Finance for non finance people

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INTRODUCTION

You are an entrepreneur, you love your business, and you want the best for it.
You invest a lot of your money and time into your business and you think you are doing everything right, but if YOU do not understand your numbers then YOU have no real way of measuring if your business is thriving or is it just getting by?

You may have great passion, huge drive and high energy for your business but the core of every successful company lies in a basic understanding of financial management.

YOU MUST UNDERSTAND YOUR NUMBERS TO SUCCEED

Business is all about numbers, and your numbers are telling you a story. If you want to be in business for the long haul, you need to understand that story.

Research has shown that 60% of businesses fail within the first 3 three years. Take the time now to invest in the financial skills that every business owner needs to thrive.

Maybe you find financial information intimidating or scary, you might feel that you don't even need to know how the finances work, or maybe you are trusting all the financial information to your accountant and bookkeeper.

But have you considered how much better you could make your business if you knew your numbers better?

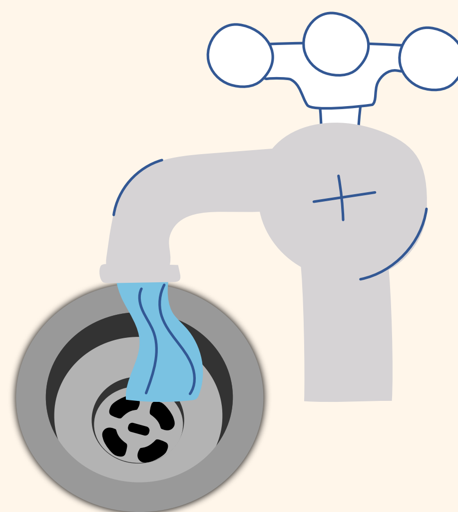
Remember that **You** are the expert of your business, and nobody knows your business better than you.

DO YOU KNOW WHAT VALUE YOUR NUMBERS COULD BRING TO THE TABLE?

Here are a few examples:

- **Is your business leaking money ? Numbers can help identify where this is occurring.**

When you run regular financial reports you will see how much you are spending on certain expenses and know to question the expenses when they appear higher than what you planned. For example, you may notice how high your marketing expenses are, and once you've identified that, you can monitor those expenses.

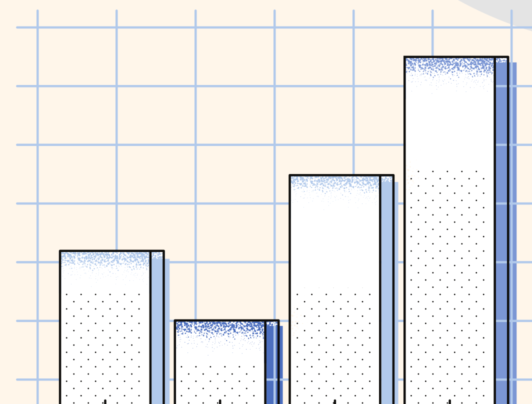


- **Do you know which of your products/services are making you the most money ?**

When you sell more than one product or service, you can measure the profit margins on each product or service and know which is more profitable and where the weaknesses are in the ones with the lower margins. You can set expected margins and make adjustments with the required expenses or price to meet your goals. You will know what price you need to charge to meet your expected profits.

Continued:

- **Do you have a clear understanding of how much your business needs to earn to meet its objectives ?**



When you understand how many sales you will need to bring in to make a profit, it helps with establishing goals. You will understand what sales level your business needs to achieve to breakeven, and you will know at the point you have achieved your breakeven for the year.

- **Do you realise that you could increase your profits without making additional sales ?**

With methods that keep your numbers in check, it will reduce your expenses thereby adding more profit to the net income. And more profit means more money in your pocket.

The bottom line here is that you deserve better, and so does your business. When you know your business numbers it makes you a better entrepreneur. And it doesn't need to be scary. Investing in this knowledge will build unshakable confidence in you as a business owner.

FINANCIAL REPORTING

Financial reports are everywhere: a bill at a restaurant is a financial report as are sales receipts and bank statements. In business, however, financial reporting refers to the financial statements that make up a company's accounts. They provide the owners, investors, lenders and stakeholders with information to assess a company's profitability, and enable them to evaluate the business.

These financial statements take many forms, and being able to deconstruct them is a vital skill for business owners as it enables them to easily see how well a business is performing and why.

1.1 Understanding the basics of Finance

The financial position of a business is impacted by every decision made and every action taken.

Every business activity is also a financial activity.

Business owners need to be aware of how their decisions impact the company. Understanding the basic principle of finance could make the difference between thriving, surviving or failing.
You don't have to assign a monetary value to every activity, but you should think in general terms about how your decisions will impact the financial well-being of the business.

You also need to be aware that there are both direct and indirect impacts on your company's finances. For example, you might deny a customer a credit on their bill that they feel they deserve and if that disgruntled customer leaves your business for the competition, you have indirectly impacted the company's finances in a negative manner because you have lost the future revenue that the customer would have provided.

1.2 Basic Finance terms:

Term	Definition
Assets	Items owned by the business (see Capital Assets, Current Assets and Fixed Assets below)
Capital	Assets available to be invested with the intention of creating new assets.
Capital Assets	Tangible property that is not easily converted into cash. Capital assets are usually held long-term and include things like buildings and equipment.
Capital Budget	The plan a company has in place to finance existing or new capital assets. Organisations usually have a capital budget and an operating budget. (See operating budget below).
Current Assets	The company's total of cash, accounts receivable, and other assets that could be converted into cash within a year.
Net Current Assets	The value of current assets after all the current liabilities have been deducted
Fixed Assets	Long-term, tangible assets that are used by the business and that the company does not plan to convert to cash in the current or next financial year
Net Assets	The value left after all liabilities have been deducted from the company's fixed and current assets
Liabilities	A financial obligation such as debts, claims, or losses.
Current Liabilities	A financial obligation payable within one year
Expenses	All costs incurred in operating the business

1.2 Basic Finance terms continued:

Revenue	Income generated as part of the operations of the business before liabilities are deducted
Depreciation	The reduction in the value of an asset over time, due particularly to wear and tear
Amortisation	The process of gradually writing off the cost of an asset
Net Book Value	The initial cost of an asset minus all of its depreciation to date
Net Assets	The value left after all liabilities have been deducted from the company's fixed and current assets
Shareholders Funds	Also known as owners equity and can be used for reinvestment to the business or distributed as a dividend
Operating Budget	A forecast of estimated income and expenses during a specifc period. An operating budget is short-term, usually for one year, while a capital budget is long-term.

2:THE FINANCIAL INFORMATION EVERY BUSINESS NEEDS

2.1 Introduction

The goal of all businesses is to maximise profits, the owners need information to help them navigate their financial decisions.

All businesses produce financial statements that provide different types of information about the company's financial health.

The three main financial statements that are produced are:

- The Balance Sheet
- The Income Statement (also called a Profit and Loss Account or Statement of Earnings)
- The Cash Flow Statement

In the following sections, we'll look at each of these statements individually to understand:

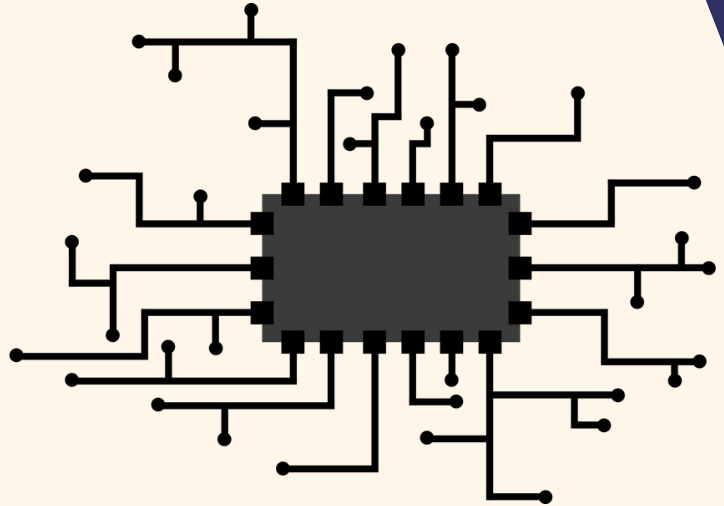
- How the statement is created
- How to read the statement
- What the statement tells you, and just as importantly
- What the statement does not tell you

However, none of these financial statements can be created without information from your accounting or bookkeeping information.

2.1 Continued...

In conventional accounting, all of the accounts the company uses are grouped together by like categories and then are numbered according to a standard format.

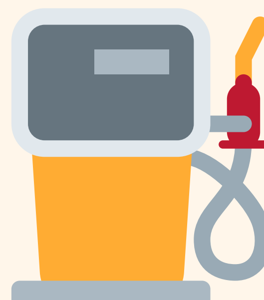
The conventional numbering system is:



- **Assets 101–199**
- **Liabilities 200–299**
- **Equity 300–399**
- **Revenue 400–499**
- **Expenses 500–599**

Some companies might use 600s for expenses. And a business can also add account identifers to further subdivide an account.
For example, you could have an expense account 501 for “utilities” and add identifers for each utility so that it might look like this:

- **501001 – Gas**
- **501002 – Electricity**
- **501003 – Water**
- **501004 – Waste Disposal**



2.2 Bookkeeping is the process of recording all of the businesses transactions.

Every time your company performs a transaction of any kind, the accounts (books) change. For example, if you operate a retail establishment and you make a sale, the inventory of that item decreases and the amount of your cash increases.
Various ledgers and journals are used to track these changes. Those ledgers and journals are then used to create the financial statements listed above.

Accounting has one very fundamental equation:

TOTAL ASSETS = TOTAL LIABILITIES + EQUITY

In other words, what the company has in value is the difference between what they own and what they owe. This is the same for you as an individual. Your net worth is the total of your assets minus any debt that you owe. For a business, there are usually just more assets and liabilities to calculate.

When a transaction occurs at least two of these factors will change. So, for example, if your equity increases, your assets must have increased or your liabilities must have decreased – or both. Accounting is the process of tracking all of these changes in the financial equation. The bookkeeping must be able to record the information and report the information in ways that are helpful for those that are making decisions about the operations and direction of the business.

2.3 The Chart of Accounts

The tool used to track the changes described above is the Chart of Accounts.

A business has specific accounts within their chart which correspond to its assets and liabilities.

For example, some accounts in the chart of accounts might be:

Assets:

- Cash
- Accounts Receivable
- Equipment

Liabilities:

- Loan
- Accounts payable
- Bank overdraft

However, there are usually dozens if not hundreds of accounts under both assets and liabilities and it depends on how the business tracks or maps all of their transactions.

In conventional accounting, all of the accounts the company uses are grouped together by like categories and then are numbered according to a standard format.

2.4 The General Journal (Original Book of Entry)

TThe General Journal is used to record transactions that occur. Today, this is usually done electronically with Accounting software, but historically it used to be done in a large written journal.

In order to record transactions correctly, you need to know the rules accountants use called “transaction analysis.”

The two rules are:

- **Asset and Expense accounts increase with a debit and decrease with a credit.**
- **Liability, Equity, and Revenue accounts increase with a credit and decrease with a debit.**

Once a transaction is recorded in a General Journal, the amounts are then posted to the appropriate accounts, such as accounts receivable, equipment, and cash transactions.

The General Journal is kept in chronological order, which can be very helpful if you need to look back over the history of your transactions. However, there is one important piece of information that is missing from the General Journal. You don’t see any information about the balance in each account that you have impacted.

For example, just by looking at the General Journal, you don’t have any idea how much cash you have left after buying raw materials. To track the changes in account balances, your Bookkeeper uses a General Ledger.

Despite advances in software technology, there will always be a need to record non-routine transactions in General Journals, such as sales of assets, a bad debt, and depreciation.

2.5 The General Ledger

The General Ledger is organised by ledger accounts. There is one ledger account for each account in your Chart of Accounts.

The Bookkeeper will take the information from the General Journal and post it to each of the General Ledger accounts that were affected by the transaction.

This is normally done electronically today with Accounting software that automatically posts to the ledger accounts each time you enter a transaction.

Now that the transactional information has been posted, the financial statements that need the information can be prepared.

3: THE BALANCE SHEET

3.1 Introduction

A balance sheet is a financial statement that shows what a business is worth at a specific point in time. It's primary purpose is to show assets, liabilities and equity (capital) rather than financial results.

There are three sections to the Balance Sheet:

- **Assets** – the items of value owned by the company
- **Liabilities** – the company's obligations, whether to pay for or provide goods or services at a future date
- **Equity** – remembering our earlier equation, equity is the amount of net assets (assets – liabilities)

A Balance Sheet gets its name from the fact that the total of the assets listed must equal the total of the liabilities and equity – in other words, the two sides of the sheet must balance.

For an example of a Balance Sheet see the Table below. It's a relatively simple example, since most businesses will have many more accounts under their assets, liabilities, and equity categories on their Chart of Accounts. But you can get the basic idea for how the information is shared via the Balance Sheet.

	ABC Ltd
Balance Sheet	
As at the 31st January 20XX	
Fixed Assets	
Tangible Assets	12,800
Investments	3,500
	16,300
Current Assets	
Cash	15,765
Stock and Work in Progress	35,150
Accounts Receivable	82,300
	133,215
Current Liabilities (Due within one year)	
Accounts payable	53,555
Bank Loan	11,760
	65,315
Net Current Assets	**67,900**
Total Assets less current Liabilities	**84,200**
Liabilities due after more than one year	
Bank loan	1,280
Net Assets	**82,920**
Capital and Reserves	
Called up Equity Share Capital	100
Retained Earnings brought forward	72,620
Current Net Income	10,200
	82,920

3.2 What does a Balance Sheet tell you

The information on the Balance Sheet includes:

- A summary of the company's assets and the claims against those assets on a specifc date.
- Information about the company's current ability to pay its current debts. This reflects the current position and if a large liability were to be incurred tomorrow, the financial picture could change signifcantly.
- The information shows how the company is positioned to keep going with the day to day business operations. For example, the assets listed give you some idea of what you have available right now to keep trying to generate new assets (new revenue).
- The Balance Sheet also shows what claim the owners have against the business assets. Of course, this is conditional on the other liabilities being satisfied.

3.3 What the Balance Sheet does not tell you

There are several parts of the financial pict that are not included in the Balance Sheet. For example, the Balance Sheet does not tell you:

- How any profits were made. For that information, you will need to look at the Income Statement.
- Which assets creditors have claims against. For example, if you are financing equipment, your lender has a claim against that equipment until it is paid.
- What kind of capital investment was made. You might assume that this only includes cash, but also, the owner or owners might have purchased a building that is not necessarily convertible back to cash (at least not immediately).
- What value the business would have on the market place.

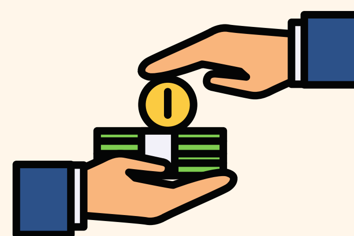
4: THE INCOME STATEMENT (ALSO KNOWN AS THE PROFIT & LOSS ACCOUNT)

4.1 Introduction

The Income Statement is a financial statement which shows all the revenues, costs and expenses during an accounting period. It is also known as the Profit and Loss Account.

The purpose of the Income Statement is to show the profitability of the business during a given period.

4.2 What is contained in the Income Statement



Whereas the Balance Sheet offers a snapshot of a company's finances at one given point in time, the Income Statement looks at incoming revenue and outgoing expenses over a period of time.

The Income Statement uses the following definitions:

- Revenue – incoming assets in return for sold goods or services (e.g. cash or accounts receivable). Income generated by the business.
- Expenses – outgoing assets or liabilities incurred (e.g. accounts payable, inventory or supplies used). Costs incurred in operating the business.
- Net Income – the difference between Revenue and Expenses.

With all of this information, the Income Statement shows you whether you are generating a profit or you are operating at a loss. *See sample Income Statement on the next page.*

ABC Ltd

Income Statement	
For the month ending January 20XX	
Revenue	
Sales Revenue	55,200
Consulting Revenue	6,845
Investment Revenue	763
	62,808
Expenses	
Salaries	17,208
Staff Benefits	580
Rent	1,500
Utilities	780
Raw Materials	28,760
Consumables	3,250
Depreciation	530
Total Expenses	52,608
Net Income	10,200

It’s important to understand that just because the company has a positive Net Income for the month, that doesn’t mean that they have that amount in cash available. Income can include more than just cash, such as interest earned from investments could also be included as Retained Earnings. In order to know exactly what cash is still available at the end of the month, you would create a Cash Flow Statement. We’ll look at how to do that in section 5.

4.3: What the Income Statement tells you

The income statement tells you:

- The main sources of income earned
- Secondary sources of income earned
- Some information about the company based on the categories of revenue that are listed. For example, “Sales Revenue” tells you that the company sells a product or service, while “Fees Earned” would tell you that the company is a professional service provider of some kind.
- What items have no value left for the company because they are expenses – they will not generate any new income for the company
- Whether the company is operating at a profit or a loss.

4.4 What the Income Statement does not tell you

An income statement does not tell you:

- Any prediction for future net income. The Income Statement is an historical document in the sense that it tells you what has already happened. It cannot be relied upon as a predictor of what will happen in future accounting periods.
- The amount of cash on hand. As we mentioned before, Net Income does not mean cash. It only means the excess revenue over expenses in a specific period. Remember that incoming cash could be used for more investments or to buy more assets, or it could actually be received in a month other than when it was generated.
- Non-financial factors surrounding the business. Examples may include environmental factors that impact either revenue sources or raw materials, or market demand that may impact the perception of the products or services offered. Other factors to consider are regulatory matters, competition, or changes in key customers or performance not noted until it’s too late. These factors require early and deliberate consideration of the financial and budgetary impact.

5:CASH FLOW STATEMENT

5.1 Introduction

The Cash Flow Statement is where we track cash coming into and going out of the business during the last accounting period. It is not a cashflow forecast.

It is important as it reveals a company's liquidity and whether it has more coming in than going out. It demonstrates if a company is making enough money to sustain itself and provide surplus capital to grow in the future, pay its debts and dividends.

5.2 The elements of a Cash Flow Statement

The Cash Flow Statement typically analyses cash flow in three different categories:

- Operations
- Financing
- Investing

The following table shows the main sources of incoming cash and the cash usage:

Forms of Cash	Common uses of Cash
Operations	Cash Dividends
New Loans	Loan repayment
New stock issues or owner investment	Stock repurchase
Property or equipment sale	Property or equipment purchase

5.3 Constructing the Cash Flow Statement

To prepare the Cash Flow Statement, you will need to look at the difference between the Balance Sheets from the beginning and the end of the accounting period. You will also need to look at the Net Income from the same period. The following Table shows a sample of a Cash Flow Statement.

	ABC Ltd	
Cash Flow Statement	For the period ending January 20XX	
Cash Flow from Operations		
Net Income	10,200	Both of these are from the Income Statement
Depreciation	530	
Increase in Accounts Receivables	-675	The difference between December and January Balance sheets
Decrease in Inventories	1,215	
Decrease in Accounts Payable	-675	
Net cash from Operations	10,595	
Cash Flow from Investing		This is negative as cash was used to purchase the asset
Equipment Purchase	-2,350	
Net cash flow from Investing	-2,350	
Cash Flow from Financing		The difference between December and January Balance sheets
Loan Payments	-980	
Net cash flow from Financing	-980	
Net Increase (Decrease) in Cash	7,265	
Cash at the beginning of the period	8,500	
Cash at the end of the period	**15,765**	Equals the amount on the January 31st Balance Sheet

Continued:

The amount given for the increase in cash is, at least partly due to the conversion of accrual accounts into actual cash value. At this point you should be able to understand where the amounts in the financial statements come from and how to read the statements. However, you should also realize that it can take years to learn and fully understand accounting and bookkeeping processes. As you get more practice reading (and possibly creating) these statements, you will find it easier to do.

6 BUDGETS

6.1 Introduction

Every business needs to budget for anticipated revenue and operating costs within the coming financial year. Unlike Capital Budgets, where the owners allocate what will be spent on specific projects or assets, revenue budgeting focuses on the overall projections for money coming in and going out for each month of the coming financial year.

As the year progresses the budgeted results are compared with the actual performance of the business. Variations and deviations can be identified and if necessary, remedied.

A budget may be a guideline regarding your expenses and revenues, but it is more than that. It is actually a policy statement that your company is issuing.

Consider your own personal budget. Where do you spend your money? What does that say about you? For example, do you value education enough to pay for it for your children? Do you value your car enough to keep a car payment? Or do you value security more so you actually invest a great deal in savings? Your personal budget would tell an observer information about you, just as a company’s budget will tell you a great deal about the business.

For example, the budget can tell you:

- How the company is structured – usually a company's budget is divided into individual budgets for each department or division. In many budget documents, each division or department's budget will include information about the size of the team and even the team's objectives for the budget year.

- What the company values – how much does the company pay its employees? How much money is budgeted for benefits and retirement plans? Does the company value training and developing its employees? What about new research and development or marketing? In an overview sense, how much budget a certain activity or group is allocated gives you a sense of the company's values and priorities.

- What the company wants to invest in – if there are new activities or projects proposed, those have to be budgeted for as well. If the company's budget is full of allocations for new activities, you can determine what type of direction the company might be headed in. For example, are they investing in higher-technology? Or are they investing in new market segment activities? You can tell a lot about the company's strategies by where they are investing their money.

Budget continued:

- How much debt the company has taken on. The budget will include payments for debt servicing. This could tell you something about how the company has invested in the past and whether or not those investments seem to be paying off. This could be an indication of how well the company manages its finances.

- Where the company may struggle to reach its objectives – you will realise this the first time that an area of the budget gets cut.

- Where the company might be weakest – the budget can give you a few clues about where the company may struggle. For example, if you have not allocated sufficient money to technology upgrades, you may not be able to keep up with the competition when the latest advances roll out onto the market. Or, if you don't invest in training for employees, you may face less productive, less satisfied employees, which could result in high, costly staff turnover.

- Where the company might be strongest – along the same vein, you can see where the company will be fully funded to meet the competition head on. If your company maximises funding for customer service representatives, your company should then develop the reputation for having a high level of customer service.

6.2 How to create a Budget

HARLO WORX

- When you are determining how to create your budget, there are three common practices:

- 1. Take last year's budget and, depending on orders or your subjective view of the year to come, either add to it or cut from it to arrive at a satisfactory budget for the new year. This is a rather random method, since it is not informed by what you hope to achieve in the coming year as far as the growth of your company.

- 2. Use the coming year's predicted sales as the basis for the budget. However, doing so means that you are relatively confident that your sales predictions are correct. If you are basing them on last year, and last year was a slow year, then you might end up with less funds than you need in order to keep up with the sales that actually occur. If last year was a great year, then you might end up with more budgeted costs than actual sales. In either case, the accurate prediction of your future sales is important for using this method.

- 3. The third common method is called 'blank-page' budgeting. This is usually considered to be the best approach by budget professionals because it allows you to start from scratch and use your identified objectives and priorities as the basis for the budget you create. In this scenario, you look at the coming year's objectives and then you examine what you will need in your budget in order to achieve those objectives.

Continued:

No matter what method you choose, you should create a few scenarios such as a minimum budget, a target budget, and a stretch budget.

- Minimum Budget: This is the bare essentials, the rock-bottom amount that you can see being required to achieve the lowest level of your objectives. It’s important that you truly defne what you will be able to do with this budget, and more importantly, what you will NOT be able to do.

- Target Budget: This is the level of a budget that you feel is the bare minimum in order to fully support the established objectives for the coming year. Again, you need to clearly delineate what you would be able to provide at this level. Make it realistic, achievable, and as accurate as possible.

- Stretch Budget: In this funding scenario, you are itemising what additional level of objectives you can meet if you have this higher level of budget. Don’t be surprised if you receive push back with this as staff may consider that they could not manage a higher level of performance than what the stated objectives will provide.

6.3 How to understand a Budget

A budget provides information on planned expenses and revenues over a given time period, usually one year. As you read the budget, you will see that:

- It is broken into categories corresponding to your Chart of Accounts. Each account will be represented by a line or lines on the budget, which is why they are called “budget line items.”
- There is a column for the amounts that were budgeted for each line item
- There is a column for the amounts that were actually spent (or earned) for each line item
- It might show the budget deviation in another column

- It might show the previous years’ budget information for each line item. Budget deviation is important because it helps you to determine how accurate your budgeting actually was. The larger the deviation, the more you need to reevaluate your budget.

For example, if you expected to earn £10,000 in one month but you only earned £8,000, you might have to readjust your budget for future months. Especially if significant deviation continues to occur.

Thank you...

We hope you have found this E-Book helpful.

Find out how we can guide and enable your business to prosper and grow by contacting us at info@harloworx.com to arrange a free, no obligation, 1:1 strategy session.