Part I: Getting Started

Before you get a business off the ground you have to do all the preliminary legwork and make sure that you have a viable business on your hands before you commit too much time and money. This part gets you on track right away by helping you to gather crucial information on your marketplace, potential customers and competitors, and so test whether your idea is viable. It also provides a chance for you to check out your skills and attributes to help you establish the right business for you to start.

Part II: Making and Funding Your Plan

To ensure that your business prospers you have to know something about the legal structures under which you can trade and which suits you best at the outset. You need a business plan to help you both test the viability of your proposition and to share your ideas and aspirations with others, including potential investors, bankers or partners. You also want to review the financing options to make sure that you get both the right amount and type of finance for your business needs. You don’t have to do all this on your own, because the chapters in this part list key organisations that offer advice and help to business starters.

Part III: Staying in Business

After you get going you'll almost certainly need to employ staff either full time, part time or on a temporary basis. This involves legal responsibilities that you should be prepared for. A business needs controlling in much the same way as a car or plane does. You need to understand what the key control documents are, and what they tell you about how your business is performing. You also need to have a sound appreciation of your income, expenses and tax liabilities, and how to minimise those liabilities legitimately.

Part IV: Making the Business Grow

After you have your business up and running you want to see how fast you can make it go without blowing a gasket or running off the road. Part of this process is a bit like fine-tuning a car engine. But part involves substantially changing everything, including the products and services, the markets you serve and perhaps even the very nature of your business operations. The process may even involve adopting a strategy to franchise your business idea, bolt a franchise onto your venture or form some other form of strategic alliance. This part covers the ins and outs of expanding your business safely and smartly.

Part V: The Part of Tens

The Part of Tens presents four chapters. One is a collection of warnings about the problems that most new businesses are likely to encounter and how to counteract them. Another contains details of the people you absolutely have to talk to before, during and after you've started up. The third chapter gives vital details on how to cut costs and so keep your business competitive. The final chapter provides pointers on maximising the value of your business, finding a buyer and then moving on to pastures new.

Icons Used in This Book

To help you pinpoint vital information, I've placed icons throughout the text to steer you to nuggets of knowledge.

This icon calls your attention to particularly important points and offers useful advice on practical topics.

This icon serves as a friendly reminder that the topic at hand is important enough for you to make a note of.

Business, like any specialist subject, is awash with specialised terms and expressions, some of which may not be familiar to you. This icon draws your attention to these.

This icon alerts you that I'm using a practical example showing how another business starter has tackled a particular topic. Often you can apply the example to your own business.

This icon alerts you to a potential danger. Proceed with caution; look left and right before crossing. In fact, think carefully about crossing at all when you see this icon.

This icon refers to specialised business facts and data that are interesting as background data but not essential for you to know. You can skip paragraphs marked by this icon without missing the point – but reading them may help you build credibility with outside investors and partners.

Where to Go From Here

Take a minute to thumb through the table of contents and get comfortable with the topics the book covers. Pick a chapter that strikes a particular chord with the aspect of starting a business that's uppermost in your mind. Read that and see where it leads you.

You can also use Chapter 6, 'Preparing the Business Plan', as a framework for gathering knowledge and diving back into the other chapters as you go.

If all else fails, start at the beginning. That technique has a pretty good track record.

Chapter 3

Can You Do the Business?

In This Chapter

- Understanding whether being your own boss is right for you
- Checking out various ventures
- Setting up your business at home
- Figuring out your profit motive
- Taking a skills inventory to identify any gaps

Governments are keen to foster entrepreneurship: new businesses create jobs for individuals and increased prosperity for nations, which are both primary goals for any government. If those new firms don't throw people out of work when recessions start to bite, supporting them becomes doubly attractive.

But people, you included, don't start businesses or grow existing ones simply to please politicians or to give their neighbours employment. They have many reasons for considering self-employment. The idea of escaping the daily grind of working for someone else and being in charge of their own destiny attracts most people. But despite the many potential benefits, they face real challenges and problems, and self-employment isn't a realistic option for everyone.

The questions you need to ask yourself are: Can I do it? Am I really the entrepreneurial type? What are my motivations and aims? How do I find the right business for me? This chapter can help you discover the answers.

Deciding What You Want From a Business

See whether you relate to any of the most common reasons people give for starting up in business:

- Being able to make your own decisions
- Having a business to leave to your children
- Creating employment for the family
- Being able to capitalise on specialist skills
- Earning your own money when you want
- Having flexible working hours
- Wanting to take a calculated risk
- Reducing stress and worry
- Having the satisfaction of creating something truly your own
- Being your own boss
- Working without having to rely on other people

The two central themes connecting all these reasons seem to revolve around gaining personal satisfaction – making work as much fun as any other aspect of life – and creating wealth – essential if an enterprise is going to last any length of time.

Even when your personality fits and your goals are realistic, you have to make sure that the business you're starting is a good fit for your abilities.

The following sections explore these reasons in more detail.

Gaining personal satisfaction (or, entrepreneurs just wanna have fun)

No one particularly enjoys being told what to do and where and when to do it. Working for someone else's organisation brings all those disadvantages. When you work for yourself, the only person to blame if your job is boring, repetitive or takes up time that you should perhaps spend with family and friends is yourself.

Another source of personal satisfaction comes from the ability to 'do things my way'. Employees are constantly puzzled and often irritated by the decisions their bosses impose on them. All too often managers in big firms say that they'd never spend their own money in the way the powers that be encourage or instruct them to do. Managers and subordinates alike feel constrained by company policy, which seems to set out arbitrary standards for dealing with customers and employees in the same way.

> The high failure rate for new businesses suggests that the glamour of starting up on their own seduces some people who may be more successful and more contented in some other line of endeavour.

Running your own firm allows you to do things in a way that you think the market, and your employees, believe to be right at the time.

Making money

Apart from winning the lottery, starting your own business is the only possible way to achieve full financial independence. But it isn't risk free. In truth, most people who work for themselves don't become mega rich. However, many do and many more become far wealthier than they would probably have become working for someone else.

You can also earn money working at your own pace when you want to and even help your family to make some money too.

Running your own business means taking more risks than you do if you're working for someone else. If the business fails, you stand to lose far more than your job. If, like most owner managers, you opt for *sole trader status* – someone working usually on his own without forming a limited company (find more on business categories in Chapter 5) – you can end up personally liable for any business debts you incur. This can mean having to sell your home and other assets to meet your obligations. In these circumstances, not only will all your hard work have been to no avail, but you can end up worse off than when you started. Also, winding up a business is far from fun or personally satisfying.

I don't want to discourage you, just to apply a reality check. The truth is that running your own business is hard work that often doesn't pay well at first. You have to be okay with those facts in order to have a chance of success.

Fighting poverty through trade

Traidcraft's mission is to fight poverty through trade, practising and promoting approaches to trade that help poor people in developing countries transform their lives. The company has more than 450 different products sourced from more than 100 producer groups in almost 30 developing countries, selling through its nationwide network of fair traders and online shop. Traidcraft raises funds and gives aid, help and advice to the tune of £1.5 million a year to help enterprises in developing countries. Projects include improving market access for women producers in Vietnam; helping Indian tea workers achieve sustainable livelihoods; and analysing the dairy sector in Kenya, identifying key constraints affecting smallholder dairy farmers and their access to markets. Traidcraft received the Queen's Award for Industry for Sustainable Development, along with a host of other awards. Oh, and it does a pretty good job of making money too – with £15 million turnover each year, business has been growing at an average of 18 per cent a year, making a return on capital of 10 per cent. More details are on the company's website, www.traidcraft.co.uk/socialaccounts.

Saving the planet

Not everyone has making money as their sole aim when setting up in business. According to the government's figures, around 20,000 'social entrepreneurs' run businesses aiming to achieve sustainable social change and trade with a social or environmental purpose. They contribute almost £25 billion to the national economy and assist local communities by creating jobs, providing ethical products and services using sustainable resources and reinvesting a share of the profits back into society.

Ethical businesses have some unique advantages. For example, according to those running such firms they can relatively easily attract and retain intelligent people. Over 70 per cent of students say that a potential employer's track record is an important factor in job choice. Customers also like ethical firms. According to a recent European Union survey on sustainable consumption, 86 per cent of those polled in the United Kingdom, Spain, Germany, Greece and Italy said that they felt very strongly about wanting things to be produced and marketed responsibly. They also blamed brands for not providing more environmentally and socially friendly products.

If you want to explore the prospects for starting a social enterprise, contact the School for Social Entrepreneurs (website: www.sse.org.uk; tel: 020 8981 0300), which can help with specific and tailored support. If you need funds to start a social enterprise, contact Bridges Community Ventures (website: www.bridgesventures.com; tel: 020 7262 5566), a venture capital firm with a social mission. Its founding principle is that all the funds it invests go to businesses with a clear social purpose as well as aiming to achieve financial returns for investors.

Exploring Different Types of Business

At one level all businesses are the same – they sell something to people who want to buy from them, while trying to make an honest buck along the way. At another level many very different types of business and ways of doing business exist, even within what superficially can appear to be very similar fields.

Selling to other businesses

Business-to-business (B2B) enterprises, such as those selling market research, database management, corporate clothing, management consultancy, telemarketing or graphic design, involve one businessperson selling to another. The attractions are that you're dealing with other people who have a definite need and usually buy in relative large quantities and at regular intervals. For example, an individual may buy envelopes in packs of a dozen a few times a year, but a business buys scores, perhaps even thousands, and puts in an order every month. Corporate customers are harder to win, but are often worth more when you have them. And unlike private individuals, businesses like to forge relationships that endure over time.

Some downsides exist too. Business customers expect credit, perhaps taking between 60 and 90 days to pay up. If they go bust they may owe a lot of money and take some of their suppliers down with them. You may have to attend exhibitions to make your presence known, a costly and time-consuming process, or advertise in trade directories. Check out these websites to find out more about these topics: www.idealbusinessshow.co.uk and www.b2bindex.co.uk.

Opening all hours

Conventional shops, restaurants and the like have long opening hours and have to meet the expectations of increasingly savvy consumers, whose access to the Internet has made them aware of competitive prices as well as high specifications and standards of service. The upside of any form of retailing is that you're almost invariably paid up front. But just because you get the cash in your hand doesn't mean that you don't have to meet exacting standards. Customers are protected in their dealings in a myriad of ways and if you fall short of their legal entitlement you can end up with a bigger bill than a simple cash refund. (I cover legal issues in Chapter 10, 'Marketing Your Wares'.) In conventional retailing you also have to rent premises and stock them with products, both factors that can add significantly to the business risk.

Increasingly, new retail business start-ups are Internet based. The website is in effect the shop window and the stock of products being sold may even be in a warehouse owned by a third party. This keeps up-front costs down but means keeping abreast of fast-changing technologies – the Internet, servers and computer hardware and software. (I look at these in more depth in Chapter 15.)

Making products

One of the attractions of manufacturing is that you have a greater degree of control over the quality, cost and specification of the end product than a retailer or wholesaler might. But with those advantages come some hefty penalties. Factories, equipment, stocks of raw materials and employees are costly overheads. You have to incur these expenses well before you're certain of any orders – an unlikely way into business for someone without previous manufacturing experience and a deep wallet. Such owners also bear some significant risks towards their employees. The UK manufacturing sector reports over 32,000 work-related accidents to the Health and Safety Executive each year. This figure includes over

6,200 major injuries such as fractures and amputations as well as around 40 fatalities.

A more likely route to manufacturing for a new business is subcontracting, where you're working for a manufacturer on part of a product. The most common examples of subcontractors are plumbers, electricians and carpenters in building work, metal and plastic casing production and the like in civil engineering and a wide range of activities in the information technology sector.

Servicing customers

Service industries now dominate the British economy and account for around 70 per cent of gross domestic product (the value of the goods and services that the country produces). Services include financial intermediaries, hairdressing, real estate, computer services, research and development, education, health and social work, refuse disposal, recreational, cultural and sporting activities and an extensive range of other activities where no physical goods play a major part in any transaction. In truth, however, most manufactured goods include a service element, though the business functions are often separated. For example, manufacturing businesses produce cars but are quite separate from the garage chains that repair those vehicles. But some manufacturers go further – Dell manufactures computers and also carries out delivery and many other service functions.

Service businesses require a high degree of personal involvement and as such call for founders who see their people skills as pivotal. In a nutshell, if you don't enjoy understanding the intimate details of what makes customers tick and then going out of your way to meet their needs, running a service business may be of little appeal.

Working from Home

Few dedicated statistics exist on the number of people operating home-based enterprises as distinct from those setting up in dedicated premises. IDC, a US-based research firm, claims that around 18 million of the 29 million owner-managed businesses in US are home based. US census data shows that 17.6 million businesses employ no one but the boss. Put these two facts together and working on the reasonable assumption that the majority of home-based businesses are one-man (and one-woman) bands, then around two thirds of all small business would appear to be home based. Even those not working from home now often start out from there, like the founders of Blooming Marvellous (see the nearby sidebar).

Blooming Marvellous

Judy Lever and Vivienne Pringle started Blooming Marvellous literally on a kitchen table back in 1983. Having attended a business start-up course in Kensington, London run by the author, they put further flesh onto their big idea. Both were pregnant, and after searching for the kind of fashionable clothes they used to wear and drawing a blank they guessed they'd found a gap in the market. They kept on their day jobs and would meet after work every day at Judy's house to answer enquiries, send out leaflets and despatch products out in the post every day. They outsourced work to a pattern cutter, a small factory, some fabric suppliers and eventually to a small distribution centre. After a year or so of modest sales they felt confident enough to set up their first business premises – a 1,200 square foot warehouse on a business park staffed by four of the women who'd been working in their distribution centre.

Eventually, the company employed 150 people in 14 shops and extended its range to include nursery products, toys, themed bedroom accessories and a separate brand called Mini Marvellous that catered for children aged 2 to 8 years. Over a third of sales came directly via their website. In July 2010 the company was bought by Mothercare, which three years earlier had also acquired the Early Learning Centre.

Starting a business from home gives you a number of distinct advantages over those plumping for premises straight away. A study by the US Small Business Administration tracking the survival rates on new businesses (www.sba.gov/ADVO/research/business.html >Redefining Business Success) concluded that starting from home significantly improved a founder's chances of succeeding. Other studies coming from organisations less impartial suggest that home-based business are two thirds more likely to survive the crucial first four years of trading and so establish a firm footing.

Three big advantages that a home-based business has over its peers that give it an edge are:

- **Lower costs:** Starting from home saves most of the $35,000 start-up costs that the average business incurs even before it takes its first order. The chances are that you have nearly everything you need to start up your business already somewhere around your home. The kitchen table worked fine for Blooming Marvellous (see the nearby sidebar) to make their plans, pack up their first orders and do their accounts from. You can press into service a garage, loft, spare bedroom or garden shed for a whole host of business-related tasks from holding stock to being a dedicated office space away from the normal hustle of home life. Your computer, however old, will almost definitely work just fine, unless you're starting a business at the cutting edge of design or on the Internet.
- More time: Money can buy lots of things, but time isn't one of them. However close to your business premises you are, you'll spend an hour or more a day travelling to and from it. I'm sure if your shop, restaurant or office is only a couple of miles away you won't believe that proposition. How on earth could it be possible to take an hour to travel just a mile? Well, an immutable law says that the closer your home is to your business premises, the more often you travel between the two. Ergo, if you're 20 miles away you go once a day, covering 40 miles, and if you're only 5 miles away you come

home for lunch and return once or twice more each week to collect things you've forgotten. Whatever the distance, the average weekly travel time is about the same. Working from home gives you back all that wasted time spent travelling and you can invest the time in your business.

- **Less stress:** Commuting to work on a daily basis is stressful. In any vibrant and successful economic area road works, accidents, delays and traffic jams are pretty much the norm. Few people are fortunate enough to work in a car-free area or where parking is never a problem. Even if you could find such a paradise the chances are it would be useless as a business proposition. Depopulated areas are equally devoid of customers, suppliers and people to employ.

Finding the space

As a first step list all the activities involved in getting your business to the point where it has something to sell. If you're going to run a bookkeeping service this could be quite a short list. You need a computer, some software and perhaps a leaflet setting out your prices and the range of services on offer. But if you're going to repair musical instruments, say, then you may need much more space including perhaps a workshop.

Clearly, if you live in a cul-de-sac at the end of a narrow lane surrounded by other houses you're unlikely to be allowed to manufacture using hazardous chemicals and have articulated vehicles delivering and collecting in the middle of the night. You also have to consider how your neighbours will be affected, even if you're legally allowed to operate your business.

You don't, of course, have to carry out every activity related to your business yourself, nor do you have to do it all on your premises. If you think about it you'll see that no business does everything itself.

When you know how much space you need for business and what you'll be doing in that space you can start to scour your home and garden for space to convert to business use. The following sections outline some areas to consider – not an exhaustive list, but enough ideas to kick-start your thinking.

Using the garage

The most obvious discreet space that's separate from the house and likely to be free of family traffic is your garage (if you have one). You can move cars onto the drive or a neighbouring street, subject to your insurance company being happy with that arrangement. According to the RAC Foundation, although 71 per cent of motorists have a garage, only 41 per cent use it to park their car. Most people use it as storage for junk or are too lazy to open the garage doors.

The Garage Conversion Company has sample plans and information on any possible restrictions that may apply (www.garageconversion.com; go to Conversion Ideas and then Home Office).

Parking in the parking space

This area and any private drive could be used for a caravan-based office, although you need to keep in mind that visitors, suppliers and of course you and your family still need to get access to your home.

WARNING! If you do think that a caravan is worth considering check out that your house deeds allow you because covenants were introduced into the title deeds of new properties from the 1960s onwards to prevent people keeping caravans at home. Even if you're legally allowed to keep a caravan at home you should consider any possible impact on your neighbours and discuss your plans with them. Caravans that could be used as a home office, though probably not as touring caravans, sell for upwards of £1,000.

Planting yourself in the garden

You can install a shed up to 4 square metres without planning consent under certain circumstances. The exact rules are a little complicated; for example the shed can't be bigger than 50 per cent of your garden, you can't erect one in a conservation area and your title deeds can't expressly prohibit you. Great Little Garden (www.greatlittlegarden.co.uk) and Leisure Buildings (www.leisurebuildings.com) both offer advice on planning issues and have sections on using garden sheds as home offices. Sheds that you could use for home office purposes sell at garden centres for £800 upwards.

A further alternative, if space allows, is to rent or buy a portable 'room'. Portakabin (www.portacabin.co.uk) and Foremans Relocatable Building Systems (www.foremansbuildings.co.uk) have selections of new and second-hand cabins for rent and sale.

Climbing into an attic

Converting an attic to usable space is likely to be an expensive option and something to consider later after your business is up and running: £10,000 is the entry level price including a ladder and a window; double that if you want to include a WC, plastered walls and a power supply.

You may not need planning permission but as with garden sheds the rules are complicated. Econoloft (www.econoloft.co.uk; go to FAQ and Will I Need Planning) and UK Loft Conversion (www.uk-loft-conversion.com; go to FAQ and Do I Need to Get Building Regulations and Planning Approval?) have information on the rules and much else besides.

Doubling up in the spare room

If you do have a spare or under-utilised room then your search for office space is probably over. It will have heat, light and power and may also be out of the way of general family traffic. If it's currently a bedroom you could get the best of both worlds by putting in a sofa bed and desk with locked drawers. In that way occasional guests can still use the room and you can have it for most of the time. Though far from ideal this can be a low cost option that you can implement quickly.

Options (www.optionsfit.com) provides guides and products for turning your spare room into an office.

Checking out the rules

Whatever business you plan to run from home and whether the space you use is inside or outside of your property you need to check out a number of important rules and regulations before you start up.

Planning consent and building regulations

The extent to which the use of your home and the land it stands on changes determines whether or not you need planning consent or to consider building regulations. You may need permission for any structural alterations, increase in traffic, noise, smells or anything such as operating unreasonable hours or any disturbance that could affect your neighbours.

You can find out informally from your local council before applying and the Communities and Local Government website (www.communities.gov.uk; go to Planning, Building and the

Environment) has detailed information on all these matters. You can also get free answers to specific questions using UK Planning's Planning Doctor (www.ukplanning.com), a service supported by some 20 UK councils.

Guidelines for using space at home

Keep these factors in mind when deciding on an area of your home to work from:

- The room or area needs to be well lit, warm in winter and cool in summer.
- The space shouldn't be claustrophobic because you could be in it 12 hours a day.
- Somewhere you can close the door, shut your business off and get on with normal family life will be a great asset.
- Allow room for some modest expansion. Try to anticipate what your business might look like a year out and make sure the space you allocate can accommodate that. Moving is disruptive, time consuming and expensive.
- You'll need power, a telephone line and access to the Internet.

Looking at health, safety and hazards

If you'll be working with materials that are flammable, toxic, give off fumes or are corrosive you should check on the website of the Health and Safety Executive (www.hse.gov.uk/risk) where you'll find detailed guidance and advice on all aspects of safety at work.

Considering insurance

Your home insurance policy won't cover any business activity so you must inform your insurer what you plan to do from home. You can find out more about whether or not what you plan to do from home needs special insurance cover and where to find an insurance company on the Business Link website (www.businesslink.gov.uk; go to Health, Safety, Premises; Insurance; Insure Your Business and Assets – General Insurances; and then Business Insurance If You Work from Home).

Managing the mortgage

Unless you own fully the freehold your property some other party such as a mortgage lender, landlord or freeholder may need to give their permission for you to run a business from home. Even as a freeholder you could find that a covenant has been included into your title deeds to prevent you operating certain activities from your home.

Realising business rates

You currently pay council tax on your home, but after you start using part of it or your grounds for business purposes you could be liable to pay business rates on the part of the property you use for work. You can see some examples of how business rating is applied to home-based businesses on the Valuation Office Agency website (www.voa.gov.uk/council_tax/examples_working_from_home.htm). Some types of small business, particularly those in rural areas providing products or services of particular benefit to the community, are exempt from paying business rates, or pay at a reduced rate. Your local council will have details of such schemes.

Anticipating capital gains tax implications

Any increase in value of your main home is usually free of capital gains tax (CGT) when you sell. However, if you set aside a room or particular area solely for working in then you may be liable for CGT on that proportion of any gain. If you expect to use a large (over 10 per cent) part of your home for business, take professional advice from your accountant and check the HM Revenue and Customs website (www.hmrc.gov.uk/cgt) for more information on CGT and how to calculate any possible liability.

Tax rates and their methods of payment are always in a state of flux, more so since the government introduced emergency measures in 2010 to reduce the country's indebtedness.

Readying for refuse

If your business will create additional or different refuse from that of a normal domestic nature then you should check your local council's policy on collecting for businesses. Also check on NetRegs (www.netregs.gov.uk), the government website that provides free environmental guidance for small businesses in the UK, what your responsibilities are for disposing of waste and hazardous substances.

Keeping in with the neighbours

After you've satisfied yourself that you're complying with all the relevant rules and regulations you'd still be prudent to advise your immediate neighbours of your plans. They may be concerned when they see any unusual comings and goings from your home and a timely word sets their minds at rest. Talking with neighbours will be especially important if you're doing building work.

The Central Office of Information service Directgov has some useful pointers on what might cause problems with neighbours and how to resolve such issues (www.direct.gov.uk; go to Home and Community, Your Neighbourhood Roads and Streets, and then Neighbour Disputes).

Dealing with the family

You might be inclined to slop around just because you're working at home. The dangers here are twofold:

- You'll give out the wrong signals to everyone around you. As far as they can see you're just 'at home' and as such available for more or less anything that they'd usually expect in a domestic environment.
- You may not feel as though you're at work yourself. The operative word here is *appropriate*. That doesn't have to mean a suit and tie, but 'smart casual' is a good yardstick and certainly a notch up from what you wear around the house normally, say at weekends.

Dress is a powerful way of sending signals to those around you that you're 'at work'. Here are some other tools to help harmonise business and personal life while you work.

Negotiating with your partner

Your spouse, partner or housemate, whether or not he has a part to play in your business, will be affected and expect to be consulted on how you plan to make use of what he probably sees as his premises. The effect is double if he's picking up the financial slack until your business gets going. These measures help keep them your loved one onside:

- Tell him about your business ideas early on and why you think you'll succeed without disrupting home life unreasonably.
- Discuss the space you need, why you need it and if necessary 'trade' space. If you have to have one of the bedrooms, see what can you offer as compensation. In one rather dramatic case a boat builder needed all of the downstairs rooms for 12 months to build a prototype. The boat builder agreed to build a patio and conservatory the year his first boat sold.
- See whether you can provide a 'quick win' for everyone in

your home. For example, if you need broadband Internet offer access to everyone either by setting time aside on your computer or by providing another wireless enabled computer. Or if you're painting and redecorating your office, get other rooms done too.

- Explain the upside potential of what success will mean for everyone in your family when your business gets established: more money; part-time employment for those who want it; and eventually perhaps, a move to business premises.

Handling children

One of the advantages of starting your business from home is that you can adopt a great work–life balance from the outset. You can take the kids to school, be home when they get back, share meals with them and handle emergency trips to doctors and dentist yourself, rather than having to call in favours from relatives and friends. Few working more conventionally out of an office an hour or more's commute away can look after family matters with such relative ease.

Pre-school children who are going to be at home when you need to work are a different matter altogether. Sometimes they're asleep or resting and you're free to work at will. Otherwise you have two options. The simplest is to have a nanny to cover your peak working hours. Make sure the nanny knows you're working and find somewhere in the house where any noise won't disturb you. Alternatively, find a childminder or nursery nearby.

Vanquishing visitors

You may live in an area besieged by door-to-door salespeople, over-friendly neighbours who now know you're working from home or politicians after your vote. You can be certain than no one will be calling uninvited to discus business. Dealing with an unwanted visitor may only take a couple of minutes, but the interruption to your work flow may add as much as 20 minutes to that wasted time. Three visitors a week and you've lost an hour's output, mounting up to nearly seven man days over the year. That's probably equivalent to half the amount of holiday you'll be able to take in your first year or so in business, so you need to find a way to isolate yourself from such distractions.

Assessing Yourself

Business isn't just about ideas and market opportunities. Business is about people too, and at the outset it's mostly about *you*. You need to make sure that you have the temperament to run your own business and the expertise and understanding required for the type of business you have in mind.

The test at the end of this section requires no revision or preparation. You may find out the truth about yourself and whether or not running a business is a great career option or a potential disaster for you.

Discovering your entrepreneurial attributes

Business founders are frequently characterised as people who are bursting with new ideas, highly enthusiastic, hyperactive and insatiably curious. But the more you try to create a clear picture of the typical small business founder, the fuzzier that picture becomes. In reality, the most reliable indicator that a person is likely to start a business is that he has a parent or sibling who runs a business – such people are highly likely to start businesses themselves.

That being said, commentators generally accept some fairly broad characteristics as desirable, if not mandatory. Check whether you recognise yourself in the following list of entrepreneurial traits.

- **Accepting of uncertainty:** An essential characteristic of someone starting a business is a willingness to make decisions and to take risks. This doesn't mean gambling on hunches. It means carefully calculating the odds and deciding which risks to take and when to take them.

  Managers in big business tend to seek to minimise risk by delaying decisions until they know every possible fact. They feel that working with out all the facts isn't prudent or desirable. Entrepreneurs, on the other hand, know that by the time the fog of uncertainty has completely lifted, too many people are able to spot the opportunity clearly. In fact, an entrepreneur is usually only interested in decisions that involve accepting a degree of uncertainty.

- **Driven to succeed:** Business founders need to be results oriented. Successful people set themselves goals and get pleasure out of trying to achieve them as quickly as possible and then move on to the next goal. This restlessness is very characteristic.

- **Hardworking:** Don't confuse hard work with long hours. At times an owner-manager has to put in 18-hour days, but that shouldn't be the norm. Even if you do work long hours, as long as you enjoy them, that's fine. Enthusiasts can be very productive. Workaholics, on the other hand, have a negative, addictive, driven quality where outputs (results) are less important than inputs. This type of hard work is counterproductive. Real hard work means sticking at a task, however difficult, until you complete it. It means hitting deadlines even when you're dead-beat. It means doing some things you don't much enjoy so you can work your way through to the activities that you enjoy most.

- **Healthy:** Apart from being able to put in long days, successful small business owners need to be on the spot to manage the firm every day. Owners are the essential lubricant that keeps the wheels of small business turning.

They have to plug any gaps when other people are ill or because they can't afford to employ anyone else for that particular job. They can't afford the luxury of sick leave. Even a week or so's holiday is something of a luxury in the early years of a business's life.

- **Innovative:** Most people recognise innovation as the most distinctive trait of business founders. They tend to tackle the unknown; they do things in new and difficult ways; they weave old ideas into new patterns. But they go beyond innovation itself and carry their concept to market rather than remain in an ivory tower.

- **Self-disciplined:** Owner-managers need strong personal discipline to keep themselves and the business on the schedule the plan calls for. This is the drumbeat that sets the timing for everything in the company. Get that wrong and you send incorrect signals to every part of the business, both inside and out.

  One of the most common pitfalls for novice businesspeople is failing to recognise the difference between cash and profit. Cash can make people feel wealthy and if it results in a relaxed attitude to corporate status symbols such as cars and luxury office fittings, then failure is just around the corner.

- **Totally committed:** You must have complete faith in your business idea. That's the only way in which you can convince all the doubters you're bound to meet along the route. But blind faith isn't enough. You have to back your commitment up with a sound business strategy.

- **Well rounded:** Small business founders are rarely geniuses. Some people in their business nearly always have more competence in one field than they could ever aspire to. But the founders have a wide range of ability and a willingness to turn their hand to anything that has to be done to make the venture succeed. They can usually make the product, market it and count the money, but above all they have the self-confidence that lets them move comfortably through uncharted waters.

Working out a business idea that's right for you

Take some time to do a simple exercise that can help you decide what type of business is a good match with your abilities. Take a sheet of paper and draw up two columns. In the left-hand column, list all your hobbies, interests and skills. In the right-hand column, translate those interests into possible business ideas. Table 3-1 shows an example of such a list.

Table 3-1 Matching a Business Idea to Your Skills

Interest/Skills	*Business Ideas*
Cars	Car dealer; repair garage; home tuning service; valet and cleaning/taxi
Cooking	Restaurant; home catering service; providing produce for home freezers
Gardening	Supplying produce to flower or vegetable shops; running a nursery; running a garden centre; landscape design; running a gardening service
Using a computer	Typing authors' manuscripts from home; typing back-up service for busy local companies; running a secretarial agency; web design; bookkeeping service; selling online

Having done this exercise, balance the possibilities against the criteria that are important to you in starting a business.

Figuring out what you're willing to invest

I'm not just talking about money here. How much are you willing to invest of your time, your interest and your education, as well as your (and your investors') money?

Spending time

How much time are you willing to devote to your business? That may sound a basic enough question, but different businesses done in different ways can have quite different time profiles. One business starter I know started a French bakery in London. He was determined to make his own croissants and did so for the first three months. But making his own bread meant starting work at 4 a.m. Because he didn't close until city workers passed his door on their way home, by the time he cleaned up and took stock, he was working a 15-hour day. But he still had the books to do, orders to place and plans to prepare. He eventually settled for a 10-hour day, which meant that he had to buy in ready-baked croissants.

Furthering your education

You may have identified a market opportunity that requires skills over and above those that you currently have. There may, for example, be a gap in the market for Teaching English as a Foreign Language (TEFL), but to do so requires a month of intensive study plus a £1,000 course fee. Doing the TEFL certificate may involve you in more skill upgrading than you want to commit to, at the outset at least. So either you need to find customers who don't require you to have that qualification, or you need to think about a less educationally challenging business.

Keeping things interesting

If you want to start a restaurant and have never worked in catering, get a job in one. That's the best way to find out whether you like a particular type of work. You may find that a restaurant looks very different from behind the chair as opposed to on it. Some businesses are inherently repetitive, with activities that follow a predictable pattern. If that suits you, fine, but if not then perhaps you need to consider a business venture with a shifting range of tasks.

Weighting your preferences

After you have an idea of some of the businesses you may want to start, you can rank those businesses according to how closely they match what you want from starting a business. Go through the standards you want your business to meet and assign a weight between 1 and 5 to each, on a range from not important at all to absolutely must have. Next, list your possible business opportunities and measure them against the graded criteria.

Table 3-2 shows a sample ranking for Jane Clark, an imaginary ex-secretary with school-aged children who needs work because her husband has been made redundant and is looking for another job. Jane isn't in a position to raise much capital, and she wants her working hours to coincide her children's school day. She wants to run her own show and she wants to enjoy what she does.

Table 3-2 Weighing Up the Factors

Criteria	*Weighting Factor*
Minimal capital required	5
Possibility to work hours that suit lifestyle	5
No need to learn new skills	4
Minimal paperwork	3
Work satisfaction	2
Opportunity to meet interesting people	1

Because minimal capital was an important criterion for Jane she gave it a weight of 5, whereas meeting interesting people, being less important to her, was only weighted 1. Jane gave each of her three business ideas a rating, in points (out of five) against these criteria. A secretarial agency needed capital to start so she gave it only 1 point. Back-up typing needed hardly any money and she allocated 5 points to it. Her worked-out chart is shown in Table 3-3.

Table 3-3 Scoring Alternatives

		Secretarial Agency		Back-up Typing		Authors' Manuscripts	
	Weighting Factor	*Points*	*Score*	*Points*	*Score*	*Points*	*Score*
Criteria							
Minimal capital	5 ×	1	5	5	25	4	20
Flexible hours	5 ×	1	5	3	15	5	25
No new skills	4 ×	2	8	5	20	5	20
Work satisfaction	3 ×	4	12	1	3	3	9
Minimal paperwork	2 ×	0	0	4	8	5	10
Meeting people	1 ×	4	4	3	3	4	4
Total score			34		74		88

The weighting factor and the rating point multiplied together give a score for each business idea. The highest score indicates the business that best meets Jane's criteria. In this case, typing authors' manuscripts scored over back-up typing, because Jane could do it exactly when it suited her.

Chapter 20

Ten People to Talk to Before You Start

In This Chapter

- Identifying all the key people who can help you get started
- Leveraging your network of contacts to maximum advantage
- Taking advantage of free advice
- Getting the lowdown on what people really think are your strengths and weaknesses

Starting up a business can be a lonely endeavour, but you don't have to do it all on your own. Hundreds of people, some just a few feet away, can give you useful insights into your skills and attributes, and they may even have a useful perspective on the viability of your business idea.

Speaking with Your Spouse

Your spouse may not know a great deal about your great business idea, but you can be sure she knows a lot about you. Your spouse can remind you of your weaknesses and help you play to your strengths. She also needs to be prepared for the long hours and lack of holidays that are sure to feature in the early months and years as you get your business established. This may mean that you need to re-divide the existing sharing of household and family tasks, such as taking children to school, family visits and painting and decorating, to reflect the new balance of work. That may prove contentious, so talking the issues through at the outset may save conflict and arguments when time constraints really start to bite.

The money put into the business is going to have an impact on the money available for other areas of family expenditure, so your spouse also has to be comfortable with the financial commitments you're taking on. Unlike most other investments you may have made – on houses and cars, for example – you can lose all the money you put into a business irrevocably.

One would-be entrepreneur who set out to open a bookshop was reminded by her partner how she disliked dealing with the general public. She loved books and delighted in visiting book fairs and auctions. But when reminded that essentially the job entailed opening and closing a shop six days a week, her enthusiasm level took a dive. Better take a dive before you start up than have your cash take a dive a few weeks afterwards.

If you're thinking of taking up some franchises – Chemical Express (www.chemicalexpress.co.uk), for example – then you may be asked to bring your partner along to the initial interview even if she's not going to be involved in the running of the business. Chemical Express wants to make sure that your partner is backing you 100 per cent, both practically and emotionally.

Making Use of Your Professional Network

The people in your network of associates have large chunks of the knowledge you need to get your business successfully launched. The ability to create and maintain strong professional relationships is an important key to business success. Networking is a vital business skill that lets you cultivate lasting business relationships and create a large sphere of influence from which you can find new clients, contacts, referrals and opportunities.

You can use a network for just about anything, from finding a new supplier to getting introductions to overseas sales agents. You can find a reliable bank manager, a new accounting software package or a great venue for your next business meeting. Your network contacts, unlike almost everyone else in the business world, are usually unbiased and authoritative. You should make few major decisions without recourse to network contacts.

Benefiting from Entrepreneurs Who Started a Similar Business

People like nothing more than talking about themselves and their successes. Obviously, if someone thinks you're going to steal her customers, she shuts up like a clam. But if the business you plan to start is unlikely to infringe on their sphere of activities, most established entrepreneurs are only too happy to pass on some of their hard-earned tips.

First establish that you're not going to tread on the entrepreneur's toes. For example, if you plan to start up in the same line of business 30 miles away, you have little chance of causing each other much trouble. You may even be able to open a shop at the far end of the same town as a competitor without doing the entrepreneur any serious damage.

Use your common sense as to whom to approach and, to be on the safe side, double the distance that you feel is a safe gap between you.

You may also find someone who's had a business failure in the field you plan to start up in and is prepared to talk. You can find such people by scouring the press or talking to trade associations and other operators in your sector.

Don't take everything entrepreneurs say, even the most successful ones, as inevitably right. The five businesspeople who comprise the dragons in the BBC programme *Dragon's Den*, with a combined personal wealth nearing £1 billion, can reasonably be expected to know a thing or two about new business ideas. Andrew Gordon presented to them his invention for propping up wobbly table legs and they unreservedly gave it the thumbs down. Despite being ripped to shreds as a concept, his stabletable (www.stabletable.co.uk), eight plastic leaves pinned together, has sold in industrial volumes on the Internet. The device earned the 34-year-old in excess of £500,000 in his first year and is now being sold in packs of 25 for use in restaurants, hotels, pubs and cafes throughout the world. Andrew is an inspiration to all would-be business starters whose ideas receive a less than rapturous reception from fellow entrepreneurs.

Events can be a valuable route to extending your business network. Useful organisations include the following:

- The Glasshouse (http://theglasshouse.net), founded in 1998, holds networking events bringing entrepreneurs, financiers and business advisers across all sectors together to provide support, encouragement and inspiration to would-be business starters.

- The Junior Chamber International United Kingdom (www.jciuk.org.uk) is a personal development and networking organisation for the under-40s. It's part of the global Junior Chamber International (JCI), which has over 250,000 members in 100 different countries.

- Networking4business (www.networking4business.com) organises business-to-business networking events that enable you to meet many other businesspeople without any commitment and in a relaxed, informal atmosphere.

Spending Time with a Friendly Banker

Despite having had a bad press during the credit crunch, these guys and girls have a lot to offer other than oodles of cash (or not!). Bankers see a lot of different people about a lot of different businesses. You can draw on their wide range of knowledge and experience. Your banker may be familiar with your type of business or the location you're interested in, or have advice on different financing options.

Start by talking with a bank manager you don't want to borrow money from. Begin the conversation by asking for advice, rather than money. Only when you've convinced yourself that your proposition is an appropriate one for a bank should you make a pitch. (See Chapter 8 for more about banks and bank managers.)

Tapping into Your Local Enterprise Agency Director

Over 1,000 business experts are sitting in a local office somewhere near you just waiting to offer advice, help, encouragement and support to anyone thinking about starting a business. The even better news is that the services they provide are either free or low cost. Enterprise Agencies (see Chapter 7) have been around for 25 years and are an initiative started by big business to help small business.

Bank managers, business executives on loan as part of their career development and the occasional civil servant, accountant and lawyer staff these agencies. Make sure that you grab your fair share of this expertise.

Communicating with Your Current Boss

Talking to your boss about anything other than the job in hand is always a tricky decision. Talk about your entrepreneurial vision too soon and you may find yourself sidetracked for promotion and pay rises and perhaps even first in line for the next downsizing event. Leave it too late and your boss may see your action as disloyalty at best and betrayal at worst.

If you plan to start up in the same line of work and possibly even try to take some key accounts with you, then you'd better talk to a lawyer rather than your boss. But if the climate is right and you can talk to your boss, a number of valuable things may happen. You boss can be a source of investment capital, a business partner or a useful resource for business advice and contacts.

Your boss may even become your first customer, if the businesses are compatible.

Calling Your Colleagues

Those you've worked alongside over the years have formed a view about your talents. Your spouse has seen you after work, but they've seen you at work. If they don't know your strengths, weaknesses, foibles and desires, then no one does. At worst they may tell you that you're barmy and explain why; at best they may join you in the venture or invest their hard-earned savings in your business.

If you were thinking about taking on a partner, then casting your eye around your colleagues is a good place to start looking. Remember, it cuts both ways. Although they may know a lot about how you perform at work, you know as much about them.

Bringing in Your Best Friend

On the assumption that your best friend isn't your spouse, then she represents someone else who should be able to tell you whether you're the right sort of person to start up the particular business you have in mind. You can start out by asking your friend to review your skills and knowledge inventory (see Chapter 3) and so provide a valuable crosscheck on your self-assessment. In fact, you should always find someone who knows you really well to go through this and the business idea-evaluation process (also in Chapter 3). Unfortunately, everyone's capacity for self-deception is unlimited, and you shouldn't miss any opportunity for a reality check.

Reporting to an Accountant

You need an accountant in any event (I explain the process of finding one in Chapter 14). However, don't miss out on making the maximum use of as many accountants as possible when researching to establish your business. Take all the free advice you can get, because most accountants give you a free first meeting in the hope of signing you up as a client.

Pump the accountants as much as you can for any tips, pointers or advice on the business you have in mind.

- REMEMBER Accountants are the first port of call for any entrepreneur seeking help and advice, ahead of bank managers, small firm advisers and business associates. As a consequence, they're the repositories of an enormous amount of information on every aspect of business, not just finance.

- Accountants draw an increasing amount of their revenue from non-accounting tasks, and some even make more money from providing general business advice than they do from auditing.
- Most accountants are sole traders or in small partnerships operating in much the same way as you plan to do when you set up your business. So unlike bank managers, who all work in large organisations, accountants can identify with your problems and concerns.

Talk to the Added Value Network (website: www.avn.co.uk; tel: 0845 226 2371), a network of over 5,000 accountants working in over 400 offices across the United Kingdom who are focused on helping entrepreneurs start up and grow their businesses. It offers a free 'Business Builder Review' tailored to suit your needs but based on its experiences in helping 115,000 owner-managed businesses.

Plugging into a Business Angel Network

Business angels (see Chapter 8) have some attractive attributes. They aren't as risk averse as venture capital firms; they act more quickly, putting up money in weeks rather than months; and they aren't so fussy about your pedigree. But when it comes to giving a helping hand, they're absolute stars. Using the business angel networks outlined in Chapter 8 you can find an angel with expertise in the sector in which you have an interest.

Chapter 22

Ten Steps to Prepare to Move On

In This Chapter

- Deciding when to sell up
- Putting a price on your business
- Getting the best advice
- Figuring out what to do next

However much you love your business, the time comes when you want to realise some or all of the value tied up in the business. It may be just that you want to buy a yacht and have the time for that round-the-world adventure you've been promising yourself; it may be that you've taken the business as far as you can and to realise its full potential it needs another skipper at the helm; or it may be that your backers, if you have any, want to bail out themselves – venture capital firms often have itchy feet and want to take their profits from one sector to pile them into the next big thing. Whatever the reason for looking for an exit, to get the best value out of your business follow these ten guidelines.

Monitoring Market Prices

Timing is crucial when it comes to selling a business. Since 1900, 27 'bull' markets have existed, when company shares rise sharply, with corresponding 'bear' markets, the latest example being in 2008–2010, when over-optimistic investors get mauled as the bottom drops out of stock markets. These ups and downs can result in very steep curves, with business values oscillating by as much as a 50 per cent and the changes in the market's perception of value often having little to do with the actual performance of businesses themselves.

Businesses listed on the stock market have no difficulty in working out what their businesses are worth at any moment in time – share prices are published daily in the financial press and every few minutes on financial websites. But because most businesses, yours in all probability included, aren't listed on a stock market, you can't easily keep tabs on market sentiment for the value of your business.

Step forward BDO Stoy Hayward and take a bow. BDO Stoy Hayward's Private Company Price Index (PCPI) tracks the relationship between the current FTSE price/earnings ratio (P/E; check how to calculate this in Chapter 5) and the P/Es currently being paid on the sale of private companies. Put simply, the PCPI lets a company without a stock market listing get a reasonable idea of what it may actually sell for now. Go to www.bdo.uk.com/library/a-z > PCPI Private Company Price Index.

Valuing Your Business

Setting a precise value on a business isn't quite as simple as, say, determining the price of your home. One possible way is to add up the assets, take away the liabilities and in theory the difference is the value of your business. However, your assets comprise items such as stock that may be hard to value, and debtors who may or may not actually pay up. (I cover these terms in Chapter 13.) Businesses are more usually valued using a formula known as the price/earnings ratio (I show how this is calculated in Chapter 5). P/E ratios vary both with the business sector and current market feeling about that sector. The market as a whole generally trades with P/Es of between 14 and 20, with the average since 1870 being 15.

You can check out the P/E for your business sector either by looking in the *Financial Times*, or at ProShare's website (www.proshareclubs.co.uk, then click Research Centre, then Performance Tables). You need to register to access the data on the ProShare website, but registration is free. There you can see the current P/E ratio for every company in your sector, as long as they're listed on the London Stock Exchange. If you want to see how much interest exists in your business sector right now, visit Interactive Investor (www.iii.co.uk, select Markets and then Sectors). There you can see the sector whose shares investors have bought and sold the most over the past day, month and year.

Private companies don't trade on as high a P/E multiple as their big brothers on the stock market. So if a public company in your sector is on a P/E of 12, as a private company your prospective P/E is around 8, or a third less. Why? Good question. The simplest answer is that although shares in your business are hard to dispose of, you can unload a public company every business day by making a phone call to your broker. In other words, the premium is for liquidity.

Figuring Out Who to Sell To

Determining a selling price is one thing, but finding a willing buyer is a much more challenging task. Price and buyer are inter-related factors, because whatever equation you use to arrive at business value, at the end of the day a business is only worth what someone with the dosh can pay. These are your options:

- **Sweetheart deal:** Selling out to someone you know or do business with is an easy option. Unfortunately, it's not always the way to get the best price for your business, because only one buyer is in the frame. Not only does it take two to tango, but your sale works better if you have at least two people interested in buying your business.

- **Trade sale:** This is when you sell out to another company, usually a much larger one with access to finance and other resources that may enable your business to have a continuing future. This involves publicising that you're selling up and creating the environment for several bidders to enter the ring. You can sell the business yourself, perhaps by advertising or by word of mouth. But usually you appoint a business broker to handle the deal, much as you'd use an estate agent to sell your house.

- **Management buy-out (MBO):** You may be able to sell your business off to your management team. That involves them raising the money, perhaps from a venture capital firm (I cover this subject in Chapter 8). You can find out more about MBOs from the Centre for Management Buy-out Research (CMBOR), founded by Barclays Private Equity and Deloitte at the Nottingham University Business School (www.nottingham.ac.uk/business/cmbor).

- **Management buy-in:** This involves selling the business to a new management team, invariably with the financial backing of a venture capital firm. The team is led by someone, usually from a similar industry to yours, who's proved successful in building up and selling out a business before.

  BIMBO is a combination of a management buy-in and buy-out, usually involving an external managing director being brought in to run your business with your management team and financial backing from a venture capital firm.

- **Employee benefit trust:** This involves forming a trust to hold shares on behalf of employees, so that the employees can in effect end up owning a substantial slice of the business.

Some tax incentives are available to retiring owners who sell (or gift) shares to such a trust. You can find out more about this option from Employee Ownership Options (www.employeeownership.co.uk/finance.htm). Its goal is to raise awareness of the business options available to small firms when they're threatened with closure either as a result of succession problems or as a result of divestment.

- **Going public:** This involves selling shares in the business to the public through a stock market flotation. In that way you can realise some of the value in your business gradually over a period. This is a complicated and expensive process and you need professional advice. AIM, the junior UK stock market, has seen over 3,000 companies listed since it started in 1985, some of which have at best a modest trading record. Check out the London Stock Exchange (www.londonstockexchange.com/companies-and-advisors/aim/for-companies/joining/aim.htm) for a full description of the options, what's involved, how much it costs (lots!) and who can advise.

- **Passing on to the family:** Less than 33 per cent of family businesses are passed on to the second generation and barely 13 per cent survive through to the third generation. So much for the bad news – the ones that do can be very successful. ALDI (short for 'Albrecht Discounts'); Michelin, controlled and run by François Michelin, his son Edouard and their partner René Zingraff; and Mars, founded by Minnesotans Frank and Ethel Mars, who invented the Milky Way bar, are among the world's biggest family businesses (check out *Family Business Magazine* at www.familybusinessmagazine.com, then Oldest Family Companies for a full list). The Family Firm Institute (www.ffi.org), the International Centre for Families in Business (www.icfib.com), Peter Leach LLP (www.peter-leach.com), who started the Family Business Centre at accountants BDO Stoy Hayward and now runs it as a stand-alone venture, and the Family Business Institute (http://familybusinessinstitute.com) are organisations dedicated to providing education and networking opportunities for family businesses, as well as help with succession planning.

- **Selling the assets:** If the business can't be sold, perhaps because it's unprofitable, or because it's a one-man band and has no prospects of operating without the owner, then the remaining option is to sell off the assets, pay out what's owed and pocket what's left.

You almost certainly already know the name of the buyer of your business. Make a list of all the competitors, customers, suppliers and employees who you believe may benefit from taking over your business. Then trawl the financial press to see who else has bought or been involved in any way in the sale of a company similar to yours. Check out *Acquisitions Monthly* (www.aqm-e.com) to see what deals have been done and what active buyers are in the market; and *Daltons Business* (www.daltonsbusiness.com/SearchStat.asp), where you can see the market demand statistics by different types of business.

Dressing to Kill

Whoever you plan to sell your business to, you should plan ahead to make the business look its best. Blemishes such as poor profit performance, bad debts, credit downgrades and being dragged through the courts by ex-employees claiming to have been unfairly dismissed aren't desirable. You should try to make the three years prior to your exit look as good as possible. That means profit margins should be consistently high, the sales and profit curve should be heading upwards and strong financial control systems should be in evidence.

Check out these organisations to see how your business is likely to appear to a would-be buyer.

- Inter Company Comparison (www.icc.co.uk) and Jordans (www.jordans.co.uk) provide regularly updated online company information services that enable users to access and retrieve data on individual companies, directors and shareholders. They also enable users to produce industry, group, peer and individual reports, allowing you to compare your business's performance with that of other similar companies, as well as obtaining in-depth financial profiles.
- Creditgate.com (www.creditgate.com) and Credit Reporting (www.creditreporting.co.uk/b2b) are among a growing number of companies that offer a comprehensive range of credit reports instantly online, including credit check, credit rating, company profile, credit score, credit reference, credit limit, company directors and county court judgments (CCJs). You can get your own business rating from one of these agencies to see how you appear to a would-be buyer.
- The Centre for Inter-firm Comparison (www.cifc.co.uk) helps businesses of every kind improve their profitability and productivity by providing expertise in benchmarking, performance measurement and financial control. It gathers financial information on industries based on detailed information that participating firms provide – in absolute confidence – on a comparable basis. The Centre then provides the information showing industry average and best and worst performance standards, without, of course, revealing the individual participants' data.

When you want to bring a purchaser to the negotiation table, you need to prepare an initial marketing document called a *sales memorandum*. The management write the initial draft and your corporate adviser then polishes it up. It should:

- Make the business sound attractive and feature product literature, photographs, charts and tables.
- Be a source of solid information, but not over-full of numbers and analysis. The buyer and their adviser will get your accounts themselves.
- Show that the business has scope for improvement and development if someone with more money and wider skills and experience takes it forward. Otherwise it's hard for potential buyers to see what value they can add.
- Contain no detailed confidential information or commercially sensitive information, such as the name of customers or suppliers. No buyer makes a final decision on the basis of a sales memorandum, so you can provide this information later to serious buyers only.
- Be tailored to meet the needs of different potential buyers. For example, competitors know a lot about the industry and your products, so you don't need to explain that to them.

Finding Advisers

The information in this chapter should give you an idea of what you need to know in order to exit from your business successfully. But although you should know the questions, you need advice with finding the answers. These organisations can help you find professional advisers and advice from those experienced in selling businesses:

- HW is a national business advisory and accountancy firm with a network of over 60 offices strategically placed throughout England, Wales and Scotland, offering advice on a range of financial matters including specific help with selling your business (www.hwca.com/business-services/buying-and-selling-businesses/).

- Business Link (www.businesslink.gov.uk, then select Buy or Sell a Business and then Getting Ready to Sell) has a comprehensive range of advice covering everything from preparing your business for the sale to handling potential redundancies, including links to sources of professional help.
- BDO Stoy Hayward, an accountancy firm, has a publication, *Guide to Selling Your Business* (available from www.bdo.co.uk), which sets out its service offer to entrepreneurs planning to sell up.

Getting the best corporate finance advice, as the whole subject of selling and buying a business is known, isn't cheap. Expect to pay out between 3 and 7 per cent of the value of your business, and to have to lay out a largish five-figure sum on the table to kick things off. But good advice can double the amount of money you actually end up with when you take tax, pensions and warranties into consideration.

Doing Due Diligence

When you buy a house, you and your surveyor crawl over everywhere with a tape measure to check out sizes, and employ various instruments to see whether any damp, dry rot or other unpleasant infestation exists that could affect its value. Your lawyer makes sure that the sellers actually own the property, no mortgage is outstanding and no imminent plans exist to build a motorway through the garden. A very similar process happens when businesses are bought and sold, in a process known as *due diligence*. The accounts have to be correct, tax paid up to date and mortgages declared, and any lawsuits rumbling in the background for unfair dismissal of employees, disputes with suppliers or defective products supplied need to be flushed out into the open.

At the end of the due diligence process, lots of people end up with liabilities. The corporate finance firm and the lawyers are responsible for the quality of their advice and if they get it wrong they can be sued. The accountants are responsible on your side for delivering proper accounts and on the buyer’s side for interpreting them correctly. The seller too has to give guarantees that she’s told the truth, the whole truth and nothing but the truth. If that proves not to be the case, she may miss out on a slug of the sale price.

Sellers are usually required to give *warranties and indemnities* to the buyer to the effect that every important thing she says about the business and its accounts is true, and that she’s have left nothing material unsaid. By way of guarantee, a portion of the selling price isn’t paid up for a period of a year or so, giving time for the buyer to uncover skeletons.

AllBusiness.com, a website with resources for entrepreneurs including how-to articles, business forms, contracts and agreements, expert advice and blogs, has a free 40-point due diligence checklist (go to www.allbusiness.com, then select Shop Legal Forms, then Mergers and Acquisitions, then Due Diligence Checklist). You can buy the full Monty for $25.

Earning Out Your Profits

One trick that buyers and their canny advisers use to make sure that your business is really worth all the bundles of dough they’re paying out is to make you do some of the hard work for them. The thinking behind this is that because you’ve been running the firm for years, no one’s better qualified than you to make sure that you keep sweet customers and suppliers with whom you presumably have a good working relationship.

Typically, if an earn-out is proposed it's for between 10 and 30 per cent of the sale price and covers a period between one and three years. The rule here is that sellers should resist such proposals and buyers should insist!

Most of the costs involved in selling your business are based on a percentage of the selling price. That figure includes the earn-out amount, whether or not the figure is actually achieved. Some unique tax implications exist that you or your adviser should check out with HM Revenue and Customs (www.hmrc.gov.uk/manuals/ersmmanual/ERSM110000.htm).

Starting Up Again

Having worked out how to start a business, build it up and sell it on, you may be justified in thinking that you have a winning formula for making money: just keep turning the handle. One business founder who came on a programme at Cranfield School of Management bought out a chain of three pubs, built it up to a dozen and then sold out to a national brewery chain for a healthy profit. He repeated the process three times more and for all I know is still following his simple but effective business model. The value he discovered was that big brewers didn't want to buy a pub or two at a time. That's too much like hard work. In any event, it takes as much management time to buy one pub as it does to acquire a chain.

A buyer doesn't want to pay you for a business only to find out that you start up a new business and become a competitor. A buyer expects you to sign a non-compete clause as part of the sale contract. This requires you not to compete for a certain number of years within a designated geographical area. The good news – for sellers, that is – is that such agreements are difficult to enforce and aren't always looked on favourably by the courts, because they restrict an individual's employment options.

Becoming a Business Angel

If you don't want to run a business but do want to stay involved, then you can consider becoming a business angel, backing other people's businesses with your money and expertise. I cover this subject in the section on business angels in Chapter 8.

Robert Wright started up his business, a one-plane regional airline, straight from business school; he'd already qualified as a pilot. Robert built the company, trading as City Flyer Express, up to a substantial venture and sold it to British Airways for a sizeable eight-figure sum. Over the years following the sale he took stakes in a handful of small businesses and some not so small ones, such as Wizzair.com, using only a modest fraction of the gain made from the sale of his own company.

Winding Up

If for any reason a business appears to have no value, perhaps because it's making losses and has no assets worthy of the name, it may still be possible to salvage something from the wreckage. In the worst case your creditors can apply to wind your business up if they're owed more than £750. They can serve a statutory demand (Form 4.1) for the money due and if it's not paid or secured, or a settlement isn't agreed, within 21 days, they can appoint a liquidator. The liquidator's job is to pay off the creditors, starting with herself. No realistic likelihood exists of anything being left for the owner(s) going this route.

Before you reach this stage you should take professional advice urgently, not least because you may be liable for more expenses than you think. In theory, if you're trading as a limited company then your liabilities are capped at your stated share capital. However, trading on after the business has become insolvent leaves the directors open to a charge of wrongful trading. In such cases the directors can be personally liable for the company's debts.

Talk with your accountant, check out your position by reading up on the government's Insolvency Service website (www.insolvency.gov.uk) or contact a member of the Insolvency Practitioners' Association (www.insolvency-practitioners.org.uk). A directory of members is on the website.

To access the cheat sheet specifically for this book, go to www.dummies.com/cheatsheet/startingabusinessuk.

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Table of Contents

Introduction

So you pulled this book off the shelf and decided to give us a try. Good move. You've come to the right place. Believe it or not, we don't need to read tea leaves to know a bit about your background. In fact, we'd go so far as to suggest that you probably find yourself in one of the following situations:

- You've a great idea for a brand-new gadget and can't wait to get your own company up and running.
- Your boss just turned over a new leaf and wants a business plan from you in three weeks.
- You've always run the business without a business plan, and you're the one who turned over the new leaf.
- You thought you had a business plan for the company, but it doesn't seem to be doing the job that it should.
- The business and economic climate looks a whole lot more hostile than the last time you thought about writing a business plan and you want to be doubly sure of getting it right.

Are we close? Whatever your situation, you're not going to need those tea leaves to make a business plan, just read this book instead. We can't tell you the future of your business. But the business plan that we help you put together prepares you for the future. And we're with you every step of the way.

Why You Need This Book

You may not know how to make a business plan just yet, but you're smart enough to know that a plan is important. We know, from years of working with companies large and small, that a business plan is of working with companies large and small, that a business plan is crucial – your plan is the only way that you can get where you want to go.

This book helps you create your business plan step by step. Along the way, you may discover things about your business that you never realised – things that just may help you beat the competition. We even throw in a few laughs as well.

Sure, for some of you, a business plan is something that you're required to put together to raise money for a startup company. At best, it's a formality; at worst, a real pain in the neck. But a business plan isn't just there to raise money; it can also be a powerful tool – one that's bound to make your company a better place to work and your business a more successful operation.

Is a business plan magic? No – no sorcery here. A business plan works because it forces you to stop and think about what you're doing. It prompts you to figure out what you want your company to be in the future and how you intend to make the future happen. Then your plan acts as a template, guiding you through the steps required to meet your goals. For example:

- A business plan requires you to look carefully at your industry, your customers and the competition to determine what your real opportunities are and what threats you face.

- A business plan takes a good hard look at your company as well, so that you can honestly and objectively recognise its capabilities and resources, its strengths and weaknesses and its true advantages.

- A business plan coaxes a financial report, a forecast and a budget out of you, so that you know where you stand today and what the future holds.

- A business plan prepares you for an uncertain future by encouraging you to come up with business strategies and alternatives to increase your chances of success down the road.

How to Use This Book

Business Plans For Dummies, 3rd Edition will help your business succeed no matter who you are or what your job description is, whether you're part of a large corporation or a one-person show. Depending on your situation, you may find yourself dipping into and out of the book in different ways:

- If business plans are new to you, you may want to start at the beginning and let us be your guides. We take you from your company mission all the way through to making your business plan work, and we keep your head above water the whole way.
- If you're a little more experienced, you may want to head straight for one of the more interesting watering holes: how to recognise the critical success factors in your business, for example, or where to look for your company's strengths and weaknesses. After dipping in anywhere along the way, you'll most likely discover yet another section where you want to spend some time.

Just remember – no matter where you find yourself, you're never too late to start a business plan, and never too late to make the one that you have even better. In each case, you can find what you're looking for between these bright-yellow covers.

How This Book Is Organised

Business Plans For Dummies is divided into six parts, based on the major elements of your business plan. You don't have to read all the parts, however, and you certainly don't have to read them in order.

Each chapter is devoted to a particular business-planning topic, and you may need some chapters more than you do others. Feel free to skip around; pick and choose what you're really interested in.

Part I: Determining Where You Want to Go

When putting together a business plan, you have to decide where you want to end up in the future. This part helps you get on track right away by establishing a mission for your company, along with business goals and objectives. Then we help you examine your company's values and your vision for the future.

Part II: Sizing Up Your Marketplace

To make a useful plan for your business, you have to know something about the market you're going after. In this part, we help you examine your industry and figure out what it takes to be successful by identifying where your opportunities and threats come from. We also help you analyse your customers, so that you can understand who they are, what they need and how you can group them to better serve them. Finally, we help you scope out your competition, trying to determine exactly what you need to win.

Part III: Weighing Up Your Company's Prospects

In this part, we turn our full attention to your company. We help you look as objectively as you can at your capabilities and resources, identifying the strengths that you can count on and the weaknesses that you need to deal with. We also help you zero in on what you do best, enabling you to figure out the real value that you provide for your customers and the true advantage that you have over your competitors. Finally, we guide you through your finances and help you put together a financial forecast and a budget.

Part IV: Looking to the Future

The main reason why you make a business plan in the first place is to get ready for what lies ahead for your business. Part IV helps you look into your future and prepares you for change. We introduce several standard alternatives and show you how you can use them to come up with strategies of your own. And we consider the different directions that you can take as your company grows bigger.

Part V: A Planner's Toolkit

Your business plan is no good if you can't put it to work. In this part, we help you shape your company to be as efficient and effective as it can be. We also help you prepare the people in your company so that they've the skills they need to accomplish the goals set out in your plan. Finally, we show you a sample of a real business plan, so that you know – start to finish – what you're aiming for.

Part VI: The Part of Tens

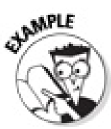
The Part of Tens is a collection of reminders, hints, observations and warnings about what to do – and not to do – as you work through your business plan. These chapters focus on the big picture, so look at them whenever you need a little perspective on where you stand and where you're headed, especially if the road ahead starts to look a little bumpy.

Icons Used in This Book

To guide you through your business plan preparation, we include icons in the left margins of the book. Here's what they mean:

This icon indicates tips to put you way ahead of the competition.

Wherever you see this icon, you find definitions of business-guru terms.



This icon calls your attention to illuminating examples from the business world.

This icon flags situations that apply mostly to large companies, but that may help small companies as well.

Ouch!, you may get burned unless you heed these warnings.

This icon serves as a friendly reminder that the topic at hand is important enough for you to note down for the future.

This icon lets you know about websites from which you can download free financial spreadsheets, tables and other useful goodies. These can help take the grunt and groan out of number-crunching cashflow forecasts, 'what if' projections and other tedious but vital repetitive calculations, as well as keep you up-to-date on important rules and regulations.

Where to Go from Here

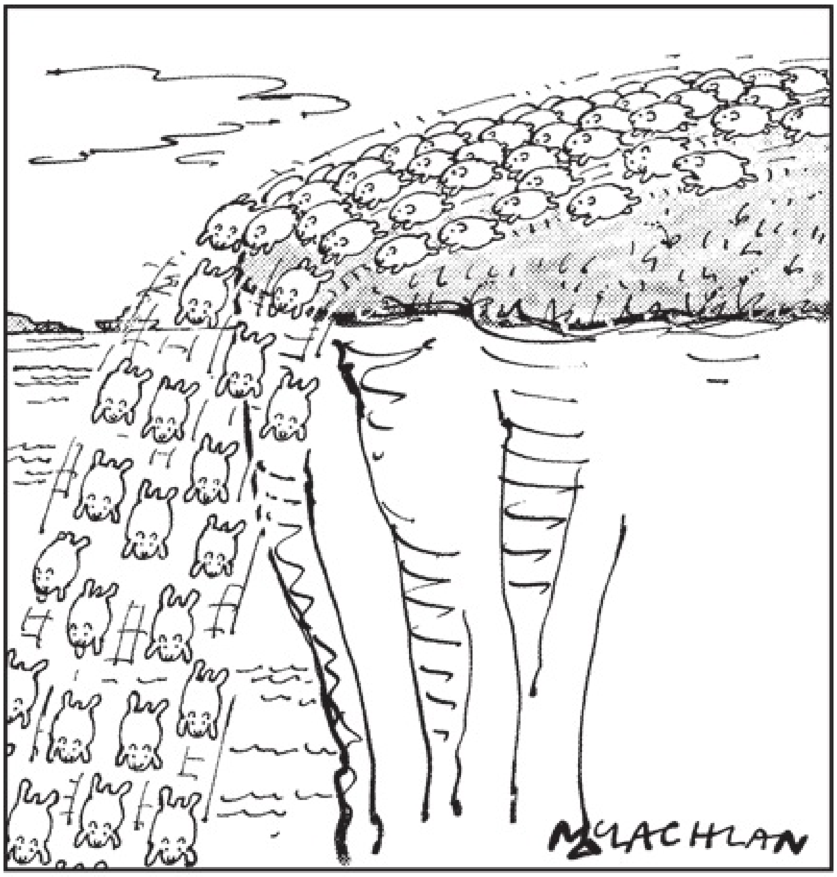
Take a minute to thumb through this book and get comfortable with what's inside. Then pick out one or two chapters that tickle your fancy. Better yet, turn to a chapter that you already know something about. Or, if you're really daring, turn the page and start at the beginning.

Don't forget to use the table of contents for a chapter-by-chapter breakdown. The index is also an excellent place to turn to find a specific topic right away.

Want to make your business plan look great, or need some hands on support? Go to `www.dummies.com/go/businessplansfordummies` to find tips and advice on shaping up your business plan. You can also download a glossary from here to get your head around the business jargon.

Part I

Determining Where You Want to Go



'In a previous life, before I became a lemming, I was a small company without a business plan'

In this part . . .

No matter what you'd like to finish, from wallpapering the bedroom to hooking up the new router, it's awfully easy to pass over all the preliminary stuff and jump right into the thick of the project. Let's face it, the preliminaries are a bit boring. But for the really important things in life – and in business – preparation is everything. So preparing to do your business plan ranks right up there in importance with each of the other major steps as you create a plan.

In this part, we help you prepare to plan by looking at what a business plan is all about. First, we look at how to establish a mission for your company and develop business goals and objectives with all your stakeholders in mind. We also point out why values are so important to your company, and show you how you can use your company's values. Finally, we look at how a vision for your company gives you something to aim for and a direction to take.

Chapter 3

Setting Off in the Right Direction

In This Chapter

- Understanding why a set of values is so important
- Figuring out who your stakeholders are
- Identifying your company's current beliefs and principles
- Putting together your company values statement

You may ask yourself why on earth you're reading a chapter on values in a book on business planning. We can hear what you're thinking: Hey, it's the twenty-first century. Today's business ethics revolve around survival in the marketplace: cater to your customers, beat the competition (hey, demolish them!), make 'loadsamoney' and run.

Yet even in a business world dominated by market economies, global competition and the laws of the jungle, values still matter. In fact, we're convinced that successful business plans must start with a statement of company values.

Now, don't get us wrong here – we have no quarrel with profits. We absolutely love them, and we expect to earn lots for ourselves over time. But short-term profits don't go far over the long haul. Values and a vision keep everybody in your company – even if you're only two people – on course and heading in the same direction. What if you're a company of one? Taking time to establish your values and vision will still keep you on track as your business grows.

In this chapter, we point out why values are so important in the first place. We help you identify your company's values by noting who has a stake in your business and discovering the beliefs and business principles that you already hold. Then we show you how to put together a values statement for your company.

Wondering Why Values Matter

Your company faces all sorts of options, alternatives and decisions every day that you're in business. If you take the time to define your company's values, these principles and beliefs can guide your managers, employees, or just you (if you're in business for yourself) as you face complicated issues that don't have easy answers. When the unexpected happens, you can react quickly and decisively, based on a clear sense of what's important.

Looking at tough choices

Consider a scenario. Frank Little is an independent consultant working for a large UK-based petrochemical firm that we'll call Bigg Oil. He's conducting market analysis for one of the company's largest divisions and is involved in an important project concerning the development of new overseas business.

Frank's good at what he does, and he sketches out several options for the production, distribution and pricing of petrochemicals in three countries. In one of his most promising scenarios, the numbers for a country that we'll call Friedonia yield substantially higher short-term profits than the other two – primarily because that nation doesn't yet have expensive pollution-control procedures in place. The other two nations have environmental laws similar to those in the UK.

Here's Frank's dilemma: by introducing its product line into Friedonia, Frank's client can make huge profits. Sure, the resulting pollution may cause ecological damage that may possibly be traced back to Bigg Oil. But this situation is not illegal, according to Friedonia's current laws, and Frank stands to get a lot more business from Bigg Oil if the project goes ahead.

He agonises over the situation and his report. What should Frank recommend to senior management:

- Go for the short-term bucks?
- Voluntarily enact procedures to control pollution, even though the company is not legally required to do so?
- Forget Friedonia until the country has stronger environmental laws?

Maybe you can relate to our friend Frank's quandary, having faced similar kinds of ethical questions and trade-offs in your own business.

If Frank had a set of values written down, those values can help him out of his quandary. Values provide a framework to guide people who are confronted with difficult choices.

WARNING!

Having no fundamental guidelines to follow – or, worse yet, being told to play it safe or 'don't rock the boat' – businesspeople in Frank's position are forced to choose the safest path, and that path is often determined by profits, promotion prospects or job security. But the easiest path is not always the best.

Avoiding being lost and unprepared

What happens when disaster strikes? We all remember headline-grabbing stories in which unexpected troubles tarnished the images of all sorts of companies, such as the following:

- **Exxon (oil manufacturer and exporter):** The infamous oil tanker *Valdez* spilled millions of gallons of crude oil into a pristine Alaskan bay, causing incalculable environmental damage. The TotalFinaElf tanker *Erika* did much the same off the Brittany coast in 1999.
- **Perrier (natural carbonated water bottler):** In 1989, French-based Perrier was the market leader in bottled mineral water, its name synonymous with purity and quality. Perrier water was on the tables of virtually every high-class restaurant around the world. Sales peaked at 1.2 billion bottles a year. The plant at Vergèze, near Nimes, was tooled up for 1.5 billion, with capital investment and personnel to match. The Perrier water benzene contamination incident in 1990 wiped out a lifetime investment in promoting the images of purity and quality. Coca-Cola had a similar experience when its brand of ‘pure’ bottled water, Dasani, had to be withdrawn in 2004. Far from being produced using a ‘highly sophisticated purification process’, based on NASA spacecraft technology, it turned out to be contaminated with bromate, a potentially cancer-causing chemical.
- **Intel (computer chip manufacturer):** A flaw in its Pentium chip (which was or wasn’t really significant, depending on who you talked to) led to corporate apologies and product replacement.

These companies all stumbled over so-called externalities (to use economics doublespeak). *Externalities* refer to those circumstances that extend beyond a firm’s immediate control to issues that are deeper than simply making a mint. Over time, the failure to see the power of these outside forces – and to account for social and ethical values when you make decisions – can result in serious or even disastrous consequences for your company. As the examples illustrate, we’re not talking about one unhappy customer, folks; we’re talking about big-time trouble.

Our list of examples could include episodes involving companies of every size in all industries. Faced with unexpected events, unprepared companies often react as though they’re in total disarray. When a company lacks a set of stated values that everybody subscribes to, the interpretation of important issues is left up to anyone and everyone in the company. Then the company is likely to find itself speaking with many voices and going in several directions, resulting in confused employees, unhappy customers, an angry public and maybe, disappointed investors.

Valuing having values

A *values statement* is a set of beliefs and principles that guides the activities and operations of a company, no matter what its size. The people at the top of your company must exemplify your stated values, and your company’s incentive and reward systems should lead all employees to act in ways that support your company’s values.

Here’s an example of just how important a values statement can be. In the summer of 1985, the United States experienced what was described by many people as a terrorist attack. Someone in the Chicago area tampered with bottles of Tylenol, the best-selling pain reliever from McNeil Laboratories, a subsidiary of the health care giant Johnson & Johnson. An unknown number of Tylenol capsules were laced with cyanide, and eight people died. The tragedy created a business crisis for Johnson & Johnson.

Johnson & Johnson reacted quickly and decisively to the threat

Johnson & Johnson reacted quickly and decisively to the threat against its customers. The company pulled every bottle of Tylenol from retail shelves throughout America – a massive undertaking that ultimately cost the company more than $100 million – and it did so immediately upon learning of the problem.

When the crisis was finally over, Johnson & Johnson became a corporate role model. The company's lightning-fast response to the Tylenol incident earned it a reputation as one of the most responsible companies in the world, one that takes its civic duties seriously and is willing to put the public good ahead of its own profits. Johnson & Johnson's many businesses benefited accordingly.

Why did Johnson & Johnson behave so well when so many other companies find themselves paralysed in similar situations? The reasons are summed up in the company's statement of values, an extraordinary document called the Johnson & Johnson Credo (see the 'The Johnson & Johnson Credo' sidebar).

The Johnson & Johnson Credo

'We believe our first responsibility is to the doctors, nurses and patients, to mothers and all others who use our products and services. In meeting their needs, everything we do must be of high quality. We must constantly strive to reduce our costs in order to maintain reasonable prices. Customers' orders must be serviced promptly and accurately. Our suppliers and distributors must have an opportunity to make a fair profit.

We are responsible to our employees, the men and women who work with us throughout the world. Everyone must be considered as an individual. We must respect their dignity and recognize their merit. They must have a sense of security in their jobs. Compensation must be fair and adequate, and working conditions clean, orderly and safe. Employees must feel free to make suggestions and complaints. There must be equal opportunity for employment, development and advancement for those qualified. We must provide competent management, and their actions must be just and ethical.

competent management, and their actions must be just and ethical.

We are responsible to the communities in which we live and work and to the world community as well. We must be good citizens – support good works and charities and bear our fair share of taxes. We must encourage civic improvements and better health and education. We must maintain in good order the property we are privileged to use, protecting the environment and natural resources.

Our final responsibility is to our stockholders. Business must make a sound profit. We must experiment with new ideas. Research must be carried on, innovative programs developed and mistakes paid for. New equipment must be purchased, new facilities provided and new products launched. Reserves must be created to provide for adverse times. When we operate according to these principles, the stockholders should realize a fair return.'

For more than half a century, the credo has successfully guided behaviour and actions across the sprawling Johnson & Johnson empire, currently a $17 billion worldwide corporation employing more than 109,500 people.

MANAGER'S TIP

The Johnson & Johnson Credo works so well because each employee takes it seriously. With the active encouragement and involvement of top management, from the chairperson on down, the credo is invoked, praised and communicated throughout the company. Old-timers and new employees alike are continually reminded of the importance of the message. Promotions depend, in part, on how well managers live up to and disseminate the values of the credo within their areas of responsibility. The credo is a significant factor in Johnson & Johnson's continued performance near the top of its industry – and an indication of why the company is so well regarded by so many people.

Remember the following points about values:

- A values statement is a set of beliefs and principles to guide your company's activities.
- Clearly stated values can help your company react quickly and decisively when the unexpected strikes.
- Everybody in your company must embrace the company's values.

Identifying Your Organisation's Values

Values statements often address several audiences. The Johnson & Johnson Credo (refer to the preceding section), for example, speaks to doctors, patients, customers, suppliers, distributors, employees, stockholders and the community at large. As you begin to work on your own company's values, you need to think about different groups, each of which has some relationship with your company.

Stakeholders are groups of people who have a claim or interest in how you operate your business. The stakes involved can be tangible and legally binding, or they may be informal arrangements or expectations that have developed over time. Although all these interested parties have a stake in what you do, stakeholders may have different ideas and rather strong feelings about what values your company should embrace.

You're going to put together a values statement primarily for the benefit of employees, of course (or just for yourself, if you operate a business alone). But your company's values are going to have an obvious impact on all your stakeholders, including owners, shareholders, customers, suppliers, regulators – and even your mother, if she loaned you £10,000 to start your business. As you start to identify the values that are most important to your company, you're going to have to consider different viewpoints, including the following:

- The demands of your shareholders (if you have any)
- The interests and expectations of all your stakeholders
- The beliefs and principles that you and your company already hold

In the following sections, we take a closer look at each of these factors. When you come up with a preliminary list of company values that you feel are most important, you are in a good position to go on and create a values statement.

A short values statement that works

McKinsey provide a marvellous example of a set of values that have been strongly and clearly articulated for over 60 years in such a way that any member of the professional staff who is or ever has been employed with McKinsey, anywhere in the world, can instantly, seriously and passionately tell you what the company stands for. This situation is brought about through a set of 'guiding principles':

Serving clients:

- Adhere to professional standards.
- Follow the top management approach.
- Assist the client in implementation and capability building.
- Perform consulting in cost-effective manner.

Building the firm:

- Operate as one firm.
- Maintain a meritocracy.
- Show a genuine concern for our people.
- Foster an open and non-hierarchical working atmosphere.
- Manage the firm's resources responsibly.

Being a member of the professional staff:

- Demonstrate commitment to client service.
- Strive continuously for superior quality.
- Advance the state of the art of management.
- Contribute to a spirit of partnership through teamwork and collaboration.
- Profit from the freedom and assume the responsibility associated with self-governance.
- Uphold the obligation to dissent.

Thinking about investors

Economists argue that when it comes to company values, you really have to worry about only one significant group: the shareholders. On paper, at least, the shareholders are the true owners of the firm, and they deserve your undivided attention. In this view of the world, managers are simply paid agents of those who own the company, no matter how far removed those owners may be, and you don't need to know much more about values except to carry out your shareholders' wishes.

Now, we can't really argue with this picture, as far as it goes, but it doesn't square with the intentions of many shareholders out there today. For starters, your company may not have any investors, unless you count yourself and the bank account that you wiped out to start your company. In addition, pension and mutual funds now control the majority of publicly held stocks, and the investors who buy these funds are mainly interested in making their own personal nest eggs grow. These shareholders are absentee owners. They seldom demand a serious say in management decision making. When something goes wrong with the company or with their fund, they simply sell the shares and get on with their next investment.

So what's our point? Although shareholders obviously are an important bunch, deserving the attention of companies that have shareholders, their demands shouldn't necessarily crowd out all other voices. Remember – your shareholders have the luxury of selling off shares and moving on to other choices when things go wrong. As a manager or owner, you don't have that option.

> Your company will be much better off in the long run if you take a broader view, acknowledging not just the shareholders, but also all the stakeholders, giving each group the attention that it deserves.

Considering the rest of the crew

If you think about it, you may be surprised at how many types of people are involved in what your company does – everyone from suppliers to distributors and from bankers to customers. Each group has its own set of interests and looks to your company to fulfil a series of promises. The explicit promises that you make may take the form of legal agreements, licences, freelance agreements, or purchase orders. Your implicit promises represent the unwritten purchase orders. Your implicit promises represent the unwritten expectations of the various groups that have dealings with your company.

For each group of stakeholders that you identify, ask two basic questions:

- What are these people most interested in?
- What do these people expect from my company?

In other words, what is their stake in the activities and behaviour of your company? At first glance, it may seem that your interests conflict with your stakeholders' interests. *You* may want to maximise profits over time as one of your company's key values, for example. You may decide that serving customers is important as well. But what do your *customers* want? They certainly have a stake in your business, and you're probably safe to say that they're looking for quality products and services at reasonable prices.

Do these two values conflict with each other? Not necessarily. Wouldn't most customers rather buy from companies that they trust, companies that they feel comfortable with, companies that have served them well in the past? In addition, customers don't really like the uncertainty and time wasted in trying new products or services, and they won't make a change unless they're really pushed to do so. In other words, most of your customers don't want to deny you profits, because they realise that your business – and their favourite goods and services – won't be around for long if you can't make any money. (For the lowdown on figuring out your customers, check out Chapters 5 and 6.)

At the same time, customers aren't stupid and certainly don't want to be taken advantage of. We've all heard stories about food and hardware stores that try to make a quick buck after floods, hurricanes or earthquakes. Although competition usually keeps prices in check, scarcity creates opportunity and the temptation to overcharge customers. But again, customers are stakeholders in the business, with interests and expectations. After a disaster is over and the clean-up is behind them, those same customers often take their cash elsewhere, rewarding stores that may have behaved more responsibly in the crisis.

Now you need to bring together all your information on the people who have a stake in your company and to create a stakeholder profile. Follow these steps:

1. **List all interest groups that have a relationship with your company.**

   Don't forget to include the less-obvious candidates. Your list may include customers, owners, shareholders, banks, creditors, suppliers, distributors, business partners, industry associates, regulatory agencies, advocacy groups and so on. (See Figure 3-1 for further detail.)

2. **Rank the stakeholders by importance to the business.**

   How does each group affect your business goals?

3. **Record what you think are the interests of each group.**

4. **Record what you think are the expectations of each group.**

Do your company's actions fit with what you've identified as being your key stakeholders' expectations? Always be aware of how your business decisions are perceived by the general public. How do those decisions look from the other side? Do you see satisfied customers, contented employees, helpful creditors, responsive suppliers and eager distributors? If not, how is your company going to respond to those stakeholders who feel that you're letting them down?

Ideally, of course, you want to plan ahead when it comes to your dealings with all stakeholders. The secret to responding before molehills become mountains lies in having a clear understanding of each group's expectations and a set of values that acknowledges each group's interests.

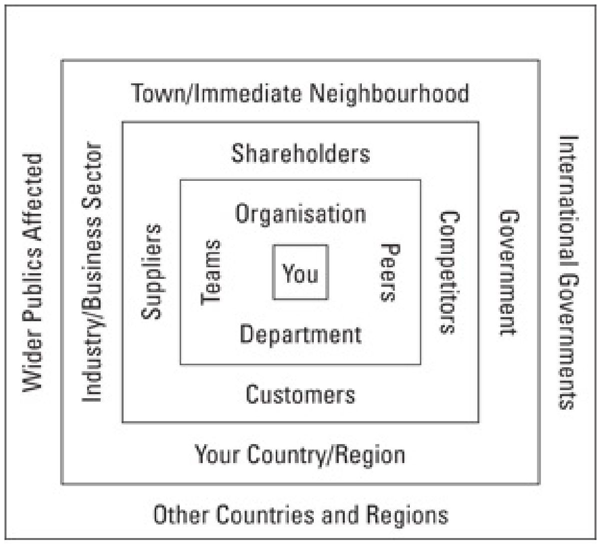


Figure 3-1: Stakeholder mapping.

Existing beliefs and principles

Drawing up a list of abstract beliefs and principles is one thing, putting those beliefs to the test is another. Tough choices come along, forcing you to examine your beliefs closely. If you run a one-person company, you already know something about what you stand for. If you're part of a bigger company, chances are that certain beliefs and values are inherent in the way in which your company does business. The best way to get to the heart of those beliefs and principles is to imagine how you'd respond to tough dilemmas.

Think about the situations described in the Beliefs and Principles Questionnaire (see Figure 3-2). Ask other people in your company, or trusted colleagues from outside your business, how they'd react to these situations. Chances are you wish that the questionnaire included a box marked *Other* or *Don't know.* But the whole point of situations that put your values to the test is that they're not always easy.

Answers to the questionnaire point to the beliefs and principles that your company's managers and employees already hold.

Keep in mind that this questionnaire has no right or wrong answers; no one's going to send a note home or give anyone a bad mark. You're simply trying to identify the basic values that your company already feels comfortable with. Completed questionnaires give insights into the general beliefs and principles that your company considers to be important.

When thinking about your company's beliefs and principles bear in mind that:

- Many people, ranging from employees to customers, have a stake in what your company does.
- Different stakeholders may have different viewpoints when it comes to your company's values.
- Your company needs to acknowledge as many stakeholder perspectives as possible.
- Company values should be tied to the beliefs and principles that you already hold.

Figure 3-2: Beliefs and Principles Questionnaire.

Beliefs and Principles Questionnaire

Situation	*Possible response*
A disgruntled customer demands a full sales refund on a product. The product isn't defective but can't be resold. The customer insists that it just doesn't work correctly. Would you be more inclined to:	❑ Send the customer away, keeping the sale on the books ❑ Refund the customer's money, absorbing the loss but betting on repeat business and loyal customers
You are faced with filling a key position in your company. Would you be more inclined to:	❑ Recruit a person from the outside who has the necessary job skills but little experience in your industry ❑ Promote an experienced and loyal employee, providing job-skills training
You are forced to let one of your employees go. Would you tend to dismiss:	❑ The young, recently hired university graduate, inexperienced but energetic ❑ The 55-year-old manager with 20 years at the company, solid and hard-working but somewhat set in his or her ways
You find out that a long-term supplier has been routinely undercharging you for services, increasing your own profit margins. Would you be inclined to:	❑ Let the matter pass, assuming that it's ultimately the supplier's mistake and responsibility ❑ Take the initiative to correct the invoice error in the future ❑ Offer to not only correct the mistake, but also pay back the accumulated difference

(continued)

Beliefs and Principles Questionnaire *Continued*

Situation	***Possible response***
You have a brilliant and creative employee. Unfortunately, this employee continually flouts the rules and disrupts the entire company. Would you tend to:	❑ Tolerate the behaviour ❑ Work on ways to correct the situation ❑ Sack the employee
An employee is faced with a personal dilemma. To meet a deadline on an important project, the employee must work overtime and miss a child's birthday celebration. Which do you tend to think of as the "better" employee:	❑ The one who willingly agrees to work overtime ❑ The one who declines to come in and instead attends the birthday party
To meet your profit target for the coming quarter, you are faced with reducing costs. Would you lean toward:	❑ Cutting back on customer-service expenses ❑ Reducing current investment in new product development ❑ Missing the quarterly target, concluding that the long-term investments are both necessary and justified
When developing the compensation packages for managers in your company, would you support:	❑ Incentives based primarily on rewarding individual effort ❑ Compensation systems that promote attainment of group or team-based goals
You discover that one of your products doesn't quite meet its published specifications. Would your likely response be to:	❑ Immediately alert your customers to the discrepancy ❑ Invest some time and effort in understanding the problem before informing customers ❑ Quietly correct the error, assuming that if customers were having problems, they would have already come to you
Rank the following in terms of their importance to you in your business:	❑ Maximise profits ❑ Satisfy customers ❑ Create jobs ❑ Promote new technologies ❑ Win product-quality awards ❑ Beat the competition ❑ Maintain long-term growth ❑ Dominate markets

Putting Together the Values Statement

When you've a good idea of just who your company's stakeholders are, and when you've got to grips with the general beliefs and principles that your company already holds, you have to bring these two worlds together. But how do you create a written statement of values based on those general beliefs and principles that also guide your company toward doing the right thing in the eyes of all your stakeholders?

First, keep in mind that your company's values statement represents

First, keep in mind that your company's values statement represents more than a quick to-do list. Your values reach beyond quarterly goals or even yearly targets. They're meant to guide you through those tough decisions as you build a sustainable business that lasts and grows over years and decades.

Maybe your company already has some sort of values credo in place. If so, you're a step ahead of the game. (You lose points, however, if you have to glance at the dusty plaque on the office wall to read it.) If you can't dig up a ready-made values statement to start with, begin putting together your own. You've two options.

Developing a values statement

You may not have the luxury of spending weeks or months to develop a values statement, so we show you a quick way to create one to set your company on the right track. If your company is small, you can follow the steps yourself or with one or two of your colleagues – no need for long meetings and careful review:

1. **Meet with your company's chief decision-makers to talk about the general company values that should guide employee behaviour.**
2. **Prepare a first-draft list of all the values discussed in the meeting and circulate copies for review.**
3. **Schedule one or two follow-up meetings with senior managers to clarify and confirm a final set of values.**
4. **Create a values statement that captures the agreed-upon values clearly and concisely, and get it approved.**
5. **Meet with managers at all levels to make sure that they understand the importance of, and reasoning behind, the company values statement.**
6. **See that every employee gets a copy of the statement.**

The values statement that you come up with here may serve you well for a long time. At the very least, it should meet your needs while you work on a more complete and permanent version.

If you're part of a larger company, however, you're going to have to go through a bit more rigmarole to get a consensus. Sorry.

Make sure that every employee receives a copy of your company's values statement, along with an explanation of its purpose. If you're in business for yourself, place a framed copy of the values statement near your desk or (if you work from home) stick it on the fridge. Don't let it gather dust. For a bigger company, print the values statement on wallet-sized cards, and don't forget to include it in the annual report. Your company's values must be referred to, relied on and understood to be a guiding force in the actions and activities of every person who represents your company.

Preparing a values statement – the full Monty

Why is the quick way to create a values statement not always good enough? If you're part of a large firm, the quick way relies heavily on the ideas and suggestions of people at the top of the organisation. Yet the best insights on company values often come from employees themselves – people from different backgrounds and various levels in the company who can draw on a range of business experiences.

The long way to create a values statement takes a little more effort, but getting these employees involved usually is worth it. Follow these steps:

1. **Select three or four representative groups of employees, including a mix of people from all levels and functions in your company.**

2. Have the groups meet on a rather formal basis over a two-to three-month period to come up with values that should guide the behaviour of every employee in the firm.

You have to point the groups in the right direction at the beginning. Start by asking everyone to fill out the questionnaire shown in Figure 3–2 earlier in this chapter.

3. Ask group members to create a short list of the values that they think are most important.

Encourage them to back up this list with their reasons, reminding them that values are often the tiebreakers when it comes to tough management decisions and difficult choices.

4. Bring the lists together and create a priority ranking of all the values suggested.

5. Compose a statement, motto, or credo that includes the most significant and widely held values, along with compelling reasons for those values.

6. Have the groups review and ratify your values statement.

When the time comes to conduct those annual employee performance reviews (you know, the ones that everyone loves to hate), use them as an opportunity to promote your company's values. Bring out a copy of the values statement and ask each employee how well his or her individual activities reflect the company's values. At the same time, ask yourself whether the incentive and reward systems in your company work toward supporting those values.

Keep the following in mind when putting together a values statement:

- Even though you think that you know your values, getting them down on paper is worth the effort.

- The best insights on company values come from employees themselves.
- Make the values statement available to everybody in your company.

Chapter 5

Taking a Closer Look at Customers

In This Chapter

- Checking out who your customers are
- Discovering why your customers buy . . .
- . . . And why they may not buy again!
- Finding out how your customers make choices
- Remembering the big picture
- Dealing with business customers

The most crucial part of business planning involves taking a long, hard look at customers – those you enjoy having, those you would love to land and those you would just as soon give away to some unsuspecting competitor. The stakes are high. How well you know your customers ultimately determines how successful you are. But figuring out what makes customers tick can be downright frustrating. If you've tried it before, you may be tempted to throw up your hands and leave the entire mess to the so-called experts – marketing gurus, consultants or perhaps astrologers. Don't. This chapter shows you how to better acquaint yourself with your customers so that you can offer them more value and serve them more profitably than anyone else out there.

In this chapter, we take a closer look at why customers buy your products and services in the first place by exploring their needs and motives. And we investigate how they make choices in the marketplace by examining customer perceptions and their decision-making process. Finally, we take a quick look at your customers that are actually other businesses.

Checking Out Who Your Customers Are

A fresh look at customers starts with the ones you enjoy seeing – those who regularly purchase goods or services from you. But sometimes, knowing what something is *not* can be just as important as knowing what it *is*. You can find out as much about your own business and best customers by observing the other kinds of customers out there – the customers who are difficult, the customers who are gone and the customers whom you never had.

The good customer

Good customers are the ones who bring a smile to your face, the ones you like serving, the ones who appreciate you, the ones who keep you in business. They're the customers you want to keep coming back time and again. To keep all those good customers happy, however, you may need to know more than the fact that Tom likes Chinese food, Mary has a weakness for chocolates and Harry loves red ties.

Why? Isn't simply knowing individual customers on some personal basis enough? Well, not quite. What happens if you've hundreds or even thousands of small customers, such as if you run a shop, or if your staff turnover is high as in most parts of the catering industry?

In such cases, you've no substitute for a good database sytem for tracking your relationship with clients and then making appropriate product or sevice offers. For example, supermarkets now analyse customer purchases and make targeted special offers based on their understanding of the customer profile. This all helps to make customers feel special and loved. Your business can measure and describe its customers in several ways:

- Track *where* your customers are, breaking them down by country, region, city or postcode.
- Figure out *who* your customers are, including their age, gender, occupation, income, education and ethnic origin.
- Discover more about *how* they live – their hobbies, favourite sports teams, restaurant choices and holiday destinations, for example.

You're probably a step ahead of us here and have already noticed that many of these criteria result in groups of customers that look alike. When marketing gurus divide customers into specific groups, they call them *market segments*. If you'd like to get a better handle on how to separate your own customers into market segments, check out Chapter 6.

When it comes to understanding customers, one good strategy is to find out what other businesses try to find out about their customers. Keep track of the questions that other companies ask you. Richer Sounds stores (a chain of hi-fi and home cinema retailers), for example, routinely ask for your postcode when you step up to the till. And you often find a list of personal questions on product registration forms, warranty cards and customer service mailings. Some companies even offer a small reward if you tell them something – anything – about yourself. But go easy here. Radio Shack, an American electronics retailer, began to lose a lot of goodwill when customers grew suspicious about – or just annoyed by – all the questions that their shop assistants were asking.

The bad customer

‘A bad customer? Isn’t that a contradiction in terms?’ you ask. ‘How can there be such a thing as a bad customer, especially for a customer-orientated company?’ Keep in mind that your initial reaction doesn’t always tell the whole story. Remember that *you* don’t really define the business that you’re in, your *customers* do. They place a series of demands on your company and then evaluate how well it performs against those demands.

Good customers do the following:

- Ask you to do things that you do well.
- Place value on the things that you do and are willing to pay for them.
- Challenge you to improve your skills, expand your knowledge and focus your resources.
- Take you in new directions that are consistent with your strategy and planning.

Bad customers represent the flip side. They do the following:

- Ask you to do things that you aren’t equipped to do well.
- Distract you, causing you to veer away from your strategy and your business plan.
- Purchase in such small quantities that the cost of doing business with them far outweighs any revenue that they generate.
- Require so much service and attention that you can’t focus your efforts on more valuable (and profitable) customers.
- Remain dissatisfied with what you do, despite all your best efforts.
- Fail to pay on time – or to pay at all!

The pundits have come up with a principle that we can apply here: the *80/20 principle*. In this case, the rule says that if you survey all your customers, 20 per cent of them account for about 80 per cent of your business. These 20 per cent are your good customers. You obviously want to keep them – and keep them happy! But look at the other 80 per cent of your customers, and you'll probably discover a few whom you'd rather hand over to the competition.

When you analyse what you do for that 80 per cent of customers and what they do for you, these customers are often more trouble than they're worth. Their shoe styles are never in stock, and their special orders are always returned. Maybe their finances are a mess, which makes them late in paying. Still, the lure of additional revenue and more customers – or the belief that you should never say no to any customer – often keeps you involved with this group. You would be better off without these customers, though, and leaving your competitors to handle such bad business impairs their ability to compete with you for good business.

To handle bad customers, follow these steps:

1. **Figure out who they are, by establishing whether you can make a profit out of doing business with them.**
2. **Convert them into good customers, by exploring ways of turning loss-making customers into profitable ones.** For example, by putting up prices, introducing minimum order sizes or minimum drop quantities or by encouraging them to order online.
3. **Alternatively, hand them over to someone else.** If they don't accept the changes to your service that you introduce to ensure that they make you money, they will soon move on to other suppliers.

A note of caution: some of this year's bad customers may become next year's good customers. Ensure that you only divest yourself of *permanently* bad customers.

The other guy's customer

You may think that focusing on customers whom you've never had points to another sort of failure on your part, but actually, these people present an opportunity. The fact that you haven't been able to serve this group gives you a challenge: to find out what your market really thinks is important. Your competitors' customers are telling you what you're not. This information is extremely useful, especially when you're working on the big picture in the early stages of business planning, defining who you are and who you want to serve.

Unfortunately, getting information out of your competitors' customers is often an expensive proposition. You don't know them, and you don't have an ongoing relationship with them. Market research firms, of course, are always eager to work with you. These companies are willing to bring together focus groups and talk to consumers about all sorts of things that relate to your products in comparison to the competition. The catch, of course, is that their services don't come cheap.

Fortunately, you don't have to be quite this formal about the information-gathering process, at least in the initial stages. As long as you can get selected people to provide sincere answers, you probably can approximate the results of a focus-group study on your own.

EXAMPLE

Bank accounts and the 80/20 principle

A large retail bank recently undertook a comprehensive study of those customers using cheque books. The results presented a classic 80/20 situation: about 19 per cent of the bank's customers were generating 90 per cent of the total profits, back in the days when banks actually made profits that is. What was the chief characteristic of the other 81 per cent? Most of those customers had accounts with average balances of less than £250, yet they wrote lots of cheques. As a consequence, the bank was losing serious money on this cheques. As a consequence, the bank was losing serious money on this customer group; internal processing costs were simply greater than the revenue generated from the use of their deposited funds.

The bank conducted further research. Obviously, not all of these account-holders were bad customers. Some of them were senior citizens, for example, and a percentage of them were new and would go on to become profitable customers over time. The bank wanted to nourish developing relationships, so it set up incentives to encourage new customers to accumulate savings in related savings accounts. But the bank also knew that many of its customers would never change and would simply remain a drain on profits. So it created hurdles to 'de-market' its less profitable customers, using a new fee structure that penalised accounts when monthly average balances fell below certain levels, unless customers maintained certain balances in savings accounts.

An acquaintance of ours used to go into supermarkets and hang around the aisles in which her company's goods were displayed. When a customer came along and picked out a competing product, she offered to buy that product from the startled shopper for more than the listed price! She would offer a minimal amount (a penny, say) and then work her way up, trying to determine the shopper's degree of loyalty to the competing brand. Finally, she would ask questions to find out why. As a reward, she paid the shopper for the price of the product when the conversation was over.

Getting to know your competitors' customers is often difficult, but not impossible. Check out these ideas:

- Spend time where customers gather. Use trade shows, user groups and industry conferences to make informal contacts and begin a dialogue with your non-customers.
- Ask pointed questions of people who choose competing

products. Did they take the time to see what was available on the market? Have they even heard of your product or service? If they have, did they actually take the time to look at it? If not, why not? If so, what were their impressions?

- Really listen to what they have to say, no matter how painful. Don't get defensive when people say negative things about your company or your products.

Information about your customers is valuable, if not priceless. A consultant charges you thousands of pounds for the same information.

A few points to remember when checking out who your customers are:

- To plan effectively, find out as much about your customers as you can.
- Of all your customers, 20 per cent are likely to account for 80 per cent of your business.
- Some of your customers may actually cost you money.
- Your competitors' customers can tip you off to new opportunities.

Discovering Why Your Customers Buy

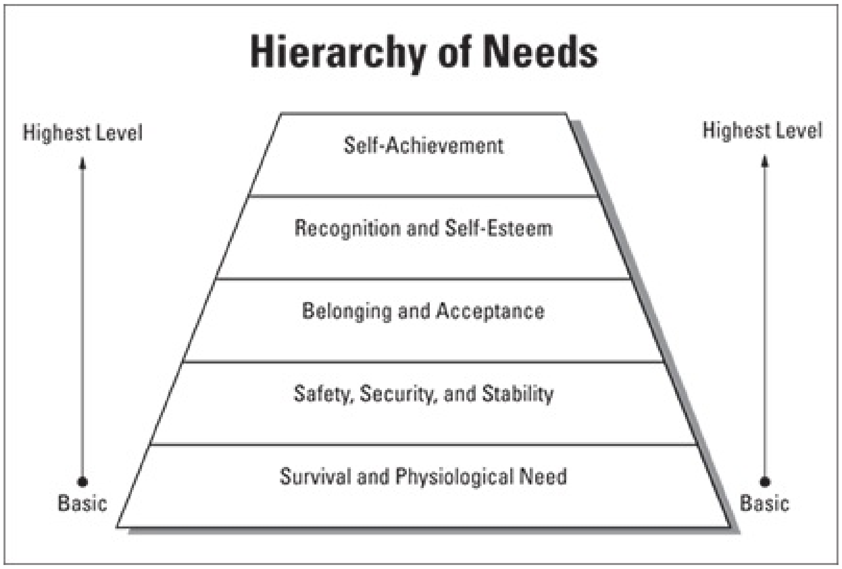
Perhaps the most difficult – and useful – question that you can answer about your customers is why they buy what they buy. What actually compels them to seek out your products or services in the marketplace? What's important to them? What are they really looking for?

Understanding needs

Why do people buy things in the first place? Psychologist types tell us that *needs fulfilment* is really at the heart of all consumer behaviour (see Figure 5-1, based on the social psychologist Abraham Maslow's famous 'Hierarchy of Needs' model). Everybody has needs and wants. When a need is discovered, it creates the motivation that drives human activity. Here's an overview of people's needs:

- Survival, at the most basic level, results in the universal need for grocery shops, carpenters and tailors.
- The urge for safety, security and stability generates the need for bank accounts, disability health insurance and home alarm systems.
- The desire for belonging and acceptance creates the need for designer-label polo shirts, members-only clubs and participation in expensive diet programmes.
- The urge to be recognised and held in esteem establishes the need for company banquets, fast cars and award plaques.
- The desire for self-achievement and fulfilment results in the need for adventure holidays, quiz shows and correspondence courses.

Figure 5-1: A basic overview of people's needs.



DHL, for example, is really in the reliability business. Many of its customers are businesses that want the assurance – absolutely, positively – that their precious shipments are delivered early the next day or even the same day. These customers are so motivated by this need that they're willing to pay a substantial premium over other alternatives, simply for absolute reliability and their own peace of mind.

Determining motives

Motives are needs that have been awakened and activated, so to speak. Motives send people scurrying into the marketplace, searching for products or services that can fulfil a particular need. Motives aren't always what they seem to be. Here are a few examples:

- Greeting card companies don't just sell cute little jingles printed on glossy paper at exorbitant prices. The prices are justified because the companies are actually selling small insurance policies against their customers' fear of feeling guilty. Perhaps fear of guilt (over a missed birthday or a forgotten anniversary) is really what propels the buyer into the greeting card market.

- Recent MBA graduates have been asked to rank the things that are most important to them when they decide among various job offers. When asked point-blank, a substantial majority rank quality of life, community and schools at the top of the list and place starting salary somewhere in the middle. A more careful survey and analysis of the MBA selection criteria, however, usually settles upon compensation as being the single most important variable in accepting a new position fresh out of university.
- Most of us have a need to be accepted and liked by other people. This powerful motivation creates great market opportunities for the likes of beauty salons, gyms and breath-mint companies.

Although motives obviously apply to individual consumers, they work equally well in the context of business or corporate behaviour. When a particular manufacturing company contracts with a private health and medical insurance company, such as Bupa, for example, is the company motivated to improve the health of its employees? Or is it motivated to reduce the cost of its health insurance premiums so that it can better compete with foreign companies (fulfilling its own need to survive)? If you run Bupa, how you answer this question has a major impact on your internal management of costs versus the overall quality of the health care that you provide.

Your job, of course, is to dig beneath the obvious customer responses and consumption patterns to determine what the buyers' real motives are in purchasing goods and services in your own market. When you understand what's actually driving customer behaviour, you're in a much better position to talk about your own product in terms that customers respond to.

Be sure to keep these points in mind:

- The most important question to ask about your customers is why they buy what they buy.
- Customer needs range from basic survival and security to the urge for self-improvement.
- Motives such as vanity, status-seeking and guilt are the hot buttons that can *really* get customers to buy.

Monitoring complaints

Discovering why your customers won't buy again is as valuable as knowing why they buy in the first place. One terrifying statistic is that 98 per cent of complaints never happen. People just don't get round to making the complaint, or worse still, they can find no one to complain to. You would have to be a hermit never to have experienced something to complain about, but just try finding someone to complain to at 8 p.m. on a Sunday at Paddington Station and you get a fair impression of how the Gobi Desert feels.

You can never be confident that just because you're not hearing complaints your customers and clients aren't dissatisfied and about to defect. Nor does silence mean that they won't run around bad mouthing you and your business to other people. You do well to remember that on average people share their complaint with a score of others, who in turn are equally eager to share the tidings with others. The viral effect of email has the potential to make any particularly juicy story run around the world in days if not hours.

Set up a system to ensure that your customers have ample opportunity to let you know what they think about your product or service. This can involve a short questionnaire, a follow up phone call or an area on your website devoted to customer feedback. As a bonus, you will probably get great ideas on how to improve your business.

One entrepreneur who is more than aware of the problems (and incidentally opportunities) presented by complaints is Julian Richer, founder of the retail hi-fi chain, Richer Sounds. His maxim is that his staff should maximise customers' opportunities to complain. The operative word in that sentence is *opportunities*, which should not be confused with *reasons.* In order to put this policy into effect, Richer has a range of techniques in place. The whole customer satisfaction monitoring process starts from the moment customers enter one of his retail outlets. A bell near the door invites those in the shop to ring it if they've had particularly good service or help while in the shop. That help may be simply getting great advice, or may be finding a product they want to buy at a very competitive price. Customers find, when they get their hi-fi equipment home, a short questionnaire on a postcard asking them for their immediate post-purchase feelings. Does the product work as specified, is it damaged in any way, were they delighted with the service they've had? The postcard is addressed to 'Julian Richer, Founder' and not, as is the case with so many other big businesses, to 'Customer Services, Department 126754, PO Box, blah blah blah'. Richer does surveys on customer satisfaction and encourages his staff to come up with their own ideas for monitoring customer reactions. In fact, he insists that they hit minimum targets for getting customer feedback. Silence on the customer satisfaction front is not an option for management in his business. Richer is clearly aware of the other great statistic when it comes to complaining customers.

Ninety-eight per cent of customers who have a complaint buy from you again if you handle their complaint effectively and promptly. Not only do they buy from you again, but also they spread the gospel about how clever they were in getting you to respond to their complaint. Nothing makes people happier than having something to complain about that ends up costing them next to nothing.

Finding Out How Your Customers Make Choices

How do customers make choices in the marketplace? The most important thing to remember is that customers decide to buy things based on their own view of the world – their own perceptions of reality. Few customers buy without thinking. Instead, they bring their perceptions of the world into a decision-making process that (ideally) leads them to purchase your product or service instead of other options.

Realising that perceptions are reality

Customer perceptions represent the market's world view and include not only what your customers think of your products and services, but also how they see your company and view your competitors.

As customers turn to the marketplace, they confront a mind-boggling array of competing products. Many variables influence your customers as they evaluate their choices: advertising, endorsements, reviews and salesmanship, not to mention their own gut reactions. You need to know how customers respond to all these stimuli if you ultimately want to earn and keep their business.

Have you ever wondered, for example, why so few yellow jumpers are available in the men's departments of clothing shops? Market research consistently shows that a majority of men believe that the colour yellow suggests weakness. Subconsciously, men feel that they may be perceived as being wimps if they have anything to do with the colour. So the yellow-jumper option isn't too popular.

Or have you noticed that Madonna doesn't do many endorsements? Okay, she doesn't need the extra income. But companies may feel that her image is just too controversial, resulting in negative perceptions and the risk that potential buyers are driven away.

Never lose sight of the marketer's motto:

Customer perceptions are the market reality.

People buy goods and services based on what they perceive to be true, not necessarily on what you know to be the facts. To be successful in the marketplace, you have to develop a clear insight into customers' perceptions, understanding how buyers react to products and services in your market before you complete your own business plans.

Finding the five steps to adoption

Marketing gurus often refer to the customer's *decision-making process* as the *DMP* (the acronym makes the term sound more official). In many markets, the DMP involves a series of well-defined steps that are dubbed the *consumer adoption process.* (Okay, we'll call it the *CAP*.) In this case, of course, *adoption* refers to a newly formed relationship with a product, not a child.

By understanding the steps that consumers often go through, you're better able to take advantage of customers' behaviour and build strategies that help them complete the adoption process. The process involves five major steps, which are described in Table 5-1.

Suppose that you're in a startup firm with a top-notch consumer-software title. You're afraid, however, that customers are reluctant to give the program a try, for fear that the software may be difficult to fathom or incompatible with their computers. (Keep in mind that people act on their perceptions of reality rather than on the reality itself!) To move potential customers past the evaluation and into the trial step of the adoption process, you may want to consider setting up a free new-user hotline and offering a money-back, no-questions-asked guarantee.

Table 5-1 The Consumer's Five-Step Adoption Process

Primary steps	Description of consumer	Your task
Awareness	Aware of a product or service but lacking detailed knowledge	Develop a strategy that educates and excites potential customers
Interest	Curious because of publicity and seeking more information	Provide more detailed product information and continue to build momentum
Evaluation	Deciding whether to test the product or service	Make the product-evaluation process as easy and rewarding as possible
Trial	Using the product or service on a test basis	Make the trial as simple and risk-free as you can
Adoption	Deciding to become a regular user	Develop strategies to retain good customers

Sounds like we need a summary of all this:

- Customers make choices based on their perceptions, not necessarily on the facts.
- Before they buy, customers go through a distinct decision-making process.
- The five steps in making a purchase are awareness, interest, evaluation, trial and adoption.

- If you understand how customers make choices, you've a better shot at getting their business.

Remembering the Big Picture

Remember that old saying about not seeing the forest for the trees? Well, when you first start to think about your customers, you don't want to fall into a similar trap. Seeing only the small number of individual customers whom you know, and focusing on their personal habits, likes and dislikes, is tempting sometimes. Even when you begin to look at more general customer trends, including why your customers buy and how they make choices, getting buried in the details still is awfully easy.

Don't take the bait! Don't view your customers and your own business activities too narrowly. Look instead at the larger forest – those general customer behaviours and basic needs that define your market.

If you think about your business only in terms of your existing products, for example, you risk losing sight of customer needs that you've overlooked – needs that a competitor is no doubt going to satisfy at some point. You also create a short-sighted view of your own strategic choices that can result in missed market opportunities and woefully inadequate business plans.

Unfortunately, companies (and even entire industries) still lose sight of the big picture all the time. Markets are viewed too narrowly, and customer needs are neglected – a classic management blunder. Check out these examples:

- Companies that make home-improvement tools often view their business in terms of product components – the making and selling of 6mm drill bits, for example. But when you think about it, nobody really wants or needs 6mm drill bits (not even your dentist). What customers are *really* looking for are 6mm holes. That basic need creates the potential opportunity for any number of possible solutions.

- Glasses manufacturers – the companies that make the frames and lenses – continue to see themselves as being in the glasses-fashion business. But the customers, frustrated by not being able to read a menu closer than three feet away when they've forgotten their glasses, simply want to see better. The manufacturers are now discovering a hard lesson with the advent of laser technologies that promise to improve vision by reshaping the cornea – no vision problems, no need for glasses, no more business.

Politics and the marketplace

Bill Clinton had a little sign tacked up on the back wall of his 1992 US presidential campaign headquarters that read:

> *It's the economy, Stupid!*

Campaign manager James Carville posted the sign because he wanted everyone to focus not so much on the product – Mr Clinton – as on the marketplace and customer needs.

In this case, of course, the marketplace was the election itself, and the customers were the voting public. At the time, workers in the United States were suffering through a steep recession, worried about foreign competition and petrified about the 'new world economy'. As a shrewd campaign strategist, Carville knew that the road to success lay in getting beyond the candidates themselves and appealing to the voters' innermost needs – those universal, underlying issues that would ultimately sway decision making in the polling booth.

As a business planner, you have to do the same thing: focus on being market-driven when you approach your customers.

Charles Revson revolutionised the cosmetics industry when he quipped, ‘In the factory, we make cosmetics; in the store, we sell hope.’ As the founder of Revlon, he understood that he was offering his customers something far more important than simple chemistry: the prospect of youth, beauty, and sex appeal.

The key point here is simple: If you don’t know what your customers really want, you can’t possibly fulfil their needs in an effective way.

Put yourself in your customer’s shoes:

- Take a hard look at one of your own products or services, and honestly ask yourself, ‘Why would *I* need this thing?’
- Ask the same question of several people who also use your product or service.
- Try to imagine a world without your product or service. What would you substitute for it?

Answering questions such as these goes a long way toward fostering creativity, generating new strategies and providing expanded market opportunities.

Dealing with Business Customers

Although we’ve mentioned companies that sell principally to other companies (as opposed to those that sell primarily to individual consumers), some of you in this so-called *business-to-business market* may think that we’re ignoring you. We aren’t – honest! In this section, you find details on how companies, institutions and government agencies act when they themselves are the customers. What makes the business buyer different? Many things.

Sizing up secondhand demand

Demand for goods and services in business-to-business markets is almost always *derived demand*. In other words, businesses purchase only those goods and services that they can use to better serve their own customers.

Steel, for example, is a product that no end-user buys. When was the last time you had the urge to go out and get your hands on some flat-rolled sheeting? Steel purchasers tend to be car manufacturers, construction firms, appliance companies and the like. After these businesses use the steel to make their own products (cars, office blocks and refrigerators), we come into the picture as potential customers.

What are the implications for the steel sellers? If a steelmaker cuts its prices across the board, for example, should it expect a huge increase in orders? Not necessarily. The steel buyers will increase their purchases only if they think that they can sell more of the things that *they* make, and their own sales may be affected by many factors beyond the underlying price of steel. How many of us dashed out to buy a new car the last time steel prices were reduced by 10 per cent?

Inelastic demand is a term that number crunchers use when they talk about demand for a particular product that doesn't stretch or change automatically when the price of the product changes.

If you offer products or services in the business-to-business market, make sure that you take the time to think through what your planning decisions mean to your business buyers. And that means thinking about your customers' customers as well. You can do this by asking yourself:

- Does a price reduction on your part result in increased sales for your customers – and your company?
- Do your customers (and their customers) benefit if you offer them additional bells and whistles while raising their costs?
- Are your customers looking for continuity and price stability?

Thinking of decision making as a formal affair

Purchase decisions in the business-to-business marketplace tend to be more formal, rational and professional than in most consumer markets. Many people from different parts of the target company are often involved in the decision-making process (DMP). One division in the company may recommend your product or service, another may acquire it, yet another may pay for it, and all of them do the work for a separate customer centre that actually uses that product. Taken together, these divisions form the *decision-making unit* (or DMU) – another marketing term foisted off on us nice folks by marketing gurus.

Table 5-2 describes three ways in which a business DMU may behave when thinking about buying a product or service.

Table 5-2 How Businesses Behave When They Buy

Table 5-2 How Businesses Behave When They Buy

Buying behaviour	Description of the customer's DMP
Business as usual	Continues to order more of the product or service, perhaps even automating the process so that inventories don't fall below certain levels
Yes, but . . .	Asks for changes in the existing sales arrangement, modifying one or more purchase terms (such as pricing, financing, quantities and options) and including various people who are part of the DMU
Opportunity knocks	Purchases a product or service for the first time, perhaps after putting out a request for proposal (RFP) to several possible suppliers and making a deliberate, complete decision involving all parties in the DMU

Judging the forces to be reckoned with

In working with business customers, you most likely have to deal with several powerful customer forces that you rarely encounter in consumer markets. If your business-to-business strategies are going to succeed over time, you must factor these forces into your business plans. Consider the following questions:

- **What's the state of the customer's business?**
  - Is the customer's business booming, mature, or dying?
  - Is it facing increased competition or enjoying record profits?
  - Is it outsourcing business, creating new opportunities?
  - Does it threaten to become a competitor?
- **How does the customer's company operate?**
  - Does the customer purchase centrally, or does it have buyers scattered around the company?
  - Does it require several levels of approval before a decision is made?
  - Do senior executives (who may or may not know a lot about the product) make the ultimate purchase decisions?

- **Who's important to whom?**
  - Do the customer's key decision makers tend to be engineers or marketing people?
  - Does the customer use both small and large suppliers?
  - Does it have a policy of requiring more than one supplier in critical areas?

As you begin to develop strategies for your business customers, take the time to investigate the forces that are unique in business-to-business markets:

- Get out into the field and talk to potential business buyers.
- Read about customers' organisations and their industries.
- Attend the conferences and conventions that your customers attend, and find out about the critical events and forces that shape their thinking.

All these activities take time and resources, of course, but your investment will be rewarded many times over when you incorporate what you discover into your business-to-business planning.

Remember the following when dealing with business customers:

- Some of your customers may be other businesses, and the way in which they buy is different from the way that individuals buy.
- Several people may be involved in making the decision to buy from you.
- Sometimes your business customers aren't the end users, so

you need to understand your customers' customers as well.

Part III

Weighing Up Your Company's Prospects

'Still no luck with the bank loan, Mr. Blenkinsop?'

In this part . . .

Whenever you tackle something new, whether it's going back to school, buying a house, changing jobs, starting a business, or planning for change – nagging questions come up. Is the new strategy really the right decision? Are you up to the challenge? Will things work out in the end? They're good questions, because they force you to be honest about the capabilities and qualities that you bring to the table.

In this part, we help you look in the mirror and make an honest assessment about what you see. We set out to discover all the capabilities and resources that you have. We try to determine which of them are strengths and which are weaknesses by looking at what you need to succeed in your sector and industry – and what opportunities and threats you face. We help you focus on what your organisation does best by looking at the areas where you provide the most value to customers, and then we help you figure out how you can maintain and extend the competitive advantages you already have in the market. Finally, we turn to your finances and help you create an objective portrait of your business based on your income, profits, assets, and cash position, and then we help you use them to create a forecast and a budget.

Chapter 9

Focusing On What You Do Best

In This Chapter

- Describing what your company does
- Constructing a value chain
- Searching for your competitive advantage
- Focusing on your company's core competence
- Sustaining a competitive advantage over time
- Using the value chain to allocate resources

Every time you leave the house to go shopping, you gear up to make a complex set of choices that together determine what you finally come home with at the end of the day. As you look down the shopping list over morning coffee, the decisions begin:

- Town centre shops or the out-of-town shopping precincts?
- Speciality shops or a department store?
- Designer brands or store labels?
- £25, £50 or £100 limit?

If you happen to be in the business of producing and selling products in shops, these are make-or-break decisions. How do shoppers make their choices? Why do they go into one shop and not the next? What determines where they stop to browse and what they take a second look at? How are customers different from one another? In what ways are they the same? No matter what industry you're in, the same kinds of questions are just as crucial.

As they go about making decisions on what to buy and where to shop, customers continually weigh various combinations of product or service benefits against price. When customers make their choices based on their own calculation of the best value they can find in the marketplace, they're using a *value equation*. (Check out Chapter 7 if you want to know more about that equation.) But what does it actually mean to have the best value out there? If you're one of the competitors, you need to know exactly where and how your products add value in the eyes of your customers.

In this chapter, we take another look at how you create customer value around your own products and services. The approach is called a *value-chain analysis* by people who try to make something simple sound difficult, and we use it to identify which parts of your business are responsible for adding the greatest value for customers. We show you how to use your value chain to help explain why you may have a competitive advantage in the marketplace. We also use the value chain to point out your company's *core competence*. We talk about how you can work to maintain your competitive advantage over the long term. Finally, we show you how to use an understanding of your value chain and core competence to make the most of your company's human and financial resources as you create your business plan.

Describing What You Do

You'd think that it would be easy to describe what your company does, summarising your key business activities in a few well-chosen sentences or in a clear diagram or two. It's not. From the inside of your business looking out, it's much harder than you may think to push away the everyday details to get at the core of what actually keeps you in business from one day to the next.

That’s why consultants hang around a lot. Many of them would like nothing better than to help you describe what you do. Their little secret, of course, is that they’re not really any smarter than you are. Consultants seem to have a clearer view of your business simply because they’re on the outside looking in.

But chances are that you’ve a built-in understanding of your own business and what really makes your company successful – you just need to unlock what you already know.

> Tom Farmer, the son of a Leith shipping clerk who earned £5 a week, launched Kwik-Fit, a company that grew into a £418 million public company with almost 1,000 outlets, before he sold out to Ford for £1 billion. In his own words, the enduring philosophy behind his business to which he ascribes its success is ‘100 per cent customer satisfaction. Just giving service – phoning back in half an hour if you say you will, standing by promises – puts you miles ahead of anyone else in the field.’ Knowing that service is as important as the exhausts themselves is what has provided Kwik-Fit with a lasting competitive advantage.

This canny businessman had a real feeling for why he was successful at what he did. Given a little guidance, you can take the same gut-level understanding of your own business and develop a chain of activities that captures what your company really does to stay in business. In particular, we focus on creating customer value, and divide your business into the specific areas and activities that build value into the products and services that you offer.

Kwik-Fit has been rather less successful under new ownership. French private equity firm PAI Partners bought Kwik-Fit in 2005 for £800 million, selling it on in March 2011 to Itochu, a Japanese conglomerate for just £637 million.

Constructing a typical value chain

Constructing a typical value chain

Your company constructs its *value chain* from the sequence of activities that it engages in to increase the value of your products and services in the eyes of your customers. (See Figure 9-1.) The chain connects you to the marketplace, making sure that you don't stray too far from the customers you serve.

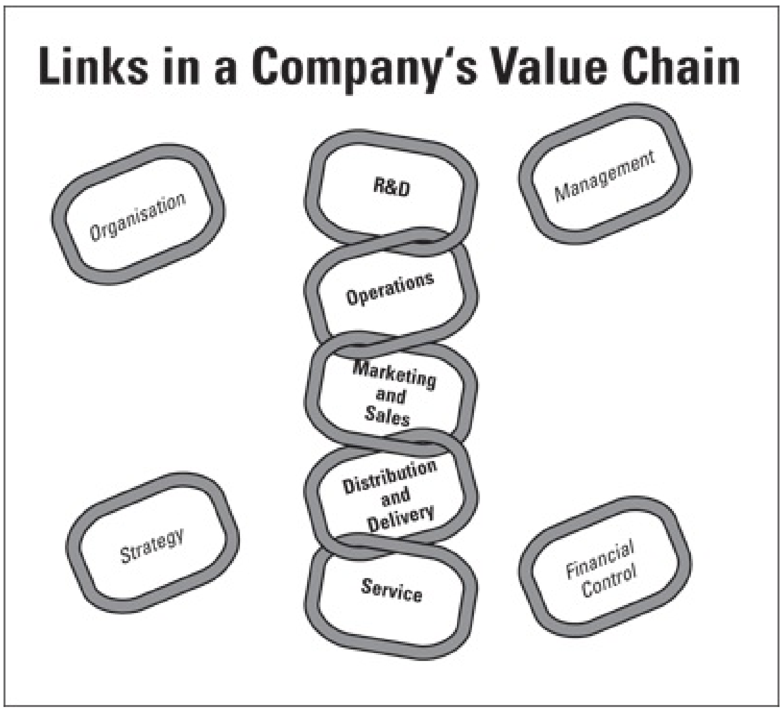


Figure 9-1: A company's value chain has two types of links: primary activities and support activities.

The links in a value chain help you to understand your company's activities.

Primary links in the value chain are the business functions that are at the heart of what your company does. Primary links are usually sequential. They're the essential stages that your company goes through in developing, producing and getting products to market and they often involve the following:

- Research and development
- Operations
- Marketing and sales
- Distribution and delivery
- Service

Supporting links in the value chain contribute to the overall success of the business by strengthening your company's primary links. Supporting links are often spread throughout your organisation. They assist and tie together all the primary business functions, as well as support one another. The activities often involve the following:

- Management
- Organisation
- Strategy and planning
- Financial control

Try to concentrate on organising your basic business functions around customer value and the bright idea that everything you do in your company should somehow contribute to that effort. A value-chain analysis allows you to take your company apart and put it back together, making sure that each link in the chain contributes to the value that customers see when they buy your product or service.

Comparing different value chains

You can find out a great deal about a company by checking out its value chain: where and how the company creates customer value. In fact, the value chain is a relatively good way to compare and contrast competitors in your own industry. You may even want to use this information to revisit your strategic groups of competitors. (See Chapter 7 to find out what the phrase *a strategic group of competitors* means.)

To see how to compare value chains, take a closer look at the airline industry. The experience of flying from London, Heathrow to Belfast, for example, is usually measured somewhere in the range of tolerable to terrible. Air travel always seems to generate metaphors that involve cattle trucks, the underground at rush hour and Guinness records that have to do with people crammed into telephone booths or Volkswagens. But within these constraints, so to speak, airlines do in fact compete for your sky business in different ways.

Ryanair and easyJet, for example, are major players in the so-called 'budget' segment. Compared with other airlines, these companies can make several additional flights a day in each airplane, based on their capability to turn the plane around – unload, reload and take off – in about 20 minutes. Most of the costs in the airline industry are tied up in things such as aircraft and buildings, so extra flights a day mean extra profits for an airline – or lower prices for customers. These companies cater primarilly to people who have to pay for travel out of their own pockets and are looking for the best deal. How do budget airlines make their businesses work? A quick glance at easyJet's value chain highlights several important value-adding activities. Key links include:

- **Operations:** Budget airlines have efficient personnel, ace ground crews and state-of-the-art equipment that allow them to get planes in and out of airports as fast as humanly possible, meet tight flight schedules and reduce overall costs.

- **Distribution:** These airlines have built up regional route systems that tend to bypass the most crowded airports and overly competitive destinations. Periodic reviews of passenger traffic and competition suggest expansion opportunities that are in line with the carrier's low-cost strategy.

- **Management:** They have put together teams of managers and professionals who have the skills, aptitude and temperament to deal with considerable job stress and who work well together.

By contrast, British Airways is a global, full-service carrier at the opposite end of the airline spectrum from the budget crew. The company serves hundreds of destinations daily and offers frequently scheduled flights to most major commercial airports in the world.

Its extensive national network feeds into international routes that span the globe. BA has a freephone reservations number, close relationships with travel agents, a frequent-flyer programme offering worldwide awards and credit cards tied to its mileage programme. Customers count on BA to provide in-flight meals on longer flights, films, to transfer their bags and to cater to them if anything goes wrong along the way. Who are these customers? Many of them are business passengers and other well-heeled travellers who are willing to pay the price to cover the costs of all these added services.

Although getting each plane turned around quickly on the ground certainly is important to British Airways, the company doesn't depend on it the same way that easyJet does. In fact, the services that BA's passengers demand make it almost impossible for its airline crews to keep up with easyJet on the ground. BA's value chain points out the areas in which the airline adds customer value. Key links include the following:

- **Research and development:** Whether developing more comfortable business-class seats, better in-flight entertainment, or Internet connections at 35,000 feet, British Airways works to please its most demanding customers. At the same time, its reservation system and yield-management software allow the airline to maximise revenue and match fares with other airlines in certain competitive markets.
- **Marketing and sales:** The company spends significant time and resources in promoting its image and worldwide brand. BA advertises in a wide range of global media, sponsors all sorts of special events and maintains strong ties with travel agencies across the country and the world.
- **Service:** Customer service is a major link in BA's value chain. The company makes every effort to create a lasting relationship with its most loyal customers through its frequent-flyer programme. And it makes sure that these valued customers are pampered with special airport lounges, hassle-free checkin and checked baggage that always arrives first in the baggage claim.
- **Financial control:** British Airways maintains the financial resources and flexibility to fund continued investments in the extensive ground facilities and huge fleet of aircraft that allow it to serve a global network of routes and destinations.

Both easyJet and British Airways are in the business of transporting passengers from one location to another by using aircraft on regularly scheduled flights, yet their value chains and the important links in creating customer value are quite different.

WARNING!

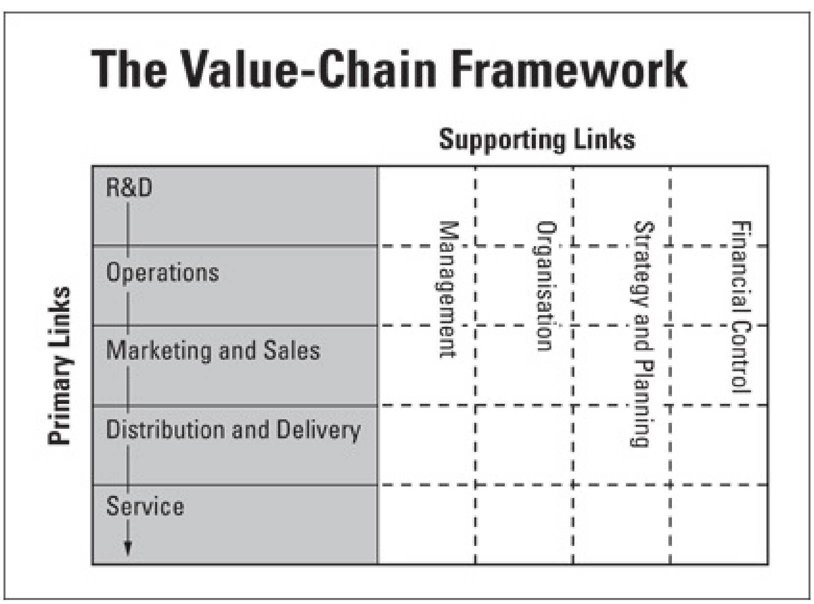
Value chains don't stand still. In April 2011, Ryanair introduced seat reservation on some flights, aimed at smoothing the travel experience for business flyers. Earlier in the year they opened a Business Lounge at Stansted offering wifi, printing, scanning and fax facilities as well as bar and bistro. In September 2011, easyJet enhanced its Flexi Fare ticket, introduced to give business travellers benefits such as speedy boarding, unlimited ticket changes and one piece of hold luggage, to include an offer to those whose arrivals are delayed by more than 15 minutes of a free leisure ticket to anywhere on easyJet's network.

Forging your own value chain

To develop your company's own value chain – the sequence of activities that you go through in the process of adding customer value to your products and services – you need a list of your company's capabilities and resources. Take a look at Chapter 8 if you need help.

You can construct a framework for your value chain by creating a grid that divides your business into value-creating areas (see Figure 9-2). Then you place activities in the grid based on whether they're part of your primary business functions or are associated with supporting areas.

Figure 9-2: The value-chain framework.



Follow these steps to create the grid that shapes your value chain:

1. **List all the key business areas that are directly involved in putting together your own company's products and services and getting them out to customers.**

   Include such things as R&D, operations, marketing, sales, distribution, delivery and service.

2. **Arrange the list of key business areas in order, from the first good idea out of R&D to the finished product or service.**

3. **List the general business areas in your company that support the primary business functions.**

   Include such things as management, organisation and human resources, strategy and planning, and financial control.

4. **Construct a grid similar to the one in Figure 9-2, using your own lists of primary and supporting business areas.**

Your value chain may not look exactly like all those organisation charts that are floating around your company. The primary and supporting business functions that end up adding customer value may be framed differently, depending on whom you ask, so make sure that you talk to customers as well as to co-workers. Ask your customers to describe your business as they see it. Your customers just may have a better vantage point.

A blueprint for change

An architectural and engineering firm in the northeast, that we'll call NAE, used to pride itself on being a full-service building consultant. Its professional staff ranged from structural engineers to interior designers and everyone in between. The company maintained a complete project-budgeting department and a full in-house blueprinting operation; in fact, the firm routinely turned down requests by small outside contractors to take over and supply down requests by small outside contractors to take over and supply blueprinting services. Business was booming, the company was growing and its clients couldn't have been happier.

All that changed in 2008. A major and sustained downturn in the property market hit NAE quite hard, and the company was forced to think about ways to cut costs as its very survival was at stake. As part of the restructuring effort, NAE took a hard look at its internal blueprinting operations, and it discovered that it should have taken the bids from outside suppliers more seriously. Independent contractors could provide the quality and reliability that NAE demanded and substantially lower the firm's blueprinting costs at the same time.

When NAE asked its most important customers what they thought about the proposed changes, the answers were surprising. No one chose the company because of the quality of its blueprints; clients saw real value in the breadth and expertise of the company's professional staff. By reviewing the value chain, NAE had an opportunity to refocus its resources and energy on the activities and links in the chain that provided the most value to its customers. Doing so also helped it to stay afloat while less observant competitors sank without trace.

To fill in the value-chain grid, you have to fill in all the specific value-adding activities – the capabilities and resources that your company uses to increase the value of your products and services in the eyes of your customers. Follow these steps:

1. **Go through the lists of capabilities and resources, and have a first go at placing them in the value-chain grid.**
2. **In the boxes on the left side of the value-chain grid, place value-adding activities that directly contribute to your primary business functions.**

   These activities make up the primary links in your value chain.
3. **Place value-adding activities that are associated with supporting functions in grid boxes across from the primary functions that they support.**

   These activities are the supporting links in the value chain.

4. On the grid, include a description of the customer value that's added at each link, as well as how that value is added.

The value chain offers you a unique look at your company through your customers' eyes. Every link in the value chain is something that you do as a company. Every link is an activity that you spend money on. The value chain allows you to see exactly what value customers are getting out of each link. A value-chain analysis gives you a relatively clear picture of why you stay in business, as well as where you can be doing a better job.

A few things to remember about the value chain:

- The value chain describes all the things that you do to add value to the products and services that you offer customers.
- Value is in the eyes of the customer.
- By comparing the value chains of other companies in your industry, you find out about the competitive landscape and how you fit in.
- A value chain shows exactly what value your customers are getting from each of your basic business functions.

Staying in Business

Companies don't just stay in business year after year by accident. Oh, maybe a manager somewhere gets lucky every once in a while, making a brilliant move without having a clue as to why the move is so brilliant. But that kind of luck never lasts long, especially when the competition is intense. Companies succeed over the long haul because they understand what their customers place the most value because they understand what their customers place the most value on, and they translate that knowledge into products and services that consistently meet or exceed customers' expectations, often at the expense of unsuspecting competitors.

Using a value chain for your own company enables you to pinpoint the business areas and activities in which most of your customer value is created. Those key areas and activities tell you about your company's advantage in the marketplace and how it achieved that advantage. The value chain may highlight the importance of your cost advantage in the market, for example, and point out that your company achieved that advantage through careful, continuous improvements in manufacturing efficiency. Or maybe your value chain flags the calibre of your professional staff as being a key advantage in the marketplace, achieved through a commitment to recruit, develop and support the most capable people out there.

Take a close look at what it means to have an advantage over the competition in your marketplace, where the advantage comes from, and how you can work to maintain it over the long haul.

Searching for competitive advantage

We all know people who like to take car trips – maybe up to the Lake District for a walking weekend or off in the family caravan whenever the weather's nice. If you ask them where they stop along the way, they always have a special burger van, a favourite pub or café, or a certain ice-cream place that they would never dream of missing. Why do these travellers develop such affection for specific stops on their route when hundreds of other places are available along the way? What makes particular establishments so unique?

If you push them, these travellers come up with all sorts of reasons. They may tell you that they've been stopping at the same places for years, that they love the food, that they like the atmosphere, that they know the owners, that they can count on the service . . . whatever. No doubt all these things are true. But take a careful look at the value chain for many of these businesses, and one important link that jumps right out at you is likely to be location. Distances and driving times most likely are the major reason why many of their customers find these businesses in the first place; the shopfronts literally happen to be in the right place at the right time. Location provides a significant competitive advantage in this on-the-move marketplace.

Competitive advantage means exactly what it says: a company has some sort of advantage over the competition. Where does it come from? Usually, out of the distinct and special value that the company can offer its customers – and from the premium that customers place on that value. Ask yourself this basic question:

Why do customers choose my company and its products when other competitors in the industry have more-or-less similar offerings?

You can find the answer in the strongest links of your value chain. The links that produce the bulk of your customer value – whether this value is location, service, image or product features – are the links that create your competitive advantage in the marketplace.

In the beginning, Microsoft was a partnership of two: Bill Gates and Paul Allen. They started out competing against a host of bright young entrepreneurs like themselves and eventually had to go head-to-head with IBM itself. Today, Microsoft has over 20,000 employees and $5.18 billion in revenue and offers a wide array of software products, ranging from word processing programs and spreadsheet applications to language tools and operating systems. Its Windows program alone has sold more than 100 million units. Microsoft's competitive advantages:

- **Standards:** Microsoft's programs pretty much set the standards in the PC world. Microsoft offers the standard operating system and the standard suite of office applications. Although other companies sell better products here and there, Microsoft is seen as being the safe and sensible choice across the board.

- **Compatibility:** Microsoft programs promise to work with one another and with the operating system. You don't have to worry that your favourite application will become an outcast or somehow misbehave inside your computer.
- **Product range:** You name it, and Microsoft probably has a product that can do it. The company continues to aggressively develop new software to meet the needs of rapidly changing markets. Most recently, the company targeted Internet users with a host of new products.
- **Service and support:** With Microsoft, you know what you're getting. If something doesn't work, the company tries hard to fix it. In the meantime, it's comforting to know that you can always find other people who have the same problem.

Hertz is by far the largest car-rental agency in the world. The company has rental locations in more than 150 countries and boasts a fleet of more than 500,000 vehicles. But Hertz faces competition at all levels, from the family-run rental companies at popular holiday spots to regional agencies such as easyCar, an offshoot of easyJet and other global companies, including Avis and National. Hertz Corporation's competitive advantages:

- **One-stop reservations:** When you call the Hertz free number, you gain immediate access to the company's worldwide fleet. You can quickly and conveniently book the kind of car that you want, when and where you want it. Changing your mind is just as easy.
- **International presence:** No matter where or why you need the car – for a safari in Africa, a tour of Italy, or a business

trip to Birmingham – you can safely bet that Hertz can rent you what you need.

- **Peace of mind:** With Hertz, you don't have to worry that the car won't be there, that the rate going to double, or that you'll end up paying for a rent-a-dent that's obviously a year old. Also, to help you find your way around, the company offers personalised maps and is introducing a new onboard navigation system.
- **Rewards for loyalty:** As a loyal Hertz customer, you're rewarded with membership in a club that provides extra service, attention and the chance to apply the pounds that you spend toward free rental days.

Biggest is useful, but best is better According to a survey in October 2010 by Condé Nast Traveler, Hertz, Enterprise, and Avis top the list of best car hire firms. The results take into account rates, reliability and locations. But to stay at the forefront of new developments in the industry, Hertz recently intoduced one-way rentals allowing customers to drop off a car at an airport instead of an original pick-up spot, a valuable benefit for business users. Enterprise and Avis, on the other hand, are pioneering electric car rentals, appealing to the green and cost conscious markets.

Focusing on core competence

Your competitive advantage is created in the marketplace. That advantage has everything to do with your customers, with the relative value that they place on your products and services, and with the purchase decisions that they finally make. But what is it about your company that allows you to achieve this competitive advantage? What internal capabilities and resources do you have, and what business activities do you engage in that lead directly to your competitive advantage?

your competitive advantage.

You probably already have the answer. Go back to your company's value chain, and focus on those links that are most responsible for your own competitive advantage. When you do, you come face to face with something that the gurus call your core competence. Simply defined, *core competence* is your company's special capability to create a competitive advantage for itself in the marketplace. In almost all cases, this gift is specific to your company. Think of core competence as being corporate DNA. Unlike your personal genetic code, however, your company's core competence is there for you to build on – or to lose, depending on how attentive you are to your markets and your business.

The section 'Searching for competitive advantage' earlier in this chapter examined two well-known companies, each of which is a household name. Can you identify the core competence behind that competitive advantage for both Microsoft and Hertz?

Microsoft's core competence is built on:

- **Visionary executives:** The executive team has a broad vision of the future, enabling the company to forge today's software standards and shape tomorrow's.
- **Top-notch development team:** The company is committed to supporting a dream-team corps of developers and programmers who are charged with creating and maintaining a state-of-the-art product line.
- **Management of complexity:** Microsoft manages a complex related set of software products that all have to behave and work together.
- **Capability to change direction:** The company has the capacity to redirect resources and energies when the fast-

moving marketplace shifts course and the rules of the game suddenly change.

Hertz Corporation's core competence consists of:

- **Information systems:** A sophisticated computer database allows the company to keep track of customer profiles and match them against an ever-changing supply of rental cars around the world.
- **Global logistics:** The company has the capability to track, distribute, arrange and rearrange a huge fleet of vehicles in all shapes and sizes on a worldwide basis.
- **Scale of operations:** The company uses its sheer size and business volume to negotiate favourable terms when it comes to new-car purchases and even insurance premiums.
- **Relationships and tie-ins:** Hertz has the resources to work closely with travel agencies and the travel industry to create new business by expanding car-rental options and opportunities.

AHEAD OF THE PACK

Sometimes, a company's core competence can point the way toward new market opportunities. Honda, for example, used a core competence in designing engines to expand its markets. The company created product lines in lawn mowers, snow throwers, snowmobiles and all-terrain vehicles, to name just a few of its motor-based businesses. Honda benefits from a related competitive advantage in each of these distinct markets. Take another look at your own company's core competence to see whether you can come up with any new business directions, based on those things that you already do well.

Sustaining an advantage over time

Every company that manages to stay in business from one month to

Every company that manages to stay in business from one month to the next has some sort of competitive advantage and core competence to draw upon; otherwise, it simply wouldn't be there. But the million-dollar question has to do with how to renew and sustain that competitive advantage over years and even decades. Customers and their needs shift over time, competition gets more intense and industries evolve, so your competitive advantage and the core competence that supports it aren't guaranteed to stay around. You rent them; you don't own them. You want to make sure that you keep a long-term lease on both.

Sustained competitive advantage – the business world's Holy Grail – is a company's capability to renew a competitive advantage over and over again in the face of a constantly changing business environment and marketplace. But if you want to sustain a competitive advantage over time, you need to have a long-term strategy in place. Chapter 7 introduces three common alternatives called generic strategies and gives you a handle on what your competitors may be up to. Chapter 13 takes a much closer look at your own strategic options.

Spend time thinking about things that your company can do on an ongoing basis to see that your core competence is preserved or evolves to meet changed market needs. How can you sustain the competitive advantage that your company already has? Get a blank sheet of paper and jot down answers to these key questions:

- Where will changes in your business most likely come from?
- How are those changes likely to affect your company's competitive advantage?
- What can your company do to maintain core competence in the face of change?

Focus on each of the major forces that fuel change in your own industry:

- Your customers and their changing needs and requirements.
- Your competitors and their changing capabilities, strategies and goals.
- Your company, its value chain and its shifting strengths and weaknesses.

As you create your business plan, make sure that you continue to track these forces so that they don't threaten the core competence you've worked so hard to achieve or so that your core competence evolves.

Sounds like a summary is in order:

- Your core competence – what sets you apart – is based on the strongest links in your value chain.
- Competitive advantage in the marketplace is a direct result of your company's distinct core competence.
- Staying ahead of the competition means sustaining your competitive advantage, which requires a long-term strategy.

Whatever happened to Daddy's Daimler?

Daimler used to be a synonym for *making it* in the UK. When a Daimler was parked in front of someone's house, it meant that they had finally arrived. In fact, you'd have been hard pressed to think of another product that could bestow quite as much status on its owner.The car was built for ultimate comfort, and it conveyed an image of wealth and luxury. Daimler owners were an intensely loyal bunch, typically ordering new models every few years, just to burnish that image.

Dailmer owners are still loyal today, but not to that brand. In the 1980s, a new generation of car buyers began to look for new status symbols. The young and wealthy began to chase foreign cars with names such as BMW, Mercedes and Volvo (or Lexus, Infiniti and Acura). Whatever happened to Daimler's enviable position in the luxury-car market? Competition, of course, and a failure on Daimler's part to respond quickly to changing tastes. The image of luxury and intense brand loyalty that the car used to enjoy simply weren't passed along to the next generation of buyers, and a once-powerful competitive advantage quietly slipped away.

Earmarking Resources

The value chain paints a portrait of your company as your customers see it. Links in the chain reflect the value that customers place on aspects of your products and services. The strongest links capture your competitive advantage in the market and define your core competence as a business. Because the value chain is so good at weighing the importance of the things that your company does, it also comes in handy when you plan how your resources are going to be used.

Have you ever been to a horse race? If you have, you know that you're bound to see a group of regulars hanging around the stands or clustered at the fence. These people are serious about horse racing. They spend time poring over form sheets and newspapers, circling this, checking that. They pace back and forth, occasionally disappearing for a while to do something or other. What are they up to?

Well, they're placing bets, of course. But they're certainly not relying on Lady Luck alone to keep them flush. Instead, they're using all the information available – the condition of the track, the horse's health, the jockey's record and the betting odds – to place their cash only on those wagers that are most likely to result in the best payoffs and the biggest winnings.

Betting on the horses is a serious business for these committed professionals. Maybe those punters can tell you something about how to divvy up working assets. Is it sensible to spread your company's limited resources equally among all the areas that make up your business? Probably not. Each time you set aside time and money for a particular business activity, you're placing a bet. What you're betting is that the resources you commit are going to contribute to your business, add value to what you do, and eventually come back around to generate revenue and profits.

Chapters 10 and 11 help you pore over the numbers (financial statements, ratios and budgets) that keep track of where you spend money and then tell you whether you're winning. In short, your financial statements tell you a great deal about how you manage your cash, what bets you place and how well you do at the track. But your financial statements alone don't tell you *what* to do. So how do you know where to place your bets in the first place?

You guessed it: you go back to your company's value chain. Consider this simple way to check your resource allocation based on your own value chain:

1. **Look at where your company currently spends money.**

   Make a quick-and-dirty estimate of how yearly expenses are divvied up among business activities – from R&D to delivery and service – and jot the numbers down on your value-chain grid. To keep things simple, use percentages. Make sure that the numbers add up to 100 per cent.

2. **Look at where customers think that you're providing them value.**

   Take the total value that customers think you provide, and divvy it up among your business activities. If customers pay £100 to buy your widget, for example, how much of that are they willing to pay for features, how much for service and how much for convenience? Again, use percentages, and jot the numbers on the same value-chain grid. Make sure that the numbers add up to 100 per cent.

3. **As a reminder, highlight the boxes on the value-chain grid that represent your core competence and account for your competitive advantage in the marketplace.**

4. **Analyse the completed grid.**

   If the percentages line up and are concentrated in the highlighted boxes, you're in fairly good shape. But if you find a glaring mismatch in terms of where you're spending money, what your core competence is, and where your customers think that your products get their value, take time to reassess where your company's resources are directed.

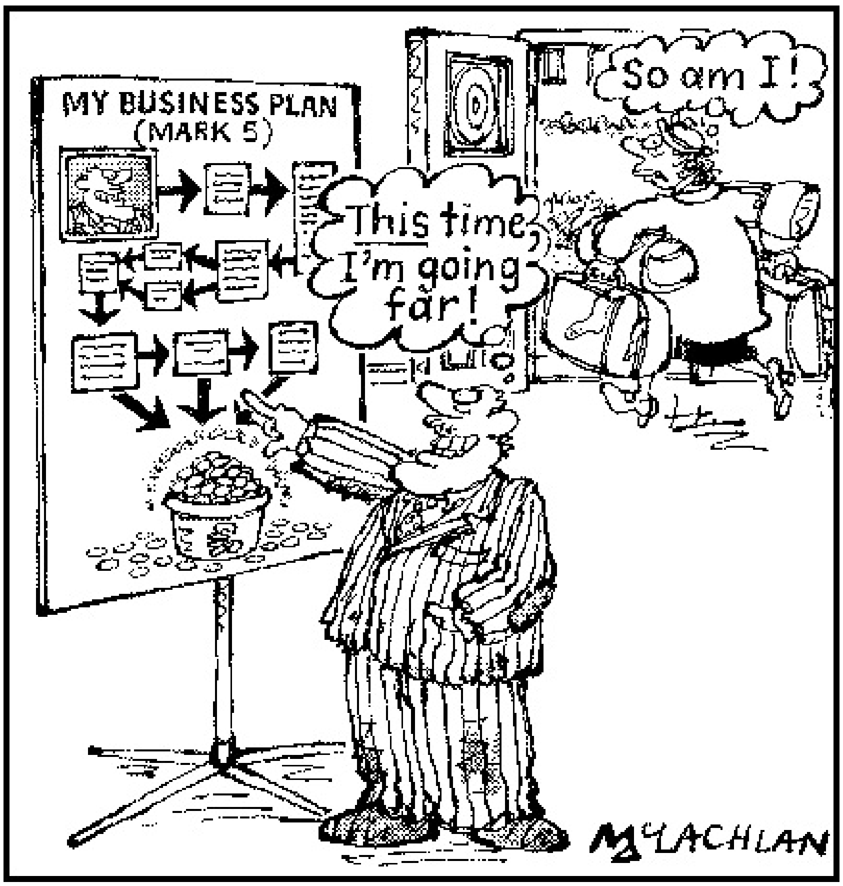
The value chain is invaluable when it comes time for you to earmark resources for your business activities. A clear understanding of your core competence and competitive advantage helps you make informed decisions when you have to allocate scarce resources.

Check out these points about the value chain:

- Value chains come in handy when it comes to planning the best way to allocate your company's resources.
- A value chain highlights mismatches between current spending and the areas that provide the most value to customers.

Part V

A Planner's Toolkit



In this part . . .

Whatever the task you're involved in, no matter how big or small, there comes a time when you have to roll up your sleeves and get down to the real business at hand. Once you know where you're headed and what you're going to do, you must go out and do the task itself. The best plans in the world aren't worth anything if you can't carry them out.

In this part, we help you put your business plan to work. First, we look at ways to organise your company, and develop the procedures and systems that allow you to carry out your plan as efficiently and effectively as possible. Second, we talk about ways to encourage leadership, develop business skills, and create a company culture so that you can achieve your plan. Third, we look at financing your plan and planning to bow out gracefully. Finally, we show you a sample business plan, so that you have a better idea of exactly what lies ahead for your company.

Chapter 17

Learning from Others: A Sample Business Plan In This Chapter

► Viewing a sample business plan ►Following a business-plan template ►Learning about the tourism industry Sometimes, you have to see something up close and personal before you really understand what it's all about. Viewing a real live business plan should get you much closer to putting your own plan down on paper.

REMEMBER

Your written business plan says something about all the important parts of your company. After all, you want to convince people – and yourself – that your company knows what it's doing. If you want to persuade people of anything, however, they have to actually sit down and read what's in front of them. So you want to be clear, concise and to the point, and it doesn't hurt to spend some time with your prose, either.

In this chapter, we show you a sample business plan. (We changed the names and some of the numbers to protect the innocent.) By reviewing the plan in some detail, you can discover a bit about how to construct a business plan of your own, and as a bonus, you can pick up some tips on the tourism industry. But please don't rely on any of the data; we provide it simply to illustrate the business plan and not to help you kick start your way into the tourism business.

There is no such thing as a universal business plan but you can use the table of contents below as a rough guide as to what to put into into your own business plan, as a sort of template. But every business is different as is the situation the business is planning for.

Safari Europe: Business Plan Prepared in July 2009

By Karen Kehoe

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Business Plan Contents

Forecasts and Financial Data

Sales Forecast

Cash Flow Projections and Sensitivity Analysis

Profit and Loss Account

Balance Sheet

Performance Ratios

Break Even

Financing Requirements

Funds Required and Timing

Funding Options

Business Controls

Financial

Sales and Marketing

Appendix: Market Research

Safari Europe: Business Plan

~ Executive Summary ~

For the past five years Karen Kehoe has been a founder director of a very successful outdoor clothing shop in Bristol: Adventure Works. Last year that business made £120,000 profit on sales of £850,000 and employed seven people.

Adventure Works recently took on an agency from European Adventure Holidays, one of the largest and most respected tour operators in the market. With virtually no marketing effort some 200 adventure holidays have been sold by Karen in the past six months, netting £40,000 in commissions. Sales of insurance policies and other services have added to this total, and could potentially add much more. From desk and field market research carried out on 300 clients, Karen is certain that there is considerable potential in the adventure travel business. In particular one important segment of that market, the professional 25- to 35-year-olds who want to adventure travel in Europe, is not having their needs properly met.

Karen Kehoe plans to sell her shares in the clothing shop and invest the proceeds in a new business, Safari Europe. The business will operate from a self-contained facility within the existing shop, with its own entrance and shop window onto the main street.

The company believes that by concentrating on one market segment, the 25- to 35-year-old professionals, and one geographic destination, Europe, it will be able to deliver a significantly superior service to anything currently on the market.

Published research shows that tourism is a fast-growing business sector and Europe is the favoured location for most travellers. Adventure holidays, though a relatively new and small market, looks set for explosive growth.

Karen has selected a small team, some of whom have worked with her in the clothing shop for several years. She has worked as the manager of a branch of a high street travel agent and other members of the staff have extensive travel, selling, and computer skills, all of which will be invaluable to the new venture.

Safari Europe expects that by concentrating full time on selling adventure holidays, clients will increase from the present level of 200 in six months, achieved with only a part time effort, to at least 660 in the first year, 1,400 in the second, and 2,100 in the third. To help achieve this growth Karen has identified three other tour operators she wishes to represent and has begun negotiations with them. Selling between two and three holidays a day will allow the business to reach cash-flow break even in year one, while making a modest profit. This compares with the 1.3 holidays currently being sold each day.

By year 2 post-tax profits should be £180,000, and in year 3 nearly £300,000.

To achieve these results the company needs to invest in Web site and database software and systems, and in refurbishing the shop premises. Our market research demonstrates that sales of travel services via the Internet accounts for approaching £3 billion a year's worth of business. It is the fastest growing business to consumer activity on the Internet.

In all, about £75,000 will be needed to fund the business during its formative months. A further £10,000 needs to be available to deal with unforeseen events, although a sensitivity analysis has been carried out which shows this is unlikely to be required.

Karen will be investing £25,000 of her own money in the business, and seeking £60,000 from outside. The purpose of this business plan is to attract other shareholders to invest in a highly profitable venture. Return on shareholders' capital by year 3 will be close to 100 per cent. This opportunity may appeal to Karen's partners in the clothes shop or to a business angel.

Alternatively, we are considering loan finance made up of a £25,000 short-term loan and an overdraft facility of £35,000.

~ *The Business and Its Management* ~

Increasingly, shop customers have asked for advice on adventurous places to go on holiday. Last year Adventure Works took on an agency from European Adventure Holidays, one of the largest and most respected tour operators in this market, and began to promote and sell their products. In the six months that we have been selling travel agency products, some 200 holidays, at an average cost of £2,000, have been sold. Adventure Works' commission on the sales has been £40,000 (10 per cent commission). In addition, 35 insurance policies have been sold at an average price of £100, yielding £1,050 (30 per cent commission).

▶ *Mission*

To be the leading provider of hassle-free European adventure holidays to the 25- to 35-year-old young professionals market. The business will initially operate within a 25-mile catchment area, but quickly start to sell its services worldwide, via the Internet. Sales of travel services is the fastest growing category of business to consumer activity on the Internet. In 2000 the value of this market will be an estimated £2.7 billion.

The emphasis will be on providing a complete specialist service based on having a detailed knowledge of the holiday destination and adventure activities being offered. Our market research shows that the major criticism our type of client has of existing travel agencies, is that they "know nothing about their products, they just open the catalogue and read", to quote one of the many disappointed adventure holidaymakers.

Also, by using our experience in the Adventure Works clothing shop, we will be able to both advise and direct our clients to sources of the type of travel equipment they will need to get the very best out of their holiday experience.

▶ *Objectives*

Our financial objectives are to be operating at, or close to, cash flow break even by the end of the first year. We aim to be profitable from year 1 onwards, then we will aim to earn at least £180,000 post-tax profit in the second year, and nearly £300,000 in the third. Our profit margin on sales by year 3 will be a respectable 7 per cent.

We also intend that the business should be fun. The present staff are passionate about adventure holidays, and we intend to maintain their enthusiasm by constant product and skill training. We will only recruit new people who share our vision.

▶ *Legal Structure*

The business will be set up as a limited company in the next few weeks. This structure will clearly separate the travel business from the shop and make it possible to attract the risk capital that will be required when the business starts to grow. For example, an Air Travel Operators License (ATOL) will eventually be required, which in turn calls for a business to have a minimum paid-up share capital of £25,000.

At a later stage the business may wish to sell and issue airline tickets and to create its own charter holidays. This will require membership of the International Air Traffic Association (IATA) and an Association of British Travel Agents (ABTA) bonding. However, in the period covered by this business plan we intend to operate only as the appointed agents for a number of tour operators. As such, we can shelter under their licenses and bonds.

~ Products and Services ~

▶ *Tour Agency Products*

We currently are appointed agents for European Adventure Holidays (EAH), a leading supplier in the market. Currently EAH offer some 40 different adventure holiday packages throughout Europe, covering such areas as: horse trekking in Iceland; above-the-clouds trekking on islands and remote mountain regions in such areas as Corsica and Norway; van-supported inn-to-inn bicycling; mountain biking and hiking adventure tours throughout France, Germany, Italy, and Austria; ballooning across the Alps.

We intend to seek to be appointed agents by three other major adventure holiday tour firms, with whom we are currently in negotiation.

▶ *Services*

We will offer a comprehensive range of complementary services to support the adventurous holidaymaker that will ensure they have a safe, enjoyable, and memorable experience. These services will include: insurance, both personal and effects; pre- and post-holiday briefing packs; a directory of advice and information services covering each country and adventure activity.

▶ *Proprietary Position*

Whilst at present we are offering only other company's adventure holidays we have protected our position in a number of ways.

Firstly, we have a two-year agency agreement with European Adventure Holidays which gives us access to all their holiday products, both existing and new. This contract is dependent on our achieving sales of at least 250 holiday packages a year. We intend to negotiate similar agreements with future suppliers, although sales targets with them will be lower to reflect their relative market position.

Secondly, we intend to maintain a high service element to our business, extending our range of value added services. In this way we will seek to build up a high level of repeat business. Customer loyalty is vital to our profitable growth.

▶ *Guarantees and Customer Protection*

Our clients will be protected financially against either our or our tour operators' failure, by virtue of the ABTA bonding held by our principals. We will only use holiday providers who can provide 24-hour emergency support services for clients whilst on holiday.

~ Markets and Competitors ~

▶ Markets, Projections, and Market Segments

The world travel market is forecast to expand at a 4.1 per cent average annual growth rate until 2012. This is faster than economic growth generally, which is expected to be around 2.4 per cent per annum.

The European market, whilst not the fastest growing, will be the most important destination, accounting for over 50 per cent of all international arrivals. France, Italy, and Spain are the most important destinations within Europe. This is why we have selected as our initial partners, tour operators with appropriate products in these countries.

Figures for the size and projected growth of adventure holidays are sketchy, but one recent study (World Adventure Travel Data Corp.) gave these figures.

Adventure Travel Holidays — World Forecast (Million Arrivals) : 2012 – 2015

Destination	2012	2013	2014	2015
Europe	0.25	0.60	1.60	2.35
N. America	0.45	0.60	1.40	2.20
Rest of World	0.10	0.25	0.95	1.10
Total	**0.85**	**1.45**	**3.95**	**5.65**

Age	2000 %	2020 %
16-24	61	38
25-35	20	31
36-45	15	25
46+	4	6
	100	**100**

Our own market study confirms that Europe is likely to be the largest destination market for adventure holidays. Our study shows only 30 per cent of adventure travellers to be under 24, whilst the World Adventure Travel Data study claims 61 per cent. We feel the difference is caused by our survey sample being confined to relatively affluent people who had spent at least $200 in adventure clothing.

One further emerging market-segment for adventure holidays is corporate clients. Our market research suggests that up to 20 per cent of adventure holidays are sold at this top-price end of the market.

Competition and Competitive Advantage

There are no adventure holiday specialist travel agents in the Bristol area. However, there are many in capital and secondary cities such as London, Paris, Lyon, Madrid, Barcelona, and Frankfurt. There are also a number of direct marketing and Internet providers. These are the types of competitors we expect to face:

General travel agents, who have added adventure holidays to their range. These agents often have little or no knowledge of adventure destinations or activities. They sell literally from the page, offering limited advice, information, and support. According to our market study 40 per cent of adventure holidays are booked through these general travel agents, but only 33 per cent of clients would use them again.

Adventure tour operators advertise their holidays in the press, attracting about 25 per cent of all adventure holiday clients. However, clients have to shop around several tour operators to find what they want, and they cannot get unbiased advice, or much help with information. Only 45 per cent would go back to a tour operator for their next holiday.

Independent travellers make up 15 per cent of those going on adventure holidays, and 65 per cent of those would travel that way again. We need to persuade this group that our superior product-knowledge and service is worth their consideration.

Internet providers sell only 5 per cent of adventure travel holidays. However, 70 per cent would buy their next holiday via the Internet. There is plenty of scope to offer a superior Web site. We believe that by having daily face-to-face contact with clients we will be better able to manage a fresh, vital, and relevant Web site aimed at the specific needs of our market segment.

Specialist adventure travel agencies only sell about 15 per cent of holidays at present, but we feel that this is due partly to lack of client awareness and partly to the comparative rarity of such outlets.

Some 65 per cent of those using specialist adventure holiday travel agents would use them again, which is many more than would use either a tour operator direct or a general travel agent.

However, these agents were criticized for having such a wide range of activities and destinations, that their sales agents knew little about them. Our research shows that whilst 41 per cent of clients take adventure holidays in Europe only 23 per cent of the 5,000 adventure tours on offer are for European destinations.

We feel that by concentrating on European destinations, which is the largest market for both holidays in general and adventure holidays in particular, we will be able to have superior product knowledge. We will only need to know perhaps 100 destinations and activities well, rather than have only a passing knowledge of the 5,000 adventure holidays on offer.

Our market research has also shown that many adventure travel agents are catering for the backpacker market, consisting mostly of very cost-conscious under 24-year-olds. This can lead to very different types of clients ending up at the same destination, with some consequent dissatisfaction. It is also evident that the backpacker market requires a much lower level of service and information, than do the more affluent professional 25- to 35-year-olds.

▶ *Customer Needs and Benefits*

We believe that by concentrating on the European market, offering a limited but extensive range of types of holiday, and aiming our service specifically at affluent professionals, we can meet the needs of our clients in a way not being achieved by any of our competitors.

Our market study has shown that this group has specific needs that are not currently being met, as 65 per cent of those taking adventure holidays would not buy from the same source again. In particular they want their travel agent to have comprehensive knowledge of the destination (87 per cent); to have an efficient administration system in which they can have confidence (84 per cent); to go on holiday with similar professional people (81 per cent); and to be offered useful advice and ancillary services such as insurance (79 per cent).

~ *Competitive Business Strategy* ~

▶ *Pricing Policy*

The normal commission paid to travel agents for this type of holiday is in the 10 to 15 per cent range. Whilst European Adventure Holidays, the first agency we have been appointed to, pay us at the lower end of the scale, they are a prestigious firm to represent. Having them in our portfolio will enable us to negotiate much higher commissions from our new principals. Accordingly we are planning on an average travel agency commission of 11 per cent rising to 13 per cent by the end of year 3. Commission on insurance and other services will be 30 per cent, throughout.

Promotional Plans

Our market research shows that editorial has the greatest impact on people's choice of an adventure holiday, closely followed by having the right 'shop window', and having a recommendation from a friend, relation, or colleague. General press advertising seems to be fairly ineffective in this sector, and even specialist press advertising only draws in 14 per cent of clients.

Accordingly, our promotional plan is as follows:

Public Relations (PR). We will put considerable effort into preparing and disseminating a regular flow of press releases. These will be based on stories about our destinations, activities, corporate clients, and our staff. We will use a freelance PR adviser to help us write copy and target editors.

Shop Front. We plan to have an exciting, informative, and actively managed display window. There will be a video display showing holidays in progress. Different destinations can be selected from outside the window via a control panel, otherwise the scenes will rotate on a random basis.

Web Site. We will have a well-managed Web site. This is fast becoming a major promotional channel and we believe it will increase in importance over time. Also it is the easiest way for us to have a global presence at the outset.

Advertising. We will undertake a small amount of specialist-press advertising in order to enhance our PR activity. There is considerable research to support the argument that the more often a potential client hears about you, the more likely they are to approach you when they have a need for your type of service.

Database. Our database will retain full details of all our clients, the holidays they have taken, and their post-holiday appraisal data. We will use this data to provide incentives to our delighted clients prompting them to recommend our services to friends, relatives, colleagues, and employers.

Direct Mail. We will write to all past shop clients announcing the establishment of the travel business, and offering them a special introductory adventure holiday package.

Wider Factors Affecting Strategy

The general economic climate in this city is good. A large influx of new businesses relocating from London and its surrounds, has added to the area's prosperity. There is now a large and growing young-professional population.

Tourism in general looks set to grow, Europe looks like continuing to be the major destination, and the Internet will be an important channel into this market.

Tourism is becoming a heavily regulated business sector. Whilst we have avoided most of the regulatory problems by becoming an appointed agent for a large established tour operator, in the future we will need our own ABTA bonding and ATOL registration.

~ Operations ~

Sales

Excellent selling skills are vital in our type of business, so everyone will be fully trained in selling. Every month we will audit each other by observing half a day's selling activity and giving feedback on strengths and weaknesses in skills.

Record Keeping

We will keep records of every sales contact. Data such as source of enquiry; client's needs; previous holidays; and job, income, and status, will be recorded. By having superior information on clients and prospects we intend to offer a truly personal service.

Premises

It is vital that the travel business has both a shop front facing onto the main street, and a visible separate entrance. It is intended that clothing-shop clients will be able to move between the premises without going outside. We will be renting 70 sq m (750 sq ft) of space at a cost of £18,000 per annum, fully serviced. In addition, we will need to spend £15,000 on internal refurbishments. We plan to do some of this work ourselves. Also a further £2,500 will be needed for office equipment such as desks and chairs.

Capacity

Our offices can accommodate five sales desks. Each sales desk has a capacity to handle 4 clients per hour, which means over the year we could handle up to 40,000 enquiries. With our average conversion rate of 1 in 5 we could service 9,600 clients from our present facilities. This is well above the numbers we are anticipating in the business plan.

Equipment

We will be renting an integrated telephone and database system from the outset. This will allow any of up to 10 sales staff to answer calls and have full on-screen data on clients and products. As service is one of our key differentiators, it is essential that all of us have full access to all relevant data speedily and efficiently.

▶ *Staffing*

From the outset, all staff will have job descriptions, a career and training history file, and a record of appraisals. New staff will take the travel agency psychometric aptitude test, and then spend time with each member of the Adventure Works Travel team.

All staff will undergo full product training, and will spend at least four weeks a year on site at key travel destinations. We plan to start with three full-time staff, including the founder, and one part timer. We plan to be operating with six staff during the third year of trading.

▶ *Quality Control*

We will be developing outline scripts to help sales staff manage enquiries. This will ensure that all incoming phone calls are dealt with in the same way and to a similar high standard.

We will encourage people enquiring about holidays to give us feedback on:

- Our ability to handle their enquiry.
- The way we manage between booking the holiday and taking the holiday.
- The client's reactions to the holiday, in terms of whether it meets their expectations.

~ Forecasts and Financial Data ~

▶ *Sales Forecast*

Our enquiry to sales conversion rate on the adventure travel holidays sold to date, whilst operating within the outdoor clothing shop, has been 33 per cent. For the purposes of our sales forecast, we are assuming that only 20 per cent of enquiries will actually result in an adventure holiday being booked. This is a very conservative estimate.

We expect there to be a steady build up of clients coming from the clothing shop to talk to us about holidays. However, the number of new enquiries generated by our promotional activity will also build up during the year, gradually overtaking enquiries from the clothes shop. This is a trend we expect to continue.

Based on the projection below, we are forecasting to sell 660 adventure travel holidays next year at an average price of £2,125.

Once insurance and other service sales are added in we expect to generate an income of £160,948 over the 12 months.

Sales Forecast Projection

	Q1	Q2	Q3	Q4	Year Total
Enquiries Generated Through Promotion	200	425	425	750	1,800
Adventure Shop Enquiries	300	300	450	450	1,500
Total Enquiries	**500**	**725**	**875**	**1,200**	**3,300**
Holidays Sold	100	145	175	240	660
Average Holiday's Cost	2,000	2,000	2,250	2,250	2,125
Commission Received	20,000	29,000	43,312	59,136	151,448
Commission on Insurance & Other Services Received	1,000	2,000	3,000	3,500	9,500
Total Commission & Fees Earned	**21,000**	**31,000**	**43,312**	**62,636**	**160,948**

In year 2 we are forecasting commission of £373,843, and in year 3 we plan to reach £590,926.

Cash Flow Projections and Sensitivity Analysis

The cash flow projections for year 1 show that after the owner has put in £25,000 the business will need additional short-term financing of about £50,000. For the last two months of the year we are forecasting a positive cumulative cash flow, and a year-end cash surplus of £11,937.

We have also done a sensitivity analysis to assess the impact on cash flow, if our sales of holidays were 10 per cent less than projected. We do not believe this to be a likely event. But even if it were to occur, our short-term financing needs would still not exceed £50,000 in any month. However, this scenario would leave the company with a small (£1,450) negative cash position at the year end.

In our cash flow projection we have assumed the whole $50,000 additional financing has come from a bank loan. We have allowed for interest on the full amount for the whole period. In practice, we would hope to finance part of this at least by an overdraft amount equal to the money actually required. In this way we believe we have made a prudent, conservative provision.

Profit and Loss Account

We expect to make a small after-tax profit in the first year of $21,898.This is before the owner's drawings. Any owner's drawings will be contingent on performance being better than that expected in the plan.

Projected Profits in Years 1 to 3

	Year 1	Year 2	Year 3
Turnover	1,416,071	3,115,356	4,545,588
Less Cost of Sales	1,255,123	2,741,513	3,954,662
Gross Profit	**160,948**	**373,843**	**590,926**
Less Expenses	133,575	145,750	207,000
Profit Before Tax	**27,373**	**228,093**	**383,926**
Provision for Tax	5,474	45,619	87,276
Proft After Tax	**21,898**	**182,474**	**296,650**

Balance Sheet

The balance sheet at the end of year 1 shows a healthy surplus of current assets over current liabilities. We have shown a conservative funding position, which does not include any of the additional capital that we hope to secure.

Performance Ratios

We plan to move our gross profit up from 11 per cent in year 1, to 13 per cent in year 3. These figures look quite low, but it should be remembered that our income is really the sales commission we earn, not the full price of an adventure holiday.

Our profit before tax is a more accurate measure of performance. This we expect to move from 2 per cent at the outset, up to 8 per cent by year 3.

Commission generated and profit per employee will be amongst the highest in the industry. At Brooker's Travel, for example, profit per employee never exceeded £19,500.

	Year 1	Year 2	Year 3
Gross Profit (%)	11	12	13
Profit Before Tax %	2	7	8
Commission Generated per Employee	£45,985	£83,076	£98,487
Profit per employee	£7,535	£41,471	£63,987

Break Even

To break even we will need to sell between 2 and 3 holidays a day. This compares with our present sales of 1.3 holidays a day, based on our part-time effort out of the clothing shop. So we feel confident that break even can be attained within a reasonable period.

~ Financing Requirements ~

Funds Required and Timing

The two major investments we plan to make are:

Web Site and Database Development (this will cost us £25,000). The database system is one of our key differentiators. It will allow us to offer superior service and ensure a high level of repeat business and referrals.

The Web site is vital if we are to reach this wide and disparate global market. The group of potential clients we have chosen as our target market (affluent, professional 25- to 35-year-olds) are prime users of the Internet. Even those people in our locality will expect to be able to research our offers on the Internet before coming to the shop.

Shop Premises Development (this will cost us £17,500). We have to look professional and to have an efficient work environment. If our staff do not have the right tools we can hardly expect them to deliver superior performance. If clients see an amateur premises, they will not be inspired to spend thousands of pounds and entrust their adventure holiday plans to us.

Both these investments need to be made at the outset to ensure the business creates the right impression from the start. We only get one chance to make a first impression.

We have decided to lease our telephone and computer systems as this is a rapidly changing area and we need to have access to the very latest technology. Financing packages from equipment suppliers are currently very attractive.

Funding Options

The owner plans to invest £25,000 of her own money (the proceeds of the sale of her share of the clothing shop business). The cash flow projections show that the business will require a further £50,000 of working capital during the early months of the first year's trading. We think we should provide for £60,000 to allow for unforeseen eventualities. We are considering two options for raising this.

Option 1: The sale of equity, perhaps to the original shop partners, of between £25,000 and £100,000. This would provide some capital to allow for growth. Any shortfall could be funded by overdraft or a bank loan.

Option 2: Approach our bank with a view to raising a medium-term loan of £25,000 and an overdraft facility of £35,000. Karen Kehoe could, with family help, provide any lender with security for part, if not all, of this facility.

~ Business Controls ~

Financial

We will be using a computer-based financial management system. This will allow us to analyse the profitability of sales of different holidays through each tour operator. In this way we can review our sales and marketing activities on a regular basis. It will also allow us to reward staff on the basis of profit achieved rather than just on sales.

Sales and Marketing

We will also be using a contact-management system that will allow us to monitor the effectiveness of different promotional strategies and of different marketing messages. The cornerstone of our strategic advantage lies in having superior data on prospects and clients.

Appendix: Market Research

International Arrivals by World Region

Indicators of Tourism Demand

Summary of Findings From our Market Research

Adventure Works Travel Market Research Questionnaire

Chapter 18

Ten Questions to Ask About Your Plan

In This Chapter

- Looking over what you've done
- Making the necessary changes

It never hurts to step back every once in a while and take stock of where you stand. With that in mind, we've filled this chapter with all sorts of questions to mull over before you share your business plan with the world.

Are Your Goals Tied to Your Mission?

Look at the goals that you set for your business. These goals are the results that you absolutely, positively intend to achieve, and to a large extent, these goals determine how you set priorities and how you run your business. Your goals have to be consistent with one another so that you're not running in different directions at the same time. In addition, you have to tie your goals to your company's mission so that you're heading in the direction in which you really want to go.

Can You Point to Major Opportunities?

If you want your business to grow and prosper in the long haul, you have to take advantage of opportunities as they come along. Don’t get too fixated on short-term economic problems, however severe; try to look over the horizon using your business plan to highlight the major opportunities that you see heading your way (in technology, markets and distribution, for example) and outline the actions that your company intends to take now so as to be in a position to take advantage of those opportunities down the road.

Have You Prepared for Threats?

You can easily paint a rosy picture of what the future holds for your company, but having a rosy picture doesn’t necessarily mean that it’s going to come true. Your company is in much better shape if you paint an objective picture – including the bad news along with the good. That way, you’re prepared for the dangers that are bound to be there.

Your business plan should point out the biggest threats that loom on the horizon (a market slowdown, new regulations, or increasing competition, for example) and offer ways to prepare for them. If you recognise threats before anybody else does, you can often turn a threat into a real business opportunity. Use Chapter 15 to help spot economic turning points.

Have You Defined Your Customers?

The more you know about your customers – who they are, how they act, what they want – the more you know about your company. Customers tell you how to succeed in the marketplace.

Describing your customers is much easier if you think about dividing them into separate groups. Each group, or market segment, has its own unique profile and places its own set of demands on your company.

Your customers are so important to your company that you can't afford to leave them out of your business plan. You should answer three questions:

- Who is buying?
- What do they buy?
- Why do they buy?

Your plan should explain how your company intends to serve those customers better than anyone else out there.

Can You Track Your Competitors?

Your competitors are around to make life interesting. They're the companies that always try to woo your customers away, promising products or services that have better value (more benefits, lower prices), and you can't ignore them. You have to be able to identify who your competitors are, what they're doing and where they plan to go in the future.

Competition represents a big piece of your business environment. Your business plan should cover what you know about your competitors and – more important – how you intend to keep track of them on an ongoing basis. Your plan should also address how you intend to use what you find out to choose competitive battles that you can win.

Where Are You Strong (and Weak)?

You may find it hard to be objective in making an honest assessment of what your company does well and what it could do assessment of what your company does well and what it could do better. But your company's strengths and weaknesses determine its odds of success as you look ahead. Strengths and weaknesses refer to your company's capabilities and resources and how well they match up with the capabilities and resources that your company really needs to have in place to be successful. Check out Chapter 8 for more tips on carrying out a SWOT (Strenths, Weaknesses, Opportunities and Threats) analysis.

Your business plan should list your company's capabilities and resources – from management skills or research expertise to operations and distribution strength or loyal customers. But the plan must go on to describe how each of these capabilities or resources is a strength or a potential weakness, given your business situation and the industry in which you compete.

Does Your Strategy Make Sense?

Strategy has to do with how you intend to make your business plan happen. For starters, you have to pull together your company's strengths and weaknesses, the opportunities and threats that your company faces and the business goals that you set. Then, given all these pieces of the puzzle, you have to figure out a way to get where you want to be, in spite of all the things that stand in your way.

It should be clear, from beginning to end, that your business plan is based on an overall strategy that makes sense. Your company should have a strategy that's grounded in reality and that makes reasonable assumptions about what's happening and what's about to happen – a strategy that's logical and rational about what can be accomplished and how long it's going to take.

Can You Stand Behind the Numbers?

Think about all your financial statements as your company's report card – one that answers some big questions. Do your customers love you? Do your competitors respect you? Are you making the right business choices? A profit and loss account presents the bottom line, the balance sheet shows your business's financial health and the cash-flow statement keeps track of the money.

Your current financial statements tell everybody how well you're doing. But many people are more interested in your financial forecasts, which say what you expect to happen in the future. Just because these forecasts include official-looking numbers, however, doesn't mean that the predictions will necessarily come true. If you want to paint an honest picture of your company, your business plan should include a realistic financial portrait, based on assumptions that you believe in and numbers that you trust.

Are You Really Ready for Change?

If one thing remains constant in the business world, it's change. Although some industries change faster than others, everything around you – from technology to competition to your market – is going to be a little different tomorrow than it is today, no matter what business you're in. If you want to keep up, you have to think two or three steps ahead. You must look carefully and continually at what may happen in the world and how it may affect your company.

Although your business plan paints an honest picture of how you see your company and what you see happening down the road, the plan should also acknowledge the fact that you don't have a crystal ball. So present some options. Include one or two alternative business scenarios, asking – and answering – the question 'What if . . .?'

Is Your Plan Clear, Concise and Current?

Current?

Your plan should certainly capture all the things that you think are essential to know about your company and its situation – everything important that you discover in the process of planning your company. But none of the information that you present is going to be of any use to anyone else if your business plan is too long, impossible to read, or out of date.

Read over your own plan. Is it easy to understand? Is it easy to navigate? How long did it take you to read? Did you know where to find all the details? Did the details get in the way?

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Learn to:

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John A Tracy is Professor of Accounting, Emeritus, in the College of Business and Administration at the University of Colorado in Boulder. Before his 35-year tenure at Boulder he was on the business faculty for four years at the University of California in Berkeley. He has served as staff accountant at Ernst & Young and is the author of several books on accounting, including The Fast Forward MBA in Finance and How To Read a Financial Report. Dr Tracy received his MBA and PhD degrees from the University of Wisconsin and is a CPA in Colorado.

Colin Barrow was until recently Head of the Enterprise Group at Cranfield School of Management, where he taught entrepreneurship on the MBA and other programmes and where he is still a visiting fellow. He is also a visiting professor at business schools in the US, Asia, France and Austria. His books on entrepreneurship and business have been translated into over twenty languages including Russian and Chinese. He worked with Microsoft to incorporate the business planning model used in his teaching programmes into the software program, Microsoft Business Planner, bundled with Office. He is a regular contributor to newspapers, periodicals and academic journals such as The Financial Times, The Guardian, Management Today and the International Small Business Journal.

Thousands of students have passed through Colin's start-up and business growth programmes, raising millions in new capital and going on to run successful and thriving enterprises. Some have made it to *The Sunday Times* Rich List. He has been a non-executive director of two venture capital funds, on the board of several small businesses, and serves on a number of Government Task Forces. Currently he is a non-executive director in several private firms and works with family businesses in the Middle East on succession planning.

Dedication

For all my grandchildren.

John A Tracy

Authors' Acknowledgments

From John: I'm deeply grateful to everyone at Wiley who helped produce this book. Their professionalism and their unfailing sense of humour and courtesy were much appreciated. I owe a debt of gratitude to a faculty colleague at Boulder, an accomplished author in his own right, Professor Ed Gac. He offered very sage advice. Ed was always ready with a word of encouragement when I needed one, and I'm very appreciative.

I often think about why I like to write books. I believe it goes back to an accounting class in my undergraduate days at Creighton University in Omaha. In a course taught by the Dean of the Business School, Dr Floyd Walsh, I turned in a term paper and he said that it was very well written. I have never forgotten that compliment. I think he would be proud of this book.

From Colin: I would like to thank everyone at Wiley for the opportunity to write this book, as well as their help, encouragement, feedback and tireless work to make this all happen.

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Understanding Business Accounting For Dummies®

Visit www.dummies.com/cheatsheet/understandingbusinessaccountin to view this book's cheat sheet.

Table of Contents

Introduction

Welcome to *Understanding Business Accounting For Dummies*, 3rd Edition. We've written this book for people who need to understand accounting information and financial reports, quickly. Unsurprisingly the business climate at the end of the first decade of the 21st Century has made this a hot topic – not quite in the Stieg Larsson league but every bit as scary in its own way. While it's *not* for accountants and bookkeepers, they should find this book very interesting and a good refresher course. This book is for people who need to use and understand accounting information – business managers and entrepreneurs, for example, who need to raise money, make profit, turn profit into cash flow and control the assets and liabilities of their venture. If you're running a business or you're a business unit manager, we're probably preaching to the converted when we say that you need a basic familiarity with accounting and financial statements in order to make good business decisions.

Business investors, lawyers, business consultants – pretty much anyone who reads (or aspires to read) *The Financial Times* – can also benefit from a solid understanding of how to read financial reports and how accounting works.

About This Book

Understanding Business Accounting For Dummies, 3rd Edition lifts the veil of obscure terminology and lays bare the methods of accounting. This book takes you behind the scenes and explains the language and methods of accounting in a down-to-earth and light-hearted manner – and *in plain English*.

Each chapter in this book is designed to stand on its own. Each chapter is self-contained, and you can jump from chapter to chapter as you please (although we encourage you to take a quick tour through the chapters in the order that we present them). We bet you'll discover some points that you may not have expected to find in a book about accounting.

Conventions Used in Financial Reports

Much of this book focuses on profit and how a business makes profit. Because profit and other financial aspects of a business are reported in *financial statements*, understanding some basic notations and conventions used in these financial reports is important.

We use the following condensed profit and loss account to illustrate some conventions that you can expect to see when reading financial reports. (The actual format of a profit and loss account includes more information about expenses and profit.) These conventions are the common ways of showing figures in financial reports just as saying hello and shaking hands are common conventions that you can expect when you greet someone.

Abbreviated Profit and Loss Account

Sales revenue		£25,000,000
Cost of goods sold expense	15,000,000	
Gross margin	£10,000,000	
Marketing expenses	£4,000,000	
Other expenses	2,000,000	6,000,000
Profit		£4,000,000

- You read a financial statement from the top down. In this sample profit and loss account, for example, sales revenue is listed first followed by cost of goods sold expense because this particular expense is the first expense deducted from sales revenue. The other two expenses are listed below the first profit line, which is called gross margin.

- The sample profit and loss account includes two columns of numbers. Note that the 6,000,000 total of the two expenses in the left column is entered in the right column. Some financial statements display all figures in a single column.
- An amount that is deducted from another amount – like cost of goods sold expense in this sample profit and loss account – may have parentheses around the amount to indicate that it is being subtracted from the amount just above it. Or, financial statements may make the assumption that you know that expenses are deducted from sales revenue – so no parentheses are put around the number. You see expenses presented both ways in financial reports. But you hardly ever see a minus or negative sign in front of expenses – it's just not done.
- Notice the use of pound signs in the sample profit and loss account. Not all numbers have a pound sign in front of the number. Financial reporting practices vary on this matter. We prefer to use pound signs only for the first number in a column and for a calculated number. In some financial reports, pound signs are put in front of all numbers, but usually they aren't.
- To indicate that a calculation is being done, a single underline is drawn under the bottom number, as you see below the 15,000,000 cost of goods sold expense number in the sample profit and loss account.
- The final number in a column is usually double underlined, as you can see for the £4,000,000 profit number in the sample profit and loss account. This is about as carried away as accountants get in their work – a double underline. Again, actual financial reporting practices are not completely uniform on this point – instead of a double underline on a bottom-line number, the number may appear in **bold.**

- Sometimes statements note that the amounts shown are in thousands (this prevents clogging up neat little columns with loads of noughts). So if a statement noting ‘amounts in thousands’ shows £300, it actually means £300,000. And that can make quite a difference!

When we present an accounting formula that shows how financial numbers are computed, we show the formula indented, like this:

Assets = Liabilities + Owners’ Equity

Terminology in financial reporting is reasonably uniform, thank goodness, although you may see a fair amount of jargon. When we introduce a new term in this book, we show the term in *italics* and flag it with an icon (see the section ‘Icons Used in This Book’ later in this Introduction). You can also turn to Appendix A to look up a term that you’re unfamiliar with.

Foolish Assumptions

While this book is designed for all of you who have that nagging feeling that you really should know more about accounting, we have made a few assumptions about you.

You don’t want to be an accountant, nor do you have any aspirations of ever sitting for the FCA (Fellow of the Institute of Chartered Accountants) exam. But you worry that ignorance of accounting may hamper your decision-making, and you know deep down that learning more about accounting would help.

We assume that you have a basic familiarity with the business world, but we take nothing for granted in this book regarding how much accounting you know. Even if you have some experience with accounting and financial statements, we think you’ll find this book useful – especially for improving your communication with accountants.

We assume that you need to *use* accounting information. Many different types of people (business managers, investors and solicitors, to name but three) need to understand accounting basics – not all the technical stuff, just the fundamentals.

We assume that you want to know something about accounting because it's an excellent gateway for understanding how business works, and it gives you an indispensable vocabulary for moving up in the business and investment worlds. Finding out more about accounting helps you understand earnings reports, mergers and takeovers, frauds and pyramid schemes, and business restructurings.

Let us point out one other very practical assumption that we have regarding why you should know some accounting. We call it the *defensive* reason. A lot of people out there in the cold, cruel financial world may take advantage of you, not necessarily by illegal means, but by withholding key information and by diverting your attention away from unfavourable aspects of certain financial decisions. These unscrupulous characters treat you as a lamb waiting to be fleeced. The best defence against such tactics is to learn some accounting basics, which can help you ask the right questions and understand the financial points that tricksters don't want you to know.

How This Book Is Organised

This book is divided into parts, and each part is further divided into chapters. The following sections describe what you can find in each part.

Part I: Accounting Basics

Part I of *Understanding Business Accounting For Dummies*, 3rd Edition introduces accounting to non-accountants and discusses the basic features of bookkeeping and accounting record-keeping systems. This part also talks about taxes of all kinds that are involved in running a business, as well as accounting in the everyday lives of individuals.

Part II: Getting a Grip on Financial Statements

Part II moves on to the end product of the business accounting process – *financial statements.* Three main financial statements are prepared every period – one for each financial imperative of business: making *profit*, keeping *financial condition* in good shape and controlling *cash flow.* The nature of profit and the financial effects of profit are explained in Chapter 5. The assets, liabilities and owners' capital invested in a business are reported in the *balance sheet*, which is discussed in Chapter 6. Cash flow from profit and the *cash flow statement* are explained carefully in Chapter 7. The last chapter in this part, Chapter 8, explains what managers have to do to get financial statements ready for the annual financial report of the business to its owners.

Part III: Accounting in Managing a Business

Business managers should know their financial statements like the backs of their hands. However, just understanding these reports is not the end of accounting for managers. Chapter 9 kicks off this part with an extraordinarily important topic – building a basic profit model – that clearly focuses on the key variables that drive profit.

model – that clearly focuses on the key variables that drive profit. This model is absolutely critical for decision-making analysis.

Chapter 10 discusses accounting-based planning and control techniques, especially budgeting. Business managers and owners have to decide on the best business ownership structure, which we discuss in Chapter 11. Managers in manufacturing businesses should be wary of how product costs are determined – as Chapter 12 explains. This chapter also explains other economic and accounting costs that business managers use in making decisions. Chapter 13 identifies and explains the alternative accounting methods for expenses and how the choice of method has a major impact on profit for the period, and on the cost of stock and fixed assets reported in the balance sheet.

Part IV: Financial Reports in the Outside World

Part IV explains financial statement reporting for investors. Chapter 14 presents a speed-reading approach that concentrates on the key financial ratios to look for in a financial report. The scope of the annual audit and what to look for in the auditor's report are explained in Chapter 15, which also explains the role of auditors as enforcers of financial accounting and disclosure standards.

Part V: The Part of Tens

This part of the book presents four chapters. Chapter 16 presents some practical ideas for managers to help them put their accounting knowledge to use while Chapter 17 lists various sources of finance available to the business. Chapter 18 gives business investors some handy tips on things to look for in a financial report – tips that can make the difference between making a good investment and a not-so-good one. Chapter 19 provides our take on reading the stars. Sure, no one knows everything about the financial future, but here we outline some ways you can spot a cloud before it becomes a thunder storm.

Part VI: Appendixes

At the back of the book, you can find two helpful appendixes that can assist you on your accounting safari. Appendix A provides you with a handy, succinct glossary of accounting terms. Appendix B fills you in on the accounting software programs available for your business.

Icons Used in This Book

For Dummies books always include little icons in the margins to draw your attention to paragraphs of particular significance:

This icon calls your attention to particularly important points and offers useful advice on practical financial topics. This icon saves you the cost of buying a yellow highlighter pen.

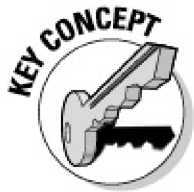
This icon serves as a friendly reminder that the topic at hand is important enough for you to put a note about it in the front of your wallet. This icon marks material that your lecturer might put on the board before the class starts, noting the important points that you should remember at the end of the class.

Accounting is the language of business, and, like all languages, the vocabulary of accounting contains many specialised terms. This icon identifies key accounting terms and their definitions. You can also check the glossary (Appendix A) to find definitions of unfamiliar terms.

This icon is a caution sign that warns you about speed bumps and potholes on the accounting highway. Taking special note of this material can steer you around a financial road hazard and keep you from blowing a fiscal tyre. In short – watch out!

We use this icon sparingly; it refers to very specialised accounting stuff that is heavy going, which only an FCA could get really excited about. However, you may find these topics important enough to return to when you have the time. Feel free to skip over these points the first time through and stay with the main discussion.

This icon alerts you that we're using a practical example to illustrate and clarify an important accounting point. You can apply the example to your business or to a business in which you invest.



This icon points out especially important ideas and accounting concepts that are particularly deserving of your attention. The material marked by this icon describes concepts that are the building blocks of accounting – concepts that you should be very clear about, and that clarify your understanding of accounting principles in general.

Where to Go from Here

If you're new to the accounting game, by all means, start with Part I. However, if you already have a good background in business and know something about bookkeeping and financial statements, you may want to jump right into Part II of this book, starting with Chapter 5. Part III is on accounting tools and techniques for managers and assumes that you have a handle on the financial statements material in Part II. Part IV stands on its own; if your main interest in accounting is to make sense of and interpret financial statements, you can read through Part II on financial statements and then jump to Part IV on reading financial reports. If you have questions about specific accounting terms, you can go directly to the glossary in Appendix A.

We've had a lot of fun writing this book. We sincerely hope that it helps you become a better business manager and investor, and that it aids you in your personal financial affairs. We also hope that you enjoy the book. We've tried to make accounting as fun as possible, even though it's a fairly serious subject. Just remember that accountants never die; they just lose their balance. (Hey, accountants have a sense of humour, too.)

Chapter 2

Bookkeeping 101: From Shoe Boxes to Computers

In This Chapter

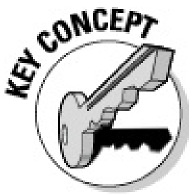
- Understanding the difference between bookkeeping and accounting
- Following the steps in the bookkeeping cycle
- Managing the bookkeeping and accounting system
- Getting down the basics of double-entry accounting
- Deterring and detecting errors, irregularities and outright fraud

Most people are pretty terrible bookkeepers just because they really don't do much bookkeeping. Admit it. Maybe you balance your chequebook against your bank statement every month and somehow manage to pull together all the records you need for your annual income tax return. But you probably stuff your bills in a drawer and just drag them out once a month when you're ready to pay them. (Hey, that's what we do.) And you almost certainly don't prepare a detailed listing of all your assets and liabilities (even though a listing of assets is a good idea for insurance purposes). We don't prepare a summary statement of our earnings and income for the year or a breakdown of what we spent our money on and how much we saved. Why not? Because we don't need to! Individuals can get along quite well without much bookkeeping – but the exact opposite is true for a business.

One key difference between individuals and businesses is that a business must prepare periodic *financial statements*, the accuracy of which is critical to the business's survival. The business uses the accounts and records generated by its bookkeeping process to prepare these statements; if the accounting records are incomplete or inaccurate, the financial statements will be incomplete or inaccurate. And inaccuracy simply won't do.

Obviously, then, business managers have to be sure that the company's bookkeeping and accounting system is adequate and reliable. This chapter shows managers what bookkeepers and accountants do – mainly so that you can make sure that the information coming out of your accounting system is complete, timely and accurate.

Bookkeeping versus Accounting



Bookkeeping is essentially the process (some would say the drudgery) of recording all the information regarding the transactions and financial activities of a business – the record-keeping aspects of accounting. Bookkeeping is an indispensable subset of accounting. The term *accounting* goes much further, into the realm of designing the bookkeeping system in the first place, establishing controls to make sure that the system is working well, and analysing and verifying the recorded information. Bookkeepers follow orders; accountants give orders.

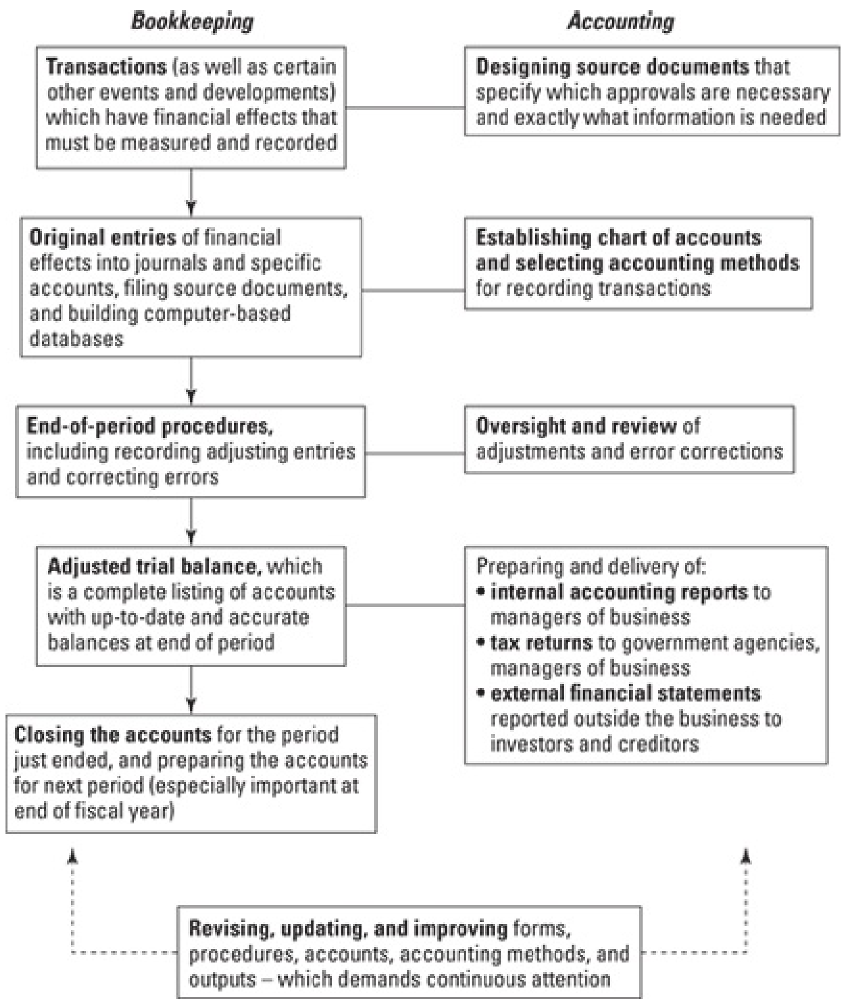
Accounting can be thought of as what goes on before and after bookkeeping. Accountants prepare reports based on the information accumulated by the bookkeeping process – financial statements, tax returns and various confidential reports to managers. Measuring profit is a very important task that accountants perform, a task that depends on the accuracy of the information recorded by the bookkeeper. The accountant decides information recorded by the bookkeeper. The accountant decides how to measure sales revenue and expenses to determine the profit or loss for the period. The tough questions about profit – where it is and what it consists of – can't be answered through bookkeeping alone.

The rest of this book doesn't discuss bookkeeping in any detail – no talk of debits and credits and all that stuff. All you really need to know about bookkeeping, as a business manager, is contained in this chapter alone.

Pedalling through the Bookkeeping Cycle

Figure 2-1 presents an overview of the bookkeeping cycle side-by-side with elements of the accounting system. You can follow the basic bookkeeping steps down the left-hand side. The accounting elements are shown in the right-hand column. The basic steps in the bookkeeping sequence, explained briefly, are as follows. (See also 'Managing the Bookkeeping and Accounting System,' later in this chapter, for more details on some of these steps.)

Figure 2-1: The basic steps and sequence of the bookkeeping cycle, including the accounting inputs and outputs.



1. Record *transactions* – the economic exchanges between a business and the other people and businesses that it deals with.

Transactions have financial effects that must be recorded – the business is better off, worse off or at least ‘different off’ as the result of its transactions. Examples of typical business transactions include paying employees, making sales to customers, borrowing money from the bank and buying products that will be sold to customers. The bookkeeping process begins by identifying all transactions and capturing the relevant information about each transaction.

2. Prepare and collect *source documents* – transaction documentation that the bookkeeper uses to record the transactions.

When buying products, a business gets a *purchase invoice* from the supplier. When borrowing money from the bank, a business signs for an *overdraft*, a copy of which the business keeps. When a customer uses a credit card to buy the business's product, the business gets the *credit card slip* as evidence of the transaction. When preparing payroll cheques, a business depends on *salary schedules* and *time cards.* All of these key business forms serve as sources of information into the bookkeeping system – in other words, information the bookkeeper uses in recording the financial effects of the transaction.

3. Record original entries (the financial effects of the transactions) into journals and accounts.

Using the source document(s) for every transaction, the bookkeeper makes the first, or original, entry into a journal and then into the business's accounts. Only an official, established book of accounts should be used in recording transactions. A *journal* is a chronological record of transactions in the order in which they occur – like a very detailed personal diary. In contrast, an *account* is a separate record for each asset, each liability and so on. One transaction affects two or more accounts. The journal entry records the whole transaction in one place; then each piece is recorded in the two or more accounts changed by the transaction.

Here's a simple example that illustrates recording of a transaction in a *journal* and then *posting* the changes caused by the transaction in the *accounts.* Expecting a big demand from its customers, a retail bookshop purchases, on credit, 50 copies of *Understanding Business Accounting For Dummies* from the publisher, John Wiley & Sons, Ltd. The books are received and placed on the shelves. (50 copies are a lot to put on the shelves, but our relatives promised to rush down and buy several copies each.) The bookshop now owns the books and also owes John Wiley £600.00, which is the cost of the 50 copies. You look only at recording the purchase of the books, not recording subsequent sales of the books and paying the bill to John Wiley.

The bookshop has established a specific stock or account called 'Stock-Trade Paperbacks' for books like this. And the purchase liability to the publisher should be entered in the account 'Creditor-Publishers'. So the journal entry for this purchase is recorded as follows:

Stock-Trade Paperbacks + £600.00 Creditor-Publishers + £600.00

This pair of changes is first recorded in one journal entry. Then, sometime later, each change is *posted,* or recorded, in the separate accounts – one an asset and the other a liability.

Not so long ago, bookkeepers had to record these entries by hand, and even today there's nothing wrong with a good hand-entry (manual) bookkeeping system. But bookkeepers can now use computer programs that take over many of the tedious chores of bookkeeping. Computers have come to the rescue – of course, typing has replaced hand cramps with repetitive strain injury, but at least the work gets done more quickly and with fewer errors! (See Appendix B for more about popular accounting software packages for personal computers.)

We can't exaggerate the importance of entering transaction data correctly and in a timely manner. For example, an important reason that most retailers these days use cash registers that read bar-coded information on products is to more accurately capture the necessary information and to speed up the entry of this information.

4. Perform end-of-period procedures – preliminary steps for preparing the accounting reports and financial statements at the end of every period.

A *period* can be any stretch of time – from one day to one month to one quarter (three months) to one year and is determined by the needs of the business. A year is usually the longest period of time that a business would wait to prepare its financial statements. As a matter of fact, most businesses need accounting reports and financial statements at the end of each quarter, and many need monthly financial statements.

Before the accounting reports can be prepared at the end of the period (see Figure 2-1), the bookkeeper needs to bring the accounts of the business up-to-date and complete the bookkeeping process. One step, for example, is recording the *depreciation expense* for the period (see Chapter 6 for more on depreciation). Another step is getting an actual count of the business's stock so that the stock records can be adjusted to account for shoplifting, employee theft and so on.

The accountant needs to take the final step and check for errors in the business's accounts. Data entry clerks and bookkeepers may not fully understand the unusual nature of some business transactions and may have entered transactions incorrectly. One reason for establishing *internal controls* (discussed in 'Protect the family jewels: Internal controls', later in this chapter) is to keep errors to an absolute minimum. Ideally, accounts should contain very few errors at the end of the period, but the accountant can't make any assumptions and should make a final check for any errors that fell through the cracks.

5. **Prepare the adjusted trial balance for the accountants.**

   After all the end-of-period procedures have been completed, the bookkeeper prepares a complete listing of all accounts, which is called the *adjusted trial balance.* Modest-sized businesses maintain hundreds of accounts for their various assets, liabilities, owners' equity, revenue and expenses. Larger businesses keep thousands of accounts, and very large businesses may keep more than 10,000 accounts. In contrast, external financial statements, tax returns and internal accounting reports to managers contain a relatively small number of accounts. For example, a typical external balance sheet reports only 20 to 25 accounts, and a typical income tax return contains less than 100 accounts.

The accountant takes the adjusted trial balance and telescopes similar accounts into one summary amount that is reported in a financial report or tax return. For example, a business may keep hundreds of separate stock accounts, every one of which is listed in the adjusted trial balance. The accountant collapses all these accounts into one summary stock account that is presented in the external balance sheet of the business.

In short, the large number of specific accounts listed in the adjusted trial balance is condensed into a comparatively small number of accounts that are reported in financial statements and tax returns. In grouping the accounts, the accountant should comply with established financial reporting standards and income tax requirements.

6. ***Close the books* – bring the bookkeeping for the fiscal year just ended to a close and get things ready to begin the bookkeeping process for the coming fiscal year.**

Books is the common term for *accounts*. A business's transactions are a constant stream of activities that don't end tidily on the last day of the year, which can make preparing financial statements and tax returns challenging. The business has to draw a clear line of demarcation between activities for the year (the 12-month accounting period) ended and the year yet to come by *closing the books* for one year and starting with fresh books for the next year.

The business may have an *accounting manual* that spells out in great detail the specific accounts and procedures for recording transactions. But all businesses change over time, and they occasionally need to review their accounting system and make revisions. Companies do not take this task lightly; discontinuities in the accounting system can be major shocks and have to be carefully thought out. Nevertheless, bookkeeping and accounting systems can't remain static for very long. If these systems were never changed, bookkeepers would still be sitting on high stools making entries with quill pens and ink in leather-bound ledgers.

Managing the Bookkeeping and Accounting System

In our experience, far too many business managers either ignore their bookkeeping and accounting systems or take them for granted – unless something obvious goes wrong. The managers assume that if the books are in balance, then everything is okay. The section 'Recording transactions using debits and credits', later in this chapter, covers just exactly what 'the books being in balance' means – it does *not* necessarily mean that everything is okay.

To determine whether your bookkeeping system is up to scratch, check out the following sections, which, taken as a whole, provide a checklist of the most important elements of a good system.

Categorise your financial information: The chart of accounts

Suppose that you're the accountant for a company and you're faced with the daunting task of preparing the annual income tax return for the business. This demands that you report the following kinds of expenses (and this list contains just the minimum!):

- Advertising
- Bad debts
- Charitable contributions
- Compensation of directors
- Cost of goods sold

- Depreciation
- Employee benefits
- Interest
- Pensions and profit-sharing plans
- Rents
- Repairs and maintenance
- Salaries and wages
- Taxes and licenses

You must provide additional information for some of these expenses. For example, the cost of goods sold expense is determined in a schedule that also requires stock cost at the beginning of the year, purchases during the year, cost of labour during the year (for manufacturers), other costs and stock cost at year-end.

Where do you start? Well, if it's March 1 and the tax return deadline is March 15, you start by panicking – unless you were smart enough to think ahead about the kinds of information your business would need to report. In fact, when your accountant first designs your business's accounting system, he or she should dissect every report to managers, the external financial statements and the tax returns, breaking down all the information into categories such as those we just listed.

JARGON ALERT

For each category, you need an *account*, a record of the activities in that category. An account is basically a focused history of a particular dimension of a business. In bookkeeping this means a basic category of information in which the financial effects of transactions are recorded and which serves as the source of information for preparing financial statements, tax returns and reports to managers.

The term *general ledger* refers to the complete set of accounts established and maintained by a business. The *chart of accounts* is a term used to describe a formal index of these accounts – the complete listing and classification of the accounts used by the business to record its transactions. *General ledger* usually refers to the actual accounts and often to the balances in these accounts at some particular time.

The chart of accounts, even for a relatively small business, normally contains 100 or more accounts. Larger business organisations need thousands of accounts. The larger the number, the more likely that the accounts are given number codes according to some scheme – all assets may be in the 100–300 range, all liabilities in the 400–500 range and so on.

As a business manager, you should make sure that the person in charge of accounting (or perhaps an outside chartered accountant) reviews the chart of accounts periodically to determine whether the accounts are up-to-date and adequate for the business's needs. Over time, income tax rules change, the company may go into new lines of business, the company could decide to offer additional employee benefits and so on. Most businesses are in constant flux, and the chart of accounts has to keep up with these changes.

Standardise source document forms and

procedures

Businesses move on paperwork. Whether placing an order to buy products, selling a product to a customer or determining the earnings of an employee for the month – virtually every business transaction needs paperwork, known as *source documents*. Source documents serve as evidence of the terms and conditions agreed upon by the business and the other person or organisation that it's dealing with. Both parties receive some kind of source document. For example, for a sale at a cash register, the customer gets a sales receipt, and the business keeps a running record of all transactions in the register.

Clearly, an accounting system needs to standardise the forms and procedures for processing and recording all normal, repetitive transactions and should control the generation and handling of these source documents.

From the bookkeeping point of view, these business forms and documents are very important because they provide the input information needed for recording transactions in the business's accounts. Sloppy paperwork leads to sloppy accounting records, and sloppy accounting records just won't do when the time comes to prepare tax returns and financial statements.

Check out a business office-supply store to see the kinds of forms that you can buy right off the shelf. You can find many – maybe all – of the basic forms and documents that you need for recording business transactions, although most firms have to design at least some of their own forms. Also, personal computer accounting software packages (see Appendix B for more detail) provide templates for common business forms.

Don’t be penny-wise and pound-foolish: The need for competent, trained personnel

What good is meticulously collecting source documents if the information on those documents isn’t entered into your system correctly? You shouldn’t try to save a few pounds by hiring the lowest-paid people you can find. Bookkeepers and accountants, like all other employees in a business, should have the skills and knowledge needed to perform their functions. No-brainer, right? Well, determining what that level is *can* be difficult. Here are some guidelines for choosing the right people to enter and manipulate your business’s data and for making sure that those people *remain* the right people:

- **University degree:** Many accountants in business organisations have a degree in accounting. However, as you move down the accounting department you find that more and more employees do not have a degree and perhaps even haven’t taken any courses in accounting.

- **ACA, ACCA or CIMA:** The main professional accounting credentials are: ACA sponsored by the Institute of Chartered Accountants; ACCA sponsored by the Association of Chartered Certified Accountants; and CIMA sponsored by the Chartered Institute of Management Accountants. All of these qualifications are evidence that the person has passed tough exams and has a good understanding of business accounting and income tax. The Association of Chartered Certified Accountants (`www.accaglobal.com`, click on ‘Public Interest’ and then on ‘Find an Accountant’) and the Institute of Chartered Accountants (`www.icaewfirms.co.uk`) have online directories of qualified accountants. You can search these directories by name (useful if you have a personal recommendation from a colleague you respect), location (handy if you just want someone nearby), the business sector you're in (helpful for tapping into specialist skills) or any specific accountancy skills or knowledge you're looking for.

- **Accounting technicians:** These people assist chartered accountants in their work, or can join a chartered institute themselves after further study. The Association of Accounting Technicians' website (www.aat.org.uk, then click on 'Employers' and 'Recruitment') provides guidance on pay structures and tips on how to find an accountant.

- **Bookkeepers:** These are the lowest-cost players in this game. They perform the basic entry work covering anything from simply recording the transactions in your books through to producing accounts, preparing the VAT return or doing the Payroll. The International Association of Bookkeepers (www.iab.org.uk) and the Institute of Certified Bookkeepers (www.bookkeepers.org) offer free matching services to help small businesses find a bookkeeper to suit their particular needs.

- **Continuing education:** Many short-term courses, e-learning and home-study programmes are available at very reasonable costs for keeping up on the latest accounting developments. Accountancy bodies that give practising certificates, which allow accountants to work with businesses in public practice, will expect them to take continuing education in approved courses in order to keep their practising certificates.

- **Integrity:** What's possibly the most important quality to look for is also the hardest to judge. Bookkeepers and accountants need to be honest people because of the amount of control they have over your business's financial records.

Protect the family jewels: Internal controls

Every accounting system should establish and vigorously enforce *internal controls* – basically, additional forms and procedures over and above what's strictly needed to move operations along. These additional controls serve to deter and detect errors (honest mistakes) and all forms of dishonesty by employees, customers, suppliers and even managers themselves. Internal controls are like a public weighbridge that makes sure that a heavy goods vehicle's load doesn't exceed the limits and that the vehicle has a valid licence. You're just checking that your staff are playing by the rules.

For example, to prevent or minimise shoplifting, most retailers now have video surveillance, tags that set off the alarms if the customer leaves the store with the tag still on the product, and so on. Likewise, a business has to implement certain procedures and forms to prevent, as much as possible, any theft, embezzlement, scams and fraud (and simple mistakes) by its own employees and managers.

In our experience, smaller businesses tend to think that they're immune to embezzlement and fraud by their loyal and trusted employees. Yet a recent study found that small businesses are hit the hardest by fraud and usually can least afford the consequences. Your business, too, should put checks and balances into place to discourage dishonest practices and to uncover any fraud and theft as soon as possible. For example, virtually every retailer that deals with the general public installs protection against shoplifting. Likewise, every business should guard against 'internal shoplifting' or fraud by its employees and managers.

Keep the scales in balance with double-entry accounting

entry accounting

A business needs to be sure that *both* sides of the economic exchange are recorded for all its transactions. Economic exchanges involve a give and take, or something given for something received. Businesses (and other entities as well) use the *double-entry accounting method* to make sure that both sides of their transactions are recorded and to keep their books in balance. This method, which has been used for hundreds of years, involves recording certain changes as debits and the counterbalancing changes as credits. See 'Double-Entry Accounting for Non-Accountants,' later in this chapter, for more details.

Check your figures: End-of-period procedures checklist

Like a pilot before take-off, an accountant should have a clear checklist to follow at the end of each period and especially at the end of the accounting year. Two main things have to be done at the end of the period:

- **Normal, routine *adjusting entries* for certain expenses:** For example, depreciation isn't a transaction as such and therefore hasn't been recorded as an expense in the flow of transactions recorded in the day-to-day bookkeeping process. (Chapter 6 explains depreciation expense.) Similarly, certain other expenses and some revenues may not have been associated with a specific transaction and will not have been recorded. These kinds of adjustments are necessary for providing complete and accurate reports.
- ***Careful sweep of all matters* to check for other developments that may affect the accuracy of the accounts:**

For example, the company may have discontinued a product line. The remaining stock of these products may have to be removed from the asset account, with a loss recorded in the period. Or the company may have settled a long-standing lawsuit, and the amount of damages needs to be recorded. Layoffs and severance packages are another example of what the chief accountant needs to look for before preparing reports.

Lest you still think of accounting as dry and dull, let us tell you that end-of-period accounting procedures can stir up controversy of the heated-debate variety. These procedures require that the accountant make decisions and judgments that upper management may not agree with. For example, the accountant may suggest recording major losses that would put a big dent in the profit for the year or cause the business to report a loss. The outside auditor (assuming that the business has an audit of its financial statements) often gets in the middle of the argument. These kinds of debates are precisely why you business managers need to know some accounting: to hold up your end of the argument and participate in the great sport of yelling and name-calling – strictly on a professional basis, of course.

Keep good records: Happy audit trails to you!

The happy trails that accountants like to walk are called *audit trails.* Good bookkeeping systems leave good audit trails.

An audit trail is a clear-cut path of the sequence of events leading up to an entry in the accounts; an accountant starts with the source documents and follows through the bookkeeping steps in recording transactions to reconstruct this path. Even if a business doesn't have an outside accountant do an annual audit, the firm's management accountant has frequent occasion to go back to the source documents and either verify certain information in the accounts or reconstruct the information in a different manner. For example, suppose that a salesperson is claiming some suspicious-looking travel expenses; the accountant would probably want to go through all this person's travel and entertainment reimbursements for the past year.

If HM Revenue and Customs comes in for a field audit of your business, you'd better have good audit trails to substantiate all your expense deductions and sales revenue for the year. Rules exist about saving source documents for a reasonable period of time (usually at least five years) and having a well-defined process for making bookkeeping entries and keeping accounts. Think twice before throwing away source documents. Also, ask your accountant to demonstrate, and lay out for your inspection, the audit trails for key transactions – such as cash collections, sales, cash disbursements, stock purchases and so on. Even in computer-based accounting systems, the importance of audit trails is recognised. Well-designed computer programs provide the ability to backtrack through the sequence of steps in the recording of specific transactions. The HM Revenue and Customs website (go to www.hmrc.gov.uk and click on 'Businesses and corporations') gives you the lowdown on which books to keep and for how long. You can search for info about any unlisted topics by using the search panel at the top of the homepage.

Look out for unusual events and developments

Business managers should encourage their accountants to be alert to anything out of the ordinary that may require attention. Suppose that the debtor balance for a particular customer is rapidly increasing – that is, the customer is buying more and more from your company on credit but isn't paying for these purchases quickly. Maybe the customer has switched more of his or her company's purchases to your business and is buying more from you only because he or she is buying less from other businesses. But maybe the customer is planning to stuff your business and take off without paying his or her debts. Or maybe the customer is secretly planning to go into bankruptcy soon and is stockpiling products before the company's credit rating heads south. To some extent, accountants have to act as the eyes and ears of the business. Of course, that's one of your main functions as business manager, but your accounting staff can play an important role as well.

Design truly useful accounting reports for managers

We have to be careful in this section; we have strong opinions on this matter. We have seen too many hit-and-miss accounting reports to managers – difficult to decipher and not very useful or relevant to the manager's decision-making needs and control functions.

Part of the problem lies with the managers themselves. As a business manager, have you told your accounting staff what you need to know, when you need it, and how to present it in the most efficient manner? Probably not. When you stepped into your position you probably didn't hesitate to rearrange your office and maybe even insisted on hiring your own support staff. Yet you most likely lay down like a lapdog regarding your accounting reports. Maybe you've assumed that the reports have to be done a certain way and that arguing for change is no use.

On the other hand, accountants bear a good share of the blame for the poor reports. Accountants should proactively study the manager's decision-making responsibilities and provide the information that is most useful, presented in the most easily digestible manner.

In designing the chart of accounts, the accountant should also keep in mind the type of information needed for management reports. To exercise control, managers need much more detail than what's reported on tax returns and external financial statements. And, as Chapter 9 explains, expenses should be regrouped into different categories for management decision-making analysis. A good chart of accounts looks to both the external and the internal (management) needs for information.

So what's the answer for a manager who receives poorly formatted reports? Demand a report format that suits your needs! See Chapter 9 for a useful profit analysis model (and make sure that your accountant reads that chapter as well).

Double-Entry Accounting for Non-Accountants

A business is a *two-sided* entity. It accumulates assets on one side – by borrowing money, persuading investors to put money in the business as owners, purchasing assets on credit and making profit. Profit (net income) is essentially an increase in assets, not from increasing liabilities and not from additional capital infusion from owners, but rather as the net result of sales revenue less expenses.

Assets don't fall on a business like manna from heaven. Assets have *sources*, and these sources are *claims* of one sort or another on the assets of a business. A business needs to keep track of the sources of assets, according to the type of claim each source has against the assets. This is precisely the reason for and nature of *double-entry accounting.*

The two-sided nature of a business entity and its activities

In a nutshell, double-entry accounting means *two-sided* accounting. Both the assets of a business and the sources of and claims on its assets are accounted for. Suppose that a business reports $10 million in total assets. That means the total sources of and claims on its assets are also reported at a total of $10 million. Each asset source has a different type of claim. Some liabilities charge interest and some don't; some have to be paid soon, and other loans to the business may not come due for five or ten years. Owners' equity may be mainly from capital invested by the owners and very little from retained earnings (profit not distributed to the owners). Or the mix of owners' equity sources may be just the reverse.

The sources of and claims on the assets of a business fall into two broad categories: *liabilities* and *owners' equity.* With a few technical exceptions that we won't go into, the amount of liabilities that the business reports are the amounts that will be paid to the creditors at the maturity dates of the liabilities. In other words, the amounts of liabilities are definite amounts to be paid at certain future dates.

In contrast, the amounts reported for owners' equity are *historical* amounts, based on how much capital the owners invested in the business in the past and how much profit the business has recorded. Owners' equity, unlike the liabilities of a business, has no maturity date at which time the money has to be returned to the owners. When looking at the amount of owners' equity reported in a balance sheet, don't think that this amount could be taken out of the business. Owners' equity is tied up in the business indefinitely.

So one reason for double-entry accounting is the two-sided nature of a business entity – assets are on one side and the sources of and claims on assets are on the other side. The second reason for double-entry accounting is the *economic exchange* nature of business activities, referring to the give-and-receive nature of the transactions that a business engages in to pursue its financial objectives. Consider a few typical transactions:

- A business borrows £10 million. It receives money, so the company's cash increases. In exchange, the business promises to return the £10 million to the lender at some future date so the company's debt increases. Interest on the loan is paid in exchange for the use of the money over time.
- The business buys products that it will later resell to its customers: It gives money for the products (the company's cash decreases) and receives the products (the company's stock increases).
- The business sells products: It receives cash or promises of cash to come later (the company's debtors increase), and it gives the products to the customer (the company's stock decreases). Of course, the business should sell the products for more than cost. The excess of the amount received over product cost is called *gross profit*, from which many other expenses have to be deducted. (Chapter 5 explains the profit-making transactions leading to bottom-line profit or loss.)

Recording transactions using debits and credits

Using *debits and credits* is a marvellous technique for making sure that both sides of exchanges are recorded and for keeping both sides of the accounting equation in balance. The recording of every transaction requires the same value for the debits on one side and the credits on the other side. Just think back to maths class in your schooldays: What you have on one side of the equal sign (in this case, in the accounting equation) must equal what you have on the other side of the equal sign.

See the table for how debits and credits work in the balance sheet accounts of a business. The rules of debits and credits:

Changes	***In Assets***	***In Liabilities and Owners' Equities***
Increases	Debit	Credit
Decreases	Credit	Debit

Note: Sales revenue and expense accounts, which aren't listed, also follow debit and credit rules. A revenue item increases owners' equity (thus is a credit), and an expense item decreases owners' equity (thus is a debit).

As a business manager, you don't need to know all the mechanics and technical aspects of using debits and credits. Here's what you do need to know:

- **The basic premise of the accounting equation:** Assets equal the sources of the assets and the claims on the assets. That is, the total of assets on the one side should equal the sum of total liabilities and total owners' equity on the other side.

- **The important difference between liabilities and owners' equity accounts:** Liabilities need to be paid off at definite due dates in the future. Owners' equity has no such claims for definite payments at definite dates. As such, these two accounts must be kept separate.

- **Balanced books don't necessarily mean correct balances:** If debits equal credits, the entry for the transaction is correct as far as recording equal amounts on both sides of the transaction. However, even if the debits equal the credits, other errors are possible. The bookkeeper may have recorded the debits and credits in a wrong account, or may have entered wrong amounts, or may have missed recording an entry altogether. Having balanced books simply means that the total of accounts with debit balances equals the total of accounts with credit balances. The important thing is whether the books (the accounts) have *correct* balances, which depends on whether all transactions and other developments have been recorded and accounted for correctly.

Making Sure the Books Don't Get Cooked

Cooked is a catch-all term; we're using the term in its broadest sense to include any type of dishonest, unethical, immoral or illegal practice. Our concern here is with the effects of distortion on a business's accounting records, not with the broader social and criminal aspects of fraudulent accounting – which are very serious, of course, but which are outside the scope of this book.

A business should capture and record faithfully all transactions in its accounting records. Having said this, we have to admit that some business activities are deliberately *not* accounted for or are accounted for in a way that disguises their true nature. For example, *money laundering* involves taking money from illegal sources (such as drug dealing) and passing it through a business to make it look legitimate – to give the money a false identity. This money can hardly be recorded as 'revenue from drug sales' in the accounts of the business.

Fraud occurs in large corporations and in one-owner/manager-controlled small businesses – and every size business in between. Some types of fraud are more common in small businesses, including *sales skimming* (not recording all sales revenue, to deflate the taxable income of the business and its owner) and the recording of personal expenses through the business (to make these expenses deductible for income tax). Some kinds of fraud are committed mainly by large businesses, including paying bribes to public officials and entering into illegal conspiracies to fix prices or divide the market. The purchasing managers in any size business can be tempted to accept kickbacks and under-the-table payoffs from vendors and suppliers.

We should mention another problem that puts accountants in the hot seat: In many situations, two or more businesses are controlled by the same person or the same group of investors. Revenue and expenses can be arbitrarily shifted among the different business entities under common control. For one person to have a controlling ownership interest in two or more businesses is perfectly legal, and such an arrangement often makes good business sense. For example, a retail business rents a building from a property business, and the same person is the majority owner of both businesses. The problem arises when that person arbitrarily sets the monthly rent to shift profit between the two businesses; a high rent generates more profit for the property business and lower profit for the retail business. This kind of manoeuvre may even be perfectly legal, but it raises a fundamental accounting issue.

Readers of financial statements are entitled to assume that all activities between the business and the other parties it deals with are based on what's called *arm's-length bargaining*, meaning that the business and the other parties have a purely business relationship. When that's not the case, the financial report should – but usually doesn't – use the term *related parties* to describe persons and organisations who are not at arm's length with the business. According to financial reporting standards, your accountant should advise you, the business manager, to disclose any substantial related-party transactions in your external financial statements.

In short, fraud occurs in the business world. Most of these schemes require *cooking the books* – which means altering entries in the accounts to cover the fraud or simply not recording certain entries that should be recorded. If you saw an expense account called *bribes,* you would tend to be a little suspicious, but unethical bookkeepers and accountants are usually a tad cleverer than that. You can find several tips on uncovering and preventing fraud in 'Managing the Bookkeeping and Accounting System' earlier in this chapter.

When the books have been cooked, the financial statements prepared from the accounts are distorted, incorrect and probably misleading. Lenders, other creditors and the owners who have capital invested in the business rely on the company's financial statements. Also, a business's managers and board of directors (the group of people who oversee a business enterprise) may be misled – assuming that they're not a party to the fraud, of course – and may also have liability to third-party creditors and investors for their failure to catch the fraud. Creditors and investors who end up suffering losses have legal grounds to sue the managers and directors (and perhaps the auditors who did not catch the fraud) for damages suffered.

The Sarbanes-Oxley Act, a new set of rules and regulations designed to ensure truthful accounting in companies listed on the American stock market, came into force in 2002. Chapter 1 gives you information about Sarbanes-Oxley.

Chapter 3

Taxes, Taxes and More Taxes

In This Chapter

- Paying taxes as an employer and a property owner
- Putting on your tax collector hat and collecting Value Added Tax (VAT)
- Determining how much of business profit goes to the government
- Allowing company tax methods to override good accounting methods
- Looking at the different ways company tax works for different business structures

As an employer, a business pays taxes. As a property owner or occupier, a business pays taxes. As a seller of goods and services, a business collects Value Added Tax paid by customers and remits the amounts to the government's Customs and Excise Department. And, of course, a business, or its owners, must pay corporate income tax. Yikes! Is there no escaping the tax millstone?

Nope, afraid not (short of resorting to illegal activity or a sly move to another country – you'll have to find another book to tell you about those options). But you can take advantage of the many options in tax laws that can minimise how much you pay and delay your payment (a perfectly legal strategy known as *tax avoidance*). This chapter starts you on your way by explaining the various types of taxation that a business faces.

We say that this chapter '*starts* you on your way' because we can't possibly provide you with exhaustive detail in one chapter. And besides, no one can give you good tax advice without first looking at your specific situation – consult a professional tax expert for that.

Taxing Wages and Property

Even if you don't earn a profit in your business, you still have to pay certain taxes. Unlike corporation tax, which is a *contingent* or *conditional* tax that depends on whether a business earns taxable income for the year, the two major types of non-income taxes – *employer payroll taxes* and *business rates* – always have to be paid. (See 'Taxing Your Bottom Line: Company Taxes,' later in this chapter, for more about income tax.)

Putting the government on the payroll: Employer taxes

In addition to deducting income tax from employees' wages and remitting those amounts to the proper government agencies, businesses need to pay National Insurance for all employees, yourself included. (Actually, National Insurance isn't really a tax, but we won't get technical.)

National Insurance

Most people don't realise that they usually pay less than half of their National Insurance bill – the employer picks up the rest of the tab. The idea is that the burden should be shared almost evenly, but with the employer generally picking up a little more of the tab.

We don’t want to get into a debate about the National Insurance system and the financial problems it’s facing; we’ll just say that the amount you’ll pay in National Insurance almost certainly won’t diminish in the future. Here’s an idea of what a business pays in National Insurance: In 20011/12, the first £5,315 of annual wages were exempt from any National Insurance charges. Then, up to a ceiling of £42,475, the employer pays 13.8 per cent.

Employment tax

Employing people requires you to manage a PAYE (Pay As You Earn) system. If your business is a limited company, the owner (you) is also liable for PAYE. You will also have to deduct National Insurance. Both these tasks will involve some additional record keeping, as, once again, owner-managers are being asked to act as unpaid tax collectors. There are serious penalties for getting it wrong.

PAYE

Income tax is collected from employees through the PAYE system, or Pay As You Earn. The employee’s liability to income tax is collected as it is earned instead of by tax assessment at some later date. If the business is run as a limited company, then the directors of the company are employees. PAYE must be operated on all salaries and bonuses paid to them, yourself included.

The way to an employee's heart is through the payroll department

Remember the first time you received a real pay cheque? Your jaw dropped when you compared the *gross wages* (the amount before deductions) and the *net,* or *take-home pay* (the amount you actually received), right? A business's accountants need to track how much of the following, by law, to deduct from employees' pay cheques:

- National Insurance.
- Pay As You Earn (PAYE) taxes on income, which go to the Government.
- Other, non-tax-related withholdings that the employee agrees to (such as union dues, pension plan contributions, and health insurance costs paid by the employee).
- Other non-tax-related withholdings required by a court order (for example, a business may be ordered to withhold part or all of an employee's wages and remit the amount to a legal agency or a creditor to which the employee owes money).

For all these deductions, a business serves as a collection agent and remits the appropriate amount of wages to the appropriate party. As you can imagine, this task requires lots of additional accounting and record-keeping.

HM Revenue and Customs now issues booklets in reasonably plain English explaining how PAYE works. The main documents you need to operate PAYE are:

- **Form P11,** a deduction working sheet for each employee.

- **The PAYE Tables.** There are two books of tax tables in general use, which are updated in line with the prevailing tax rates.
    - Pay Adjustment Tables show the amount that an employee can earn in any particular week or month before the payment of tax.
    - Taxable Pay Tables show the tax due on an employee's taxable pay.
- **Form P45,** which is given to an employee when transferring from one employment to another.
- **Form P46,** which is used when a new employee does not have a P45 from a previous employment (for example, a school-leaver starting work for the first time).
- **Form P60,** which is used so that the employer can certify an employee's pay at the end of the income tax year in April.
- **Form P35,** the year-end declaration and certificate. This is used to summarise all the tax and National Insurance deductions from employees for the tax year.
- **Form P6,** the tax codes advice notice issued by the Inspector of Taxes telling you which tax code number to use for each employee.

You can find tables giving details of PAYE and NIC rates and limits for the current tax year, for every conceivable category, at the HM Revenue and Customs website (www.hmrc.gov.uk/employers/).

Taxing everything you can put your hands on: Property taxes

Businesses and other occupiers of non-domestic properties pay Non-Domestic Rates (also known as Business Rates) to directly contribute towards the costs of local authority services. Noncontribute towards the costs of local authority services. Non-domestic properties are business properties such as shops, offices, warehouses and factories, and any other property that is not classed as domestic property. In some cases, properties may be used for both domestic and non-domestic purposes (for example, a shop with a flat above it), in which case both council tax, the tax charged on personal properties, and Business Rates will be charged.

Apart from the few lucky properties such as churches, agricultural land, sewers, public parks, certain property used for disabled people, and swinging moorings for boats, which are all exempt from Business Rates, each non-domestic property has a rateable value. The valuation officers of the Valuation Office Agency (VOA) set the rateable values. The VOA is a part of HM Revenue and Customs. It draws up and maintains a full list of all rateable values.

The Valuation Office Agency carries out a revaluation every five years so that the values in the rating lists can be kept up-to-date. The total amount of Business Rates collected does not change except to reflect inflation, but revaluations make sure that this is spread fairly between ratepayers. The most recent revaluation took place in April 2005.

The rateable value broadly represents the yearly rent the property could have been let for on the open market on a particular date. Your local council works out your Business Rates bill by multiplying your rateable value by the multiplier or ‘poundage’ which the Government sets from 1 April each year for the whole of England. For example, if the multiplier (which is often called the uniform business rate or UBR) was set at 43.3p (43.7 in Central London) and your rateable value was £10,000, the local authority would multiply this by 43.3p and your ‘property tax’ bill for the year would be £4,330.

REMEMBER

Your property may qualify for exemption under various national and local regulations or may be eligible for special reductions.

You may be able to get relief if one of the following applies to you:

- **Your business is small.** A UBR of 42.6p applies to certain businesses with rateable values below £6,000. The rules are complex and operate on a sliding scale.

- **Your property is empty and unused.** For the first three months that a business property is empty, councils don't charge Business Rates for the property. For industrial and warehouse property the rate-free period is six months. After this, a 100 per cent business rate charge usually applies.

- **Your business is in a rural village with a population below 3,000.** The types of business that qualify for this relief are:

  - The only village general store or post office as long as it has a rateable value of up to £8,500.
  - A food shop with a rateable value of up to £8,500.
  - The only village pub and the only petrol station as long as it has a rateable value of up to £12,500.

  These premises are entitled to a 50 per cent reduction in the Business Rates bill, or more if the council believes you need it.

  If you are a business in a qualifying rural village with a rateable value of up to £16,500, your local council may decide to give you up to 100 per cent relief, as long as your business is of benefit to the community.

- **You are suffering severe hardship and cannot pay your Business Rates bill.** Your local council may decide to give you up to 100 per cent relief – the decision is up to them. They normally only do this in extreme cases of hardship and for businesses that are particularly important to the local community. This takes account of the fact that local council tax payers will cover part of the cost of the relief.

If you think you may qualify for any of these types of relief, you should contact the Business Rates section of your local council for more information and advice on how to apply.

Working from home

REMEMBER If you work from home, your local council may charge Business Rates for the part of the property used for work, and you will have to pay council tax for the rest of the property (although your property's valuation band may change). It will depend on the circumstances of each case and you should ask your local office of the Valuation Office Agency for advice.

TIP Property taxes can take a big chunk out of a business's profit. In large organisations, an in-house accountant who deals with property taxes and knows the tax law language and methods is responsible for developing strategies to minimise property taxes. Small-business owners may want to consult a rating adviser. Members of the Royal Institution of Chartered Surveyors (RICS) and the Institute of Revenues Rating and Valuation (IRRV) are qualified and are regulated by rules of professional conduct designed to protect the public from misconduct.

You can find details of these organisations and their members on their websites:

- RICS – www.rics.org
- IRRV – www.irrv.org.uk

You can find the latest information on business rates on the official Government website at www.businesslink.gov.uk.

Before you employ a rating adviser, you should check that they have the necessary knowledge and expertise, as well as appropriate indemnity insurance. You should also be wary of false or misleading claims.

Getting to Grips with Value Added Tax

Most governments, and the UK Government is no exception, levy *sales taxes* on certain products and services sold within their jurisdictions. In the UK this tax is known as the Value Added Tax (VAT). The final consumer of the product or service pays the VAT – in other words the tax is tacked onto the product's price tag at the very end of the economic chain. The business that is selling the product or service collects the VAT and remits it to the appropriate tax agency (HM Revenue and Customs in the UK). Businesses that operate earlier in the economic chain (that is, those that sell products to other businesses that in turn resell the products) generally do not end up paying VAT but simply collect it and pass it on.

For example, when you run to your local chemist for some headache pills after all this tax business, you pay the chemist the cost of the pills plus VAT. But the chemist can reclaim the VAT it paid to the wholesaler (and so on, back along the retail chain). Only you, the final consumer, pays the VAT. (Lucky you!)

VAT is a complicated tax. Currently, you must register if your taxable turnover, that is, sales (not profit), exceeds £73,000 in any 12-month period, or looks as though it might reasonably be expected to do so. This rate is reviewed each year in the budget and is frequently changed. (The UK is significantly out of line with many other countries in Europe, where VAT entry rates are much lower.) The general rule is that all supplies of goods and services are taxable at the standard rate (20 per cent) unless they are specifically stated by the law to be zero-rated or exempt. In deciding whether your turnover exceeds the limit you have to include the zero-rated sales (things like most foods, books and children's clothing), as they are technically taxable; it's just that the rate of tax is 0 per cent. You leave out exempt items. As a designated tax collector, the business does not pay VAT on goods and services it buys from other VAT registered businesses that are destined to be sold to its customers.

If you are a small business owner/manager, be aware that if you overlook this role imposed on the business by the government, you're still responsible for paying the tax over to the government. Suppose you make a sale for £100 but don't add the £20.00 VAT, which is the rate currently applying in the UK. Big Brother says you did collect the VAT, whether you think you did or not. So you still have to pay the government the VAT element in the £100 (£16.67), which leaves you with only £83.33 in sales revenue.

There are three free booklets issued by HM Revenue and Customs: a simple introductory booklet called *Should you be registered for VAT?* and two more detailed booklets called *General Guide* and *Scope and Coverage*. If in doubt (and the language is not easy to understand) ask your accountant or the local branch of HM Revenue and Customs; after all, they would rather help you to get it right in the first place than have to sort it out later when you have made a mess of it.

Each quarter, you have to complete a return, which shows your purchases and the VAT you paid on them, and your sales and the VAT you collected on them. The VAT paid and collected are offset against each other and the balance sent to HM Revenue and Customs. If you have paid more VAT in any quarter than you have collected, you will get a refund. For this reason it sometimes pays to register if you don't have to – if you're selling mostly zero-rated items for example; also, being registered for VAT may make your business look more professional and less amateurish to your potential customers.

Tracking and recording Value Added Tax is a big responsibility for many businesses, especially if the business operates across several European countries. Having well-trained accounting staff manage this side of the business is well worth the cost. You can check the HM Revenue and Customs website for the latest rules (go to www.hmrc.gov.uk and click on 'VAT').

You can find a useful VAT calculator on the small business portal www.bytestart.co.uk. Click on 'Tax and Accounting' and then on 'VAT Calculator'.

Taxing Your Bottom Line: Company Taxes

This chapter focuses on the tax dimensions of business entities. Chapter 4 presents a basic income tax model for individuals (see the section 'The Accounting Vice You Can't Escape').

Every business must determine its annual *taxable income*, which is the amount of profit subject to corporate tax or income tax if the business is not a limited company. To determine annual *taxable income*, you deduct certain allowed expenses from gross income. Corporation tax law rests very roughly on the premise that all income is taxable unless expressly exempted, and nothing can be deducted unless expressly allowed.

When you read a profit-and-loss account that summarises a business's sales revenue and expenses for a period and ends with bottom-line profit, keep in mind that the accrual basis of accounting has been used to record sales revenue and expenses. The accrual basis gives a more trustworthy and meaningful profit number. But accrual-based sales revenue and expense numbers are not cash inflows and outflows during the period. So the bottom-line profit does not tell you the impact on cash from the profit-making activities of the business. You have to convert the revenue and expense amounts reported in the profit-and-loss account to a cash basis in order to determine the net cash increase or decrease. Well, actually, you don't have to do this – the cash flow statement does this for you, as Chapter 7 explains.

Although you determine your business's taxable income as an annual amount, you don't wait until you file your tax return to make that calculation and payment. Instead, corporation tax law requires you to estimate your corporation income tax for the year and, based on your estimate, to make two half-yearly instalment payments on your corporation tax during the year, one at the end of January and one at the end of July. Rather than calculating the tax due yourself, you can rely on HM Revenue and Customs to do the sums for you if you send in a completed tax return before the 30 September for the year in question. When you file the final tax return – with the official, rather than the estimated, taxable income amount – after the close of the year, you pay any remaining amount of tax you owe or claim a refund if you have overpaid your corporation tax during the year. If you grossly underestimate your taxable income for the year and thus end up having to pay a large amount of tax after the end of the year, you probably will owe a late payment penalty. After your first year in business, the tax you have to pay will be based on your profits for the previous tax year. A tax year runs from 6 April to 5 April.

A word on cash basis accounting for Value Added Tax

Cash basis accounting (also known as *chequebook accounting*) isn't generally acceptable in the world of business, but is permitted by Value Added Tax law for some businesses. To use cash basis VAT accounting, a business must keep these factors in mind:

- Cash accounting is open to you if you are a registered trader with an expected turnover not exceeding **£1,350,000** in the next 12 months. There is a 25 per cent tolerance built into the scheme. This means that once you are using cash accounting, you can normally continue to use it until the annual value of your taxable supplies reaches **£1,600,000**.

- The main accounting record you must keep will be a cash book summarising all payments made and received, with a separate column for the relevant VAT. You will also need to keep the corresponding tax invoices and ensure that there is a satisfactory system of cross-referencing.

- These VAT records must be kept for six years, unless you have agreed upon a shorter period with your local VAT office.

- The longer the time lag between your issuing sales invoices and receiving payment from your customers, the more benefit cash accounting is likely to be to you. If you are usually paid as soon as you make a sale (e.g. if you use a retail scheme) you will normally be worse off under cash accounting. The same applies to the situation where you regularly receive re-payments of VAT (e.g. because you make zero-rated supplies).

- One major advantage of the scheme is that it simplifies your bookkeeping requirements, and many businesses can be controlled simply by using an appropriately analysed cash book.

For the great majority of businesses, cash basis accounting is not acceptable, either for reporting to HM Revenue and Customs or for preparing financial statements. So this last advantage of cash-based VAT accounting is illusory. This method falls short of the information needed for even a relatively small business. Accrual basis accounting, described in Chapters 5 and 6, is the only real option for most businesses. Even small businesses that don't sell products should carefully consider whether cash basis is adequate for:

- Preparing external financial statements for borrowing money and reporting to owners.

- Dividing profit among owners.

For all practical purposes, only sole proprietorships (one-owner businesses) that sell just services and no products can use cash basis VAT accounting. Other businesses must use the accrual basis – which provides a much better income statement for management control and decision-making, and a much more complete picture of the business's financial condition.

You must keep adequate accounting records to determine your business's annual taxable income. If you report the wrong taxable income amount, you can't plead that the bookkeeper was incompetent or that your accounting records were inadequate or poorly organised – in fact, the good old tax man may decide that your poor accounting was intentional and is evidence of income tax evasion. If you under-report your taxable income by too much, you may have to pay interest and penalties in addition to the tax that you owe.

When we talk about adequate accounting records, we're not talking about the accounting *methods* that you select to determine annual taxable income – Chapter 13 discusses choosing among alternative accounting methods for certain expenses. After you've selected which accounting methods you'll use for these expenses, your bookkeeping procedures must follow these methods faithfully. Choose the accounting methods that minimise your current year's taxable income – but make sure that your bookkeeping is done accurately and on time and that your accounting records are complete. If your business's income tax return is audited, HM Revenue and Customs agents first look at your accounting records and bookkeeping system.

Furthermore, you must stand ready to present evidence for expense deductions. Be sure to hold on to receipts and other relevant documents. In an HM Revenue and Customs audit, the burden of proof is on *you*. HM Revenue and Customs don't have to disprove a deduction; you have to prove that you were entitled to the deduction. *No evidence, no deduction* is the rule to keep in mind.

The following sections paint a rough sketch of the main topics of business income taxation. (We *don't* go into the many technical details of determining taxable income, however.)

Different tax rates on different levels of business taxable income

Personal taxes, which apply to sole traders and partnerships, come on a sliding scale up to a maximum of 40 per cent. When trading as a company a business's annual taxable income isn't taxed at a flat rate either. In writing the income tax law, the government gave the little either. In writing the income tax law, the government gave the little guy a break. As of 2011, the corporate income tax rate starts at 20 per cent on the first £300,000 of taxable income, then quickly moves up to a 26 per cent rate on taxable income in the range of £300,001 to £1,500,000, after which it drops back to 20 per cent. Simple it ain't! The income tax on the taxable income for the year is calculated using these tax rates.

In years past, corporate income tax rates were considerably higher, and the rates could go up in the future – although most experts don't predict any increase. The Chancellor of the Exchequer looks at the income tax law every year and makes some changes virtually every year. Many changes have to do with the accounting methods allowed to determine annual taxable income. For instance, the methods for computing annual *writing down expense*, which recognises the wear and tear on a business's long-lived operating assets, have been changed back and forth by chancellors over the years. You can check with HM Revenue and Customs for the latest rules at www.hmrc.gov.uk by simply clicking on 'Corporation Tax'.

Businesses pay tax on income at different rates depending on their size. But any capital gains (made, for example, when part of a business is sold or when owners cash in) used to be taxed at 10 per cent (if the asset concerned had been owned for two years or more) and then on a sliding scale up to 40 per cent for some assets and some time periods. However, some fiendishly complicated 'taper reliefs' existed that made understanding the true tax position very difficult. So, from 2008, all capital gains are now taxed at a single rate of 18 per cent. The simplification does mean that some taxpayers (in particular, any entrepreneurs selling up) face a tax hike of 80 per cent (from 10 per cent up to 18 per cent).

Profit accounting and taxable income accounting

You're probably thinking that this section of the chapter is about how a business's bottom-line profit – its net income – drives its taxable income amount. Actually, we want to show you the exact opposite: how income tax law drives a business's profit accounting. That's right: Tax law plays a large role in how a business determines its profit figure, or more precisely the accounting methods used to record revenue and expenses.

Before you explore that paradox, you need to understand something about the accounting methods for recording profit. For measuring and recording many expenses (and some types of revenue), no single accounting method emerges as the one and only dominant method. Accountants have a certain amount of legitimate leeway in measuring and reporting the revenue and expenses that drive the profit figure. (See Chapter 13 for further discussion of alternative accounting methods.) Therefore, two different accountants, recording the same profit-making activities for the same period, would most likely come up with two different profit figures – the numbers would be off by at least a little, and perhaps by a lot.

And that inconsistency is fine – as long as the differences are due to legitimate reasons. We'd like to be able to report to you that in measuring profit, accountants always aim right at the bull's-eye, the dead centre of the profit target. One commandment in the accountants' bible is that annual profit should be as close to the truth as can be measured; accounting methods should be objective and fair. But in the real world, profit accounting doesn't quite live up to this ideal.

Be aware that a business may be tempted to deliberately *overstate* or *understate* its profit. When a business overstates its profit in its profit and loss account, some amount of its sales revenue has been recorded too soon and/or some amount of its expenses has not yet been recorded (but will be later). Overstating profit is a dangerous game to play because it deceives investors and other interested parties into thinking that the business is doing better than it really is. Audits of financial reports by chartered accountants (as discussed in Chapter 15) keep such financial reporting fraud to a minimum but don't necessarily catch every case.

More to the point of this chapter is the fact that most businesses are under some pressure to *understate* the profit reported in their annual income statements. Businesses generally record sales revenue correctly (with some notable exceptions), but they may record some expenses sooner than these costs should be deducted from sales revenue. Why? Businesses are preoccupied with minimising income tax, which means minimising *taxable income.* To minimise taxable income, a business chooses accounting methods that record expenses as soon as possible. Keeping two sets of books (accounting records) – one for tax returns and one for internal profit accounting reports to managers – is not very practical, so the business uses the accounting methods kept for tax purposes for other purposes as well. And that's why tax concerns can drive down a business's profit figure.

In short, the income tax law permits fairly conservative expense accounting methods – expense amounts can be *front-loaded*, or deducted sooner rather than later. The reason is to give a business the option to minimise its current taxable income (even though this course has a reverse effect in later years). Many businesses select these conservative expense methods – both for their income tax returns and for their financial statements reported to managers and to outside investors and lenders. Thus financial statements of many businesses tilt to the conservative, or understated, side.

Of course, a business should report an accurate figure as its net profit, with no deliberate fudging. If you can't trust that figure, who knows for sure exactly how the company is doing? Not the owners, the value of whose investment in the business depends mostly on profit performance, and not even the business's managers, whose business decisions depend on recorded profit performance. Every business needs a reliable profit compass to navigate its way through the competitive environment of the business world – that's just common sense and doesn't even begin to address ethical issues.

Other reasons for understating profit

Minimising taxable income is a strong motive for understating profit, but businesses have other reasons as well. Imagine for the moment that business profit isn't subject to income tax (you wish!). Even in this hypothetical, no-tax world, many businesses probably would select accounting methods that measure their profit on the low side rather than the high side. Two possible reasons are behind this decision:

- **Don't count your chickens before they hatch philosophy:** Many business managers and owners tend to be financially conservative; they prefer to err on the low side of profit measurement rather than on the high side.

- **Save for a rainy day philosophy:** A business may want to keep some profit in reserve so that during a future downturn, it has a profit cushion to soften the blow.

The people who think this way tend to view *overstating profit* as a form of defrauding investors but view *understating profit* as simply being prudent. Frankly, we think that putting your thumb on either side of the profit scale (revenue being one side and expenses the other) is not a good idea. *Let the chips fall where they may* is our philosophy. Adopt the accounting methods that you think best reflect how you operate the business. The income tax law has put too much downward pressure on profit measurement, in our opinion.

We should say that many businesses do report their annual profit correctly – sales revenue and expenses are recorded properly and without any attempt to manipulate either side of the profit equation.

Refer to Chapter 13 for more about how choosing one expense accounting method over another method impacts profit. (***Note:*** The following sections, which discuss expenses and income that are not deductible or are only partially deductible, have nothing to do with choosing accounting methods.)

Deductible expenses

What expenses can you claim when you are self-employed? Expenditure can be split into two main categories, 'Capital' and 'Revenue'.

- **Capital Expenditure:** Capital expenditure is expenditure on such items as the purchase or alteration of business premises, purchase of plant, machinery and vehicles, or the initial cost of tools. You cannot deduct 'capital expenditure' in working out your taxable profits, but some relief may be due on this type of expenditure in the form of capital allowances. Your Tax Office can give further advice on these allowances.

- **Revenue Expenditure:** Listing all the expenses that can be deducted is impossible but, generally speaking, allowable expenditure relates to day-to-day running costs of your business. It includes such items as wages, rent, lighting and heating of business premises, running costs of vehicles used in the business, purchase of goods for resale and the cost of replacing tools used in the business.

Non-deductible expenses

To be deductible, business expenses must be *ordinary and necessary* – that is, regular, routine stuff that you need to do to run your business. You're probably thinking that you can make an argument that *any* of your expenses meet the ordinary and necessary test. And you're mostly right – almost all business expenses meet this twofold test.

However, HM Revenue and Customs consider certain business expenses to be anything but ordinary and necessary; you can argue about them until you're blue in the face, and it won't make any difference. Examples of non-allowable expenditure are your own wages, premiums on personal insurance policies, and income tax and National Insurance contributions. Where expenditure relates to both business and private use, only the part that relates to the business will be allowed; examples are lighting, heating and telephone expenditure. If a vehicle is used for both business and private purposes, then the capital allowances and the total running expenses will be split in proportion to the business and private mileage. You will need to keep records of your total mileage and the number of miles travelled on business to calculate the correct split.

Here's a list of expenses that are *not* deductible or are only partially deductible when determining annual taxable income:

- **Customer entertainment expenses:** Definitely a no go area. For a while entertaining overseas customers was an allowable tax expense until the Revenue became suspicious of the amazing number of people being entertained by businesses with no export activity whatsoever.

- **Bribes, kickbacks, fines and penalties:** Oh, come on, did you really think that you could get rewarded for doing stuff that's illegal or, at best, undesirable? If you were allowed to deduct these costs, that would be tantamount to the Revenue encouraging such behaviour – a policy that wouldn't sit too well with the general public.

- **Lobbying costs:** You can't deduct payments made to influence legislation. Sorry, but you can't deduct the expenses you ran up to persuade Minister Hardnose to give your bicycle business special tax credits because riding bicycles is good exercise for people.

- **Start-up costs:** You can't just deduct the cost of everything needed to start a business in year one. Some assets, such as cars and equipment or machinery, have to be written down over a number of future years. This area of the tax law can get a little hairy. If you have just started a new business, you may be wise to consult a tax professional on this question, especially if your start-up costs are rather large.

- **Working from home:** If you use part of your home for work, you need to keep sufficient records to back up the proportion of heating and lighting costs that relate to your business and your private use. Sometimes you may not get evidence, such as a receipt, for cash expenses, especially where the amounts are small. If this happens, make a brief note as soon as you can of the amount you spent, when you spent it, and what it was for. HM Revenue and Customs don't expect you to keep photocopies of bills, although you may find them useful.

- **Life insurance premiums:** A business may buy life insurance coverage on key officers and executives, but if the business is the beneficiary, the premiums are not deductible. The proceeds from a life insurance policy are not taxable income to the business if the insured person dies, because the cost of the premiums was not deductible. In short, premiums are not deductible, and proceeds upon death are excluded from taxable income.

- **Travel and convention attendance expenses:** Some businesses pay for rather lavish conventions for their managers and spend rather freely for special meetings at attractive locations that their customers attend for free. The Revenue takes a dim view of such extravagant expenditures and may not allow a full deduction for these types of expenses. HM Revenue and Customs holds that such conventions and meetings could have been just as effective for a much more reasonable cost. In short, a business may not get a 100 per cent deduction for its travel and convention expenses if the Revenue audits these expenditures.
- **Transactions with related parties:** Income tax law takes a special interest in transactions where the two parties are related in some way. For example, a business may rent space in a building owned by the same people who have money invested in the business; the rent may be artificially high or low in an attempt to shift income and expenses between the two tax entities or individuals. In other words, these transactions may not be based on what's known as *arm's-length bargaining*. A business that deals with a related party must be ready to show that the price paid or received is consistent with what the price would be for an unrelated party.

TIP

You can find a useful guide to business expenses on the www.bytestart.co.uk small business portal. Just click on 'Tax and Accounting' and 'Business Expenses Guide'.

Equity capital disguised as debt

The general term *debt* refers to money borrowed from lenders who require that the money be paid back by a certain date, and who require that interest be paid on the debt until it is repaid. *Equity* is money invested by owners (such as shareholders) in a business in return for hoped-for, but not guaranteed, profit returns. Interest is deductible, but cash dividends paid to shareholders are not – which gives debt capital a big edge over equity capital at tax time.

Not surprisingly, some businesses try to pass off equity capital as debt on their tax returns so that they can deduct the payments to the equity sources as interest expense to determine taxable income. Don’t think that HM Revenue and Customs are ignorant of these tactics: Everything that you declare as interest on debt may be examined carefully, and if the Revenue determines that what you’re calling debt is really equity capital, it disallows the interest deduction. The business can make payments to its sources of capital that it calls and treats as interest – but this does not mean that HM Revenue and Customs will automatically believe that the payments are in fact interest. The Revenue follows the general principle of substance over form. If the so-called debt has too many characteristics of equity capital, HM Revenue and Customs treat the payments not as interest but rather as dividend distributions from profit to the equity sources of capital.

In summary, debt must really be debt and must have few or none of the characteristics of equity. Drawing a clear-cut line between debt and equity has been a vexing problem for HM Revenue and Customs, and the rules are complex. You’ll probably have to consult a tax professional if you have a question about this issue. Be warned that if you attempt to disguise equity capital as debt, your charade may not work – and the Revenue may disallow any ‘interest’ payments you have made.

Part II

Getting a Grip on Financial Statements

'Look, Mr Brinkley, you don't fool me — you don't have a proper accountant in this company do you?'

In this part . . .

Financial statements are like the tip of an iceberg – they only show the visible part, underneath which are a lot of record-keeping, accounting methods, and reporting decisions. The managers of a business, the investors in a business, and the lenders to a business need a firm grasp on these accounting communications. They need to know which handles to grab hold of and how to find both the good and bad signals in financial statements – and, ugh, this includes the small-print footnotes that go with financial statements.

Accountants prepare three primary financial statements. The profit and loss account reports the profit-making activities of the business and how much profit or loss the business made. (Sounds odd, doesn't it, to say a business made a loss? But to make profit, a business has to take the risk that it may suffer a loss.) The balance sheet reports the financial situation and position of the business at a point in time – usually the last day of the profit period. The cash flow statement reports how much cash was actually realised from profit and other sources of cash, and what the business did with this money. In short, the financial life of a business and its prospects for success or potential danger of failing is all revealed in its financial statements, as this part of the book exposes.

But, as with much in accounting, not everything is quite as it appears. Changing a single letter (FIFO to LIFO) in the footnotes to the accounts can add (or subtract) a small fortune from the reported profit, as you'll see in Chapter 8.

Chapter 6

The Balance Sheet from the Profit and Loss Account Viewpoint

In This Chapter

- Coupling the profit and loss account with the balance sheet
- Seeing how sales revenue and expenses drive assets and liabilities
- Sizing up assets and liabilities
- Drawing the line between debt and owners' equity
- Grouping short-term assets and liabilities to determine solvency
- Understanding costs and other balance sheet values

This chapter explores one of the three primary financial statements reported by businesses – the *balance sheet*, or, to be more formal, the *statement of financial condition*. This key financial statement may seem to stand alone – like an island to itself – because it's presented on a separate page in a financial report. In fact, the assets and liabilities reported in a balance sheet are driven mainly by the transactions the business engages in to make profit. These sale and expense transactions of a business are summarised for a period in its *profit and loss account,* which is explained in Chapter 5.

You've probably heard the expression that it takes money to make money. For a business it takes *assets* to make profit. This chapter identifies the particular assets needed to make profit. Also, the chapter points out the particular liabilities involved in the pursuit of profit.

In brief, a business needs a lot of assets to open its doors and to carry on its profit-making activities – making sales and operating the business from day to day. For example, companies that sell products need to carry a *stock* of products that are available for delivery to customers when sales are made. A business can purchase products for its stock on credit, and delay payment for the purchase (assuming it has a good credit rating). In most cases, however, the business has to pay for these purchases before all the products have been sold – the stock-holding period is considerably longer than the credit period. The business needs cash to pay for its stock purchases. Where does the cash come from?

In fact a business needs many more assets than just stock. Where does the money for these assets come from? Assets are the first act of a two-act play. The second act looks at where the money comes from, or the *sources of capital* for businesses. As Chapter 1 explains, the *balance sheet* of a business is the financial statement that reports its assets on one side and the sources of capital on the other side.

Of course, as we repeat throughout this book, you need to use all three primary financial statements to paint a business's complete financial picture. The *profit and loss account* details sales revenue and expenses, which directly determine the amounts of assets (and two or three of the liabilities) that are summarised in the *balance sheet.* The *cash flow statement* answers the important question of how much of the profit has been converted to cash, and the company's other sources and uses of cash during the period.

This chapter connects sales revenue and expenses, which are reported in the profit and loss account, with their corresponding assets and liabilities in the balance sheet. The chapter also explains the sources of capital that provide the money a business uses to invest in its assets.

Coupling the Profit and Loss Account with the Balance Sheet

Sales revenue generates the inflow of assets and expenses cause the outflow of assets. These increases and decreases in assets have to be recorded. Also, some expenses spawn short-term liabilities that have to be recorded. In short, accounting for profit involves much more than keeping track of cash inflows and outflows. Which specific assets and liabilities are directly involved in recording the sales revenue and expenses of a business? And how are these assets and liabilities reported in a business's balance sheet at the end of the profit period? These are the two main questions that this chapter answers.

This chapter explains how the profit-making transactions reported in the profit and loss account connect with the assets (and some operating liabilities) reported in the balance sheet. We stress the dovetail fit between these two primary financial statements (the profit and loss account and the balance sheet). And don't forget that business accounting also keeps track of where the money for the assets comes from – to invest in its assets, a business needs to raise money by borrowing and persuading owners to put money in the business. You shouldn't look at assets without also looking at where the money (the capital) for the assets comes from.

The *balance sheet*, or statement of financial condition, summarises a business's assets, liabilities and owners' equity at a point in time and, as shown in Chapter 5, can be summarised in the following equation:

Assets	Liabilities	Owners' Equity
Cash + Non-cash Assets =	Operating Liabilities + Debt +	Invested Capital +
Retained Earnings		

Figure 6-1 shows a balance sheet for a fictitious company – not from left to right as shown in the accounting equation just above, but rather from top to bottom, which is a vertical expression of the accounting equation. This balance sheet is stripped down to the bare-bone essentials – please note that it would need a little tidying up before you'd want to show it off to the world in an external financial report (see Chapter 8).

Figure 6-1: A balance sheet example showing a business's various assets, liabilities and owners' equity.

Assets		
Cash		£ 2,000,000
Debtors		£ 2,500,000
Stock		£ 3,575,000
Prepaid Expenses		£ 480,000
Fixed Assets (at Original cost)	£ 11,305,000	
Accumulated Depreciation	£ (5,780,000)	£ 5,525,000
Total		£ 14,080,000
Liabilities and Owners' Equity		
Creditors	£ 800,000	
Accrued Expenses Payable	£ 1,200,000	
Income Tax Payable	£ 80,000	
Total Operating Liabilities		£ 2,080,000
Notes Payable (Interest-bearing debt)		£ 5,000,000
Owners' Invested Capital		£ 2,000,000
Retained Earnings		£ 5,000,000
Total		£ 14,080,000

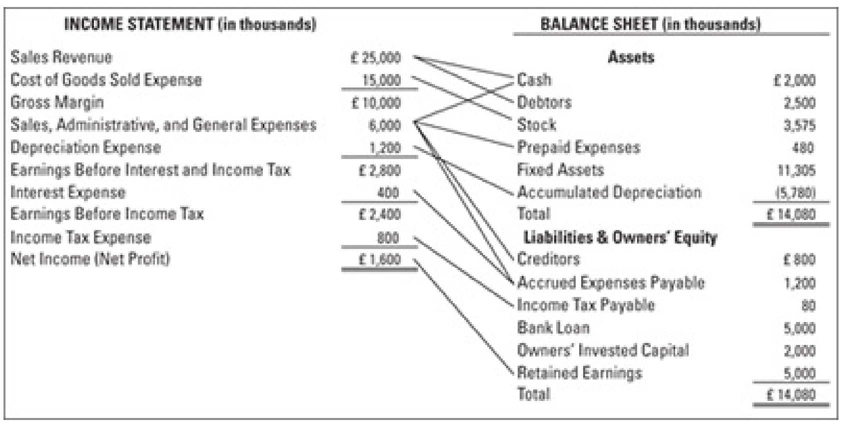
A balance sheet doesn't have a punch line like the profit and loss account does – the profit and loss account's punch line being the net income line (which is rarely humorous to the business itself, but can cause some sniggers among analysts). You can't look at just one item on the balance sheet, murmur an appreciative 'ah-hah,' and rush home to watch the footy game. You have to read the whole thing (sigh) and make comparisons among the items. See Chapters 8 and 14 for more information on interpreting financial statements.

TIP

At the most basic level, the best way to understand a balance sheet (most of it, anyway) is to focus on the assets that are generated by the company's profit-making activities – in other words, the cause-and-effect relationship between an item that's reported in the profit and loss account and an item that's reported in the balance sheet.

Figure 6-2 lays out the vital links between sales revenue and expenses and the assets and liabilities that are driven by these profit-seeking activities. You can refer back to each connection as sales revenue and expenses are discussed below. The format of the profit and loss account is virtually the same as the format introduced in Chapter 5, except that depreciation expense is reported on a separate line (in Chapter 5, depreciation is buried in the sales, administrative and general expenses account).

Figure 6-2: Connections between the assets and operating liabilities of a business and its sales revenue and expenses.



The amounts reported in the profit and loss account are the cumulative totals for the whole year (or other time period). In contrast, the amounts reported in the balance sheet are the *balances* at the end of the year – the net amount, starting with the balance at the start of the year, adjusted for increases and decreases that occur during the year. For example, the total cash inflows and outflows over the course of the entire year were much more than the £2 million ending balance for cash.

The purpose of Figure 6-2 is to highlight the connections between the particular assets and operating liabilities that are tightly interwoven with sales revenue and expenses. Business managers need a good grip on these connections to control assets and liabilities. And outside investors need to understand these connections to interpret the financial statements of a business (see Chapter 14).

Most people intuitively understand that sooner or later sales revenue increases cash and expenses decrease cash. (The exception is depreciation expense, as explained in Chapters 5 and 7.) It's the 'sooner or later' that gives rise to the assets and liabilities involved in making profit.

The assets and liabilities driven by sales revenue and expenses are as follows:

- Sales revenue derives from selling products and services to customers.
- The cost of goods sold expense is what the business paid for the products that it sells to its customers. You can't charge the cost of products to this expense account until you actually sell the goods, so that cost goes into the *stock* asset account until the goods are sold.
- The sales, administrative and general expenses (SA&G) category covers many different operating expenses (such as advertising, travel and telephone costs). SA&G expenses drive the following items on the balance sheet:
  - The *prepaid expenses* asset account holds the total amount of cash payments for future expenses (for example, you pay insurance premiums before the policy goes into effect, so you charge those premiums to the months covered by the policy).
  - The *creditor* liability account is the total amount of expenses that haven't been paid yet but that affect the current period. For example, you receive a bill for electricity that you used the month before, so you charge that bill to the month benefited by the electricity – thanks to the accrual basis of accounting.

- The *accrued expenses payable* account is the opposite of the prepaid expenses asset account: this liability account holds costs that are paid after the cost is recorded as an expense. An example is the accumulated holiday pay that the company's employees have earned by the end of the year; when the employees take their holidays next year the company pays this liability.

- The purpose of depreciation is to spread out the original cost of a *fixed asset* over the course of the asset's life. If you buy a vehicle that's going to serve you for five years, you charge one-fifth of the cost to depreciation expense each of the five years. (Instead of charging this straight line, or level amount to each year, a business can choose an accelerated depreciation method, as explained in Chapter 13.) Rather than decreasing the fixed assets account directly (which would make some sense), accountants put depreciation expense in an offset account called *accumulated depreciation*, the balance of which is deducted from the original cost of fixed assets. Thus, both the original cost and the amount by which the original cost has been depreciated to date are available in separate accounts – both items of information are reported in the balance sheet.

- Interest expense depends on the amount of money that the business borrows and the interest rate that the lender charges. *Debt* is the generic term for borrowed money; and debt bears interest. *Loans* and *overdrafts* are the most common terms you see for most debt because the borrower (the business) signs a legal instrument called a *note.* Normally, the total interest expense for a period hasn't been paid by the end of the period so the unpaid part is recorded in *accrued expenses payable* (or in a more specific account of this type called *accrued interest payable*).

- A small part of the total income tax owed on the company's taxable income for the year probably will not be paid by the end of the year, and the unpaid part is recorded in the *income tax payable* account.

- A final note: The bottom-line profit (net income) for the year increases the reserves or, as it is also known, the *retained earnings* account, which is one of the two owners' equity accounts.

Sizing Up Assets and Liabilities

Although the business example shown in Figure 6–2 is hypothetical, we didn't make up the numbers at random – not at all. We use a medium-sized business that has £25 million in annual sales revenue as the example. (Your business may be a lot smaller or larger than one with £25 million annual sales revenue, of course.) All the other numbers in both the profit and loss account and the balance sheet of the business are realistic relative to each other. We assume the business earns 40 per cent gross margin (£10 million gross margin ÷ £25 million sales revenue = 40 per cent), which means its cost of goods sold expense is 60 per cent of sales revenue. The sizes of particular assets and liabilities compared with their relevant profit and loss account numbers vary from industry to industry, and even from business to business in the same industry.

Based on its history and policies, the managers of a business can estimate what the size of each asset and liability should be – and these estimates provide very useful *control benchmarks*, or yardsticks, against which the actual balances of the assets and liabilities are compared to spot any serious deviations. In other words, assets (and liabilities, too) can be too high or too low in relation to the sales revenue and expenses that drive them, and these deviations can cause problems that managers should try to correct as soon as possible.

Turning over assets

Assets should be *turned over,* or put to use by making sales. The higher the turnover (the more times the assets are used and then replaced), the better. The more sales, the better – because every sale is a profit-making opportunity. The *asset turnover ratio* compares annual sales revenue with total assets:

Annual sales revenue ÷ total assets = asset turnover ratio

The asset turnover ratio is interesting as far as it goes, but it unfortunately doesn't go very far. This ratio looks only at total assets as an aggregate total. And the ratio looks only at sales revenue. The expenses of the business for the year are not considered – even though expenses are responsible for most of the assets of a business.

Note: The asset turnover ratio is a quick-and-dirty test of how well a business is using its assets to generate sales. The ratio does not evaluate profitability; profit is not in the calculation. Basically, the ratio indicates how well assets are being used to generate sales – nothing more.

For example, based on the credit terms extended to customers and the company's actual policies regarding how aggressive the business is in collecting past-due receivables, a manager can determine the range for how much a proper, or within-the-boundaries, balance of accounts receivable should be. This figure would be the control benchmark. If the actual balance is reasonably close to this control benchmark, the debtors' level is under control. If not, the manager should investigate why the debtors' level is higher or lower than it should be.

The following sections discuss the relative sizes of the assets and liabilities in the balance sheet that result from sales and expenses. The sales and expenses are the *drivers*, or causes, of the assets and liabilities. If a business earned profit simply by investing in stocks and bonds, for example, it would not need all the various assets and liabilities explained in this chapter. Such a business – a mutual fund, for example – would have just one income-producing asset:

investments in securities. But this chapter focuses on businesses that sell products to make profit.

Sales revenue and debtors

In Figure 6-2 the annual sales revenue is £25 million. Debtors represent one-tenth of this, or £2.5 million. In rough terms, the average customer's credit period is about 36 days – 365 days in the year multiplied by the 10 per cent ratio of ending debtors balance to annual sales revenue. Of course, some customers' balances owed to the business may be past 36 days and some quite new. It's the overall average that you should focus on. The key question is whether or not a customer-credit period averaging 36 days is reasonable or not.

Cost of goods sold expense and stock

In Figure 6-2 the annual cost of goods sold expense is £15 million. The stock is £3,575,000, or about 24 per cent. In rough terms, the average product's stock-holding period is 87 days – 365 days in the year multiplied by the 24 per cent ratio of ending stock to annual cost of goods sold. Of course, some products may remain in stock longer than the 87-day average and some products may sell in a much shorter period than 87 days. It's the overall average that you should focus on. Is an 87-day average stock-holding period reasonable?

TIP

The 'correct' average stock-holding period varies from industry to industry. In some industries, the stock-holding period is very long, three months or longer, especially for manufacturers of heavy equipment and high-tech products. The opposite is true for high-volume retailers such as retail supermarkets who depend on getting products off the shelves as quickly as possible. The 87-day average holding period in the example is reasonable for many businesses, but would be far too high for many other businesses.

SA&G expenses and the four balance sheet accounts that are connected with the expenses

Note that in Figure 6-2 sales, administrative and general (SA&G) expenses connect with four balance sheet accounts – cash, prepaid expenses, creditors and accrued expenses payable. The broad SA&G expense category includes many different types of expenses that are involved in making sales and operating the business. (Separate expense accounts are maintained for specific expenses; depending on the size of the business and the needs of its various managers, hundreds or thousands of specific expense accounts are established.)

Cash is paid when recording payroll, mailing and some other expenses. In contrast, insurance and office supplies costs are prepaid, and then released to expense gradually over time. So, cash is paid before the recording of the expense. Some of these expenses are not paid until weeks after being recorded; to recognise the delayed payment the amounts owed are recorded in an accounts payable or an accrued expenses payable liability account.

TIP

One point we would like to repeat is that the company's managers should adopt benchmarks for each of these accounts that are connected with the operating expenses of the business. For example, the £1.2 million ending balance of accrued expenses payable is 20 per cent of the £6 million SA&G for the year. Is this ratio within control limits? Is it too high? Managers should ask and answer questions like these for every asset and liability connected with the expenses of the business.

Fixed assets and depreciation expense

As explained in Chapter 5, depreciation is a truly unique expense. Depreciation is like other expenses in that, like all other expenses, it is deducted from sales revenue to determine profit. Other than this, however, depreciation is very different. None of the depreciation expense recorded to the period requires cash outlay during the period. Rather, depreciation expense for the period is that portion of the total cost of a business's fixed assets that is allocated to the period to record an amount of expense for using the assets during the period. Depreciation is an imputed cost, based on what fraction of the total cost of fixed assets is assigned to the period.

The higher the total cost of its fixed assets, the higher a business's depreciation expense. However, there is no standard ratio of depreciation expense to the total cost of fixed assets. The amount of depreciation expense depends on the useful lives of the company's fixed assets and which depreciation method the business selects. (How to choose depreciation methods is explained in Chapter 13.) The annual depreciation expense of a business is seldom more than 10–15 per cent of the total cost of its fixed assets. The depreciation expense for the year is either reported as a separate expense in the profit and loss account (as in Figure 6–2) or the amount is disclosed in a footnote.

Because depreciation is based on the cost of fixed assets, the balance sheet reports not one but two numbers – the original cost of the fixed assets and the *accumulated depreciation* amount (the amount of depreciation that has been charged as an expense from the time of acquiring the fixed asset to the current balance sheet date).

The point isn't to confuse you by giving you even more numbers to deal with. Seeing both numbers gives you an idea of how old the fixed assets are and also tells you how much these fixed assets originally cost.

What about cash?

A business's cash account consists of the money it has in its bank accounts plus the money that it keeps on hand to provide change for its customers. Cash is the essential lubricant of business activity. Sooner or later, virtually everything passes through the cash account.

How much of a cash balance should a business maintain? This question has no right answer. A business needs to determine how large a cash safety reserve it's comfortable with to meet unexpected demands on cash while keeping the following wisdom in mind:

- Excess cash balances are non-productive and don't earn any profit for the business.
- Insufficient cash balances can cause the business to miss taking advantage of opportunities that require quick action and large amounts of cash – such as snatching up a prized piece of property that just came on the market and that the business has had its eye on for some time, or buying out a competitor when the business comes up for sale.

The cash balance of the business whose balance sheet is presented in Figure 6–2 is £2,000,000 – which would be too large for some other businesses and too small for others.

In the example, the business has, over several years, invested £11,305,000 in its fixed assets (that it still owns and uses), and it has already charged off depreciation of £4,580,000 in previous years. In this year, the business records £1,200,000 depreciation expense (you can't tell from the balance sheet how much depreciation was charged this year; you have to look at the profit and loss account in Figure 6–2). The remaining non-depreciated cost of this business's fixed assets at the end of the year is £5,525,000. So the fixed assets part of this year's balance sheet looks like this:

Fixed assets	£11,305,000
Accumulated depreciation	(5,780,000)
Net amount included in total assets	£5,525,000

You can tell that the collection of fixed assets includes both old and new assets because the company has recorded £5,780,000 total depreciation since the assets were bought, which is a fairly sizable percentage of original cost (more than half). But many businesses use accelerated depreciation methods, which pile up a lot of the depreciation expense in the early years and less in the back years (see Chapter 13 for more details) so it's hard to estimate the average age of the assets.

Debt and interest expense

The business example whose balance sheet and profit and loss accounts are presented in Figure 6–2 has borrowed $5 million on loans, which, at an 8 per cent annual interest rate, is $400,000 in interest expense for the year. (The business may have had more or less borrowed at certain times during the year, of course, and the actual interest expense depends on the debt levels from month to month.)

For most businesses, a small part of their total annual interest is unpaid at year-end; the unpaid part is recorded to bring the expense up to the correct total amount for the year. In Figure 6–2, the accrued amount of interest is included in the more inclusive accrued expenses payable liability account. You seldom see accrued interest payable reported on a separate line in a balance sheet unless it happens to be a rather large amount or if the business is seriously behind in paying interest on its debt.

Income tax expense

In Figure 6-2, earnings before income tax – after deducting interest and all other expenses from sales revenue – is £2,400,000. (The actual taxable income of the business for the year probably would be somewhat more or less than this amount because of the many complexities in the income tax law, which are beyond the scope of this book.) In the example we use a tax rate of one-third for convenience, so the income tax expense is £800,000 of the pre-tax income of £2,400,000. Most of the income tax for the year must be paid over to HM Revenue and Customs before the end of the year. But a small part is usually still owed at the end of the year. The unpaid part is recorded in the *income tax payable* liability account – as you see in Figure 6–2. In the example, the unpaid part is £80,000 of the total £800,000 income tax for the year – but we don't mean to suggest that this ratio is typical. Generally, the unpaid income tax at the end of the year is fairly small, but just how small depends on several technical factors. You may want to check with your tax professional to make sure you have paid over enough of the annual income tax by the end of the year to avoid a penalty for late payment.

The bottom line: net profit (net income) and cash dividends (if any)

A business may have other sources of income during the year, such as interest income on investments. In this example, however, the business has only sales revenue, which is gross income from the sale of products and services. All expenses, starting with cost of goods sold, down to and including income tax, are deducted from sales revenue to arrive at the last, or bottom line, of the profit and loss account. The preferred term for bottom-line profit is *net income*, as you see in Figure 6–2.

The £1,600,000 net income for the year increases *retained earnings* by the same amount, hence the line of connection from net income and retained earnings in Figure 6-2. The £1,600,000 profit (here we go again using the term profit instead of net income) either stays in the business, or some of it is paid out and divided among the owners of the business. If the business paid out cash dividends from profit during the year, these cash payments to its owners (shareholders) are deducted from retained earnings. You can't tell from the profit and loss account or the balance sheet whether any cash dividends were paid. You have to look in the cash flow statement for this information – which is explained in Chapter 7.

Financing a Business: Owners' Equity and Debt

KEY CONCEPT

You may have noticed in Figure 6-2 that there are two balance sheet accounts that have no lines of connection from the profit and loss account – loans and owners' invested capital. Revenue and expenses do not affect these two key balance sheet accounts (nor the fixed assets account for that matter, which is explained in Chapter 7). However, both debt and owners' invested capital are extremely important for making profit.

To run a business you need financial backing, otherwise known as *capital.* Capital is all incoming funds that are not derived from sales revenue (or from selling off assets). A business raises capital by borrowing money, getting owners to invest money in the business, and making profit that is retained in the business. Borrowed money is known as *debt*; invested money and retained profits are the two sources of *owners' equity*. Those two sources need to be kept separate according to the rules of accounting. See Chapters 5 and 9 for more about profit.

How much capital does the business shown in Figure 6-2 have? Its total assets are £14,080,000, but this is not quite the answer. The company's profit-making activities generated three operating liabilities – creditors, accrued expenses payable and income tax payable – and in total these three liabilities provided £2,080,000 of the total assets of the business. So, deducting this amount from total assets gives the answer: The business has £12 million in capital. Where did this capital come from? Debt provided £5 million and the two sources of owners' equity provided the other £7 million (see Figure 6-1 or 6-2 to check these numbers).

JARGON ALERT

Creditors, accrued expenses payable and income tax payable are short-term, non-interest-bearing liabilities that are sometimes called *current liabilities* because they arise directly from a business's expense activities – they aren't the result of borrowing money but rather are the result of buying things on credit or delaying payment of certain expenses.

REAL WORLD EXAMPLE

This particular business has decided to finance itself through debt and equity in the following mix:

Debt	£5,000,000
Owners' equity	7,000,000
Total sources of capital	£12,000,000

Deciding how to divide your sources of capital can be tricky. In a very real sense, the debt-versus-equity question never has a final answer; it's always under review and reconsideration by most businesses. Some companies, just like some individuals, are strongly anti-debt, but even they may find that they need to take on debt eventually to keep up with changing times.

Debt is both good and bad, and in extreme situations it can get very ugly. The advantages of debt are:

- Most businesses can't raise all the capital they need from owners' equity and debt offers another source of capital (though, of course, many lenders may provide only half or less of the capital that a business needs).
- Interest rates charged by lenders are lower than rates of return expected by owners. Owners expect a higher rate of return because they're taking a greater risk with their money – the business is not required to pay them back the same way that it's required to pay back a lender. For example, a business may pay 8 per cent interest on its debt and have to earn a 13 per cent rate of return on its owners' equity. (See Chapter 14 for more on earning profit for owners.)

The disadvantages of debt are:

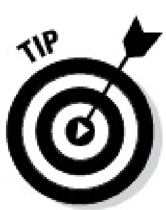
- A business must pay the fixed rate of interest for the period even if it suffers a loss for the period.
- A business must be ready to pay back the debt on the specified due date, which can cause some pressure on the business to come up with the money on time. (Of course, a business may be able to *roll over* its debt, meaning that it replaces its old debt with an equivalent amount of new debt, but the lender has the right to demand that the old debt be paid and not rolled over.)

If you default on your debt contract – you don't pay the interest on time, or you don't pay back the debt on the due date – you face some major unpleasantries. In extreme cases, a lender can force you to shut down and liquidate your assets (that is, sell off everything you own for cash) to pay off the debt and unpaid interest. Just as you can lose your home if you don't pay your home mortgage, your business can be forced into involuntary bankruptcy if you don't pay your business debts.

A lender may allow the business to try to work out its financial crisis through bankruptcy procedures, but bankruptcy is a nasty business that invariably causes many problems and can really cripple a business.

Reporting Financial Condition: The Classified Balance Sheet

The assets, liabilities and owners' equity of a business are reported in its *balance sheet,* which is prepared at the end of the profit and loss account period.



The balance sheet is not a flow statement but a *position* statement which reports the financial condition of a company at a precise moment in time – unlike the income and cash flow statements which report inflows and outflows. The balance sheet presents a company's assets, liabilities and owners' equity that exist at the time the report is prepared.

An accountant can prepare a balance sheet at any time that a manager wants to know how things stand financially. However, balance sheets are usually prepared only at the end of each month, quarter and year. A balance sheet is always prepared at the close of business on the last day of the profit period so that the financial effects of sales and expenses (reported in the profit and loss account) also appear in the assets, liabilities and owners' equity sections of the balance sheet.

Trading on the equity: Taking a chance on debt

The large majority of businesses borrow money to provide part of the total capital needed for their assets. The main reason for debt, by and large, is to close the gap between how much capital the owners can come up with and the amount the business needs. Lenders are willing to provide the capital because they have a senior claim on the assets of the business. Debt has to be paid back before the owners can get their money out of the business. The owners' equity provides the permanent base of capital and gives the lenders a cushion of protection.

The owners use their capital invested in the business as the basis to borrow. For example, for every two pounds the owners have in the business, lenders may be willing to add another pound (or even more). Thus, for every two pounds of owners' equity the business can get three pounds total capital to work with. Using owners' equity as the basis for borrowing is called *trading on the equity.* It is also referred to as *financial leverage,* because the equity is the lever for increasing the total capital of the business.

These terms also refer to the potential gain a business can realise from making more EBIT (earnings before interest and tax) on the amount borrowed than the interest on the debt. For a simple example, assume that debt supplies one-third of the total capital of a business (and owners' equity two-thirds, of course), and the business's EBIT for the year just ended is a nice, round £3,000,000. Fair is fair, so you could argue that the lenders who put up one-third of the money should get one-third or £1,000,000 of the profit. This is not how it works. The lenders (investors) get only the interest amount on their loans (their investments). Suppose this total interest is £750,000. The financial leverage gain, therefore, is £250,000. The owners would get their two-thirds share of EBIT plus the £250,000 pre-tax financial leverage gain.

Trading on the equity may backfire. Instead of a gain, the business may realise a financial leverage loss – one-third of its EBIT may be *less* than the interest due on its debt. That interest has to be paid no matter what amount of EBIT the business earns. Suppose the business just breaks even, which means its EBIT equals zero for the year. Nevertheless, it must pay the interest on its debt. So, the business would have a bottom-line loss for the year.

We haven't said much about the situation in which a business has a loss for the year, instead of a profit. A loss has the effect of decreasing the assets of a business (whereas a profit increases its assets). To keep it simple, assume cash is the only asset decreased by the loss (although other assets could also decrease as a result of the loss). Basically, cash goes down by the amount of the loss; and, on the other side of the balance sheet, the retained earnings account goes down the same amount. The owners do not have to invest additional money in the business to cover the loss. The impact on the owners is that their total equity (the recorded value of their ownership in the business) takes a hit equal to the amount of the loss.

The balance sheet shown in Figure 6-1 is a bare-bones statement of financial condition. Yes, the basic assets, liabilities and owners' equity accounts are presented but for both internal management reporting and for external reporting to investors and lenders, the balance sheet must be dressed up rather more than the one shown in Figure 6-1.

TIP

For internal reporting to managers, balance sheets include much more detail either in the body of the financial statement itself or, more likely, in supporting schedules. For example, only one cash account is shown in Figure 6-1 but the chief financial officer of a business needs to see the balances in each of the business's bank accounts.

As another example, the balance sheet shown in Figure 6-1 includes just one total amount for debtors but managers need details on which customers owe money and whether any major amounts are past their due date. Therefore, the assets and liabilities of a business are reported to its managers in greater detail, which allows for better control, analysis and decision-making. Management control is very detail-oriented: Internal balance sheets and their supporting schedules should provide all the detail that managers need to make good business decisions.

In contrast, balance sheets presented in *external* financial reports (which go out to investors and lenders) do not include much more detail than the balance sheet shown in Figure 6-1. However, external balance sheets must classify (or group together) short-term assets and liabilities. For this reason, external balance sheets are referred to as *classified balance sheets.* This classification is not mandatory for internal reporting to managers, although separating short-term assets and liabilities is also useful for managers.

Business balance sheets are not vetted by the accountant to make sure no secrets are being disclosed that would harm national security. The term 'classified' applied to a balance sheet does not mean restricted or top secret; rather, the term means that assets and liabilities are sorted into basic classes, or groups, for external reporting. Classifying certain assets and liabilities into current categories is done mainly to help readers of the balance sheet more easily compare total current assets with total current liabilities for the purpose of judging the short-term solvency of the business.

Solvency refers to the ability of a business to pay its liabilities on time. Delays in paying liabilities on time can cause very serious problems for a business. In extreme cases, a business could be thrown into *bankruptcy* – even the threat of bankruptcy can cause serious disruptions in the normal operations of a business, and profit performance is bound to suffer. If current liabilities become too high relative to current assets – which are the first line of defence for paying those current liabilities – managers should move quickly to raise additional cash to reduce one or more of the current liabilities. Otherwise, a low current ratio will raise alarms in the minds of the outside readers of the business's financial report.

Figure 6-3 presents the *classified* balance sheet for the same company. What's new? Not the assets, liabilities and owners' equity accounts and their balances. These numbers are the same ones shown in Figure 6-1. The classified balance sheet shown in Figure 6-3 includes the following new items of information:

- The first four asset accounts (cash, debtors, stock and prepaid expenses) are added to give the £8,555,000 subtotal for *current assets*.
- The £5,000,000 total debt of the business is divided between £2,000,000 short-term notes payable and £3,000,000 long-term notes payable.
- The first four liability accounts (accounts payable, accrued expenses payable, income tax payable and short-term notes payable) are added to give the £4,080,000 subtotal for *current liabilities*.

Figure 6-3: Example of an external (classified) balance sheet for a business.

Assets		
Cash		£ 2,000,000
Debtors		£ 2,500,000
Stock		£ 3,575,000
Prepaid Expenses		£ 480,000
Current Assets		£ 8,555,000
Fixed Assets (at original cost)	£ 11,305,000	
Accumulated Depreciation	£ (5,780,000)	£ 5,525,000
Total Assets		£ 14,080,000
Liabilities and Owners' Equity		
Creditors		£ 800,000
Accrued Expenses Payable		£ 1,200,000
Income Tax Payable		£ 80,000
Overdraft		£ 2,000,000
Current Liabilities		£ 4,080,000
Loans		£ 3,000,000
Owners' Invested Capital	£ 2,000,000	
Retained Earnings	£ 5,000,000	£ 7,000,000
Total Liabilities and Owners' Equity		£ 14,080,000

Current (short-term) assets

Short-term, or *current*, assets are:

- Cash
- Marketable securities that can be immediately converted into cash
- Operating assets that are converted into cash within one *operating cycle*

Operating cycle refers to the process of putting cash into stock, selling products on credit (which generates debtors) and then collecting the receivables in cash. In other words, the operating cycle is the 'from cash – through stock and debtors – back to cash' sequence. The term *operating* refers to those assets that are directly part of making sales and directly involved in the expenses of the company.

Current (short-term) liabilities

Short-term, or *current*, liabilities are those non-interest-bearing liabilities that arise from the operating activities of the business, as well as interest-bearing overdrafts that have a maturity date one year or less from the balance sheet date. Current liabilities also include any other liabilities that must be paid within the upcoming financial period.

Current liabilities are generally paid out of current assets. That is, current assets are the first source of money to pay the current liabilities when those liabilities come due. Thus, total current assets are compared against total current liabilities in order to compute the *current ratio*. For the balance sheet shown in the preceding section, you can compute the current ratio as follows:

£8,555,000 current assets ÷ £4,080,000 current liabilities = 2.1 current ratio

The general rule is that a company's current ratio should be 1.5 or higher. However, business managers know that the current ratio depends a great deal on how the business's short-term operating assets are financed from current liabilities. Some businesses do quite well with a current ratio less than 1.5. Therefore, take the 1.5 current ratio rule with a grain of salt. A lower current ratio does not necessarily mean that the business won't be able to pay its short-term (current) liabilities on time. Chapters 14 and 17 explain current term (current) liabilities on time. Chapters 14 and 17 explain current ratios in more detail.

Costs and Other Balance Sheet Values

The balance sheet summarises the financial condition for a business at a point in time. Business managers and investors should clearly understand the values reported in this primary financial statement. In our experience, understanding balance sheet values can be a source of confusion for both business managers and investors who tend to put all pound amounts on the same value basis. In their minds, a pound is a pound, whether it's in the debtors, stock, fixed assets, or accounts payable. Assigning the same value to every account value tends to gloss over some important differences and can lead to serious misinterpretation of the balance sheet.

A balance sheet mixes together several different types of accounting values:

- **Cash:** Amounts of money on hand in coin and currency; money on deposit in bank accounts
- **Debtors:** Amounts not yet collected from credit sales to customers
- **Stock:** Amounts of purchase costs or production costs for products that haven't sold yet
- **Fixed assets (or Property, plant, and equipment):** Amounts of costs invested in long-life, tangible, productive operating

assets

- **Creditors and accrued liabilities:** Amounts for the costs of unpaid expenses
- **Overdrafts and loans:** Amounts borrowed on interest-bearing liabilities
- **Capital stock:** Amounts of capital invested in the business by owners (shareholders). This can be either by way of the initial capital introduced or profits left in the business after trading gets under way
- **Retained earnings (or reserves):** Amounts remaining in the owners' equity account

In short, a balance sheet represents a diversity, or a rainbow, of values – not just one colour. This is the nature of the generally accepted accounting principles – the accounting methods used to prepare financial statements.

TIP

Book values are the amounts recorded in the accounting process and reported in financial statements. Do not assume that the book values reported in a balance sheet necessarily equal the current *market values.* Book values are based on the accounting methods used by a business. Generally speaking – and we really mean *generally* here because we're sure that you can find exceptions to this rule – cash, debtors, and liabilities are recorded at close to their market or settlement values. These receivables will be turned into cash (at the same amount recorded on the balance sheet) and liabilities will be paid off at the amounts reported in the balance sheet. It's the book values of stock and fixed assets that most likely are lower than current market values, as well as any other non-operating assets in which the business invested some time ago.

A business can use alternative accounting methods to determine the cost of stock and the cost of goods sold, and to determine how much of a fixed asset's cost is allocated to depreciation expense each year. A business is free to use very conservative accounting methods – with the result that its stock cost value and the non-depreciated cost of its fixed assets may be much lower than the current replacement cost values of these assets. Chapter 13 explains more about choosing different accounting methods.

Growing Up

In the layout in Figure 6-4 we start with the fixed assets rather than liquid assets such as cash and work our way down. After the fixed asset sum has been determined to arrive at the residual unwritten down ‘value’ of those assets, in this case £5,525,000, we work our way down the current assets in the reverse order of their ability to be turned into cash. The total of the current assets comes to £8,555,000.

Next we get the current liabilities, which come to a total of £4,080,000, and subtract that from the current asset total of £8,555,000 to arrive at a figure of £4,475,000. This is often referred to as the *working capital*, as it represents the money circulating through the business day to day.

By adding the net current assets (working capital) of £4,475,000 to the net book value of the fixed assets, £5,525,000, bingo! We can see we have £10,000,000 tied up in net total assets. Deduct the money we owe long term, the creditors due over one year (a fancy way of describing bank and other debt other than overdraft), and we arrive at the net total assets. Net, by the way, is accountant-speak for deduction of one number from another, often adding a four-figure sum to the bill for doing so.

The net total assets figure of £7,000,000 bears an uncanny similarity to the total of the money put in by the owners of the business when they started out, £2,000,000, and the sum they have left in by way of profits undistributed over the years, £5,000,000. So the balance sheet balances, but with a very different total from that of Figure 6-3.

You can find a blank balance sheet and profit and loss accounts in Excel format, as well as a tutored exercise and supporting notes, at www.bized.co.uk/learn/sheets/tasker.xls.

Figure 6-4: A balance sheet.

	£	£	£
Fixed Assets	11,305,000		
Less Accumulated Depreciation	5,780,000		
Net Book Value			5,525,000
Current Assets			
Prepaid Expenses	480,000		
Stock	3,575,000		
Debtors	2,500,000		
Cash	2,000,000		
Total Current Assets		8,555,000	
Less Current Liabilities			
Overdraft	2,000,000		
Income Tax Payable	80,000		
Accrued Expenses	1,200,000		
Creditors	800,000		
Total Current Liabilities		4,080,000	
Net Current Assets			4,475,000
Total Assets			10,000,000
Less Creditors, amounts falling due in over one year			3,000,000
Net Total Assets			7,000,000
Financed By:			
Owners' Capital Introduced		2,000,000	
Reserves (Accumulated Profits)		5,000,000	7,000,000

Chapter 7

Cash Flows and the Cash Flow Statement

In This Chapter

- Separating the three types of cash flows
- Figuring out how much actual cash increase was generated by profit
- Looking at a business's other sources and uses of cash
- Being careful about free cash flow
- Evaluating managers' decisions by scrutinising the cash flow statement

This chapter talks about *cash flows* – which in general refers to cash inflows and outflows over a period of time. Suppose you tell us that last year you had total cash inflows of £145,000 and total cash outflows of £140,000. We know that your cash balance increased £5,000. But we don't know where your £145,000 cash inflows came from. Did you earn this much in salary? Did you receive an inheritance from your rich uncle? Likewise, we don't know what you used your £140,000 cash outflow for. Did you make large payments on your credit cards? Did you lose a lot of money at the races? In short, cash flows have to be sorted into different sources and uses to make much sense.

The Three Types of Cash Flow

Accountants categorise the cash flows of a business into three types:

- Cash inflows from making sales and cash outflows for expenses – sales and expense transactions – are called the *operating activities* of a business (although they could be called profit activities just as well, because their purpose is to make profit).

- Cash outflows for making investments in new assets (buildings, machinery, tools and so on) and cash inflows from liquidating old investments (assets no longer needed that are sold off); these transactions are called *investment activities.*
- Cash inflows from borrowing money and from the additional investment of money in the business by its owners, and cash outflows for paying off debt, returning capital that the business no longer needs to owners and making cash distributions of profit to its owners; these transactions are called *financing activities.*

The cash flow statement (or *statement of cash flows*) summarises the cash flows of a business for a period according to this three-way classification. Generally accepted accounting principles require that whenever a business reports its income statement, it must also report its cash flow statement for the same period – a business shouldn't report one without the other. A good reason exists for this dual financial statement requirement.

KEY CONCEPT

The income statement is based on the *accrual basis of accounting* that records sales when made, whether or not cash is received at that time, and records expenses when incurred, whether or not the expenses are paid at that time. (Chapter 3 explains accrual basis accounting.) Because accrual basis accounting is used to record profit, you can't equate bottom-line profit with an increase in cash. Suppose a business's annual income statement reports that it earned £1.6 million net income for the year. This does not mean that its cash balance increased £1.6 million during the period. You have to look in the cash flow statement to find out how much its cash balance increased (or, possibly, decreased!) from its operating activities (sales revenue and expenses) during the period.

In the chapter, we refer to the net increase (or decrease) in the business's cash balance that results from collecting sales revenue and paying expenses as *cash flow from profit* (the alternative term for *cash flow from operating activities*). Cash flow from profit seems more user-friendly than cash flow from operating activities, and in fact the term is used widely. In any case, do not confuse cash flow from profit with the other two types of cash flow – from the business's investing activities and financing activities during the period.

Before moving on, here's a short problem for you to solve. This summary of the business's net cash flows (in thousands) for the year just ended, which uses the three-way classification of cash flows explained earlier, has one amount missing:

(1) From profit (operating activities)	?
(2) From investing activities	– £1,275
(3) From financing activities	+ £160
Decrease in cash balance during year	– £15

Note that the business's cash balance from all sources and uses decreased £15,000 during the year. The amounts of net cash flows from the company's investing and financing activities are given. So you can determine that the net cash flow from profit was £1,100,000 for the year. Understanding cash flows from investing activities and financing activities is fairly straightforward. Understanding the net cash flow from profit, in contrast, is more challenging – but business managers and investors should have a good grip on this very important number.

Setting the Stage: Changes in Balance Sheet Accounts

The first step in understanding the amounts reported by a business in its cash flow statement is to focus on the *changes* in the business's assets, liabilities and owners' equity accounts during the period – the increases or decreases of each account from the start of the period to the end of the period. These changes are found in the comparative two-year balance sheet reported by a business. Figure 7-1 presents the increases and decreases during the year in the assets, liabilities and owners' equity accounts for a business example. Figure 7-1 is not a balance sheet but only a summary of *changes* in account balances. We do not want to burden you with an entire balance sheet, which has much more detail than is needed here.

Take a moment to scan Figure 7-1. Note that the business's cash balance decreased £15,000 during the year. (An increase is not necessarily a good thing, and a decrease is not necessarily a bad thing; it depends on the overall financial situation of the business.) One purpose of reporting the cash flow statement is to summarise the main reasons for the change in cash – according to the three-way classification of cash flows explained earlier. One question on everyone's mind is this: How much cash did the profit for the year generate for the business? The cash flow statement begins by answering this question.

Figure 7-1:
Changes in

balance sheet assets and operating liabilities that affect cash flow from profit.

Assets	
Cash	(15)
Debtors	800
Stock	975
Prepaid Expenses	145
Fixed Assets	1,275
Accumulated Depreciation*	(1,200)
Total	1,980
Liabilities & Owners' Equity	
Creditors	80
Accrued Expenses Payable	1,20
Income Tax Payable	20
Overdraft	200
Long-term Loans	300
Owners' Invested Capital	60
Retained Earnings	1,200
Total	1,980

* Accumulated Depreciation is a negative asset account which is deducted from Fixed Assets. The negative £1,200 change increases the negative balance of the account.

Getting at the Cash Increase from Profit

Although all amounts reported on the cash flow statement are important, the one that usually gets the most attention is *cash flow from operating activities*, or *cash flow from profit* as we prefer to call it. This is the increase in cash generated by a business's profit-making operations during the year exclusive of its other sources of cash during the year (such as borrowed money, sold-off fixed assets and additional owners' investments in the business). *Cash flow from profit* indicates a business's ability to turn profit into available cash – cash in the bank that can be used for the needs of business. Cash flow from profit gets just as much attention as net income (the bottom-line profit number in the income statement).

Before presenting the cash flow statement – which is a rather formidable, three-part accounting report – in all its glory, in the following sections we build on the summary of changes in the business's assets, liabilities and owners' equities shown in Figure 7-1 to explain the components of the £1,100,000 increase in cash from the business's profit activities during the year. (The £1,100,000 amount of cash flow from profit was determined earlier in the chapter by solving the unknown factor.)

The business in the example experienced a rather strong growth year. Its accounts receivable and stock increased by relatively large amounts. In fact, all the relevant accounts increased; their ending balances are larger than their beginning balances (which are the amounts carried forward from the end of the preceding year). At this point, we need to provide some additional information. The £1.2 million increase in retained earnings is the net difference of two quite different things.

The £1.6 million net income earned by the business increased retained earnings by this amount. As you see in Figure 7-1, the account increased only £1.2 million. Thus there must have been a £400,000 decrease in retained earnings during the year. The business paid £400,000 cash dividends from profit to its owners (the shareholders) during the year, which is recorded as a decrease in retained earnings. The amount of cash dividends is reported in the *financing activities* section of the cash flow statement. The entire amount of net income is reported in the *operating activities* section of the cash flow statement.

Computation of Cash Flow from Profit (in thousands of pounds)

	Negative Cash Flow Effects	Positive Cash Flow Effects
Net income for the year		£1,600
Debtors increase	£800	
Stock increase	£975	
Prepaid expenses increase	£145	
Depreciation expense		£1,200
Creditors increase		£80
Accrued expenses payable increase		£120
Income tax payable increase		£20
Totals	£1,920	£3,020
Cash flow from profit (£3,020 positive increases minus £1,920 negative increases)	£1,100	

Cash flow from profit (£3,020 positive increases minus £1,920 negative increases) £1,100

Note that net income (profit) for the year – which is the correct amount of profit based on the accrual basis of accounting – is listed in the positive cash flow column. This is only the starting point. Think of this the following way: If the business had collected all its sales revenue for the year in cash, and if it had made cash payments for its expenses exactly equal to the amounts recorded for the expenses, then the net income amount would equal the increase in cash. These two conditions are virtually never true, and they are not true in this example. So the net income figure is just the jumping-off point for determining the amount of cash generated by the business's profit activities during the year.

We'll let you in on a little secret here. The analysis of cash flow from profit asks what amount of profit would have been recorded if the business had been on the cash basis of accounting instead of the accrual basis. This can be confusing and exasperating, because it seems that two different profit measures are provided in a business's financial report – the true economic profit number, which is the bottom line in the income statement (usually called *net income*), and a second profit number called *cash flow from operating activities* in the cash flow statement.

When the cash flow statement was made mandatory, many accountants worried about this problem, but the majority opinion was that the amount of cash increase (or decrease) generated from the profit activities of a business is very important to disclose in financial reports. For reading the income statement you have to wear your accrual basis accounting lenses, and for the cash flow statement you have to put on your cash basis lenses. Who says accountants can't see two sides of something?

The following sections explain the effects on cash flow that each balance sheet account change causes (refer to Figure 7-1).

Getting specific about changes in assets and liabilities

As a business manager, you should keep a close watch on each of your assets and liabilities and understand the cash flow effects of increases (or decreases) caused by these changes. Investors should focus on the business's ability to generate a healthy cash flow from profit, so investors should be equally concerned about these changes.

Debtors increase

Remember that the *debtors* asset shows how much money customers who bought products on credit still owe the business; this asset is a promise of cash that the business will receive. Basically, *debtors* is the amount of uncollected sales revenue at the end of the period. Cash does not increase until the business collects money from its customers.

But the amount in debtors *is* included in the total sales revenue of the period – after all, you did make the sales, even if you haven't been paid yet. Obviously, then, you can't look at sales revenue as being equal to the amount of cash that the business received during the period.

To calculate the actual cash flow from sales, you need to subtract from sales revenue the amount of credit sales that you did not collect in cash over the period – but you add in the amount of cash that you collected during the period just ended for credit sales that you made in the *preceding* period. Take a look at the following equation for the business example, which is first introduced in Chapter 6 – the income statement figures used here are given in Figure 6–2 and the asset and liability changes are shown in Figure 7–1. (No need to look back to Figure 6–2 unless you want to review the income statement.)

> £25 million sales revenue – £0.8 million increase in debtors = £24.2 million cash collected from customers during the year

The business started the year with £1.7 million in debtors and ended the year with £2.5 million in debtors. The beginning balance was collected during the year but at the end of the year the ending balance had not been collected. Thus the *net* effect is a shortfall in cash inflow of £800,000, which is why it's called a negative cash flow factor. The key point is that you need to keep an eye on the increase or decrease in debtors from the beginning of the period to the end of the period.

- If the amount of credit sales you made during the period is greater than the amount collected from customers during the same period, your debtors *increased* over the period. Therefore you need to *subtract* from sales revenue that difference between start-of-period debtors and end-of-period debtors. In short, an increase in debtors hurts cash flow by the amount of the increase.
- If the amount you collected from customers during the period is greater than the credit sales you made during the period, your debtors *decreased* over the period. In this case you need to *add* to sales revenue that difference between start-of-period debtors and end-of-period debtors. In short, a decrease in debtors helps cash flow by the amount of the decrease.

In the example we've been using, debtors increased £800,000. Cash collections from sales were £800,000 less than sales revenue. Ouch! The business increased its sales substantially over last period, so you shouldn't be surprised that its debtors increased. The higher sales revenue was good for profit but bad for cash flow from profit.

An occasional hiccup in cash flow is the price of growth – managers and investors need to understand this point. Increasing sales without increasing debtors is a happy situation for cash flow, but in the real world you can't have one increase without the other (except in very unusual circumstances).

Stock increase

Stock is the next asset in Figure 7-1 – and usually the largest short-term, or *current,* asset for businesses that sell products. If the stock account is greater at the end of the period than at the start of the period – because either unit costs increased or the quantity of products increased – what the business actually paid out in cash for stock purchases (or manufacturing products) is more than the business recorded as its cost-of-goods-sold expense in the period. Therefore, you need to deduct the stock increase from net income when determining cash flow from profit.

REAL WORLD EXAMPLE

In the example, stock increased £975,000 from start-of-period to end-of-period. In other words, this business replaced the products that it sold during the period *and* increased its stock by £975,000. The easiest way to understand the effect of this increase on cash flow is to pretend that the business paid for all its stock purchases in cash immediately upon receiving them. The stock on hand at the start of the period had already been paid for *last* period, so that cost does not affect this period's cash flow. Those products were sold during the period and involved no further cash payment by the business. But the business did pay cash *this* period for the products that were in stock at the end of the period.

In other words, if the business had bought just enough new stock (at the same cost that it paid out last period) to replace the stock that it sold during the period, the actual cash outlay for its purchases would equal the cost-of-goods-sold expense reported in its income statement. Ending stock would equal the beginning stock; the two stock costs would cancel each other out and thus would have no effect on cash flow. But this hypothetical scenario doesn't fit the example because the company increased its sales substantially over the last period.

the last period.

To support the higher sales level, the business needed to increase its stock level. So the business bought £975,000 more in products than it sold during the period – and it had to come up with the cash to pay for this stock increase. Basically, the business wrote cheques amounting to £975,000 more than its cost-of-goods-sold expense for the period. This step-up in its stock level was necessary to support the higher sales level, which increased profit – even though cash flow took a hit.

It's that accrual basis accounting thing again: The cost that a business pays *this* period for *next* period's stock is reflected in this period's cash flow but isn't recorded until next period's income statement (when the products are actually sold). So if a business paid more *this* period for *next* period's stock than it paid *last* period for *this* period's stock, you can see how the additional expense would adversely affect cash flow but would not be reflected in the bottom-line net income figure. This cash flow analysis stuff gets a little complicated, we know, but hang in there. The cash flow statement, presented later in the chapter, makes a lot more sense after you go through this background briefing.

Prepaid expenses increase

The next asset, after stock, is prepaid expenses (refer to Figure 7-1). A change in this account works the same way as a change in stock and debtors, although changes in prepaid expenses are usually much smaller than changes in those other two asset accounts.

Again, the beginning balance of prepaid expenses is recorded as an expense this period but the cash was actually paid out last period, not this period. This period, a business pays cash for next period's prepaid expenses – which affects this period's cash flow but doesn't affect net income until next period. So the £145,000 increase in prepaid expenses from start-of-period to end-of-period in this example has a negative cash flow effect.

TIP

As it grows, a business needs to increase its prepaid expenses for such things as fire insurance (premiums have to be paid in advance of the insurance coverage) and its stocks of office and data processing supplies. Increases in debtors, stock and prepaid expenses are the price a business has to pay for growth. Rarely do you find a business that can increase its sales revenue without increasing these assets.

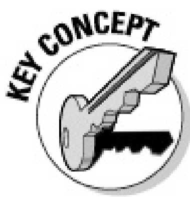
The simple but troublesome depreciation factor

Depreciation expense recorded in the period is both the simplest cash flow effect to understand and, at the same time, one of the most misunderstood elements in calculating cash flow from profit. (Refer to Chapters 5 and 6 for more about depreciation.) To start with, depreciation is not a cash outlay during the period. The amount of depreciation expense recorded in the period is simply a fraction of the original cost of the business's fixed assets that were bought and paid for years ago. (Well, if you want to nit-pick here, some of the fixed assets may have been bought during this period, and their cost is reported in the investing activities section of the cash flow statement.) Because the depreciation expense is not a cash outlay this period, the amount is added back to net income in the calculation of cash flow from profit – so far so good.

When measuring profit on the accrual basis of accounting you count depreciation as an expense. The fixed assets of a business are on an irreversible journey to the junk heap. Fixed assets have a limited life of usefulness to a business (except for land); depreciation is the accounting method that allocates the total cost of fixed assets to each year of their use in helping the business generate sales revenue. Part of the total sales revenue of a business constitutes *recovery of cost invested in its fixed assets*. In a real sense, a business 'sells' some of its fixed assets each period to its customers – it factors the cost of fixed assets into the sales prices that it charges its customers. For example, when you go to a supermarket, a very small slice of the price you pay for that box of cereal goes toward the cost of the building, the shelves, the refrigeration equipment and so on. (No wonder they charge so much for a box of cornflakes!)

Each period, a business recoups part of the cost invested in its fixed assets. In other words, £1.2 million of sales revenue (in the example) went toward reimbursing the business for the use of its fixed assets during the year. The problem regarding depreciation in cash flow analysis is that many people simply add back depreciation for the year to bottom-line profit and then stop, as if this is the proper number for cash flow from profit. It ain't so. The changes in other assets as well as the changes in liabilities also affect cash flow from profit. You should factor in *all* the changes that determine cash flow from profit, as explained in the following section.

Adding net income and depreciation to determine cash flow from profit is mixing apples and oranges. The business did not realise £1,600,000 cash increase from its £1,600,000 net income. The total of the increases of its debtors, stock and prepaid expenses is £1,920,000 (refer to Figure 7-1), which wipes out the net income amount and leaves the business with a cash balance hole of £320,000. This cash deficit is offset by the £220,000 increase in liabilities (explained later), leaving a £100,000 net income *deficit* as far as cash flow is concerned. Depreciation recovery increased cash flow £1.2 million. So the final cash flow from profit equals £1.1 million. But you'd never know this if you simply added depreciation expense to net income for the period.



The managers did not have to go outside the business for the £1.1 million cash increase generated from its profit for the year. Cash flow from profit is an *internal* source of money generated by the business itself, in contrast to *external* money that the business raises from lenders and owners. A business does not have to find sources of external money if its internal cash flow from profit is sufficient to provide for its growth.

Net income + depreciation expense doesn't equal cash flow from profit!

The business in our example earned £1.6 million in net income for the year, plus it received £1.2 million cash flow because of the depreciation expense built into its sales revenue for the year. The sum of these figures is £2.8 million. Is £2.8 million the amount of cash flow from profit for the period? The knee-jerk answer of many investors and managers is 'yes'. But if net income +

depreciation truly equals cash flow, then *both* factors in the brackets – both net income and depreciation – must be fully realised in cash. Depreciation is, but the net income amount is not fully realised in cash because the company's debtors, stock and prepaid expenses increased during the year, and these increases have negative impacts on cash flow.

In passing, we should mention that a business could have a negative cash flow from profit for a year – meaning that despite posting a net income for the period, the changes in the company's assets and liabilities caused its cash balance to decrease. In reverse, a business could report a bottom line *loss* in its income statement yet have a *positive* cash flow from its operating activities: The positive contribution from depreciation expense plus decreases in its debtors and stock could amount to more than the amount of loss. More commonly, a loss leads to negative cash flow or very little positive cash flow.

Operating liabilities increases

The business in the example, like almost all businesses, has three basic liabilities that are inextricably intertwined with its expenses: creditors, accrued expenses payable and income tax payable. When the beginning balance of one of these liability accounts is the same as the ending balance of the same account (not too likely, of course), the business breaks even on cash flow for that account. When the end-of-period balance is higher than the start-of-period balance, the business did not pay out as much money as was actually recorded as an expense on the period's income statement.

In the example we've been using, the business disbursed £720,000 to pay off last period's creditors balance. (This £720,000 was reported as the creditors balance on last period's ending balance sheet.) Its cash flow this period decreased by £720,000 because of these payments. But this period's ending balance sheet shows the amount of creditors that the business will need to pay next period – £800,000. The business actually paid off £720,000 and recorded £800,000 of expenses to the year, so this time cash flow is *richer* than what's reflected in the business's net income figure by £80,000 – in other words, the increase in creditors has a positive cash flow effect. The increases in accrued expenses payable and income tax payable work the same way.

Therefore, liability increases are favourable to cash flow – in a sense the business borrowed more than it paid off. Such an increase means that the business delayed paying cash for certain things until next year. So you need to add the increases in the three liabilities to net income to determine cash flow from profit, following the same logic as adding back depreciation to net income. The business did not have cash outlays to the extent of increases in these three liabilities.

The analysis of the changes in assets and liabilities of the business that affect cash flow from profit is complete for the business example. The final result is that the company's cash balance increased $1.1 million from profit. You could argue that cash should have increased $2.8 million – $1.6 million net income plus $1.2 million depreciation that was recovered during the year – so the business is $1.7 million behind in turning its profit into cash flow ($2.8 million less the $1.1 million cash flow from profit). This $1.7 million lag in converting profit into cash flow is caused by the $1,920,000 increase in assets less the $220,000 increase in liabilities, as shown in Figure 7–1.

Presenting the Cash Flow Statement

The cash flow statement is one of the three primary financial statements that a business must report to the outside world, according to generally accepted accounting principles (GAAP). To be technical, the rule says that whenever a business reports a profit and loss account, it should also report a cash flow statement. The *profit and loss account* summarises sales revenue and expenses and ends with the bottom-line profit for the period. The *balance sheet* summarises a business's financial condition by reporting its assets, liabilities and owners' equity. (Refer to Chapters 5 and 6 for more about these reports.)

You can probably guess what the *cash flow statement* does by its name alone: This statement tells you where a business got its cash and what the business did with its cash during the period. We prefer the name given to this statement in the old days in the US – the *Where Got, Where Gone* statement. This nickname goes straight to the purpose of the cash flow statement: asking where the business got its money and what it did with the money.

To give you a rough idea of what a cash flow statement reports, we repeat some of the questions we asked at the start of the chapter: How much money did you earn last year? Did you get all your income in cash (or did some of your wages go straight into a pension plan or did you collect a couple of IOUs)? Where did you get other money (did you take out a loan, win the lottery or receive a gift from a rich uncle)? What did you do with your money (did you buy a house, support your out-of-control Internet addiction or lose it playing bingo)?

Getting a little too personal for you? That's exactly why the cash flow statement is so important: It bares a business's financial soul to its lenders and owners. Sometimes the cash flow statement reveals questionable judgment calls that the business's managers made. At the very least, the cash flow statement reveals how well a business handles the cash increase from its profit.

As explained at the start of the chapter, the cash flow statement is divided into three sections according to the three-fold classification of cash flows for a business: operating activities (which we also call *cash flow from profit* in the chapter), investing activities and financing activities.

The cash flow statement reports a business's net cash increase or decrease based on these three groupings of the cash flow statement. Figure 7-2 shows what a cash flow statement typically looks like – in this example, for a *growing* business (which means that its assets, liabilities and owners' equity increase during the period).

The history of the cash flow statement

The cash flow statement was not required for external financial reporting until the late 1980s. Until then, the accounting profession had turned a deaf ear to calls from the investment community for cash flow statements in annual financial reports. (Accountants had presented a *funds flow statement* prior to then, but that report proved to be a disaster – the term *funds* included more assets than just cash and represented a net amount after deducting short-term liabilities from short-term, or current, assets.)

In our opinion, the reluctance to require cash flow statements came from fears that the *cash flow from profit* figure would usurp net income – people would lose confidence in the net income line.

Those fears have some justification – considering the attention given to cash flow from profit and what is called 'free cash flow' (discussed later in the chapter). Although the profit and loss account continues to get most of the fanfare (because it shows the magic bottom-line number of net income), cash flow gets a lot of emphasis these days.

Figure 7-2: Cash flow statement for the business in the example.

Cash Flow Statement for Year (in thousands of pounds)

Cash Flows from Operating Activities		
Net Income		£ 1,600
Debtors	£ (800)	
Stock Increase	£ (975)	
Prepaid Expenses Increase	£ (145)	
Depreciation Expense	£ 1,200	
Creditors Increase	£ 80	
Accrued Expense Increase	£ 120	
Income Tax Payable Increase	£ 20	£ (500)
Cash Flow from Operating Activities		£ 1,100
Cash Flows from Investing Activities		
Purchases of Property, Plant & Equipment		£ (1,275)
Cash Flows from Financing Activities		
Short-term Debt Borrowing Increase	£ 200	
Long-term Debt Borrowing Increase	£ 300	
Share Issue	£ 60	
Dividends Paid Stockholders	£ (400)	£ 160
Increase (Decrease) In Cash During Year		£ (15)
Beginning Cash Balance		£ 2,015
Ending Cash Balance		£ 2,000

TIP The trick to understanding cash flow from profit is to link the sales revenue and expenses of the business with the changes in the business's assets and liabilities that are directly connected with its profit-making activities. Using this approach earlier in the chapter, we determine that the cash flow from profit is £1.1 million for the year for the sample business. This is the number you see in Figure 7-2 for cash flow from operating activities. In our experience, many business managers, lenders and investors don't fully understand these links, but the savvy ones know to keep a close eye on the relevant balance sheet changes.

What do the figures in the first section of the cash flow statement (See Figure 7-2) reveal about this business over the past period? Recall that the business experienced rapid sales growth over the last period. However, the downside of sales growth is that operating assets and liabilities also grow – the business needs more stock at the higher sales level and also has higher debtors.

The business's prepaid expenses and liabilities also increased, although not nearly as much as debtors and stock. The rapid growth of the business yielded higher profit but also caused quite a surge in its operating assets and liabilities – the result being that cash flow from profit is only £1.1 million compared with £1.6 million in net income – a £500,000 shortfall. Still, the business had £1.1 million at its disposal after allowing for the increases in assets and liabilities. What did the business do with this £1.1 million of available cash? You have to look to the remainder of the cash flow statement to answer this key question.

A very quick read through the rest of the cash flow statement (refer to Figure 7-2) goes something like this: The company used £1,275,000 to buy new fixed assets, borrowed £500,000 and distributed £400,000 of the profit to its owners. The result is that cash decreased £15,000 during the year. Shouldn't the business have cash decreased £15,000 during the year. Shouldn't the business have increased its cash balance, given its fairly rapid growth during the period? That's a good question! Higher levels of sales generally require higher levels of operating cash balances. However, you can see in its balance sheet at the end of the year (refer back to Figure 6-2) that the company has £2 million in cash, which, compared with its £25 million annual sales revenue, is probably enough.

A better alternative for reporting cash flow from profit?

We call your attention, again, to the first section of the cash flow statement in Figure 7-2. You start with net income for the period. Next, changes in assets and liabilities are deducted or added to net income to arrive at cash flow from operating activities (the cash flow from profit) for the year. This format is called the *indirect method.* The alternative format for this section of the cash flow statement is called the *direct method* and is presented like this (using the same business example, with pound amounts in millions):

Cash inflow from sales	£24.2
Less cash outflow for expenses	£23.1
Cash flow from operating activities	£1.1

You may remember from the earlier discussion that sales revenue for the year is £25 million, but that the company's debtors increased £800,000 during the year, so cash flow from sales is £24.2 million. Likewise, the expenses for the year can be put on a cash flow basis. But we 'cheated' here – we have already determined that cash flow from profit is £1.1 million for the year, so we plugged the figure for cash outflow for expenses. We would take more time to explain the direct approach, except for one major reason.

> **Where to put depreciation?**
>
> Where the depreciation line goes within the first section (operating activities) of the cash flow statement is a matter of personal preference – no standard location is required. Many businesses report it in the middle or toward the bottom of the changes in assets and liabilities – perhaps to avoid giving people the idea that cash flow from profit simply requires adding back depreciation to net income.

Although the Accounting Standards Board (ASB) expresses a definite preference for the direct method, this august rule-making body does permit the indirect method to be used in external financial reports – and, in fact, the overwhelming majority of businesses use the indirect method. Unless you're an accountant, we don't think you need to know much more about the direct method.

Sailing through the Rest of the Cash Flow Statement

After you get past the first section, the rest of the cash flow statement is a breeze. The last two sections of the statement explain what the business did with its cash and where cash that didn't come from profit came from.

Investing activities

The second section of the cash flow statement reports the investment actions that a business's managers took during the year. Investments are like tea leaves, serving as indicators regarding what the future may hold for the company. Major new investments are the sure signs of expanding or modernising the production and distribution facilities and capacity of the business. Major disposals of long-term assets and the shedding of a major part of the business could be good news or bad news for the business, depending on many factors. Different investors may interpret this information differently, but all would agree that the information in this section of the cash flow statement is very important.

Certain long-lived operating assets are required for doing business – for example, Federal Express wouldn't be terribly successful if it didn't have aeroplanes and vans for delivering packages and computers for tracking deliveries. When those assets wear out, the business needs to replace them. Also, to remain competitive, a business may need to upgrade its equipment to take advantage of the latest technology or provide for growth. These investments in long-lived, tangible, productive assets, which we call *fixed assets* in this book, are critical to the future of the business and are called *capital expenditures* to stress that capital is being invested for the long term.

One of the first claims on cash flow from profit is capital expenditure. Notice in Figure 7–2 that the business spent £1,275,000 for new fixed assets, which are referred to as *property, plant and equipment* in the cash flow statement (to keep the terminology consistent with account titles used in the balance sheet, because the term *fixed assets* is rather informal).

Cash flow statements generally don't go into much detail regarding exactly what specific types of fixed assets a business purchased – how many additional square feet of space the business acquired, how many new drill presses it bought and so on. (Some businesses do leave a clearer trail of their investments, though. For example, airlines describe how many new aircraft of each kind were purchased to replace old equipment or expand their fleets.)

Note: Typically, every year a business disposes of some of its fixed assets that have reached the end of their useful lives and will no longer be used. These fixed assets are sent to the junkyard, traded in on new fixed assets, or sold for relatively small amounts of money. The value of a fixed asset at the end of its useful life is called its *salvage value.* The disposal proceeds from selling fixed assets are reported as a source of cash in the investments section of the cash flow statement. Usually, these amounts are fairly small. In contrast, a business may sell off fixed assets because it's downsizing or abandoning a major segment of its business. These cash proceeds can be fairly large.

Financing activities

Note that in the annual cash flow statement (refer to Figure 7-2) of the business example we've been using, the positive cash flow from profit is $1,100,000 and the negative cash flow from investing activities is $1,275,000. The result to this point, therefore, is a net cash outflow of $175,000 – which would have decreased the company's cash balance this much if the business did not go to outside sources of capital for additional money during the year. In fact, the business increased its short-term and long-term debt during the year, and its owners invested additional money in the business. The third section of the cash flow statement summarises these financing activities of the business over the period.

The term *financing* generally refers to a business raising capital from debt and equity sources – from borrowing money from banks and other sources willing to loan money to the business and from its owners putting additional money in the business. In addition, the term includes making payments on debt and returning capital to owners. *Financing* also refers to cash distributions (if any) from profit by the business to its owners.

Most businesses borrow money for a short term (generally defined as less than one year), as well as for longer terms (generally defined as more than one year). In other words, a typical business has both short-term and long-term debt. (Chapter 6 explains that short-term debt is presented in the current liabilities section of the balance sheet.) The business in our example has both short-term and long-term debt. Although not a hard-and-fast rule, most cash flow statements report just the *net* increase or decrease in short-term debt, not the total amount borrowed and the total payments on short-term debt during the period. In contrast, both the total amount borrowed and the total amount paid on long-term debt during the year are reported in the cash flow statement.

For the business we've been using as an example, no long-term debt was paid down during the year but short-term debt was paid off during the year and replaced with new short-term notes payable. However, only the net increase (£200,000) is reported in the cash flow statement. The business also increased its long-term debt by £300,000 (refer to Figure 7-2).

The financing section of the cash flow statement also reports on the flow of cash between the business and its owners (who are the stockholders of a corporation). Owners can be both a *source* of a business's cash (capital invested by owners) and a *use* of a business's cash (profit distributed to owners). This section of the cash flow statement reports capital raised from its owners, if any, as well as any capital returned to the owners. In the cash flow statement (Figure 7–2), note that the business did issue additional stock shares for £60,000 during the year, and it paid a total of £400,000 cash dividends (distributions) from profit to its owners.

Free Cash Flow: What on Earth Does That Mean?

A new term has emerged in the lexicon of accounting and finance – *free cash flow.* This piece of language is not – we repeat, *not* – an officially defined term by any authoritative accounting rule-making body. Furthermore, the term does *not* appear in the cash flow statements reported by businesses. Rather, free cash flow is street language, or slang, even though the term appears often in *The Financial Times* and *The Economist.* Securities brokers and investment analysts use the term freely (pun intended). Like most new words being tossed around for the first time, this one hasn't settled down into one universal meaning although the most common usage of the term pivots on cash flow from profit.

The term *free cash flow* is used to mean any of the following:

- Net income plus depreciation (plus any other expense recorded during the period that does not involve the outlay of cash but rather the allocation of the cost of a long-term asset other than property, plant and equipment – such as the intangible assets of a business).
- Cash flow from operating activities (as reported in the cash flow statement).
- Cash flow from operating activities minus some or all of the capital expenditures made during the year (such as purchases or construction of new, long-lived operating assets such as property, plant and equipment).
- Cash flow from operating activities plus interest, and depreciation, and income tax expenses, or, in other words, cash flow before these expenses are deducted.

In the strongest possible terms, we advise you to be very clear on which definition of *free cash flow* the speaker or writer is using. Unfortunately, you can't always determine what the term means in any given context. The reporter or investment professional should define the term.

One definition of free cash flow, in our view, is quite useful: cash flow from profit minus capital expenditures for the year. The idea is that a business needs to make capital expenditures in order to stay in business and thrive. And to make capital expenditures, the business needs cash. Only after paying for its capital expenditures does a business have 'free' cash flow that it can use as it likes. In our example, the free cash flow is, in fact, negative – £1,100,000 cash flow from profit minus $1,275,000 capital expenditures for new fixed assets equals a *negative* $175,000.

This is a key point. In many cases, cash flow from profit falls short of the money needed for capital expenditures. So the business has to borrow more money, persuade its owners to invest more money in the business, or dip into its cash reserve. Should a business in this situation distribute some of its profit to owners? After all, it has a cash *deficit* after paying for capital expenditures. But many companies like the business in our example do, in fact, make cash distributions from profit to their owners.

Scrutinising the Cash Flow Statement

Analysing a business's cash flow statement inevitably raises certain questions: What would I have done differently if I were running this business? Would I have borrowed more money? Would I have raised more money from the owners? Would I have distributed so much of the profit to the owners? Would I have let my cash balance drop by even such a small amount?

One purpose of the cash flow statement is to show readers what judgment calls and financial decisions the business's managers made during the period. Of course, management decisions are always subject to second-guessing and criticising, and passing judgment based on a financial statement isn't totally fair because it doesn't reveal the pressures the managers faced during the period. Maybe they made the best possible decisions given the circumstances. Maybe not.

REAL WORLD EXAMPLE

The business in our example (refer to Figure 7-2) distributed £400,000 cash from profit to its owners – a 25 per cent *pay-out ratio* (which is the £400,000 distribution divided by £1.6 million net income). In analysing whether the pay-out ratio is too high, too low or just about right, you need to look at the broader context of the business's sources of, and needs for, cash.

First look at cash flow from profit: £1.1 million, which is not enough to cover the business's £1,275,000 capital expenditures during the year. The business increased its total debt £500,000. Given these circumstances, maybe the business should have hoarded its cash and not paid so much in cash distributions to its owners.

So does this business have enough cash to operate with? You can't answer that question just by examining the cash flow statement – or any financial statement for that matter. Every business needs a buffer of cash to protect against unexpected developments and to take advantage of unexpected opportunities, as we explain in Chapter 10 on budgeting. This particular business has a £2 million cash balance compared with £25 million annual sales revenue for the period just ended, which probably is enough. If you were the boss of this business how much working cash balance would you want? Not an easy question to answer! Don't forget that you need to look at all three primary financial statements – the profit and loss account and the balance sheet as well as the cash flow statement – to get the big picture of a business's financial health.

You probably didn't count the number of lines of information in Figure 7-2, the cash flow statement for the business example. Anyway, the financial statement has 17 lines of information. Would you like to hazard a guess regarding the average number of lines in cash flow statements of publicly owned companies? Typically, their cash flow statements have 30 to 40 lines of information by our reckoning. So it takes quite a while to read the cash flow statement – more time than the average investor probably has. (Professional stock analysts and investment managers are paid to take the time to read this financial statement meticulously.) Quite frankly, we find that many cash flow statements are not only rather long but also difficult to understand – even for an accountant. We won't get on a soapbox here but we definitely think businesses could do a better job of reporting their cash flow statements by reducing the number of lines in their financial statements and making each line clearer.

The website www.score.org offers a downloadable Excel spreadsheet that enables you to tailor a cash flow statement to your requirements. You can find the spreadsheet by going to the SCORE homepage and clicking on ‘Templates & Tools’ where you can find an extensive selection of templates and calculators. Microsoft also has a comprehensive range of templates at http://office.microsoft.com/en-gb/Templates followed by a search term, in this case ‘cash flow’.

Chapter 8

Getting a Financial Report Ready for Prime Time

In This Chapter

- Making sure that all the pieces fit together
- Looking at the various changes in owners' equity
- Making sure that disclosure is adequate
- Touching up the numbers
- Financial reporting on the Internet
- Dealing with financial reports' information overload

The primary financial statements of a business (as explained in Chapters 5, 6 and 7) are:

- **Profit and loss account:** Summarises sales revenue inflows and expense outflows for the period and ends with the bottom-line profit, which is the net inflow for the period (a loss is a net outflow).
- **Balance sheet:** Summarises financial condition at the end of the period, consisting of amounts for assets, liabilities and owners' equity at that instant in time.
- **Cash flow statement:** Summarises the net cash inflow (or outflow) from profit for the period plus the other sources and uses of cash during the period.

An annual financial report of a business contains more than just these three financial statements. In the 'more', the business manager plays an important role – which outside investors and lenders should understand. The manager should do certain critical things before the financial report is released to the outside world.

1. **The manager should review with a critical eye the *vital connections* between the items reported in all three financial statements –** all amounts have to fit together like the pieces of a

jigsaw. The net cash increase (or decrease) reported at the end of the cash flow statement, for instance, has to tie in with the change in cash reported in the balance sheet. Abnormally high or low ratios between connected accounts should be scrutinised carefully.

2. The manager should carefully review the *disclosures* in the financial report (all information in addition to the financial statements) to make sure that disclosure is adequate according to financial reporting standards, and that all the disclosure elements are truthful but not damaging to the interests of the business.

This disclosure review can be compared with the notion of *due diligence*, which is done to make certain that all relevant information is collected, that the information is accurate and reliable, and that all relevant requirements and regulations are being complied with. This step is especially important for public corporations whose securities (shares and debt instruments) are traded on national securities exchanges.

3. The manager should consider whether the financial statement numbers need *touching up* to smooth the jagged edges off the company's year-to-year profit gyrations or to improve the business's short-term solvency picture. Although this can be described as putting your thumb on the scale, you can also argue that sometimes the scale is a little out of balance to begin with and the manager is adjusting the financial statements to jibe better with the normal circumstances of the business.

In discussing the third step later in the chapter, we walk on thin ice. Some topics are, shall we say, rather delicate. The manager has to strike a balance between the interests of the business on the one hand and the interests of the owners (investors) and creditors of the business on the other. The best analogy we can think of is the advertising done by a business. Advertising should be truthful but, as we're sure you know, businesses have a lot of leeway in how to advertise their products and they have been known to engage in hyperbole. Managers exercise the same freedoms in putting together their financial reports.

Reviewing Vital Connections

Business managers and investors read financial reports because these reports provide information regarding how the business is doing. The top managers of a business, in reviewing the annual financial report before releasing it outside the business, should keep in mind that a financial report is designed to answer certain basic financial questions:

- Is the business making a profit or suffering a loss, and how much?
- How do assets stack up against liabilities?
- Where did the business get its capital and is it making good use of the money?
- Is profit generating cash flow?
- Did the business reinvest all its profit or distribute some of the profit to owners?
- Does the business have enough capital for future growth?

As a hypothetical but realistic business example, Figure 8-1 highlights some of the vital connections – the lines connect one or more balance sheet accounts with sales revenue or an expense in the profit and loss account. The savvy manager or investor checks these links to see whether everything is in order or whether some danger signals point to problems. (We should make clear that these lines of connection do not appear in actual financial reports.)

Figure 8-1: Vital connections between the profit and loss account and the balance sheet.

(Amounts in thousands)

Profit and Loss Account for Year

Sales Revenue	£ 52,000
Cost of Goods Sold Expense	31,200
Gross Margin	£ 20,800
Sales, Administration, and General Expenses	15,600
Depreciation Expense	1,650
Earnings Before Interest and Income Tax	£ 3,550
Interest Expense	750
Earnings Before Income Tax	£ 2,800
Income Tax Expense	900
Net Income	£ 1,900

Balance Sheet at End of Year

Assets	
Cash	£ 3,500
Debtors	5,000
Stock	7,800
Prepaid Expenses	900
Fixed Assets	19,500
Accumulated Depreciation	(6,825)
Total Assets	£ 29,875
Liabilities	
Creditors	£ 1,500
Accrued Expenses Payable	2,400
Income Tax Payable	75
Overdraft	4,000
Long Term Loans	6,000
Owners' Equity	
Share Capital	4,000
Retained Earnings	11,900
Liabilities and Owners' Equity	£ 29,875

In the following list, we briefly explain these five connections, mainly from the manager's point of view. Chapters 14 and 17 explain how investors and lenders read a financial report and compute certain ratios. (Investors and lenders are on the outside looking in; managers are on the inside looking out.)

Note: We cut right to the chase in the following brief comments and we do not illustrate the calculations behind the comments. The purpose here is to emphasise why managers should pay attention to these important ratios. (Chapters 5 and 6 provide fuller explanations of these and other connections of operating assets and liabilities with sales revenue and expenses.)

1. **Sales Revenue and Debtors:** This business's ending balance of debtors is five weeks of its annual sales revenue. The manager should compare this ratio to the normal credit terms offered to the business's customers. If the ending balance is too high, the manager should identify which customers' accounts are past due and take actions to collect these amounts, or perhaps shut off

future credit to these customers. An abnormally high balance of debtors may signal that some of these customers' amounts owed to the business should be written off as uncollectable bad debts.

2. Cost of Goods Sold Expense and Stock: This business's ending stock is 13 weeks of its annual cost of goods sold expense. The manager should compare this ratio to the company's stock policies and objectives regarding how long stock should be held awaiting sale. If stock is too large the manager should identify which products have been in stock too long; further purchases (or manufacturing) should be curtailed. Also, the manager may want to consider sales promotions or cutting sales prices to move these products out of stock faster.

3. Sales, Administration and General (SA&G) Expenses and Prepaid Expenses: This business's ending balance of prepaid expenses is three weeks of the total of these annual operating expenses. The manager should know what the normal ratio of prepaid expenses should be relative to the annual SA&G operating expenses (excluding depreciation expense). If the ending balance is too high, the manager should investigate which costs have been paid too far in advance and take action to bring these prepaids back down to normal.

4. Sales, Administration and General (SA&G) Expenses and Creditors: This business's ending balance of creditors is five weeks of its annual operating expenses. Delaying payment of these liabilities is good from the cash flow point of view (refer to Chapter 7) but delaying too long may jeopardise the company's good credit rating with its key suppliers and vendors. If this ratio is too high, the manager should pinpoint which specific liabilities have not been paid and whether any of these are overdue and should be paid immediately. Or, the high balance may indicate that the company is in a difficult short-term solvency situation and needs to raise more money to pay the amounts owed to suppliers and vendors.

5. Sales, Administration and General (SA&G) Expenses and Accrued Expenses Payable: This business's ending balance of this operating liability is eight weeks of the business's annual operating expenses. This ratio may be consistent with past experience and the normal lag before paying these costs. On the other hand, the ending balance may be abnormally high. The manager should identify which of these unpaid costs are higher than they should be. As with creditors, inflated amounts of accrued liabilities may signal serious short-term solvency problems.

These five key connections are very important ones, but the manager should scan all basic connections to see whether the ratios pass the common sense test. For example, the manager should make a quick eyeball test of interest expense compared with interest-bearing debt. In Figure 8-1, interest expense is £750,000 compared with £10 million total debt, which indicates a 7.5 per cent interest rate. This seems OK. But if the interest expense were more than £1 million, the manager should investigate and determine why it's so high.

TIP

There's always the chance of errors in the accounts of a business. Reviewing the vital connections between the profit and loss account items and the balance sheet items is a very valuable final check before the financial statements are approved for inclusion in the business's financial report. After the financial report is released to the outside world, it becomes the latest chapter in the official financial history of the business. If the financial statements are wrong, the business and its top managers are responsible.

Statement of Changes in Owners' Equity and Comprehensive Income

In many situations a business needs to prepare one additional financial statement – the *statement of changes in owners' equity.* Owners' equity consists of two fundamentally different sources – capital invested in the business by the owners, and profit earned by and retained in the business. The specific accounts maintained by the business for its total owners' equity depend on the legal organisation of the business entity. One of the main types of legal organisation of business is the *company*, and its owners are *shareholders* because the company issues ownership *shares* representing portions of the business. So, the title *statement of changes in shareholders' equity* is used for companies. (Chapter 11 explains the corporation and other legal types of business entities.)

First, consider the situation in which a business does *not* need to report this statement – to make clearer why the statement is needed. Suppose a company has only one class of share and it did not buy any of its own shares during the year and it did not record any gains or losses in owners' equity during the year due to *other comprehensive income* (explained below). This business does not need a statement of changes in shareholders' equity. In reading the financial report of this business you would see in its cash flow statement (Figure 7–2 shows an example) whether the business raised additional capital from its owners during the year and how much in *cash dividends* (distributions from profit) was paid to the owners during the year. The cash flow statement contains all the changes in the owners' equity accounts during the year.

In sharp contrast, larger businesses – especially publicly traded corporations – generally have complex ownership structures consisting of two or more classes of shares; they usually buy some of their own shares and they have one or more technical types of gains or losses during the year. So, they prepare a statement of changes in stockholders' equity to collect together in one place all the changes affecting the owners' equity accounts during the year. This particular 'mini' statement (that focuses narrowly on changes in owners' equity accounts) is where you find certain gains and losses that increase or decrease owners' equity but which are *not* reported in the profit and loss account. Basically, a business has the option to bypass the profit and loss account and, instead, report these gains and losses in the statement of changes in owners' equity. In this way the gains or losses do not affect the bottom-line profit of the business reported in its profit and loss account. You have to read this financial summary of the changes in the owners' equity accounts to find out whether the business had any of these gains or losses and the amounts of the gains or losses.

TECHNICAL STUFF

The special types of gains and losses that can be reported in the statement of owners' equity (instead of the profit and loss account) have to do with foreign currency translations, unrealised gains and losses from certain types of securities investments by the business and changes in liabilities for unfunded pension fund obligations of the business. *Comprehensive income* is the term used to describe the normal content of the profit and loss account *plus* the additional layer of these special types of gains and losses. Being so technical in nature, these gains and losses fall in a 'twilight zone' as it were, in financial reporting. The gains and losses can be tacked on at the bottom of the profit and loss account or they can be put in the statement of changes in owners' equity – it's up to the business to make the choice. If you encounter these gains and losses in reading a financial report, you'll have to study the footnotes to the financial statements to learn more information about each gain and loss.

Keep on the lookout for the special types of gains and losses that are reported in the statement of changes in owners' equity. A business has the option to tack such gains and losses onto the bottom of its profit and loss account – below the net income line. But, most businesses put these income gains and losses in their statement of changes in shareholders' equity, or in a note or notes to their accounts. So, watch out for any large amounts of gains or losses that are reported in the statement of changes in owners' equity.

The general format of the statement of changes in shareholders' equity includes a column for each class of stock (ordinary shares, preference shares and so on); a column for any shares of its own that the business has purchased and not cancelled; a column for retained earnings; and one or more columns for any other separate components of the business's owners' equity. Each column starts with the beginning balance and then shows the increases or decreases in the account during the year. For example, a comprehensive gain is shown as an increase in retained earnings and a comprehensive loss as a decrease. The purchase of its own shares is shown as an increase in the relevant column and if the business reissued some of these shares (such as for stock options exercised by executives), the cost of these shares reissued is shown as a decrease in the column.

We have to admit that reading the statement of changes, or *notes to the accounts* in shareholders' equity can be heavy going. The professionals – stock analysts, money and investment managers and so on – carefully read through and dissect this statement, or at least they should. The average non-professional investor should focus on whether the business had a major increase or decrease in the number of shares during the year, whether the business changed its ownership structure by creating or eliminating a class of stock, and the impact of stock options awarded to managers of the business.

Making Sure that Disclosure Is Adequate

The primary financial statements (including the statement of changes in owners' equity, if reported) are the backbone of a financial report. In fact, a financial report is not deserving of the name if the primary financial statements are not included. But, as mentioned earlier, there's much more to a financial report than the financial statements. A financial report needs *disclosures.* Of course, the financial statements provide disclosure of the most important financial information about the business. The term disclosures, however, usually refers to additional information provided in a financial report. In a nutshell, a financial report has two basic parts: (1) the primary financial statements and (2) disclosures.

The chief officer of the business (usually the CEO of a publicly owned company, the president of a private corporation or the managing partner of a partnership) has the primary responsibility to make sure that the financial statements have been prepared according to prevailing accounting standards and that the financial report provides adequate disclosure. He or she works with the chief financial officer of the business to make sure that the financial report meets the standard of adequate disclosure. (Many smaller businesses hire an independent qualified accountant to advise them on their financial statements and other disclosures in their financial reports.)

Types of disclosures in financial reports

For a quick survey of disclosures in financial reports – that is to say, the disclosures in addition to the financial statements – the following distinctions are helpful:

- **Footnotes** that provide additional information about the basic figures included in the financial statements; virtually all financial statements need footnotes to provide additional information for the account balances in the financial statements.

- **Supplementary financial schedules and tables** that provide more details than can be included in the body of financial statements.
- A wide variety of **other information**, some of which is required if the business is a company quoted on a stock market subject to government regulations regarding financial reporting to its shareholders and other information that is voluntary and not strictly required legally or according to GAAP.

Footnotes: Nettlesome but needed

Footnotes appear at the end of the primary financial statements. Within the financial statements you see references to particular footnotes. And at the bottom of each financial statement, you find the following sentence (or words to this effect): 'The footnotes are integral to the financial statements.' You should read all footnotes for a full understanding of the financial statements.

Footnotes come in two types:

- One or more footnotes must be included to identify the **major accounting policies and methods** that the business uses. (Chapter 13 explains that a business must choose among alternative accounting methods for certain expenses, and for their corresponding operating assets and liabilities.) The business must reveal which accounting methods it uses for its major expenses. In particular, the business must identify its cost of goods sold expense (and stock) method and its depreciation methods.

- Other footnotes provide **additional information and details** for many assets and liabilities. Details about share option plans for key executives are the main type of footnote to the capital stock account in the owners' equity section of the balance sheet.

One problem that most investors face when reading footnotes – and, for that matter, many managers who should understand their own footnotes but find them a little dense – is that footnotes often deal with complex issues (such as lawsuits) and rather technical accounting matters. Let us offer you one footnote that brings out this latter point. This footnote is taken from the recent financial report of a well-known manufacturer that uses a very conservative accounting method for determining its cost of goods sold expense and stock cost value. We know that we have not yet talked about these accounting methods; this is deliberate on our part. (Chapter 13 explains accounting methods.) We want you to read the following footnote from the 2011 Annual Report of this manufacturer and try to make sense of it (amounts are in thousands).

> ***D. Inventories****: Inventories are valued principally by the LIFO (last-in, first-out) method. If the FIFO (first-in, first-out) method had been in use, inventories would have been £2,000 million and £1,978 million higher than reported at December 31, 2010 and 2011, respectively.*

Yes, these amounts are in *millions* of pounds. The company's stock cost value at the end of 2010 would have been £2 billion higher if the FIFO method had been used. Of course, you have to have some idea of the difference between the two methods, which we explain in Chapter 13.

You may wonder how different the company's annual profits would have been if the alternative method had been in use. A manager can ask the accounting department to do this analysis. But, as an outside investor, you would have to compute these amounts. Businesses disclose which accounting methods they use but they do not have to disclose how different annual profits would have been if the alternative method had been used – and very few do.

Other disclosures in financial reports

The following discussion includes a fairly comprehensive list of the various types of disclosures found in annual financial reports of larger, publicly owned businesses – in addition to footnotes. A few caveats are in order. First, not every public company includes every one of the following items although the disclosures are fairly common. Second, the level of disclosure by private businesses – after you get beyond the financial statements and footnotes – is much less than in public companies. Third, tracking the actual disclosure practices of private businesses is difficult because their annual financial reports are circulated only to their owners and lenders. A private business may include any or all of the following disclosures but, by and large, it is not legally required to do so. The next section further explains the differences between private and public businesses regarding disclosure practices in their annual financial reports.

Warren Buffett's annual letter to shareholders

We have to call your attention to one notable exception to the generally self-serving and slanted writing found in the letter to shareholders by the chief executive officer of the business in annual financial reports. The annual letter to stockholders of Berkshire Hathaway, Inc. is written by Warren Buffett, the Chairman and CEO. Mr Buffett has become very well known – he's called the 'Oracle of Omaha'. In the annual ranking of the world's richest people by *Forbes* magazine he is near the top of the list – right behind people like Bill Gates, the co-founder of Microsoft. If you had invested £1,000 with him in 1960, your investment would be worth well over £1,000,000 today. Even in the recent financial meltdown Berkshire Hathaway stock delivered a return of nearly 80% over the period 2000–2011 compared to a negative 12% return for the S&P 500. Mr Buffett's letters are the epitome of telling it like it is; they are very frank and quite humorous.

You can go to the website of the company (www.berkshirehathaway.com) and download his most recent letter. You'll learn a lot about his investing philosophy and the letters are a delight to read.

Public corporations typically include most of the following disclosures in their annual financial reports to their shareholders:

- **Cover (or transmittal) letter):** A letter from the chief executive of the business to the shareholders.
- **Highlights table:** A short table that presents the shareholder with a financial thumbnail sketch of the business.
- **Management discussion and analysis (MD&A):** Deals with the major developments and changes during the year that affected the financial performance and situation of the business.
- **Segment information:** The sales revenue and operating profits are reported for the major divisions of the organisation or for its different markets (international versus domestic, for example).
- **Historical summaries:** Financial history that extends back beyond the years (usually three but can be up to five or six) included in the primary financial statements.
- **Graphics:** Bar charts, trend charts and pie charts representing financial conditions; photos of key people and products.
- **Promotional material:** information about the company, its products, its employees and its managers, often stressing an over-arching theme for the year.
- **Profiles:** Information about members of top management and the board of directors.
- **Quarterly summaries of profit performance and share prices and dividends:** Shows financial performance for all

four quarters in the year and share price ranges for each quarter.

- **Management's responsibility statement:** A short statement that management has primary responsibility for the accounting methods used to prepare the financial statements and for providing the other disclosures in the financial report.

- **Independent auditor's report:** The report from the accounting firm that performed the audit, expressing an opinion on the fairness of the financial statements and accompanying disclosures. (Chapter 15 discusses the nature of audits.) Public companies are required to have audits; private businesses may or may not have their annual financial reports audited depending on their size.

- **Company contact information:** Information on how to contact the company, the website address of the company, how to get copies of the reports filed with the London Stock Exchange, SEC, the stock transfer agent and registrar of the company, and other information.

Managers of public corporations rely on lawyers, auditors and their financial and accounting officers to make sure that everything that should be disclosed in the business's annual financial reports is included and that the exact wording of the disclosures is not misleading, inaccurate or incomplete. This is a tall order. The field of financial reporting disclosure changes constantly. Laws, as well as authoritative accounting standards, have to be observed. Inadequate disclosure in an annual financial report is just as serious as using wrong accounting methods for measuring profit and for determining values for assets, liabilities and owners' equity. A financial report can be misleading because of improper accounting methods or because of inadequate or misleading disclosure. Both types of deficiencies can lead to nasty lawsuits against the business and its managers.

Companies House provides forms showing how the Companies Act requires balance sheets and profit and loss accounts to be laid out. To access their guidance, go to www.companieshouse.gov.uk/forms/introduction.shtml. All their statutory forms are available on request and free of charge.

Keeping It Private versus Going Public

Compared with their big brothers and sisters, privately owned businesses provide very little additional disclosures in their annual financial reports. The primary financial statements and footnotes are pretty much all you get.

The annual financial reports of publicly owned corporations include all, or nearly all, of the disclosure items listed earlier. Somewhere in the range of 3,000 companies are publicly owned, and their shares are traded on the London Stock Exchange, NASDAQ or other stock exchanges. Publicly owned companies must file annual financial reports with the Stock Exchange, which is the agency that makes and enforces the rules for trading in securities and for the financial reporting requirements of publicly owned corporations. These filings are available to the public on the London Stock Exchange's website (www.londonstockexchange.com) or for US companies on the Securities Exchange Commission's (SEC's) EDGAR database at the SEC's website – www.sec.gov/edgar/searchedgar/cik.htm.

Both privately held and publicly owned businesses are bound by the same accounting rules for measuring profit, assets, liabilities and owners' equity in annual financial reports to the owners of the business and in reports that are made available to others (such as the lenders to the business). There aren't two different sets of accounting rules – one for private companies and another one for public businesses. The accounting measurement and valuation rules are the same for all businesses. However, *disclosure* requirements and practices differ greatly between private and public companies.

REMEMBER

Publicly owned businesses live in a fish bowl. When a company goes public with an *IPO* (initial public offering of shares), it gives up a lot of the privacy that a closely held business enjoys. Publicly owned companies whose shares are traded on national stock exchanges live in glass houses. In contrast, privately owned businesses lock their doors regarding disclosure. Whenever a privately owned business releases a financial report to its bank in seeking a loan, or to the outside non-management investors in the business, it should include its three primary financial statements and footnotes. But beyond this, they have much more leeway and do not have to include the additional disclosure items listed in the preceding section.

A private business may have its financial statements audited by a professional accounting firm. If so, the audit report is included in the business's annual financial report. The very purpose of having an audit is to reassure shareholders and potential investors in the business that the financial statements can be trusted. But as we look up and down the preceding list of disclosure items we don't see any other absolutely required disclosure item for a privately held business. The large majority of closely held businesses guard their financial information like Fort Knox.

The less information divulged in the annual financial report, the better – that's their thinking. And we don't entirely disagree. The better – that's their thinking. And we don't entirely disagree. The shareholders don't have the liquidity for their shares that shareholders of publicly held corporations enjoy. The market prices of public companies are everything, so information is made publicly available so that market prices are fairly determined. The shares of privately owned businesses are rarely traded, so there is not such an urgent need for a complete package of information.

A private company could provide all the disclosures given in the preceding list – there's certainly no law against this. But usually they don't. Investors in private businesses can request confidential reports from managers at the annual shareholders' meetings, but doing so is not practical for a shareholder in a large public corporation.

Nudging the Numbers

This section discusses two accounting tricks that business managers and investors should know about. We don't endorse either technique, but you should be aware of both of them. In some situations, the financial statement numbers don't come out exactly the way the business wants. Accountants use certain tricks of the trade – some would say sleight-of-hand – to move the numbers closer to what the business prefers. One trick improves the appearance of the *short-term solvency* of the business, in particular the cash balance reported in the balance sheet at the end of the year. The other device shifts profit from one year to the next to make for a smoother trend of net income from year to year.

Not all businesses use these techniques, but the extent of their use is hard to pin down because no business would openly admit to using these manipulation methods. The evidence is fairly convincing, however, that many businesses use these techniques. We're sure you've heard the term *loopholes* applied to income tax accounting. Well, some loopholes exist in financial statement accounting as well.

Fluffing up the cash balance by 'window dressing'

Suppose you manage a business and your accountant has just submitted to you a preliminary, or first draft, of the year-end balance sheet for your review. (Chapter 6 explains the balance sheet, and Figure 6-1 shows a complete balance sheet for a business.) Your preliminary balance sheet includes the following:

Preliminary Balances, Before Window Dressing

Cash	£0	Creditors	£235,000
Debtors	£486,000	Accrued expenses payable	£187,000
Stock	£844,000	Income tax payable	£58,000
Overdraft	£200,000		
Prepaid expenses	£72,000		
Current assets	£1,402,000	Current liabilities	£680,000

You start reading the numbers when something strikes you: a zero cash balance? How can that be? Maybe your business has been having some cash flow problems and you've intended to increase your short-term borrowing and speed up collection of debtors to help the cash balance. But that plan doesn't help you right now, with this particular financial report that you must send out to your business's investors and your banker. Folks generally don't like to see a zero cash balance – it makes them kind of nervous, to put it mildly, no matter how you try to cushion it. So what do you do to avoid alarming them?

Your accountant is probably aware of a technique known as *window dressing*, a very simple method for making the cash balance look better. Suppose your financial year-end is October 31. Your accountant takes the cash receipts from customers paying their bills that are actually received on November 1, 2 and 3, and records them as if these cash collections had been received on October 31. After all, the argument can be made that the customers' cheques were in the mail – that money is yours, as far as the customers are concerned, so your reports should reflect that cash inflow.

What impact does window dressing have? It reduces the amount in debtors and increases the amount in cash by the same amount – it has absolutely no effect on the profit figure. It just makes your cash balance look a touch better. Window dressing can also be used to improve other accounts' balances, which we don't go into here. All of these techniques involve holding the books open to record certain events that take place after the end of the financial year (the ending balance sheet date) to make things look better than they actually were at the close of business on the last day of the year.

Sounds like everybody wins, doesn't it? Your investors don't panic and your job is safe. We have to warn you, though, that window dressing may be the first step on a slippery slope. A little window dressing today and tomorrow, who knows? – Maybe giving the numbers a nudge will lead to serious financial fraud. Any way you look at it, window dressing is deceptive to your investors who have every right to expect that the end of your fiscal year as stated on your financial reports is truly the end of your fiscal year. Think about it this way: If you've invested in a business that has fudged this data, how do you know what other numbers on the report are suspect?

Smoothing the rough edges off profit

Managers strive to make their numbers and to hit the milestone markers set for the business. Reporting a loss for the year, or even a dip below the profit trend line, is a red flag that investors view with alarm.

Managers can do certain things to deflate or inflate profit (the net income) recorded in the year, which are referred to as *profit-smoothing* techniques. Profit smoothing is also called *income smoothing*. Profit smoothing is not nearly as serious as *cooking the books*, or *juggling the books*, which refers to deliberate, fraudulent accounting practices such as recording sales revenue that has not happened or not recording expenses that have happened. Cooking the books is very serious; managers can go to jail for fraudulent financial statements. Profit smoothing is more like a white lie that is told for the good of the business, and perhaps for the good of managers as well. Managers know that there is always some noise in the accounting system. Profit smoothing muffles the noise.

Managers of publicly owned companies whose shares are actively traded are under intense pressure to keep profits steadily rising. Security analysts who follow a particular company make profit forecasts for the business, and their buy-hold-sell recommendations are based largely on these earnings forecasts. If a business fails to meet its own profit forecast or falls short of analysts' forecasts, the market price of its shares suffers. Share option and bonus incentive compensation plans are also strong motivations for achieving the profit goals set for the business.

The evidence is fairly strong that publicly owned businesses engage in some degree of profit smoothing. Frankly, it's much harder to know whether private businesses do so. Private businesses don't face the public scrutiny and expectations that public corporations do. On the other hand, key managers in a private business may have incentive bonus arrangements that depend on recorded profit. In any case, business investors and managers should know about profit smoothing and how it's done.

Most profit smoothing involves pushing revenue and expenses into other years than they would normally be recorded. For example, if the president of a business wants to report more profit for the year, he or she can instruct the chief accountant to accelerate the recording of some sales revenue that normally wouldn't be recorded until next year, or to delay the recording of some expenses until next year that normally would be recorded this year. The main reason for smoothing profit is to keep it closer to a projected trend reason for smoothing profit is to keep it closer to a projected trend line and make the line less jagged.

Chapter 13 explains that managers choose among alternative accounting methods for several important expenses. After making these key choices the managers should let the accountants do their jobs and let the chips fall where they may. If bottom-line profit for the year turns out to be a little short of the forecast or target for the period, so be it. This hands-off approach to profit accounting is the ideal way. However, managers often use a hands-on approach – they intercede (one could say interfere) and override the normal accounting for sales revenue or expenses.

Both managers who do it and investors who rely on financial statements in which profit smoothing has been done should definitely understand one thing – these techniques have robbing-Peter-to-pay-Paul effects. Accountants refer to these as *compensatory effects.* The effects on next year's statement simply offset and cancel out the effects on this year. Less expense this year is counterbalanced by more expense next year. Sales revenue recorded this year means less sales revenue recorded next year.

Two profit histories

Figure 8-2 shows, side by side, the annual profit histories of two different companies over six years. Business X shows a nice steady upward trend of profit. Business Y, in contrast, shows somewhat of a rollercoaster ride over the six years. Both businesses earned the same total profit for the six years – in this case, £1,050,449. Their total six-year profit performance is the same, down to the last pound. Which company would you be more willing to risk your money in? We suspect that you'd prefer Business X because of the steady upward slope of its profit history.

Question: Does Figure 8-2 really show two different companies – or are the two profit histories actually alternatives for the same company? The year-by- year profits for Business X could be the company's *smoothed* profit, and the annual profits for Business Y could be the *actual* profit of the same business – the profit that would have been recorded if smoothing techniques had not been applied.

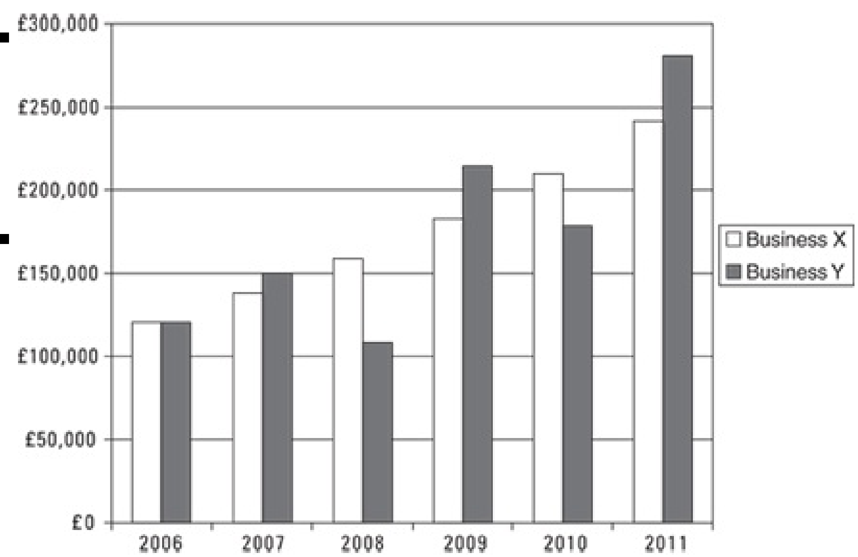
For the first year in the series, 2006, no profit smoothing occurred. Actual profit is on target. For each of the next five years, the two profit numbers differ. The under-gap or over-gap of actual profit compared with smoothed profit for the year is the amount of revenue or expenses manipulation that was done in the year. For example, in 2007, actual profit would have been too high, so the company moved some expenses that normally would be recorded the following year into 2007. In contrast, in 2008, actual profit was running too low, so the business took action to put off recording some expenses until 2011.

If a business has a particularly bad year, all the profit-smoothing tricks in the world won't close the gap. But several smoothing techniques are available for filling the potholes and straightening techniques are available for filling the potholes and straightening the curves on the profit highway.

Profit-smoothing techniques

One common technique for profit smoothing is *deferred maintenance.* Many routine and recurring maintenance costs required for vehicles, machines, equipment and buildings can be put off, or deferred until later. These costs are not recorded to expense until the actual maintenance is done, so putting off the work means that no expense is recorded. Or a company can cut back on its current year's outlays for market research and product development. Keep in mind that most of these costs will be incurred next year, so the effect is to rob Peter (make next year absorb the cost) to pay Paul (let this year escape the cost).

Figure 8-2: Comparison of two annual profit histories.



A business can ease up on its rules regarding when slow-paying customers are decided to be bad debts (uncollectable debtors). A business can put off recording some of its bad debts expense until next year. A fixed asset out of active use may have very little or no future value to a business. Instead of writing off the non-depreciated cost of the *impaired asset* as a loss this year, the business may delay the write-off until next year.

So, managers have control over the timing of many expenses, and they can use this discretion for profit smoothing. Some amount of expenses can be accelerated into this year or deferred to next year in order to make for a smoother profit trend. Of course, in its external financial report a business does not divulge the extent to which it has engaged in profit smoothing. Nor does the independent auditor comment on the use of profit-smoothing techniques by the business – unless the auditor thinks that the company has gone too far in massaging the numbers and that its financial statements are misleading.

Sticking to the accounting conventions

Over time, a generally accepted approach to the boundaries of acceptable number nudging has been arrived at. This hinges on the use of three conventions: conservatism, materiality and consistency.

Conservatism

Accountants are often viewed as merchants of gloom, always prone to taking a pessimistic point of view. The fact that a point of view has to be taken at all is the root of the problem. The convention of *conservatism* means that, given a choice, the accountant takes the figure that will result in a lower end profit. This might mean, for example, taking the higher of two possible expense figures. Few people are upset if the profit figure at the end of the day is higher than earlier estimates. The converse is never true.

Materiality

A strict interpretation of depreciation could lead to all sorts of trivial paperwork. For example, pencil sharpeners, staplers and paperclips, all theoretically items of fixed assets, should be depreciated over their working lives. This is obviously a useless exercise and in practice these items are written-off when they are bought.

Clearly, the level of *materiality* is not the same for all businesses. A multinational may not keep meticulous records of every item of machinery under £1,000. For a small business this may represent all the machinery it has.

Consistency

Even with the help of those concepts and conventions, there's a fair degree of latitude in how you can record and interpret financial information. You need to choose the methods that give the fairest picture of how the firm is performing and stick with them. Keeping track of events in a business that's always changing its accounting methods is very difficult. This doesn't mean that you're stuck with one method forever. Any change, however, is an important step.

Browsing versus Reading Financial Reports

Very few people have the time to carefully read all the information in an annual financial report – even if the report is relatively short.

Annual financial reports are long and dense documents – like lengthy legal contracts in many ways. Pick up a typical annual financial report of a public corporation: You would need many hours (perhaps the whole day) to thoroughly read everything in the report. You would need at least an hour or two just to read and absorb the main points in the report. How do investors in a business deal with the *information overload* of annual financial reports put out by businesses?

An annual financial report is like the Sunday edition of *The Times* or *The Telegraph.* Hardly anyone reads every sentence on every page of these Sunday papers – most people pick and choose what they want to read. Investors read annual financial reports like they read Sunday newspapers. The information is there if you really want to read it, but most readers pick and choose which information they have time to read.

Annual financial reports are designed for archival purposes, not for a quick read. Instead of addressing the needs of investors and others who want to know about the profit performance and financial condition of the business – but have only a very limited amount of time to do so – accountants produce an annual financial report that is a voluminous financial history of the business. Accountants leave it to the users of annual reports to extract the main points from an annual report. So, financial statement readers use relatively few ratios and other tests to get a feel for the financial performance and position of the business. (Chapters 14 and 17 explain how readers of financial reports get a fix on the financial performance and position of a business.)

Some businesses (and non-profit organisations in reporting to their members and other constituencies) don't furnish an annual financial report. They know that few people have the time or the technical background to read through their annual financial reports. Instead, they provide relatively brief summaries that are boiled-down versions of their official financial statements. Typically these summaries do not provide footnotes or the other disclosures that are included in annual financial reports. These *condensed financial statements*, without footnotes, are provided by several non-profit organisations – credit unions, for instance. If you really want to see the complete financial report of the organisation you can ask its headquarters to send you a copy.

You should keep in mind that annual financial reports do not report everything of interest to owners, creditors and others who have a financial interest in the business. *Annual* reports, of course, come out only once a year – usually two months or so after the end of the company's fiscal (accounting) year. You have to keep abreast of developments during the year by reading financial newspapers or through other means. Also, annual financial reports present the 'sanitised' version of events; they don't divulge scandals or other negative news about the business.

TIP

Finally, not everything you may like to know as an investor is included in the annual financial report. For example, for US companies, information about salaries and incentive compensation arrangements with the top-level managers of the business are disclosed in the *proxy statement*, not in the annual financial report of the business. A proxy statement is the means by which the corporation solicits the votes of shareholders on issues that require their approval – one of which is compensation packages of top-level managers. In the US, proxy statements are filed with the SEC and are available on its EDGAR database, www.sec.gov/edgar/searchedgar/cik.htm. In the UK this information would usually appear in the body of the main report under the heading 'Report of the Directors on Remuneration'.

The quality of financial reports varies from company to company. The Investor Relations Society (go to www.irs.org.uk and click on 'IR Best Practice') makes an award each year to the company producing the best (in other words, 'complete' and 'clear') set of reports and accounts.

Part IV

Financial Reports in the Outside World

'Oh no! Not another bad company financial report.'

In this part . . .

This part looks at accounting and financial reporting from the outside investor's, or non-manager's point of view. Outside investors in a business – the owners who are not on the inside managing the business – depend on the financial reports from the business as their main source of information about the business. Investors should know how to read and interpret the financial statements and what to look for in the footnotes to the statements. Their main concerns are the business's profit and cash flow performance and its financial health. Lenders to the business have similar interests in how the business is doing. Key ratios are calculated to test the success of the business in making profit and keeping its financial affairs in order. You can use the same ratios on the accounts of your competitors, customers, suppliers or potential acquisition targets to see how they're performing.

Investors should also read the independent auditor's report, which provides some, though far from conclusive, assurance that the financial statements have been prepared properly. The auditor's report may reveal serious shortcomings in the statements (if they find any), and warns investors in the event that the business is standing on thin financial ice and may not be able to continue as a going concern. Investors should also look and see from a financial perspective how comparable businesses are performing.

Chapter 14

How Investors Read a Financial Report

In This Chapter

- Looking after your investments
- Keeping financial reports private versus making them public
- Using ratios to understand profit performance
- Using ratios to interpret financial condition and cash flow
- Scanning footnotes and identifying the important ones
- Paying attention to what the auditor has to say

In reading financial reports, directors, managers, business owners and investors need to know how to navigate through the financial statements to find the vital signs of progress and problems. The financial statement ratios explained in this chapter point the way – these ratios are signposts on the financial information highway. You can also keep abreast of business affairs by reading financial newspapers and investment magazines, and investment newsletters are very popular. These sources of financial information refer to the ratios discussed in this chapter on the premise that you know what the ratios mean. Most managers or individual investors in public companies don't have the time or expertise to study a financial report thoroughly enough to make decisions based on the report, so they rely on stockbrokers, investment advisers and publishers of credit ratings (like Standard & Poor's) for interpretations of financial reports. The fact is that the folks who prepare financial reports have this kind of expert audience in mind; they don't include explanations or mark passages with icons to help *you* understand the report.

Sure you may have your own accountant or investment adviser on tap so why should you bother reading this chapter if you rely on others to interpret financial reports anyway? Well, the more you understand the factors that go into interpreting a financial report, the better prepared you are to evaluate the commentary and advice of stock analysts and other investment experts. If you can at least nod intelligently while your stockbroker talks about a business's P/E and EPS, you'll look like a savvy investor – and may get more favourable treatment. (P/E and EPS, by the way, are two of the key ratios explained later in the chapter.)

This chapter gives you the basics for comparing companies' financial reports, including the points of difference between private and public companies, the important ratios that you should know about and the warning signs to look out for on audit reports. Part II of this book explains the three primary financial statements that are the core of every financial report: the profit and loss account, the balance sheet and the cash flow statement. In this chapter, we also suggest how to sort through the footnotes that are an integral part of every financial report to identify those that have the most importance to you. Believe us, the pros read the footnotes with a keen eye.

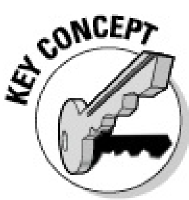
Financial Reporting by Private versus Public Businesses

The main impetus behind the continued development of generally accepted accounting principles (GAAP) has been the widespread public ownership and trading in the securities (stocks and bonds) issued by thousands of companies. The 1929 stock market crash and its aftermath plainly exposed the lack of accounting standards, as well as many financial reporting abuses and frauds. Landmark federal securities laws were passed in the US in 1933 and 1934, and a federal regulatory agency with broad powers – the Securities and Exchange Commission (SEC) – was created and given jurisdiction over trading in corporate securities. In the UK, the Government has enacted a series of Companies Acts, culminating in one consolidated act in 2006, that have strengthened the protection for shareholders. Financial reports and other information must be filed with The London Stock Exchange or the relevant authorities elsewhere, such as the SEC in the US, and made available to the investing public.

Accounting standards are not limited to public companies whose securities are traded on public exchanges, such as the London and New York Stock Exchanges and NASDAQ. These financial accounting and reporting standards apply with equal force and authority to private businesses whose ownership shares are not traded in any open market. When the shareholders of a private business receive its periodic financial reports, they are entitled to assume that the company's financial statements and footnotes are prepared in accordance with the accounting rules in force at the time. Even following the rules leaves a fair amount of wriggle room – look back to Chapter 13 if you need a refresher on this subject. So it always pays to check over the figures yourself to be sure of what is really going on. The bare-bones content of a private business's annual financial report includes the three primary financial statements (balance sheet, profit and loss account, and cash flow statement) plus several footnotes. We've seen many private company financial reports that don't even have a letter from the chairman – just the three financial statements plus a few footnotes and nothing more. In fact, we've seen financial reports of private businesses (mostly small companies) that don't even include a cash flow statement; only the balance sheet and profit and loss account are presented. Omitting a cash flow statement violates the rules – but the company's shareholders and its lenders may not demand to see the cash flow statement, so the company can get away with it.

Publicly owned businesses must comply with an additional layer of rules and requirements that don't apply to privately owned businesses. These rules are issued by the Stock Exchange, the agency that regulates financial reporting and trading in stocks and bonds of publicly owned businesses. The Stock Exchange has no jurisdiction over private businesses; those businesses need only worry about GAAP, which don't have many hard-and-fast rules about financial report formats. Public businesses have to file financial reports and other forms with the Stock Exchange that are made available to the public. These filings are available to the public on the London Stock Exchange's website `www.londonstockexchange.com/` or for US companies on the Securities Exchange Commission's (SEC's) EDGAR database at the SEC's website – `www.sec.gov/edgar/quickedgar.htm`.

The best known of these forms is the annual 10-K, which includes the business's annual financial statements in prescribed formats with all the supporting schedules and detailed disclosures that the SEC requires.



Here are some (but not all) of the main financial reporting requirements that publicly owned businesses must adhere to. (Private businesses may include these items as well if they want, but they generally don't.)

- **Management discussion and analysis (MD&A) section:** Presents the top managers' interpretation and analysis of a business's profit performance and other important financial developments over the year.
- **Earnings per share (EPS):** The only ratio that a public business is *required* to report, although most public businesses do report a few other ratios as well. See 'Earnings per share, basic and diluted' later in this chapter. Note that private businesses' reports generally don't include any ratios (but you can, of course, compute the ratios yourself).
- **Three-year comparative profit and loss account:** See Chapter 5 for more information about profit and loss accounts.

Note: A publicly-owned business can make the required filings with the Stock Exchange or SEC and then prepare a different annual financial report for its shareholders, thus preparing two sets of financial reports. This is common practice. However, the financial information in the two documents can't differ in any material way. A typical annual financial report to shareholders is a glossy booklet with excellent art and graphic design including high-quality photographs. The company's products are promoted and its people are featured in glowing terms that describe teamwork, creativity and innovation – we're sure you get the picture. In contrast, the reports to the London Stock Exchange or SEC look like legal briefs – nothing fancy in these filings. The core of financial statements and footnotes (plus certain other information) is the same in both the Stock Exchange filings and the annual reports to shareholders. The Stock Exchange filings contain more information about certain expenses and require much more disclosure about the history of the business, its main markets and competitors, its principal officers, any major changes on the horizon and so on. Professional investors and investment managers read the Stock Exchange filings.

JARGON ALERT

Most public companies solicit their shareholders' votes in the annual election of persons to the board of directors (whom the business has nominated) and on other matters that must be put to a vote at the annual shareholders' meeting. The method of communication for doing so is called a *proxy statement* – the reason being that the shareholders give their votes to a *proxy*, or designated person, who actually casts the votes at the annual meeting. The Stock Exchange requires many disclosures in proxy statements that are not found in annual financial reports issued to shareholders or in the business's annual accounts filed at Companies House. For example, compensation paid to the top-level officers of the business must be disclosed, as well as their shareholdings. If you own shares in a public company, take the time to read through all the financial statements you receive through the post and any others you can get your hands on.

Analysing Financial Reports with Ratios

Financial reports have lots of numbers in them. (Duh!) The significance of many of these numbers is not clear unless they are compared with other numbers in the financial statements to determine the relative size of one number to another number. One very useful way of interpreting financial reports is to compute *ratios* – that is, to divide a particular number in the financial report by another. Financial report ratios are also useful because they enable you to compare a business's current performance with its past performance or with another business's performance, regardless of whether sales revenue or net income was bigger or smaller for the other years or the other business. In other words, using ratios cancels out size differences.

The following sections explain the ten financial statement ratios that you're most likely to run into. Here's a general overview of why these ratios are important:

- **Gross margin ratio and profit ratio:** You use these ratios to measure a business's profit performance with respect to its sales revenue. Sales revenue is the starting point for making profit; these ratios measure the percentage of total sales revenue that is left over as profit.
- **Earnings per share (EPS), price/earnings (P/E) ratio and dividend yield:** These three ratios revolve around the market price of shares, and anyone who invests in publicly owned businesses should be intimately familiar with them. As an investor, your main concern is the return you receive on your invested capital. Return on capital consists of two elements:
  - Periodic **cash dividends** distributed by the business.
  - Increase (or decrease) in the **market price** of the shares.

  Dividends and market prices depend on earnings – and there you have the relationship among these three ratios and why they're so important to you, the investor. Major newspapers report P/E ratios and dividend yields in their stock market activity tables; stockbrokers' investment reports focus mainly on forecasts of EPS and dividend yield.
- **Book value per share and return on equity (ROE):** Shares for private businesses have no ready market price, so investors in these businesses use the ROE ratio, which is based on the value of their ownership equity reported in the balance sheet, to measure investment performance. Without a market price for the shares of a private business, the P/E ratio cannot be determined. EPS can easily be determined for

a private business but does not have to be reported in its profit and loss account.

- **Current ratio and acid-test ratio:** These ratios indicate whether a business should have enough cash to pay its liabilities.
- **Return on assets (ROA):** This ratio is the first step in determining how well a business is using its capital and whether it's earning more than the interest rate on its debt, which causes financial leverage gain (or loss).

The profit and loss account and balance sheet of the business example that we first use in Chapter 8 are repeated here so that you have a financial statement for reference – see Figures 14-1 (profit and loss account) and 14-2 (balance sheet). Notice that a cash flow statement is not presented here – mainly because no ratios are calculated from data in the cash flow statement. (Refer to the sidebar 'The temptation to compute cash flow per share: Don't give in!') The footnotes to the company's financial statements are not presented here, but the use of footnotes is discussed in the following sections.

Figure 14-1: A sample profit and loss account.

(Amounts in thousands, except per share amounts)

Profit and Loss Account for Year

Sales Revenue	£ 52,000
Cost of Goods Sold Expense	31,200
Gross Margin	£ 20,800
Sales, Administration, and General Expenses	15,600
Depreciation Expense	1,650
Earnings Before Interest and Tax	£ 3,550
Interest Expense	750
Earnings Before Tax	£ 2,800
Corporation Tax Expense	900
Net Income	£ 1,900
Earnings Per Share	£ 2.39

Figure 14-2: A sample balance sheet.

(Amounts in thousands)

Balance Sheet at End of Year

Assets		
Cash	£ 3,500	
Debtors	5,000	
Stock	7,800	
Prepaid Expenses	900	
Current Assets		£ 17,200
Fixed Assets	£ 19,500	
Accumulated Depreciation	(6,825)	12,675
Total Assets		£ 29,875
Liabilities		
Creditors	£ 1,500	
Accrued Expenses Payable	2,400	
Tax Payable	75	
Overdraft	4,000	
Current Liabilities		£ 7,975
Long-term Loans		6,000
Owners' Equity		
Share Capital (795,000 shares)	£ 4,000	
Retained Earnings	11,900	15,900
Total Liabilities and Owners' Equity		£ 29,875

Gross margin ratio

Making bottom-line profit begins with making sales and earning enough gross margin from those sales, as explained in Chapters 5 and 9. In other words, a business must set its sales prices high enough over product costs to yield satisfactory gross margins on its products, because the business has to worry about many more expenses of making sales and running the business, plus interest expense and income tax expense. You calculate the *gross margin ratio* as follows:

Gross margin ÷ sales revenue = gross margin ratio

So a business with a £20.8 million gross margin and £52 million in sales revenue (refer to Figure 14-1) ends up with a 40 per cent gross margin ratio. Now, if the business had only been able to earn a 41 per cent gross margin, that one additional point (one point is 1 per cent) would have caused a jump in its gross margin of £520,000 (1 per cent × £52 million sales revenue) – which would have trickled down to earnings before income tax. Earnings before income tax would have been 19 per cent higher (a £520,000 bump in gross margin ÷ £2.8 million income before income tax). Never underestimate the impact of even a small improvement in the gross margin ratio!

Outside investors know only the information disclosed in the external financial report that the business releases. They can't do much more than compare the gross margin for the two- or three-yearly profit and loss accounts included in the annual financial report. Although publicly owned businesses are required to include a management discussion and analysis (MD&A) section that should comment on any significant change in the gross margin ratio, corporate managers have wide latitude in deciding what exactly to discuss and how much detail to go into. You definitely should read the MD&A section, but it may not provide all the answers you're looking for. You have to search further in stockbroker releases, in articles in the financial press, or at the next professional business meeting you attend.

As explained in Chapter 9, managers focus on *contribution margin per unit* and *total contribution margin* to control and improve profit performance business. Contribution margin equals sales revenue minus product cost and other variable operating expenses of the business. Contribution margin is profit before the company's total fixed costs for the period are deducted. Changes in the contribution margins per unit of the products sold by a business and changes in its total fixed costs are extremely important information in managing profit.

However, businesses do not disclose contribution margin information in their *external* financial reports – they wouldn't even think of doing so. This information is considered to be proprietary in nature; it should be kept confidential and out of the hands of its competitors. In short, investors do not have access to information about the business's contribution margin. Neither accounting standards nor the Stock Exchange requires that such information be disclosed. The external profit and loss account discloses gross margin and operating profit, or earnings before interest and income tax expenses. However, the expenses between these two profit lines in the profit and loss account are not separated between variable and fixed (refer to Figure 14-1).

Profit ratio

Business is motivated by profit, so the *profit ratio* is very important to say the least. The profit ratio indicates how much net income was earned on each £100 of sales revenue:

Net income ÷ sales revenue = profit ratio

For example, the business in Figure 14-1 earned £1.9 million net income from its £52 million sales revenue, so its profit ratio is 3.65 per cent, meaning that the business earned £3.65 net income for each £100 of sales revenue.

A seemingly small change in the profit ratio can have a big impact on the bottom line. Suppose that this business had earned a profit ratio of 5 per cent instead of 3.65 per cent. That increase in the profit ratio translates into a £700,000 increase in bottom-line profit (net income) on the same sales revenue.

Profit ratios vary widely from industry to industry. A 5–10 per cent profit ratio is common in most industries, although some high-volume retailers, such as supermarkets, are satisfied with profit ratios around 1 per cent or 2 per cent.

You can turn any ratio upside down and come up with a new way of looking at the same information. If you flip the profit ratio over to be sales revenue divided by net income, the result is the amount of sales revenue needed to make £1 profit. Using the same example, £52 million sales revenue ÷ £1.9 million net income = 27.37 to 1 upside-down profit ratio, which means that this business needs £27.37 in sales to make £1 profit. So you can say that net income is 3.65 per cent of sales revenue, or you can say that sales revenue is 27.37 times net income – but the standard profit ratio is expressed as net income divided by sales revenue.

Earnings per share, basic and diluted

Earnings per share, basic and diluted

Publicly owned businesses, according to generally accepted accounting principles (GAAP), must report *earnings per share (EPS)* below the net income line in their profit and loss accounts – giving EPS a certain distinction among the ratios. Why is EPS considered so important? Because it gives investors a means of determining the amount the business earned on their share investments: EPS tells you how much net income the business earned for each share you own. The essential equation for EPS is as follows:

Net income ÷ total number of capital stock shares = EPS

For the example in Figures 14-1 and 14-2, the company's £1.9 million net income is divided by the 795,000 shares of stock the business has issued to compute its £2.39 EPS.

Note: Private businesses do not have to report EPS if they don't want to. Considering the wide range of issues covered by GAAP, you find surprisingly few distinctions between private and public businesses – these authoritative accounting rules apply to all businesses. But EPS is one area where GAAP makes an exception for privately owned businesses. EPS is extraordinarily important to the shareholders of businesses whose shares are publicly traded. These shareholders focus on market price *per share*. They want the total net income of the business to be communicated to them on a per share basis so that they can easily compare it with the market price of their shares. The shares of privately owned companies are not actively traded, so there is no readily available market value for their shares. The thinking behind the rule that privately owned businesses should not have to report EPS is that their shareholders do not focus on per share values and are more interested in the business's total net income performance.

The business in the example is too small to be publicly owned. So we turn here to a larger public company example. This publicly owned company reports that it earned $1.32 billion net income for the year just ended. At the end of the year, this company has 400 million shares *outstanding*, which refers to the number of shares that have been issued and are owned by its shareholders. Thus, its EPS is $3.30 ($1.32 billion net income ÷ 400 million stock shares). But here's a complication: The business is committed to issuing additional capital shares in the future for share options that the company has granted to its managers, and it has borrowed money on the basis of debt instruments that give the lenders the right to convert the debt into its capital stock. Under terms of its management share options and its convertible debt, the business could have to issue 40 million additional capital shares in the future. Dividing net income by the number of shares outstanding plus the number of shares that could be issued in the future gives the following computation of EPS:

$1.32 billion net income ÷ 440 million capital stock shares = $3.00 EPS

This second computation, based on the higher number of shares, is called the *diluted* earnings per share. (*Diluted* means thinned out or spread over a larger number of shares.) The first computation, based on the number of shares actually outstanding, is called *basic* earnings per share. Publicly owned businesses have to report two EPS figures – unless they have a *simple capital structure* that does not require the business to issue additional shares in the future. Generally, publicly owned companies have *complex capital structures* and have to report two EPS figures. Both are reported at the bottom of the profit and loss account. So the company in this example reports £3.30 basic EPS and £3.00 diluted EPS. Sometimes it's not clear which of the two EPS figures is being used in press releases and in articles giving investment advice. Fortunately, *The Financial Times* and most other major financial publications leave a clear trail of both EPS figures.

Calculating basic and diluted EPS isn't always as simple as our examples may suggest. An accountant would have to adjust the EPS equation for the following complicating things that a business may do:

- Issue additional shares during the year and buy back some of its shares (shares of its stock owned by the business itself that are not formally cancelled are called *treasury stock*).
- Issue more than one class of share, causing net income to be divided into two or more pools – one pool for each class of share.
- Go through a merger (business combination) in which a large number of shares are issued to acquire the other business.

The shareholders should draw comfort from the fact that the top management of many businesses in which they invest are probably just as anxiously reviewing EPS performance as they are. This extract from Tesco's annual accounts reveals much:

Annual bonuses based on achieving stretching EPS growth targets and specific corporate objectives.

- Annual bonuses are paid in shares. On award, the Executive can elect to defer receipt of the shares for a further two years, which is encouraged, with additional matching share awards.

- Longer-term bonus based on a combination of relative total shareholder return, and the achievement of stretching EPS growth targets and specific corporate objectives. Longer-term bonuses are paid in shares, which must be held for a further four years. Executive Directors are encouraged to hold shares for longer than four years with additional matching share awards. Further details are provided below.
- Share options are granted to Executive Directors at market value and can only be exercised if EPS growth exceeds Retail Price Index (RPI) plus 9 per cent over any three years from grant.
- Executive Directors are required to build and hold a shareholding with a value at least equal to their basic salary; full participation in the Executive Incentive scheme is conditional upon meeting this target.

Price/earnings (P/E) ratio

The *price/earnings (P/E) ratio* is another ratio that's of particular interest to investors in public businesses. The P/E ratio gives you an idea of how much you're paying in the current price for the shares for each pound of earnings, or net income, being earned by the business. Remember that earnings prop up the market value of shares, not the book value of the shares that's reported in the balance sheet. (Read on for the book value per share discussion.)

The P/E ratio is, in one sense, a reality check on just how high the current market price is in relation to the underlying profit that the business is earning. Extraordinarily high P/E ratios are justified only when investors think that the company's EPS has a lot of upside potential in the future.

The P/E ratio is calculated as follows:

> Current market price of stock ÷ most recent trailing 12 months diluted EPS = P/E ratio

If the business has a simple capital structure and does not report a diluted EPS, its basic EPS is used for calculating its P/E ratio. (See the earlier section 'Earnings per share, basic and diluted'.)

Assume that the stock shares of a public business with a £3.65 diluted EPS are selling at £54.75 in the stock market. ***Note:*** From here forward, we will use the briefer term EPS in reference to P/E ratios; we assume you understand that it refers to diluted EPS for businesses with complex capital structures and to basic EPS for businesses with simple capital structures.

The actual share price bounces around day to day and is subject to change on short notice. To illustrate the P/E ratio, we use this price, which is the closing price on the latest trading day in the stock market. This market price means that investors trading in the stock think that the shares are worth 15 times diluted EPS (£54.75 market price ÷ £3.65 diluted EPS = 15). This value may be below the broad market average that values shares at, say, 20 times EPS. The outlook for future growth in its EPS is probably not too good.

Dividend yield

The *dividend yield* tells investors how much *cash flow income* they're receiving on their investment. (The dividend is the cash flow income part of investment return; the other part is the gain or loss in the market value of the investment over the year.)

Market cap – not a cap on market value

One investment number you see a lot in the financial press is the *market cap.* No, this does not refer to a cap, or limit, on the market value of a company's capital shares. The term is shorthand for *market capitalisation,* which refers to the total market value of the business that is determined by multiplying the stock's current market price by the total number of shares issued by the company. Suppose a company's stock is selling at £50 per share in the stock market and it has 200 million shares outstanding. Its market cap is £10 billion. Another business may be willing to pay higher than £50 per share for the company. Indeed, many acquisitions and mergers involve the acquiring company paying a hefty premium over the going market price of the shares of the company being acquired.

Suppose that a stock of a public company that is selling for £60 paid £1.20 cash dividends per share over the last year. You calculate dividend yield as follows:

> £1.20 annual cash dividend per share ÷ £60 current market price of stock = 2% dividend yield

You use dividend yield to compare how your stock investment is doing to how it would be doing if you'd put that money in corporate or Treasury bonds, gilt edged stock (UK government borrowings) or other debt securities that pay interest. The average interest rate of high-grade debt securities has recently been three to four times the dividend yields on most public companies; in theory, market price appreciation of the shares over time makes up for that gap. Of course, shareholders take the risk that the market value will not increase enough to make their total return on investment rate higher than a benchmark interest rate. (At the time of writing, this yield gap has shrunk to nothing and is causing an agonizing reappraisal of the value of equities, in relation to debt, as an investment medium.)

Assume that long-term government gilt edged stock are currently paying 6 per cent annual interest, which is 4 per cent higher than the business's 2 per cent dividend yield in the example just discussed. If this business's shares don't increase in value by at least 4 per cent over the year, its investors would have been better off investing in the debt securities instead. (Of course, they wouldn't have had all the perks of a share investment, like those heartfelt letters from the chairman and those glossy financial reports.) The market price of publicly traded debt securities can fall or rise, so things get a little tricky in this sort of investment analysis.

Book value per share

Book value per share is one measure, but it's certainly not the only amount, used for determining the value of a privately owned business's shares. As discussed in Chapter 6, book value is not the same thing as market value. The asset values that a business records in its books (also known as its *accounts*) are *not* the amounts that a business could get if it put its assets up for sale. Book values of some assets are generally lower than what the cost would be for replacing the assets if a disaster (such as a flood or a fire) wiped out the business's stock or equipment. Recording current market values in the books is really not a practical option. Until a seller and a buyer meet and haggle over price, trying to determine the market price for a privately owned business's shares is awfully hard.

You can calculate book value per share for publicly owned businesses too. However, market value is readily available, so shareholders (and investment advisers and managers) do not put much weight on book value per share. EPS is the main factor that affects the market prices of stock shares of public companies – not the book value per share. We should add that some investing strategies, known as *value investing*, search out companies that have a high book value per share compared to their going market prices. But by and large, book value per share plays a secondary role in the market values of stock shares issued by public companies.

Although book value per share is generally not a good indicator of the market value of a private business's shares, you do run into this ratio, at least as a starting point for haggling over a selling price. Here's how to calculate book value per share:

> Total owners' equity ÷ total number of stock shares = book value per share

REAL WORLD EXAMPLE

The business shown in Figure 14-2 has issued 795,000 shares: Its £15.9 million total owners' equity divided by its 795,000 shares gives a book value per share of £20. If the business sold off its assets exactly for their book values and paid all its liabilities, it would end up with £15.9 million left for the shareholders, and it could therefore distribute £20 per share. But the company will not go out of business and liquidate its assets and pay off its liabilities. So book value per share is a theoretical value. It's not totally irrelevant, but it's not all that definitive, either.

Return on equity (ROE) ratio

The *return on equity (ROE) ratio* tells you how much profit a business earned in comparison to the book value of shareholders' equity. This ratio is useful for privately owned businesses, which have no way of determining the current value of owners' equity (at least not until the business is actually sold). ROE is also calculated for public companies, but, just like book value per share, it plays a secondary role and is not the dominant factor driving market prices. (Earnings are.) Here's how you calculate this key ratio:

Net income ÷ owners' equity = ROE

REMEMBER

The owners' equity figure is at book value, which is reported in the company's balance sheet. Chapter 6 explains owners' equity and the difference between share capital and retained earnings, which are the two components of owners' equity.

The business whose profit and loss account and balance sheet are shown in Figures 14-1 and 14-2 earned £1.9 million net income for the year just ended and has £15.9 million owners' equity. Therefore, its ROE is 11.95 per cent (£1.9 million net income ÷ £15.9 million owners' equity = 11.95 per cent). ROE is net income expressed as a percentage of the amount of total owners' equity of the business, which is one of the two sources of capital to the business, the other being borrowed money, or interest-bearing debt. (A business also has non-interest-bearing operating liabilities, such as creditors.) The cost of debt capital (interest) is deducted as an expense to determine net income. So net income 'belongs' to the owners; it increases their equity in the business, so it makes sense to express net income as the percentage of improvement in the owners' equity.

Gearing or leverage

Your company's liquidity keeps you solvent from day to day and month to month and we come to that next when we look at the current ratio and acid test. But what about your ability to pay back long-term debt year after year? Two financial ratios indicate what kind of shape you're in over the long term.

If you've read this chapter from the beginning, you may be getting really bored with financial ratios by now, but your lenders – bankers and bondholders, if you have them – find these long-term ratios to be incredibly fascinating, for obvious reasons.

The first ratio gauges how easy it is for your company to continue making interest payments on the debt:

Times interest earned = earnings before interest and taxes ÷ interest expense

Don't get confused – earnings before any interest expense and taxes are paid (EBIT) is really just the profit that you have available to make those interest payments in the first place. Figure 14-1, for example, shows an EBIT of $3,550 (thousand) and an interest expense of $750 (thousand) this year for a times-interest-earned ratio of 4.73. In other words, this business can meet its interest expense 4.73 times over.

You may also hear the same number called an *interest coverage*. Lenders get mighty nervous if this ratio ever gets anywhere close to 1.0, because at that point, every last penny of profits goes for interest payments on the long-term debt.

The second ratio tries to determine whether the principal amount of your debt is in any danger:

Debt-to-equity ratio = long-term liabilities ÷ owners' equity

The debt-to-equity ratio says a great deal about the general financial structure of your company. After all, you can raise money to support your company in only two ways: borrow it and promise to pay it back with interest, or sell pieces of the company and promise to share all the rewards of ownership. The first method is debt; the second, equity.

Figure 14-2, for example, shows a debt-to-equity ratio of $6,000 ÷ $15,900, or .38. This ratio means that the company has around three times more equity financing than it does long-term debt.

Lenders love to see lots of equity supporting a company's debt because then they know that the money they loan out is safer. If something goes wrong with the company, they can go after the something goes wrong with the company, they can go after the owners' money. Equity investors, on the other hand, actually want to take on some risk. They like to see relatively high debt-to-equity ratios because that situation increases their leverage and (as the following section points out) can substantially boost their profits. So the debt-to-equity ratio that's just right for your company depends not only on your industry and how stable it is, but also on who you ask.

Current ratio

The *current ratio* is a test of a business's *short-term solvency* – its capability to pay off its liabilities that come due in the near future (up to one year). The ratio is a rough indicator of whether cash-on-hand plus the cash flow from collecting debtors and selling stock will be enough to pay off the liabilities that will come due in the next period.

As you can imagine, lenders are particularly keen on punching in the numbers to calculate the current ratio. Here's how they do it:

Current assets ÷ current liabilities = current ratio

Note: Unlike with most of the other ratios, you don't multiply the result of this equation by 100 and represent it as a percentage.

Businesses are expected by their creditors to maintain a minimum current ratio (2.0, meaning a 2-to-1 ratio, is the general rule) and may be legally required to stay above a minimum current ratio as stipulated in their contracts with lenders. The business in Figure 14-2 has £17.2 million in current assets and £7,975,000 in current liabilities, so its current ratio is 2.16 and it shouldn't have to worry about lenders coming by in the middle of the night to break its legs. Chapter 6 discusses current assets and current liabilities and how they are reported in the balance sheet.

How much working capital, ready or nearly ready money do you need to ensure survival? Having the liquid assets available when you absolutely need them to meet short-term obligations is called *liquidity*. You don't have to have cash in the till to be liquid. Debtors (that is, people who owe you money and can be reasonably expected to cough up soon) and stock ready to be sold are both part of your liquid assets. You can use several financial ratios to test a business's liquidity, including the current ratio and the acid test. You can monitor these ratios year by year and measure them against your competitors' ratios and the industry averages.

Acid-test ratio

Most serious investors and lenders don't stop with the current ratio for an indication of the business's short-term solvency – its capability to pay the liabilities that will come due in the short term. Investors also calculate the *acid-test ratio* (also known as the *quick ratio* or the *pounce ratio*), which is a more severe test of a business's solvency than the current ratio. The acid-test ratio excludes stock and prepaid expenses, which the current ratio includes, and limits assets to cash and items that the business can quickly convert to cash. This limited category of assets is known as *quick* or *liquid* assets.

You calculate the acid-test ratio as follows:

Liquid assets ÷ total current liabilities = acid-test ratio

Note: Unlike most other financial ratios, you don't multiply the result of this equation by 100 and represent it as a percentage.

For the business example shown in Figure 14-2, the acid-test ratio is as follows:

Cash	£3,500,000
Marketable securities	none
Debtors	5,000,000
Total liquid assets	£8,500,000
Total current liabilities	£7,975,000
Acid-test ratio	1.07

A 1.07 acid-test ratio means that the business would be able to pay off its short-term liabilities and still have a little bit of liquid assets left over. The general rule is that the acid-test ratio should be at least 1.0, which means that liquid assets equal current liabilities. Of course, falling below 1.0 doesn't mean that the business is on the verge of bankruptcy, but if the ratio falls as low as 0.5, that may be cause for alarm.

This ratio is also known as the *pounce ratio* to emphasise that you're calculating for a worst-case scenario, where a pack of wolves (more politely known as *creditors*) has pounced on the business and is demanding quick payment of the business's liabilities. But don't panic. Short-term creditors do not have the right to demand immediate payment, except under unusual circumstances. This is a very conservative way to look at a business's capability to pay its short-term liabilities – too conservative in most cases.

Keeping track of stock and debtor levels

Two other areas that effect liquidity need to be monitored carefully: how fast your stock is selling out (if your business requires holding goods for sale), and how fast your customers are paying up.

Here's the ratio for stock levels:

> Stock turnover = cost of goods sold ÷ stock

Stock turnover tells you something about how liquid your stocks really are. This ratio divides the cost of goods sold, as shown in your yearly profit and loss account, by the average value of your stock. If you don't know the average, you can estimate it by using the stock figure listed in the balance sheet at the end of the year.

For the business represented in Figures 14-1 and 14-2, the stock turnover is £31,200 ÷ £7,800, or 4.0. This ratio means that this business turns over its stocks four times each year. Expressed in days, the business carries a 91.25-day (365 ÷ 4.0) supply of stock.

REMEMBER

> Is a 90-day plus inventory good or bad? It depends on the industry and even on the time of year. A car dealer who has a 90-day supply of cars at the height of the season may be in a strong stock position, but the same stock position at the end of the season could be a real weakness. As Just In Time (JIT) supply chains and improved information systems make business operations more efficient across all industries, stock turnover is on the rise, and the average number of days that stock of any kind hangs around continues to shrink.

What about debtor levels?

> Debtor turnover = sales on credit ÷ debtors

Debtor turnover tells you something about liquidity by dividing the sales that you make on credit by the average debtors. If an average isn’t available, you can use the debtors from a balance sheet.

If the business represented in Figures 14-1 and 14-2 makes 80 per cent of its sales on credit, its debtor turnover is ($52,000 × 0.8) ÷ $5,000, or 8.3. In other words, the company turns over its debtors 8.3 times per year, or once every 44 days, on average. That’s not too bad: payment terms are 30 days. But remember, unlike fine wine, debtors don’t improve with age.

Return on assets (ROA) ratio

As discussed in Chapter 6 (refer to the sidebar ‘Trading on the equity: Taking a chance on debt’), one factor affecting the bottom-line profit of a business is whether it used debt to its advantage. For the year, a business may have realised a *financial leverage gain* – it earned more profit on the money it borrowed than the interest paid for the use of that borrowed money. So a good part of its net income for the year may be due to financial leverage. The first step in determining financial leverage gain is to calculate a business’s *return on assets (ROA) ratio*, which is the ratio of EBIT (earnings before interest and tax) to the total capital invested in operating assets.

Here’s how to calculate ROA:

EBIT ÷ net operating assets = ROA

Note: This equation calls for *net operating assets*, which equals total assets less the non-interest-bearing operating liabilities of the business. Actually, many stock analysts and investors use the total assets figure because deducting all the non-interest-bearing operating liabilities from total assets to determine net operating assets is, quite frankly, a nuisance. But we strongly recommend using net operating assets because that’s the total amount of capital raised from debt and equity.

Compare ROA with the interest rate: If a business’s ROA is 14 per

Compare ROA with the interest rate: If a business's ROA is 14 per cent and the interest rate on its debt is 8 per cent, for example, the business's net gain on its debt capital is 6 per cent more than what it's paying in interest. There's a favourable spread of 6 points (one point = 1 per cent), which can be multiplied by the total debt of the business to determine how much its total earnings before income tax is traceable to financial leverage gain.

In Figure 14-2, notice that the company has £10 million total interest-bearing debt (£4 million short-term plus £6 million long-term). Its total owners' equity is £15.9 million. So its net operating assets total is £25.9 million (which excludes the three short-term non-interest-bearing operating liabilities). The company's ROA, therefore, is

£3.55 million earnings before interest and tax ÷ £25.9 million net operating assets = 13.71% ROA

The business earned £1,371,000 (rounded) on its total debt – 13.71 per cent ROA times £10 million total debt. The business paid only £750,000 interest on its debt. So the business had £621,000 financial leverage gain before income tax (£1,371,000 less £750,000). Put another way, the business paid 7.5 per cent interest on its debt but earned 13.71 per cent on this money for a favourable spread of 6.21 points – which, when multiplied by the £10 million debt, yields the £621,000 pre-tax financial gain for the year.

ROA is a useful earnings ratio, aside from determining financial leverage gain (or loss) for the period. ROA is a *capital utilisation* test – how much profit before interest and tax was earned on the total capital employed by the business. The basic idea is that it takes money (assets) to make money (profit); the final test is how much profit was made on the assets. If, for example, a business earns £1 million EBIT on £20 million assets, its ROA is only 5 per cent. Such a low ROA signals that the business is making poor use of its assets and will have to improve its ROA or face serious problems in the future.

Using combined ratios

You wouldn’t use a single ratio to decide whether one vehicle was a better or worse buy than another. MPG, MPH, annual depreciation percentage and residual value proportion are just a handful of the ratios that you’d want to review. So it is with a business. You can use a combination of ratios to form an opinion on the financial state of affairs at any one time.

TIP

The best known of these combination ratios is the Altman Z-Score (www.creditguru.com/CalcAltZ.shtml) that uses a combined set of five financial ratios derived from eight variables from a company’s financial statements linked to some statistical techniques to predict a company’s probability of failure. Entering the figures into the onscreen template at this website produces a score and an explanatory narrative giving a view on the businesses financial strengths and weaknesses.

Appreciating the limits of ratios

A danger with ratios is to believe that because you have a precise number, you have a right figure to aim for. For example, a natural feeling with financial ratios is to think that high figures are good ones, and an upward trend represents the right direction. This theory is, to some extent, encouraged by the personal feeling of wealth that having a lot of cash engenders.

Unfortunately, no general rule exists on which way is right for financial ratios. In some cases a high figure is good; in others, a low figure is best. Indeed, in some circumstances, ratios of the same value aren't as good as each other. Look at the two working capital statements in Table 14-1.

Table 14-1 Difficult Comparisons

	1		2	
Current Assets				
Stock	10,000			22,990
Debtors	13,000			100
Cash	100	23,100	10	23,100
Less Current Liabilities				
Overdraft	5,000		90	
Creditors	1,690	6,690	6,690	6,690
Working Capital		16,410		16,410
Current Ratio		3.4:1		3.4:1

The amount of working capital in examples 1 and 2 is the same, £16,410, as are the current assets and current liabilities, at £23,100 and £6,690 respectively. It follows that any ratio using these factors would also be the same. For example, the current ratios in these two examples are both identical, 3.4:1, but in the first case there's a reasonable chance that some cash will come in from debtors, certainly enough to meet the modest creditor position. In the second example there's no possibility of useful amounts of cash coming in from trading, with debtors at only £100, while creditors at the relatively substantial figure of £6,600 will pose a real threat to financial stability.

So in this case the current ratios are identical, but the situations being compared are not. In fact, as a general rule, a higher working capital ratio is regarded as a move in the wrong direction. The more money a business has tied up in working capital, the more difficult it is to make a satisfactory return on capital employed, simply because the larger the denominator, the lower the return on capital employed.

In some cases the right direction is more obvious. A high return on capital employed is usually better than a low one, but even this situation can be a danger signal, warning that higher risks are being taken. And not all high profit ratios are good: sometimes a higher profit margin can lead to reduced sales volume and so lead to a lower Return on Capital Employed (ROCE).

In general, business performance as measured by ratios is best thought of as lying within a range; liquidity (current ratio), for example, staying between 1.2:1 and 1.8:1. A change in either direction may represent a cause for concern.

The temptation to compute cash flow per share: Don't give in!

Businesses are prohibited from reporting a *cash flow per share* number on their financial reports. The accounting rule book specifically prohibits very few things, and cash flow per share is on this small list of contraband. Why? Because – and this is somewhat speculative on our part – the powers that be were worried that the cash flow number would usurp net income as the main measure for profit performance. Indeed, many writers in the financial press were talking up the importance of cash flow from profit, so we see the concern on this matter. Knowing how important EPS is for market value of stocks, the authorities declared a similar per share amount for cash flow out of bounds and prohibited it from being included in a financial report. Of course, you could compute it quite easily – the rule doesn't apply to how financial statements are interpreted, only to how they are reported.

Should we dare give you an example of cash flow per share? Here goes: A business with £42 million cash flow from profit and 4.2 million total capital stock shares would end up with £10 cash flow per share. Shhh.

The Biz/ed (www.bized.co.uk/compfact/ratios/index.htm) and Harvard Business School (http://harvardbusinessonline.hbsp.harvard.edu/b02/en/academi websites contain free tools that calculate financial ratios from company accounts. They also provide useful introductions to ratio analysis and definitions of each ratio and the formula used to calculate it. To download their spreadsheet, you first need to register with the Harvard website.

By registering (for free) with the Proshare website (go to www.proshareclubs.co.uk and click on 'Research Centre' and 'Performance Tables'), you have access to a number of tools that crunch public company ratios for you. Select the companies you want to look at, and then the ratios you're most interested in (EPS, P/E, ROI, Dividend Yield and so on). All is revealed within a couple of seconds. You can then rank the companies by performance in more or less any way you want. You can find more comprehensive tools on the Internet, on the websites of share traders for example, but Proshare is a great site to cut your teeth on – and the price is right!

Frolicking through the Footnotes

Reading the footnotes in annual financial reports is no picnic. The investment pros have to read them because in providing consultation to their clients, they are required to comply with due diligence standards or because of their legal duties and responsibilities of managing other peoples' money.

We suggest you do a quick read-through of the footnotes and identify the ones that seem to have the most significance. Generally, the most important footnotes are those dealing with the following matters:

- **Share options awarded by the business to its executives:** The additional shares issued under share options dilute (thin out) the earnings per share of the business, which in turn puts downside pressure on the market value of its shares, everything else being the same.
- **Pending legal actions, litigation and investigations by government agencies:** These intrusions into the normal affairs of the business can have enormous consequences.
- **Segment information for the business:** Most public businesses have to report information for the major segments of the organisation – sales and operating profit by territories or product lines. This gives a better glimpse of the different parts making up the whole business. (However, segment information may be reported elsewhere in an annual financial report than in the footnotes.)

These are just three of the many important pieces of information you should look for in footnotes. But you have to stay alert for other critical matters that a business may disclose in its footnotes – scan each and every footnote for potentially important information. Finding a footnote that discusses a major lawsuit against the business, for example, may make the shares too risky for your portfolio.

Checking for Ominous Skies on the Audit Report

The value of analysing a financial report depends directly and entirely on the accuracy of the report’s numbers. Top management wants to present the best possible picture of the business in its financial report (which is understandable, of course). The managers have a vested interest in the profit performance and financial condition of the business.

Independent auditors are like umpires in the financial reporting process. The auditor comes in, does an audit of the business’s accounting system and procedures, and gives a report that is attached to the company’s financial statements. You should check the audit report included with the financial report. Publicly owned businesses are required to have their annual financial reports audited by an independent accountancy firm, and many privately owned businesses have audits done, too, because they know that an audit report adds credibility to the financial report.

What if a private business’s financial report doesn’t include an audit report? Well, you have to trust that the business prepared accurate financial statements that follow generally accepted accounting principles and that the footnotes to the financial statements provide adequate disclosure.

Unfortunately, the audit report gets short shrift in financial statement analysis, maybe because it’s so full of technical terminology and accountant doublespeak. But even though audit reports are a tough read, anyone who reads and analyses financial reports should definitely read the audit report. Chapter 15 provides a lot more information on audits and the auditor’s report.

The auditor judges whether the business used accounting methods and procedures in accordance with accepted accounting principles. In most cases, the auditor's report confirms that everything is hunky-dory, and you can rely on the financial report. However, sometimes an auditor waves a yellow flag – and in extreme cases, a red flag. Here are the two most important warnings to watch out for in an audit report:

- The business's capability to continue normal operations is in doubt because of what are known as *financial exigencies*, which may mean a low cash balance, unpaid overdue liabilities or major lawsuits that the business doesn't have the cash to cover.
- One or more of the methods used in the report is not in line with the prevailing accounting body rules, leading the auditor to conclude that the numbers reported are misleading or that disclosure is inadequate.

Although auditor warnings don't necessarily mean that a business is going down the tubes, they should turn on that light bulb in your head and make you more cautious and sceptical about the financial report. The auditor is questioning the very information on which the business's value is based, and you can't take that kind of thing lightly.

In very small businesses it is likely that the accounts will not be independently audited and their accounts come with a rather alarming caveat, running something like this: *These accounts have been prepared on the basis of information provided by the owners and have not been independently verified*. A full audit is an expensive process and few businesses that don't have to will go to the expense and trouble just to be told what they probably already know anyway.

Just because a business has a clean audit report doesn't mean that the financial report is completely accurate and above board. As discussed in Chapter 15, auditors don't necessarily catch everything. Keep in mind that the accounting rules are pretty flexible, leaving a company's accountants with room for interpretation and creativity that's just short of *cooking the books* (deliberately defrauding and misleading readers of the financial report). Window dressing and profit smoothing – two common examples of massaging the numbers – are explained in Chapter 8.

Finding Financial Facts

Understanding how to calculate financial ratios and how to interpret that data is all fine and dandy, but before you can do anything useful you need to get a copy of the accounts in the first place. Seeing the accounts for your own business shouldn't be too much of a problem. If you're the boss, the accounts should be on your desk right now; if you're not the boss, try snuggling up to the accounts department. If they're too coy to let you have today's figures, the latest audited accounts are in the public domain anyway filed away at Companies House (www.companieshouse.gov.uk), as required by law.

Public company accounts

Most companies make their glossy annual financial reports available to download from their websites, which you can find by typing the company name into an Internet search engine. You need to have Adobe Acrobat Reader on your computer to open the files. No problem, though: Adobe Acrobat Reader is free and you can easily download the program from Adobe's website (http://adobe-reader.download-start.net/download). The software enables you to search for key words in the annual report – a handy feature indeed for tracking down the sections of the report that you're most interested in.

Yahoo has direct online links to several thousand public company reports and accounts and performance ratios at http://uk.finance.yahoo.com (enter the name of the company you're looking for in the box on the left of the screen under Investing. It appears after you've entered about three letters, click and follow the threads). Paying this site a visit saves you the time and trouble of hunting down company websites.

Private company accounts

Finding financial information on private companies is often a time-consuming and frustrating job. Not for nothing do these companies call themselves 'private'. Businesses, and particularly smaller businesses, can be very secretive about their finances and have plenty of tricks to hide information from prying eyes. Many smaller businesses can elect to file abbreviated accounts with Companies House that provide only the barest details. You can find out just what these shortened accounts must contain at the Business Link website (go to www.businesslink.gov.uk and click on 'Taxes, returns, & payroll', 'Introduction to business taxes' and 'Accounting and audit exceptions for small companies'). The accounts of very small companies don't need to be audited, so the objective reliability of the scant data given may be questionable. Having said that, tens of thousands of private companies file full and generally reliable accounts.

Two fruitful sources of private company accounts exist:

- **Companies House** (www.companieshouse.gov.uk) is the official repository of all company information in the UK. Their WebCHeck service offers a free Company Names and Address Index that covers 2 million companies, searchable either by company name or by company registration numbers. You can use WebCHeck to purchase (at a cost of £1 per company) a company's latest accounts that give details of sales, profits, margins, directors, shareholders and bank borrowings.
- **Keynote** (www.keynote.co.uk) offers business ratios and trends for 140 industry sectors and provides information to assess accurately the financial health of each industry sector. This service enables you to find out how profitable a business sector is and how successful the main companies operating in each sector are. Executive summaries are free, but expect to pay between £250 and £500 for most reports.

Scoring credit

If all you want is a quick handle on whether a company is likely to be around long enough to pay its bills, including a dividend to shareholders, then a whole heap of information exists about credit status for both individual sole traders and companies of varying complexity. Expect to pay anywhere from £5 for basic information up to £200 for a very comprehensive picture of a company's credit status. So you can avoid trading unknowingly with individuals or businesses that pose a credit risk.

Experian (www.ukexperian.com), Dun & Bradstreet (www.dnb.com), Creditgate.com (www.creditgate.com) and Credit Reporting (www.creditreporting.co.uk/b2b) are the major agencies compiling and selling credit histories and small-business information. Between them they offer a comprehensive range of credit reports instantly available online that include advice about credit limits.

Using FAME (Financial Analysis Made Easy)

FAME (Financial Analysis Made Easy) is a powerful database that contains information on 7 million companies in the UK and Ireland. Typically, the following information is included: contact information including phone, email and web addresses plus main and other trading addresses; activity details; 29 profit and loss account and 63 balance sheet items; cash flow and ratios; credit score and rating; security and price information (listed companies only); names of bankers, auditors, previous auditors and advisors; details of holdings and subsidiaries (including foreign holdings and subsidiaries); names of current and previous directors with home addresses and shareholder indicator; heads of department; and shareholders. You can compare each company with detailed financials with its peer group based on its activity codes and the software lets you search for companies that comply with your own criteria, combining as many conditions as you like. FAME is available in business libraries and on CD from the publishers, who also offer a free trial (www.bvdinfo.com/Products/Company-Information/National/FAME.aspx).

Looking beyond financial statements

Investors can't rely solely on the financial report when making investment decisions. Analysing a business's financial statements is just one part of the process. You may need to consider these additional factors, depending on the business you're thinking about investing in:

- Industry trends and problems.
- National economic and political developments.
- Possible mergers, friendly acquisitions and hostile takeovers.
- Turnover of key executives.
- International markets and currency exchange ratios.
- Supply shortages.
- Product surpluses.

Whew! This kind of stuff goes way beyond accounting, obviously, and is just as significant as financial statement analysis when you're picking stocks and managing investment portfolios. A good book for new investors to read is *Investing For Dummies* by Tony Levene.

Chapter 16

Ten Ways Savvy Business Managers Use Accounting

In This Chapter

- Making better profit decisions
- Leveraging – both the operating kind and the financial kind
- Putting your finger on the pulse of cash flow
- Better budgeting for planning and control
- Developing financial controls
- Taking charge of the accounting function
- Explaining your financial statements to others

So how can accounting help make you a better business manager? This is the bottom-line question. Speaking of the bottom line, that's exactly the place to start. Accounting provides the financial information and analysis tools you need for making insightful profit decisions – and stops you from plunging ahead with gut decisions that may feel right but that don't hold water after diligent analysis.

Make Better Profit Decisions

Making profit starts with earning margin on each unit sold and then selling enough units to overcome your total fixed expenses for the period (the basic concept that we explain more fully in Chapter 9). We condense the accounting model of profit into the following equation:

equation:

(Margin per unit × sales volume) – fixed expenses = profit

Note: Profit here is *before* corporation tax. Regular corporations pay tax based on the amount of their taxable income; different rates apply to different brackets of taxable income. The bottom-line net income in the profit and loss account of a business is after-tax income. A business may distribute all, part or none of its profit for the year to its owners.

Insist that your accountant determines the margin per unit for all products you sell. The margin is also called the *contribution margin* to emphasise that it contributes toward the business's fixed expenses. Here's an example for determining the *margin per unit* for a product:

Margin Factors	**Amount**
Sales price	£100.00
Less product cost	60.00
Equals gross margin	£40.00
Less sales revenue-driven expenses	8.00
Less sales volume-driven expenses	5.00
Equals margin per unit	£27.00

We'd bet that your accountant provides the gross margin (also called *gross profit*) on your products. So far, so good. But don't stop at the gross margin line. Push your accountant to determine the two variable expenses for each product. In this example, you don't make $40 per unit sold; you make only $27 from selling the product. Two products may have the same $40 gross profit, but one could provide a $27 margin and the other a $32 margin because the second one's variable expenses are lower.

TIP

Have your accountant differentiate between *revenue*-driven and *volume*-driven variable expenses for each product. Suppose you raise the sales price to $110.00, a 10 per cent increase. The sales revenue-driven expense increases by 10 per cent as well, to $8.80, because these expenses (such as sales commission) are a certain *percentage* of the sales price. Your margin increases not $10.00, but only $9.20 (the $10.00 sales price increase minus the $0.80 expense increase). In contrast, the higher sales price by itself does not increase the sales volume-driven expenses (such as shipping costs); these expenses remain at $5.00 per unit unless other factors cause them to increase.

You earn profit (or to be precise, profit before tax) by selling enough products that your total margin is higher than your total fixed expenses for the period. The excess of total margin over fixed expenses is profit before tax. Setting sales prices to generate an adequate total contribution margin is one of the most important functions of managers.

When thinking about changing sales price, focus on what happens to the *margin per unit*. Suppose, for example, that you're considering dropping the sales price 10 per cent from $100.00 to $90.00. You predict that your product cost and variable expenses will remain unchanged. Here's what would happen to your margin:

Margin Factors	After	Before
Sales price	£90.00	£100.00
Less product cost	60.00	60.00
Equals gross margin	£30.00	£40.00
Less sales revenue-driven expenses	7.20	8.00
Less sales volume-driven expenses	5.00	5.00
Equals margin per unit	£17.80	£27.00

Your margin would plunge £9.20 per unit – more than one-third!

Suppose you sold 100,000 units of this product during the year just ended. These sales generated £2.7 million total margin. If you drop the sales price, you give up £920,000 total margin. Where will the replacement come from for this £920,000 contribution margin? Higher sales volume? Sales volume would have to increase more than 50 per cent to offset the drastic drop in the contribution margin per unit. You'd better have a good answer. The profit model directs attention to this critical question and gives you the amount of margin sacrificed by dropping the sales price.

Understand That a Small Sales Volume Change Has a Big Effect on Profit

JARGON ALERT

Is that big push before year-end for just 5 per cent more sales volume really that important? You understand that more sales mean more profit, of course. But what's the big deal? A 5 per cent increase in sales volume means just 5 per cent more profit, doesn't it? Oh no. If you think so, you need to read

Chapter 9. Because fixed expenses are just that – fixed and unchanging over the short run. Seemingly small changes in sales volume cause large swings in profit. This effect is called *operating leverage*.

The following example illustrates operating leverage. Suppose your £12.5 million annual fixed expenses provide the personnel and physical resources to sell 625,000 units over the year. However, you didn't hit capacity; your company's actual sales volume was 500,000 units for the year, or 80 per cent of sales capacity – which isn't bad. Your average margin across all products is £30 per unit. Using the basic profit equation, you determine profit before income tax as follows:

[£30 margin per unit × 500,000 units] =	£15,000,000	contribution margin
	– 12,500,000	fixed expenses
	= £2,500,000	pre-tax profit

Now, what if you had sold 25,000 more units, which is just 5 per cent more sales volume? Your fixed expenses would have been the same because sales volume would still be well below the sales capacity provided by your fixed expenses. Therefore, the profit increase would have been the £30 margin per unit times the 25,000 additional units sold, or £750,000. This is a 5 per cent gain in contribution margin. But compared to the £2,500,000 pre-tax profit, the additional £750,000 is a 30 per cent gain – from only a 5 per cent sales volume gain, which is a 6-to-1 payoff!

Operating leverage refers to the wider swing in profit rather than the smaller swing in sales volume. In this example, a 5 per cent increase in sales volume would cause a 30 per cent increase in profit. Unfortunately, operating leverage cuts both ways. If your sales volume had been 5 per cent less, your profit would have been £750,000 less, which would have resulted in 30 per cent less profit.

Here's a quick explanation of operating leverage. In this example, total contribution margin is 6 times profit: £15 million contribution margin ÷ £2.5 million profit = 6. So a 5 per cent swing in contribution margin has a 6-times effect, or a 30 per cent impact on profit. Suppose a business had no fixed expenses (highly unlikely). In this odd situation, there is no operating leverage. The percentage gain or loss in profit would equal the percentage gain or loss in sales volume.

The fundamental lesson of operating leverage is to make the best use you can of your fixed expenses – that is, take advantage of the capacity provided by the resources purchased with your fixed expenses. If your sales volume is less than your sales capacity, the unsold quantity would have provided a lot more profit. Most businesses are satisfied if their actual sales volume is 80–90 per cent of their sales capacity. But keep in mind one thing: That last 10 or 20 per cent of sales volume would make a dramatic difference in profit!

Fathom Profit and Cash Flow from Profit

Profit equals sales revenue minus expenses – you don't need to know much about accounting to understand this definition. However, business managers should dig a little deeper. First, you should be aware of the accounting problems in measuring sales revenue and expenses. Because of these problems, profit is not a revenue and expenses. Because of these problems, profit is not a clear-cut and precise number. Second, you should know the real stuff of profit and know where to find profit in your financial statements.

Profit is not a politically correct term. Instead, business financial reports call profit *net income* or *net earnings*. So don't look for the term *profit* in external financial statements. Remember, net income (or net earnings) = bottom-line profit after tax.

Profit accounting methods are like hemlines

Profit is not a hard-and-fast number but is rather soft and flexible on the edges. For example, profit depends on which accounting method is selected to measure the cost-of-goods-sold expense, which is usually the largest expense for businesses that sell products. The rules of the game, called *generally accepted accounting principles* (or GAAP for short), permit two or three alternative methods for measuring cost of goods sold and for other expenses as well. (Chapter 13 discusses accounting methods.)

When evaluating the profit performance of your own business or when sizing up the net income record of a business you're considering buying, look carefully at whether profit measurement is based on stingy (conservative) or generous (liberal) accounting methods. You can assume that profit is in the GAAP ballpark, but you have to determine whether profit is in the right field or the left field (or perhaps in centre field). Businesses are not required to disclose how different the profit number would have been for the period if different accounting methods had been used, but they do have to reveal their major accounting methods in the footnotes to their annual financial statements.

The real stuff of profit

Most people know that, in the general sense of the word, *profit* is a gain, or an increase in wealth, or how much better off you are. But managers and investors hit the wall when asked to identify the real stuff of profit earned by a business. To make our point, suppose that your business's latest annual profit and loss account reports £10 million sales revenue and £9.4 million expenses, which yields £600,000 bottom-line net income. Your profit ratio is 6 per cent of sales revenue, which is about typical for many businesses. But we digress.

Our question is this: *Where is that £600,000 of profit?* Can you find and locate the profit earned by your business? Is it in cash? If not, where is it? If you can't answer this question, aren't you a little embarrassed? Quick – go and read Chapter 5!

Profit accounting is more complicated than simple cash-in, cash-out bookkeeping. Sales for cash increase cash, of course, but sales on credit initially increase an asset called debtors. So *two* assets are used in recording sales revenue. Usually, a minimum of four assets and two liabilities are used in recording a business's expenses. To locate profit, you have to look at all the assets and liabilities that are changed by revenue and expenses. The *measure* of profit is found in the profit and loss account. But the *substance* of profit is found in assets and liabilities, which are reported in the *balance sheet*.

Your accountant will have determined that your £600,000 net income consists of the following three components:

> £600,000 profit = £420,000 cash + £290,000 net increase in other assets – £110,000 increase in liabilities

This is a typical scenario for the makeup of profit – we don't mean the pound amounts but rather the three components of profit. The pound amounts of the increases or decreases in assets and liabilities vary from business to business, of course, and from year to year. But rarely would the profit equation be

£600,000 profit = £600,000 cash

Cash is only one piece of the profit pie. Business managers need accounting to sort out how profit is divided among the three components – in particular, you need to know the cash flow generated from profit.

Govern Cash Flow Better

A business wants to make profit, of course, but equally important, a business must convert its profit into *usable cash flow*. Profit that is never turned into cash or is not turned into cash for a long time is not very helpful. A business needs cash flow from profit to provide money for three critical uses:

- To distribute some of its profit to its equity (owner) sources of capital – to provide a cash income to them as compensation for their capital investment in the business.
- To grow the business – to invest in new fixed (long-term) operating assets and to increase its stock and other short-term operating assets.
- To meet its debt payment obligations and to maintain the general liquidity and solvency of the business.

REMEMBER

One expense, depreciation, is not a cash outlay in the period it's recorded as an expense. Rather, depreciation expense for a period is an allocated amount of the original cost of the business's fixed assets that were bought and paid for in previous years. More importantly, the sales revenue collected by the business includes money for its depreciation expense. Thus the business converts back into cash some of the money that it put in its fixed assets years ago. Understanding how depreciation works in cash flow analysis is very important.

In one sense, you can say that depreciation generates cash flow. But please be careful here. This does *not* mean that if you had recorded more depreciation expense, you would have had more cash flow. What it means is that through making sales at prices that include recovery of some of the cost of fixed assets, your sales revenue (to the extent that it is collected by year-end) includes cash flow to offset the depreciation expense.

To illustrate this critical point, suppose a business did not make a profit for the year but did manage to break even. In this zero-profit situation, there is cash flow from profit because of depreciation. The company would realise cash flow equal to its depreciation for the year – assuming that it collected its sales revenue. Depreciation is a process of recycling fixed assets back into cash during the year, whether or not the business makes a profit.

In the example in the preceding section, the business earned £600,000 net income (profit). But its cash increased only £420,000. Why? The *cash flow statement* provides the details. In addition to reporting the depreciation for the year, the first section of the cash flow statement reports the short-term operating asset and liability changes caused by the business's sales and expenses. These changes either help or hurt cash flow from profit (from operating activities, to use the correct technical accounting term).

An increase in debtors hurts cash flow from profit because the business did not collect all its sales on credit for the year. An increase in stock hurts cash flow from profit because the business replaces the products sold and spends more money to increase its stock of products. On the other hand, an increase in creditors or accrued expenses payable helps cash flow from profit. These two liabilities are, basically, unpaid expenses. When these liabilities increase, the business did not pay all its expenses for the year – and its cash outflows for expenses were less than its expenses.

Generally speaking, growth hurts cash flow from profit. To grow its sales and profit, a business usually has to increase its debtors and stock. Some of this total increase is offset by increases in the business's short-term operating liabilities. Usually, the increase in assets is more than the increase in liabilities, particularly when growth is faster than usual, and therefore cash flow from profit suffers. When a business suffers a decline in sales revenue, its bottom-line profit usually goes down – but its cash flow from profit may not drop as much as net profit, or perhaps not at all. A business should decrease its debtors and stock at the lower sales level; these decreases help cash flow from profit. Even if a business reported a loss for the year, its cash flow from profit could be positive because of the depreciation factor and because the business may have reduced its debtors and stock.

Call the Shots on Your Management Accounting Methods

Business managers too often defer to their accountants in choosing accounting methods for measuring sales revenue and expenses. You should get involved in making these decisions. The best accounting method is the one that best fits the operating methods and strategies of your business. As a business manager, you know these operating methods and strategies better than your accountant. Chapter 13 gives you the details on various accounting methods.

For example, consider sales prices. How do you set your sales prices? Many factors affect your sales prices, of course. What we're asking here concerns your general sales pricing policy relative to product cost changes. For example, if your product cost goes up, do you allow your 'old' stock of these products to sell out before you raise the sales price? In other words, do you generally wait until you start selling the more recently acquired, higher-cost products before you raise your sales price? If so, you're using the first-in, first-out (FIFO) method. You might prefer to keep your cost-of-goods-sold expense method consistent with your sales pricing method. But the accountant may choose the last-in, first-out (LIFO) expense method, which would mismatch the higher-cost products with the lower-sales-price products.

JARGON ALERT

> The point is this: Business managers formulate a basic strategy regarding expense recovery. Sales revenue has to recoup your expenses to make a profit. How do you pass along your expenses to your customers in the sales prices you charge them? Do you attempt to recover the cost of your fixed assets as quickly as possible and set your sales prices on this basis? Then you should use a fast, or *accelerated*, depreciation method. On the other hand, if you take longer to recover the cost of your fixed assets through sales revenue, then you should probably use the longer-life *straight-line* depreciation method.

In short, we encourage you to take charge and choose the accounting methods that best fit your strategic profit plan. You need to speak some of the accounting language and know which accounting methods are available. In short, business managers should take charge of the accounting function just like they take charge of marketing and other key functions of the business.

This applies only to management accounting. Your accountants and auditors will call the shots when preparing accounts for the outside world.

Build Better Budgets

Budgeting (explained in Chapter 10) provides important advantages – first, for understanding the profit dynamics and financial structure of your business, and second, for planning for changes in the coming period. Budgeting forces you to focus on the factors that have to improve in order to increase profit and helps you prepare for the future. The basic profit model provides the framework for the profit budget. A good profit model is the essential starting point for budgeting. To develop your profit plan for the coming year, focus on the following:

- Margins
- Sales volume
- Fixed expenses

The profit budget, in turn, lays the foundation for changes in your operating assets and liabilities that are driven by sales revenue and expenses. Suppose you project a 10 per cent rise in sales revenue. How much will your debtors asset increase? Suppose your sales volume target for next year is 15 per cent higher than this year. How much will your stock increase? The budgeted changes in sales revenue and expenses for next year lead directly to the budgeted changes in operating assets and operating liabilities. These changes, in turn, direct attention to two other key issues.

First, if things go according to plan, how much cash flow from profit will be generated? Second, will you need more capital, and where will you get this money? You need the budgeted cash flow from profit (operating activities) for the coming year for three basic financial planning decisions:

- **Cash distributions from profit to owners** (cash dividends to shareholders of companies and cash distributions to partners).
- **Capital expenditures** (purchases of new fixed assets to replace and upgrade old fixed assets and to expand the business's capacity).
- **Raising capital** from borrowing on debt and, possibly, raising new equity capital from owners.

TIP

The higher your budgeted cash flow from profit, the more flexibility you have in having money available for cash distributions from profit and for capital expenditures and the less pressure to go out and raise new capital from debt and equity sources of capital.

To sum up, your profit budget is dovetailed with the assets and liabilities budget and the cash flow budget. Your accountant takes your profit budget (your strategic plan for improving profit) and builds the budgeted balance sheet and the budgeted cash flow statement. This information is essential for good planning – focusing in particular on how much cash flow from profit will be realised and how much capital expenditures will be required, which in turn lead to how much additional capital you have to raise and how much cash distribution from profit you will be able to make.

Optimise Capital Structure and

Financial Leverage

Our friend Ron, a florist, made this point one night: ‘To make profit, you must make sales.’ We quickly added that you also must invest in operating assets, which means that you must raise capital. Where do you get this money? Debt and equity are the two basic sources. *Equity* refers to the money that owners invest in a business with the hopes that the business will turn a profit. Profit builds the value of owners’ equity; profit fundamentally is an increase in assets that accrues to the benefit of the owners. Chapter 11 discusses ownership structures; Chapter 6 covers debt and equity.

The return on the owners’ equity interest in the business consists of two quite distinct parts:

- Cash distributions from profit to the owners.
- Increases in the value of their ownership interest in the business.

In contrast, lenders are paid a *fixed* rate of interest on the amount borrowed. This fixed nature of interest expense causes a *financial leverage* or *gearing* effect that either benefits or hurts the amount of profit remaining for the equity investors in the business.

Financial leverage refers in general to using debt in addition to equity capital. A financial leverage gain (or loss) refers to the difference between the earnings before interest and tax (EBIT) that a business can make on its debt capital versus the interest paid on the debt. The following example illustrates a case of financial leverage gain.

REAL WORLD EXAMPLE

Your business earned £2.1 million EBIT for the year just ended. Your net operating assets are £12 million – recall that net operating assets equal total assets less non-interest-bearing operating liabilities (mainly creditors and accrued expenses payable). Thus your total capital sources equal £12 million. Suppose you have £4 million debt. The other £8 million is owners' equity. You paid 8 per cent annual interest on your debt, or £320,000 total interest. Debt furnishes one-third of your capital, so one-third of EBIT is attributed to this capital source. One-third of EBIT is £700,000. But you paid only £320,000 interest for this capital. You earned £380,000 more than the interest. This is the amount of your pre-tax *financial leverage gain*.

Three factors determine financial leverage gain (or loss):

- Proportion of total capital provided from debt.
- Interest rate.
- Return on assets (ROA), or the rate of EBIT the business can earn on its total capital invested in its net operating assets.

In the example, your business earned 17.5 per cent on its net operating assets (£2.1 million EBIT ÷ £12 million total net operating assets). You used £4 million debt capital for the investment in your net operating assets, and you paid 8 per cent annual interest on the debt, which gives a favourable 9.5 per cent spread (17.5 per cent – 8 per cent). The 9.5 per cent favourable spread times £4 million debt equals the £380,000 leverage gain for the year (before tax).

Business managers should watch how much financial leverage gain contributes to the earnings for owners each year. In this example, the after-interest earnings for owners is £1,780,000 (equal to EBIT less interest expense). The £380,000 financial leverage gain provided a good part of this amount. Next year, one or more of the three factors driving the financial leverage gain may change. Savvy business managers sort out each year how much financial leverage impacts the earnings available for owners. Check out Chapter 14 for more on leverage, or *gearing* as it is also known.

A financial leverage gain enhances the earnings on owners' equity capital. The conventional wisdom is that a business should take advantage of debt that charges a lower interest rate than it can earn on the debt capital. Looking at the bigger picture, however, the long-run success of a business depends mainly on maintaining and improving the factors that determine its profit from operations (EBIT) – rather than going overboard and depending too much on financial leverage.

Develop Better Financial Controls

Experienced business managers can tell you that they spend a good deal of time dealing with problems. Things don't always go according to plan. Murphy's Law (if something can go wrong, it will, and usually at the worst possible time) is all too true. To solve a problem, you first have to know that you have one. You can't solve a problem if you don't know about it. Managers are problem solvers; they need to get on top of problems as soon as possible. In short, business managers need to develop good *financial controls*.

Financial controls act like trip wires that sound alarms and wave red flags for a manager's attention. Many financial controls are accounting-based. For example, actual costs are compared with budgeted costs or against last period's costs; serious variances are highlighted for immediate management attention. Actual sales revenue for product lines and territories are compared with budgeted goals or last period's numbers. Cash flow from profit period by period is compared with the budgeted amount of cash flow for the period from this source. These many different financial controls don't just happen. You should identify the handful of critical factors that you need to keep a close eye on and insist that your internal accounting reports highlight these operating ratios and numbers.

You must closely watch the margins on your products. Any deviation from the norm – even a relatively small deviation – needs your attention immediately. Remember that the margin per unit is multiplied by sales volume. If you sell 100,000 units of a product, a slippage of just 50 pence causes your total margin to fall £50,000. Of course, sales volume must be closely watched, too; that goes without saying. Fixed expenses should be watched in the early months of the year to see whether these costs are developing according to plan – and through the entire year.

Debtors' collections should be monitored closely. Average days before collection is a good control ratio to keep your eye on, and you should definitely get a listing of past-due customers' accounts. Stock is always a problem area. Watch closely the average days in stock before products are sold, and get a listing of slow-moving products. Experience is the best teacher. Over time you learn which financial controls are the most important to highlight in your internal accounting reports. The trick is to make sure that your accountants provide this information.

Minimise Tax

The first decision regarding tax concerns which type of legal ownership structure to use for carrying on the activities of the business, which is discussed in Chapter 11. When two or more owners provide capital for the business, you have two basic choices:

- A *partnership* – a specific contractual agreement among the owners regarding division of management authority, responsibilities and profit.
- A *limited liability company*, which has many characteristics of a partnership but is a separate legal entity, like a

corporation.

Partnerships are *pass-through* tax entities. A pass-through business entity pays no tax on its taxable income but passes the obligation to its owners, who pick up their shares of the total taxable income in their individual income tax returns. In contrast, the individual shareholders of companies pay tax only on the amount of actual cash dividends from profit distributed by the company. Keep in mind here that the company pays corporation tax based on its taxable income. Factors other than tax affect the choice of ownership structure. You need the advice of tax professionals and financial consultants.

Regardless of the ownership structure, you should understand how accounting methods determine taxable income. Basically, the choice of accounting methods enables you to shift the timing of expenses – such as depreciation and cost of goods sold – between early years and later years. Do you want more expense deductions this year? Then choose the last-in, first-out (LIFO) method for cost-of-goods-sold expense and an accelerated method for depreciation. But keep in mind that what you gain today, you lose tomorrow. Higher expense deductions in early years cause lower deductions in later years. Also, these income-tax-driven accounting choices make the stock and fixed assets in your balance sheet look anaemic. Remember that expenses are asset decreases. You want more expense? Then lower asset values as reported in your balance sheet.

Think twice before jumping on the tax minimisation bandwagon. Knowing about accounting methods and their effects in both the profit and loss account and the balance sheet helps you make these important decisions.

Explain Your Financial Statements to

Others

On many occasions, as a business manager you have to explain your financial statements to others:

- When applying for a loan.
- When talking with people or other businesses who may be interested in buying your business.
- When dealing with the press.
- When dealing with unions or other employee groups in setting new wages and benefit packages.
- When explaining the profit-sharing plan to your employees.
- When reporting financial statement data to national trade associations that collect this information from their members.
- When presenting the annual financial report before the annual meeting of owners.

Knowledge of financial statement reporting and accounting methods is also extremely useful when you sit on a bank's board of directors, or a hospital board, or any of several other types of oversight boards. In the preceding list, you're the explainer, the one who has to do the explaining. As a board member, you're the explainee, the person who has to make sense of the financial statements and accounting methods being presented. A good accounting foundation is invaluable.

Part II of this book shows you how to understand financial reports. In brief, you need a good grip on the purpose, nature and limitations of each of the three primary financial statements reported by a business:

- **The profit and loss account:** Many people think that bottom-line profit is cash in the bank, but you know better.
- **The cash flow statement:** Many people just add back depreciation to net income to determine cash flow from profit, but you know better.
- **The balance sheet:** Many people think that this financial statement reports the current values for assets, but you know better.

We'll tell you one disadvantage of knowing some accounting: The other members of the board will be very impressed with your accounting knowledge and may want to elect you chairperson.

A short word on massaging the numbers: Don't!

I (John) taught accounting to future business managers and accountants. I didn't encourage profit smoothing, window dressing and other techniques for manipulating accounting numbers to make a company's financial statements look better – no more than my marketing professor colleagues encouraged their students to engage in deceptive advertising tactics. Yet these things go on, and I felt obligated to expose my students to these practices as a warning that accountants face difficult moral decisions. In a similar vein, I caution you, a business manager, that you will surely face pressures from time to time to massage the accounting numbers – to make profit look smoother from year to year, or to make the short-term solvency of the business look better (by window dressing). Don't!

Chapter 17

Ten Places a Business Gets Money From

In This Chapter

- Checking out stock markets
- Getting private investors on board
- Banking on the banks
- Financing short-and long-term assets
- Looking for government loot
- Winning free dosh
- Redeploying pensions

All business ventures need some cash to get going and need more money as they become more successful. They have to invest in staff, equipment and websites, and need to remain competitive and visible by keeping products and services up to date.

Many sources of funds are available to businesses, both big and small. However, not all of them are equally appropriate to all businesses at all times. Different sources of finance carry very different obligations, responsibilities and opportunities for profitable business. Having some appreciation of these differences enables business people to make informed choices.

Stock Markets

A stock market is quite simply a marketplace for trading company stock. A company listing on the London Stock Exchange, The New York Stock Exchange or FWB Frankfurt Stock Exchange is the way serious players raise money. The new breed of ‘super exchanges’ such as NYSE Euronext are also becoming popular. If you want a few hundred million, or a billion or so, stock markets are the places to come to.

All the stock markets have different rules and different outcomes. For example, the value placed on new companies on US stock markets is between 1.5 and 3 times that of UK and European markets.

To get listed on a major stock exchange, a company needs a track record of making substantial profits, with decent seven-figure sums being made in the year you plan to *float*, as this process is known. A large proportion (usually at least 25 per cent) of the company’s shares must be put up for sale at the outset. Also, companies are expected to have 100 shareholders now and to demonstrate that 100 more will come on board as a result of the listing.

TIP

You can check out all the world stock markets from Amsterdam to Zagreb on the Stock Exchanges Worldwide Links website at www.tdd.lt/slnews/Stock_Exchanges/Stock.Exchanges.htm and at www.worldwide-tax.com/stockexchanges/worldstockexchanges.asp. Almost all stock exchange websites have pages in English. Look out for a term such as ‘Listing Center’, ‘Listing’ or ‘Rules’ and you’ll find the latest criteria for floating a company on that exchange.

Junior stock markets such as London’s Alternative Investment Market (AIM) were formed in the mid to late 1990’s specifically to provide risk capital for new rather than established ventures. These markets have an altogether more relaxed atmosphere than the markets have an altogether more relaxed atmosphere than the major exchanges.

These junior markets are an attractive proposition for entrepreneurs seeking equity capital. AIM is particularly attractive to any dynamic company of any size, age or business sector that has rapid growth in mind. The smallest firm on AIM entered to raise less than £1 million and the largest raised over £500 million.

As with the major stock markets, these junior versions expect something in return. The formalities for floating are minimal but the costs of entry are high, and you must have a nominated adviser such as a major accountancy firm, stockbroker or banker. The cost of floating on the junior market is around 6.5 per cent of all funds raised, and companies valued at less than £2 million can expect to shell out a quarter of funds raised in costs alone. The market is regulated by the London Stock Exchange. You can find out more by going to their website (www.londonstockexchange.com) and clicking on 'AIM'.

One rung down from AIM is PLUS-Quoted Market whose roots lie in the market formerly known as Ofex. It began life in November 2004 and was granted Recognised Investment Exchange (RIE) status by the Financial Services Authority (FSA) in 2007. Aimed at smaller companies wanting to raise up to £10 million, it draws on a pool of capital primarily from private investors. The market is regulated, but requirements aren't as stringent as those of AIM or the main market and the costs of flotation and ongoing costs are lower. Keycom used this market to raise £4.4 million in September 2008 to buy out a competitor to give them a combined contract to provide broadband access to 40,000 student rooms in UK universities. There are 174 companies quoted on PLUS with a combined market capitalisation of £2.3 billion. Even in 2009, a particularly bad year for stock market activity, 30 companies applied for entry to PLUS and 18 were admitted. You can find out more about PLUS at www.plusmarketsgroup.com.

Private Equity

Organisations known as *venture capitalists* provide private equity by investing other people's money, often from pension funds. They are likely to be interested in investing large sums of money, often more than can be raised on AIM. Some 7,000 or so companies worldwide get private equity backing each year, around half of which are in the US where the average deal is $7.8 million.

Venture capitalists generally expect their investment to pay off within seven years, but they are hardened realists. Two in every ten investments they make are total write-offs, and six perform averagely well at best. So, the one star in every ten investments they make has to cover a lot of duds. Venture capitalists have a target rate of return of over 30 per cent, to cover this poor hit rate.

Raising venture capital is an expensive option and deals are slow to arrange. Six months is not unusual, and over a year has been known. Every venture capitalist has a deal done in six weeks in its portfolio, but that truly is the exception rather than the rule.

PricewaterhouseCoopers produce the Money Tree Report (www.pwcmoneytree.com), which is a quarterly study of venture capital investment activity in the United States, and individual country associations do something similar for their own markets. The PSEPS Venture Capital and Private Equity Directory (www.pseps.com/associations.php) lists the venture capital associations of various countries.

The British Venture Capital Association (www.bvca.co.uk), the European Venture Capital Association (www.evca.com) and the National Venture Capital Association (www.nvca.org) in the US have online directories giving details of hundreds of venture capital providers both inside and outside of their respective countries and continents.

You can see how those negotiating with or receiving venture capital rate the firm in question at the Funded website (www.thefunded.com) in terms of the deal offered, the firm's apparent competence and how good they are at managing the relationship.

Business Angels

One possible first source of equity or risk capital is a private individual with his or her own funds and perhaps some knowledge of your type of business. In return for a share in the business, such investors will invest money at their own risk. About 40 per cent of these individuals suffer a partial or complete loss of their investment, which suggests that many are prepared to take big risks. They've been christened 'business angels', a term first coined to describe private wealthy individuals who backed a play on Broadway or in London's West End.

Most business angels have worked in a small firm or have owned their own businesses before, so know the business world well. They are more likely to invest in early-stage investments where relatively small amounts of money are needed. 10 per cent of business angel investment is for less than £10,000 and 45 per cent is for over £50,000. They are up to five times more likely to invest in start-ups and early-stage investments than venture capital providers in general. Most business angels invest close to home, and syndicated deals make up more than a quarter of all deals, proving that angels flock together!

In return for their investment, most angels want some involvement beyond merely signing a cheque and may hope to play a part in your business in some way. They are looking for big rewards. One angel who backed the fledgling software company Sage (who supply accounting, payroll and business management software for small and medium sized companies) with £10,000 in its first round of £250,000 financing saw his stake rise to £40 million. Various industry estimates suggest that upwards of £6.5 billion of angels' money is looking for investment homes, although the sum actually invested each year is probably much smaller than that.

To find a business angel, check out the online directory of the British Business Angels Association (`www.bbaa.org.uk`). The European Business Angels Network website has directories of national business angel associations both inside and outside of Europe. Go to `www.eban.org` and click on 'Members' to find individual business angels.

Corporate Venture Funds

Venture capital firms often get their hands dirty taking a hand in the management of the businesses they invest in. Another type of business is also in the risk capital business, without it necessarily being their main line of business. These firms, known as *corporate venturers*, usually want an inside track to new developments in and around the edges of their own fields of interest.

Sinclair Beecham and Julian Metcalfe founded takeaway food chain Pret a Manger with a £17,000 loan and a name borrowed from a boarded-up shop. They had global ambitions and they joined forces with the corporate venturing arm of a big firm. It was only by cutting in McDonald's, the burger giant, that they could see any realistic way to dominate the world. They sold a 33% stake for £25 million in 2001 to McDonald's Ventures, LLC, a wholly-owned subsidiary of McDonald's Corporation, the arm of McDonalds that looks after its corporate venturing activities. They could also have considered Cisco, Apple Computers, IBM and Microsoft who also all have corporate venturing arms.

For an entrepreneur, corporate venture funds can provide a 'friendly customer' and help to open doors. For the 'parent' it provides a privileged ring-side seat as a business grows and so be able to decide if the area is worth plunging into more deeply, or at least gain valuable insights into new technologies or business processes.

Global Corporate Venturing (www.globalcorporateventuring.com) is a new website devoted to publishing information on who's who and who's doing what in the sector.

Banks

Banks are the principal, and frequently the only, source of finance for businesses that are not listed on a stock market or that don't have private equity backers.

For long-term lending, banks can provide term loans for a number of years, with either a variable interest rate payable or an interest rate fixed for a number of years ahead. The proportion of fixed-rate loans has increased from a third of all term loans to around one in two. In some cases, moving between a fixed interest rate and a variable one at certain intervals may be possible. Unlike in the case of an overdraft, the bank cannot pull the rug from under you if circumstances (or the local manager) change.

Bankers look for asset security to back their loan and to provide a near-certainty of getting their money back. They also charge an interest rate that reflects current market conditions and their view of the risk level of the proposal.

Bankers like to speak of the 'five Cs' of credit analysis – factors they look at when they evaluate a loan request.

- **Character.** Bankers lend money to borrowers who appear honest and who have a good credit history. Before you apply for a loan, obtain a copy of your credit report and clean up any problems.

  You can check out your own business credit rating at CheckSure (`www.checksure.biz`). By using the comparative ratios for your business sector you can see how to improve your own rating. The service costs around £6 to £10 depending on the level of detail you require.

- **Capacity.** This is a prediction of the borrower's ability to repay the loan. For a new business, bankers look at the business plan. For an existing business, bankers consider financial statements and industry trends.

- **Collateral.** Bankers generally want a borrower to pledge an asset that can be sold to pay off the loan if the borrower lacks funds.
- **Capital.** Bankers scrutinise a borrower's net worth, the amount by which assets exceed debts.
- **Conditions.** Whether bankers give a loan can be influenced by the current economic climate as well as by the amount.

You can see an A to Z listing of business bank accounts at www.find.co.uk/commercial/commercial_banking_centre/business-banking where the top six or so are rated and reviewed.

Governments around the world have schemes to make raising money from banks easier for small and new businesses. These *Small Firm Loan Guarantee Schemes* are operated by banks at the instigation of governments. They are aimed at small and new businesses with viable business proposals that have tried and failed to obtain a conventional loan because of a lack of security. Loans are available for periods of between two and ten years on sums from £5,000 to £250,000. The government guarantees 70–90 per cent of the loan. In return for the guarantee, the borrower pays a premium of 1–2 per cent per year on the outstanding amount of the loan. The commercial aspects of the loan are matters between the borrower and the lender.

You can find out more about the UK Small Firms Loan

Guarantee Scheme on the Business Link website (go to www.businesslink.gov.uk and click on 'Finance and grants', 'Finance options, 'Borrowing', and 'Government lending schemes').

As a means of short-term borrowing, banks can offer *overdrafts* – a facility to cover you when you want to withdraw more money from a bank account than it has funds available. The overdraft was originally designed to cover the timing differences of, say, having to acquire raw materials to manufacture finished goods that are later sold. However, overdrafts have become part of the core funding of most businesses, with a little over a quarter of all bank finance provided in this way.

Almost every type and size of business uses overdrafts. They are very easy to arrange and take little time to set up. That is also their inherent weakness. The key words in the arrangement document are *repayable on demand*, which leaves the bank free to make and change the rules as it sees fit. (This term is under constant review, and some banks may remove it from the arrangement.) With other forms of borrowing, as long as you stick to the terms and conditions, the loan is yours for the duration, but not with overdrafts. Small businesses can expect to pay interest at three to four per cent above base – the rate at which banks can borrow. Larger and more creditworthy firms may pay much less.

Bonds, Debentures and Mortgages

Bonds, debentures and mortgages are all kinds of borrowing with different rights and obligations for the parties concerned. A mortgage is much the same for a business as for an individual. The loan is for buying a particular property asset such as a factory, office or warehouse. Interest is payable and the loan itself is secured against the property, so if the business fails, the mortgage can substantially be redeemed.

Companies wanting to raise funds for general business purposes, rather than a mortgage where a particular property is being bought, issue debentures or bonds. These run for a number of years, typically three years and upwards, with the bond or debenture holder receiving interest over the life of the loan with the capital returned at the end of the period.

The key difference between debentures and bonds lies in their security and ranking. Debentures are unsecured, so in the event of the company being unable to pay interest or repay the sum, the loaner may well get little or nothing back. Bonds are secured against specific assets and so rank ahead of debentures for any pay out.

Unlike bank loans that are usually held by the issuing bank, bonds and debentures are sold to the public in much the same way as shares. The interest demanded is a factor of the prevailing market conditions and the financial strength of the borrower.

You can find out more about raising these forms of finance on the Business Link website (www.businesslink.gov.uk).

Leasing and Hire-Purchase

You can usually finance physical assets such as cars, vans, computers and office equipment by leasing them or buying them on hire purchase. This leaves other funds free to cover the less tangible elements in your cash flow. In this way, a business gets the use of assets without paying the full cost all at once.

Companies take out *operating leases* where you use the equipment for less than its full economic life, as you might with a motor vehicle, for example. The lessor takes the risk of the equipment becoming obsolete, and assumes responsibility for repairs, maintenance and insurance. As you, the lessee, pay for this, the service is more expensive than a *finance lease*, where you lease the equipment for most of its economic life, taking care of the maintenance and insurance yourself. Leases can normally be extended, often for fairly nominal sums, in the latter years.

Businesses that need lots of fixed assets such as computers, machinery or vehicles are the big customers for leasing. The obvious attraction of leasing is that you need no deposit, which leaves your working capital free for more profitable use elsewhere. Also, you know the cost from the start, making forward planning simpler. Tax advantages over other forms of finance may even exist.

Hire purchase differs from leasing in that you have the option to eventually become the owner of the asset, after you make a series of payments.

TIP

You can find a leasing or hire purchase company through the Finance and Leasing Association. Their website (go to www.fla.org.uk and click on 'For Businesses' and 'Business Finance Directory') gives details of all UK-based businesses that offer this type of finance. The website also has general information on terms of trade and code of conduct. Euromoney produce an annual World Leasing Yearbook that contains details about 4,250 leasing companies worldwide (go to their website at www.euromoney.com and click on 'Leasing & Asset Finance' and 'Books' for ordering information). You can, however, see a listing of most countries' leasing associations for free in the 'Contributors' listing on this site.

Factoring and Invoice Discounting

Customers take on average around 60 to 90 days to pay their suppliers. In effect, this means that companies are granting a loan to customers for that time. In periods of rapid growth, this can put a strain on cash flow. One way to alleviate that strain is to *factor* creditworthy customers' bills to a financial institution and receive some of the funds as goods leave the door, and this speeds up the cash flow.

Factoring is an arrangement that allows a business to receive up to 80 per cent of the cash due from customers more quickly than normal. The factoring company in effect buys the trade debts, provides a 100 per cent protection against bad debts and can also provide a debtor accounting and administration service.

Factoring costs a little more than normal overdraft rates. The factoring service costs between 0.5 and 3.5 per cent of the turnover, depending on volume of work, the number of debtors, average invoice amount and other related factors.

Factoring is generally only available to a business that invoices other business customers for services provided. These customers can be either in the business's home market or overseas. Companies that sell directly to the public, sell complex and expensive capital equipment, or expect progress payments on long-term projects may find factoring their debtor book to be difficult, if not impossible.

Invoice discounting is a variation on the same theme. Factors collect in money owed by their clients' customers, take a fee and pass the balance on, whereas invoice discounters leave their clients to collect the money themselves. This could be an advantage for firms that fear the factoring method might reduce their contact with clients. Invoice discounting is, in any case, typically available only to businesses with a turnover in excess of £1 million.

You can find an invoice discounter or factoring business through the Asset Based Finance Association's directory at www.thefda.org.uk/public/membersList.asp.

Grants, Incentives and Competitions

Surprisingly, there really is such a thing as a free lunch in the money world. These free lunches come from benevolent governments whose agenda is either to get businesses to locate in an area bereft of business but jammed full of people looking for work, or to pioneer new, unproven and risky technologies. Absolutely no evidence exists that governments get any value out of this generosity, but that's the thing with governments – they feel they have to *govern*, and people are more prepared to listen to others that have open wallets.

Grants are constantly being introduced (and withdrawn), but no system exists to let you know automatically. You have to keep yourself informed. The Business Link website (go to www.businesslink.gov.uk and click on 'Finance and grants' and 'Grants and government support') has advice on how to apply for a grant as well as a directory of grants on offer. The Microsoft Small Business Centre (www.microsoft.com/uk/businesscentral/euga/home.aspx) has a European Union Grant Advisor with a search facility to help you find which of the 6,000 grants on offer might suit your business needs. www.grants.gov is a guide to how to apply for over 1,000 federal government grants in the US.

Governments aren’t the only guys with open wallets. More than a thousand annual awards around the world aimed at businesses exist. They are awarded for such achievements as being the greenest, cleanest, fastest (growing, that is), best company to work for and a thousand other plausible superlatives to make you feel good. The guys giving these awards are in it for the publicity, and heck, if you can get your hands on some free money, swallow your pride and head on down. Business plans are central to most of these competitions, which are sponsored by banks, the major accountancy bodies, chambers of commerce, local or national newspapers, business magazines and the trade press. Government departments may also have their own competitions as a means of promoting their initiatives for exporting, innovation, job creation and so forth. You can find directories of business plan competitions at www.smallbusinessnotes.com/planning/competitions.html and www.awardsintelligence.co.uk.

Using the Pension Fund

This financing strategy is mostly available to private companies with a relatively limited number of participants – usually directors, partners, top managers and shareholders. In these cases, the company can pay money out of business profits, thus escaping tax, into either a Small Self-Administered Scheme (SSAS) or a Self-Invested Personal Pension Plan (SIPP). That scheme can then invest in a narrow range of asset classes such as the company’s own shares, purchase of commercial property and loans to the company, subject to certain conditions and with the approval of the pension trustees. The trustees are themselves regulated by the Pensions

Regulator (www.the pensionsregulator.gov.uk). The aim of any pension investment must be to enhance the value of the pension fund for the ultimate benefit of all the pensioners equally.

> The fun doesn't stop at being able to use pensioners' money to invest in the business they work in. Both SSAS and SIPP schemes can (since April 2006) borrow up to 50 per cent of their net assets to purchase property. So, if an SSAS/SIPP has total assets of £100,000, it can borrow a further £50,000, thus providing up to £150,000 to invest in qualifying business assets.

You can get the lowdown on SSAS and SIPP pension schemes from companies such as Westerby Trustee Service (www.sipp-ssas-pensions.co.uk) and SIPPS Guide (www.sippsguide.com).

Chapter 18

Ten (Plus One) Questions Investors Should Ask When Reading a Financial Report

In This Chapter

- Analysing sales and profit performance
- Investigating changes in assets and liabilities
- Looking for signs of financial distress
- Examining asset utilisation and return on capital investment

You have only so much time to search for the most important signals in a business's financial report. For a quick read through a financial report – one that allows you to decode the critical signals in the financial statements – you need a checklist of key questions to ask.

TIP

Before you read a business's annual financial report, get up to speed on which products and services the business sells and learn about the history of the business and any current problems it's facing. One place to find much of this information is the company's annual accounts filed at Companies House, which is a public document available to everyone. (You can also usually find this information on the company's website, in the investor affairs section.) Company profiles are prepared by securities brokers and investment advisers, and they’re very useful. *The Economist*, *Investors Chronicle* and other national newspapers, such as *The Financial Times*, are good sources of information about public companies.

Did Sales Grow?

A business makes profit by making sales (although you do have to take controlling expenses into account). Sales growth is the key to long-run sustained profit growth. Even if profit is up, investors get worried when sales revenue is flat.

Start reading a financial report by comparing this year’s sales revenue with last year’s, and with all prior years included in the financial report. A company’s sales trend is the most important factor affecting its profit trend. We dare you to find a business that has had a steady downward sales trend line but a steady upward profit line – you’d be looking for a long time.

Did the Profit Ratios Hold?

Higher sales from one year to the next don’t necessarily mean higher profit. You also need to look at whether the business was able to maintain its profit ratio at the higher sales level. Recall that the *profit ratio* is net income divided by sales revenue. If the business earned, say, a 6 per cent profit ratio last year, did it maintain or perhaps improve this ratio on its higher sales revenue this year?

Also compare the company's *gross margin ratios* from year to year. Cost-of-goods-sold expense is reported by companies that sell products. Recall that gross margin equals sales revenue less cost of goods sold. Any significant slippage in a company's gross margin ratio (gross margin divided by sales revenue) is a very serious matter. Suppose that a company gives up two or three points (one point = 1 per cent) of its gross margin ratio. How can it make up for this loss? Decreasing its other operating expenses isn't easy or very practical – unless the business has allowed its operating expenses to become bloated.

In most external financial reports, profit ratios are *not* discussed openly, especially when things have not gone well for the business. You usually have to go digging for these important ratios and use your calculator. Articles in the financial press on the most recent earnings of public corporations focus on gross margin and profit ratios – for good reason. We always keep an eye on profit as a percentage of sales revenue, even though we have to calculate this key ratio for most businesses. We wish that all businesses would provide this ratio.

Were There Any Unusual or Extraordinary Gains or Losses?

Every now and then, a business records an *unusual* or *extraordinary* gain or loss. The first section of the profit and loss account reports sales revenue and the expenses of making the sales and operating the business. Also, interest and income tax expenses are deducted. Be careful: The profit down to this point may *not* be the final bottom line. The profit down to this point is from the business's ongoing, normal operations before any unusual, one-time gains or losses are recorded. The next layer of the profit and loss account reports these extraordinary, non-recurring gains or losses that the business recorded during the period.

These gains or losses are called extraordinary because they do not recur – or at least should not recur, although some companies report these gains and losses on a regular basis. These gains and losses are caused by a *discontinuity* in the business – such as a major organisational restructuring involving a reduction in the workforce and paying substantial severance packages to laid-off employees, selling off major assets and product lines of the business, retiring a huge amount of debt at a big gain or loss, or settling a huge lawsuit against the business. Generally, the gain or loss is reported on one line net of the corporation tax effect for each extraordinary item, and a brief explanation can be found in the footnotes to the financial statements.

Investors have to watch the pattern of these items over the years. An extraordinary gain or loss now and then is a normal part of doing business and is nothing to be alarmed about. However, a business that reports one or two of these gains or losses every year or every other year is suspect. These gains or losses may be evidence of past turmoil and future turbulence. We classify these businesses as high-risk investments – because you don't know what to expect in the future.

WARNING!

In any case, we advise you to consider whether an unusual loss is the cumulative result of inadequate accounting for expenses in previous years. A large legal settlement, for example, may be due to the business refusing to admit that it is selling unsafe products year after year; its liability finally catches up with it.

Did Earnings Per Share Keep Up with Profit?

Chapter 14 explains that a publicly owned business with a simple capital structure – meaning that the business is not required to issue additional shares in the future – reports just one earnings per share (EPS) for the period, which is called *basic* EPS. You calculate basic EPS by using the actual number of shares owned by shareholders. However, many publicly owned businesses have complex capital structures that require them to issue additional shares in the future. These businesses report *two* EPS numbers – basic EPS and *diluted* EPS. The diluted EPS figure is based on a larger number of shares that includes the additional number of shares that will be issued under terms of management share options, convertible debt and other contractual obligations that require the business to issue shares in the future.

In analysing earnings per share, therefore, you may have to put on your bifocals, as it were. For many businesses, you have to look at both basic EPS and diluted EPS. We suppose you could invest only in companies that report only basic EPS, but this investment strategy would eliminate a large number of businesses from your stock investment portfolio. Odds are, your stock investments include companies that report both basic and diluted EPS. The two EPS figures may not be too far apart, but then again, diluted EPS may be substantially less than basic EPS for some businesses.

Suppose you own stock in a public corporation that reports bottom-line net income that is 10 per cent higher than last year's. So far, so good. But you know that the market price of your shares depends on earnings per share (EPS). Ask what happened to basic and diluted EPS. Did both EPS figures go up 10 per cent? Not necessarily – the answer is often 'no', in fact. You have to check.

Public companies whose shares are traded on one of the national stock exchanges (London Stock Exchange, New York Stock Exchange, NASDAQ and so on) are required to report EPS in their profit and loss accounts, so you don't have to do any computations. (Private businesses whose shares are not traded do not have to report EPS.)

EPS increases exactly the same percentage that net income increases only if the total number of shares remains constant. Usually, this is not the case. Many public corporations have a fair amount of activity in their shares during the year. So they include a schedule of changes in shareholders' equity during the year. (Chapter 8 discusses this financial summary of changes in shareholders' equity.) Look at this schedule to find out how many shares were issued during the year. Also, companies may purchase some of their own shares during the year, which is reported in this schedule.

Suppose net income increased, say, 10 per cent, but basic EPS increased only 6.8 per cent because the number of shares issued by the business increased 3 per cent during the year. (You can check the computation if you like.) You should definitely look into why additional shares were issued. And if diluted EPS does not keep pace with the company's earnings increase, you should pinpoint why the number of shares included in the calculation of diluted EPS increased during the period. (Maybe more management share options were awarded during the year.) The number of shares may increase again next year and the year after. Businesses do not comment on why the percentage change in their EPS is not the same as the percentage change in their net income. We wish that companies were required to leave a clear explanation of any difference in the percentage of change in EPS compared with the percentage of change in net income. However, this is just wishful thinking on our part. You have to ferret out this information yourself, which we advise you to do.

An increase in EPS may not be due entirely to an increase in net income, but rather to a *decrease* in the number of shares. Cash-rich companies often buy their shares to reduce the total number of shares that is divided into net income, thereby increasing basic and diluted EPS. You should pay close attention to increases in EPS that result from decreases in the number of shares. The long-run basis of EPS growth is profit growth, although a decrease in the number of shares helps EPS and, hopefully, the market price of the shares.

Did the Profit Increase Generate a Cash Flow Increase?

Increasing profit is all well and good, but you also should ask: Did *cash flow from profit* increase? Cash flow from profit is found in the first section of the cash flow statement, which is one of the three primary financial statements included in a financial report. The cash flow statement begins with an explanation of cash flow from profit.

Accountants use the term *cash flow from operating activities* – which, in our opinion, is not nearly as descriptive as *cash flow from profit*. The term *profit* is avoided like the plague in external financial reports; it's not a politically correct word. So you may think that accountants would use the phrase *cash flow from net income*. But no, the official pronouncement on the cash flow statement mandated the term *cash flow from operating activities*. *Operating activities* refers simply to sales revenue and expenses, which are the profit-making operations of a business. We'll stick with *cash flow from profit* – please don't report us to the accounting authorities.

Almost all expenses are bad for cash flow, except one: depreciation. Depreciation expense is actually good for cash flow. Each year, a business converts part of the cost of its fixed assets back into cash through the cash collections from sales made during the year. Over time, fixed assets are gradually used up, so each year is charged with part of the fixed assets' cost by recording depreciation expense. And each year, a business retrieves cash for part of the cost of its fixed assets. Thus depreciation expense decreases profit but increases cash flow. But net income plus depreciation does not equal cash flow from profit – except in the imaginary scenario in which all the company's other operating assets (mainly debtors and stock) and all its operating liabilities (mainly creditors and accrued expenses payable) don't increase or decrease during the year.

Here's the key question: Should cash flow from profit change about the same amount as net income changed, or is it normal for the change in cash flow to be higher or lower than the change in net income?

As a general rule, sales growth penalises cash flow from profit in the short run. A business has to build up its debtors and stock, and these increases hurt cash flow – although, during growth periods, a business also increases its creditors and accrued expenses payable, which helps cash flow. The asset increases, in most cases, dominate the liability increases, and cash flow from profit suffers.

We strongly advise you to compare cash flow from operating activities (see, we use the officially correct term here) with net income for each of the past two or three years. Is cash flow from profit about the same percentage of net income each year? What does the trend look like? For example, last year, cash flow from profit may have been 90 per cent of net income, but this year it may have dropped to 50 per cent. Don't hit the panic button just yet.

A dip in cash flow from profit in one year actually may be good from the long-run point of view – the business may be laying a good foundation for supporting a higher level of sales. But then again, the slowdown in cash flow from profit could present a short-term cash problem that the business has to deal with.

A company's cash flow from profit may be a trickle instead of a stream. In fact, cash flow from profit could be *negative*; in making a profit, the company could be draining its cash reserves. Cash flow from profit is low, in most cases, because debtors from sales haven't been collected and because the business has made large increases in its inventories. These large increases raise questions about whether all the receivables will be collected and whether all the stock will be sold at regular prices. Only time can tell. But generally speaking, you should be cautious and take the net income number that the business reports with a grain of salt.

Analysing cash flow from *loss* (instead of from profit) is very important. When a company reports a loss for the year – instead of a profit – an immediate question is whether the company's cash reserve will buy it enough time to move out of the loss column into the profit column. When a business is in a loss situation (the early years of a start-up business, for example) and its cash flow from operating activities is negative, focus on the company's cash balance and how long the business can keep going until it turns the corner and becomes profitable. Stock analysts use the term *burn rate* to refer to how much cash outflow the business is using up each period. They compare this measure of how much cash the business is haemorrhaging each period to its present cash balance. The key question is this: Does the business have enough cash on hand to tide it over until it starts to generate positive cash flow from profit, and if not, where will it get more money to burn until it can record a profit?

Are Increases in Assets and Liabilities Consistent with the Business's Growth?

Publicly owned businesses present their financial statements in a three-year comparative format (or sometimes a two-year comparative format). Strictly speaking, you don't have to provide comparative financial statements – although all businesses, private and public, are encouraged to present comparative financial statements. Furthermore, business investors and lenders demand comparative financial statements. Thus, three columns of numbers are reported in profit and loss accounts, balance sheets and cash flow statements – for the current and two preceding years. To keep financial statement illustrations in this book as brief as possible, we present only one year; we do not include two additional columns for the two previous years. Please keep this point in mind.

Presenting financial statements in a three-year comparative format, as may be obvious, helps the reader make year-to-year comparisons. Of course, you have to deal with three times as many numbers in a three-year comparative financial statement compared with a one-year financial statement. And we should point out that the *amounts of changes* are not presented; you either eyeball the changes or use a calculator to compute the amounts of changes during the year. For example, the ending balances of a business's property, plant and equipment asset account may be reported as follows (in millions of pounds): £4,097, £4,187 and £3,614 for the last three fiscal years. Only these ending balances are presented in the company's comparative balance sheet – the increase or decrease during the year is not presented.

A three-year comparative format enables you to see the general trend of sales revenue and expenses from year to year and the general drift in the amounts of the company's assets, liabilities and owners' equity accounts. You can easily spot any major differences in each line of the cash flow statement across the years. Whether you just cast a glance at adjacent amounts or actually calculate changes, ask yourself whether the increases of a company's assets and liabilities reported in its balance sheet are consistent with the sales growth of the business from year to year.

Unusually large increases in assets that are greatly out of line with the company's sales revenue growth put pressure on cash flow and could cast serious doubts on the company's solvency – which we explain in the next section.

Can the Business Pay Its Liabilities?

JARGON ALERT

A business can build up a good sales volume and have very good profit margins, but if the company can't pay its bills on time, its profit opportunities could go down the drain. *Solvency* refers to the prospects of a business being able to meet its debt and other liability payment obligations on time. Solvency analysis asks whether a business will be able to pay its liabilities, looking for signs of financial distress that could cause serious disruptions in the business's profit-making operations. In short, even if a business has a couple of billion quid in the bank, you should ask: How does its solvency look?

To be solvent doesn't mean that a business must have cash in the bank equal to its total liabilities. Suppose, for example, that a business has £2 million in non-interest-bearing operating liabilities (mainly creditors and accrued expenses payable), £1.5 million in overdraft (due in less than one year) and £3.5 million in long-term debt (due over the next five years). Thus, its total liabilities are £7 million. To be solvent, the business does not need £7 million in its bank account. In fact, this would be foolish.

There's no point in having liabilities if all the money were kept in the bank. The purpose of having liabilities is to put the money to good use in assets other than cash. A business uses the money from its liabilities to invest in *non-cash* assets that it needs to carry on its profit-making operations. For example, a business buys products on credit and holds these goods in stock until it sells them. It borrows money to invest in its fixed assets.

Solvency analysis asks whether assets can be converted quickly back into cash so that liabilities can be paid on time. Will the assets generate enough cash flow to meet the business's liability payment obligations as they come due?

Short-term solvency analysis looks a few months into the future of the business. It focuses on the *current* assets of the business in relation to its *current* liabilities; these two amounts are reported in the balance sheet. A rough measure of a company's short-term liability payment ability is its *current ratio* – current assets (cash, debtors, stock and prepaid expenses) are divided by current liabilities (creditors and accrued expenses payable, plus interest-bearing debt coming due in the short term). A 2-to-1 current ratio usually is a reasonable benchmark for a business – but don't swallow this ratio hook, line and sinker.

A 2-to-1 current ratio is fairly conservative. Many businesses can get by on a lower current ratio without alarming their sources of short-term credit.

Business investors and creditors also look at a second solvency ratio called the *quick ratio*. This ratio includes only a company's *quick assets* – cash, debtors and short-term marketable investments in other company shares (if the company has any). Quick assets are divided by current liabilities to determine the quick ratio. It's also called the *acid-test ratio* because it's a very demanding test to put on a business. More informally, it's called the *pounce ratio*, as if all the short-term creditors pounced on the business and demanded payment in short order.

Many people consider a safe acid-test ratio to be 1-to-1 – £1 of quick assets for every £1 of current liabilities. However, be careful with this benchmark. It may not be appropriate for businesses that rely on heavy short-term debt to finance their inventories. For these companies, it's better to compare their quick assets with their quick liabilities and exclude their short-term notes payable that don't have to be paid until stock is sold.

The current and acid-test ratios are relevant. But the solvency of a business depends mainly on the ability of its managers to convince creditors to continue extending credit to the business and renewing its loans. The credibility of management is the main factor, not ratios. Creditors understand that a business can get into a temporary bind and fall behind on paying its liabilities. As a general rule, creditors are slow to pull the plug on a business. Shutting off new credit may be the worst thing lenders and other creditors could do. This may put the business in a tailspin, and its creditors may end up collecting very little. Usually, it's not in their interest to force a business into bankruptcy, except as a last resort.

Also check out the gearing. If borrowings are growing faster than retained profits or new shareholder investments, then gearing is going up, as are the financing risks. Have a look at Chapter 14 to see what gearing/leverage is all about.

Are There Any Unusual Assets and Liabilities?

Most businesses report a miscellaneous, catch-all account called *other assets*. Who knows what might be included in here? If the balance in this account is not very large, trust that the auditor did not let the business bury anything important in this account.

Marketable securities is the asset account used for investments in shares and bonds (as well as other kinds of investments). Companies that have more cash than they need for their immediate operating purposes put the excess funds to work earning investment income rather than let the money lie dormant in a bank checking account. The accounting rules for marketable securities are fairly tight; you needn't be concerned about this asset.

If you encounter an asset or liability you're not familiar with, look in the footnotes to the financial statements, which present a brief explanation of what the accounts are and whether they affect profit accounting. (We know, you don't like reading footnotes; neither do we.) For example, many businesses have large liabilities for unfunded pension plan obligations for work done in the past by their employees. The liability reveals that the business has recorded this component of labour expense in determining its profit over the years. The liability could be a heavy demand on the future cash flow of the business.

How Well Are Assets Being Utilised?

The overall test of how well assets are being used is the *asset turnover ratio*, which equals annual sales revenue divided by total assets. (You have to calculate this ratio; most businesses do not report this ratio in their financial statements, although a minority do.) This ratio tests the efficiency of using assets to make sales. Some businesses have low asset turnover ratios, less than 2-to-1. Some have very high ratios, such as 5-to-1. Each industry and retail sector in the economy has a standard asset turnover ratio, but these differ quite a bit from industry to industry and from sector to sector. There is no standard asset turnover ratio for all businesses. A supermarket chain couldn't make it if its annual sales revenues were only twice its assets. Capital-intensive heavy manufacturers, on the other hand, would be delighted with a 2-to-1 asset turnover ratio.

TIP

Financial report readers are wise to track a company's asset turnover ratio from year to year. If this ratio slips, the company is getting less sales revenue for each pound of assets. If the company's profit ratio remains the same, it gets less profit out of each pound of assets, which is not good news for equity investors in the business.

What Is the Return on Capital Investment?

We need a practical example to illustrate the *return on capital investment* questions you should ask. Suppose a business has £12 million total assets, and its creditors and accrued liabilities for unpaid expenses are £2 million. Thus, its *net operating assets* – total assets less its non-interest-bearing operating liabilities – are £10 million. We won't tell you the company's sales revenue for the year just ended. But we will tell you that its earnings before interest and tax (EBIT) were £1.32 million for the year. The basic question you should ask is this: How is the business doing in relation to the total capital used to make this profit?

EBIT is divided by assets (net operating assets, in our way of thinking) to get the *return on assets (ROA)* ratio. In this case, the company earned 13.2 per cent ROA for the year just ended:

£1,320,000 EBIT ÷ £10,000,000 net operating assets = 13.2% ROA

Was this rate high enough to cover the interest rate on its debt? Sure; it's doubtful that the business had to pay a 13.2 per cent interest rate. Now for the bottom-line question: How did the business do for its *owners*, who have a lot of capital invested in the business?

The business uses £4 million total debt, on which it pays 8 per cent annual interest. Thus, its total owners' equity is £6 million. The business is organised as a company that pays, for example, 30 per cent tax on its taxable income.

Given the company's capitalisation structure, its EBIT (or profit from operations) for the year just ended was divided three ways:

- **£320,000 interest on debt:** £4,000,000 debt × 8 per cent interest rate = £320,000
- **£300,000 income tax:** £1,320,000 EBIT – £320,000 interest = £1,000,000 taxable income; £1,000,000 taxable income × 30 per cent tax rate = £300,000 income tax
- **£700,000 net income:** £1,320,000 operating earnings – £320,000 interest – £300,000 income tax = £700,000 net income

Net income is divided by owners' equity to calculate the *return on equity (ROE)* ratio, which in this example is

£700,000 net income ÷ £6,000,000 owners' equity = 12% ROE

Some businesses report their ROE ratios, but many don't – generally accepted accounting principles don't require the disclosure of ROE. In any case, as an investor in the business, would you be satisfied with a 12 per cent return on your money?

You made only 4 per cent more than the debt holders, which may not seem much of a premium for the additional risks you take on as an equity investor in the business. But you may predict that the business has a bright future and over time your investment will increase two or three times in value. In any case, ROE is a good point of reference – although this one ratio doesn't give you a final answer regarding what to do with your capital. Reading Tony Levene's *Investing For Dummies* (Wiley) can help you make a wise decision.

What Does the Auditor Say?

A business pays a lot of money for its audit, and you should read what the auditor has to say. We'll be frank: The wording of the auditor's report is tough going. Talk about jargon! In any case, focus on the sentence that states the auditor's *opinion* on the financial statements. In rough terms, the auditor gives the financial statements a green light, a yellow light or a red light – green meaning that everything's okay (as far as can be ascertained by the process of the audit), yellow meaning that you should be aware of something that prevents the auditor from giving a green light and red meaning that the financial statements are seriously deficient.

Look for the key words *true and fair*. These code words mean that the audit firm has no serious disagreement with how the business prepared its financial statements. This unqualified opinion is called a *clean opinion*. Only in the most desperate situations does the auditor give an adverse opinion, which in essence says that the financial statements are misleading. If the audit firm can't give a clean opinion on the financial statements or thinks that something about the financial statements should be emphasised, a fourth paragraph is added to the standard three-paragraph format of the audit report (or additional language is added to the one-paragraph audit report used by the big accountancy firm PricewaterhouseCoopers). The additional language is the tip-off; look for a fourth paragraph (or additional language), and be sure to read it. The auditor may express doubt about the business being able to continue as a going concern. The solvency ratios discussed earlier should have tipped you off. When the auditor mentions it, things are pretty serious.

Chapter 19

Ten Ways to Get a Better Handle on the Financial Future

In This Chapter

- Appreciating the difference between forecasts and objectives
- Putting your maths to work
- Unravelling the reasons for trends
- Getting at the real facts
- Keeping projections current
- Building in assumptions

Managers are accustomed to using accounting to unravel the past. Accounts are usually a record of the effect of last year's, month's or week's decisions. Did your strategies for collecting money from customers more quickly or reducing stock levels actually happen, and if so, did they deliver better profits? (We cover this area in Chapter 6.)

But the past, as the saying goes, is another country. The future is where reputations are made and promotion achieved. Managers get maximum value from their grasp of accounting and finance from being able to blend that knowledge with some related skills to get a better handle on the ground ahead.

Sales Forecasts versus Sales Objectives

Objectives

Sales drive much of a business's activities; they determine cash flow, stock levels, production capacity and ultimately how profitable or otherwise a business is. So, unsurprisingly, much effort goes into attempting to predict future sales. A sales forecast isn't the same as a sales objective. An *objective* is what you want to achieve and will shape a strategy to do so. A *forecast* is the most likely future outcome given what has happened in the past and the momentum that provides for the business.

A forecast is made up of three components and to get an accurate forecast you need to use the historic data to better understand the impact of each on the end result:

- **Underlying trend:** This is the general direction – up, flat or down – over the longer term, showing the rate of change.
- **Cyclical factors:** These are the short-term influences that regularly superimpose themselves on the trend. For example, in the summer months you expect sales of swimwear, ice cream and suntan lotion, to be higher than in the winter. Ski equipment would follow a reverse pattern.
- **Random movements:** These are irregular, random spikes up or down caused by unusual and unexplained factors.

Dealing with Demand Curves

The price you charge for your goods and services is perhaps the single most important number in the financial firmament. Predictions about what price to set influences everything from the amount of materials you have to buy to achieve a given level of profit (the higher the price, the less you have to purchase), to the amount of money you have to invest in fixed assets (a low price may involve selling a lot more to make a given level of profit, requiring a higher level of productive resources).

higher level of productive resources).

The main economic concept that underpins almost the whole subject of pricing is that of the *price elasticity of demand*. The concept itself is simple enough. The higher the price of an item or service, the less of it you're likely to sell. Obviously it's not quite that simple in practice; you also need to consider the number of buyers, their expectations, preference and ability to pay, and the availability of substitute products. Figure 19-1 shows a theoretical demand curve.

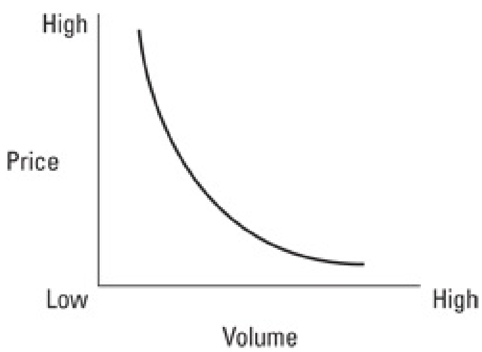


Figure 19-1: The demand curve.

Figure 19-1 shows how the volume of sales of a particular good or service alters with changes in price. You calculate the elasticity of demand by dividing the percentage change in demand by the percentage change in price. If a price is reduced by 50% (say, from £100 to £50) and the quantity demanded increased by 100% (from 1,000 to 2,000), the elasticity of demand coefficient is 2 (100/50). Here the quantity demanded changes by a bigger percentage than the price change, so demand is considered to be *elastic*. Were the demand in this case to rise by only 25%, then the elasticity of demand coefficient would be 0.5 (25/100). Here the demand is *inelastic*, as the percentage demand change is smaller than that of the price change.

Having a feel for elasticity is important in developing a business's financial strategy, but there's no perfect scientific way to work out what the demand coefficient is; it has to be assessed by 'feel'. Unfortunately the price elasticity changes at different price levels. For example, reducing the price of vodka from $10 to $5 might double sales, but halving it again may not have such a dramatic effect. In fact it could encourage a certain group of buyers, those giving it as a gift for example, to feel that giving something so cheap is rather insulting.

Maths Matters

The simplest way to predict the future is to assume that it will be more or less the same as the recent past. Despite Henry Ford's attributed quote that history is bunk, very often the past is a very good guide to what's likely to happen in the fairly immediate future – far enough ahead for budgeting purposes, if not for shaping long-term strategy.

The three most common mathematical techniques that use this approach are as follows:

- **Moving average** takes a series of data from the past, say, the last six months' sales, adds them up, divides by the number of months and uses that figure as the most likely forecast of what will happen in month seven. This method works well in a static, mature market place where change happens slowly, if at all.
- **Weighted moving average** gives more recent data more significance than earlier data because it gives a better representation of current business conditions. So before adding up the series of data, each figure is weighted by multiplying it by an increasingly higher factor as you get closer to the most recent data.

- **Exponential smoothing** is a more sophisticated averaging technique that gives exponentially decreasing weights as the data gets older. More recent data is given relatively more weight in making the forecasting. You can use double and triple exponential smoothing to help with different types of trend.

Fortunately all you need to know is that these and other statistical forecasting methods exist. The choice of which is the best forecasting technique to use is usually down to trial and error.

TIP

Various software programs calculate the best-fitting forecast by applying each of these techniques to the historic data you enter. See what actually happens and use the forecast technique that's closest to the actual outcome. Professor Hossein Arsham of the University of Baltimore provides a useful tool that enables you to enter data and see how different forecasting techniques perform. (`http://home.ubalt.edu/ntsbarsh/Business-stat/otherapplets/ForecaSmo.htm#rmenu`)

Duke University's Fuqua School of Business provides a helpful link to all their lecture material on forecasting (`www.duke.edu/~rnau/411home.htm`).

Averaging Out Averages

A common way forecasts are predicted is around a single figure that purports to be representative of a whole mass of often conflicting data. This single figure is usually known as an *average*, with the process of averaging seen as a way of smoothing over any conflicts. When some customers pay one price and others quite a different one, an average is used as the basis for forecasting. That would be all fine and dandy were it not for the fact that you have three different ways of measuring an average (the mean, median and mode). In fact, averages are the most frequently confused and misrepresented set of numbers in the whole field of forecasting.

To analyse anything for forecasting purposes you first need a data set such as that in Table 19-1.

Table 19-1 The Selling Prices of Company's Products to Different Customers

Customer	*Selling Price (£s)*
1	30
2	40
3	10
4	15
5	10

You then have three ways of working with the numbers:

- **The mean (or average):** This is the most common tendency measure and is used as a rough and ready check for many types of data. In Table 19-1 you add up the prices (£105) and divide by the number of customers (5), to arrive at a *mean*, or average selling price of £21.

- **The median:** The *median* is the value occurring at the centre of a data set. Recasting the figures in Table 19-1 in order puts Customer 4's purchase price of £15 in central position, with two higher and two lower prices. The median comes into its own in situations where the outlying values in a data set are extreme, as they are in the example, where, in fact, most of the customers buy for well below £21. In this case the median is a better measure of the average.

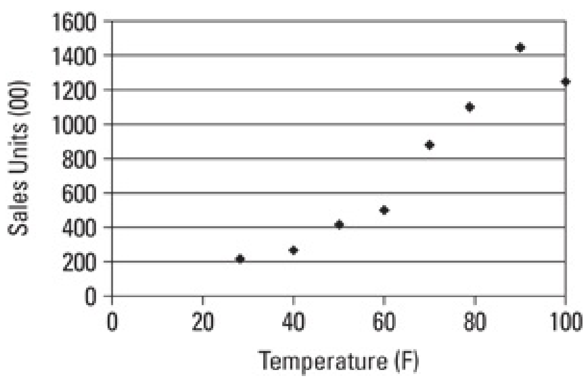
Always use the median when the distribution is skewed. You can use either the mean or the median when the population is symmetrical because they'll give very similar results.

- **The mode:** The mode is the observation in a data set that appears the most; in this example it is £10. So if you were surveying a sample of customers you'd expect more of them to say they were paying £10 for the products, even though you know the average price is £21.

Looking for Causes

Often when looking at historic data (the basis of all projections), a relationship between certain factors becomes apparent. Look at Figure 19-2, which is a chart showing the monthly sales of barbeques and the average temperature in the preceding month for the past eight months.

Figure 19-2: Scatter diagram.



You can clearly see a relationship between temperature (the *independent variable*) and sales (the *dependant variable*). By drawing the line that most accurately represents the slope, called the *line of best fit* (see Figure 19-3), you have a useful tool for estimating what sales might be next month, given the temperature that occurred this month.

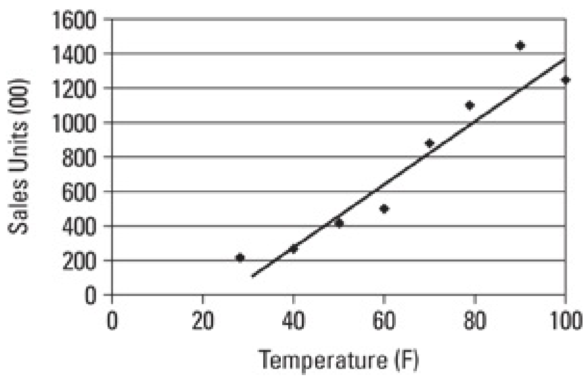


Figure 19-3: Scatter diagram with the line of best fit.

This example is a simple one. Real life data is usually more complicated, so it's harder to see a relationship between the independent and dependant variables with real life data than it is here. Fortunately, an algebraic formula known as *linear regression* can calculate the line of best fit for you.

A couple of calculations can test if a causal relationship is *strong* (even if strongly negative, the test is still useful for predictive purposes) and *significant* – the statisticians way of telling you if you can rely on the data as an aid to predicting the future. The tests are known as *R-Squared* and the *Students t test*, and all you need to know is that they exist and that you can probably find the software to calculate them on your computer.

Try Web-Enabled Scientific Services & Applications' (www.wessa.net/slr.wasp) free software, which covers almost every type of statistic calculation. For help in understanding statistical techniques, read Gerard E. Dallal's book *The Little Handbook of Statistical Practice* available free online (www.tufts.edu/~gdallal/LHSP.HTM). At Princeton University's website you can find a tutorial and lecture notes on the subject as taught to their Master of International Business students (http://dss.princeton.edu/online_help/analysis/interpreting_r

Straddling Cycles

Economies tend to follow a cyclical pattern that moves from *boom*, when demand is strong, to *slump*, economists' shorthand for a downturn. Politicians believe they have become better managers of demand and proclaim the death of the cycle, but the 'this time it's different' school of thinking has been proved wrong time and time again. The cycle itself is caused by the collective behaviour of billions of people – the unfathomable 'animal spirits' of businesses and households. Maynard Keynes, the British economist whose strategy of encouraging governments to step up investment in bad times did much to alleviate the slump in the 1930s, explained animal spirits in the following way: 'Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits – a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities'.

Added to the urge to act is the equally inevitable herd-like behaviour that leads to excessive optimism and pessimism. From the tulip mania in 17th-century Holland and the South Sea Bubble

(1711–1720), to the Internet Bubble in 1999 and the collapse in US real estate in 2008, the story behind each bubble has been uncomfortably familiar. Strong market demand for some commodity (such as gold, copper or oil), currency, property or type of share leads the general public to believe the trend cannot end. Over-optimism leads the public at large to overextend itself in acquiring the object of the mania, while lenders fall over each other to fan the flames. Finally, either the money runs out or groups of investors become cautious. Fear turns to panic selling, so creating a vicious downward spiral that can take years to recover from.

Economics is a science of the indistinctly knowable rather than the exactly predictable. Although all cycles are difficult to understand or predict with much accuracy, they do have discernable patterns and some distinctive characteristics. Give some consideration to where you think you are in the cycle and build that into your projections.

Figure 19-4 shows an elegant curve, which depicts the theoretical textbook cycle.

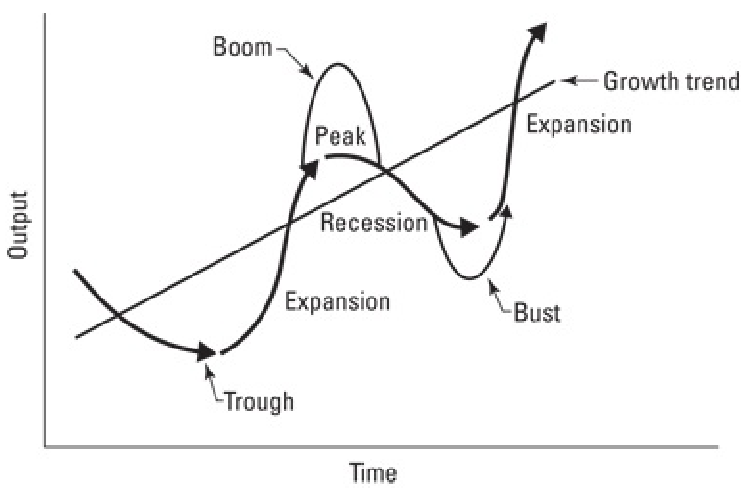


Figure 19-4: The textbook economic cycle.

The National Bureau of Economic Research provides a history of all US business cycle expansions and contractions since 1854 (www.nber.org/cycles.htm). The Foundation for the Study of Cycles, an international research and educational institution, provides a detailed explanation of different cycles (http://foundationforthestudyofcycles.org). The Centre for Growth and Business Cycle Research based in Manchester University's School of Social Sciences provides details of current research, recent publications and downloadable discussion papers on all aspects of business cycles (www.socialsciences.manchester.ac.uk/cgbcr).

Surveying Future Trends

Surveys are the most common research method used in organisations to get a handle on almost every aspect of future demand. If you ask your customers how much they plan to spend on their next holiday, car, haircut or laptop, you have a figure to base your projections on. Leaving aside the practical aspects of preparing and executing surveys (read *Statistics For Dummies* by Deborah J. Rumsey (Wiley) to find out about that), to be sure of the degree to which surveys are likely to be meaningful, you need a modest grasp of maths.

The size of the survey you undertake is vital to its accuracy. You frequently hear of political opinion polls taken on samples of 1,500–2,000 voters. This is because the accuracy of your survey clearly increases with the size of sample, as Table 19-2 shows:

Table 19-2	Survey Accuracy
Size of Sample	***95% of Surveys are Right within this many Percentage Points***
250	6.2
500	4.4
750	3.6
1,000	3.1
2,000	2.2
6,000	1.2

If on a sample size of 500, your survey showed that 40 per cent of your customers plan to spend £1,000 on your products, the true proportion would probably lie between 35.6 and 44.4 per cent. A sample of 250 completed replies is about the minimum to provide meaningful information.

Andrews University in the United States has a free set of lecture notes explaining the subject of sample size comprehensively (www.andrews.edu/~calkins/math/webtexts/prod12.htm). At www.auditnet.org/docs/statsamp.xls you can find some great spreadsheets that do the boring maths of calculating sample size and accuracy for you.

Talking To The Troops

Financial forecasts are usually in the domain of top management and senior staff such as CFOs. However all the decisions that have a direct bearing on these forecasts rely on information provided by people on the front line. They know where the bodies are, so it makes good sense to talk to them early in the planning process.

Also, you need their commitment because chances are they'll have a big influence on whether your projections bear fruit.

This process is known as *bottom up* projection. It involves, for example, building up a sales forecast customer by customer for every product or service they buy or may buy. Bottom up projection also requires an estimate of how many customers will be lost and won. Clearly only someone with detailed knowledge can prepare this. You can check this against your top down projection, based on, say, using a sales forecasting technique such as those covered earlier in this chapter. If you find a wide divergence between your theoretical projections and those made by the front line troops, discuss them and come up with a consensus that everyone can buy into.

Setting Out Assumptions

All future projections are based on assumptions – the stage of the economic cycle, government strategies on tax and expenditure, market size and growth rates, the level and type of competition . . . oh yes, and the weather comes into future projections too. The people running Heathrow hadn't expected the last week of 2010 to deliver so much snow it shut the airport just as peak Christmas demand was about to get underway.

Even the environment gets a look in here. Eyjafjallajökull, the Icelandic volcano that erupted in April 2010, caused air traffic around Europe and across the Atlantic to grind to a halt for six days. Airlines lost up to half their annual profits, business passengers were stranded for days and supply chains shortened by just-in-time purchasing strategies dried up. Now, arguably, business could do little directly or immediately to mitigate these problems, but the experience served to demonstrate the interconnection of seemingly remote environmental factors and made more obvious the reasons businesses have to take issues such as climate change seriously. Even if you are in no danger – unlike Lohachara, the first inhabited island to be wiped off the face of the Earth by global warming in 2006 – you'll eventually be affected by environmental issues. So build them into your thinking when making future financial projections, if only to state, for example, 'these plans are based on the assumption that the weather will be no more extreme than in the past fifty years'.

Pay particular attention to any outside factors that can have a significant effect on sales revenue – demand or price pressures; cost or availability of materials and key services; labour costs, rents, taxes and exchange rates.

Making Regular Revisions

Luca Paccioli, who wrote the world's first accounting book over 500 years ago, claimed that 'frequent accounting makes for long friendships'. No doubt he was hoping to sell more copies of his book (what author isn't?), but he could have said much the same about financial projections. The business world is dynamic, recently to an alarming degree. Frequently revisit your projections to see if they still hold good. Unforeseen and unforeseeable events such as the loss of a major customer or the entry of a new player into the market can throw plans off course. Sure, you may be able to get back on track, but that may mean making more changes in the short term to get to your long-term destination.

Some managers think revising projections to be a sign of weakness. Maynard Keynes, one of the greatest economic gurus of all time and a man who made a fortune out of the stock market over the period of the great depression, summed up the subject neatly: ‘When the facts change, I change my mind.’

Revisions are one thing; constant sail trimming is something quite different. The army maxim – order, counter order, disorder – is one that holds good here. Rolling quarterly projections work best, giving the remaining planning period the once-over while adding a new quarter. That way you always have at least one full year’s horizon to your projection.

Appendix A

Glossary: Slashing through the Accounting Jargon Jungle You can keep up with the latest financial jargon on the Free Dictionary Web site at http://financial-dictionary.thefreedictionary.com.

accounting: The methods and procedures for analysing, recording, accumulating and storing financial information about the activities of an entity, and preparing summary reports of these activities internally for managers and externally for those entitled to receive financial reports about the entity.

accounting equation: Assets = Liabilities + Owners' Equity. This basic equation is the foundation for *double-entry accounting* and reflects the balance between a business's assets and the sources of capital that is invested in its assets.

Accounting Standards Board (ASB): The highest authoritative private-sector standard-setting body of the accounting profession in the United Kingdom. The ASB issues pronouncements that establish *generally accepted accounting principles (GAAP).*

accrual-basis accounting: From the profit accounting point of view this refers to recording revenue at the time sales are made (rather than when cash is actually received from customers), and recording expenses to match with sales revenue or in the period benefited (rather than when the costs are paid). From the financial condition point of view this refers to recording several assets, such as receivables from customers, cost of stock (products not yet sold) and cost of long-term assets (fixed assets); and recording several liabilities in addition to debt (borrowed money), such as payables to vendors and payables for unpaid expenses.

accrued expenses payable: One main type of short-term liabilities of a business that arise from the gradual build-up of unpaid expenses, such as holiday pay earned by employees or profit-based bonus plans that aren't paid until the following period. ***Caution:*** The specific titles of this liability vary from business to business; you may see accrued liabilities, accrued expenses or some other similar account name.

accumulated depreciation: The total cumulative amount of depreciation expense that has been recorded since the fixed assets being depreciated were acquired. In the *balance sheet* the amount in this account is deducted from the cost of fixed assets. (Thus it is sometimes referred to as a contra account.) The purpose is to report how much of the total cost has been depreciated over the years. The balance of cost less accumulated depreciation is included in the total assets of a business – which is known as the *book value* of the assets.

acid-test ratio: See *quick ratio.*

activity based costing (ABC): The ABC approach classifies overhead costs into separate categories of support activities that are needed in manufacturing operations and in other areas of the business organisation (such as a sales territory). Cost drivers are developed for each support activity to measure the extent of usage of that support. The annual cost of each support activity is allocated to manufacturing and other areas according to how many cost driver units are used.

Alternative Investment Market (AIM): A stock market in London for shares in small and relatively unproven businesses.

annualised rate of interest and rate of return: The result of taking a rate of interest or a rate of return on investment for a period shorter than one year and converting it into an equivalent rate for the entire year. Suppose you earn 2 per cent interest rate every quarter (three months). Your annualised rate of interest (as if you received interest once a year at the end of the year) equals 8.24 per cent rounded – which is not simply 4 times the 2 per cent quarterly rate. (The annualised rate equals [1+0.02] raised to the fourth power minus one.) See also *compound interest*.

asset turnover ratio: A measure of how effectively assets were used during a period, usually one year. To find the asset turnover ratio, divide annual sales revenue either by total assets or by *net operating assets*, which equals total assets less short-term, non-interest-bearing liabilities.

Association of Chartered Accountants (ACA): The ACA designation is a widely recognised and respected badge of a professional accountant. A person must meet educational and experience requirements and pass a national uniform exam to qualify.

audit report: A one-page statement issued by an accountancy firm, after having examined a company's accounting system, records, and supporting evidence, that gives an opinion whether the company's financial statements and footnotes are presented fairly in conformity with *generally accepted accounting principles*. Annual audits are required by limited companies of publicly owned corporations; many privately held businesses also have audits. The auditor must be independent of the business. An auditor expresses doubts about the financial viability of a business if it is in dire financial straits.

bad debts: The particular expense that arises from a customer's failure to pay the amount owed to the business from a prior credit sale. When the credit sale was recorded, the accounts receivable asset account was increased. When it becomes clear that this debt owed to the business will not be collected, the asset account is written-off and the amount is charged to bad debts expense.

balance sheet: The *financial statement* that summarises the assets, liabilities and owners' equity of a business at an instant moment in time. Prepared at the end of every profit period, and whenever needed, the balance sheet shows a company's overall financial situation and condition.

basic earnings per share (EPS): Equals *net income* for the year (the most recent twelve months reported, called the trailing twelve months) divided by the number of shares of a business corporation that have been issued and are owned by shareholders (called the number of shares outstanding). See also *diluted earnings per share*. Basic EPS and diluted EPS are the most important factors that drive the market value of shares issued by publicly owned corporations.

book value of assets: Refers to the recorded amounts of assets which are reported in a *balance sheet* – usually the term is used to emphasise that the amounts recorded in the accounts of the business may be less than the current replacement costs of some assets, such as fixed assets bought many years ago that have been depreciated.

book value of owners' equity, in total or per share: Refers to the *balance sheet* value of owners' equity, either in total or on a per-share basis for corporations. Book value of owners' equity is not necessarily the price someone would pay for the business as a whole or per share, but it is a useful reference, or starting point for setting market price.

break-even point (sales volume): The annual sales volume (total number of units sold) at which total *contribution margin* equals total annual *fixed expenses* – that is, the exact sales volume at which the business covers its fixed expenses and makes a zero profit, or a zero loss depending on your point of view. Sales in excess of the break-even point contribute to profit, instead of having to go towards covering fixed expenses. The break-even sales volume is a useful point of reference for analysing profit performance and the effects of *operating leverage*.

budgeting: The process of developing and adopting a profit and financial plan with definite goals for the coming period – including forecasting expenses and revenues, assets, liabilities and cash flows based on the plan.

burden rate: An amount per unit that is added to the direct costs of manufacturing a product according to some method for the allocation of the total indirect fixed manufacturing costs for the period, which can be a certain percentage of direct costs or a fixed pound amount per unit of the common denominator on which the indirect costs are allocated across different products. Thus, the indirect costs are a 'burden' on the direct costs.

business angel: Private individuals who invest in entrepreneurial businesses with a view to making a substantial capital gain and perhaps helping with the management.

capital expenditures: Outlays for *fixed assets* – to overhaul or replace old fixed assets, or to expand and modernise the long-lived operating resources of a business. Fixed assets have useful lives from 3 to 39 (or more) years, depending on the nature of the asset and how it's used in the operations of the business. The term 'capital' here implies that substantial amounts of money are being invested that are major commitments for many years.

capital stock: The certificates of ownership issued by a corporation for capital invested in the business by owners; total capital is divided into units, called shares of capital stock. Holders of shares participate in cash dividends paid from profit, vote in board member elections, and receive asset liquidation proceeds; and have several other rights as well. A business corporation must issue at least one class of share called ordinary shares, which in the US are known as *common stock*. It may also issue other classes of stock, such as *preference shares*.

cash flow(s): In the most general and broadest sense this term refers to any kind of cash inflows and outflows during a period – monies coming in, and monies paid out.

cash flow from operating activities: See *cash flow from profit*.

cash flow from profit: In the *cash flow statement* this is called *cash flow from operating activities*, which equals net income for the period, adjusted for changes in certain assets and liabilities, and for depreciation expense. Some people call this *free cash flow* to emphasise that this source of cash is free from the need to borrow money, issue capital stock shares or sell assets. ***Be careful:*** The term free cash flow is also used to denote cash flow from profit minus capital expenditures. (Some writers deduct cash dividends also; usage has not completely settled down.) **cash flow statement:** This financial statement of a business summarises its cash inflows and outflows during a period according to a threefold classification: *cash flow from profit* (or, *operating activities*), *investing activities* and *financing activities*.

chart of accounts: The official, designated set of accounts used by a business that constitute its *general ledger*, in which the transactions of the business are recorded.

Companies Acts: A series of UK laws governing the establishment and conduct of incorporated businesses, consolidated into the Companies Act 2006.

compound interest: 'Compound' is a code word for reinvested. Interest income *compounds* when you don't remove it from your investment, but instead leave it in and add it to your investment or savings account. Thus, you have a bigger balance on which to earn interest the following period.

comprehensive income: Includes net income which is reported in the *profit and loss account* plus certain technical gains and losses in assets and liabilities that are recorded but don't necessarily have to be included in the profit and loss account. Most companies report their comprehensive gains and losses (if they have any) in their *statement of changes in owners' equity*.

conservatism: If there is choice as to the amount of certain figures, when preparing accounts the lower figure for assets and the higher for liabilities should be used.

contribution margin: Equals sales revenue minus cost of goods sold expense and minus all *variable expenses* (in other words, contribution margin is profit before *fixed expenses* are deducted). On a per unit basis, contribution margin equals sales price less *product cost* per unit and less variable expenses per unit.

cooking the books: Refers to any one of several fraudulent (deliberately deceitful with intent to mislead) accounting schemes used to overstate profit and to make the financial condition look better than it really is. Cooking the books is different from *profit smoothing* and *window dressing*, which are tolerated – though not encouraged – in financial statement accounting. Cooking the books for income tax is just the reverse: It means overstating, or exaggerating, deductible expenses or understating revenue to minimize taxable income.

corporate venturing: Refers to large companies taking a share of small entrepreneurial ventures in order to have access to a new technology. If this approach works, they often buy out the whole business.

corporation tax: Tax paid by UK companies (with some exceptions) on 'chargeable profits'. Rates are fixed each year by the government. Reduced rates apply for small businesses.

cost-benefit analysis: Analysis of the costs and benefits of a particular investment or action, conducted to establish if that action is worthwhile from a purely accounting perspective.

cost of capital: For a business, this refers to joint total of the interest paid on debt capital and the minimum net income it should earn to justify the owner's equity capital. Interest is a contractually set amount of interest; no legally set amount of net income is promised to owners. A business's *return on assets (ROA)* rate should ideally be higher than its weighted-average cost of capital rate (based on the mix of its debt and equity capital sources).

creative accounting: The use of dubious accounting techniques and deceptions designed to make profit performance or financial condition appear better than things really are. See *profit smoothing* and *cooking the books*.

creditors: One main type of the short-term liabilities of a business, representing the amounts owed to vendors or suppliers for the purchase of various products, supplies, parts and services that were bought on credit; these do not bear interest (unless the business takes too long to pay). In the US, *creditors* or *trade creditors* are usually called accounts payable.

credit crunch: A time when cash is in short supply; businesses find it difficult to raise loans and when they can, interest rates are relatively high.

current assets: Includes cash plus *debtors, stock* and *prepaid expenses* (and marketable securities if the business owns any). These assets are cash or assets that will be converted into cash during one *operating cycle.* Total current assets are divided by total current liabilities to calculate the *current ratio*, which is a test of short-term solvency.

current liabilities: Short-term liabilities, principally *creditors, accrued expenses payable*, corporation tax payable, overdrafts and the portion of long-term debt that falls due within the coming year. This group includes both non-interest bearing and interest-bearing liabilities that must be paid in the short-term, usually defined to be one year. Total current liabilities are divided into total *current assets* to calculate the *current ratio*.

current ratio: A test of a business's short-term solvency (debt-paying capability). Find the current ratio by dividing the total of its *current assets* by its total *current liabilities.*

debits and credits: These two terms are accounting jargon for decreases and increases that are recorded in assets, liabilities, owners' equity, revenue and expenses. When recording a transaction, the total of the debits must equal the total of the credits.

debtors: The short-term assets representing the amounts owed to the business from sales of products and services on credit to its customers. In the US these are known as *accounts receivable*.

deferred income: Income received in advance of being earned and recognised.

depreciation expense: Allocating (or spreading out) a fixed asset's cost over the estimated useful life of the resource. Each year of the asset's life is charged with part of its total cost as the asset gradually wears out and loses its economic value to the business. Either *reducing balance* or *straight-line depreciation* is used; both are acceptable under *generally accepted accounting principles (GAAP).*

diluted earnings per share (EPS): Diluted earnings per share equals net income divided by the sum of the actual number of shares outstanding plus any additional shares that will be issued under terms of share options awarded to managers and for the conversion of senior securities into common stock (if the company has issued convertible debt or *preference* shares). In short, this measure of profit per share is based on a larger number of shares than basic EPS (earnings per share). The larger number causes a dilution in the amount of net income per share. Although hard to prove for certain, market prices of shares are driven by diluted EPS more than basic EPS.

dividend yield: Measures the cash income component of return on investment in shares of a corporation. The dividend yield equals the most recent 12 months of cash dividends paid on a share, divided by the share's current market price. If a share is selling for £100 and over the last 12 months has paid £3 cash dividends, its dividend yield equals 3 per cent.

double-entry accounting: Symbolised in the *accounting equation,* which covers both the assets of a business as well as the sources of money for the assets (which are also claims on the assets).

due diligence: a process of thoroughly checking every aspect of a business's position, including its financial state of affairs, usually as a prelude to a sale or to raising additional funds.

earnings before interest and taxes (EBIT): Sales revenue less cost of goods sold and all operating expenses – but before deducting interest on debt and tax expenses. This measure of profit also is called *operating earnings, operating profit* or something similar; terminology is not uniform.

earnings management: See *profit smoothing*.

earnings per share: See *basic earnings per share* and *diluted earnings per share*.

earn-out: When a business is sold, buyers often make part of their offer conditional on the future profits being as forecasted. This, in effect, makes the seller earn out that portion.

effective interest rate: The rate actually applied to your loan or savings account balance to determine the amount of interest for that period. See also *annualised rate of interest and rate of return*.

equity capital: See *owners' equity.*

external financial statements: The financial statements included in financial reports that are distributed outside a business to its shareholders and debt-holders.

extraordinary gains and losses: These are unusual, non-recurring gains and losses that happen infrequently and that are aside from the normal, ordinary sales and expenses of a business.

Financial Accounting Standards Board (FASB): The highest authoritative private-sector standard-setting body of the accounting profession in the US.

financial leverage: The term is used generally to mean using debt capital on top of equity capital in any type of investment. For a business it means using debt in addition to equity capital to provide the total capital needed to invest in its *net operating assets.* The strategy is to earn a rate of *return on assets (ROA)* higher than the interest rate on borrowed money. A favourable spread between the two rates generates a financial leverage gain to the benefit of *owners' equity*.

financial reports: The periodic financially oriented communications from a business (and other types of organisations) to those entitled to know about the financial performance and position of the entity. Financial reports of businesses include three primary financial statements (*balance sheet*, *profit and loss account* and *statement of cash flows*), as well as footnotes and other information relevant to the owners of the business.

financial statement: The generic term for *balance sheet, cash flow statement and profit and loss account*, all three of which present summary financial information about a business.

financing activities: One of three types of *cash flows* reported in the *cash flow statement*. These are the dealings between a business and its sources of debt and equity capital – such as borrowings and repayments of debt, issuing new shares and buying some of its own shares, and paying dividends.

first-in, first-out (FIFO): One of two widely-used accounting methods by which costs of products when they are sold are charged to cost of goods sold expense. According to the FIFO method, costs of goods are charged in chronological order, so the most recent acquisition costs remain in stock at the end of the period. However, the reverse order also is acceptable, which is called the *last-in, first-out (LIFO)* method.

fixed assets: The shorthand term for the long-life (generally three years or longer) resources used by a business, which includes land, buildings, machinery, equipment, tools and vehicles. The most common account title for these assets you see in a balance sheet is 'property, plant and equipment'.

fixed expenses (costs): Those expenses or costs that remain unchanged over the short run and do not vary with changes in sales volume or sales revenue – common examples are property rental and rates, salaries of many employees and telephone lease costs.

footnotes: Footnotes are attached to the three primary financial statements to present detailed information that cannot be put directly in the body of the financial statements.

free cash flow: Many people use this term to mean the amount of *cash flow from profit* – although some writers deduct capital expenditures from this number, and others deduct cash dividends as well.

gearing: The relationship between a firm's *debt capital* and its *equity*. The higher the proportion of debt, the more highly geared is the business. In the US, the term leverage is usually used here.

general ledger: The complete collection of all the accounts used by a business (or other entity) to record the financial effects of its activities. More or less synonymous with *chart of accounts*.

generally accepted accounting principles (GAAP): The authoritative standards and approved accounting methods that should be used by businesses and private not-for-profit organisations to measure and report their revenue and expenses, and to present their assets, liabilities and owners' equity, and to report their cash flows in their financial statements.

going-concern assumption: The accounting premise that a business will continue to operate and will not be forced to liquidate its assets.

goodwill: Goodwill has two different meanings, so be careful. The term can refer to the product or brand name recognition and the excellent reputation of a business that provide a strong competitive advantage. Goodwill in this sense means the business has an important but invisible 'asset' that is not reported in its balance sheet. Second, a business may purchase and pay cash for the goodwill that has been built up over the years by another business. Only purchased goodwill is reported as an asset in the balance sheet.

gross margin (profit): Equals sales revenue less cost of goods sold for the period. On a per unit basis, gross margin equals sales price less product cost per unit. Making an adequate gross margin is the starting point for making bottom-line *net income*.

hedge fund: A fund that uses derivatives, short selling and arbitrage techniques, selling assets that one does not own in the expectation of buying them back at a lower price. This gives hedge fund managers a range of ways to generate growth in falling, rising and even in relatively static markets.

hedging: A technique used to manage commercial risk or to minimise a potential loss by using counterbalancing investment strategies.

hostile merger: The term used where a business is acquired against the wishes of the incumbent management.

hurdle rate: The rate of return required before an investment is considered worthwhile.

hyperinflation: A situation where prices increase so quickly that money is virtually useless as a store of value.

imputed cost: A hypothetical cost used as a benchmark for comparison. One example is the imputed cost of equity capital. No expense is recorded for using owners' equity capital during the year. However, in judging net income performance, the company's rate of *return on equity (ROE)* is compared with the rate of earnings that could be accrued on the capital if it were invested elsewhere. This alternative rate of return is an imputed cost. Close in meaning to the economic concept of *opportunity cost*.

income smoothing: See *profit smoothing*.

income statement: American term used for the profit and loss account.

income tax payable: The tax due, but as yet unpaid, on profits earned.

incubator: Usually both a premises and some or all of the services (legal, managerial or technical) needed to launch a business and access seed capital.

initial public offering (IPO): The first offer of a company's shares made to the general public.

insider trading: Buying or selling shares based on information not in the public domain.

internal (accounting) controls: Accounting forms, procedures and precautions that are established primarily to prevent and minimise errors and fraud (beyond what would be required for record keeping).

investing activities: One of three classes of *cash flows* reported in the *cash flow statement*. In large part these are the *capital expenditures* by a business during the year, which are major investments in long-term assets. A business may dispose of some of its fixed assets during the year, and proceeds from these disposals (if any) are reported in this section of the cash flow statement.

junior market: A stock market (such as the AIM) where shares of smaller or younger companies are traded.

last-in, first-out (LIFO): One of two widely used accounting methods by which costs of products when they are sold are charged to cost of goods sold expense. According to the LIFO method, costs of goods are charged in reverse chronological order, one result being that the ending stock cost value consists of the costs of the earliest goods purchased or manufactured. The opposite order is also acceptable, which is called the *first-in, first-out (FIFO)* method. The actual physical flow of products seldom follows a LIFO sequence. The method is justified on the grounds that the cost of goods sold expense should be the cost of replacing the products sold, and the best approximation is the most recent acquisition costs of the products.

leverage: see *financial leverage* and *operating leverage*.

leveraged buyout: A situation where a company is bought by another financed mainly by debt, such as bank borrowings.

LIFO liquidation gain: A unique result of the *last-in, first-out (LIFO)* method, which happens when fewer units are replaced than sold during the period. The decrease in stock requires that the accountant go back into the old cost layers of stock for part of the cost of goods sold expense. Thus, there is a one-time windfall gain in *gross margin*, roughly equal to the difference between the historical cost and the current cost of the stock decrease. A large LIFO liquidation gain should be disclosed in a footnote to the financial statements.

limited liability company (Ltd): Company whose shareholders have limited their liability to the amounts they subscribe to the shares they hold.

listed company: A company whose shares are on the official list of a major stock market, such as the London Stock Exchange.

management accounting: The branch of accounting that prepares internal financial statements and various other reports and analyses to assist managers to do their jobs.

management buy-out: The term used when the management of a business buys out the existing shareholders, usually with the help of a venture capital firm.

margin of safety: Equals the excess of actual sales volume over the company's *break-even point*; often expressed as a percentage. This information is used internally by managers and is not disclosed in external financial reports.

market cap: The total value of a business calculated by multiplying the current market price of its capital stock by the total number of shares issued by the business. This calculated amount is not money that has been invested in the business, and the amount is subject to the whims of the stock market.

net income: American term used to describe profit.

net operating assets: The total amount of assets used in operating a business, less its short-term non-interest-bearing liabilities. A business must raise an equal amount of capital.

net realisable value (NRV): A special accounting test applied to stock that can result in a write-down and charge to expense for the loss in value of products held for sale. The recorded costs of products in stock are compared with their current replacement costs (market price) and with net realisable value if normal sales prices have been reduced. If either value is lower, then recorded cost is written down to this lower value. ***Note:*** Stock is not written up when replacement costs rise after the stock was acquired.

net worth: Balance sheet value of owner's stake in the business. It consists both of the money put in at the start and any profits made since and left in the business.

notes to financial statements: Notes attached to the *balance sheet* and *income statement* which explain: (a) Significant accounting adjustments; (b) Information required by law, if not disclosed in the financial statements.

operating activities: The profit-making activities of a business – that is, the sales and expense transactions of a business. See also *cash flow from operating activities*.

operating assets: The several different assets, or economic resources, used in the profit-making operations of a business. Includes cash, accounts receivable from making sales on credit, stock of products awaiting sale, prepaid expenses and various fixed, or long-life assets.

operating cycle: The repetitive sequence over a period of time of producing or acquiring stock, holding it, selling it on credit and finally collecting the account receivable from the sale. It is a 'cash-to-cash' circle – investing cash in stock, then selling the products on credit, and then collecting the receivable.

operating earnings (profit): See *earnings before interest and income tax (EBIT)*.

operating leverage: Once a business has reached its *break-even point*, a relatively small percentage increase in sales volume generates a much larger percentage increase in profit; this wider swing in profit is the idea of operating leverage. Making sales in excess of its break-even point does not increase total fixed expenses, so all the additional *contribution margin* from the sales goes to profit.

operating liabilities: Short-term liabilities generated spontaneously in the profit-making operations of a business. The most common ones are *payable creditors*, *accrued expenses payable* and *income tax payable* – none of which are interest-bearing unless a late payment penalty is paid, which is in the nature of interest.

opportunity cost: An economic definition of cost referring to income or gain that could have been earned from the best alternative use of money, time or talent foregone by taking a particular course of action.

ordinary shares: Normal shares in business used to apportion ownership.

overhead costs: Sales and administrative expenses, and manufacturing costs that are indirect, which means they cannot be naturally matched or linked with a particular product, revenue source, or organisational unit – one example is the annual property tax on the building in which all the company's activities are carried out.

owners' equity: The ownership capital base of a business. Owners' equity derives from two sources: investment of capital in the business by the owners (for which shares are issued by a company) and profit that has been earned by the business but has not been distributed to its owners (called *retained earnings or reserves* for a company).

partnership: When two or more people agree to carry on a business together intending to share the profits.

preference share: A second class, or type, of share that can be issued by a company in addition to its *ordinary shares.* Preference shares derive their name from the fact that they have certain preferences over the *ordinary shares* – they are paid cash dividends before any can be distributed to ordinary shareholders, and in the event of liquidating the business, preference shares must be redeemed before any money is returned to the ordinary shareholders. Preference shareholders usually do not have voting rights and may be callable by the company, which means that the business can redeem the shares for a certain price per share.

preferred stock: American term for preference share.

prepaid expenses: Expenses that are paid in advance for future benefits.

price/earnings (P/E) ratio: The current market price of a capital stock divided by its most recent, or 'trailing', twelve months' *diluted* *earnings per share (EPS)*, or *basic earnings per share* if the business does not report diluted EPS. A low P/E may signal an undervalued share price or a pessimistic forecast by investors.

private equity: Large-scale pooled funds, usually geared up (see *gearing*) with borrowings that buy out quoted companies. This takes those companies off the stock market and makes them private, but the companies are often returned to the market after a few years of financial engineering.

product cost: Equals the purchase cost of goods that are bought and then resold by retailers and wholesalers (distributors).

profit: Equals sales revenue less all expenses for the period.

profit and loss (P&L) statement: The *financial statement* that summarises sales revenue and expenses for a period and reports one or more *profit* lines.

profit ratio: Equals *net income* divided by sales revenue. Measures net income as a percentage of sales revenue.

profit smoothing: Manipulating the timing of when sales revenue and/or expenses are recorded in order to produce a smoother profit trend year to year.

proxy statement: The annual solicitation from a company's top executives and board of directors to its shareholders that requests that they vote a certain way on matters that have to be put to a vote at the annual meeting of shareholders. In larger public companies most shareholders cannot attend the meeting in person, so they delegate a proxy (standin person) to vote their shares' yes or no on each proposal on the agenda.

quick ratio: The number calculated by dividing the total of cash, *accounts receivable* and marketable securities (if any) by total *current liabilities*. This ratio measures the capability of a business to pay off its current short-term liabilities with its cash and near-cash assets. Note that stock and prepaid expenses, the other two current assets, are excluded from assets in this ratio. (Also called the acid-test ratio.) **reducing balance:** One of two basic methods for allocating the cost of a fixed asset over its useful life and for estimating its useful life. Reducing balance (sometimes called accelerated depreciation) allocates greater amounts of depreciation in early years and lower amounts in later years, and also uses short life estimates. For comparison, see *straight-line depreciation*.

reserves: Another term used for *retained earnings*.

retained earnings: One of two basic sources of owners' equity of a business (the other being capital invested by the owners). Annual profit (*net income*) increases this account, and distributions from profit to owners decrease the account.

return on assets (ROA): Equals *earnings before interest and taxes (EBIT)* divided by the *net operating assets* (or by total assets, for convenience), and is expressed as a percentage.

return on equity (ROE): Equals *net income* divided by the total *book value of owners' equity*, and is expressed as a percentage. ROE is the basic measure of how well a business is doing in providing 'compensation' on the owners' capital investment in the business.

return on investment (ROI): A very broad and general term that refers to the income, profit, gain or earnings on capital investments, expressed as a percentage of the amount invested. The most relevant ROI ratios for a business are *return on assets (ROA)* and *return on equity (ROE).*

road show: Presentations where companies and their advisers pitch to potential investors to 'sell' them on buying into a business.

sales revenue-driven expenses: Expenses that vary in proportion to, or as a fixed percentage of, changes in total sales revenue (total pounds). Examples are sales commissions, credit-card discount expenses, and rent expense and franchise fees based on total sales revenue. (Compare with *sales volume-driven expenses.*) **sales volume-driven expenses:** Expenses that vary in proportion to, or as a fixed amount with, changes in sales volume (quantity of products sold). Examples include delivery costs, packaging costs and other costs that depend mainly on the number of products sold or the number of customers served. (Compare with *sales revenue-driven expenses*.) **Securities and Exchange Commission (SEC):** The US federal agency established by the federal Securities Exchange Act of 1934, which has broad jurisdiction and powers over the public issuance and trading of securities (stocks and bonds) by business corporations. In the UK, the London Stock Exchange and the Department of Trade and Industry cover some of the same ground.

seed capital: The initial capital required to start a business and prove that the concept is viable.

sole trader: Simplest type of business. No shareholders, just the owner's money and borrowings. Also known as a sole proprietor.

statement of cash flows: See *cash flow statement.*

statement of changes in owners' (shareholders') equity: More in the nature of a supplementary schedule than a fully fledged financial statement – but, anyway, its purpose is to summarise the changes in the owners' equity accounts during the year.

stock: Goods on hand for resale, or held in raw materials, or as work in process. In the US, the term inventory is more commonly used. Stock, in the US, is usually used to describe share capital.

straight-line depreciation: Spreading the cost of a fixed asset in equal amounts of depreciation expense to each year of its useful life. Depreciation is the same amount every year by this method.

true and fair: The auditors' confirmation that the balance sheet and income statement show a 'true and fair' view of the business, in accordance with generally accepted accounting principles.

variable expenses (costs): Any expense or cost that is sensitive to changes in sales volume or sales revenue.

venture capital: Professionally managed funds that buy stakes, usually in private companies, to help them realise their growth potential.

warranties: A guarantee given by the officers of a company to a buyer of that company that all the material facts have been disclosed. Serious financial penalties await if this is found not to be the case.

window dressing: Accounting devices that make the short-term liquidity and solvency of a business look better than it really is.

working capital: The difference between current assets and current liabilities.

zero based budgeting: Where every expense has to be justified in full for an upcoming period as opposed to just accounting for any higher rate of expenditure.

Z-Score: An algorithm that uses various financial ratios to arrive at a figure below which firms have a high chance of failure.