment that we hope will pay off.

First, we must consider our liquidity needs, that is our cash needs over many different time horizons. What do we need next week, next year, or in 10 years' time? Second, we must think about our attitude to risk and how easily we wish to sleep at nights. We are all individuals and different in terms of the risks we're prepared to take and also the need for cash at any particular point in our lives. So, we must each do our own thinking and decision-making.

Another major aspect is protecting ourselves as much as possible by spreading our investments in case any one of them should go wrong. Not putting all your eggs in one basket is another fundamental principle of investing.

How does all this help us?

Now that we have established an outline we can start to think through some of the implications.

The most fundamental piece of thinking when considering any organisational activity of any kind, or our personal investment decisions, is to consider in great depth what our objectives are.

What are we trying to achieve? Only by clearly understanding that can we see how our new decisions are going to fit in with everything else and how best can we take those decisions forward.

On the **in my prime** website we separate those issues which surround running or being part of an organisation from what we might do with our money in personal terms.

However, as far as the world of finance is concerned they should be seen as two sides of the same coin. When we are part of an organisation we are on the inside looking out. We are using other people's money. When we are investing in an organisation we are on the outside looking in. Others are using our money. Same issues, different perspectives.

Many of the implications of what we have described above are examined in other factsheets alongside advice on how they should be managed and taken forward. Some things you may wish to do yourselves, others you may wish to leave to professionals. The choice is yours. We will guide you where we feel able.