South Dublin County Enterprise Board

Managing Business Finances

Contents

Foreword

South Dublin is a great place to do business. Our county has a population of almost 200,000 and plays host to a vibrant small business sector.

South Dublin County Enterprise Board is a State Enterprise Development Agency offering support to anyone in the county who is thinking of starting a business and to those who are looking to grow their existing small business.

We provide a range of supports and services to entrepreneurs and microenterprises (up to 10 employees). They include:

- Advice and Information
- Management Development Training Courses
- One-to-One Business Mentoring
- Monthly Business Networks for Owner/Managers
- Financial Assistance via, “priming” or “business development” supports, feasibility study grants & preference share investments
- Business Seminars

Nothing can replace the effort, talent and dedication which are essential in starting or running your own venture but we can help you get off to the best possible start and to build a better business.

Contact us today on (01) 4057073 or visit www.sdenterprise.ie

Best of luck with your business.

Loman O’Byrne
CEO, South Dublin County Enterprise Board 3 a Village Square, Tallaght, Dublin 24.
May 2009

1. Introduction

The aim of this publication is to provide small business owners/managers with the skills necessary to manage the financial performance of their business.

Good financial management is based upon the idea of having easy access to reliable information about how your business is performing on a day-to-day basis.

All of this information should be available to the owner/manager of every small business, without having to rely upon the assistance of an accountant, financial advisor or anybody else who is not connected directly with the business. This will ensure that all of the information and decisions regarding financial management are made by the people in the best position to do so, i.e., owners/managers.

Setting up a Financial Management System

A good financial management system will collect all the information about your business and present it to you in a way that is easy to understand.

If all of this information is presented to you in a readable format, you can:

» Make all of your business decisions based on sound financial information.
» Examine the financial state of your business on a weekly or monthly basis.
» Maintain control of your creditors and debtors.
» Plan for your business in the short to medium term.
» Present your best case to the bank.

Every owner/manager should be in the position to do all of the above, by establishing a financial management system that can provide reliable information on a regular basis.

The Sections

There are four sections in this publication, each dealing with a particular area of financial management:

» Bookkeeping systems.
» Profit & loss account.
» Balance sheet.
» Sources of finance.

Bookkeeping Systems

In order to establish a good financial management system, you need to organise the financial information within your business in an orderly fashion.

The first step in this process is to set-up a record and bookkeeping system that keeps track of all transactions in your business.

This booklet provides an introduction to bookkeeping and explains its role in an effective financial management system.

Profit & Loss Account

The profit & loss account is an excellent source of information regarding the performance of your business. Every aspect of the financial performance of your business is summarised on one page and, when analysed properly, can be used for managing the future performance of your business.

This section:

- » Introduces the profit & loss account.
- » Explains the main terms used in the account.
- » Describes how owners/managers can use the information from the account to review the performance of their business on an ongoing basis.

Balance Sheet

Interpreted properly, a balance sheet can provide you with valuable information about the ability of the business to pay its bills. Having a good idea of how to use the information in the balance sheet puts the owner/manager in a very good position to present the business' best case to the bank.

This section:

- » Explains the role of the balance sheet.
- » Describes how the information in the document can be interpreted to examine the financial state of the business.

Sources of Finance

The key to good financial management is to understand each of the main sources of finance and to be able to match these sources with the needs of your business.

This section:

- » Introduces the main sources of finance.
- » Provides useful information on how to identify the most appropriate and cost-effective methods of managing your business' finances, without putting unnecessary strain on your short-to medium-term cashflow.

2. Bookkeeping Systems

Setting up a Bookkeeping System

Setting up a good bookkeeping system is not as difficult as it may first appear and, when established, it provides you with a good source of sound financial information about your own business. It also reduces significantly the amount of time and effort you and your accountant need to spend on VAT returns, PAYE/PRSI returns, annual accounts, etc.

It is important to remember that the bookkeeping system you will use in your business will depend entirely upon your own needs and those of your business. Apart from a few simple ground rules, every book mentioned in this section can be adapted to your own purposes. As long as the necessary information is there, you can format the book in any way to make it easier to understand and read.

Not all of the books mentioned in the section will be relevant to every business. For example, some businesses will need a Sales Book, Purchases Book, Cash Book and Cheque Journal, while others can simply make do with a Cash Book and Cheque Journal. The types of books needed for your business will be determined by your business' size, the number of sales, purchases, employees, etc

Why Have a Bookkeeping System?

Keeping up-to-date books of account provides you with good current information on the state of your business and, just as importantly, allows you to format this information in a manner which is designed specifically for your business and can be read with ease.

This includes information relating to the following areas:

» Monitoring business profits and projecting future earnings.
» Identifying the most/least profitable products or services.
» Analysing trends in sales of products or services.
» Debt collection.
» Cashflow problems.
» VAT records.
» Costing and Pricing decisions.
» Increasing sales and profits.

Although they can appear as nothing more than a set of figures on a page, a good set of books can help you to better manage and understand your business. The more control you have over your books and accounts, the easier it is to understand the information contained within them.

You can adapt your books to show the information you need, as you need it.

Bookkeeping Systems vs Annual Accounts

Bookkeeping systems can provide more information to an owner/manager than the annual accounts.

The reasons for this include the following:

» Relevance.
» Presentation.

Relevance

Most annual accounts are given to the owner/manager a couple of months after the end of the accounting year. This means that, during the year, many owners/managers are unaware of the real profitability of the business. Furthermore, when annual accounts are prepared, the information contained within them is dated and may not be useful for examining the state of the business.

Presentation

Annual accounts are often presented in a format devised by the accountant. This format is often devised to make it easier to prepare the accounts for the Revenue Commissioners. However, the format is not always ideally suited for owners/managers and it can be difficult to extract useful information about the business. Keeping an up-to-date set of books gives you a greater understanding of the state of your business and provides the information necessary to make key decisions regarding your business' future.

Record Systems

If you want to have a good bookkeeping system, then you will need to have a good record system. Put simply, a record system is a method of filing all information regarding your business that will make it easier for you to prepare your books.

Records are the basic evidence of business transactions. These records include copies of sales invoices, supplier invoices, bank statements, cheque stubs and counterfoils of lodgements. You need to record every transaction which is made through your business.

A simple recording system can be set up using the following lever-arch files:

» A Sales Invoices File - If you issue invoices, the invoices should be kept in the file in numerical order the most recent ones at the front. You can subdivide this file into Sales Invoices Paid and Sales Invoices Unpaid. The unpaid section will give you a clear indication of who owes you money and how long it has been owed.

» A Purchases Invoices File - This should include all purchases – for example, equipment, ESB, telephone, insurance, stock, etc. The invoices should be kept in the file according to the date they were received – the most recent invoices at the front. You can subdivide this file into Purchases Invoices Paid and Purchases Invoices Unpaid. The unpaid section will give you a clear indication of who you owe money to and how long it has been owed.

The better your record system, the easier it is for you, your bookkeeper or your accountant to prepare your books. This will save you time, money and effort. In other words, start filing your receipts and invoices in lever-arch files and get rid of the old shoebox, if you are still using it.

» Bank Records File - This file will contain monthly bank statements, issued on the last day of each month, showing all the transactions to/from your business bank account during each month of the year.

» Tax File - This file will contain all records of your VAT, PAYE/PRSI, tax documents, etc., for the year.

All of the above files should be kept for each year of your business. Label each of the files and keep this year's and last year's files to hand in the office. The previous years can be filed in a filing cabinet. For tax purposes, you should keep all records of your files for the past six years.

Bookkeeping System

Having established your record system, you are now in a position to develop your bookkeeping system. A bookkeeping system consists of “books of account”, which is a term used to describe documents that contain information about transactions within your business.
There are a number of books of account that form the basis of a bookkeeping system within most businesses. Not all of these books are essential to every business and their use will depend on the needs of the particular business in question.

The most important of these books include the following:

» Sales Book.
» Purchases Book.
» Cash Book.
» Cheque Journal.
» Debtors Ledger.
» Creditors Ledger.

The diagram on the following page shows how these books fit into the overall bookkeeping system. Don’t let the diagram worry you, as it is only a picture of how all of these books would fit into a fully integrated system. Most small businesses will pick and choose amongst these books to decide which suit their business best. Other items displayed in the diagram, such as the Profit and Loss Account and Balance Sheet, will be discussed later.

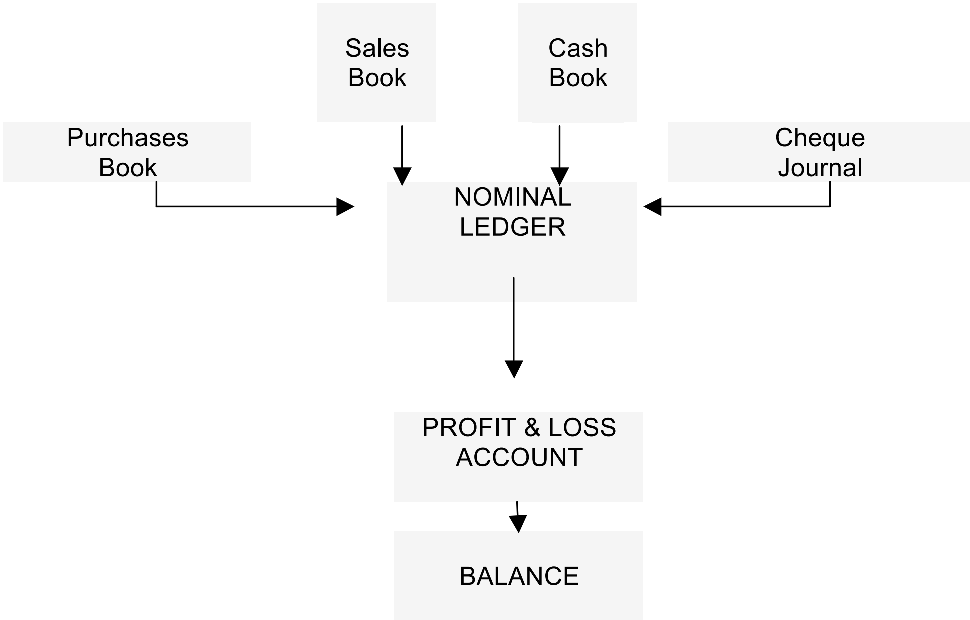
Most manual systems consist of a Sales Book, Purchases Book, Cash Book and Cheque Journal. An accountant takes the information from these books and develops a Nominal Ledger, Profit & Loss Account and Balance Sheet at the end of the year for the business. As businesses grow, however, the need for more detailed and up-to- date information from the bookkeeping system becomes more of a priority.

This results in the development of Nominal Ledgers and Profit & Loss Accounts on an on going basis throughout the year.

Due to the cost involved in developing these documents on a regular basis, most businesses in this situation will use a computerised accounting package, which updates all of the books automatically as transactions are entered on the system.

In this publication, we will focus on a manual bookkeeping system. This is an easier way to explain how a bookkeeping system works and. can also be used to manage a business.
We will provide a summary of computerised, accounting packages at a later stage.

Figure 1: Example of a Fully-Functioning Financial System



Sales Book

A Sales Book records all the sales that have been made by the business. The information in the book is taken from your sales invoices and it can be updated each week or month, using the documents kept in your Sales Invoices lever-arch file.

The information in the Sales Book will enable you to:

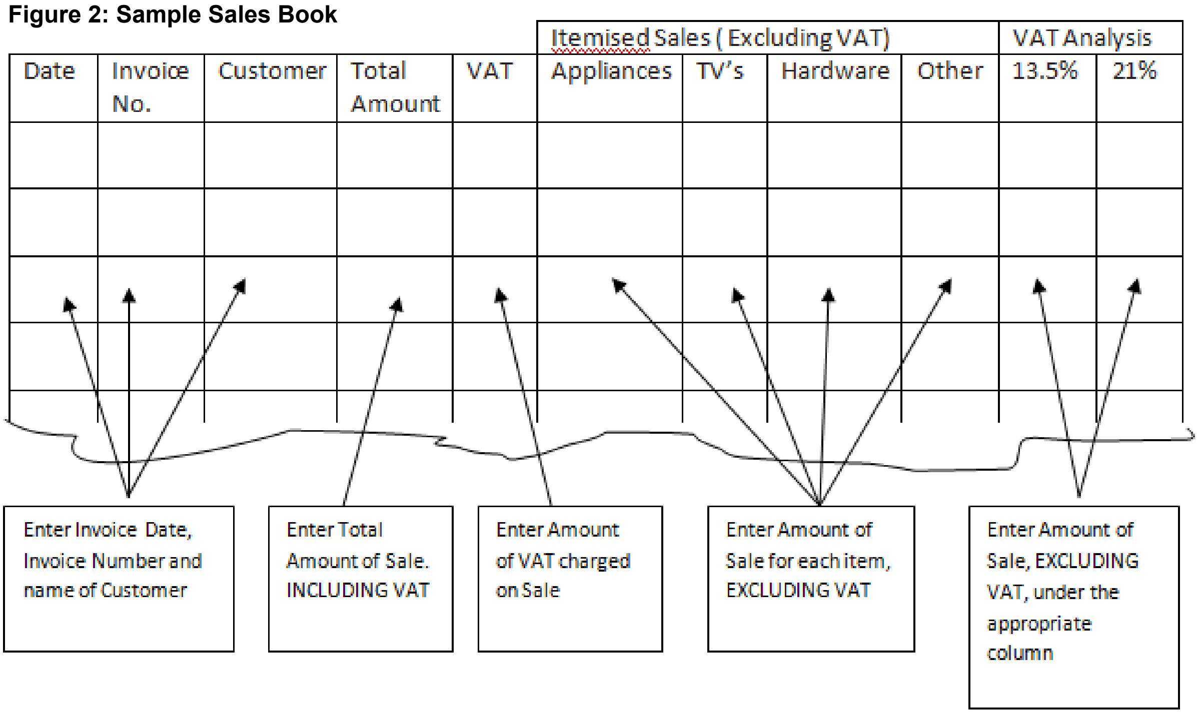
» Identify the most profitable products/services by item.
» Plan for the business and project future sales.
» Prepare VAT reports and forms.

There is no need to keep a separate Sales Book and Sales Returns book.

For sales returns, issue a credit note and enter the details and amount as a minus figure in the Sales Book.
If you are not issuing many invoices or you have mainly cash sales, it may be convenient for you to combine your Cash Book and your Sales Book. This reduces the number of books you have to keep and makes them easier to read.

The Cash Book will be described later in this chapter.

Figure 2: Sample Sales Book



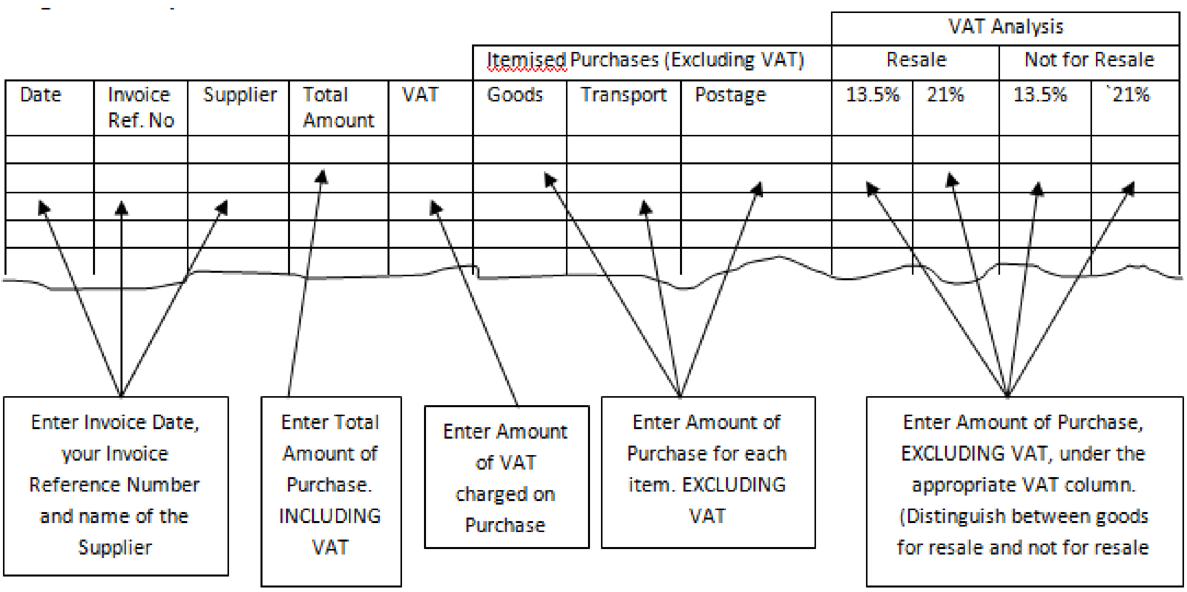
Purchases Book

This book records all the purchases made by the business, including stock, electricity, services, equipment, insurance, etc. The normal source of information is suppliers' invoices, which you will file in your current year's Purchases Invoice lever-arch file. All purchases should be recorded in the Purchases Book.

The information in the Purchases Book will enable you to:

» Review purchase costs by item.
» Prepare cashflow forecasts, profit projections, etc.
» Prepare VAT returns and forms.

Figure 3: Sample Purchases Book



There is no need to keep a separate Purchases Book and Purchases Returns book. For purchases returns, get a credit note from the supplier and enter the details and amount as a minus figure in the Purchases Book.

If you do not have many purchases and you are not registered for VAT, you might find it convenient to combine your Cheque Journal and Purchases Book. The Cheque Journal will be described later in this section. If you are registered for VAT, you are required to analyse your purchases at the different VAT rates. In most cases, this means it is more convenient to keep a separate Purchases Book.

Cash Book

This is a record of all cash receipts and payments within the business. You should remember that the term "cash" includes cheques as well as ordinary cash receipts.

The book is divided into two sections, Money In and Money Out. The Money In section shows all of the money received by the business, including the following:

- All money received from customers, both cash and cheques.
- Refunds of VAT.
- All grants received.

The Money Out section shows:

- All cash payments (excluding cheques).
- All money lodged to the business bank account.

While the receipts and payments are itemised to allow you to examine the main sources of money in and money out, it is not necessary to itemise all transactions.

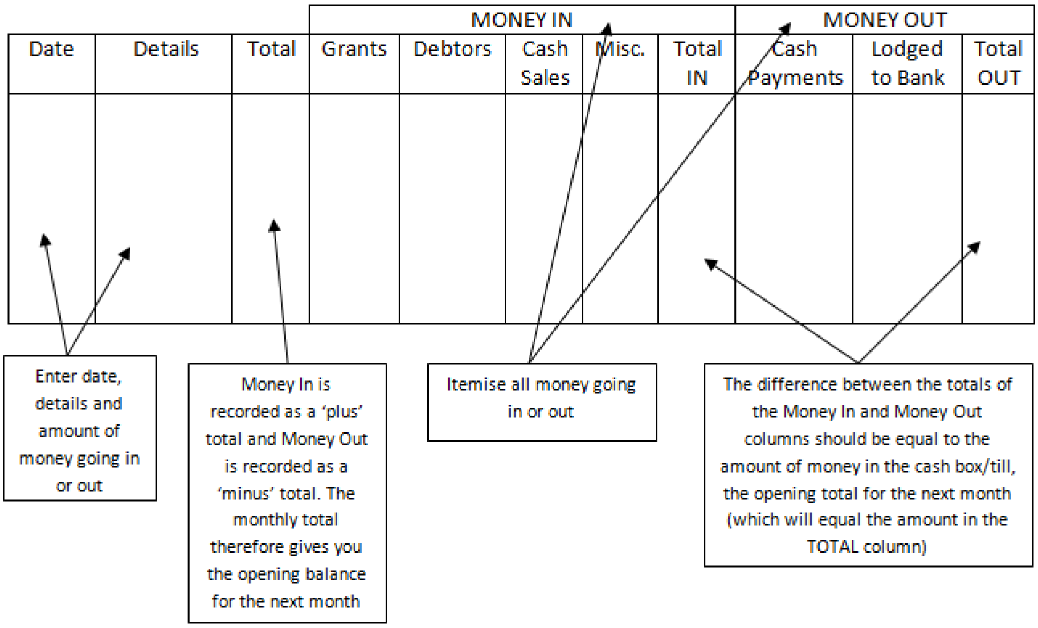
Small transactions can be entered under an "other" or "miscellaneous" column and identified in the 'details' column.

The difference between the totals of the Receipts and Payments sections shows the amount of money left in the till/cash box.

The only payments that are recorded in the Cash Book are small cash payments, not cheques. Cheque payments will be recorded in the Cheque Journal, described in a later section. Keep cash payments to a minimum.

To reduce the number of cash payments, you could pay for small cash payments yourself, keep the receipt, and pay yourself a cheque from the business to cover the expenses each month. This will reduce the number of cash payments by the business. Just remember to keep a record of the expenses paid to you each month in a simple report, including the receipts for each payment, which can be stapled to the monthly expense report.

Figure 4: Sample Cash Book



Cheque Journal

The Cheque Journal records all amounts of money paid out of your bank account. These are also called "debits" to your bank account and include the following:

» Cheques paid out of the account.
» Direct debits & standing orders.
» Bank fees & interest.

Remember, the Cheque Journal only records money going out of your bank account. The amounts going in are recorded in the Cash Book in the lodgements column.

The information in the Cheque Journal will enable you to:

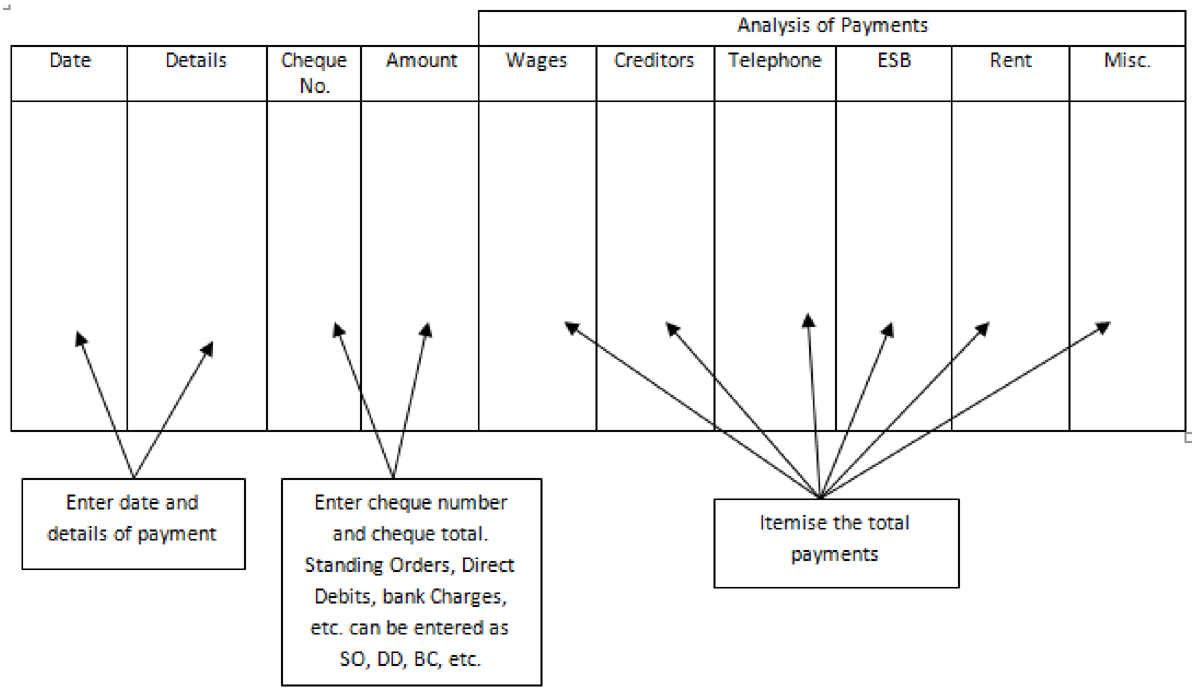
» Analyse all bank payments.
» Prepare a Bank Reconciliation Statement, which will be discussed in a later section.
» Monitor and predict cash flow.
» Manage cash resources effectively.

Always keep a separate bank account for your business. Don't mix your personal account with the money coming in and out of your business at any stage. This makes it easier to keep an eye on your business finances, without them getting mixed up with your own personal finances.

If you want to take some money out of the business for your own private use, write a cheque from the business bank account to yourself. However, try to avoid doing this in a haphazard fashion. It is a good idea to decide on a weekly or monthly salary to pay yourself and stick to this figure. Review the figure every couple of months and decide whether it needs to be increased or decreased.

Remember, the business should be able to pay you a salary. If it cannot, it is not financially viable.

Figure 5: Sample Cheque Journal



Ledgers

Ledgers keep a detailed account of the running totals of transactions involving individual debtors, creditors, expenses, assets and liabilities.

All of the information is taken from the books mentioned earlier -for example, Sales Book, Purchases Book, Cash Book, Cheque Journal.

Ledgers are normally prepared for small businesses as follows:

» A bookkeeper or accountant prepares the ledgers for the business at the end of the year.
» A bookkeeper prepares the ledgers for the business on an ongoing basis during the year.
» The business prepares its own ledgers, using a computerised accounting package, which provides access to the ledgers throughout the year.

This publication is not going to discuss ledgers in detail, primarily because, in most cases, businesses that need access to their ledgers on an ongoing basis throughout the year will do so by using a computerised accounting package. To prepare the ledgers on an ongoing basis manually often uses more time and money than would be spent on installing a computerised package.

There are three main types of ledger:

» Sales (Debtors') Ledger.
» Purchases (Creditors') Ledger.
» Nominal Ledger.

Examples of each of these are given on the following pages.

Sales (Debtors' Ledger)

The Sales Ledger is a record of all money owed to you by your debtors. The information contained in the Sales Ledger is taken directly from the Sales Book and/or Cash Book. Each debtor is given his/her own ledger account.

Figure 6: Sample Sales Ledger

Debtor: Paul Kearns					
Date	Details	F[1]	Debit	Credit	Balance
06/08/05	Sales Invoice 2056	SB	1,200		1,200
08/08/05		CB		1,000	200

In this case, the Debtor's name is Paul Kearns. On 06/08/05, we issued him an invoice no. 2056 for *€1,200, which was recorded in the Sales Book (SB.) This meant he owed us €1,200, so we recorded that on the Debit side of his account. This created a debit balance of €1,200. On 08/08/05, he paid us with cheque no. 105246 for €1,000, which was recorded in the Cash Book (CB.) We recorded this on the credit side of his account and it reduced the balance to €200.*

Purchases (Creditors) Ledger

The Purchases Ledger is a record of all the money owed by you to your suppliers. All the information is taken from the Purchases Book and/or Cheque Journal. Each creditor is given his/her own ledger account.

In this case, the Creditor's name is Mary Evans. On 09/08/05, she issued us with invoice no. 215 for purchases totaling €2,000, which was recorded in the Purchases Book (PB.) This meant we owed her €2,000, so we record that on the Credit side of her account. This creates a credit balance of €2,000.

On 14/08/05, we paid her with cheque no. 203215 for €1,900, which was recorded in the Cheque Journal (CJ.). We recorded this on the debit side of her account and it reduced the balance to €100.

1 The letter F in this column is short for folio. It is simply a column that is used to record any references you want to make to the entries in the account. For example, in this case, the folio column shows where the entries were taken from, e.g., Sales Book (SB) and Cash Book (CB).

Figure 7: Sample Purchases Ledger

Debtor: Mary Evans					
Date	Details	F [1]	Debit	Credit	Balance
09/08/05	Purchase Inv. 215	PB		2,000	2,000
14/08/05	Cheque 203215	CJ	1,900		100

Nominal Ledger

Every transaction in the business is recorded somewhere in the Nominal Ledger. All the information is taken from the Sales Book, Purchases Book, Wages Book, Cash Book and Cheque Journal (see next page).

Computerised Accounting Packages

At some stage, most businesses will consider moving from a manual bookkeeping system to a computerised accounting package.

The main reasons for this move include:

» Saving time in the preparation of books and accounts.
» Ease of numerical calculations.
» Management reports are updated automatically.
» Presentation and formatting of documents.

Before you set up your own computerised bookkeeping system it is a good idea to speak to

» Accounting Periods – 12 Months/13 Periods.
» Accounting Dates – Financial Year Start Date.
» Type of VAT – Standard/Cash Accounting/Markup.
» Accountant's familiarity with accounting software package.

In a computerised accounting package, any entry in, for example, the Sales Book will be automatically recorded in the Debtors and Nominal Ledger. A similar process will occur when the customer pays. For example, any entry in the Cash Book will also be automatically recorded in the Debtors and Nominal Ledger. This means that the accounting package can prepare an updated Profit & Loss account for the owner/ manager at the end of any month.

Figure 8: Sample Nominal Ledger

Nominal Account: Sales					
Date	Details	F	Debit	Credit	Balance
31/08/05	Sales (August)	SB		1,200	1,200

The Sales entry in the Sales Account is the total sales for August. It is taken from the monthly figure in the Sales Book.

Nominal Account: Purchases					
Date	Details	F	Debit	Credit	Balance
31/08/05	Purchases (August)	PB	2,000		2,000

The Purchases entry in the Purchases Account is the total purchases for August. It is taken from the monthly figure in the Purchases Book.

Nominal Account: Bank Account					
Date	Details	F	Debit	Credit	Balance
31/08/05	Lodgements	CB	1,200		1,200
31/08/05	Payments	CJ		1,900	700cr

The entries in the Bank Account are taken from the Lodgements column in the Cash Book and the Total Payments column in the Cheque Journal.

In this case, the balance at the end of the month in the account is recorded as a credit, because it is overdrawn.

Selecting an accounting package

Each of the accounting packages available on the market varies in terms of technical and functional capabilities.

Before making a decision on which one you want to buy, you should consider the following:

Technical issues:

- Ease of use - the packages vary significantly in style and some people find one package easier to use and read than others.
- Statutory requirements - the package must be able to meet statutory requirements, especially if it is a foreign-based package.
- Accountant's and other users' opinion.
- Type of installation & training provided - installation and training fees can be as expensive as the package itself.
- Accessibility and cost of support - more than likely, you will need to call the support line, particularly during the first year.
- Experience of your accounts personnel.
- Your budget.
- Ecommerce – is the package compatible with any ecommerce facilities you offer customers?
- Backup facilities – for safety, the package should provide an easy backup facility that enables you to copy any existing files.

Function capabilities:

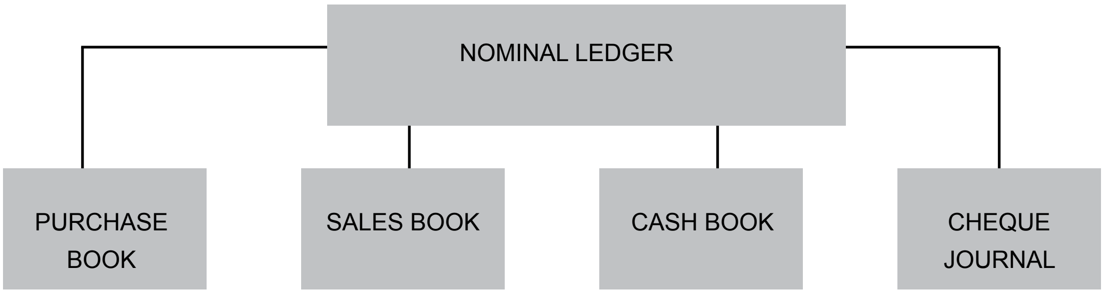
Function capabilities refer to the level of detail you require from the accounting package. These include:

- Basic books of account – Cash Book; Cheques Journal; Sales Book; Purchases Book; Bank Accounts; Debtors' Ledger; Creditors' Ledger.
- Bank Reconciliation.
- Facility to print Invoices and Statements.
- Management Accounts – Trading Profit & Loss Account; Balance Sheet.
- Additional features - Point of sale; Multicurrency; Full Sales Analysis; Multi-location stock control; Quotations; Sales & Purchase Order Processing; Job costing; Electronic Document Transfer; Thin Client Remote Access.

Summary

In summary, a good bookkeeping system should:

- Be simple.
- Require as few books as possible.
- Save time and not be time-consuming.
- Provide ease of access to information.
- Be accurate.
- Satisfy the Revenue Commissioners' requirements.
- Provide you with the sound financial information you need to manage the business.



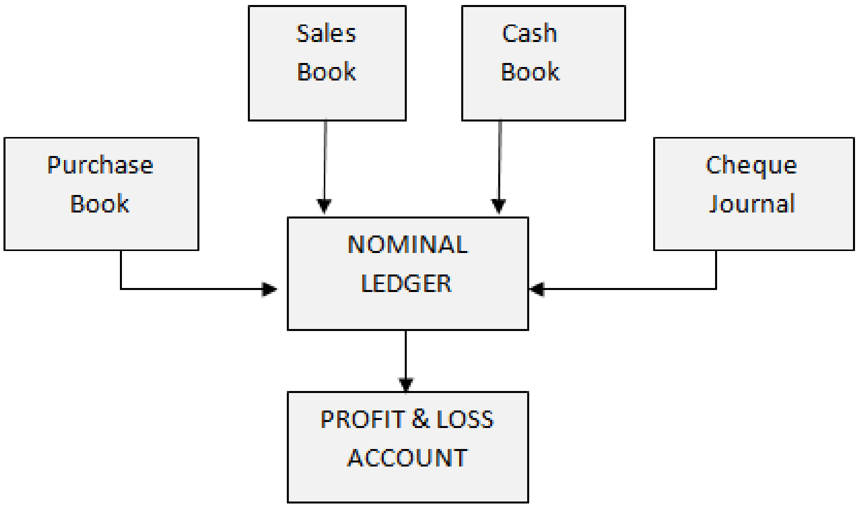
Remember, apart from a few simple ground rules, the bookkeeping system can be adapted by you to suit your own needs. Keeping an up-to-date, simple set of books gives you a greater understanding of the state of your business and provides the information necessary to make key decisions regarding your business' future.

3. Profit & Loss Account

A Profit & Loss Account is a document that tells you whether your business made a profit or a loss during a particular period of time. For example, the Profit & Loss Account takes all of the sales you made during the year and deducts any costs or expenses that the business incurred in making those sales. The difference between the total sales and the total costs gives you the business' profit or loss for that period of time.

All of the information contained in the Profit & Loss Account is taken from your bookkeeping system, computerised or manual, and summarised in one document.

For most small businesses, the information is drawn from the following documents:



The better organised your bookkeeping system, the easier it is for you and/or your accountant to prepare a Profit & Loss Account. This enables you to access a preliminary Profit & Loss Account at any time of the year and puts you in an excellent position to implement decisions based on sound financial information regarding the performance of your business.

Use of the Profit & Loss Account

» A Profit & Loss Account has two main uses:
» Financial management of your business.
» Submission to the Revenue Commissioners.

Financial management

The Profit & Loss Account is an excellent source of information regarding the performance of your business. Every aspect of the financial performance of your business is summarised on one page and, when analysed properly, can be used for managing the future performance of your business.

Submission to the Revenue Commissioners

In this case, the Profit & Loss Account is prepared by an accountant, once a year, for submission to the Revenue Commissioners. The net profit is adjusted for tax purposes. The tax-adjusted net profit forms the basis for the calculation of the tax liability.

From the point of view of an owner/ manager, the role of the Profit & Loss Account as a tool in the financial management of your business is more important than its use merely for submission to the Revenue Commissioners. While the use of the Profit & Loss Account for tax purposes is obviously an important one, it is also a very limited one. The accountant prepares this Profit & Loss Account at the end of the business year and, as a result, some of the information contained in the document, when given to the owner/manager, is over 12 months old. Furthermore, the detailed layout of the Profit & Loss Account for tax purposes can make it difficult to read and understand, two elements which are important in the use of the document for the management of your business.

If you have a good financial management system, which allows you to use the Profit & Loss Account to its full effect, its adaptability for use at the end of the accounting year for tax purposes will come as an added bonus.

Accessibility

To use a Profit & Loss Account effectively in managing a business, the owner/ manager should be able to access the information in the document every 3 to 6 months, if not more frequently. Furthermore, as indicated above, the information must also be easy to read and understand. To have an accountant prepare a Profit & Loss Account on such a regular basis might cost the business too much in terms of time and money. Instead, the owner/manager should become accustomed to the idea of preparing and reading their own preliminary Profit & Loss Account every 6 months, at a minimum.

Guidelines

» The Profit & Loss Account only includes details of sales, cost of sales and expenses (explained later) that actually occurred during the relevant accounting period, regardless of when you pay for them. For example, a Profit & Loss Account for 2005 will not include insurance expenses relating to 2004 or 2006, even if you pay for them in 2005. Always remember that each Profit & Loss Account only relates to a specific period of time, whether it is 1 year, 6 months or 3 months. The aim is to tell you how much it cost you to make your sales during that particular period of time. Expenses or sales outside that period of time are of no relevance. If it cost you more to make your sales than you received in income, then you made a loss, if it cost you less, then you made a profit. This is a simple guideline, but it will continually repeat itself throughout the remainder of this section.

» The Profit & Loss Account only includes sales and expenses incurred during the normal day-to-day operations of the business. For example, rent, rates, insurance, electricity, stock, etc., all relate to the day-to-day operations of the business and will go in the Profit & Loss Account. Capital expenses, such as buying a building, building an extension, buying equipment or a van for the business are not part of the normal operations of the business and will not be included in the Profit & Loss Account. If you buy a van in 2005 for €10,000, can you put all of the €10,000 in the Profit & Loss Account in 2005? The total cost of the van, €10,000, will not go in the 2005 Profit & Loss Account because the total cost does not just relate to 2005. The van will be in the business for the next 6 or 7 years, therefore putting the full €10,000 in one year, 2005, does not accurately reflect the effect on the business. Only some of the €10,000 relates to the sales in 2005, the remaining proportion affects sales over the next few years. As a result, you are only allowed to put in a proportion of the cost of the van for 2005 and each of the following years, e.g., 15%, until the total cost of the van has been accounted for. This is described in more detail in the Depreciation section on page 20.

» If you are repaying a bank loan, only the interest portion of the loan goes in the Profit & Loss Account. The capital repayment portion is not included in the Profit & Loss Account.

» If your business is VAT registered, then the figures used in the Profit & Loss Account, including sales and expenses, will not include VAT. If your business is not VAT registered, then the figures in the Profit & Loss Account will include VAT.

Layout

Examples of Profit & Loss Accounts are given on the following pages.

The first – John Taylor Repairs – is an example of a service business. The second –Corner shop-is an example of a retail business and the third is a manufacturing business, Lowland Ltd For the moment, don't worry about the terms that are used on the three Profit & Loss Accounts and just get used to looking at eh layout. The terms will be explained later in this section.

This is a simple form of Profit & Loss Account that is common for most service businesses. The sales for the period are shown at the top, while the expenses that were incurred in generating those sales are shown at the bottom section. Deducting the expenses from the sales tells you whether your business made a profit or not. All of the information contained in the Profit & Loss Account, such as the one above, should be readily available to businesses with good bookkeeping systems.

Figure 9: Profit & Loss Account for John Taylor Repairs

Sales	2005	2006
Maintenance Services	90,000	125,000
Operating Expenses		
Employee Wages	48,000	63,000
Electricity	6,000	8,500
Rent and Rates	3,000	3,500
Insurances	2,500	4,000
Advertising	1,200	2,250
Postage and Stationery	800	950
Motor Expenses	8,500	13,000
Bank Interest	1,000	1,600
Bank Fees	600	650
Audit Fees	900	920
Depreciation	4,000	6,630
Total Overheads	76,500	105,000
Net Profit	13,500	20,000

The Profit & Loss Account for Corner shop contains slightly more detail than the one for the service business. Like the service business, the Sales are shown at the top and the Expenses are shown at the bottom. However, in between the Sales and Expenses are two new terms, Cost of Sales and Gross Profit. Cost of Sales refers to costs incurred by the business that can be directly related to each item that was sold by the shop. For example, a paper which was sold for €1 may have cost the shop 60c to buy from the distributors. As a result, the 60c can be directly related to the €1 in sales from the paper. Other expenses, e.g., electricity, are more general and cannot be allocated to each item sold in the shop; therefore, they are included in general expenses. Gross Profit is the result of deducting Cost of Sales from Sales. Gross Profit and Cost of Sales are described in more detail later in the section.

Figure 10: Profit & Loss Account for Corner Shop

	2005	2006
Shop Sales	120,000	126,000
Cost of Sales		
Opening Stock	12,000	8,000
Purchases	44,000	50,000
	56,000	58,000

Closing Stock	8,000	14,000
Cost of Sales	48,000	44,100
Gross Profit	72,000	81,900
Operating Expenses		
Employee Wages	20,000	22,000
Electricity	6,000	6,500
Rent and Rates	4,150	4,870
Insurances	2,500	4,000
Advertising	3,200	4,250
Postage & Stationery Bank	800	1,950
Fees	450	650
Audit Fees	900	920
Depreciation	4,000	4,000
Total Overheads	42,000	49,140
Net Profit	30,000	32,760

The Profit & Loss Account for Lowland Ltd. is slightly more detailed than the two examples. Like the Profit & Loss Account for Corner shop, Lowland Ltd. has a Cost of Sales, because they are buying in stock for use in manufacturing their products. But, also have another term in the Cost of Sales, i.e., manufacturing wages. This figure is included in Cost of Sales because the cost of paying employees to manufacture the item is directly related to the income from each item manufactured. This is discussed in detail later.

Figure 11: Profit and Loss Account for Lowland LTD.

	2005	2006
Income		
Sales	700,000	805,000
Cost of Sales		
Opening Stock & Work in Progress	90,000	110,000
Materials	120,000	153,950
Labour	180,000	200,000
	390,000	463,950
Closing Stock & Work in Progress	110,000	150,000
Cost of Sales	280,000	313,950
Gross Profit	420,000	491,050
Overheads		
Salaries	80,000	84,900
Electricity	22,000	25,000
Postage & Stationery	1,000	2,500
Rent & Rates	5,000	5,500
Insurances	15,000	19,000
Advertising	10,000	12,250
Motor Expenses	27,500	30,750
Bank Interest	9,000	9,500
Audit Fees	2,000	2,100
Depreciation	50,000	50,000
Total Overheads	220,500	241,500
Net Profit	199,500	249,550

Main Terms Used

“Income”

This refers to the income received from the sale of goods/services normally traded by the business. It includes cash sales made and credit sales invoiced during the business period.

Remember, only sales from the period relevant to the Profit & Loss Account are included. The terms income, sales, revenue and turnover are virtually interchangeable.

“Cost of Sales”

Cost of Sales refers to costs that can be allocated directly to each product manufactured and/or sold by the business. These costs are often called direct costs.

If a business has a Cost of Sales, it is very important for that business to distinguish between the Cost of Sales and the general expenses or overheads.

The terms overheads and expenses are often interchangeable. From a practical point of view, service businesses tend to use the term expenses and manufacturing businesses use the term overheads.

The reason for this is that knowing your Cost of Sales allows you to identify the direct cost of manufacturing or selling your product.

Knowing this cost helps you identify how much you have to sell each product for, before you have covered your direct costs. Any money received above this point will go towards meeting your general expenses. This information also helps to identify your “breakeven point”, which is discussed later.

The two main types of Cost of Sales are the following:

» Stock or Materials – If a business is buying stock for resale – for example, a fruit & vegetable shop, newsagent, arts & crafts shop, pub, etc., the cost of buying stock is included in the Cost of Sales. If a business is manufacturing a product, the cost of buying the raw materials for inclusion in the manufacturing process is included in the Cost of Sales – for example, fabrication, mould making, engineering, etc. The cost of stock or materials is included in the Cost of Sales because it can easily be allocated to each item manufactured or sold. This is in contrast to expenses such as rent, electricity, insurance, telephone, audit fees, bank fees, etc., which cannot be directly allocated to each item.

» Manufacturing Wages – If a business is manufacturing a product, the cost of paying employees directly involved in the manufacturing process is included in Cost of Sales. The reason for this is because all of their wages are directly related to the cost of each item manufactured. This is in contrast to other salaries – for example, office salaries, etc. – which are not directly involved in manufacture and do not add to the direct cost of manufacturing the product. These other salaries are instead included in the general expenses or overheads.

Remember, not all businesses have a Cost of Sales. If you are not buying stock for resale or manufacture then, in most cases, you will not have a Cost of Sales.

“Gross Profit “

Gross Profit is Sales less Cost of Sales. As explained, the Cost of Sales is the direct cost of manufacturing and/or selling your products. Therefore, Gross Profit represents the income that is left over, to cover all remaining expenses or overheads in the business after these direct costs have been accounted for.

If you have a Cost of Sales, it is very important for you to know your Gross Profit, particularly as a % of your total Sales. In general, the Gross Profit as a % of Sales for businesses in each sector tends to be the same – for example, public houses, restaurants, engineering, etc. This allows you to identify a target Gross Profit % and attempt to improve it.

You should also keep track of your Gross Profit % over a period of years to judge the effect of improvements/changes in business. Increasing your Gross Profit is the key to improving profitability because, in most cases, general expenses, such as electricity, rent, rates, etc., tend to remain somewhat the same over the years. Therefore, if you can improve Gross Profit, you can improve the overall profitability of the business.

"General Expenses or Overheads "

Overheads represent the general costs of running a business which cannot be allocated directly to the products or services – for example, insurance, electricity, telephone, marketing, accountancy expenses, etc. It includes the majority of all expenses of the business. Larger businesses often break down overhead expenses further to show how costs arise in different sections of the business – for example, different departments, etc. However, this is not necessary when dealing with a small to medium-sized business.

As mentioned earlier, reducing your general expenses or overheads is a very limited way of increasing your profitability because these expenses tend to remain the same. In other words, no matter what happens to sales, significant reductions in this area are very hard to achieve.

"Depreciation"

You cannot put all of your capital costs into the Profit & Loss Account. However, you are allowed to put a portion of the capital costs into the Profit & Loss Account in the form of what is known as "depreciation". There are two types of depreciation, examples of which are given in Figure 12.

One is called "straight line" depreciation. In "straight line" depreciation, the same % is deducted each year until the value of the asset has been written off completely.

The second method of depreciation is called "reducing balance". In "reducing balance", the depreciation figure is based on the written down value (WDV) of the asset in the current year.

Your accountant will decide on the most appropriate method of depreciation to use for your business.

"Net Profit"

This is the difference between the Sales revenue and all costs, including Cost of Sales and general expenses. Your tax liability is based upon your Net Profit figure.

If your business is a Company, your salary will be deducted from the profits of the company before the profit is taxed by the Revenue.

If your business is a Sole Trader, your salary and the profit of the business are the same thing in the eyes of the Revenue. This means that your own salary is not deducted from the profit of the business for the purposes of tax. However, when you are calculating the profit of the business to see how you have done during the year, you should deduct your salary as this gives a truer picture of your business' profit. This is for your own benefit as opposed to the returns you have to send to the Revenue.

Information Available

The information in the Profit & Loss Account is at its most revealing when presented in the form of ratios or formulas that can be compared over a number of years or with ratios in other businesses within the industry/ service sector.

Figure 12: Depreciation

A business buys a van for €,000. The business will include a portion of the cost of the van for each year in the Profit & Loss Account, until the full price has been included in expenses over a number of years. For example, the business includes depreciation of 15% per year for 6 years and 10%in the seventh year. Under" straight line" depreciation, the calculation is as follows:

	Depreciation
Year 1 @ 15%	€1,800
Year 2 @ 15%	€1,800
Year 3 @ 15%	€1,800
Year 4 @ 15%	€1,800
Year 5 @ 15%	€1,800
Year 6 @ 15%	€1,800
Year 7 @ 10%	€1,200
Total Depreciation	€12,000

The amount of % depreciation is worked out with your accountant, who bases his calculation in accordance with the guidelines of the Revenue Commissioners.

Under “reducing balance” depreciation, the calculation is as follows:

	Depreciation	WDV
Value at purchase €12,000		
Year 1 @ 15%	€1,800	€10,200
Year 2 @ 15%	€1,530	€8,670
Year 3 @ 15%	€1,301	€7,369

Profitability ratios

These ratios are used to show how the business is performing in terms of profit.

Gross Profit %

This shows how much Gross Profit is earned on each of sales.

Gross Profit % = Gross Profit / Sales x 100

For businesses with a Cost of Sales, the Gross Profit % is one of the most important calculations in financial management. Improving the Gross Profit % is the real key to increasing profitability.
In general, the Gross Profit % for businesses in the same industry or service sector tends to be the same, for example, restaurants, pubs, engineering firms, etc., all tend to share a similar Gross Profit % in their respective sectors.

When you have calculated the Gross Profit %, you cannot just say if it is good (high) or bad (low), without considering the type of business involved. The Gross Profit % varies according to a number of external factors – for example, size of firm, type of industry, target market, as well as internal factors, such as quality of stock control and wastage of stock.

This difference in expected Gross Profit % becomes clearer if we look at two businesses selling groceries. A large supermarket chain will have a relatively low Gross Profit %; it may buy a can of beans from the manufacturer for 10c and sell it at 13c. Many supermarket chains have a Gross Profit % of around 18%. On the other hand, a corner shop may have a relatively high Gross Profit % because it may buy a can of beans from the wholesaler at 12c and sell it at 20c. The supermarket trades with a lower Gross Profit % because it can spread its other costs over a large number of sales, on the other hand the corner shop will have relatively high expenses

(overheads), and these have to be covered by a high Gross Profit % because there are lower sales. It is also difficult to compare the Gross Profit % of businesses in different industries. For example, a jeweller will have a very high Gross Profit % – for example, 60% to 80% – because he/she may sell his/her goods at two or three times the price paid, but, on the other hand, a dairy farmer might find that the price he/she receives for his/her milk is little more than the cost of producing it.
The Gross Profit % for Corner shop in 2005 in Figure 10 is as follows:

Gross Profit % = €72,000 x 100 / €120,000 = 60%
Calculate the Gross Profit % for Lowland Ltd. in 2005 in Figure 11[1].

Net Profit Margin

This shows how much profit is earned on each € of sales.

Net Profit Margin = Net Profit before tax / Sales x 100

The Net Profit Margin (NPM) does not vary by as much as Gross Profit % over different industries and sizes of business. This limit on variation occurs because the differences in Gross Profit % are often evened out because of differences in expenses. For example, a firm with a high Gross Profit % often has proportionately high expenses, whilst a firm with a low Gross Profit % often has proportionately low expenses.
One important factor that will lower NPM is if the business is relatively young. A new business, in its first years of trading, may have high expenses as it tries to establish itself. A good example of this would be high expenditure on advertising. Because of this a new business could have a low NPM, but this may not necessarily indicate problems.

Perhaps the easiest way to judge NPM is to construct bands of performance, such as the following:

- » NPM of 18% + is good, indicating effective business management of costs and expenses.
- » NPM of 10% to 17% is satisfactory, but cost or expenses management could be improved.
- » NPM of less than 10% could be regarded as poor, indicating that there are real opportunities for improving cost and expenses management.

Do not be overly critical about your business, unless you are looking at a very low NPM. Also, you should look for the main causes of poor performance. Is Cost of Sales high? This would lead to a low Gross Profit %, which in turn will lead to a low NPM. Do some expenses seem out of proportion? Work your way down the Profit & Loss Account and see what stands out.

The Net Profit % for Corner shop in 2005 in Figure 10 is as follows:

Net Profit % = €30,000 x 100 / €120,000 = 25%
Calculate the Net Profit % for Lowland Ltd. in 2005 in Figure 11. [2]

Interest Cover

This ratio measures the number of times a business can repay its yearly interest bill on its borrowings from its trading or operating profits. It is of importance to creditors and investors as it indicates the potential long-term financial stability of a business.

1 The Gross Profit % is 60%.
2 The Net Profit % is 28.5%.

The Interest Cover is measured as a multiple, formula below, so firms could have an Interest Cover of 6 times, or 3 times and so on. The higher the Interest Cover, the greater the firm's financial strength, all other things being equal. Firms with low Interest Cover may have difficulty in meeting interest payments if either interest rates rise, or profits fall.

Interest Cover = Annual Interest Payments / Net Profit

A low ratio would be in the region of 2 or less. Below this level, the majority of profits earned are going to cover interest payments, and are not being used for payments to the owners or reinvestment in the business.

Break-Even analysis

The Break-Even Point is described as the minimum level of sales at which the business is covering all of its costs, including Cost of Sales and expenses, i.e., making neither a profit nor a loss. In theory, the first step in identifying the Break-Even Point is to identify the Fixed and Variable costs involved in the business. Fixed costs are defined as costs that tend to remain the same at any level of sales – for example, rent, insurance, office salaries, etc. Variable costs are defined as costs that vary directly in line with the level of sales – for example, materials, production wages, etc. The following is the theoretical formula for the Break-Even Point:

Break-Even Point = Fixed costs x 100 / 1 – Variable costs divided by Sales

In practice, however, the easiest way to calculate Variable costs is by using the Cost of Sales figure in the Profit & Loss Account, while Fixed costs can be calculated by using the Overhead Expenses, also shown in the Profit & Loss Account. The rearranged formula, can be written as:

Break-Even Point = Overhead Expenses / Gross Profit % [3]

The theory behind the Break-Even Point is that, as sales vary, the only costs to vary are the Cost of Sales – Overhead Expenses are expected to remain somewhat the same, regardless of sales. As a result, the theory is that there is a point at which the business' Gross Profit is exactly the same as the Overhead Expenses.
Any sales beyond that point represent a profit to the business.

While the theory behind the Break-Even point is slightly flawed – not all Overhead Expenses are going to remain the same regardless of sales – for example, electricity – this does not affect the legitimacy of use for the Break-Even Point as a tool in the financial management of a business. Using the Break-Even Point encourages owner/ managers to examine the different costs involved in running the business, particularly Cost of Sales, and identify the approximate level of minimum sales necessary to make a profit in the business. This is also vital for entrepreneurs in the pre-or early startup phase of business development – how much do you have to sell before you breakeven?

The Break-Even Point for Corner shop in 2005 in Figure 10 is:
Break-even Point = €42,000 / 60% = €70,000

This means that, based upon the current prices, Gross Profit % and Overhead Expenses, Corner shop needs to create a total sales of €70,000 to break-even – profit would be €0. Any sales made above that point at the current prices produce a profit.

3 (1variable costs divided by sales) x 100 can be rewritten as the Gross Profit %

The difference between the existing level of sales and the Break-Even Point is called the Break-Even Gap – in this case, it is €,000 – €,000 less €,000. This is the amount of sales on which the business is making a Gross Profit above and beyond the Overhead Expenses.

Calculate the Break-Even Point and Break-Even Gap for Lowland Ltd. in 2005 in Figure 11.[4]

Summary

The Profit & Loss Account tells you how well your business has traded over a specific period of time. It shows you how much your business has earned from selling its product or service, and how much it paid out in costs. The difference between the earnings and the costs is the profit or loss. While most businesses prepare the Profit & Loss Account once a year for tax purposes, it is most useful as a tool to review the ongoing financial performance of the business.

This means that a draft Profit & Loss Account should be prepared by the owner/manager themselves a number of times during the year and reviewed on a regular basis. This draft Profit & Loss Account should be used in conjunction with the projections and budgets of the business, discussed in another publication in this series.

4 The Break-Even Point is €,500 and the Break-Even Gap is €,500.

4-Balance Sheet

The Balance Sheet is a statement that shows the assets and liabilities of a business – what the business owns and what it owes. The financial health, or lack thereof, is represented within this document through the provision of the following information:
It shows the value of the business' assets, the extent of liabilities and the amount of owner's funds invested in the business.

» It shows the financial position of your-business at a single point in time.
» It identifies your working capital position and funding needs.

The Balance Sheet is normally prepared once a year, by an accountant, for presentation to the owner/manager and the Revenue Commissioners.

Terms Used

The main terms used in the Balance Sheet include the following:

» **"Assets"** – When money is invested in a business, it is spent on either long-term or short-term assets. Short-term assets are used on a day-today basis by the business, while long-term assets remain in use by the business for a number of years. In the Balance Sheet, short-term assets are called:
» **"Current Assets"**, while long-term assets are called:
» **"Fixed Assets**. Examples of fixed assets include vehicles, equipment, office equipment, computers, furniture and fittings, premises, etc. These are permanent assets, whose value can only be realised by their sale. The value of most fixed assets is reduced each year to reflect wear and tear during the course of running the business. This reduction is called:
» "**Depreciation".** It is calculated at a fixed percentage of the value of the asset. The actual percentage figure to be used will be worked out by an accountant[5].The figure for depreciation is deducted from the cost of the assets, to provide what is called the "**Net Book Value"**.
» **"Current Assets"** – This refers to short-term assets that are owned by the business and can be readily turned into cash. Examples include stocks, debtors, cash at bank, VAT refundable, etc.
» **"Current Liabilities"** – Current liabilities are liabilities that, by their nature, must be paid in the near future – generally within 30 days or 1 year of the Balance Sheet date. These include trade creditors, overdraft, expenses due, VAT payable, etc.
» **"Working Capital"** – This is the difference between current assets and current liabilities: Current Assets less Current Liabilities. Working capital represents the business' ability to meet its short term debts with its current assets.
» **"Net Assets"** – The figure for Net Assets is arrived at by adding Working Capital to Fixed Assets.
» **"Long-Term Liabilities"** – Long-term liabilities generally refer to debts that are repayable in a period greater than 1 year of the date of the Balance Sheet – for example, commercial loans.
» **"Capital Employed"** – This refers to the sources of finance that fund the business' operations. One of the first sources of capital is money invested in the business by the owner(s) and/or other people. Another common source is money that has been reinvested in the business from profits profits from previous years and this year's profit.

Unlike the Profit & Loss Account, the Balance Sheet refers to a specific time and not to a period of time.

For example, while a Profit & Loss Account may be prepared for January to December 2006, a Balance Sheet will be prepared for 31 December 2006.

5 The percentage figure used for depreciation will be given in the financial notes given by the accountant to accompany the Balance Sheet.

The Balance Sheet

There are two halves to a Balance Sheet (the layout of the Balance Sheet will vary depending on the accountant and the business, but the basic information is always the same).

The top half shows how the money is being used in the business – the Net Assets – while the bottom half shows where that money came from – Capital Employed.

The totals of the two halves must be equal, giving the Balance Sheet its name.

Figure 13: Balance Sheets as at 31/12/2005 and 31/12/2006 for Print Ltd.

	2005	2006
Fixed Assets		
Equipment	115,000	115,000
Furniture & Fittings	25,000	25,000
Less Depreciation to Date	15,000	30,000
Net Book Value of Assets	125,000	110,000
Current Assets		
Stock	15,000	17,500
Debtors	25,000	35,000
Bank	5,000	12,500
	45,000	65,000
Current Liabilities		
Creditors	20,000	15,000
Working Capital (CA less CL)	20,000 25,000	15,000 50,000
Net Assets	150,000	160,000
Financed By		
Long –term Loans	76,000	70,000
Share Capital	20,000	20,000
Add Retained Profit	40,000	54,000
	136,000	142,000
Add Net Profit	14,000	16,000
	150,000	160,000

“ This figure refers to profits kept in the business from previous years.

The Retained Profit in 2006 includes the Retained Profit for 2005 plus the Net Profit for 2005,
i.e., €40,000 + €14,000
This figure refers to this year’s profit

Information Available

The information provided in a Balance Sheet gives a good indication of the state of a business’ finances. It can be read in two ways:

- » By using the general information provided on the Balance Sheet – for example, looking at total fixed assets, comparing current liabilities with current assets, comparing figures from different years, etc., and/or
- » By using a number of ratios developed to help owner/managers assess the state of their business.

These ratios use the information provided in the Balance Sheet and allow the performance of the business to be measured against other businesses or the general industry. A number of the most common ratios are described below.

The information extracted from the Balance Sheet should be used in conjunction with the information from the Profit & Loss Account. Ratio Analysis Ratio analysis is a technique for analysing financial accounts. The ratios can be compared on a yearly basis to track the financial performance of the company, or they can be compared to ratios in other companies or against the industry/service sector.
Financial or creditor ratios would be used by the owner/manager or any person or business that may be considering becoming financially involved with the business – for example, banks, other commercial lenders, leasing companies and potential creditors.

The use of these ratios would be to consider the financial strength of the business in the following circumstances:

» Granting of credit.
» Likelihood of a bank loan.
» Financial constraints of the business.
» Potential of investing for growth.
» Working capital/liquidity analysis.

The notes accompanying each of the ratios below will indicate how and when they are usually used by businesses or lenders.

Profitability Ratios

These ratios are used to show how the business is performing in terms of profit and are usually considered in relation to the Profit & Loss account. But, since we also use information drawn from the balance sheet, they are included in this section.

Return on capital (ROCE)
This measures the return that can be achieved from the business, relative to the amount of money invested in it. The Return on Capital can be compared with the return offered by risk-free investments such as bank deposits or building societies – for example, the interest rate. As a general rule, the return should be at least 3% above the cost of long-term borrowing.

Return on Capital = Net Profit before tax x 100 / Capital employed

The ratio shows the Net Profit of the business as a percentage of the amount of money invested. The return should be greater than that offered by risk-free investments – for example, building societies – in order to justify the investment of money in the business as opposed to other options. The return is generally lower in the early years of business.

The Return on Capital Employed for Print Ltd. in 2005 is as follows:
Return on Capital = €14,000 x 100 / €150,000 = 9.33%
Calculate the figure for 2006[6].

Net Profit margin
This shows how much profit is earned on each € of sales.

Net Profit Margin = Net Profit before tax x 100 / Sales

6 The ROCE for 2006 is 10%

This ratio can also be used to compare and contrast the profitability of different products/services. Net Profit Margin is described in greater detail in **Chapter 3.**

Liquidity Ratios

A business is liquid if it has enough available assets that it can convert to cash to meet its immediate commitments – if all the business' short-term credit was called in, could the business raise the cash from its own current assets to meet the payments?

Current ratio

This gives a general picture of liquidity – it shows the ratio of your short-term assets to your short-term liabilities.

Current Assets / Current Liabilities = (Stocks, debtors and cash) / (Trade creditors, overdraft and shortterm debts)

Since stocks and debtors may not be easily changed into hard cash, this ratio may not give a reliable measure. Generally, a ratio that is less than 3:1 may give cause for concern.

The Current Ratio for Print Ltd. in 2005 is:
Current Assets / Current Liabilities = €45,000 / €20,000 = 2.25
Calculate the figure for 2006[7].

Acid test or Liquidity ratio

This is more commonly used to measure liquidity. Liquid assets are current assets that would not be difficult to convert to hard cash if needed. As a result, stock and any doubtful debtors are excluded from this ratio.

Liquid Assets / Current Liabilities = (Debtors and cash) / (Trade creditors, overdraft and short-term debts)

A ratio of 1:1 is the general requirement for liquidity. If the ratio is less than this, there may be cause for concern because it would indicate that there are not enough liquid assets to meet short-term liabilities if those arose immediately. Alternatively, a ratio that is considerably higher than 1:1 would indicate that the business is not using its cash to best effect. The point should be made, do not be overly prescriptive, a low ratio does not mean impending financial disaster. Consider the type of business – is it cash rich?

The Acid Test Ratio for Print Ltd. in 2005 is: Liquid Assets / Current Liabilities = €30,000 / €20,000 = 1.5
Calculate the figure for 2006.[8]

Other Ratios

Other ratios that are useful for analysing the Balance Sheet include the following:

Gearing

Gearing, sometimes called the debt-equity ratio, is a measurement of the degree to which a business is funded by outside loans rather than shareholders' equity – Share Capital and Reserves plus Profit & Loss Account.

7 The Current Ratio is 4.33.
8 The Acid Ratio is 2.

A business with low Gearing is one that is funded (financed) in the main by share capital (equity – for example, owner's investment) and reserves (money retained in the business from profits made in previous years), whilst one with high Gearing is funded in the main by borrowings.

Gearing =(Interest-bearing debt less Cash x 100) /Equity
Interest-bearing debt includes, for example, bank loans, commercial mortgages, leasing, etc. When times are tough, highly geared companies are seen as vulnerable.

As a result, investors and banks often show a preference for businesses without a high gearing. As a guide, a gearing ratio of above 60% is high, while below 40% is low. However, do not be too prescriptive, the ratio is only a guideline, to be considered in light of all the circumstances surrounding the business.

The Gearing for Print Ltd. in 2005 is:
(Interest-bearing debt – Cash x 100) / Equity =(€71,000 x 100) / €74,000 = 95%
Calculate the figure for 2006[9].

Debtor and Creditor Days ratio

These ratios are measures of how long it takes on average to pay debts and to collect debts. When looking at these ratios, two points must be considered.

First, it is normal to offer 30 or 60 days trade credit, and second, the type of business will affect the Debtor Days Ratio – businesses that deal in cash, for example, taxis, fast-food takeaways, supermarkets, etc., will have Debtor Days' Ratios of virtually nil as normal. You should look for a falling collection period in Debtor Days, and anything above 60 days, in any type of business, is a cause for concern

When examining trade creditors, we would expect most firms to be paying in around 30 to 60 days. If the figure is below this, we would look at Debtor Days for a comparison and, if creditors are being paid before debtors are paying, then there might be liquidity problems. If Debtor and Creditor Days are in approximate balance, this indicates effective management of working capital – as creditors are being used to fund debtors.

If the Creditor Days Ratio is above 60 days, then the firm may be in a situation where suppliers do not want to extend further credit, but on the other hand if the firm is a large one, and the suppliers relatively small companies, then there may be little the smaller suppliers can do to encourage quick payment. Any pressure for payment may be met with a threat to end purchases.

Debtor Days Ratio =(Debtors x 365) / Credit Sales
Creditor Days Ratio =(Creditors x 365) / Credit Purchases
As with other ratios, the absolute level of Debtor and Creditor Days is less important than the trend over time and how the business compares with competitors.

Stock turnover ratio

This indicates the number of times stock is being turned over within the business in one year.

Stock Turnover Ratio =Cost of Sales / Average stocks held

9 The Gearing is 77%.

In general, the higher the stock turnover ratio, the higher the profitability and the greater the cash flow.
For manufacturing businesses, a stock turnover figure of around 20% is the norm, but figures have been falling, and with management efficiency in mind, you should always look for a pattern of lower ratios over a number of years.

Summary

The Balance Sheet is normally provided once a year by an accountant for use by the owner/manager and for submission to the Revenue Commissioners.
Interpreted properly, a Balance Sheet can show:

» The liquidity of the business, its ability to sustain operations and pay bills.
» The burden of debt carried by the business.
» The invested capital of the owners, and the return on this capital.
» The information extracted from the Balance Sheet should be used in conjunction with information from other financial documents within the business as part of a fully integrated financial management system.

5-Sources of Finance

Introduction

Owner/managers have access to several options in financing their business activities. Among these are debt finance – loans, investment by others in return for ownership of a portion of the business, and grant funding, which may or may not require repayment.

The key to good financial management is to understand each of the main sources of finance and to be able to match these sources with the needs of your business. Doing so will enable you to identify the most appropriate and cost-effective methods of managing your business' finances, without putting unnecessary strain on your short-to medium-term cashflow.

Types of Sources of Finance

The four main sources of finance for businesses include the following:

» Owner's capital.

» Outside equity.

» Debt finance.

» Grant funding.

Each of these is described in detail below.

Owner's Capital[10]

By owner's capital we mean the cash invested in the business by the owner or partners.

For most small businesses, this is the only source of capital available, particularly in the first few years of operations.

Owner's capital has a number of limitations as an ongoing source of finance to the business, particularly in regard to the following:

» The initial cash investment is often quickly turned into long-term assets – for example, premises, equipment, etc., which cannot be readily converted into cash to support the ongoing trading operations of the business.

» In most cases, the owner will already have invested all of his/her available money and may not be willing to risk further investment.

» Although the owner's capital may be limited, particularly in the startup phase, it is a vital source of finance that is often required before any other source will become involved in the business – for example, an investor, bank or grant agency.

Outside Equity

Outside equity refers to investments in the business by people or organisations other than the owners.

Outside equity is different from a loan or other source of debt finance because of the following:

» It does not include any form of interest and does not require repayment in the short-term.

» If the business fails, so does the equity. In other words, all other debts, including debt finance such as loans, are repaid before the equity is returned to the investor.

Due to the level of risk involved in providing equity to businesses, the investment needs to provide a certain level of return to the investor that cannot be acquired through other investments.

The most common of these include the following:

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10 In the case of limited companies, owners capital is often called shareholders' capital, because shareholders are the owners of limited companies.

- The contract negotiated between the investors and the business may include a certain percentage of profits to be provided to the investor on an annual basis.
- Some investors will provide equity to the business in return for a percentage of shares in the business. This means that the investors will have some element of control over the business, depending on the number of shares they hold. If the business is sold, they will be entitled to a share of the profit from the sale.
- The investor can benefit from a number of tax breaks in return for providing equity to certain types of small business. The most popular forms of tax breaks in this regard are the Business Expansion Scheme and the Seed Capital Scheme, details of which can be accessed on www.revenue.ie.

Debt Finance

Debt finance refers to the main bank and lender products that incorporate some form of interest and short-to long-term repayment schedule. The most popular forms of debt finance include the following:

- Bank overdrafts.
- Term loans.
- Leasing.
- Hire Purchase.
- Commercial mortgage.

Bank overdrafts

An overdraft is a form of bank loan whereby the business is allowed to withdraw more money from its account than is currently available, thereby leaving a negative balance.
The main features of a bank overdraft include the following:

- You pay interest on the amount you are overdrawn each day.
- You repay the overdraft simply by lodging money to your account.
- The overdraft is normally agreed with the bank for a period of 6 to 12 months. This can be reviewed with the bank if necessary.
- Once arranged, the overdraft can be called upon at various times, without having to inform the bank.
- It is very costly to exceed your credit limit, due to high interest rates and surcharges for exceeding the limit without prior authorisation from the bank.

A bank overdraft can be the cheapest source of finance for a business, as long as it is repaid promptly. Otherwise it can become the most expensive, due to the high interest rate being charged.
Term loans, leases and Hire Purchase agreements are often seen as similar alternatives to financing the same types of expenses–the purchase of equipment, vehicles, etc. These similarities have increased over the past few years, with the introduction of new financial products by the banks and lending institutions. For example, most leasing arrangements contain a term whereby the ownership of the equipment or vehicle will pass to the lessee upon completion of the lease and the payment of an appropriate fee.
As a result, when choosing between a term loan, lease and Hire Purchase agreement, the choice can often be based solely on the cost of the financial product – interest rates, fees and repayment schedules. The cost of debt finance (described in greater detail later in the section) can vary significantly, depending on the bank or lending institution you approach.

Term loans

Term loans are suitable for your business if you need a fixed amount of finance for a year or more.
The main features of term loans include the following:

- Most loans are for a fixed period of 1 to 8 years.
- Repayments are agreed in advance.

» Loans are much more suitable than overdrafts for long-term finance.
» Loans are unsuitable for solving short-term cash flow problems.

Leasing

Leasing is used to finance equipment or vehicles you do not need to own. The main features of leasing include the following:

» You rent the item instead of buying it.
» Payments are spread out over the rental period.
» You get full tax relief on lease payments, both interest and capital repayments.
» Capital allowances are not allowed because you do not own the item leased.

Hire Purchase

Hire Purchase is used to finance the purchase of equipment or vehicles. The main features of a Hire Purchase agreement include the following:

» You buy the equipment or vehicle, but payments are spread out over a fixed period.
» You can claim capital allowances on the equipment or vehicle, and interest payments receive full tax relief.
» Depending on the agreement, ownership of the equipment or vehicle may not pass to the business until the final payment is made.

Commercial mortgage

This is a long-term source of finance for the purchase, development or refurbishment of business property. The main features of a commercial mortgage include the following:

» Security is likely to be required on the property.
» You can arrange the repayment schedule to suit your needs.
» It may be possible to secure a moratorium (explained in a later section) on the interest and/or capital repayments.

Cost of Debt Finance

The cost to the business of using each of the debt finance products listed above is based upon a number of factors, primarily the interest rate, bank fees/costs and the repayment schedule.

Interest rate

The rate of interest charged on each of the products tends to decrease in line with the length of the finance available.

For example, a 12% interest rate may be charged on a short-term product such as an overdraft facility, while a 4.5% interest rate may be charged on a long-term product such as a 15year commercial mortgage.

However, the cost of the product should not be based solely on the interest rate. The level of interest is calculated over the life of the debt and for very short term requirements a short-term loan or bank overdraft can be cheaper than arranging a medium-term loan, despite the lower interest rate for the latter option. For example, using a bank overdraft to finance a shortfall of €1,000 over a few weeks can result in minimal interest repayments if managed properly – it is repaid within a short period of time.

Use the Annual Percentage Rate (APR) to compare interest rates between products for different banks. This is a standard form of interest calculation used by the main banks and is provided on all advertising and literature relating to the product.

Costs and fees

Some costs of debt finance are less obvious than interest rates and tend to be "hidden" within the product package. For example, the bank or lending institution may charge the following for some of its products:

» General bank fees and costs.
» Commitment fee.
» Arrangement fee.
» Legal & professional fee.
» Negotiation fee.
» Management fee.

Always ask the bank or lender what fees and costs, apart from interest payments, are involved in obtaining and repaying the financial product. For example, most Hire Purchase agreements include a final fee, to be paid in conjunction with the last repayment on the contract.

Repayment schedule's Interest and capital repayment moratoriums

Moratoriums are a suspension of interest and/or capital repayments, usually for 6 months or 1 to 2 years. Although they do not significantly affect the actual cost of a financial product, repayment moratoriums can be very beneficial to a business. This is particularly true during the start-up period when they can provide a breathing space for the business, during which it can generate the income necessary to meet the on-going repayments.

Be prepared to shop around for the best deal on any financial product. The interest rates, fees/costs and repayment schedules for each of the products can vary significantly, depending on the bank or lending institution you approach. Remember, you are purchasing their financial product and they should adapt their own costs to attract your custom.

State Funding

Various types of grant aid and repayable 'soft' finance are available from state enterprise development agencies. Details of the financial supports available from South Dublin County Enterprise Board are listed in Figure 14. overleaf.

Matching Sources of Finance to Business Expenses

To effectively manage your sources of finance, you will need to understand each of the main sources of finance and to be able to match these sources with the expenses of your business. Most business expenses can be classified as Capital or Operational Expenses.

Capital expenses

This is usually described as expenditure incurred in the purchase or lease of assets – for example, premises, equipment, vehicles, fixtures & fittings, etc. – that are going to be used in the business for a period greater than one year. These are also sometimes called the development costs of the business.

Capital expenses can be further sub-divided into the following:

» Medium term expenses – Assets that are going to be used in the business for one to five years – for example, equipment, vehicles, etc. In other words, the benefit to the business from the expenditure will be over a period of 1 to 5 years.
» Long-term expenses – Assets that are going to be used in the business for greater than 5 years – for example, buying a new business, premises, etc. In other words, the benefit to the business from the

expenditure will be over a period of 5 to 20 years or even greater.

Operational expenses

Operational expenses refer to the normal day-to-day expenses involved in running a business – for example, insurance, rent, travel, wages, etc. In other words, the benefit to the business from the expenditure will be over a period less than 12 months. These expenses will always be listed in the Profit & Loss Account of the business. Having identified the three main classes of expenses in your business, you must match these expenses to appropriate sources of finance. general rule is to use sources of finance that are repaid over a similar period of time during which the expense provides a benefit to the business.

For example, consider a business that is buying a car. The car is going to be used in the business for 4 to 5 years, thereby assisting in the generation of trading income during this period – the benefit of purchasing the car is going to last 4 to 5 years. Therefore, the source of finance being used to purchase the car should match this benefit period.

The most appropriate source of finance for this period is a term loan, lease or hire purchase for 4 to 5 years. The choice between each of these options should be based on the cost of each product and whether the business needs to own the vehicle at the end of the period.

Financing the car through an overdraft is inappropriate in this case, because an overdraft should only be used to finance expenses, the benefit of which should accrue to the business within, for example, 3 months. In other words, the expense should repay itself within the 3month period. Otherwise, the business is going to be paying high interest rates on the overdraft over a period of time that might be better served through a term loan offering lower interest rates.

Financing the car by adding it to the commercial mortgage is inappropriate in this case also, because the commercial mortgage is going to be paid back over a period of approximately 15 years. As a result, although the car may be disposed of within 5 years, the business will repay the cost of the car for another 10 years, despite the fact that the car is providing no further benefit to the business whatsoever within those 10 years – it has been replaced. Obviously, this would not be a good financial management decision.

The scenario above may seem a bit extreme, but it is a valid example of the situations faced by many businesses and demonstrates how a business can easily run into financial difficulties by matching the wrong source of finance to the wrong business expense.

Examples of other financing decisions include the following:

» Some businesses will use an overdraft to pay for the purchase of equipment, merely because it is readily available to them and, as a result, they do not have to approach the bank to arrange further finance. While they may do this with the intention of quickly paying back the overdraft from the income to be generated from the new equipment, in most cases the increase in income will not arrive as quickly as envisaged. As a result, they will be faced with an increase in high interest repayments on the overdraft facilities, which they cannot meet through their trading income, putting increasing pressure and stress on the business and, more importantly, the owner/manager. This is called “chasing your own tail” – the business is generating income merely to meet the cost of repaying its debts. In this example, it may be beneficial for the business to convert the overdraft into term loan (it is never too late to do this) thereby reducing the monthly interest repayments and ensuring the repayment period is matched appropriately to the expense.

Figure 14: Matching Expenses & Sources of Finance

		Source of Finance	
	Short-Term	Medium-Term	Long-Term
Long-term capital expenses Buy a new business Buy new property Develop your premises			» Owners capital » Outside equity » Mortgage » Grants
Medium-term capital expenses Buy new machinery Buy new equipment		» Term loan » Leasing » Hire Purchase » Grants	
Operating expenses Buy stock Day-to-day costs	» Trading income » Overdraft » Trade credit		

Trading expenses should only be met by trading income, trade credit from suppliers or short-term sources of finance, such as a bank overdraft that can be repaid within a few weeks. If the business cannot meet its trading expenses from trading income, then it is not financially viable.

» Business may find themselves somewhat cash rich at a particular point in time – for example, at the end of a busy trading period. The temptation at this time is to use the available cash to purchase new equipment, thereby avoiding the need to use debt finance such as a term loan. While this may be of benefit to the business, the owner/manager should consider the options available to him/her in this case. Debt finance is not necessarily a bad thing and, as long as it is matched to the appropriate expense, it can be financed adequately by the business, without putting any undue strain on the cash resources. As a result, the cash-rich business may be in a position to use the cash to better effect elsewhere or hold it in reserve for a later period – for example, the lull that can often follow the busy trading period!
» Businesses experiencing trading difficulties may look to a term loan as a source of finance to meet their day-to-day expenses. Although this provides a quick injection of cash to the business – its trading income is not enough to meet its trading expenses. As a result, putting the repayment of another term loan on to the business could be a recipe for disaster. A short term overdraft, renegotiation of credit terms with suppliers, or calling in cash from debtors may be the better answer – for example, renegotiating credit terms to ensure that income from sales arrives in sufficient time for payments to suppliers. , while you may see youras a source of credit, many your own customers will lookuyou in the same way.

The above are examples of real financial decisions taken by businesses every day of the year and illustrate the importance of matching the right source of finance with the right expense. Mismatching the sources to the expenses will cause unnecessary pressure and strain on the business and owner/manager.
The main expenses and appropriate sources of finances are summarised in Figure 14.

Approaching Banks & Funders - The Business Plan

Banks and funders often make their decision to finance a business based upon the viability of the business proposal and the ability of the owner/manager to manage the business. They base the decision upon the information available to them regarding both the business and the owner/manager, most of which will be supplied by the owner/manager themselves. As a result, in order to deal successfully with your bank and/or funders, you must be able to present your best possible case in as clear and concise a format as possible. The most effective means of achieving this is, without doubt, the preparation and presentation of a Business Plan to the bank and/

or funding agency.

The business plan will provide the following information:

Main document

- » Introduction to the owner/manager.
- » Introduction to the business.
- » Description of the product/service.
- » Market analysis.
- » List of competitors.
- » Marketing plan.
- » Capital expenditure.
- » Sources of finance for capital expenditure.

Appendices

- » Financial projections.
- » Business details – for example, bank, solicitor, accountant, architect, etc.
- » Short CV of owner/manager.

The business plan should be prepared by the owner/manager, unless the level of detail is such that he/she will need the assistance of a mentor/consultant.

Even in that case, however, the owner/manager should be heavily involved in the research and preparation of the plan. This involvement will enable the owner/manager to update the plan, particularly the projections, on a regular basis, thereby putting him/her in the position of being able to approach the banks/funders to provide accurate information regarding the progress of the business. This is extremely beneficial when approaching the banks for the annual meeting or at any other time when the business needs to access debt finance – the owner/manager has a very accurate idea of the level of finance needed by the business over the next 6 to 12 months and can convey this to the bank.

Capital expenditure, both medium-and long-term expenditure, is shown in the main body of the Business Plan. The sources of finance for these expenses should be shown alongside the costs.

6-Glossary of Terms

Balance Sheet: The Balance Sheet is a statement that shows the assets and liabilities of a business – what the business owns and what it owes.

Bookkeeping: A system of recording all of a business' transactions. The records can be kept on a manual or computerised basis. A bookkeeping system consists of "books of account", which is a term used to describe documents that contain information about transactions within your business.

Break-Even Point: The Break-Even Point is described as the minimum level of sales at which the business is covering all of its costs, including Cost of Sales and expenses – making neither a profit nor a loss.

Capital Allowances: Depreciation calculated for tax purposes

Capital Employed: This refers to the sources of finance that fund the business' operations. One of the first sources of capital is money invested in the business by the owner(s) and/or other people. Another common source is money that has been reinvested in the business from profits – retained profits from previous years and this year's profit.

Capital Expenditure: This is usually described as expenditure incurred in the purchase or lease of assets – for example, premises, equipment, vehicles, fixtures & fittings, etc. – which are going to be used in the business for a period greater than one year. These are also sometimes called the development costs of the business.

Cash Book: This is a record of all cash receipts and payments within the business. You should remember that the term "cash" includes cheques as well as ordinary cash receipts. The book is divided into two sections: Money In and Money Out.

Cheque Journal: The Cheque Journal records all amounts of money paid out of your bank account. These are also called "debits" to your bank account. Remember, the Cheque Journal only records money going out of your bank account.

Commercial Mortgage: This is a long-term source of finance for the purchase, development or refurbishment of business property.

Computerised Accounts: These are accounts that are recorded on computer by specifically designed accounting packages that update all of the books once one entry is made. The choice of whether to use manual or computerised accounts is entirely up to the owner/manager.

Cost of Sales: Cost of Sales refers to costs that can be allocated directly to each product manufactured and/or sold by the business. These costs are often called direct costs.

Current Assets: This refers to short-term assets that are owned by the business and can be readily turned into cash. Examples include stocks, debtors, cash at bank, VAT refundable, etc.

Current Liabilities: Current liabilities are liabilities that, by their nature, must be paid in the near future – generally within 30 days or 1 year of the Balance Sheet date. These include trade creditors, overdraft, expenses due, VAT payable, etc.

Debt Finance: Debt finance refers to the main bank and lender products that incorporate some form of interest and short-to long-term repayment schedule.

Depreciation: A method by which the portion of a total cost of a capital expenditure is included as a cost in the Profit & Loss Account.

Fixed Assets: These are permanent assets, whose value can only be realised by their sale. Examples of fixed assets include vehicles, equipment, office equipment, computers, furniture and fittings, premises, etc.

Gearing: Gearing, sometimes called the Debt/ Equity ratio, is a measurement of the degree to which a business is funded by outside loans rather than shareholders' equity. A business with low Gearing is one that is funded (financed) in the main by share capital (equity, the owner's investment) and reserves, whilst one with high Gearing is funded in the main by borrowings.

General Expenses: General Expenses represent the general costs of running a business which cannot be allocated directly to the products or services – for example, insurance, electricity, telephone, marketing,

accountancy expenses, etc. They are sometimes called overheads.

Grant Funding: The term "grants" is used to describe money given by State agencies to businesses for a specific purpose – for example, purchase machinery, develop premises, carry out feasibility study, employ extra personnel, etc.

Gross Profit: Gross Profit is Sales less Cost of Sales. Hire Purchase: Hire Purchase is used to finance the purchase of equipment or vehicles - you buy it, but the repayments are spread out over a period of time.

Income: This refers to the income received from the sale of goods/services normally traded by the business. It includes cash sales made and credit sales invoiced during the business period. The terms income, sales, revenue and turnover are virtually interchangeable.

Leasing: Leasing is used to finance equipment or vehicles you do not need to own – you rent it rather than buying.

Ledgers: Ledgers keep a detailed account of the running totals of transactions involving individual debtors, creditors, expenses, assets and liabilities. All of the information is taken from the business' books – for example, Sales Book, Purchases Book, etc.

Long-term Liabilities: Long-term liabilities generally refer to debts that are repayable in a period greater than one year of the date of the Balance Sheet – for example, commercial loans.

Manual Accounts: Manual accounts refer to bookkeeping systems that are "written" in a book such as an analysis book. The choice of whether to use manual or computerised accounts is entirely up to the owner/ manager.

Net Assets: The figure for Net Assets is arrived at by adding Working Capital to Fixed Assets.

Net Profit: This is the difference between the Sales revenue and all costs, including Cost of Sales, and general expenses/overheads.

Operational Expenditure: Operational expenses refer to the normal day-to-day expenses involved in running a business – for example, insurance, rent, travel, wages, etc. In other words, the benefit to the business from the expenditure will be over a period less than 12 months. These expenses will always be listed in the Profit & Loss Account of the business.

Outside Equity: Outside equity refers to investments in the business by people or organisations other than the owners.

Overdraft: An overdraft is a form of bank loan whereby the business is allowed to withdraw more money from its account than is currently available, thereby leaving a negative balance.

Owner's Capital: By owner's capital, we mean the cash invested in the business by the owner or partners. For most small businesses, this is the only source of capital available, particularly in the first few years of operations.

Profit and Loss Account: A Profit and Loss Account is a document that tells you whether your business made a profit or a loss during a particular period of time. The difference between the total sales and the total costs gives you the business' profit or loss for that period of time.

Purchases Book: This book records all the purchases made by the business. These include stock, electricity, services, equipment, insurance, etc. The normal source of information is suppliers' invoices.

Ratio Analysis: Ratio analysis is a technique for analysing financial accounts. The ratios can be compared on a yearly basis to track the financial performance of the company or they can be compared to ratios in other companies or against the industry/service sector. Records: Records are the basic evidence of business transactions. They include copies of sales invoices, supplier invoices, bank statements, cheque stubs and counterfoils of lodgements. You need to record every transaction made through your business.

Sales Book: A Sales Book records all the sales that have been made by the business. The information in the book is taken from your sales invoices/receipts and it can be updated each week or month.

Term Loans: Term loans are repayable over a period of between 1 to 8 years. Term loans are suitable for your business if you need a fixed amount of finance for a year or more.

Working Capital: This is the difference between Current Assets and Current Liabilities. Working capital represents the business' ability to meet its short-term debts with its Current Assets.

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