

Suite 404**FINANCIAL PAGES*****Introduction******An Operating Budget******The Balance Sheet******The Income Statement / Profit and Loss******A Cash Flow Projection******Break-Even Analysis******Glossary of Finance Terms*****404.01 INTRODUCTION**

The following information is for educational purposes only. It is not intended to be used to replace your professional accountant or accounting firm. You must keep foremost in your mind the purpose of your Financial Pages. Are they being created for company use or to seek capital? Are they intended for domestic or international use and presentation? There is a difference between let us say a Balance Sheet and a Consolidated Balance Sheet; one being the summary of the other. If it is your intention to present your financials on an International basis you must take into account that there are 'International Accounting Standards' and your accounting firm can provide you with a current 'Disclosure Checklist'.

Most businesses typically use one of two basic accounting methods in their bookkeeping systems: the cash basis or the accrual basis.

While most businesses use the accrual basis, the most appropriate method for your company depends on your sales volume, whether or not you sell on credit, and your business structure. The cash method is the most simple in that the books are kept based on the actual flow of cash in and out of the business. Income is recorded when it is received, and expenses are reported when they are actually paid. The cash method is used by many sole proprietors and businesses with no inventory.

From a tax standpoint, it is sometimes advantageous for a new business to use the cash method of accounting. That way recording income can be put off until the next tax year while expenses are counted right away.

With the accrual method, income and expenses are recorded as they occur regardless of whether or not cash has actually changed hands. An excellent example is a sale on credit. The sale is entered into the books when the invoice is generated rather than when the cash is collected. Likewise, an expense occurs when materials are ordered or when a workday has been logged in by an employee, not when the check is actually written. The downside of this method is that you pay income taxes on revenue before you've actually received it.

Should you use the cash or accrual method? The accrual method is required if your annual sales exceed \$5 million and your venture is structured as a corporation. In addition, businesses with inventory must also use this method. It also is highly recommended for any business that sells on credit, as it more accurately matches income and expenses during a given time period. The cash method may be appropriate for a small, cash-based business or a small service company. You should consult your accountant when deciding on an accounting method.

(Excerpted from Start Your Own Business: by Rieva Lesonsky and the Staff of Entrepreneur Magazine.)

The following will help provide you with a general understanding of the basic financial pages normally required when making a business presentation.

AN OPERATING BUDGET

404.02 THE STARTING POINT

A lot of businesses do not make a profit or have enough cash at the right time because the management has not planned ahead. Too often, they do not know how much profit or loss has been made until months after the end of the financial year. And often, cash is not properly provided for until there is a crisis.

Budgeting gives you a useful planning tool. By comparing your actual performance with the budget, you can spot difficulties early on and take action to put them right. Remember, forecasts are based on assumptions, so these must be specific and as realistic as possible.

Alternative plans if the worst happens:

Also think about 'building in' unforeseen costs in case the worst happens. This can be shown as a separate item or by building it into the individual cost figures.

Whatever you do, you must explain your reasoning. Remember, this is a plan for your trading operations. It is to do with profit and loss, not cash. Include any item that gives a profit, or is a cost against profit. Do not include any other items, such as capital expense, if they will not directly affect your profits.

Your operating budget helps you to forecast your profit and loss and means you can compare your projections with actual performance. Include everything that produces a profit or is a cost against profit.

You must also be clear about the difference between the various costs of running your business. Some will vary depending on how well your business is doing (variable costs). Some will not change (fixed costs or overheads).

Variable Costs

You may see the terms 'cost of sales' and 'direct costs' as well as 'variable costs'. They are all similar.

Your variable costs are linked directly to producing your goods and services. They are the costs of your raw materials, components and so on, as well as the wages of any employees who actually produce the product or service.

Fixed Costs

You may see the terms 'indirect costs', 'overheads' and 'expenses' as well as 'fixed costs'. They are all similar.

You will have fixed costs, even if you do not make any sales. They include rent, rates, heating, lighting, insurance and salaries, including your own.

At this point, we must explain the term 'depreciation'. Depreciation takes into account the reduction in value of an asset over its working life. It is an expense the business must pay regardless of how much business it does, and so you should include it in the Operating Budget as a fixed cost.

Notes to Forecast:

- Leave out your bank overdraft but include any other loans, including those from the bank.
- Show any long-term money being put into the business by you or anyone else.
- Show grants, selective financial help and so on
- Show all owner or director's withdrawals from the business
- All items should tie in with your Business Plan
- Include power, heating, water, telephone and so on.
- Your Business Manager can arrange for quotations
- Any other appropriate items
- Show the opening current account balance from your bank account but leave out bank loans.

Show: **Sales**; cash, credit – to Total Sales
Variable costs; Goods & materials used, wages, - Total variable costs,
 Gross profit, Gross profit as % of sales
Fixed costs; production/operation, selling/distribution, administration,
 and other expenses, finance charges, depreciation = total fixed costs
Conclusion: Total fixed costs, Net profit before tax, Sales required to
 break-even.

404.03 FINANCIAL STATEMENTS

The primary financial statements of any business include the Balance Sheet and the Profit and Loss (Income Statement). They must be reviewed as a set because collectively they tell you about your business, both in the short term and the long term. By law companies are expected to produce financial statements each year. These appear in Company Reports. They are the Balance Sheet and the Profit and Loss (or Income Statement).

THE BALANCE SHEET

A balance sheet is a snapshot of a business' financial condition at a specific moment in time, usually at the close of an accounting period. A balance sheet comprises assets, liabilities, and owners' or stockholders' equity. Assets and liabilities are divided into short and long-term obligations including cash accounts such as checking, money market, or government securities. At any given time, assets must equal liabilities plus owners' equity. An asset is anything the business owes that has monetary value. Liabilities are the claims of creditors against the assets of the business.

A pro forma balance sheet is similar to a historical balance sheet, but it represents a future projection. Pro forma balance sheets are used to project how the business will be managing its assets in the future. For example, a pro forma balance sheet can quickly show the projected relative amount of money tied up in receivables, inventory, and equipment. It can also be used to project the overall financial soundness of the company. For example, a pro forma balance sheet can help quickly pinpoint a high debt-to-equity ratio.

What is a balance sheet used for?

A balance sheet helps a small business owner quickly get a handle on the financial strength and capabilities of the business. Is the business in a position to expand? Can the business easily handle the normal financial ebbs and flows of revenues and expenses? Or should the business take immediate steps to bolster cash reserves?

Balance sheets can identify and analyze trends, particularly in the area of receivables and payables. Is the receivables cycle lengthening? Can receivables be collected more aggressively? Is some debt uncollectible? Has the business been slowing down payables to forestall an inevitable cash shortage?

Balance sheets, along with income statements, are the most basic elements in providing financial reporting to potential lenders such as banks, investors, and vendors who are considering how much credit to grant the firm.

404.04 PRO FORMA BALANCE SHEET (RETAINED EARNINGS)

Pro forma retained earnings can be tricky to determine. They are the last item to be calculated on a pro forma balance sheet.

Total assets must balance the total liabilities and owners' equity. Also, total liabilities added to total owners' equity must equal total liabilities and owners' equity. So, you can determine total owners' equity by subtracting total liabilities from total liabilities and owners' equity.

Common stock added to retained earnings must equal total owners' equity. So, by subtracting common stock from total owners' equity, retained earnings can be determined. This completes the pro forma balance sheet.

Link to a Balance Sheet template:

<http://www.sba.gov/library/balsheet.xls>

THE INCOME STATEMENT (PROFIT AND LOSS)

An income statement, otherwise known as a profit and loss statement, is a summary of a company's profit or loss during any one given period of time, such as a month, three months, or one year. The income statement records all revenues for a business during this given period, as well as the operating expenses for the business.

What are income statements used for?

You use an income statement to track revenues and expenses so that you can determine the operating performance of your business over a period of time. Small business owners use these statements to find out what areas of their business are over budget or under budget. Specific items that are causing unexpected expenditures can be pinpointed, such as phone, fax, mail, or supply expenses. Income statements can also track dramatic increases in product returns or cost of goods sold as a percentage of sales. They also can be used to determine income tax liability.

It is very important to format an income statement so that is it appropriate to the business being conducted.

Income statements, along with balance sheets, are the most basic elements required by potential lenders, such as banks, investors, and vendors. They will use the financial reporting contained therein to determine credit limits.

404.05 PRO FORMA INCOME STATEMENTS

A pro forma income statement is similar to a historical income statement, except it projects the future rather than tracks the past. Pro forma income statements are an important tool for planning future business operations. If the projections predict a downturn in profitability, you can make operational changes such as increasing prices or decreasing costs before these projections become reality.

Pro forma income statements provide an important benchmark or budget for operating a business throughout the year. They can determine whether expenses can be expected to run higher in the first quarter of the year than in the second. They can determine whether or not sales can be expected to be run above average in June. They can determine whether or not your marketing campaigns need an extra boost during the fall months. All in all, they provide you with invaluable information – the sort of information you need in order to make the right choices for your business.

The following link will provide a template for an Income Statement (Profit and Loss)

<http://www.sba.gov/library/incstmt.xls>

404.06 THE PROFIT AND LOSS FORECAST

A profit and loss forecast is a projection of what sales you think you will achieve, what costs you will incur in achieving those sales and hence what profit you will earn.

A cash flow forecast, as the name implies, forecasts changes in the cash resources available to the business, i.e. the size of your bank balance or overdraft.

The main difference between the profit and loss and the cash flow forecasts is that for many businesses, sales and payments are not always made for and with cash, i.e. the invoice for a sale made in January may not be paid until February or March. These delays in receiving and making payments can have a significant impact upon the cash flow of a business.

Preparing profit and loss forecasts

Here are some notes to help you. It may be that you have a different pattern of income and expenses but we believe these forecasts will nevertheless be a useful guide

Notes

- **'Sales'** is the value of work completed or invoiced – whether payment is actually received at the time the work is done or not.
- **'Cost of materials'** is the direct cost of what you sell. For a retailer it is the cost of his/her stock; for a plumber the cost of a bathroom suite or copper piping etc., whether these are actually paid for at the time or not (they might be bought on credit, for example). It does not include larger 'one-off' purchases (e.g. A van) – nor does the cost of these appear in the profit and loss forecast. This is because they are regarded as being part of the business's assets.
- **'Administrative expenses'** – the costs given are those for which our tradesman or woman is liable over the period of the forecast, whether the bills are actually paid at the time or not.
- **'Advertising', 'printing', 'postage' and 'stationary'** – we have assumed that besides the usual cost of letters there was an initial distribution of leaflets followed by local press advertising to advertise the business.
- **'Telephone'** – this includes the installation charge, with phone bills subsequently arriving quarterly.
- **'Bank charges', 'overdraft interest' and 'hire purchase interest'** – we have assumed that a van is bought on hire purchase for 6,000 in the first month and 1,000 of equipment is bought outright. Interest is payable on the overdraft created by this and other expenses and since the business has an overdraft some bank charges are payable (the interest on the overdraft is calculated as a percentage on the average overdraft each quarter, and is paid quarterly). There are also interest charges on equipment bought on Hire Purchase.
- **'Motor expenses'** – these include the cost, in the first month, of insurance and road tax.
- **'Depreciation'** – this is simply a way of spreading the cost of equipment, machinery, motor vehicles and other assets over their useful lives.

- **'Depreciation of equipment'** – we have assumed the useful life on the equipment is five years and that it depreciates at an even rate over its life. Hence it is calculated at a given % of the equipment's original cost per annum.
- **'Depreciation of motor vehicle'** – we have assumed the useful life is four years and that it depreciates at an even rate over its life. Hence it is calculated at 25% of the van's original cost.

A CASH FLOW PROJECTION

404.07 A ROAD TO DISCOVERY

Once you have worked out your Operating Budget, you are ready to move on to your Cash flow Forecast.

This shows the actual movement of money into and out of your business account. It thus takes full account of the fact that you may often not be paid immediately for work done – and, correspondingly, that you may not have to pay immediately for things you acquire.

Preparing a Cash flow Forecast is not just about taking the figures from your Operating Budget. We will discuss some of the differences soon, first, let's consider the reason for a Cash flow Forecast. Cash is the lifeblood of your business. Managing cash badly is one of the main reasons for business failure.

One main use of the Cash flow forecast is to establish how much finance you may need to cover the gap between your income and your expenses. The time you spend working out your cash needs and monitoring cash flow is time well spent. This is because you can:

- find out when you might not have enough cash before it happens;
- find out when you might make extra cash and use it efficiently;
- make sure you have enough cash for any necessary capital expense; and
- find out how to use your resources more efficiently and reduce costs.

404.08 PRO FORMA CASH FLOW

A pro forma cash flow is created to predict inflow and outflow of cash to your business. It is particularly valuable in predicting when your business may experience a cash shortage. This allow you to determine in advance whether or not you will need to cover your cash shortage by borrowing money, selling more stock in the business, or taking other steps, such as cutting expenses, to improve your cash position.

How do I work out my Cash flow Forecast

Like your Operating Budget, your Cash flow Forecast will be based upon assumptions. Again you must be realistic. Think about the best and worst cases and explain the assumptions you make. Your forecasts need to be realistic, in order for your bank to understand your business.

Unlike your Operating Budget, your Cash flow Forecast is not to do with profit and loss. It is just your best estimates of how the cash will go in and out of your business over a certain period.

Things to bear in mind

- Think about the period of credit you give your customers or take from your suppliers. For example, if you can keep your customers to 30 days' credit (which will not be easy), your Operating Budget could show the sales you invoiced, say, in January. But this cash should not be in your cash flow projection until February. And then only if you are sure your customers will pay on time. If you have never had dealings with your suppliers before, you might have to settle their bills immediately. Obviously, this will affect your cash flow.
- Your forecast should show all cash you will pay and receive, including your own salary, capital spending and loans. These are all part of your cash flow. However, depreciation is not included in the cash flow because it is only a book entry. It does not mean real cash coming in or going out of the business.
- Sales Tax (VAT) will be shown in your Cash flow Forecast but not in your Operating Budget. This is because it is not a charge against profit and loss, but a cash settlement.

Please Note: If your business cannot claim back Sales Tax (VAT) because it is not registered, you must include the Sales Tax (VAT) element of your costs as an expense in your Operating Budget. As you will not get it back, it will affect your projected profit.

The following link will provide a template for a Cash Flow Budget.

<http://www.sba.gov/library/cfrbudget.xls>

The following link will provide a calculator to determine Cash Flow:

<http://www.bplans.com/common/calculators/cashcalculator.cfm>

BREAK – EVEN ANALYSIS

This type of report is not one that is automatically generated by most accounting software, nor is it one that is normally produced by your accountant, but it is an important analysis for you to have and understand. For any new business, you should predict what gross sales volume level you will have to achieve before you

reach the break-even point and then, of course, build to make a profit. For early-stage businesses, you should be able to assess your early prediction and determine how accurate they were, and monitor whether you are actually on track to make the profits you need. Even the mature business would be wise to look at their current break-even point and perhaps find ways to lower that benchmark to increase profits.

Break-even is the volume where all fixed expenses are covered.

You will start a break-even analysis by establishing all the fixed (overhead) expenses of your business. Since most of these are done on a monthly basis, don't forget to include the estimated monthly amount of line items that are normally paid on a quarterly or annual basis such as payroll taxes or insurance.

You may do a break-even analysis before you even begin your business and determine that your gross margin will come in at a certain percentage and your fixed expense budget will be set at a certain level. You will then be able to establish that your business will break even (and then go on to a profit) at a certain level of sales volume. But your pre-start projections and your operating realities may be very different. After three to six months in business, you should compare projections to the real-world results and reassess, if necessary, what volume is required to reach break-even levels.

Along the way, expenses tend to creep up in both the direct and indirect categories, and you may fall below the break-even volume because you think it is lower than it has become. Take your profit and loss statement every six months or so and refigure your break-even number.

404.09 WORKING OUT YOUR BREAK-EVEN POINT

Now that you have looked at the different costs, you can work out your break-even point which is the level of sales above which you start to make a profit.

You will need to work out your gross profit margin. This is your profit before allowing for fixed costs. It is written as a percentage of sales.

$$\frac{\text{Gross profit} \times 100}{\text{Sales}} = \text{-- \%}$$

If you can reach the gross profit margin and your fixed costs do not change, the break-even turnover is worked as follows:

$$\frac{\text{Fixed costs} \times 100}{\text{Gross profit margin}} =$$

Finally, work out the amount you need to sell every month just to break even. This figure is important because you can use it to check whether or not you are on target, or need to make some adjustments. But remember that this calculation does not take into account any seasonal changes which might affect your business.

To work out monthly targets, simply take your break-even sales figure for the year and divide by 12.

Ways to lower break-even

There are three ways to lower your break-even volume, only two of them involve cost controls (which should always be your goal on an ongoing basis).

1. Lower direct costs, which will raise the gross margin.
2. Exercise cost controls on your fixed expense, and lower the necessary total.
3. Raise prices! Most entrepreneurs are reluctant to raise prices because they think that overall business will fall off. But the effect can be startling and if small your customers may not notice.

Your goal is profit

You are in business to make a profit not just break even, but by knowing where that number is you can accomplish a good bit.

Once you have gotten this far in the knowledge of the elements of your business, you are well on your way to success.

GLOSSARY OF FINANCE TERMS

The following will provide definition to various terms used in the production of your financial pages:

- **Annual accounts** – A summary of the records of the financial activities of your business which are prepared by your accountant, presented to either the State or Tax offices, if you are a company.
- **Articles of Association** – These are the rules which govern the internal management of the company
- **Asset** – Something which is owned by or owed to the business which has a measurable value (e.g. cash, property, machinery) and is therefore in its favour.
- **Audit** – A process carried out by an accountant (auditor) on all companies each year to check that the financial records are accurate and give a true and fair view of a company's business. The auditor cannot be an employee of the company. Sole traders and partnerships do not need to have their accounts audited.
- **Balance sheet** – A statement of assets and liabilities of the business at a particular point in time.

- **Business plan** – A document which analyses your business activities in detail and predicts the expectations of the business for at least the coming year. Usually presented to the bank to support a request for a loan and/or overdraft facilities.
- **Capital** – This has several meanings but usually refers to the amount of money in the business belonging to the proprietors or shareholders, including cash from profitable transactions.
- **Capital employed** – Total assets (excluding intangibles e.g. goodwill) less current liabilities (*overdrafts, short term loans, trade and other creditors etc).
- **Cash book** – A daily record of payments and receipts.
- **Cash flow projection** – A prediction of future cash flow.
- **Cost of sales** – Costs incurred in the marketing of a product or service.
- **Credit** – Foregoing immediate payment. The period allowed or taken to pay for goods or services
- **Credit account** – A running account with a trusted customer showing the amount owed by them to you.
- **Creditor** – A party to whom money is owed by the business.
- **Debtor** – A party who owes money to the business.
- **Depreciation** – This is simply a way of spreading the cost of equipment, machinery, motor vehicles and other assets over their useful lives.
- **Direct costs or Variable costs** – Expenses, such as materials, labour and energy, which vary according to the number of goods produced or services offered.
- **Facility** – Usually a loan or overdraft offered to the business by a bank.
- **Financial year** – The accounting year of your business, the period covered by your profit and loss account.
- **Fixed Asset** – Assets such as machinery, land and buildings, plant and equipment which are normally not for sale and which are intended for use within the business.
- **Fixed costs** – These are also known as Overheads. These are the costs of a business which do not vary in proportion to changes in sales or output.
- **Franchise** – The right to use the name of another company, and to sell its products or services in exchange for a royalty. The franchisee agrees to abide by the conditions set out in the franchise agreement.

- **Gross profit (or contribution)** – The difference between sale and the direct costs of making those sales.
- **Income (or sales income)** – Money obtained by selling goods or services and from investments.
- **Indirect costs** – (See Fixed costs)
- **Liabilities** – Amounts owed by a business to others.
- **'Liquid asset'** – Cash or an asset which can be converted into cash very easily, for example stock exchange investments.
- **Memorandum of Association** – This states the name of the company, the location of the registered office, the objects of the company, its limited liability, its share capital and details of the shares.
- **Net profit, trading profit, variable profit.** The figure remaining after direct costs and overheads (i.e. All the expenses of running the business; including usually sales costs) have been subtracted from Income. $\text{Net profit} = \text{Income} - \text{Total Cost}$.
- **Overdraft** – A short term line of credit from the bank granted for a fixed period, normally up to 12 months.
- **Overheads** – See Fixed Costs
- **Patent** – The exclusive legal right to make and sell an invention or new product as a patent holder or licensee.
- **Profit and loss forecast** – Statement showing forecast sales, costs, expenses and profit (or loss) for an accounting period, normally one year.
- **Registered office** – The address where a company is officially registered with the State or Registrar of Companies (not necessarily the trading address).
- **Statement of Account** – The record you receive, from your bank or a company with which you have been dealing, which shows all the relevant transactions and finishes with the amount you owe or are owed.
- **Stock** – goods held for resale – whether finished, in production or raw materials.
- **Trading account** – A summary of your sales for a period, usually a year, together with the cost of sales for the same period, showing the resulting gross profit.
- **Variable costs** – See Direct costs.
- **Working capital** – The capital required to finance the short term activities of the business, principally the investment in stock and debtors.