presents:

your guide to... understanding business finances

your guide to understanding business finances

why should I understand what my accountant produces for me?

We all go into business to make money.

We may have a list of important and valid reasons why we choose to do what we do, and why running our own business helps us to achieve our goals - these reasons rarely revolve around money.

However, we cannot escape the fact that we need our businesses to make enough money for our individual circumstances. Any business which does not earn us a living is essentially a hobby – something we like to spend our time doing, but we need to do something else to put bread on the table.

It is vital, therefore, that you understand your business finances, and what drives your business's financial success. The financial statements your accountant produces for you are a key to unlocking the mysteries surrounding money in your business.

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profit or loss

an overview of profitability

The profit and loss statement is a financial document which should give you a clear picture of whether or not your business is making a profit, and how that profit is derived.

See example of profit and loss on next page (please note that restrictions on page space mean that not all regular overhead costs lines could be included):

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Profit and Loss Account

Marvin the Paranoid Android Industries

For the year ended 31st March X12

		X12		X11
		£		£
Turnover		50,000		45,000
Cost of Sales		(15,000)		(14,000)
Gross Profit		**35,000**		**31,000**
Overheads:				
Wages and Salaries	15,000		13,000	
Rent and Rates	2,000		2,000	
Utilities	1,500		1,000	
Motor and travel	524		354	
Stationary, telephone, IT	2,230		1,687	
Bank charges, interest	45		37	
Subscriptions	650		450	
Insurance	1,500		1,650	
Marketing, Advertising	2,560		1,235	
Depreciation	2,500		2,100	
Total Overheads		28,509		23,513
NET PROFIT		**6,491**		**7,489**

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quick guide to terms

Turnover –	The total amount you have invoiced to customers
Cost of sales –	The total direct cost of what you sold, either in terms of materials or time, which varies with the quantity you have sold
Gross Profit -	Sales/Turnover less Cost of Sales
Overheads -	Running costs in your business, not dependant on the quantity you sell in the short/medium term
Net Profit -	Gross margin less overheads

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detailed review

➔ Sales/Turnover

The sales, or turnover line on the profit and loss statement is the one most business owners understand. It represents the money you have earned from selling your products/services.

However, most business owners only know the total sales they have made without any reference to which customers, or which products/services, have generated the income.

The benefits of having this knowledge are:

- If a large proportion of your sales are coming from one customer you will want to protect your business by selling more widely by expanding your customer base – this will reduce the risk to your business of this customer failing or going elsewhere.

  At the same time you will want to make sure you keep this customer happy as they are key to your current business success.

- If a large proportion of your sales come from delivering a particular product or service you need to acknowledge its importance to your business and ensure you continue to deliver.

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- In general you will want to focus future sales and marketing effort on those types of customers and products/services which work well for you now.

➔ Cost of Sales/Direct Costs

Cost of sales, or direct costs, are those costs which go directly into producing your products or services, and will fluctuate directly with your level of sales.

For example, if you are making a table the direct costs will be the wood you use, any incidentals such as screws, and the cost of the labour.

For a service company, direct costs might be employee wages, or subcontractor costs.

➔ Gross Profit/Margin

Gross profit, or margin, is simply the difference between turnover and direct costs. It is important, therefore, that the direct costs incurred in producing a table, for example, are taken into account at the same time point as the sale of the table. This is called cost matching. If you don't make sure the costs and the sale appear in the same period your financial reports will show wild swings in margin which are not representative of the real situation.

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In service companies you will find the gross profit is generally a large percentage of sales. This is particularly true where the business owner is also the main service deliverer.

In contrast retail businesses will have a relatively lower gross profit, because much of the value of their offer is bought in, in the way of stock.

As with turnover, it is important you know the profit generated by each of your business's product/service areas.

You may find that much of the turnover generated by your business comes from products or services which make relatively little gross profit. If this is the case you may want to move your selling effort to higher margin products/services.

➔ Overheads

'Overheads' is the general term used to describe those business costs which are 'fixed'. This means that, within reason, they remain the same irrespective of the level of sales.

Another important feature of overheads is that they only relate to types of individual expenditure which produce short term benefits for the company (i.e. less than 1 year). Land and buildings, motor vehicles, computers, furniture, as well as a company's intellectual property, can all be used by the company for many years – these are <u>not</u> overheads they are fixed assets (see below).

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Overhead costs include:

- Wages and salaries of staff, not involved in producing your product or delivering your service (including yours)
- Rent and rates (including payments to you to compensate you for using your home as an office)
- Utilities
- Motor and travel expenses
- Professional fees
- Stationary, telephone and IT costs
- Bank charges and interest
- Networking and other subscriptions
- Insurance
- Marketing and advertising

If you understand your overhead expenses, and keep them under control, you can ensure every penny you spend contributes to the current, or future, goals of your business.

It is quite often useful to look at how much you will have to sell to enable you to spend.

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Take the following example:

A joiner makes 25% gross margin on everything he sells. If he is going to make money he will have to make sure he sells at least £4 worth of goods for every £1 he spends on overheads.

Given that increasing sales is generally quite difficult, he may think twice about advertising in Yellow Pages, unless he is pretty confident the customers he wants to target use Yellow Pages to find suppliers.

➔ Net Profit

The profit you are left with once you have deducted all your day-to-day expenses.

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profit v cash

turnover is vanity, profit is sanity, cash is reality

Whilst it is true that unprofitable businesses will have cash flow difficulties, it does not follow that profitable businesses will have cash in the bank.

There are several key reasons for this and these are found in the balance sheet.

The balance sheet shows what the business owns, is owed and owes. The amount a business is owed and owes will affect the cash flow.

An example of a balance sheet is on the next page:

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Balance Sheet

Marvin the Paranoid Android Industries

For the year ended 31st March X12

		X12		X11
		£		£
Fixed Assets		4,500		2,465
Current Assets:				
Stock	11,650		12,895	
Debtors	11,500		1,000	
Cash in Bank and in hand	4,560		(546)	
Current Liabilities:				
Trade Creditors	(14,985)		(5,580)	
Tax	(1,500)		(1,000)	
Net Current Assets		11,225		6,769
Net Assets		**15,725**		**9,234**
Capital and Reserves:				
Share Capital		100		100
Profit and Loss Account		15,625		9,134
Capital and Reserves		**15,725**		**9,234**

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quick guide to terms

Fixed Assets –	Items you buy for long term use in your business
Depreciation –	The annual amount charged in the profit and loss, for the use of fixed assets above (price/number of years planned use in the business)
Stock -	Items bought for resale OR work done but not yet invoiced to the customer
Debtors -	Unpaid customer invoices
Creditors -	Unpaid supplier invoices

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detailed review

➔ Fixed assets and depreciation

Fixed assets are the type of business expenditure, which produce benefits for the business for more than one year.

Main types of fixed asset are:

- Land and buildings (including leases)
- Plant and equipment (factory/workshop machinery)
- Office equipment (computers and printers, photocopiers, telephone systems etc.)
- Motor vehicles
- Intellectual property

Accountants deal with these items in a very particular way. If we included such high value items in the year in which they were purchased, profits would move up and down erratically year on year. This would make it difficult to see what the underlying profit of the business is. To avoid this problem the costs are instead spread over the years the asset is expected to be used in the business.

So, a motor car might be spread over five years, and each individual year would be charged with one fifth of the value as an expense called depreciation.

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However, from a cash flow perspective fixed assets would go out in one hit, unless they were funded by HP or a loan.

This means a year when there were lots of fixed asset purchases might show a very poor cash flow even if profits are good.

➔ Stock

We have already said that we want to match costs with the income they produce. However, sometimes a business will buy items, or do work, which will produce income in a subsequent period. This is known as stock or work in progress.

Although the business will get the sales, and payment from the customer, in the subsequent period, the stock may well have to be paid for earlier.

For example, in the case of a large project, many hours of work might need to be done before the customer can be invoiced. This work might be spread over several months or years. All this work will be held in work in progress, so the profits of the company will not be impacted by the costs until the customer is invoiced.

However, throughout this time the company has to pay out wages and other costs. So its cash flow will be affected even if its profitability isn't.

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➔ Customers (Debtors)

When you look at your sales in a period you may expect your cash flow to improve by the same amount. However, any credit you give your customers will delay the benefit of these sales. The less credit you give, the closer receipts into your bank will mirror sales you have achieved.

As you are not bankers by profession ask yourself why you are giving credit. If you are dealing with larger businesses, who will only buy from you if you offer credit, understand that you are taking the risk that they will pay slowly or, possibly, not at all. Are these risks you are prepared to take?

If dealing with smaller companies resist the temptation to give credit terms just because you think it is expected of you.

➔ Suppliers (Creditors)

Conversely, any delay in paying suppliers will improve your cash flow.

A note of caution: use slow payment of suppliers judiciously. If you rely on suppliers to give you a good service don't jeopardise this relationship by delaying payment unfairly.

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➔ Bank loans and HP

By financing your business using loans and HP agreements you can mitigate the adverse cash flow effects of relatively large expenditure on fixed assets and other long term investments.

These are tools which should be used by companies with care. Both these instruments can be expensive and can be a drain on resources a long time into the future.

Never use a loan to finance working capital – i.e. a short term hole in your cash flow.

➔ Tax

Most business owners forget about tax!

Remember whether you are a sole trader, partnership, or limited company, you will need to pay tax on the profits your business creates. Don't forget that at some point you will have to pay it!

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and finally…

It is vital to the success of your business that you understand its financial position. To do this you need to understand the financial statements produced by your staff or your accountant.

However, for these statements to be relevant to your decision making they need to be as current as possible. So make sure they are available to you as soon as possible.

Also, don't be embarrassed to ask your accountant about anything you don't understand.

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