ZAZEN TAX

Building a Three-Statement Model

How the statements link, why the balance sheet is the check, and the errors that break it.

Eight chapters, one worked company, and a model you can download and take apart.

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Contents

One company runs through every chapter: Meridian Studio Ltd, a 24-person services company with 40 clients on an average retainer of £6,700 a month. Its model is free on zazentax.com, built exactly as these chapters describe.

1 What a model is actually for

A financial model is not a prediction. It is a machine for pricing decisions before you make them: the hire, the raise, the price change, the client you can afford to lose.

The test of a model is not whether the future matches it, because it will not. The test is whether every number in it can explain itself: where it came from, what it assumes, and what else moves when it moves. A spreadsheet that produces a number nobody can interrogate is not a model, it is an opinion with formatting.

This book builds one properly: a profit and loss, a balance sheet and a cash flow that are linked, so the balance sheet balances by construction rather than by plug. The worked company is Meridian Studio Ltd: 40 clients at £6,700 a month, £3,216,000 of annual revenue, variable delivery costs at 45 per cent, fixed costs of £120,000 a month, and a £250,000 facility with £180,000 drawn.

> THE ONE-SENTENCE VERSION
>
> The P&L is the engine, the balance sheet is the memory, the cash flow is the truth, and the balance check is the proof that the other three are talking to each other.

2 The P&L is the engine

Everything in the model flows from a small set of drivers: clients, fee, variable rate, fixed costs, growth. The P&L turns them into profit.

Meridian's month one, from drivers to EBITDA:

Line	Month one
Revenue: 40 clients at £6,700	£268,000
Variable costs at 45 per cent	£120,600
Contribution	£147,400
Fixed costs	£120,000
EBITDA	**£27,400**

Below EBITDA sit depreciation (£3,000 a month on the demo), interest on the drawn facility (£180,000 at 9 per cent is £1,350 a month), and corporation tax accrued at the 25 per cent main rate. Each is a formula off an assumption, not a typed number.

The discipline that matters: no line on the P&L is a number. Every line is a driver times something, so that when a driver moves, the whole statement moves with it. The moment someone types 268,000 into a cell instead of 40 times 6,700, the model has started to die.

3 The balance sheet is the memory

The P&L says what you earned. The balance sheet remembers what that earning did to you: who owes you, who you owe, and what is left in the bank.

The two working capital lines are formulas off the trading, not guesses. Debtors are revenue times debtor days over 365: Meridian collects in 52 days, so a £268,000 month means a £458,000 debtor book. Creditors are total costs times creditor days over 365: paying in 38 days on £240,600 of monthly costs is £300,000 owed.

Say those two sentences aloud and you have the working capital problem of every growing services company: each pound of monthly revenue drags about £1.71 of debtor book behind it. Grow the revenue and the book grows first, and the cash arrives 52 days after the work.

> **WHY THE BALANCE SHEET IS THE CHECK**
>
> The P&L and the cash flow can both look plausible while being wrong. The balance sheet cannot: if assets do not equal liabilities plus equity, something in the other two statements is broken. That is why it is the statement modellers skip, and the one that catches them.

4 The cash flow is the truth

Profit is an opinion about timing. Cash is a fact. The cash flow statement reconciles the two, and the reconciliation is where the insight lives.

The indirect method starts at EBITDA and adjusts for what the balance sheet remembered: money earned but not collected (debtors rising), costs incurred but not paid (creditors rising), interest, capex, and tax actually paid.

Meridian's demo year, growing 1 per cent a month, makes the point sharply:

The year	Amount
Profit after tax	£282,901
Cash generated	£330,048
Cash beats profit by	**£47,147**

Cash beating profit surprises people, and the model explains it: £94,300 of corporation tax is accrued in the P&L but not paid until nine months after year end, which more than covers the £35,153 of working capital that growth absorbed and the capex running ahead of depreciation. The cash is real and it is also spoken for. A company that spends its tax accrual is borrowing from HMRC without the paperwork.

5 How the three link, and the check that proves it

Three links make the statements one machine. Break any of them and the model becomes three drawings.

- Cash on the balance sheet IS the cash flow statement's closing balance. Not similar to it, equal to it, by reference.
- Retained earnings roll forward: last month's retained earnings plus this month's profit after tax.
- Every P&L accrual that is not yet cash sits on the balance sheet: the tax charge accumulates as a liability until it is paid.

With those three links in place, the balance check row - assets less liabilities less equity - is zero every month, for any assumptions, because equality is built in rather than checked in. The downloadable Meridian model carries the check row along the bottom of the balance sheet, and its verifier holds it at zero across every scenario it throws.

6 The errors that break models

Every broken model in the wild is broken in one of a small number of ways, and each one has a tell.

The plugged balance sheet

Cash is typed to make the check row zero. The tell: cash on the balance sheet does not equal the cash flow closing balance. The model now agrees with itself the way a diary agrees with its author.

Growth without working capital

Revenue grows, debtors stay flat, and the model shows cash arriving the month the invoice is raised. This flatters growth exactly when growth is most dangerous. Meridian's 52 debtor days mean growth eats cash for nearly two months before feeding it.

Depreciation without capex

Assets depreciate to zero and nothing replaces them. Free cash flow is overstated by the entire maintenance capex line. The tell: fixed assets trend to nothing while revenue trends up.

Tax paid the month it accrues

UK corporation tax is due nine months and a day after the year end. A model that pays it monthly understates in-year cash by the whole accrual, £94,300 on the demo.

Interest that creates a circle

Interest depends on debt, debt depends on the cash shortfall, the shortfall depends on interest. Fix it by charging interest on the opening balance, not the closing one. The tell is a spreadsheet warning about circular references that somebody switched off.

7 Assumptions that survive contact

A model is only as honest as its assumptions sheet, and an assumptions sheet is only honest if it is small, visible and stated in units someone can argue with.

- Drivers, not line items: clients and fee, not 'revenue'. Growth as a rate someone can challenge.
- Days, not balances: debtor days and creditor days, so working capital moves with trading.
- Conventions written down: what EBITDA means here, what net debt nets, which tax rate and why. Lenders adjust EBITDA; your covenant tests their definition, not yours.
- Every assumption on one sheet. An assumption buried in a formula on row 214 is not an assumption, it is a trap.

> THE DEMO CONVENTION THAT EARNS ITS SENTENCE
>
> Meridian accrues tax at the 25 per cent main rate because its profit runs above £250,000. Between £50,000 and £250,000, marginal relief tapers the rate, and a model for a company in that band should say so. Stating which band you are in is one sentence; discovering it in diligence is a week.

8 From model to decisions

The model earns its keep the day it prices a decision. Four it prices immediately:

- The hire: a £60,000 salary is £71,250 fully loaded, which at Meridian's 55 per cent margin is a £129,545 revenue target wearing a job title.
- The runway: with the largest client gone and costs uncut, the downside scenario shows months of cash, not adjectives.
- The covenant floor: EBITDA can fall 80 per cent before the interest cover test breaches. Known now, not in the quarter it happens.
- The raise: the use of funds, the milestones and the runway all come off the model, which is why diligence reads the model before it reads the deck.

Every one of those is a free tool on zazentax.com, built on the same worked company. Download the Three-Statement Model, break it, and watch the check row catch you. That is the whole skill, acquired in an afternoon.

Where to go next

Download the Three-Statement Financial Model and the 13 Week Cash Flow Forecast, then work through the Covenant Headroom and True Cost of a Hire calculators with your own figures.

Every calculator and workbook mentioned in this book is free on zazentax.com, with no email form. They use the same figures, the same conventions and the same worked company as the chapters here.

Zazen Tax

Accountants and fractional CFO support for growing companies. If you would rather someone built this machine with you, that is what we are for.

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